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Retirement PLAN news

Service provider fee disclosure

Three years ago, the U.S. Department of Labor (DOL) launched a three-part project designed to improve the transparency of fees in 401(k)-type plans. The first part of the project, requiring plans to disclose the direct and indirect fees it pays on Form 5500 Schedule C, is already in place. Part two is a new regulation requiring service providers to disclose fees to plan sponsors. Part three, a regulation requiring plan sponsors to disclose fees to participants, is still in the works.

In July, the DOL issued the long-awaited part two — an interim final regulation addressing service provider fee disclosure. This is an important topic that affects every plan sponsor. As responsible plan fiduciaries, sponsors have a duty to make informed decisions about the "reasonableness" of the fees the plan pays for the services it receives (as required under ERISA, the law governing qualified retirement plans). The disclosures that service providers will be sending out will help simplify that task.

Background

ERISA has strict rules for plan fiduciaries. First and foremost, they are required to act prudently and solely in the interest of the plan's participants and beneficiaries. Fiduciaries should apply this standard when selecting and monitoring service providers and plan investments. This means that fiduciaries must ensure that arrangements with a plan's service providers are reasonable, that only reasonable compensation is paid for the services the plan receives, and that there are no substantive conflicts of interest.

Otherwise, a plan may run afoul of ERISA's prohibited transaction rules, which govern the relationship between a plan and a "party in interest," such as a fiduciary or a person providing services to the plan (including, but not limited to, a recordkeeper, trustee, or investment advisor).

The availability of information is fundamental to a plan fiduciary's ability to make informed decisions about services, costs, and service providers. Thus, this regulation is vital to a fiduciary performing his or her duty and avoiding a prohibited transaction.

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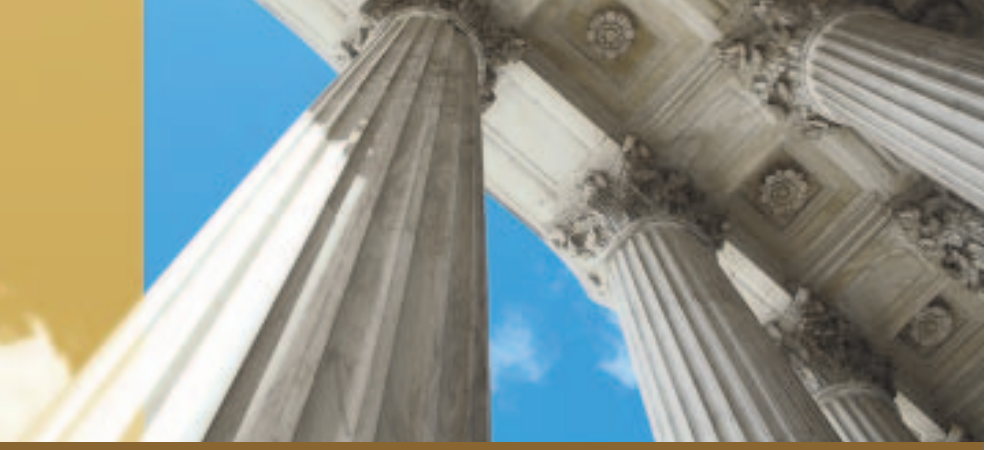

Supreme Court ruling in fee case

Earlier this year, the Supreme Court unanimously ruled that fees paid to an investment advisor would not be considered excessive unless the fees were so disproportionate that they could not have been the product of arm's-length bargaining. The decision in *Jones v. Harris Associates L.P.* (No. 08-586) may influence the standard used by courts to determine future ERISA excessive fee cases.

Background

The plaintiffs claimed the defendant violated Section 36(b) of the Investment Company Act of 1940 (the Act) by charging excessive fund investment advisor fees. Section 36(b) subjects an investment advisor to fiduciary duties with respect to the compensation the advisor receives for services. The Act also requires a fund's board of trustees to annually review and approve the fund's contract with the advisor and the amount of compensation the advisor earns from the fund.

The fees charged by Harris Associates in this case were comparable to fees charged by other advisors but were nearly twice the amount the company charged its institutional clients for similar services. The Supreme Court applied the *Gartenberg* standard for determining whether the defendant violated Section 36(b). In *Gartenberg v. Merrill Lynch Asset Management Inc.*, a federal appeals court held that to be guilty of a violation of Section 36(b), an advisor "must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." Since 1982, other federal courts have adopted the *Gartenberg* standard, and the Securities and Exchange Commission's regulations have recognized certain aspects of this standard.

Fee comparisons

Justice Samuel Alito warned that courts should not rely too heavily on comparing fees of one investment advisor to that of another investment advisor because those fees may not have resulted from arm's-length negotiations. The Supreme Court also held that the courts should reject comparisons of fees charged to a mutual fund client versus fees charged to an institutional fund client if the services provided are quite different. It was noted that mutual funds might have a greater frequency of redemptions, higher marketing costs, and a higher turnover of assets compared to institutional funds. Alito also stressed that a mutual fund board's decision to approve a particular fee after all relevant factors have been considered is a point that carries considerable weight and that the courts should not overrule the board's decision.

Service provider fee disclosure

(Continued from page 1)

Changes for the better

In recent years, changes in the way employee plan services are provided have improved efficiency and reduced the costs of administrative services and benefits for plans and their participants. Yet these same changes have made it more difficult to determine how, and at what cost, service providers are compensated for the specific services being rendered.

Under the new regulation, service providers will be disclosing the actual cost of each of the services being provided to plan sponsors and fiduciaries. The regulation contains a prohibited transaction exemption with steps for an employer to follow to gain protection from the prohibited transaction penalties that apply if the required disclosure(s) has not been provided.

Effective date

The effective date of the regulation is July 16, 2011. Service providers will be sending written disclosures to plan sponsors prior to that time. Fiduciaries should make arrangements to review the disclosures carefully.

Covered plans

Defined benefit and defined contribution plans, such as profit sharing and 401(k) plans, are covered by this regulation. Plans that are not covered include governmental plans, non-electing church plans, plans maintained outside the United States primarily for nonresident aliens, unfunded excess benefit plans, SEPs (Simplified Employee Pension plans), SIMPLE IRAs, IRAs, and non-ERISA 403(b) plans. Note that there is a reserved section of the regulation for welfare plans, but they are not currently covered by this ruling.

Stay tuned

There will undoubtedly be much more news to follow about the pending part-three regulation on participant-level fee and expense disclosure as well as additional information regarding the sponsor-level disclosure rules.

Back to basics: Record retention

Retirement plans create a massive amount of paperwork. Retirement plan records include basic plan documents and adoption agreements, summary plan descriptions (SPDs), specific information about plan participants and beneficiaries, data needed to perform various tests, the tests themselves, governmental reporting, and contribution and distribution information.

The Employee Retirement Income Security Act (ERISA) provides rules for retaining retirement plan records. In addition, the U.S. Department of Labor (DOL) has issued regulations on keeping these records in electronic form. Keep in mind that the longer the paper trail, the easier it will be for a plan to respond to inquiries from a governmental agency or requests for information from plan participants.

Whose responsibility is it?

Generally, the burden of record retention falls on the plan administrator (the employer). However, it is possible that the job may be delegated to an outside service provider under the terms of its service agreement. Prior to changing service providers, employers should ensure that they receive copies of all necessary plan records from their current provider to alleviate future issues involving record retrieval.

How long must records be preserved?

Some plan records are retained for a fixed time period; others must be retained permanently. According to ERISA (Section 107), records used in the preparation of governmental reporting (such as Form 5500 and Form 1099-R) and participant disclosures (such as participant statements) must be preserved for at least six years from the date the report was filed (or should have been filed) or the disclosure provided.

Note that retained reporting records must provide enough detail for the government to verify the accuracy of the report.

Plan records that must be maintained permanently include plan documents (including all adoption agreements and plan amendments), IRS determination letters, insurance contracts, SPDs, and board resolutions.

What about participant information?

As a practical matter, plan administrators may want to keep participant records longer than six years in case of legal action, such as participant divorce proceedings or disgruntled employee lawsuits. Participant information that should be retained includes:

- Determination of eligibility
- Hire and termination dates
- Beneficiary designations
- Notarized spousal consents and waivers
- Loan, hardship, and distribution documentation
- Hours worked for vesting and allocation purposes
- Compensation used for testing and allocations
- Elective deferral, matching contribution, and payroll records

How should plan records be preserved?

Proper and complete archiving of plan records is essential. Due to technological advancements, many transactions no longer take place on paper, which presents an added challenge. According to DOL regulations, electronic media may be used to comply with record retention rules provided the following requirements are met:

- The recordkeeping system has reasonable controls in place to ensure the accuracy of the records.
- The electronic records are maintained in reasonable order and in a safe and accessible place.
- The recordkeeping system should be capable of indexing, retaining, preserving, retrieving, and reproducing the electronic records. (The retrieval issue becomes more interesting as equipment is updated and upgraded. For example, records retained on floppy disks may fail this test if no system drives are maintained to read that media).
- The electronic records can be readily converted into legible paper copies.
- The recordkeeping system is not subject to restrictions that would inappropriately limit access to the records.

With a few exceptions, original paper records may be disposed of after they are transferred to an electronic recordkeeping system, provided the system complies with these requirements. *The original may not be discarded* if it has legal significance or inherent value in its original form (e.g., notarized documents, insurance contracts, stock certificates, and documents executed under seal).

RECENT developments

DB plan funding relief

The Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010 (signed into law by President Obama on June 25, 2010) includes a provision offering funding relief for both active and frozen defined benefit plans for up to two plan years during the 2008-2011 plan-year period. The relief allows single-employer plans to amortize their funding shortfall by electing either a "2 plus 7" schedule or a 15-year schedule.

The 2 plus 7 schedule allows interest-only payments for the first two years; then the shortfall is amortized over the following seven years. Under the 15-year schedule, the shortfall is amortized in level installments over a 15-year period.

The options provide the employer with two substantially different cash flow choices. The payments during the seven-year period of the 2 plus 7 method are higher than the amounts paid annually under the 15-year payment method. However, the 2 plus 7 method is beneficial from a cash flow standpoint for the first two years and results in a lower total payment amount since interest is paid for fewer years. Other rules relating to executive compensation and corporate distributions and stock redemptions are also applicable.

If relief is elected for two years, the method used must be the same for both years. Multiemployer plan relief is also addressed. Plan sponsors who elect relief must notify participants, beneficiaries, and the PBGC.

ACT report

With the first five-year amendment cycle nearing completion, the IRS's Advisory Committee on Tax Exempt and Government Entities (ACT) took the opportunity to study the process. The resulting ACT report, published recently, contains proposals for improving the interim plan amendment process. It also recommends that the IRS publish an annual notice that includes effective dates, due dates, whether an amendment is discretionary or mandatory, and a description of required changes. Recommendations for streamlining the determination letter process, improving customer service, and reviewing the current fee structure used to correct certain plan failures are also included in the committee report.

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