eActionAlert

DOL Proposes New Service Agreement Rules

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ERISA prohibits the furnishing of services to an employee benefit plan, such as a health and welfare plan or a 401(k) plan (as well as other types of pension plans) unless the fees for such services are "reasonable." ERISA also requires plan fiduciaries to act prudently and solely in the interests of participants and beneficiaries. The plan often pays for various services provided to it, yet bundled service arrangements and associated fee structures are increasingly complex. For these reasons, the Department of Labor ("DOL") has issued proposed regulations which, when they become final, will require that contracts between service provider(s) and a plan disclose enough information to assist the fiduciaries in ascertaining and understanding (1) exactly what the plan actually pays for specific services (2) whether all the compensation received by the vendor is reasonable for those services and (3) the potential for conflicts of interest that may affect a vendor's performance of those services. This is important because failure to adhere to the regulations would cause the contract itself to be "unreasonable" and therefore constitute a prohibited transaction under ERISA.

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The Proposed Regulations

Section 408(b)(2) of ERISA exempts certain arrangements between service providers and plans from being prohibited transactions, provided (1) the service contract is reasonable, (2) the services are necessary and (3) no more than reasonable compensation is paid for the services. The proposed regulations redefine what constitutes a reasonable contract under ERISA for purposes of the statutory exemption from certain prohibited transactions. In order for a contract to be reasonable, the proposed rules would require service providers to disclose detailed information about the services the vendor and its affiliates will provide to the plan and all the compensation they will receive for such services.

Compensation means money and anything else of monetary value to be received by the service provider and its affiliates in connection with the services to be provided as well as any financial products to be offered to the plan. This includes, but is not limited to, direct and indirect compensation. Direct compensation is any compensation paid directly by the plan (out of plan assets) or the sponsor. Indirect compensation includes compensation received by the vendor from other sources and is sometimes called "revenue sharing." Compensation includes recordkeeping fees, investment management fees, trustee or custodial fees, trips for employees, research fees, finder's fees, placement fees, asset distribution fees, soft dollar income and commissions. Such compensation may be paid by

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the plan, the sponsor, the vendor's affiliates or by unrelated third parties.

The proposed regulations specify that, in order to be reasonable, the contract between the service provider and the fiduciary must:

- Be in writing;
- Disclose fully and accurately all direct and indirect compensation to be received by the service provider and its affiliates;
- Describe any material financial, referral or other relationships between the service provider and other parties (such as investment advisers, asset managers, trustees and custodians) that may create a conflict of interest for the service provider; and
- Disclose all information needed to complete Form 5500, including Schedule C for years 2008 and 2009 (the latter year requires significantly greater disclosure of both eligible direct and indirect compensation paid by ERISA plans to their service providers).

To be reasonable under the proposed regulations, the contract must also include a representation by the vendor that, before the contract was entered into, all required information was provided to the fiduciary. Although the disclosure can be provided in several documents at different times before the contract is consummated, the vendor must, in fact, describe its compensation and fees in such as way that the responsible fiduciary can evaluate its reasonableness. Similarly, the vendor must disclose specific information in a manner that will allow such fiduciary to assess any real or potential conflicts of interest.

Core ERISA Fiduciary Issues

Although it may be several months before the DOL publishes specific regulations on what fiduciaries must do, fiduciaries should be certain they follow the general ERISA rules in order to fulfill their core responsibilities to a plan and its participants.

For example, a fiduciary must act prudently at all times and use the care, skill, prudence and diligence that an experienced and knowledgeable person would use in the management of an employee benefit plan. Whether a fiduciary has acted properly is not measured by the results in a particular instance. Instead, it is measured by whether the fiduciary used a reasonable procedure in making decisions about the plan.

Thus, a fiduciary must be prudent in selecting each service provider. Part of the process is to issue a proper request for proposal and to analyze and compare the candidates' responses. Another part of the process is that, once a vendor is selected, the fiduciary must insist on a proper, written contract and, before it is executed, scrutinize the draft, understand all the issues and ask as many questions as necessary in order to decide whether the contract should be signed on behalf of the plan.

As if to prove the point, there are several fee disclosure cases currently being litigated in various federal courts. For example, in *Hecker v. Deere & Company*, the plaintiffs claim that Deere, as well as Fidelity Management Trust Company and Fidelity Management and Research Company, breached their fiduciary duties to two 401(k) plans by (1) imprudently causing the plan to pay excessive fees and such fees were not incurred solely for the benefit of participants and beneficiaries and (2) failing to communicate honestly, clearly and accurately with participants concerning the fees and failing to disclose to other fiduciaries how much the plan paid in fees and expenses as well as who received compensation and for what services. As to Deere, plaintiffs claim

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that there was no process in place to help it to prudently select investment funds and that the sponsor breached its duties by accepting investment options with unreasonably high fees.

The DOL filed a friend of the court brief. The DOL argued that ERISA's language does not provide an exhaustive list of the information that a fiduciary must provide to participants. The DOL said that the fiduciary's general obligations of prudence and loyalty to participants require the fiduciary to collect information about service-provider fees and to provide the information to participants so they can understand and protect their interests under the plan.

What this Means to you and M&A's Recommendations

Firstly, a person must understand whether or not he is a fiduciary. A person is a fiduciary if he (1) has discretionary authority for the administration of the plan or (2) exercises control over the administration of the plan or its investments (even if not authorized to do so). A person who performs ministerial functions (i.e. benefit calculations) for the plan but who cannot (and does not) make decisions about the plan or its assets, is not a fiduciary.

A fiduciary is not expected to be an expert in everything. But, he is required to know in what areas he needs help, to engage an expert and, when the fiduciary does not understand a particular point or issue, to ask as many questions as necessary.

Mahoney & Associates has compliance experts and other professionals on staff who would be pleased to be of service. We can:

- Help fiduciaries establish procedures to enable them to make prudent decisions that are in the best interest of plan participants;
- Help fiduciaries ask the right questions and properly answer your questions;
- Analyze service agreements, determine if the vendor has listed all services to be provided and disclosed all its compensation for such services and whether (1) the services are necessary or appropriate for the administration of the plan, (2) the total compensation is reasonable and (3) there exists relationships that could result in a conflict of interest that could interfere with the vendor's ability to perform its obligations under the contract; and
- Otherwise help the plan fiduciaries perform their duties in a professional, prudent manner consistent with ERISA.

We can also prepare a handbook to be used by qualified plan fiduciaries that are responsible for selecting vendors and investment funds. We can provide similar assistance for fiduciaries of welfare plans that fund benefits through a trust (i.e. a VEBA).

M&A is an employee benefit consulting and management firm and, as such, we do not practice law. However, if you have any questions about a fiduciary's role in understanding a proposed service agreement and the fees that the plan and its participants will pay, please contact your Senior Consultant at (877) 564-4300.

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