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Major New Duties for 401(k) Plan Sponsors and Vendors

Expanded Regulations Under ERISA

By Louis S. Harvey

The year 2012 will see the full effect of a set of fee disclosure regulations for 401(k) and other defined contribution plans under ERISA (Employee Retirement Income Security Act of 1974). These fee disclosures extend beyond the mere preparation of a blanket statement, because they need to be specific to each plan and include a breakdown of the financial details of the plan's fees and expenses. The new regulations contain an intricate set of enforcement mechanisms and penalties that are new to retirement and investment advisors. The regulations require financial reports to three audiences that all need to be reconciled and, most importantly, used to determine if the fees and payments made by an ERISA plan are reasonable.

Three Sets of Reports

The first of the three reports is Schedule C of Form 5500, filed annually with the IRS, the Department of Labor, and the Pension Benefit Guarantee Corporation. Schedule C has been expanded to include details of direct and indirect payments. The enforcement and penalties for failing to file a complete and accurate Schedule C are described in the Form 5500 filing instructions and involve fines and imprisonment.

The second reporting is a disclosure of fees and expenses that must be made to each ERISA plan by each covered service provider. This disclosure is mandated by a revision to ERISA section 408(b)(2) and makes it a fiduciary breach if a plan fails to receive it. The fiduciary breach can be avoided by filing a complaint against the failing service provider. Three different criteria are used, and satisfying any one defines an entity as a covered service provider. Each such entity is required to disclose compensation received and payments made to other entities, services provided to the plan, the entity's fiduciary status, and material facts such as potential conflicts of interest. The three criteria that define a covered service provider are as follows.

Fiduciary status. Fiduciaries include entities registered as fiduciaries (such as registered investment advisors [RIA]), fiduciaries by virtue of providing services deemed to be fiduciary in nature (such as investment advice), and fiduciaries by self-identification (such as material, representations, or agreements to that effect).

Services provided. The regulation identifies three services for which fee disclosure must be made, regardless of any other criteria. These services are recordkeeping, brokerage, and investment management for all but mutual funds.

Compensation method. Any entity that expects to receive indirect compensation in excess of $1,000 must submit a fee disclosure. Indirect compensation includes payments made by mutual funds, recordkeepers, and others. Examples are 12b-1 fees, revenue sharing, and finder's fees.

The third type of fee disclosure is made to participants in the plan, beneficiaries, and those eligible to participate, before they participate. ERISA section 404(a)(5) has been amended to mandate three disclosures. The first is a general explanation of the structure and mechanics of the plan. The second is a detailed description of the fees and penalties associated with each designated investment option in the plan, together with its past returns. The third is a quarterly statement of the fees and expenses actually paid by each participant or beneficiary in the plan. Failing to make these disclosures is a fiduciary breach and is subject to the corresponding penalties and litigation.

These new fee disclosures carry with them a number of new obligations for companies that sponsor ERISA plans, service providers, and advisors to these plans, as

well as for auditors of the plans and those who audit companies that offer ERISA plans. The specific new responsibilities are described below.

Intended and Unintended Consequences

These new fee disclosure regulations are in response to the belief among regulators and legislators that there are fees which, if disclosed, would not be tolerated by employers offering retirement plans or by the participants and beneficiaries who pay the fees. The expected response to the disclosures is that fees charged to ERISA plans will decline by nearly $15 billion and that, by holding both sponsors of plans and service providers responsible, fee reductions will in fact take place.

The consequences of this pressure on fees will be to favor providers that can deliver low fees and to disfavor inefficient providers. It is expected that providers with high fee structures will either revise their business models or exit the ERISA business. The effect is particularly acute among providers to small and mid-sized plans that, to date, have not had the buying power to demand lower fees.

A second expected effect is that plan sponsors that have trusted service providers for guidance in regulatory compliance must now evaluate these providers. The compliance enjoyed by employers in the past is replaced by skepticism that their providers may not be charging a fair price. This change in attitude might create distrust and compromise the relationship between plan sponsor and provider.

Certain plan participants might also react when they first discover that plan expenses are being funded out of their retirement savings. Large numbers of plan participants are unaware of what expenses are and how they are funded. The 2007 AARP Fee Awareness study, upon which much of the fee disclosure regulation is based, found that 83% of participants are unaware of the fees they pay. The effects are likely to be more participants switching to investments with lower fees or leaving the plan entirely.

New Plan Sponsor Responsibilities

Under the regulations, plan sponsors now have added responsibility for the accuracy of Schedule C and for the participant disclosures under section 404(a)(5). Plan sponsors must reasonably expect that these disclosures are complete and accurate. The implication is that plan sponsors will take steps to establish reasonableness, such as verifying that the comparable data in each disclosure can be reconciled.

Plan sponsors also have a more complex task in determining what section 408(b)(2) fee disclosures are to be received. It will be necessary for the plan sponsor to thoroughly understand the regulation in order to make this determination, because a covered service provider that fails to make the required disclosure is unlikely to advise the plan sponsor of that fact.

If a plan sponsor does receive complete, accurate, and usable disclosure, it must then make a determination that the fees paid to each covered service provider are reasonable for the services provided. If the fees are not reasonable, the plan sponsor must take corrective action.

If, on the other hand, any disclosure is incomplete, inaccurate, or unusable, the plan sponsor is required to notify the covered service provider in writing and, after 90 days, file a complaint with the Department of Labor and the IRS if the problem has not been corrected.

New Service Provider Responsibilities

The new responsibility of covered service providers is to make complete, accurate, and usable disclosures to every ERISA plan to which services are provided. These disclosure obligations require service providers to connect previously unconnected systems and records to provide a full picture of each plan.

Service providers should expect challenges from their plan sponsor clients who learn of their obligations under the new fee regulations and evaluate the fees being paid.

New Advisor Responsibilities

Advisors with ERISA expertise are likely to be asked to assist plan sponsors in carrying out their responsibilities. Advisors who provide this service must be thoroughly schooled in the fee disclosure requirements and the additional implied responsibilities that plan sponsors have.

Advisors will also be faced with the dilemma of not being able to judge their own fees, because of the obvious conflict of interest. In these cases, advisors must turn to an independent third party to assist the plan sponsor in this final step of complying with the regulations.

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New Auditor Responsibilities

Given the assets in ERISA plans, a fiduciary breach can represent material exposure for the sponsoring employer. Such a fiduciary breach can occur by failing to comply with the new fee disclosure regulations.

This exposure raises two audit-related issues. The first is the audit of the ERISA plan itself and the second is the recognition in the financial statements of the exposure in the event of noncompliance. For purposes of an ERISA audit, an auditor should include a determination of whether the plan is complying with the new fee disclosure regulations. This will also require an understanding of the regulation and development of audit practices to establish that the plan is compliant. In the event of noncompliance, it may become necessary to address this issue in the financial statements. ❑

***Louis S. Harvey** is president and CEO of Dalbar, Boston, Mass.*