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Compensation for MEP Sponsors, Part 1

Handling such compensation and expenses without engaging in a prohibited transaction is… complicated.

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There is a public policy concern about 401(k) coverage. More specifically, the concern is that many employees work for companies that don't offer deferral-based plans to their employees. As a result, both the Department of Labor and Congress are working on proposals to encourage multiple employer plans (MEPs) — including "open" MEPs that any employer can join.

In response, there is a growing interest in the TPA and advisory communities about the sponsorship and administration of both open and "Association" MEPs. However, there are complex issues about the payment of compensation and expenses for those services, including:

- Can MEP sponsors make a profit, or would that be a prohibited transaction?
- Can they be reimbursed for costs?
- Can the compensation or reimbursements be paid from plan assets?

This is the first of two articles addressing these and similar questions. In Part 1, we discuss the background of MEPs. In Part 2, we'll delve into the details about compensation and expenses.

BACKGROUND

MEPs are plans adopted by a number of unrelated employers; that is, employers that are not part of a common or controlled group. Why would companies want to do this? MEPs offer some potential for lower costs through economies of scale, but a more significant incentive for an employer to participate in a MEP is the reduction of administrative burdens and fiduciary responsibilities and potential liability.

This seems simple enough, except that there are different types of MEPs, arising out of differences between the tax and ERISA rules. Under the Internal Revenue Code, MEPs are treated as a single plan. Under ERISA, they may be considered a single plan or an aggregation of individual plans. Using these distinctions, there are three common types of MEP (note that these are common names for these types of entities, not legal designations):

- **Association MEP.** This is treated as a single plan for ERISA purposes, so long as the participating employers meet a "commonality" test, i.e., they are part of a group or association that exists to promote common business interests, but was not formed solely for the purpose of providing employee benefits. An Association MEP files a single Form 5500, has a single fidelity bond and, if a financial audit is required, it is a single audit of the aggregate MEP assets.
- **Open MEP.** This is treated as an aggregation of individual plans because the commonality test is not met. For example, a TPA sponsors a plan and the only common factor among participating employers is that they are clients of the TPA. A Form 5500 is filed for each participating employer's portion of the plan; financial audits are done on an individual basis; and each participating employer plan must have its own fidelity bond.
- **PEO MEP.** This is sponsored by a staffing firm or "PEO," in which only the PEO's employer-clients participate. Whether a particular PEO MEP constitutes one ERISA plan (i.e., a single employer plan) or a group of ERISA plans (i.e., an open MEP) will depend on facts and circumstances.

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When we refer to the MEP "sponsor," we mean the entity that takes on the fiduciary responsibility and administrative duties of running the plan. Its employees may participate in the plan, but generally do not. In an Open MEP, the sponsor is often a TPA, although it could also be a recordkeeper, investment advisory firm or other entity. In a PEO MEP, the "sponsor" is the PEO itself. Association MEPs have a variety of structures. The association is rarely the sponsor, since it does not wish to take on the fiduciary role. In many cases, it will engage a third party to serve as the sponsor, somewhat like the Open MEP, but occasionally the first employer that adopts the plan would take on the title of sponsor.

Generally, the sponsor engages the MEP's other service providers, such as a recordkeeper, investment manager, accountants or others. In this respect, the sponsor takes on the fiduciary responsibility for prudent selection and monitoring of those providers.

PROVIDER COMPENSATION: ERISA PRINCIPLES

We use the term "compensation" to refer to a traditional fee-for-services. "Direct" compensation refers to specified amounts paid out of plan assets or by a participating employer. Commonly, the amount is a set percentage of assets or a specified dollar amount plus a per participant fee. "Indirect" compensation refers to amounts received by the sponsor from third parties, generally in the form of revenue sharing. Reimbursement of expenses refers to the sponsor's direct, out-of-pocket expenses (not including overhead) incurred in providing plan-specific services that are not paid by the plan or effectively subsumed in the sponsor's fee.

MEP sponsor compensation is subject to several principles under ERISA and the Code. It's important to understand these before getting into the specific items of compensation.

1. Compensation of service providers must be reasonable. There are two parallel "reasonableness" requirements under ERISA. The first is the requirement that fiduciaries act for the exclusive purpose of providing benefits to the participants and "defraying reasonable expenses." In addition, all service providers, including fiduciaries that are compensated for that service, are considered "parties-in-interest" under ERISA. Service arrangements between a plan and a service provider are prohibited transactions unless they satisfy the exemption in Section 408(b)(2). (There are parallel provisions in the Code, but for the sake of simplicity, we have focused on the ERISA rules.) Section 408(b)(2) imposes a "reasonableness" requirement on all service and compensation arrangements. The "reasonableness" of compensation can be determined in a variety of ways, but is most often assessed using benchmark information that compares industry data.

   Section 408(b)(2) also requires that the amount of compensation be disclosed to a "responsible plan

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fiduciary." In the MEP context, the employers engage the MEP sponsor, and the MEP sponsor engages service providers. Since the 408(b)(2) regulation didn't explicitly contemplate that scenario, the safest course may be for the MEP sponsor to provide the disclosure to each participating employer when it elects to join the MEP. In turn the service providers would need to make their disclosures to the MEP sponsor (which is obligated, as the responsible fiduciary, to evaluate the reasonableness of their compensation and services).

2. Fiduciaries cannot set or influence their compensation. Under ERISA Section 406(b), a fiduciary engages in a prohibited transaction if it uses its fiduciary authority to cause itself (or another entity in which it has an interest that might affect its best judgment) to receive additional compensation for plan services. The 408(b)(2) exemption does not cover this prohibition.

3. Service provider compensation must be approved by an independent fiduciary. The DOL and courts have said that a provider can negotiate its compensation with potential plan clients without engaging in self-dealing, assuming it is an "arms-length" negotiation. This is because the provider is not acting in a fiduciary role when negotiating in a business capacity. (This is sometimes referred to as the "hire me" concept.) For example, a provider proposes contract terms to the sponsoring employer of a single-employer plan, and it is the employer that evaluates the proposal and decides whether to enter into the arrangement on behalf of the plan.

   The requirement of independent fiduciary approval applies to changes in compensation. It means that the service provider cannot monitor or increase its own compensation. If a service provider wishes to change its compensation arrangement (and it is impracticable to obtain affirmative consent from all participating employers), the DOL recognizes the concept of "deemed" consent.

   The leading "deemed consent" guidance is DOL Advisory Opinion 1997-16A, often called the "Aetna Opinion." There, the DOL held that a recordkeeper which was compensated from mutual fund revenue sharing could change the fund lineup, which affected its compensation, without engaging in a prohibited transaction. To achieve this result, it had to give each employer reasonable (e.g., 60-day) advance notice. During that time, an employer could approve or object to the change, but if the employer said nothing, it would be "deemed" to have approved the change, thus making the decision that of the employer and not the recordkeeper.

In Part 2, we will apply these principles to MEP sponsor compensation and expenses. PC

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FOOTNOTES

[1] See DOL Advisory Opinion 2012-04A.

[2] ERISA §404(a).

[3] ERISA §406(a)(1)(C).

[4] *See* Internal Revenue Code Section 4975.

[5] *See* ERISA Regulation §2550.408b-2; see also Code Section 4975(d)(2).