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Schedule C—A New Era in Annual Reporting

by Bradford P. Campbell and David J. Witz

The annual ritual of filing the Form 5500 is a familiar one for the hundreds of thousands of plan administrators charged with this responsibility. However, 2009 is a year of sweeping change for the Form 5500, and everyone involved, from plan administrators to plan service providers, is confronting new issues.

Perhaps the most substantive change to the Form 5500's content, and the change most responsible for the steady increase in discussions between plan administrators and plan service providers in recent months, is the expanded reporting of direct and indirect service provider compensation on the new Schedule C. The concept of indirect compensation on the new Schedule C is very different than in the past, and though the Department of Labor (DOL) published the new requirements more than two years ago, real questions and concerns about their interpretation linger. While the DOL provided additional clarity by issuing two sets of Frequently Asked Questions (FAQs) on the Schedule C addressing 65 specific questions in all, plan administrators and service providers will still be facing a difficult adjustment and some uncertainty in this first year of the new reporting rules.

The DOL expanded Schedule C disclosure as the first of a series of three "fee disclosure" regulations intended to improve transparency and to provide plan fiduciaries and plan participants better information on which to base their decisions regarding the selection of service providers and the services they render. The Schedule C's more detailed disclosure of indirect payments received by service providers in connection with plan business was intended to achieve several DOL objectives:



- **More Information for Plan Fiduciaries**—By requiring the plan administrator to annually report on specific fee arrangements (and to identify service providers that refuse to provide necessary information), the new Schedule C addresses the DOL's longstanding concern that some fiduciaries have difficulty getting the information needed to understand and assess plan service provider fees.[1]
- **More Public Information about Fee Arrangements and Plan Costs**—Though the exception for "eligible indirect compensation" prevents all fees from being publicly disclosed, the new Schedule C provides the DOL, plan fiduciaries, researchers and policymakers with more public data about the types of fee arrangements and their costs.

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1 See discussion of fiduciary's need for disclosure in the preamble to the proposed 408(b)(2) regulation, Federal Register, December 13, 2007 (Volume 72, Number 239) at 70988 "Fundamental to a fiduciary's ability to discharge these obligations (*i.e.*, "to act prudently and solely in the interest of the plan's participants for the exclusive purpose of providing benefits and defraying reasonable expenses") is the availability of information sufficient to enable the fiduciary to make informed decisions about the services, the costs and the service providers."

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- **More Enforcement Tools for DOL Investigators**—Though the DOL has indicated that it will be understanding of the near-term transition problems plans and service providers are experiencing, the expanded Schedule C provides the DOL with new long-term enforcement tools. The additional data will allow the DOL to expand its fee-related enforcement capabilities and audit targeting.

Compliance Complexity

Despite the DOL's interpretive guidance, the new rules are complex, causing confusion and uncertainty. Plan administrators, who are charged with the responsibility of accurately completing the Schedule C, will have to review the disclosures they receive from service providers and decide if they appear sufficient. Service providers will have to review not only their compensation arrangements with the plan, but also their other business dealings to ensure that they are capturing all reportable compensation from third parties. Given the significant variation in the form and content of compensation arrangements for financial services and the potential for different interpretations of the new rules, service providers and plan administrators are well-advised to start working together in advance of the filing deadlines and to seek legal counsel as necessary to ensure compliance.

For example, the number of codes identifying specific services received by the plan more than doubled, from 23 to 55, but the instructions do not define the new terms. Indirect compensation includes "money and any other thing of value... received from sources other than directly from the plan or plan sponsor...if the person's eligibility for a payment or the amount of the payment is based, in whole or in part, on services rendered to the plan..."[2] Only certain kinds of indirect compensation must be reported in detail—certain gifts and gratuities are not reported, and there are special rules for bundled service arrangements and certain fully-insured welfare contracts.[3]

Most significantly, "eligible indirect compensation" (certain fees charged to investment funds and reflected in net return) is subject to reduced reporting if previously disclosed to plan fiduciaries.[4] This prior disclosure may be through existing documents (the prospectus, Form ADV, etc.) but must be flagged for the plan administrator as serving both the original purpose and also the Form 5500 disclosure purpose.[5] Further, in order to meet the eligible indirect compensation requirements, the disclosure must allow "a reasonable plan administrator [to] readily determine from the documents:

- The existence of the indirect compensation;
- The services provided for the indirect compensation or the purpose for the payment of the indirect compensation;
- The amount (or estimate) of the compensation or a description of the formula used to calculate or determine the compensation; and
- The identity of the party or parties paying and receiving the compensation."[6]

While these requirements reflect the existing diversity of arrangements used by service providers and plans, the practical effect is that the same services provided at the same cost but through different payment structures can yield different degrees of reportable compensation on the Schedule C. Service providers can custom design collaborative bundled relationships[7] so that a single service provider can provide a range of services, and the structure chosen can either increase or decrease the amount of disclosure required under the Schedule C. Critics of this flexibility point out that it undermines the DOL's goal of increasing disclosure to plan fiduciaries. However, the DOL has indicated that it will address this issue through a separate regulation requiring disclosures to plan fiduciaries when entering into a service provider relationship as a requirement of the statutory prohibited transaction exemption for reasonable services under ERISA Section 408(b)(2).

While the 65 FAQs issued by the DOL help clarify the application of the rules to various compensation arrangements, service providers and plan administrators will have unanswered questions as they begin to actually complete the Form. Beginning early to collect and evaluate information is important, because as legitimate disputes regarding the disclosure requirements emerge, both parties need time to work together to resolve their concerns.

Limited Relief for 2009 Transition Year

While the DOL signals that its enforcement efforts for the 2009 filing season will take into account the

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2 See "2009 Instructions for Form 5500," pg 22.
3 Ibid, pg 23.
4 "...[i]ndirect compensation that is fees or expense reimbursement payments charged to investment funds and reflected in the value of the investment or return on investment of the participating plan or its participants[,] finders' fees[,] 'soft dollar' revenue, float revenue, and/or brokerage commissions or other transaction-based fees for transactions or services involving the plan that were not paid directly by the plan or plan sponsor (whether or not they are capitalized as investment costs)." Ibid, pg 24. See also DOL's "FAQs about the 2009 Form 5500 Schedule C," #8.
5 DOL's "FAQs about the 2009 Form 5500 Schedule C.," #29.
6 Ibid.
7 Ibid, #13.

difficulties inherent in the transition to the new Form 5500 and electronic filing, a prudent plan administrator or service provider must recognize the limited nature of this relief.

Overall, the DOL has increased funding for enforcement activities, and the Employee Benefits Security Administration (EBSA) is undertaking a review for "strategic planning" purposes of whether Form 5500 compliance can be linked to benefit plan management as a "long-term performance indicator..." suggesting that compliance in this area will be under increased scrutiny in the future.[8] Form 5500 compliance is already an active part of EBSA's enforcement program, and the penalties for violations can be severe. ERISA and the Code provide for civil penalties of up to $1,100 a day for deficient or delinquent Form 5500 filings, and there are criminal penalties or fines of up to $100,000 and imprisonment for up to ten years for certain willful or knowing violations.[9] While reduced civil penalties often can be negotiated with EBSA, even honest mistakes can be quite expensive.

With that in mind, let's examine two very specific DOL statements regarding enforcement in 2009.

Reporting Service Providers to the DOL for Failure to Disclose

Line 4 of Part II of the Schedule C directs a plan administrator to report to the DOL "each service provider who failed or refused to provide the information necessary to complete this Schedule."[10] Because the statute does not give the DOL the authority to require reporting directly from service providers, inclusion of this line on the Schedule C is an indirect means to compel service provider compliance.

Reporting a service provider for noncompliance is something a plan administrator needs to consider carefully. First, the Schedule C instructions require the plan administrator to contact the service provider, request the information and inform them that they will be reported if they do not comply.[11] Procedures should be established to document this process. Second, though the DOL has not specifically said how it will respond when a provider is reported, it is likely that the DOL will follow up with the plan and/or provider reported. The DOL may inquire about the initial selection process for the service provider and whether information needed to assess the reasonableness of fees and potential conflicts of interest was collected prior to the time of appointment.[12] There is also a possibility that a DOL review might result in an overall plan audit that is not limited to a Schedule C reporting concern.[13]

In response to concerns expressed by plans and service providers that it may be difficult to fully comply with the new rules in the first year, the DOL provided some limited transitional relief. The DOL explains in Schedule C FAQ #40 that it recognizes some service providers "may have to modify their recordkeeping and information management systems" to gather the data to report, and that it "may be difficult...to make those adjustments sufficiently in advance."[14] The plan administrator does not need to report the service provider for failing to provide the correct disclosures if the service provider provides the plan administrator with a written statement that "(i) the service provider made a good faith effort to make any necessary recordkeeping and information system changes in a timely fashion, and (ii) despite such efforts, was unable to complete those changes for the 2009 plan year."[15]

The DOL further limited this relief in its Supplemental Schedule C FAQ #10, clarifying that the service provider has to disclose all such information it is able to collect, and that "the Department also expects plan administrators... will communicate with the service provider regarding the statement and the steps the service provider is taking to be able to provide the necessary information in connection with future Schedule Cs..."[16] It is also important to note that the service provider may also provide an estimate or formula rather than the actual dollar amount, making it easier to comply.

Thus the written statement is not a panacea for service providers, but rather a limited form of temporary relief. All compensation data required by the Schedule C that can be gathered must be disclosed, and only the portion of data that could not be gathered timely due to changing recordkeeping and information systems—despite "good faith efforts"—is excused.

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8 See "FY 2011 Congressional Budget Justification, Employee Benefits Security Administration," pgs. 9, 20, 26.
9 See ERISA Sections 501 and 502, and IRC Sections 6652 and 6692.
10 Schedule C (Form 5500) 2009, Part II, line 4, pg. 6.
11 2009 Instructions for Form 5500, pg. 25.
12 See preamble to the proposed 408(b)(2) regulation, Federal Register, December 17, 2007 at 70989, "The Department believes that in order to satisfy their ERISA obligations, plan fiduciaries need information concerning all compensation to be received by the service provider and any conflicts of interest that may adversely affect the service provider's performance under the contract or arrangement."
13 "Therefore, even if an investigation initially focuses on a specific issue, every plan investigated does get an overall review. This approach enables us to identify emerging areas of noncompliance..." EBSA response to Government Accountability Office report on EBSA enforcement programs, December 19, 2006.
14 "FAQs about the 2009 Form 5500 Schedule C," #40.
15 Ibid.
16 "Supplemental FAQs about the 2009 Form 5500 Schedule C," #10.

Though each service provider would have to be judged based on its unique facts and circumstances, it is likely that many service providers will not qualify for this exception and, certainly, any direct fees and expenses would be known.

Fiduciary service providers may also find it difficult to use this form of relief, as fiduciaries are subject to prohibited transaction rules preventing self-dealing.[17] While a fiduciary service provider may be receiving indirect compensation legitimately under certain contractual arrangements approved by the plan fiduciary that specifically address the nature and permissible amount of such compensation (for example, agreements regarding "float" retention), an inability to report such compensation to the plan administrator is likely to be questioned by the DOL and should be by the plan administrator regardless of cost to modify the recordkeeping or information systems.

Service Provider Code Issues

The significant expansion of the number of codes is complicated by the fact that many service providers could be described by more than one code and the instructions do not define the code terms. The Schedule C requires the plan administrator to select from the list "all codes that describe the services provided and the compensation received" and to "enter as many codes as apply."[18] While some private groups have suggested definitions, such as that found in PlanTools' April 2010 Technical Release, preparers are left to their own resources to accurately assign the appropriate Code to the service rendered.[19]

The DOL provided limited relief for this concern in Supplemental FAQ #15, stating that "a reasonable good faith effort to properly classify services and fees is required," but the DOL will not reject a filing "solely because [DOL] might have used a different service or fee code."[20]

2010 and Beyond

Though everyone likely agrees that the transition period will cause some disruption and additional cost, the lessons learned from this first all-electronic Form 5500 filing cycle will help refine the process going forward. The DOL will likely consider a variety of suggestions for improvement, from logistical issues regarding the mechanics of filing to substantive concerns regarding the reporting of compensation in a variety of circumstances. It is clear that the Schedule C will become the impetus for a number of long-term changes to the service provider/plan relationship.

First, the new Schedule C is, in effect, making plans with more than 100 participants engage in an annual review of their service provider arrangements and cost. Plan fiduciaries have always had a duty to monitor their service providers and reassess their provider relationships periodically, but the Schedule C is likely to result in annual assessments of service provider fee reasonableness.[21] This monitoring may present new opportunities for many service providers.

Second, relationships and payment arrangements will be more public, though what impact this will have is less clear. The data available will offer only a partial picture of the arrangements of the plan universe as a whole, or even the arrangements of individual plans, due to the different reporting requirements for eligible indirect compensation and inconsistent code usage from plan to plan.

Finally, the DOL has created significant new enforcement tools for its investigations. The fee data will be used to identify certain plans and service providers for audit or investigation, and compliance with the new Schedule C requirements forms the basis for additional enforcement activity.

Service providers and plan administrators are understandably focused on getting through the 2009 filing cycle, but the new Schedule C is going to result in long-term changes. The DOL will be increasingly focused on filing compliance under the new Form 5500 in 2010 and beyond, and the challenges listed here are just a few of the issues plans and service providers will need to address to reduce the likelihood of being an audit target. Service providers, especially those who do not work with ERISA plans on a regular basis, need to be aware that the Schedule C disclosure requirements impose year-round data collection obligations. The combined effect of the Schedule C requirements and the forthcoming Section 408(b)(2) regulation governing service provider disclosures will significantly affect the operating environment for plans and service providers alike, with new challenges—and new traps for the unwary.



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17 See ERISA Section 406(b).
18 2009 Form 5500 Instructions at 24.
19 **www.fraplantools.com**.
20 Supplemental FAQs, #15.
21 See preamble to the proposed 408(b)(2) regulation, Federal Register, December 17, 2007 at 70993, "Section 404(a) of ERISA requires that the responsible plan fiduciary engage in an objective process designed to elicit information necessary to assess not only the reasonableness of the compensation or fees to be paid for services, but also the qualification of the service provider and the quality of the service that will be provided."