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Management Alert

Department of Labor Issues Final Rules on Fee Disclosures From Service Providers

Executive Summary

On February 2, 2012, the Department of Labor ("DOL") issued final regulation section 2550.408b-2(c) (the "Regulation"), regarding required disclosure of fee-related information by service providers to plan fiduciaries. Generally, a service provider must disclose the services provided, its status as a fiduciary or registered investment adviser, compensation received, and certain information with respect to services provided to individual account plans. The new disclosure requirements are effective as of July 1, 2012 and will apply to both existing and future contracts or arrangements.[1]

Section 408(b)(2) of the Employee Retirement Security Act of 1974, as amended ("ERISA") provides an exemption from the prohibited transaction rules for certain contracts and arrangements for services between a plan and a party in interest. In general, the requirements for the exemption are that: (i) the service is necessary for the operation of the plan;[2] (ii) the service is furnished under a contract or arrangement which is reasonable; and (iii) no more than reasonable compensation is paid for the service.[3] The Regulation provides guidance with respect to item (ii), specifically indicating what service provider disclosures must be made to a plan fiduciary for a contract or arrangement to be reasonable.

The Regulation, except as specifically indicated, is independent from the regulations and other rules under section 404 of ERISA, which provide guidance related to the information a fiduciary must consider when engaging and monitoring a service provider, as well as the new regulations regarding participant-level fee disclosures.[4]

A failure to meet the requirements of the section 408(b)(2) exemption could cause the payment of compensation to a service provider to a plan to be a prohibited transaction under ERISA and the corresponding provisions of the Internal Revenue Code of 1986, as amended (the "Code").[5] The consequences of a prohibited transaction can include punitive excise taxes, disgorgement of fees, and other potential liabilities for the service provider and personal liability for the plan fiduciary. Therefore, it is critical for service providers, including those that provide advice to private funds, hedge funds, or other investment vehicles that hold plan assets and plan fiduciaries that are subject to the Regulation, to make sure they are in compliance by July 1, 2012.

This Management Alert is intended to provide plan sponsors and plan fiduciaries with an understanding of what they need to receive in order to avoid a prohibited transaction. It is also intended to provide service providers with a roadmap of the disclosures they are required to provide under the Regulation.

Covered Plans and Covered Service Providers

The disclosure requirements apply to services provided to "covered plans" by "covered service providers" for "compensation".

A "covered plan" is an employee pension benefit plan (also referred to as a pension plan), within the meaning of section 3(2)(A) of ERISA. This generally includes both defined benefit plans and defined contribution plans, but does not include:

- Governmental plans;

- Church plans not subject to ERISA;
- Ex-US plans maintained primarily for non-resident aliens;
- Unfunded excess benefit plans;
- Individual retirement accounts and annuities and those employer established plans which utilize IRAs, such as SEPs and SIMPLEs;
- Pre-2009 issued annuities and custodial accounts under a 403(b) plan for which the employer ceased to have any obligation to make contributions, including salary deferral contributions, before 2009 (all rights and benefits under such contracts or accounts must be enforceable solely by the individual owner of the annuity/account and the individual must be fully vested in the account);
- Welfare plans; or
- Plans with no employees (*i.e.*, Keogh plans covering only owners and their spouses).

A "covered service provider" ("CSP") is a service provider that (i) enters into a contact or arrangement with a covered plan and (ii) reasonably expects to receive $1,000 or more[6] in direct and/or indirect compensation (see Disclosure Requirements for definition of compensation) for providing the types of services listed below (regardless of whether the services are performed or compensation is received directly by the CSP or by an affiliate or a subcontractor of the CSP).

Services as a Fiduciary or Registered Investment Adviser

This category of service includes: (i) services provided directly to a covered plan as an ERISA fiduciary; (ii) services provided as a fiduciary to an investment contract, product or entity that holds plan assets[7] (a "plan asset vehicle") in which the covered plan has a direct equity investment; and (iii) services provided directly to a covered plan as an investment adviser registered under either the Investment Advisers Act of 1940 or state law (an "RIA").

Recordkeeping or Brokerage Services

This category of service includes recordkeeping or brokerage services provided solely to an individual account plan (defined contribution-type plan) that permit participants to direct the investment of their accounts, provided that one or more designated investment alternatives ("DIA") will be made available in connection with such recordkeeping or brokerage services. Thus, a service provider who provides recordkeeping or brokerage services to a defined benefit plan is not a CSP. A DIA is an investment alternative on a menu of investment options from which a plan participant may choose to invest his or her account's assets, *but does not include brokerage windows or accounts*. Therefore, a CSP need not furnish investment-specific information for each possible investment available through brokerage windows. However, the CSP is required to describe the services available to participants who elect to use the brokerage window and any fees or other compensation the CSP may receive directly or indirectly.

Other Services for Indirect Compensation

The final category of services covers accounting, auditing, actuarial, appraisal, banking, consulting, custodial, insurance, investment advisory, legal, recordkeeping, securities or other investment brokerage, third party administration, or valuation services for which the CSP, an affiliate of the CSP, or a sub-contractor of the CSP reasonably expects to receive "indirect compensation" (as described below) or certain compensation from related parties (as described below).

Notwithstanding the list of services above, there are two exceptions – no person will become a CSP solely by providing services (i) to a vehicle in which the covered plan invests that is not a plan assets vehicle or in which the covered plan's investment is not a direct equity investment and (ii) as an affiliate or a subcontractor under the contract or arrangement with the covered plan (*i.e.*, the entity entering into the contract or arrangement is the CSP).

Disclosure Requirements

A CSP must disclose in writing[8] certain information regarding its services to a responsible plan fiduciary reasonably in advance of entering into, extending, or renewing a contract for services with a covered plan. Below are descriptions of the types of

disclosure that must be made by a CSP.

Services to be Provided and Status of CSP

The CSP must describe the services to be provided to the covered plan pursuant to the contract or arrangement in detail and in a manner that is clear and understandable to the responsible plan fiduciary.[9] If applicable, the disclosure must indicate whether the CSP will or reasonably expects to provide services as (i) an ERISA fiduciary and/or (ii) an RIA. No statement is required if the CSP is not either a fiduciary or an RIA.

Compensation and How it is Received

"Compensation" is anything of monetary value (*e.g.*, money, gifts, awards, and trips), but does not include non-monetary compensation valued at $250 or less, in the aggregate, during the term of the contract or arrangement. The Regulation separates compensation into four categories that must be disclosed: (i) direct compensation; (ii) indirect compensation; (iii) compensation paid among related parties; and (iv) compensation at termination of a contract.

In each case, the CSP must disclose how compensation will be paid (*i.e.*, whether the plan will be billed or whether the compensation will be deducted directly from the plan's accounts). Compensation may be expressed as a cost, monetary amount, formula, percentage of the covered plan's assets, per capita charge for each participant or beneficiary, or range. If the CSP cannot otherwise describe compensation or cost, the description may include a reasonable and good faith estimate provided the CSP explains the methodology and assumptions used to prepare the estimate.

Direct Compensation

Direct compensation is compensation received directly from the covered plan. The description must include all direct compensation, either in the aggregate or by service, that the CSP reasonably expects to receive in connection with services provided to the covered plan. If a plan sponsor pays the compensation, but is reimbursed by the covered plan, that is still considered to be direct compensation.

Indirect Compensation

Indirect compensation is compensation received from any source other than directly from the covered plan, the plan sponsor, the CSP, or an affiliate. For example, indirect compensation typically includes the 10 basis points of 12b-1 and sub-transfer agency fees a recordkeeper collects from a mutual fund in which the covered plan invests. According to the DOL, in an example provided in the Preamble of the Regulation, a CSP that has a relationship with a financial institution that subsidizes the cost of attendance at a conference that the CSP offers to its clients is considered to have indirect compensation in the form of such subsidies.

The description must include all indirect compensation that the CSP, an affiliate, or a subcontractor reasonably expects to receive in connection with services; including identification of the services, identification of the payer, and a description of the applicable arrangement between the payer and CSP (or affiliate or subcontractor). According to the Preamble of the Regulation, the description of the applicable arrangement should be sufficient to allow the plan fiduciary to identify any conflicts of interest.

Compensation Paid Among Related Parties

The CSP's description must include compensation that will be paid among the CSP, an affiliate, or a subcontractor which is determined on a transactional basis (*e.g.*, commissions, soft dollars, or finder's fees) or is charged directly against the covered plan's investment and reflected in the net value (*e.g.*, Rule 12-b1 fees). In addition, the CSP must identify the services for which such compensation will be paid and identify the applicable payers and recipients, including the status (as a fiduciary or RIA) of the recipients.

Compensation at Termination of a Contract or Arrangement

The CSP must provide a description of any compensation that it, an affiliate, or a subcontractor reasonably expects to receive in connection with the termination of the contract or arrangement, as well as how any prepaid expenses will be calculated

and refunded at termination.

Recordkeeping Services

If recordkeeping services are to be provided to the covered plan, the CSP must provide a description of all direct and indirect compensation it reasonably expects to receive in connection with recordkeeping. If, however, the CSP expects recordkeeping service to be provided in whole or part, without explicit compensation or to be rebated based on other compensation, the CSP must give a reasonable and good faith estimate of the cost to the covered plan of recordkeeping services. In such a case, the CSP will be required to explain the methodology and assumptions used in the estimate.

Investment Disclosure - Fiduciary Services

CSPs of fiduciary services to a plan asset vehicle must provide certain additional investment disclosures if the covered plan has a direct equity investment. First, the CSP must describe compensation charged directly against the investment (*e.g.*, commissions, sales loads, sales charges, deferred sales charges, or redemption fees) that are not included in the annual operating expenses. Second, the CSP must describe the annual operating expenses if the return is not fixed and any ongoing expenses in addition to annual operating expenses (*e.g.*, wrap fees or mortality and expense fees). However, if the investment is a DIA, the total operating expenses must be expressed as a percentage and calculated in accordance with the DOL's participant level fee disclosure rules. Finally, with respect to a DIA, the CSP must give any other information or data about the DIA that is in the control of, or reasonably available to, the CSP and is required to be disclosed by a plan administrator to comply with the participant level fee disclosure rules.

Investment Disclosure- Recordkeeping and Brokerage Services

CSPs of recordkeeping services or brokerage services to an individual account plan that permits participants to direct investments are also required to provide the same investment disclosures as required by a fiduciary (as described above) if one or more DIA is made available in connection with the recordkeeping or brokerage services. However, the CSP may comply with these requirements by providing in good faith current disclosure materials of certain regulated issuers that are not affiliates of the CSP.

Timing and Form of Disclosure

Initial Timing

The CSP generally must make the applicable disclosures reasonably in advance of the date the contract or arrangement is entered into, extended, or renewed. If an investment's status changes (*i.e.*, begins to hold plan assets or becomes a DIA), the CSP must make the applicable disclosures as soon as practicable, but not later than 30 days after becoming a plan assets vehicle, and not later than the date an investment becomes a DIA.

Timing Relating to Changes

A CSP must disclose a change to services, status, compensation, recordkeeping services, or the manner of receipt of compensation as soon as practicable, but not later than 60 days from the date on which the CSP is informed of such change (except in extraordinary circumstances). Also, a CSP must disclose changes to investment disclosure at least annually.

Form of Disclosure

Other than the disclosure being in writing, the Regulation does not require a certain method of disclosure. However, the DOL did release a guide along with the Regulation that can be used by CSPs to indicate where specified information can be found in existing documents. Although this guide is not currently required, the Preamble of the Regulation indicates that the DOL may issue a proposed regulation requiring the use of a similar guide.

Requests for Additional Information

Under the Regulation, CSPs must furnish, upon written request of the responsible plan fiduciary or covered plan administrator, any other information relating to the compensation received in connection with the contract or arrangement

that the covered plan needs in order to comply with the reporting and disclosure requirements of ERISA. The information must be furnished reasonably in advance of the date upon which the responsible plan fiduciary or covered plan administrator states that it must comply with the applicable reporting or disclosure requirements, unless the disclosure is precluded due to extraordinary circumstances beyond the CSP's control, in which case the information must be disclosed as soon as practicable.

Disclosure of Errors

If the CSP discovers an error or omission in its initial or subsequent disclosure, the CSP must disclose the correct information to the responsible plan fiduciary as soon as practicable, but not later than 30 days after discovery of the error or omission. Provided that the CSP acted in good faith and with reasonable diligence, the error or omission will not cause the contract or arrangement to fail to be "reasonable", as long as the corrective measures are taken.

Prohibited Transaction Exemption for Responsible Plan Fiduciary Who Does Not Receive Required Information

Under the Regulation, a responsible plan fiduciary and a CSP will be deemed to have engaged in a prohibited transaction if the CSP fails to disclose required information. Recognizing that the responsible plan fiduciary must necessarily rely on the CSP to make the proper disclosures to avoid engaging in a prohibited transaction, the DOL included a prohibited transaction exemption in the Regulation. The exemption provides relief solely to the responsible plan fiduciary from certain of the prohibited transaction provisions of ERISA and the Code, notwithstanding any failure by a CSP to comply with its disclosure obligations, provided certain conditions are satisfied:

- The responsible plan fiduciary did not know that the CSP failed or would fail to make required disclosures and reasonably believed that the CSP disclosed the information required by the final rule.
- Upon discovering that the required information was not disclosed, the responsible plan fiduciary must request in writing the applicable information.
- If the requested information is not furnished, the responsible plan fiduciary must notify the DOL not later than 30 days following the earlier of: (i) the CSP's refusal to furnish the requested information; or (ii) the date which is 90 days after the date the written request is made. However, providing this notice to the Department does not relieve a plan administrator of the obligation to report a prohibited transaction on the covered plan's Annual Report Form 5500.

To take advantage of the exemption, the responsible plan fiduciary must determine the extent to which the contract or arrangement at issue can be continued consistent with the fiduciary's duty of prudence under section 404 of ERISA without the required disclosures. Further, the Regulation requires that if the requested information relates to future services and is not disclosed, then the responsible plan fiduciary must terminate the contract or arrangement promptly.

If these conditions are satisfied, the responsible plan fiduciary will not be deemed to have engaged in a prohibited transaction and will not be subject to the excise taxes that normally result from participation in a prohibited transaction under the Code.

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[1]The Department had previously issued interim regulations on the same topic, which were to become effective April 1, 2012. The new Regulation takes the place of the interim regulations.

[2]A service is considered necessary if it is appropriate and helpful to the plan in carrying out the purposes for which the plan is

established and maintained.

[3]DOL regulation §2550.408c-2 contains provisions relating to what constitutes reasonable compensation; generally, it is a matter of facts and circumstances.

[4]It should be noted, however, that certain of the changes from the earlier interim final regulation have been made to increase the consistency of the Regulation with the participant level fee disclosure rules. For more information regarding the new participant level fee disclosure rules, see our Management Alert entitled *Plan and Investment Disclosure Requirements*, dated July 26, 2011. For information relating to how the DOL postponed requirements relating to participant level fee disclosure in this Regulation, see our One Minute Memo entitled *Deadline for New 401(k) Plan Disclosures Postponed to August 30*, dated February 2, 2012.

[5]All references to section 408(b)(2) of ERISA and the corresponding regulations are intended to be read to include references to the parallel provisions of section 4975(d)(2) of the Code.

[6]Note that the time period over which the $1,000 (see discussion of "covered service providers" above) and the $250 is to be determined is the term of the contract or arrangement, which in the case of an evergreen arrangement means that the relevant amount is for an indeterminate time period.

[7]The term "plan assets" has the meaning set forth in the DOL regulation §2510.3-101, the so-called "Plan Asset Regulation", as amended by section 3(42) of ERISA.

[8]Although the DOL has indicated that the written disclosure need not be given in the form of a formal contract. Consequently, mutual fund disclosure documents, such as prospectuses and statements of additional information, can be used in satisfying the written disclosure requirement.

[9]In the Preamble of the Regulation, the DOL has suggested that the level of disclosure may differ depending on the sophistication of a given plan fiduciary.

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