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Department of Labor Issues Interim Final Regulations Requiring New Fee Disclosures by Pension Plan Service Providers

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The U.S. Department of Labor ("DOL") recently published interim final regulations (the "Interim Final Regulations") under Section 408(b)(2) of the U.S. Employee Retirement Income Security Act of 1974, as amended ("ERISA"), which will require certain service providers to employee pension benefit plans and entities holding "plan assets" to disclose information regarding their compensation so as to assist plan fiduciaries in assessing the reasonableness of the service provider's contract with the plan and the potential for conflicts of interest.[1]

The Interim Final Regulations are set to become effective on July 16, 2011, and will apply to arrangements entered into on or after the effective date, as well as to arrangements already in effect as of the effective date. The DOL has requested comments on the Interim Final Regulations, and all comments must be received by the DOL no later than August 30, 2010.

The following is a brief overview of the background leading up to the Interim Final Regulations, and thereafter, a summary of the material terms of the Interim Final Regulations.

Background

Section 406 of ERISA sets forth the "prohibited transaction" rules for plans subject to ERISA. In particular, Section 406(a)(1)(C) of ERISA generally prohibits the furnishing of goods, services, or facilities between a plan and a "party in interest" to the plan (which includes, among others, plan fiduciaries and service providers). As a result, any service relationship between a plan and a service provider to the plan would constitute a "prohibited transaction" absent an exemption.[2]

Section 408(b)(2) of ERISA provides such an exemption from ERISA's prohibited transaction rules for service contracts or arrangements between a plan and such a party in interest, if (i) the contract or arrangement is "reasonable", (ii) the services are necessary for the establishment or operation of the plan, and (iii) no more than reasonable compensation is paid for the applicable services. The DOL has issued regulations clarifying each of these requirements at 29 C.F.R. §2550.408b-2. [3]

Currently, 29 C.F.R. §2550.408b-2(c) provides that no contract or arrangement is "reasonable" if it does not permit termination by the plan without penalty to the plan on reasonably short notice under the circumstances to prevent the plan from becoming locked into an arrangement that has become disadvantageous.

The Interim Final Regulations amend 29 C.F.R. §2550.408b-2 to expand the requirement for reasonableness in the case of a contract or arrangement between "covered service providers" and "covered plans," by providing that a contract between a covered service provider and a covered plan is not reasonable unless the covered service provider discloses to that plan certain specified information regarding its compensation. The specific disclosure requirements are discussed in more detail below.

It bears noting that given the need for fiduciaries to select service providers prudently, the DOL has been focused on service provider fee disclosures for a number of years. The DOL previously issued proposed regulations in December 2007 on service provider fee disclosures which received a large number of public comments. The Interim Final Regulations address a number of the concerns raised in the public comments, and because there are significant differences between those proposed regulations and the Interim Final Regulations, the DOL has issued these regulations as "interim final" to provide for an additional comment period until August 30, 2010. In addition, in November 2007, the DOL revised the reporting requirements for Schedule C of the Form 5500 by requiring significant additional reporting by plans of the direct and indirect compensation received by plan service providers. The revised Schedule C reporting requirements became effective for plan years beginning on or after January 1, 2009. Lastly, the DOL is expected to issue additional guidance in the near future regarding the information that plan administrators must provide to participants in participant-directed individual account plans.

Covered Plans

The Interim Final Regulations only apply to ERISA-covered "employee pension benefit plans" and "pension plans," which includes both defined contribution and defined benefit plans.

The Interim Final Regulations do not apply to "employee pension benefit plans" and "pension plans" that are exempt from coverage under ERISA pursuant to Section 4(b) of ERISA (e.g., governmental plans) or "simplified employee pensions," "simple retirement accounts," "individual retirement accounts" or "individual retirement annuities."

The DOL has reserved a subsection in the Interim Final Regulations for a separate regulatory framework to be developed which will be applicable to welfare benefit plans some time in the future.

Covered Service Providers

The Interim Final Regulations generally define a "covered service provider" as a service provider that enters into a contract or arrangement with a covered plan and reasonably expects to receive $1,000 or more in "compensation," direct or indirect, in connection with certain types of services, regardless of whether such services will be performed, or such compensation received, by the service provider, an affiliate or a subcontractor. "Compensation" is defined as 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.

A service provider is only a covered service provider if it is providing one or more of an enumerated list of services. The specified services are as follows:

- Direct Fiduciary Services. Services provided directly to the covered plan as a fiduciary.
- Plan Asset Entity Fiduciary Services. Services provided as a fiduciary to an investment contract, product or entity that holds "plan assets" and in which the covered plan has a direct equity investment (a "Plan Asset Entity"). This does not include (i) non-fiduciary services provided to a Plan Asset Entity, or (ii) services provided to an investment contract, product or entity in which a Plan Asset Entity invests, even if that "downstream" investment contract, product or entity itself is also considered to hold "plan assets."
- Direct Investment Adviser Services. Services provided directly to the covered plan as an investment adviser registered under either the Investment Advisers Act of

1940 or any state law.

- Recordkeeping and Brokerage Services. Recordkeeping or brokerage services provided to a participant-directed covered plan that is an individual account plan, if one or more "designated investment alternatives" will be made available (e.g., through a platform or similar mechanism) in connection with such recordkeeping services or brokerage services. The term "designated investment alternative" generally includes any investment alternative made available under the plan into which participants may direct the investment of their individual accounts, other than brokerage windows, self-directed brokerage accounts, or similar arrangements.
- Other Services for Indirect Compensation. Accounting, auditing, actuarial, appraisal, banking, consulting (i.e., consulting related to the development or implementation of investment policies or objectives, or the selection or monitoring of service providers or plan investments), custodial, insurance, investment advisory (for plan or participants), legal, recordkeeping, securities or other investment brokerage, third party administration, or valuation services provided to the covered plan, for which the covered service provider, an affiliate, or a subcontractor reasonably expects to receive "indirect compensation" (as described below) or "compensation paid among related parties" (as described below).

A person or entity will not be considered a "covered service provider" solely because it provides any of the foregoing services as an affiliate or subcontractor under the contract or arrangement with the covered plan. Thus, only the party to the contract with the covered plan will be considered the covered service provider – not its affiliates or subcontractors.

Required Disclosures

The covered service provider is required to disclose the following information to the "responsible plan fiduciary," who is the fiduciary with authority to cause the covered plan to enter into, or extend or renew, the contract or arrangement:

- Services. A description of the services to be provided to the covered plan pursuant to the contract or arrangement. Non-fiduciary services to be provided to an investment contract, product or entity in which the covered plan invests do not need to be disclosed, even if the investment contract, product or entity is a Plan Asset Entity.
- Status as a Fiduciary. If applicable, a statement that the covered service provider, an affiliate, or a subcontractor will provide, or reasonably expects to provide,

services as a fiduciary either directly to the covered plan or to a Plan Asset Entity.

- Status as an Investment Adviser. If applicable, a statement that the covered service provider, an affiliate, or a subcontractor will provide, or reasonably expects to provide, services to the covered plan as an investment adviser registered under either the Investment Advisers Act of 1940 or any state law.
- Direct Compensation. A description of all “direct compensation” (i.e., compensation received directly from the covered plan), either in the aggregate or by service, that the covered service provider, an affiliate, or a subcontractor reasonably expects to receive in connection with the disclosed services.
- Indirect Compensation. A description of all “indirect compensation” (i.e., compensation that is received from any source other than the covered plan, the plan sponsor, the covered service provider, an affiliate or a subcontractor) that the covered service provider, an affiliate, or a subcontractor reasonably expects to receive in connection with the disclosed services, including identification of the services for which the indirect compensation will be received and identification of the payer of the indirect compensation.
- Compensation Paid Among Related Parties. A description of any “compensation paid among related parties” (i.e., compensation that will be paid among the covered service provider, an affiliate or a subcontractor that is either set on a transaction basis (e.g., commissions, soft dollars, finder’s fees or other similar incentive compensation based on business placed or retained) or that is charged directly against the covered plan’s investment and reflected in the net value thereof (e.g., Rule 12b-1 fees)); including identification of the services for which such compensation will be paid and identification of the payers and recipients of such compensation, as well as their status as an affiliate or subcontractor. Compensation received by an employee from his or her employer on account of work performed by the employee does not need to be disclosed as “compensation paid among related parties.”
- Compensation for Termination of Contract or Arrangement. A description of any compensation that the covered service provider, an affiliate, or a subcontractor reasonably expects to receive in connection with the termination of the contract or arrangement, and how any prepaid amounts will be calculated and refunded.
- Form of Compensation Disclosure. A description or an estimate of any compensation that must be disclosed may be expressed as a monetary amount, formula, percentage of the covered plan’s assets, or a per capita charge for each participant or beneficiary or by any other reasonable method if the compensation cannot reasonably be expressed in such terms.

- Manner of Receipt. A description of the manner in which the compensation will be received (e.g., direct billing, deduction from account, etc.).
- Additional Requested Disclosures. Upon the request of the responsible plan fiduciary or the administrator of the covered plan, the covered service provider must furnish any other information relating to the compensation received in connection with the contract or arrangement that is required for the covered plan to comply with the reporting and disclosure requirements of ERISA.

The Interim Final Regulations do not require the covered service provider to make disclosures in any particular manner or format. In addition, contrary to the proposed regulations, the Interim Final Regulations do not require that the covered service provider's disclosure obligations be set forth in a formal written contract or arrangement. However, the DOL is considering adding a requirement that the covered service provider furnish a "summary" disclosure statement to the responsible plan fiduciary which includes an overview of the information required to be disclosed, as well as a roadmap for the plan fiduciary as to where to find more detailed elements of the required disclosures.

Special Disclosure Rules

The following situations require further disclosures from a covered service provider that are in addition to the general disclosure requirements set forth above:

- Recordkeeping Services. If recordkeeping services will be provided to the covered plan, then the covered service provider must describe all direct and indirect compensation that the covered service provider, an affiliate or a subcontractor reasonably expects to receive in connection with these services. If the covered service provider reasonably expects that recordkeeping services will be provided in whole or in part without explicit compensation, or if the compensation for these services will be offset or rebated based on other compensation received by the covered service provider, an affiliate or a subcontractor, then the covered service provider must furnish (i) a reasonable and good faith estimate of the cost of those recordkeeping services, including an explanation as to the methodology and assumptions used in preparing the estimate, and (ii) a detailed explanation of the recordkeeping services that will be provided to the plan.
- Plan Asset Entities. A fiduciary to a Plan Asset Entity must disclose (i) any compensation that will be charged directly against the amount invested in connection with the acquisition, sale, transfer of, or withdrawal from the Plan Asset Entity, (ii) the annual operating expenses if the return is not fixed, and (iii) any

ongoing expenses in addition to annual operating expenses.

- Participant-Directed Individual Account Plan Designated Investment Alternatives. If a covered service provider is providing recordkeeping or brokerage services to an individual account plan and will be making available one or more designated investment alternatives, then, with respect to each designated investment alternative, the covered service provider must disclose (i) any compensation that will be charged directly against the amount invested in connection with the acquisition, sale, transfer of, or withdrawal therefrom, (ii) the annual operating expenses if the return is not fixed, and (iii) any ongoing expenses in addition to annual operating expenses. The covered service provider may satisfy these requirements by providing current disclosure materials of the issuer of the designated investment alternative, provided that the issuer is not an affiliate, the materials are regulated by a state or federal agency and the covered service provider does not know that the materials are incomplete or inaccurate.

Timing of Disclosures

General Rule for Initial Disclosures. The required disclosures generally must be made in advance of the date the contract or arrangement is entered into, and extended or renewed. With respect to contracts or arrangements entered into prior to the effective date of the Interim Final Regulations, the required disclosures must be furnished no later than July 16, 2011.

Exceptions to General Rule. When a covered plan invests in an investment contract, product or entity that is not a Plan Asset Entity at the time of the covered plan's investment, but the entity later becomes a Plan Asset Entity, the required disclosures must be made as soon as practicable thereafter, but not later than 30 days from the date the covered service provider knows such investment contract, product or entity has become a Plan Asset Entity. In addition, with respect to any designated investment alternative disclosure required for recordkeeping or brokerage services to participant-directed individual account plans, if the designative investment alternative is not available at the time the contract or arrangement is entered into, disclosure must be made as soon as practicable, but not later than the date the investment alternative is designated by the responsible plan fiduciary.

Changes. A covered service provider must disclose a change to any information previously disclosed as soon as practicable, but not later than 60 days from the date on which the covered service provider is informed of the change. If such disclosure is precluded due to extraordinary circumstances beyond the covered service provider's control, then disclosure must be made as soon as practicable.

Additional Requested Disclosures. As stated above, the covered service provider must furnish, upon the request of the responsible plan fiduciary or the administrator of the covered plan, any other information relating to the compensation received in connection with the contract or arrangement that is required for the covered plan to comply with the reporting and disclosure requirements of ERISA. Such information must be disclosed not later than 30 days following receipt of the written request therefore. If disclosure is precluded due to extraordinary circumstances beyond the covered service provider's control, then disclosure must be made as soon as practicable.

Relief for Disclosure Errors

The DOL provided relief for inadvertent disclosure errors, stating that a contract or arrangement will not fail to be "reasonable" solely because the covered service provider makes an error or omission in disclosing the requisite information; provided, that, the covered service provider (i) was acting in good faith and with reasonable diligence, and (ii) discloses the correct information as soon as practicable, and in no event later than 30 days from the date it knows of such error or omission. This relief applies to both the responsible plan fiduciary and the covered service provider.

Class Exemption for the Responsible Plan Fiduciary

The DOL has also provided relief in the form of a prohibited transaction class exemption for the responsible plan fiduciary from the prohibited transaction rules under Section 406(a)(1)(C) and (D) of ERISA where a covered service provider has failed to make the requisite disclosures and the conditions for relief are met. This relief only applies to the responsible plan fiduciary and not the covered service provider. The conditions for relief are as follows:

- The responsible plan fiduciary did not know of the failure and reasonably believed the required disclosures were made;

- Upon discovering the failure, the responsible plan fiduciary requests in writing that the covered service provider furnish such information; and
- If the covered service provider fails to comply with such written request within 90 days, the responsible plan fiduciary must notify the DOL of such failure. The notice must be filed with the DOL not later than 30 days following the earlier of the covered service provider's refusal to furnish such information or the end of such 90-day period. The notice to the DOL must include, among other things, a description of the services that the covered service provider provided to the plan, a description of the information that the covered service provider failed to disclose, and a statement as to whether the covered service provider continues to provide services to the plan.[4]

Following discovery of a failure to disclose the requisite information, the responsible plan fiduciary must determine whether to terminate or continue the contract or arrangement based on the nature of the failure, the availability, qualifications and cost of replacement service providers, and the covered service provider's response to notification of the failure.

Preemption of State Law

The DOL made clear that nothing in the Interim Final Regulations should be construed to supersede any provision of state law that governs disclosures by parties that provide the services described in the regulations, except to the extent that such law prevents the application of a requirement of the Interim Final Regulations.

Termination of Contract or Arrangement

The Interim Final Regulations also continue the existing rule (without revision) that no contract or arrangement is "reasonable" if it does not permit termination by the plan without penalty to the plan on reasonably short notice under the circumstances to prevent the plan from becoming locked into an arrangement that has become disadvantageous. Other than a change to where such language is located within the regulations, such rule has not been revised.

Conclusion

Although the Interim Final Regulations will not become effective until July 16, 2011, plan fiduciaries and covered service providers should consider establishing and implementing their compliance plan of attack sooner rather than later. If you have any questions regarding the Interim Final Regulations or this client alert, please feel free to contact any of the lawyers listed in this alert.

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[1] The full text of the Interim Final Regulations can be found on the DOL's website at http://www.dol.gov/federalregister/HtmlDisplay.aspx?DocId=24028&AgencyId=8&D .

[2] A violation of such prohibited transaction rules could result in a breach of fiduciary duty under ERISA and the imposition of excise taxes under the U.S. Internal Revenue Code of 1986, as amended (the "Code"), adversely affecting both the applicable plan fiduciary and the service provider.

[3] Section 4975 of the Code contains prohibited transaction rules and exemptions similar to those provided under Sections 406 and 408 of ERISA. The Interim Final Regulations provide that all references to Section 408(b)(2) of ERISA and the regulations thereunder should be read to include reference to the parallel provisions of the Code and the regulations thereunder.

[4] The DOL has provided a model notice that the responsible plan fiduciary may use to notify the DOL of the failure, a copy of which can be found on the DOL's website at http://www.dol.gov/ebsa/DelinquentServiceProviderDisclosureNotice.doc.

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