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BENEFITS BRIEF

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The Department of Labor Fee Transparency Initiatives: Part 2 - Mandatory Service Provider Fee Disclosures - Updated

For a number of years, the Department of Labor has been concerned about the amount of fees and expenses charged to tax-deferred retirement plans and the transparency of fee and expense information available to plan fiduciaries and plan participants to assess their reasonableness and effect on investment return. In response, the Department commenced three separate initiatives to improve the transparency of fee and expense information. In this *Benefits Brief*, we will provide a general overview of the second of those initiatives--regulations requiring service providers to defined benefit plans and defined contribution plans (like profit sharing and 401(k) plans) to provide detailed fee and expense information to the plan's fiduciaries.[1]

This *Benefits Brief* is a complete update of our July 2011 *Benefits Brief* on this subject to reflect final Department of Labor regulations issued in February, 2012.

Background and Overview

At the outset, the Department of Labor had to overcome a very real impediment to mandating fee and expense disclosure by brokers, investment advisors, recordkeepers and other parties providing service to a plan -- it had a no statutory authority over those service providers. Its solution was to do so indirectly via the prohibited transaction rules. Those rules generally subject all non-exempt transactions between a plan and certain parties with a close relationship to the plan (e.g., the plan sponsor, officers, directors and key owners of the plan sponsor, and service providers) to an excise tax. Among the numerous exemptions from those rules is one for "reasonable" arrangements for services necessary for the establishment or administration of the plan. Under the DOL's regulations, an arrangement with a service provider will no longer be considered to be "reasonable" unless the specified disclosures are made.

Simply stated, the regulations provide that a contract or arrangement for services between a "covered plan" and a "covered service provider," including extensions or renewals, will not be considered reasonable (and thereby qualify under the exemption to the prohibited transaction rules) unless the covered service provider provides a written summary to the "responsible plan fiduciary"[2]

[1] Department of Labor Reg. § 2550.408b-2. The first of those initiatives mandated additional disclosures on the Form 5500 (the annual informational return filed with the Department of Labor) for retirement plans with more than 100 participants and was first effective for Forms 5500 filed for the 2009 plan year. The last of those projects mandates the investment and fee and expense information that must be provided by plan administrators to participants in participant-directed retirement plans. The participant fee disclosure regulations were issued in October, 2010, but the initial disclosures are not required before August 30, 2012 for most plans. A discussion of the participant fee disclosure regulations will be the subject of a separate *Benefits Brief*.

[2] The responsible plan fiduciary is the party authorized under the plan to enter into, or to renew or extend, a contract with a covered service provider.

of the services to be provided, the "compensation" reasonably expected to be received in connection with the plan, and, where required, the additional special disclosures. These disclosures are required for most plans beginning July 1, 2012.

Covered Plans

A "covered plan" for purposes of these rules is a pension plan within the meaning of the labor code provisions of the Employee Retirement Income Security Act of 1974 (or "ERISA"). For the most part that definition includes defined benefit and defined contribution plans (i.e., 401(k), profit sharing, money purchase pension and employee stock ownership plans) of private employers and Section 403(b) tax sheltered annuities and profit sharing and 401(k) plans of tax-exempt employers; excluded are primarily governmental plans; plans of churches which have not elected to be covered by ERISA; individual retirement accounts and annuities, including simplified employee pensions (or SEPs) and "SIMPLE" IRAs; certain pre-2009 Section 403(b) annuity contracts to which the employer has not contributed since January 1, 2009; and plans covering only a sole business owner, a sole business owner and his or her spouse, a self-employed individual, or self-employed individuals and their spouses.[3]

The Department of Labor specifically rejected suggestions that plans below a certain level of participants or plan assets be exempted from these requirements. Instead, so long as the services are provided by a person or entity who is a "covered service provider," the disclosures must be made.

Covered Service Providers

A "covered service provider" is a service provider that enters into a contract with a covered plan and reasonably expects $1,000 or more in compensation, direct or indirect, to be received in connection with providing one or more specified services, whether the services will be performed or the compensation received by the covered service provider, an affiliate or a subcontractor of the covered service provider. The $1,000 threshold is to be measured by reference to the services provided under the agreement without regard to the amount to be received within a particular year or during the stated term (so, for example, it would include trailing commissions paid after the term of the agreement). Note that the required disclosures only apply to services paid from plan assets, not with respect to any services which are paid by the plan sponsor.

The specified services to be considered a covered service provider are:

Fiduciary or *Registered Investment Adviser Services*: These services include: (1) services provided directly to the plan as a fiduciary under ERISA; (2) services as a fiduciary to an investment contract, product or entity that holds plan assets and in which the plan has a direct equity interest; or (3) services provided directly to a covered plan as an investment adviser subject to regulation under federal or state law. Examples of this second category include investment managers of collective investment trusts in which plan assets are invested and managers of non-publicly traded, non-mutual fund investments in which "benefit plan investors" own 25% or more of the fund by value.

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[3] Although the regulations do not apply to certain types of plans, the provision of these disclosures may become the de facto standard for determining whether a fiduciary has properly discharged his or her fiduciary duties. Accordingly, fiduciaries of exempted plans should consider the desirability of requiring these disclosures in their contracts with plan service providers.

Certain Recordkeeping or Brokerage Services: Recordkeeping or brokerage services provided to an individual account plan that permits participant investment direction if one or more designated investment alternatives (i.e., a core line up of funds) will be made available (e.g., through a platform) in connection with the recordkeeping or brokerage services.

Other Services for Indirect Compensation: Accounting, auditing, actuarial, appraisal, banking, consulting (i.e., related to development or implementation of investment policies, or the selection or monitoring of service providers or plan investments), custodial, insurance, investment advisory services for the plan or participants (including services by broker-dealers, even if the broker-dealer not considered a fiduciary), legal, recordkeeping, securities or investment brokerage, third party administration or valuation services provided to the covered plan, for which the service provider, an affiliate, or a subcontractor reasonably expects to receive indirect compensation or compensation from related parties.

Required Disclosures

The covered service provider must provide the following information in writing to the responsible plan fiduciary:

Services: A description of the services to be provided to the covered plan, including services to be provided by any affiliate or subcontractor of the covered service provider.

Status: If applicable, a statement that the service provider, an affiliate, or a subcontractor will provide or reasonably expects to provide fiduciary services (as described above) pursuant to the contract.

Compensation: A description of all direct and indirect compensation to be received, compensation paid among related parties, and contract termination compensation. For this purpose, compensation means anything of monetary value but excludes non-monetary compensation valued at $250 or less, in the aggregate, during the term of the contract.

As the name connotes, direct compensation refers to amounts received directly from the covered plan or paid by the plan sponsor and reimbursed by the plan. Indirect compensation means compensation from any source other than the plan, the plan sponsor, the covered service provider, an affiliate or, for amounts unrelated to the purpose of the subcontract, a subcontractor, such as amounts paid by a mutual fund in which the plan is invested (e.g., 12b-1 fees). The description of indirect compensation must identify the services for which the compensation will be received, the payer of that compensation, and describe the relationship between the payer of the indirect compensation and, as applicable, the covered service provider, affiliate, or subcontractor.[4] Special provisions for indirect compensation reporting are also added in the case of brokerage windows and similar arrangements (e.g., when the broker-dealer cannot identify the payer in advance).

Compensation paid among the covered service provider and an affiliate or subcontractor must be described if it is set on a transaction basis (e.g., commissions, soft dollars, finder's fees or similar incentive compensation based on the amount of business placed or retained) or is charged directly against the plan's investment and reflected in the net value of the investment (e.g., 12b-1 fees). It must identify both the services for which the compensation will be paid and the payer(s)

[4] The description of the relationship between the parties is intended to further assist the responsible plan fiduciary in identifying potential conflicts of interest arising from the receipt of indirect compensation.

and recipient(s), including the status of a payer or recipient as an affiliate or subcontractor. The greatest impact of the indirect compensation disclosure will likely be on bundled providers (i.e., a single provider or related providers that provide the investment funds and handle the recordkeeping, participant communications, and reporting and disclosure obligations).

Compensation reasonably expected to be received upon termination of the contract must also be described, including how any prepaid amounts will be calculated and refunded upon termination. The greatest impact of this disclosure will be on insurance companies that issue group annuity contracts with surrender charges.

Compensation may be expressed as a monetary amount, formula or percentage of assets, or a per capita charge, or, if it cannot be reasonably expressed in those terms, in any other reasonable manner. The use of reasonable estimates or a range of amounts (e.g., a range of basis points) is also permitted if greater precision is not readily available. Any description or estimate must contain sufficient information to permit an evaluation of its reasonableness, including the methodologies utilized to determine the estimate or range.

Manner of Receipt: A description of the manner in which the compensation will be received -- whether the plan will be billed or the compensation deducted from the plan's account or investments.

Special Rules for Recordkeeping Services: If recordkeeping services are to be provided to the plan, the description must include a description of all direct or indirect compensation that the covered service provider, an affiliate or subcontractor reasonably expects to receive. If the service provider expects that recordkeeping services will be provided (even in part) without explicit compensation, or when compensation for recordkeeping services is offset or rebated based on other compensation received, the disclosure must include a reasonable good faith estimate of the cost of the recordkeeping services, including an explanation of the methodology and assumptions used to prepare the estimate and a detailed explanation of the recordkeeping services to be provided. In other words, the covered service provider must disclose what the service provider would charge for similar services for which it received no indirect compensation and no proprietary investment funds were utilized.

Special Rules for Investment Fiduciaries, Recordkeepers and Brokers: If fiduciary services will be provided to the plan, the fiduciary to an investment contract, product, or entity that holds plan assets and in which the plan has a direct equity interest must provide the following information: (1) a description of any compensation that will be charged directly against the amount invested in connection with the acquisition, sale, transfer of, or withdrawal from the contract, product, or entity (e.g., sales loads and charges, redemption fees, surrender charges, and exchange and purchase fees); (2) a description of the annual operating expenses (e.g., expense ratio) if the rate of return is not fixed; and (3) a description of any ongoing expenses in addition to annual operating expenses (e.g., wrap fees and mortality and expense charges). The final regulations coordinate these rules with the rules on required participant disclosures (in participant-directed plans) -- so the service provider description of fees and expenses can be used in the participant-level disclosures where applicable. Similar disclosure rules apply to recordkeepers and brokers who are considered covered service providers because they provide designated investment alternatives with respect to the plan, although coordination rules are in place to avoid duplicate disclosure obligations. Similar disclosure rules apply to recordkeepers and brokers who are considered covered service providers because they provide designated investment alternatives with respect to the plan, although coordination rules are in place to avoid duplicate disclosure obligations.

Investment Information: Covered service providers which (1) are fiduciaries to an investment contract, product or entity that holds plan assets and in which a plan has a direct equity interest or (2) which are recordkeepers or broker-dealers which offer designated investment alternatives[5] are required to provide investment information with respect to the designated alternatives. Specifically, all information relating to the designated investment alternatives reasonably available to or within the control of the covered service provider must be provided if the plan administrator is required to disclose that information to participants under the participant-level disclosure rules, including the name and type of investment, performance data, benchmarks, and information included on the required website. To satisfy these obligations, the covered service provider in many instances may rely upon information provided by the designated investment alternative issuer. If the covered service provider "passes through" information from the designated investment alternative issuer and is therefore only serving as an intermediary, the covered service provider is not responsible for the completeness or accuracy of the information provided a statement to that effect is provided to the responsible plan fiduciary (e.g., in the service agreement itself). The provision of this information is intended simply to assist the plan administrator, who still retains the responsibility for making the participant-level disclosures (if applicable).

Self-Directed Brokerage Accounts: Although these arrangements are not considered designated investment alternatives, covered service providers must still disclose the services to be provided to electing participants, the applicable fees and expenses to be charged to the account, and any indirect compensation to be received in relation to the account.

Format, Timing and Special Rules

All required disclosures must be made in writing. At this date, no particular format is mandated for these disclosures, and service providers may utilize multiple documents to satisfy their obligations.[6] It will be incumbent upon the responsible plan fiduciary to determine whether sufficient information has been provided and to seek clarification from the covered service provider or a third party as prudent under the circumstances.

The disclosures can be provided by use of electronic technologies, although provision through a secure website will not be adequate unless the responsible plan fiduciary is provided clear notification on how to access the website.

The covered service provider must make the required disclosure reasonably in advance of the date the contract or arrangement is entered into, extended or renewed, subject to limited exceptions. If there are changes in the information, the covered service provider must provide updated disclosures as soon as practicable but not more than sixty days from the date the service provider is informed of the change, although only annual reporting is required with respect to investment fund information by certain covered service providers.

Special rules apply to protect against unintentional errors or omissions. As a general rule, a violation will not be deemed to occur if the covered service provider, acting in good faith, makes an

[5] For this purpose, a designated investment alternative includes a group of funds made available for participant investment direction and probably includes asset allocation models as well.

[6] The Department of Labor regulations do not require that the covered service provider include a "road map" or guide to the disclosures for fiduciaries to locate the required information when multiple or complex documents are utilized to satisfy the disclosure requirements. The DOL is, however, commencing a proposed rulemaking project to determine whether such a requirement should be imposed. They have somewhat tipped their hand here as the regulations include a "sample" that covered service providers are encouraged to consider using.

error or omission in disclosing the required information, provided the correct information is provided to the responsible plan fiduciary as soon as practicable but not later than thirty days after the date the covered service provider knows of the error of omission.

Aside from these disclosures, a covered service provider must also provide to the responsible plan fiduciary or plan administrator the information required for the plan to comply with the reporting and disclosure obligations under ERISA (e.g., the information required to be reported on the Form 5500). This information must generally be provided reasonably in advance of the date on which the fiduciary indicates that it must comply with the particular reporting or disclosure obligation.

Consequences of Failure to Provide Disclosures

A failure to provide the required disclosures will constitute a prohibited transaction for which the covered service provider will be responsible for the applicable excise tax until it is "corrected." This excise tax is self assessing and is not subject to the discretion of the Internal Revenue Service. The burden of proof in establishing that these disclosures are made falls on the covered service provider, not the IRS.

A fiduciary of a plan for which the required disclosures are not provided may be considered to have breached his or her fiduciary duties and could be personally liable for any losses resulting to the plan (for example, if fees were determined to be excessive). The fiduciary could also be responsible for a breach of fiduciary duty penalty assessed by the Department of Labor.

Special rules apply to protect plan fiduciaries who act reasonably but to whom the required disclosures are not provided but who reasonably believed that they were. Among other requirements for this relief, the fiduciary must make written requests on the covered service provider and notify the Department of Labor of the failure. It will also be incumbent on the fiduciary to determine whether termination of the contract is appropriate in light of the failure to provide the required information within 90 days of the written request. If the requested information relates to future services and is not provided within 90 days of the request, then the agreement must be terminated as expeditiously as possible, consistent with the duty of prudence.

Suggested Plan Fiduciary Actions

The responsible plan fiduciary should identify the covered service providers, if any, who are providing services to its plan and may be covered by these regulations. Because the deadline is now upon us, the plan fiduciaries should discuss the required disclosures with those service providers at this time and obtain appropriate assurances that the service providers will timely comply.

Plan fiduciaries will also need to develop procedures to track, review and evaluate required disclosures to ensure that the requirements of the regulations have been satisfied. All such due diligence should be contemporaneously documented by the plan fiduciaries in writing. Plan fiduciaries who simply file the disclosures received without any review or analysis will do so at their peril.

Plan fiduciaries who have not recently undertaken a recent review of their plan, including a review of fees and expenses, should do so at this time.

Finally, although not legally required under these regulations, plan fiduciaries should consider the prudency of requiring a written agreement with each service provider. Among the benefits should be a clear delineation of responsibilities between the plan sponsor or fiduciary and the service provider, thereby minimizing the risk of errors or omissions, or at the very least, misunderstandings.

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