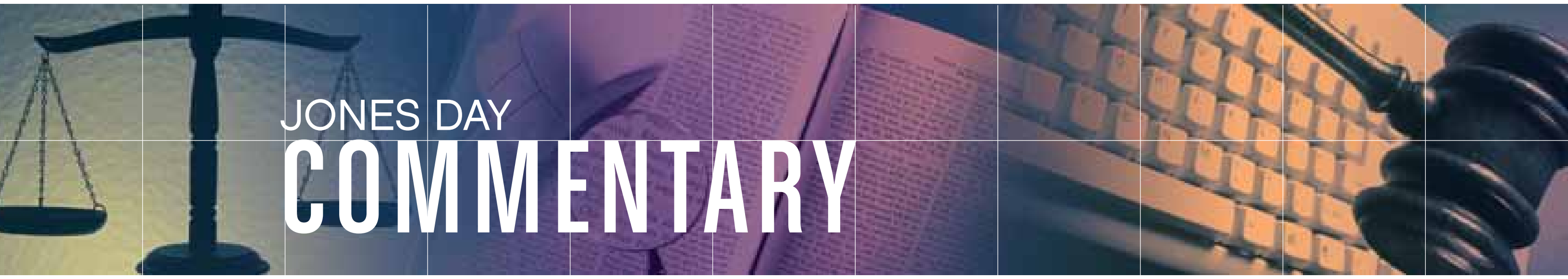
AUGUST 2010



FEE DISCLOSURE REGULATION: DEPARTMENT OF LABOR PROVIDES LEVERAGE FOR PLAN SPONSORS

On July 16, the Department of Labor published regulations outlining required disclosures by certain service providers in connection with services provided to retirement plans (the "Regulation").[1] The Regulation will become effective on July 16, 2011, and will apply to all covered service contracts or arrangements, even those that were entered into before the regulatory effective date. This *Commentary* outlines the key elements of the Regulation, briefly summarizes related Form 5500 reporting requirements, and discusses the potential impact of the Regulation on plan fiduciaries and covered service providers.

1 The Regulation is issued under section 408(b)(2) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") and amends DOL Reg. § 2550.408b-2(c). It is subject to a 45-day comment period ending August 30, 2010, and the Department may determine to make additional changes in response to public comments. Employee pension benefit plans and welfare plans are treated separately under the Regulation. Guidance concerning welfare plan disclosure requirements are reserved until a future, undetermined date. Contracts or agreements falling outside the scope of the Regulation must nevertheless be reasonable within the meaning of ERISA § 404(a).

BACKGROUND

For more than a decade, there has been increased emphasis on better disclosure regarding the fees and expenses incurred in connection with plan administration and investment advice, especially in the area of bundled 401(k) services.[2] The Department of Labor has been concerned that many plan fiduciaries have been poorly informed about the amount of direct and indirect fees being paid to service providers, a problem that is exacerbated by the opaque nature of many indirect fees and bundled service arrangements. The Department concluded that the most effective method for addressing the problem was to require increased disclosure by service

2 *See, e.g.*, the DOL publication *A Look at 401(k) Plan Fees,* and the related report *entitled Study of 401(k) Plan Fees and Expenses*, first published on July 1, 1998 (available at www.dol.gov/ebsa).

providers to plan fiduciaries, so the fiduciaries can make better decisions.

The problem is, ERISA's reporting and disclosure requirements generally do not reach service providers. Unable to directly impose disclosure obligations not supported by the statute, the Department was required to look for some other means for gaining the necessary leverage over service providers. The solution came in the form of the prohibited transaction rules.

ERISA generally prohibits the furnishing of goods, services, or facilities between a plan and a party in interest to the plan under a service arrangement. Without some type of relief, an ongoing service relationship between a plan and a service provider would involve payments to a party in interest and result in a prohibited transaction. Since enactment in 1974, Section 408(b)(2) of ERISA has provided relief from the prohibited transaction restrictions for service contracts or arrangements if the contract or arrangement is reasonable, the services are necessary for the establishment or operation of the plan, and no more than reasonable compensation is paid.

The Regulation generally provides that no contract or arrangement for plan services, nor any extension or renewal thereof, will be "reasonable" within the meaning of ERISA § 408(b)(2) unless the service provider discloses specified information. Regardless of whether the amount of the compensation paid under the contract is reasonable, failure to follow the new disclosure requirements will constitute a *per se* prohibited transaction, and the service provider will be subject to excise taxes and obligations to rescind the transaction. Moreover, plan fiduciaries have a duty to avoid engaging in prohibited transactions, and thus will have an incentive to require compliance by service providers.

SUMMARY OF THE REGULATION

Application. The Regulation applies to contracts or arrangements between a "covered plan" and a "covered service provider." A "covered plan" includes both defined benefit and defined contribution retirement income plans. Governmental plans, simplified employee pensions, simple retirement accounts, individual retirement accounts, and individual retirement annuities are not covered plans. A "covered service provider" must *expect* to earn $1,000 or more in direct or indirect compensation from a covered plan. The term refers only to the party directly responsible to the covered plan, even though some or all of the services may be performed by its affiliates or subcontractors. The following categories are "covered service providers" under the Regulation:

- ERISA fiduciaries providing services directly to a covered plan.
- Federal or state law registered investment advisers providing services directly to a covered plan.
- ERISA fiduciaries to "initial-level" investment vehicles that *hold plan assets* in which a covered plan makes a direct equity investment (but not to the underlying "down-level" investments held by the "plan assets" vehicles).
- Recordkeepers and brokers who make investments available via a platform or similar mechanism to participant-directed individual account plans (including investments added to the platform at the request of an independent plan fiduciary).
- Providers of specified services (*e.g.*, auditing, actuarial, legal, recordkeeping, investment advisory (whether or not registered), and brokerage services) who *expect* to receive indirect compensation or certain types of payments from related parties.

A service provider that provides nonfiduciary, administrative, or other services to an investment vehicle is not a covered service provider, even if the investment vehicle holds plan assets. For example, a recordkeeper that provides recordkeeping services to a collective investment fund, but does not perform services for a plan that invests in the fund, is not subject to the regulatory requirements. However, if the recordkeeper performs services for both the fund and the plan that invests in the fund, it is a covered service provider solely by reason of its relationship to the plan. If an investment vehicle does not hold plan assets (*e.g.*, a mutual fund, or investment funds that qualify as a "venture capital operating company" or "real estate operating company" under the Department's plan assets regulations), the disclosure rules generally do not apply. For example, an investment adviser to a mutual fund offered as an investment option under a covered plan is not required to make the required disclosures. However, if such adviser or its affiliates or subcontractors provide other services to the plan, the adviser's fees may be required to be disclosed as indirect compensation.

Disclosure Requirements. The Regulation requires no formal written contract or arrangement, and although the disclosures must be in writing, no particular manner or format is prescribed at this time. Different documents from separate sources may be used as long as they collectively contain all of the required information. Unlike the prior proposal, *all* services are not required to be disclosed. The amount of detail required in the disclosure will vary depending on the needs of the responsible plan fiduciary. Unlike the prior proposed regulations, a specific narrative conflict of interest disclosure is not required. Specific disclosure is required, however, in circumstances where a covered service provider will or *reasonably expects* to provide services as a fiduciary or registered investment adviser directly to a covered plan or an investment vehicle in which a covered plan has a direct equity investment.

The following types of compensation must be disclosed:

- Direct compensation (*i.e.*, compensation from the covered plan).
- Indirect compensation (*i.e.*, compensation received from any source other than the covered plan, the plan sponsor, the covered service provider, an affiliate, or a subcontractor).
- Certain transaction-based compensation (*e.g.*, commissions, soft dollars, finders fees) or direct charges against the plan's investment (*e.g.*, 12b-1 fees) paid *among* the covered service provider, affiliate, or subcontractor (*i.e.*, no breakdown of fees paid to specific recipients is required).
- Compensation expected to be received in connection with termination of the contract or arrangement.
- All direct and indirect compensation *reasonably expected* to be received in connection with recordkeeping services, with special rules for situations where recordkeeping services are *reasonably expected* to be provided without explicit compensation or will be offset or rebated based on other compensation.

Compensation may be expressed as a dollar fee, formula, percentage of covered plan assets, per capita charge, or any other reasonable method. Except for recordkeeping services, compensation may be reported in the aggregate or by service.

With respect to a covered plan's investment options, a covered service provider must disclose fee information (*e.g.*, sales loads and charges, redemption fees, exchange fees, expense ratios) regarding each of the designated investment alternatives for which it provides fiduciary, recordkeeping, or brokerage services.

Timing. Disclosures must be provided *reasonably in advance* of the date any service contract or arrangement is entered into, extended, or renewed. However, where a covered plan invests in an investment vehicle that does not hold plan assets but later acquires plan assets, the required disclosures must be made not later than 30 days after the date the service provider knows that the investment vehicle holds plan assets. For investment vehicles not designated at the time of the contract or arrangement, the disclosures are required as soon as practicable but not later than the date the plan fiduciary designates the investment alternative for the covered plan. Unless precluded by extraordinary circumstances, changes to disclosures must be made as soon as practicable but not later than 60 days from the date the covered service provider learns of any such change.

Disclosure Errors. No contract or arrangement will fail to be reasonable solely because the covered service provider makes an error or omission in disclosing the required information, provided the service provider acts in good faith and with reasonable diligence and discloses the correct information as soon as practicable but not later than 30 days from the date the error or omission is discovered.

Class Exemption. A class exemption is set forth in the Regulation to provide relief to responsible plan fiduciaries for failures by a covered service provider to comply with its disclosure obligations, provided the fiduciary did not know about the failure and reasonably believed the required disclosures were made; requests additional information upon discovery of the failure; timely notifies the Department of any continuing failure; and analyzes whether to continue or terminate the contract in light of the failure.

RELATED FORM 5500 REQUIREMENTS

Effective for plan years beginning after December 31, 2008, the Department has revised Schedule C to Form 5500, which reports fees paid by plans for services. The revisions broadened the definition of "service providers" whose compensation must be disclosed and requires reporting of direct compensation and, for the first time, *indirect* compensation paid to service providers. A plan sponsor should discuss these requirements with its Form 5500 preparer and, as necessary, its legal counsel.

IMPACT OF THE REGULATION

Plan Fiduciaries. A fiduciary must decide whether it has enough information to determine reasonableness of the costs associated with services. In addition, the plan fiduciary's general fiduciary obligation to make prudent and diligent decisions is independent of the new Regulation. Thus, the fact that a service provider makes all the required disclosures under the Regulation does not relieve the plan fiduciary from its general fiduciary duties or ensure that entering into the service contract would be consistent with those duties. To fulfill its responsibilities, a fiduciary should (i) understand the type of information that is necessary to determine the reasonableness of any fees; (ii) review all disclosures thoroughly to determine what, if any, further information it needs; (iii) keep a record evidencing its due diligence with respect to the selection and monitoring of service providers and fees; and (iv) report any service provider failure to the Department in accordance with the Regulation's class exemption, discussed above.

Service Providers. Under the Regulation, a covered service provider must act in good faith and with reasonable diligence to prepare its disclosures. The process will involve assessing the needs of a plan fiduciary to determine what disclosures are necessary and making timely disclosures. Since the plan fiduciary is charged with requesting any additional, necessary disclosure information, the covered service provider also must respond promptly to a fiduciary's request for additional information. (The Department declined to limit fiduciary requests to "reasonable" requests, taking the position that the scope of the Regulation would suitably limit the scope of such requests.) Errors in disclosure information also must be corrected in a timely manner, and any failure to provide the required disclosures is reportable by the plan fiduciary under the class exemption included in the Regulation. Thus, despite the Department's efforts to clarify the identities of the covered service providers and streamline certain disclosure requirements, compliance is anticipated to be labor intensive and costly, at least in the initial stages of implementation.

CONCLUSION

The Regulation thus shifts the balance of power between the plan fiduciary who is charged with understanding fees that its plans will pay and the service providers that generate those fees. Although a plan fiduciary retains responsibility if it uses plan assets to pay unreasonable fees, the Regulation enhances the fiduciary's ability to obtain the information it needs to determine reasonableness.

LAWYER CONTACTS

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