FEBRUARY 2012

JONES DAY

COMMENTARY

FINAL FEE DISCLOSURE REGULATION: ADDITIONAL HURDLES FOR SERVICE PROVIDERS AND PLAN FIDUCIARIES

On February 2, 2012, the Department of Labor ("DOL") released the much-anticipated final regulation on service provider fee disclosures. Although the DOL had issued an interim final regulation in July 2010 (*see* "Fee Disclosure Regulation: Department of Labor Provides Leverage for Plan Sponsors" *Jones Day Commentary*, August 2010), at that time the DOL also requested additional public comments, leading to the inference among practitioners that it might make additional significant changes. This, in turn, led to reluctance of service providers to prepare for the impending effective date of the regulation because of uncertainty over the potential changes to the regulation's July 2010 version. The February 2012 final regulation contains relatively few changes of any significance. In this *Commentary*, we summarize the provisions of the final regulation, as well as highlight changes made subsequent to the July 2010 interim regulation.

The DOL has been working on an initiative for several years to enhance fee disclosures at various levels, including requiring more disclosure through the Form 5500, and requiring additional disclosures to participants in certain plans. The latest regulation addresses disclosures by service providers to plan fiduciaries. It resolves the longstanding problem that the DOL faced in reaching service providers in its enforcement efforts. Now, by using ERISA's prohibited transaction provisions and statutory exemptions, the DOL can more easily reach service providers. Essentially, if a service provider does not comply with the details of the new regulation, it cannot meet the exemption requirements of ERISA § 408(b)(2), which exempts certain contracts and arrangements from ERISA's prohibited transaction rules if the contract or arrangement is reasonable, the services provided are necessary, and no more than reasonable compensation is paid.

© 2012 Jones Day. All rights reserved. Printed in the U.S.A.

If a service provider fails to comply with the regulation, it will be subject to an excise tax under the Internal Revenue Code and will likely be forced to rescind the transaction, which for practical purposes would entail refunding to the plan the amount paid for the services provided. The regulation also provides a reporting process a responsible plan fiduciary must follow if a service provider fails to provide the required information. This process could potentially involve the responsible plan fiduciary terminating its relationship with the service provider, which comes with its own set of challenges.

SUMMARY OF THE REGULATION

Entities Covered by the Regulation. The regulation applies to contracts or arrangements between a "covered plan" and a "covered service provider." The relationship between the covered plan and the covered service provider need not be in the form of a written contract. A covered plan may be either a defined contribution or defined benefit pension plan. The regulation excludes from the definition of "covered plan" governmental plans, simplified employee pensions, simple retirement accounts, individual retirement accounts, and individual retirement annuities. The final regulation also changes the treatment of certain 403(b) plans, excluding them from the "covered plan" definition if certain specific conditions are met. The DOL has indicated that it is planning to issue a separate set of disclosure obligations for welfare plans at a later date.

The regulation applies to a covered service provider that expects at least $1,000 in indirect or direct compensation from a covered plan. While subcontractors or affiliates of the service provider may also provide services to a covered plan, unless these entities have a direct relationship with the plan, they need not fulfill the disclosure obligations. Any entity that performs the following services for a covered plan is considered to be a covered service provider:

- Fiduciary services provided directly to the covered plan.
- Fiduciary services to an investment contract, product, or entity that holds plan assets and in which the covered plan has a direct equity investment.
- Investment adviser services.
- Recordkeeping services to participant-directed individual account plans where the services also include access to one or more designated investment alternatives.
- Accounting, auditing, actuarial, consulting, legal, banking, and other services for which the covered service provider, an affiliate, or subcontractor expects to receive indirect compensation.

DISCLOSURE REQUIREMENTS

The final regulation included several changes to the various disclosure requirements. The DOL enhanced the disclosure of indirect compensation, added certain requirements for investment-related disclosure, and made some minor changes to the timing of disclosures. In addition, the final regulation includes a "Sample Guide" that may serve as summary or index of where certain key disclosures can be located in the documents provided to plan fiduciaries. While the "Sample Guide" is neither required at this time nor serves as a safe harbor, the DOL has indicated that it intends to propose further regulations on this issue and that it supports this type of "best practice."

The contract or arrangement between the covered service provider and the plan need not be in writing; however, the disclosures by the covered service provider to the responsible plan fiduciary must be in writing, although some of the information may be transmitted electronically. The Sample Guide suggests that required disclosures may be provided in a format that cross-references other documents, such as specific provisions in a written contract or a web site with fee information for a certain investment option. As noted above, however, the format of the Sample Guide is not required at this time.

The disclosures fall into several categories: general disclosures; compensation-related disclosures; recordkeeping disclosures; and investment-related disclosures.

General Disclosures. A covered service provider must disclose:

- A description of the services provided.
- If applicable, a statement that the covered service provider expects to provide fiduciary or investment adviser services.

Compensation-Related Disclosures. A covered service provider must disclose:

- A description of all direct compensation. The description may include all direct compensation in the aggregate or by service. It may be in the form of an amount, a formula, a percentage of assets, or a per-participant charge. If the service provider cannot provide the description of compensation in any of these forms, it may provide it by any other reasonable method. Unlike prior versions of the regulation, the final regulation allows the description to include a reasonable good faith estimate, as long as the assumptions and methodology that went into the estimate are included.
- A description of all indirect compensation. Indirect compensation includes compensation to the covered service provider from anyone other than the plan, the plan sponsor, or an affiliate of the covered service provider. The final rule adds a requirement that the covered service provider describe the arrangement between itself and the payer of that compensation so that the plan fiduciaries can analyze why the payer is compensating the covered service provider. The description of indirect compensation must also identify the services for which the covered service provider is receiving indirect compensation and the identity of the payer of the indirect compensation.
- A description of compensation paid among the covered service provider, an affiliate, or a subcontractor, including such things as commissions, soft dollars, and 12b-1 fees. This compensation must be described separately, even if it is already included in one of the other required disclosures. In addition, the identity of the payer and recipients, as well as the services for which the compensation is paid, must be disclosed.
- A description of any compensation that the covered service provider would receive upon termination of the contract or arrangement.
- An explanation as to whether compensation will be paid by the plan based on direct billing or whether it is deducted from the plan's accounts or investments.

Recordkeeping Disclosures. A covered service provider must disclose:

- A description of all direct and indirect compensation the service provider expects to receive for recordkeeping.
- A description of the comparable cost of any recordkeeping services for which there is no explicit compensation or for which compensation is offset or rebated by other compensation received by the service provider who is also providing recordkeeping services.

The recordkeeping disclosures listed above must be provided separately, even if they are already included in the general compensation or investment-related disclosures.

Investment-Related Disclosures. The disclosures are split between those required by a fiduciary and those required by an entity providing recordkeeping or brokerage services.

For any investment contract, product, or entity that holds plan assets and for which fiduciary services will be provided, a fiduciary must disclose:

- A description of any compensation charged directly against the investment such as commission, exchange fees, and any other fees that are not included in the annual operating expenses of the investment.
- A description of the expense ratio for any variable return vehicles and any other ongoing expenses.
- A description of the annual operating expenses for a designated investment alternative in the form of a percentage, as described in the participant disclosure regulation, as well as any other information regarding a designated investment alternative that is required by the participant disclosure regulation and is reasonably within the control of the covered service provider. This requirement was added to the final rule.

A covered service provider who provides recordkeeping and brokerage services must provide the same investment-related disclosures as a covered service provider who is a fiduciary. Based on changes to the final rules, however, the covered service provider may fulfill its disclosure obligations by referencing materials provided by the issuer of the designated investment alternative, as long as certain conditions are met.

TIMING OF DISCLOSURES

All contracts or arrangements involving covered service providers must be in compliance with the regulation by July 1, 2012. This is a change from the prior version, which had an April 1, 2012 deadline. The regulation applies not just to new contracts or arrangements but to any existing arrangements as well. The change in the effective date for service provider disclosures will affect the timing of participants' disclosures under the DOL's participant-level disclosure regulation. Because the service provider regulation is now effective July 1, 2012, the first annual disclosure to participants will be due on August 30, 2012 for a calendar-year plan (60 days after the July 1 effective date for the service provider regulation).

The final regulation incorporated modest changes to each of the time periods set forth in the regulation. Changes to investment-related information must be disclosed at least annually. Changes to the other disclosures must be made to the responsible plan fiduciary within 60 days of the date the covered service provider learns of the change. To the extent that the covered service provider realizes that it has erred in the disclosure of any information, it must correct the error within 30 days after it discovers the error. To the extent that the plan fiduciary requests in writing information from a covered service provider in order to meet its own reporting and disclosure obligations, the covered service provider must provide it reasonably in advance of the date that the plan fiduciary has indicated the information is needed.

LIMITED RELIEF FOR PLAN FIDUCIARIES

While the covered service providers have responsibility for disclosing required information under the regulation, the prohibited transaction rules apply to both fiduciaries and parties in interest, such as service providers. In order to protect plan fiduciaries who do not receive required disclosures, the regulation provides a class exemption by which plan fiduciaries may be absolved of any responsibility for inadvertently engaging in a prohibited transaction. In order to qualify for the exemption, the plan fiduciary must take several steps. The responsible plan fiduciary must not know about the failure and must have reasonably believed that appropriate disclosures were made. The responsible plan fiduciary must request the missing information upon discovery that it is missing. At that point, the covered service provider has 90 days in which to respond to the request. If the covered service provider does not respond to the request within 90 days, or if the covered service provider affirmatively refuses to provide the requested information, the plan fiduciary must notify the Department of Labor and must include a number of details set forth in the regulation. This must be done within 30 days of the earlier of the expiration of the 90-day period or the affirmative refusal by the covered service provider to provide the requested information. Once all of these steps are completed, the plan fiduciary must determine whether to continue the contract or arrangement with the covered service provider in accordance with its ERISA fiduciary obligations as set forth in ERISA § 404(a). The final rule adds a requirement to the exemption that if the contract or arrangement was for future services, and a covered service provider refuses to provide required information, the fiduciary must terminate the relationship with that service provider as soon as possible.

IMPACT OF THE REGULATION

The regulation has practical implications for both plan fiduciaries and covered service providers.

Plan Fiduciaries. The preamble to the regulation is clear that the receipt of adequate disclosures does not absolve a plan fiduciary of compliance with its ERISA fiduciary obligations. Thus, not only must the plan fiduciary ensure that it is receiving all required information from each covered service provider, it must also ensure that it understands and analyzes that information on a regular basis. While the regulation does not contain any directives to plan fiduciaries regarding the use of that information, the strong implication from the preamble is that plan fiduciaries must use this information in ensuring that their retention of all service providers complies with their fiduciary obligations. In order to protect itself from potential breach of fiduciary duty lawsuits, the plan fiduciary should make sure to document any and all analysis conducted regarding the information received from service providers. While it is not required that the arrangement or contract between a plan fiduciary and a service provider be in writing, plan fiduciaries should consider obtaining written assurances that any service provider will fulfill its disclosure obligations set forth in the final regulation. This is particularly important in light of the regulation's requirement that in order to apply for exemptive relief, the plan fiduciary must not have known that the covered service provider would fail to provide the required disclosures.

Service Providers. Covered service providers must act in good faith in fulfilling their obligations under the final regulation. A covered service provider will need to examine the details of its own relationship with affiliates and subcontractors, as well as its relationship with each plan, in order to determine its precise obligations under the rule. If a covered service provider fails to comply with its obligations, regardless of its intent, it will be held responsible for a prohibited transaction, resulting in significant excise taxes as well as a demand to rescind the transaction, which would effectively result in the service provider paying back to the plan all fees it received.

CONCLUSION

While the final regulation incorporates modest changes to the regulation issued in July 2010, the crux of the regulation remains the same. The regulation imposes additional responsibilities directly on service providers. Although it also provides some leverage to plan fiduciaries in obtaining useful fee information, it does nothing to limit the responsibility of plan fiduciaries to ensure that they are using plan assets (including those to pay fees) prudently and with the interests of plan participants foremost in mind. There is no question that initial compliance will be time-consuming and costly for service providers, but the other implications of the regulation on both service providers and plan fiduciaries remain to be seen.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Sara Pikofsky
Washington
+1.202.879.3781
spikofsky@jonesday.com

Alan S. Miller
New York / Dallas
+1.212.326.3445 / +1.214.969.4559
asmiller@jonesday.com

Evan Miller
Washington
+1.202.879.3840
emiller@jonesday.com

Steven J. Sacher
Washington
+1.202.879.5402
sjsacher@jonesday.com

Daniel C. Hagen
Cleveland
+1.216.586.7159
dchagen@jonesday.com

Michael K. Blais
Dallas
+1.214.969.4564
mkblais@jonesday.com

Jones Day publications should not be construed as legal advice on any specific facts or circumstances. The contents are intended for general information purposes only and may not be quoted or referred to in any other publication or proceeding without the prior written consent of the Firm, to be given or withheld at our discretion. To request reprint permission for any of our publications, please use our "Contact Us" form, which can be found on our web site at www.jonesday.com. The mailing of this publication is not intended to create, and receipt of it does not constitute, an attorney-client relationship. The views set forth herein are the personal views of the authors and do not necessarily reflect those of the Firm.