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August 2008

Overview of Recent Department of Labor ERISA Service Provider Fee Disclosure Initiatives

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401(k) and other plan fiduciaries are under intense scrutiny with respect to the transparency and appropriateness of service provider compensation paid by plans and their participants. This has largely resulted from a wave of lawsuits against both employers and financial institutions relating to "revenue sharing" and other fee arrangements and the adequacy of fee-related disclosures.

The U.S. Department of Labor ("**DOL**") has jumped into the fray with a three-part fee disclosure project aimed at providing fee transparency for plan participants, plan fiduciaries and the DOL, which includes: (1) just issued proposed regulations under ERISA Sections 404(a) and 404(c), requiring disclosures from plan fiduciaries to plan participants; (2) proposed regulations under ERISA Section 408(b)(2), the prohibited transaction exemption for the provision of services to ERISA-covered plans, requiring significant fee disclosure by service providers to plan fiduciaries; and (3) changes to Form 5500, Schedule C, requiring significant reporting of service provider compensation.

In order to help our clients understand and comply with this regulatory flurry of activity, we set forth "Action Items" below that highlight the steps plan fiduciaries and service providers should consider taking in light of these regulatory developments, followed by a brief overview of the proposed regulations under Sections 404(a), 404(c) and 408(b)(2) and the changes to Form 5500.

Action Items for Plan Sponsors / Named Fiduciaries

- Appoint a point person or committee to develop a strategy and timeline for complying with the three fee initiatives.
- Decide whether to use the DOL's model or a customized form of disclosure with respect to the disclosures required by proposed Section 404(a) and 404(c) regulations.
- Prepare for collection of administrative and investment fees and expense information that will be required by the regulations, once final.
- Solicit input from investment advisors and managers for performance data for underlying investments and benchmarks that will be required by the new 404 regulations, once final; and obtain advice from securities and ERISA counsel on how to address investment options that are not registered under the Investment Act of 1940.

- Take an inventory of all plan service providers.
- Contact every service provider to determine how and when the service provider will be providing the fee information required by the proposed regulation under Section 408(b)(2); collect this information from each provider and forward to the person or entity who prepares Schedule C for Form 5500.
- If written agreements with each service provider do not exist, enter into written agreements that satisfy the prohibited transaction exemption once the regulation is finalized.
- Make a list of the dates for extension or renewal of existing service provider contracts and ensure that such agreements are amended to comply with the final regulations under the 408(b)(2) prohibited transaction exemption.
- Create a standardized and comprehensive set of guidelines for procuring and contracting with plan service providers that are designed to satisfy existing and these new legal requirements, including (1) requiring service providers to provide all required disclosures to the responsible plan fiduciaries as part of the initial vendor selection and evaluation process (e.g. at the RFP stage); (2) developing standardized contract language that satisfies the prohibited transaction exemption; and (3) periodically monitoring plan service providers' performance and compensation levels and verifying that compensation arrangements continue to be reasonable.

Action Items for Plan Service Providers

- Prepare disclosures that satisfy the requirements of Form 5500 Schedule C and the proposed regulations under Section 408(b)(2).
- Disclose all direct and indirect compensation, pursuant to Section 408(b)(2).
- Furnish investment-related information disclosures in a chart or similar format that permits straightforward comparison of the plan's designated investment alternatives by participants and beneficiaries, pursuant to the proposed regulations under Sections 404(a) and Section 404(c).
- Determine whether existing disclosures can be incorporated by reference and whether arrangements should be re-structured to minimize disclosure obligation (e.g., though bundling services).
- Be prepared to explain to clients how compensation arrangements are reasonable in relationship to the services being rendered.
- Modify service agreements to comply with the proposed regulations.

I. Proposed Regulations for ERISA Sections 404(a) and 404(c)

The proposed 404(a) and 404(c) regulations govern the disclosure fiduciaries will need to make to participants to assist participant investment decision making. The disclosures are required for all participant-directed plans, not just plans seeking 404(c) protection. Disclosures generally must be made on or before the date that an employee becomes eligible to participate in a plan, and annually thereafter. The regulations are scheduled to be effective 90 days after the final regulations are published in the Federal Register.

By issuing the proposed regulations under Code Section 404(a), the DOL is stating that

failure to comply with these regulations will be a per se breach of fiduciary duty, rather than merely causing the loss of Section 404(c) protection.

Plan-Related Information

Plan fiduciaries must disclose the following plan-related information: (1) general plan information (e.g., how participants and beneficiaries may give investment instructions and the specific designated plan investment alternatives); (2) administrative expense information (e.g., annual explanation of fees and expenses and how they are allocated, quarterly statements of the dollar amounts actually charged during the preceding quarter to individual accounts and descriptions of the services to which they relate); and (3) individual expense information (e.g., disclosure of participant loan expenses and investment advice services).

Investment-Related Information

The following investment-related information must automatically be provided to each participant or beneficiary: (1) the name (and type or category) of each designated plan investment alternative; (2) an Internet website address that is sufficiently specific to lead participants and beneficiaries to supplemental information regarding the investment alternative; (3) the type of management utilized by the investment (e.g., active or passive).

In addition, for each designated investment alternative, plan fiduciaries must generally provide (1) performance data; (2) benchmarks; (3) fee and expense information; (4) the total annual operating expenses of the investment expressed as a percentage (e.g., expense ratio); and (5) a statement indicating that fees and expenses are only one of several factors that participants and beneficiaries should consider when making investment decisions. Certain additional information must be provided upon request.

The proposed regulations require calculation of average total annual return and total annual operating expenses by reference to the standards applicable to open-end management investment companies registered under the Investment Company Act of 1940 and invite suggestions for alternative definitions for investment options that are not subject to this Act.

The DOL issued a model comparative chart that would comply with the proposed 404(c) regulations, if tailored to reflect a plan's investment-related information. The DOL advises that fiduciaries are responsible for ensuring that the information contained in the disclosure statement is complete and current, but fiduciaries are not liable for reasonable and good faith reliance on certain information provided by service providers, such as performance data and fee and expense information for the investment alternatives.

II. Proposed Regulations for Section 408(b)(2)

ERISA Section 408(b)(2) provides an exemption from the prohibited transaction that otherwise would result from every arrangement between a plan and its service providers (who are deemed parties-in-interest). In order to secure this exemption, the underlying service provider contract or arrangement must be reasonable, the service must be necessary for the plan and no more than reasonable compensation may be paid. The only existing regulatory requirement for reasonableness is that the service arrangement must be terminable without penalty on short notice.

Recent trends involving service provider compensation have made it increasingly difficult for plan sponsors and fiduciaries to understand the service provider compensation actually paid by the plan and to identify potential conflicts of interest. In response, the DOL has proposed substantially more expansive Section 408(b)(2) regulations, which

specify the information fiduciaries must receive and service providers must disclose before a contract or arrangement may be considered "reasonable." The regulations are scheduled to be effective 90 days after the final regulations are published in the Federal Register.

If adopted as proposed, the ERISA prohibited transaction exemption would be available to the extent that service providers comply with the new disclosure requirements.

Under the proposed regulations, to satisfy the Section 408(b)(2) reasonableness requirement, the contract or arrangement must: (1) be in writing; (2) require the service provider to disclose all direct and indirect compensation the service provider will receive and any conflicts of interest that may arise based on its providing services to the plan; and (3) require the service provider to comply with requests for fee and compensation information from plan fiduciaries in order to fulfill the ERISA's reporting and disclosure requirements (including Form 5500).

The Required Information

The service provider must provide the plan fiduciary with a description of every service that the service provider will provide to the plan. In addition, with respect to those services, the service provider must disclose to the plan fiduciary:

- All direct and indirect compensation received by the service provider, including money, gifts, finder's fees, placement fees, commissions or other fees related to investment products;
- Any compensation the service provider's affiliates received from a third party;
- Whether the service provider will act in a fiduciary capacity;
- Whether the service provider will participate, or acquire a financial interest, in any transaction entered into by the plan;
- Whether the service provider can affect its own compensation and fees without the approval of an independent plan fiduciary; and
- Whether there are any potential conflicts of interest.

If a material change occurs that would affect these disclosures, the service provider must disclose the change to the plan fiduciaries within 30 days.

As with the Form 5500 changes discussed below, DOL's proposed regulations appear to target even asset pools that do not hold "plan assets" for purposes of ERISA, including registered mutual funds.

Bundled Service Arrangements

The DOL has also proposed that if a service provider is providing bundled services, the service provider generally must disclose only the aggregate amount of the compensation received by any party to the contract or arrangement with respect to the bundled services, rather than an individual breakdown of each part of the bundled service.

However, the DOL's proposal carves out a significant exception to this rule, requiring unbundling of (and individual disclosure of) certain service provider compensation. In particular, separate disclosure is required of (i) any compensation paid to an underlying service provider that would be reflected in the net value of the plan's investment (e.g. investment management fees) and (ii) service provider fees charged directly against the plan's investment, including finder's fees, brokerage commissions and soft dollars. The apparent result is that the majority of service providers participating in a bundled services arrangement will still be required to provide the required disclosures on an unbundled

basis, which can be complicated and could include disclosure of intra-company arrangements that may be proprietary, confusing, or both.

The Proposed Class Exemption

In conjunction with the proposed regulations, the DOL is proposing a class exemption to provide protection in the event that a plan fiduciary enters into a contract or arrangement for necessary services with a service provider (or permits such contract to be extended or renewed), but the service provider does not comply with its contractual obligation to disclose certain information. The requirements for this exemption are:

1. If a plan fiduciary does not have all the information required under the regulations, it must request the missing information in writing from the service provider.

2. The service provider then has 90 days to provide the requested information.

3. If the service provider does not timely supply the requested information, the plan fiduciary must notify the DOLwithin 30 days.

Plan fiduciaries faced with such situations will need to decide whether to terminate the service provider relationship.

III. Form 5500 Required Disclosure

Finally, the DOL has issued a final rule revising Schedule C to Form 5500, the schedule that reports fees paid by plans for services. The revisions:

- are effective for plan years beginning after December 31, 2008;

- broaden the definition of "service providers" whose compensation must be reported;

- provide for reporting of "direct compensation" paid to service providers; and

- for the first time, require reporting of "indirect compensation" received by service providers.

The revisions to Schedule C are intended to help fiduciaries satisfy their obligation to monitor and review arrangements with plan service providers (especially with respect to plan fees and expenses). If a plan fiduciary requests the necessary information from a service provider and the plan service provider fails to provide it, the plan fiduciary is required to report the name and tax identification number of the service provider and a description of the missing information.

Unlike past regulatory initiatives, in the new Schedule C, the DOL seeks to require disclosures relating to "investment funds" that do not hold plan assets for purposes of ERISA. In recently issued FAQs for its new Form 5500 rules the DOL provided further clarification on the definition of an "investment fund," by citing "mutual funds" and "collective investment funds" as examples, thus making unambiguous the DOL's view that even non-"plan asset" vehicles are swept into the new reporting rules. The DOL did clarify that compensation received in connection with the management of REOCs, VCOCs and other operating companies does not need to be reported.

The DOL's recent reporting and disclosure initiatives will necessitate an extensive evaluation by plan sponsors and service providers alike of their reporting and disclosure content and compliance systems.

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In order to provide our clients with the most up-to-date information regarding these developments, we are hosting a complimentary teleconference entitled "ERISA Plan Fee Disclosures: The Untold Story" on September 9, 2008 at 12:00 EST. You will soon receive an invitation and registration link for the teleconference.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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