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DOL Issues Interim Final Rule on ERISA Plan Service Provider Fee Disclosures

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On July 16, 2010, the Department of Labor ("DOL") published an interim final rule (the "Final Rule") clarifying the disclosures required by service providers to ERISA-covered employee benefit plans. Because of the breadth of ERISA's prohibited transaction rules, payments by an ERISA plan to a service provider are prohibited unless the exemption provided by Section 408(b)(2) of ERISA is available.[1] Section 408(b)(2) provides that the exemption is available only where, in connection with a particular contract or arrangement between an ERISA plan and a service provider: (i) such 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 services.

The Final Rule establishes new guidelines for when a particular contract or arrangement for services will be considered "reasonable" for purposes of Section 408(b)(2). Specifically, as discussed further below, in order to satisfy the requirements of the Final Rule, service providers must furnish certain disclosures to the plan fiduciary who is responsible for entering into the contract or arrangement that includes detailed information regarding the services that will be provided and the direct or indirect compensation to be received by the service provider in connection with such services. Although the Final Rule retains the basic structure of the proposed rule issued by DOL on December 13, 2007 (the "Proposed Rule"),[2] DOL revised many of the substantive provisions in the Final Rule in response to approximately 100 written comment letters that it received. Most significantly, the Final Rule includes new categories of service providers that are subject to the disclosure provisions, removes the requirement that the disclosures to be provided be specified as part of the terms of the contract or arrangement and defers application of the rules to services provided to welfare plans (as opposed to pension plans) until a later date. The Final Rule also removes the very broad and general requirements of the Proposed Rule regarding narrative disclosure of potential conflicts of interest.

Due to the detailed nature of the required disclosures and the variety of circumstances to which they apply, ERISA plan fiduciaries and service providers covered by the Final Rule are well-advised to familiarize themselves with the requirements and how they apply to their particular circumstances. The Effective Date of the Final Rule is July 16, 2011, and, at that time, disclosures will be required with respect to all pre-existing arrangements as well as any new contracts or arrangements entered into or amended or modified after that date. Key elements of the Final Regulation are summarized on the following pages.

Who Must Provide Disclosure? Service Providers Subject to the Final Rule

When the Final Rule goes into effect (discussed below), a Covered Service Provider (as defined below) that enters into, extends, or renews a contract or arrangement to provide services to the Covered Plan and reasonably expects to receive aggregate compensation of $1,000 or more, directly or indirectly, in connection with such services will be required to furnish comprehensive disclosures to the plan fiduciary who is responsible for entering into, extending, or renewing the contract or arrangement on behalf of the Covered Plan.

For purposes of the Final Rule, a "**Covered Service Provider**" includes a person or entity that provides the following services:

(i) **services as a fiduciary**, either directly to a Covered Plan (as defined below) or indirectly to one or more Covered Plans through its services in connection with an investment contract, product, or entity that holds plan assets and in which a Covered Plan has a direct equity investment, or services directly to a Covered Plan as an investment adviser registered with the Securities and Exchange Commission (the "SEC");

(ii) **recordkeeping or brokerage services** to a Covered Plan that is participant-directed and such recordkeeping or brokerage services include a platform of investment options or investment alternatives which are selected by the plan fiduciary as an investment alternative; and

(iii) **other specified services**, including, but not limited to, accounting, custodial, investment advisory, legal, and valuation services, to a Covered Plan for which the firm, an affiliate, or subcontractor reasonably expects to receive *indirect* compensation or compensation from related parties which is set on a transaction basis (e.g, commissions, soft dollars, or finder's fees) or charged directly against the Covered Plan's investment and reflected in the investment's net value (e.g., 12b-1 fees).

Only the party directly responsible to the Covered Plan for the provision of services will be required to submit the required disclosures. Therefore, affiliates or subcontractors of Covered Service Providers will not be required to furnish disclosures solely because they provide services to Covered Plans. Covered Service Providers must furnish disclosures regarding their affiliates or subcontractors if such parties expect to receive compensation of $1,000 or more or perform the services required under the contract or arrangement with the Covered Plan.

Notably, parties that provide services in connection with an investment contract, product, or entity in which a Covered Plan (e.g., a bank collective fund, insurance company account, or hedge fund or other pooled investment vehicle) invests will not be subject to the Final Rule (even if the entity holds "plan assets") unless such parties are fiduciaries. DOL noted that while some service contracts and arrangements will fall outside the scope of the disclosure requirements of the Final Rule, ERISA still requires such contracts to be reasonable in order to qualify for exemptive relief under Section 408(b)(2), and fiduciaries remain obligated to obtain and carefully consider the information necessary to assess the services provided to the plan. We note that the scope of the service providers and compensation to be disclosed pursuant to the Final Rule is not identical to the scope of coverage of compensation required to be reported for purposes of the new Schedule C to the Form 5500.

A "**Covered Plan**" is defined to include any employee benefit plan or pension plan. As mentioned above, a Covered Plan does not include a welfare benefit plan, nor does it include any governmental

plan, a church plan, a simplified employee pension, a simple retirement account, an individual retirement account, or an individual retirement annuity. DOL decided to remove welfare benefit plans from the purview of the Final Rule after being persuaded by comment letters that significant differences existed between the service and compensation arrangements of welfare benefit plans and employee benefit plans. However, DOL noted that it plans to adopt a "comprehensive disclosure framework" tailored to welfare benefit plans in the future.

What Must Be Disclosed? Description of Required Disclosures

The Final Rule defined "compensation" to include anything of monetary value (i.e., money, gifts, trips, etc.), but does not include non-monetary compensation valued at $250 or less, in the aggregate, during the term of the contract or arrangement. Direct compensation is compensation received directly from Covered Plans, while indirect compensation is compensation received from any source other than Covered Plans, plan sponsors, Covered Service Providers, an affiliate, or certain subcontractors. DOL noted that direct compensation will not include compensation received from a vehicle holding plan assets in which the Covered Plan has a direct investment.

At a minimum, Covered Service Providers must disclose the following information to plan fiduciaries responsible for entering into, extending, or renewing the contract or arrangement on behalf of the Covered Plan:

- A description of the services to be provided. DOL noted that the level of detail required will vary depending on the needs of a plan fiduciary. A plan fiduciary may request that a Covered Service Provider furnish more specific details if it finds that a description lacks sufficient detail to enable it to determine whether the compensation is reasonable.

- If applicable, a statement that the Covered Service Provider, an affiliate, or a subcontractor, reasonably expects to provide services as a fiduciary and/or as an investment adviser registered with the SEC or under any State law.

- A description of all direct compensation, *either in the aggregate or by service*, that the Covered Service Provider, an affiliate, or a subcontractor reasonably expects to receive. We note that the Final Rule permits disclosure of compensation in the aggregate, subject to certain exceptions, such that "bundled" service arrangements need not be "unbundled" for purposes of the disclosure.

- A description of all indirect compensation that the Covered Service Provider, an affiliate, or subcontractor reasonably expects to receive. The description must identify the services provided in connection with the indirect compensation and the payer of the indirect compensation.

- A description of direct and indirect compensation that will be paid among the Covered Service Provider, an affiliate, or subcontractor that is set on a transaction basis (e.g., commissions, soft dollars, or finder's fees) or charged directly against the Covered Plan's investment and reflected in the investment's net value (e.g., 12b-1 fees). The description must be provided regardless of whether the compensation was also disclosed as direct or indirect compensation. Further, the description must identify the services provided and the payers and recipients of such compensation. DOL believes disclosures concerning payments among related parties will

enable plan fiduciaries to better assess the reasonableness of the compensation and the existence of actual or potential conflicts of interests that may impact the quality of services.

- 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 upon termination.

- If the Covered Service Provider will provide recordkeeping services, then it must make the following disclosures:

    - A description of all direct and indirect compensation that the Covered Service Provider, an affiliate, or subcontractor reasonably expects to receive in connection with such recordkeeping services; and

    - If the compensation for recordkeeping services is not explicit or is rebated against other compensation received by the Covered Service Provider, an affiliate, or subcontractor, then the Covered Service Provider must furnish a reasonable good faith estimate of the cost of such services, including an explanation of the methodology and assumptions used therein.

- A description of the manner in which compensation will be received.

- If a Covered Service Provider (i) is a fiduciary in connection with an investment contract, product, or entity that holds plan assets and in which the Covered Plan has a direct equity investment[3] or (ii) provides recordkeeping or brokerage services that include a platform of investment options or investment alternatives which are selected by the plan fiduciary as an investment alternative under a Covered Plan that is participant-directed, then such Covered Service Provider must disclose compensation information concerning the investments and investments options. These investment-related disclosures must include:

    - 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 investment contract, product or entity, or designated investment alternative;

    - A description of the annual operating expenses (e.g., expense ratio) if the return is not fixed; and

    - A description of any ongoing expenses in addition to annual operating expenses (e.g., wrap fees, mortality and expense fees).

  A Covered Service Provider subject to this provision because it provides recordkeeping or brokerage services may satisfy this requirement by providing current disclosure materials for the designated investment alternative as long as the issuer of the designated investment alternative is not an affiliate, the disclosure materials are regulated by a State or federal agency, and the Covered Service Provider does not know the materials are incomplete or inaccurate.

Under the Final Rule, a description of compensation may take the form of an estimated monetary amount, formula, percentage of the Covered Plan's assets, or a per capita charge for each participant

or beneficiary. In addition to the above, Covered Service Providers are also required to furnish information relating to their compensation if a plan fiduciary or administrator requests such information as necessary to comply with the reporting and disclosure requirements under Title I of ERISA.

When and How Must the Information Be Disclosed? Timing and Format of Disclosures and Information Contained in Disclosures

After the Effective Date of July 16, 2011, the Final Rule will require Covered Service Providers to provide written disclosures to plan fiduciaries prior to entering into, extending or renewing the contract or arrangement with a Covered Plan. Covered Service Providers also must provide the disclosures described above with respect to preexisting arrangements by such date. Covered Service Providers may satisfy the written disclosure requirement by furnishing plan fiduciaries with a variety documents from separate sources. DOL decided not to impose requirements relating to the format or method of disclosure because it believed that the costs and burdens associated with such a requirement may prove prohibitive. However, DOL noted that it believes plan fiduciaries would benefit from receiving uniform disclosures and has requested comments on whether it should adopt such a requirement in the future.

Unless extraordinary circumstances exist, Covered Service Providers must notify the plan fiduciary of any change in the disclosures within 60 days from the date they discover such change. Under the Proposed Rule, Covered Service Providers were only required to disclose "material" changes to the disclosures. DOL eliminated the concept of materiality from this provision, reasoning that Covered Service Providers would struggle to understand the types of changes that must be disclosed. Consequently, Covered Service Providers must disclose any and all changes in the disclosures to the plan fiduciary.

In response to comment letters, DOL incorporated a provision into the Final Rule permitting contracts and arrangements to continue to qualify for exemptive relief under Section 408(b)(2) even if the disclosures contain an error, as long as the Covered Service Provider acted in good faith and discloses the correct information to the plan fiduciary within 30 days after discovery of such error or omission.

Exemption for Plan Sponsors or Other Fiduciaries Responsible for Entering into the Contract or Arrangement

In conjunction with the Proposed Rule, DOL proposed a class exemption to provide protection when a plan fiduciary enters into a contract or arrangement for services with a Covered Service Provider that fails to comply with its obligation to disclose certain information. DOL revised the Final Rule to incorporate the proposed class exemption. Under the Final Rule, a plan fiduciary will receive exemptive relief from ERISA's prohibited transaction restrictions in circumstances described below where the plan fiduciary was unaware of the disclosure failure and takes appropriate action to remedy it, including notifying DOL in certain circumstances. Notably, DOL expanded the exemption to include Section 406(a)(1)(D) to cover situations when a plan fiduciary decides to continue a service arrangement with a Covered Service Provider, including to continue paying fees, during periods when the parties are attempting to cure a disclosure failure by the Covered Service Provider.

Under the Final Rule, a plan fiduciary will qualify for exemptive relief if:

- The plan fiduciary did not know that the required disclosures were not made and reasonably believed that the Covered Service Provider disclosed all of the necessary information;
- Upon, discovering such failure, the plan fiduciary requested in writing that the Covered Service Provider furnish the correct or missing information.

The plan fiduciary notifies DOL that the Covered Service Provider failed to satisfy the written request within 30 days upon the earlier of the Covered Service Provider's refusal to furnish the information or 90 days after the written request.

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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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[1] All references to Section 408(b)(2) include reference to the parallel provisions of Section 4975(d)(2) of the Internal Revenue Code of 1986.

[2] For more information regarding the Proposed Rule, please see the Paul Hastings client alert dated August 7, 2008 entitled "Overview of Recent Department of Labor ERISA Service Provider Fee Disclosure Initiatives".

[3] Note that a Covered Service Provider in clause (i) is not subject to this provision if the applicable information is disclosed to a plan fiduciary by a Covered Service Provider that provides recordkeeping or brokerage services.