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A legal update from Dechert's Employee Benefits and Executive Compensation Group

Enhanced Fee Disclosure by ERISA Plan Sponsors Required and New Reporting for Plan Service Providers Proposed

Under several pending and final regulations, the Department of Labor will require more and enhanced disclosure of the fees that service providers receive in connection with the services that they render to certain employee benefit plans subject to the Employee Retirement Income Security Act of 1974 ("ERISA") [1] or to the prohibited transaction provisions of the Internal Revenue Code of 1986. This update examines these regulations as well as the impact they may have on ERISA plan sponsors.

Reporting by Plans

The DOL has revised the fee and expense reporting requirements in Schedule C to Form 5500 (the Annual Return/Report of Employee Benefit Plans).[2] The revised Schedule C to Form 5500 is now effective for plan years beginning on or after January 1, 2009. In a significant expansion of existing rules, the new rules require the reporting of direct and indirect compensation paid to plan service providers. Reportable indirect compensation is compensation received from sources other than directly from the plan or plan sponsor, if the compensation is received in connection with services rendered to the plan.

Most recently, the DOL issued guidance in the form of FAQs[3] on how to report service provider fees and other compensation on the revised Schedule C. The reporting rules distinguish between fees related to "investment funds" and "operating" companies. The FAQs clarify that fees received by third parties from funds that qualify for ERISA purposes as venture capital operating companies (VCOCs), real estate operating companies (REOCs) and other operating companies generally would not be reportable indirect compensation. However, the reporting of indirect compensation by investment funds (such as registered mutual funds and hedge funds), even if those funds are not treated as "plan assets," will be required.

The revised Form 5500 Schedule C requires plan administrators to identify any service providers that fail to provide information necessary for the plan administrator to complete Schedule C; however, the DOL recognized that some service providers may have to modify their current recordkeeping and information management systems in order to furnish their employee benefit plan clients with information necessary to comply with the new annual reporting requirements. Therefore, a

1 In addition to these regulatory actions, several bills have been introduced in the U.S. Congress which would require additional disclosures related to defined contribution plans, for example, H.R. 3185 "401(k) Fair Disclosure for Retirement Security Act of 2007."

2 72 Fed. Reg. 64,710 (November 16, 2007).

3 "FAQs About The 2009 Form 5500 Schedule C" (July 14, 2008).

plan administrator of an employee benefit plan that is dependent on service providers for information necessary to complete the Schedule C will not be required to list a service provider as failing to provide information necessary to complete the Schedule C for the 2009 plan year if the plan administrator receives certain representations from the service provider.

Disclosure to Plans

The DOL has issued proposed regulations[4] under Section 408(b)(2) of ERISA that would require certain employee benefit plan service providers to disclose information to assist plan fiduciaries in assessing the reasonableness of the compensation or fees paid for services rendered to the plan and the potential for conflicts of interest that may affect a service provider's performance of services.

Under the DOL's proposed 408(b)(2) regulations, any contract or arrangement between an employee benefit plan and certain service providers must require the service provider to disclose the compensation it will receive, directly or indirectly, and any conflicts of interest that may arise in connection with its services to the plan in order for the contract to be considered "reasonable" and compliant with ERISA Section 408(b)(2).

The proposed regulations cover contracts or arrangements with service providers that:

- provide services as a fiduciary under ERISA or under the Investment Advisers Act of 1940;
- provide banking, consulting, custodial, insurance, investment advisory (plan or participants), investment management, recordkeeping, securities or other investment brokerage, or third party administration services, regardless of the type of compensation or fees that they receive; and
- receive any indirect compensation in connection with accounting, actuarial, appraisal, auditing, legal, or valuation services.

Persons who provide investment management, recordkeeping, participant communication, and other services to the plan as a result of an investment of plan assets will be treated as service providers for these purposes.

Covered contracts or arrangements would be required to satisfy a number of specific requirements, including the following:

- The contract or arrangement must be in writing.
- The terms of the contract or arrangement must require the service provider to disclose in writing, to the best of its knowledge, all services to be provided to the plan pursuant to the contract or arrangement and, with respect to each service, the compensation or fees to be received by the service provider and its affiliates (including for this purpose its agents) and the manner of receipt of such compensation or fees.
  - "Compensation or fees" is defined broadly to include money and any other thing of monetary value received (directly from the plan or the plan sponsor or indirectly) by the service provider or its affiliate in connection with the services provided to the plan or the financial products in which plan assets are invested.
  - The DOL in the preamble to the proposed regulations stated that this definition includes, for example, gifts, awards, finders fees, placement fees, commissions, or other fees related to investment products, sub-transfer agency fees, shareholder servicing fees, Rule 12b-1 fees, soft dollar payments, float income, fees deducted from investment returns, fees based on a share of gains or appreciation of plan assets, and fees based upon a percentage of the plan's assets.
  - Compensation or fees may be disclosed in terms of a specific monetary amount, by using a formula, a percentage of the plan's assets, or a per capita charge for each participant or beneficiary.
  - If a service provider offers a bundle of services that is priced as a package, then the bundled service provider would be required to disclose information concerning all services to be provided in the "bundle," the aggregate direct compensation or fees that will be paid for the bundle, and all indirect compensation that will be received by the service provider, or its affiliates or subcontractors within the bundle, from third parties. The bundled provider generally would not be required to disclose the allocation of revenue sharing or

[4] 72 Fed. Reg. 70987 (December 13, 2007)

other payments among affiliates or subcontractors within the bundle. However, the bundled provider must disclose separately the compensation or fees of any party providing services under the bundle that receives a separate fee charged directly against the plan's investment reflected in the net value of the investment (such as management fees paid by mutual funds to their investment advisers, etc.). In addition, separate disclosure of compensation or fees of any service provider under the bundle that are set on a transaction basis would be required, such as finder's fees, brokerage commissions, or soft dollars, even if such compensation and fees are paid from mutual fund management fees or other similar fees.

- The service provider must explain the manner of receipt of compensation (i.e., whether the service provider will bill the plan, deduct fees directly from plan accounts, or reflect a charge against the plan investment).

- The contract or arrangement must contain a representation by the service provider that, before the contract or arrangement was entered into (or extended or renewed), all required information was provided to the responsible plan fiduciary.

- The service provider must inform the responsible plan fiduciary of the service provider's relationships or interests that may raise conflicts of interest for the service provider in its performance of services for the plan. The service provider must identify whether it will provide services to the plan as a fiduciary, and the service provider must disclose any financial or other interest in transactions in which the plan will partake in connection with the contract or arrangement and whether it will be able to affect its own compensation or fees without the prior approval of an independent plan fiduciary.

- A service provider must disclose whether it has policies or procedures to manage real or potential conflicts of interest and, if so, provide a description of such policies or procedures. (Plan fiduciaries may come to expect service providers to have such policies or procedures; therefore, service providers may wish to consider adopting such policies or procedures, if they have not done so already.)

- The proposed regulations would require, during the term of the contract or arrangement, service providers to disclose to responsible plan fiduciaries any material changes to the information that is required by the proposed regulations to be disclosed. In addition, the service provider would be obligated to furnish all information related to the contract or arrangement and the service provider's receipt of compensation or fees thereunder that is requested by the responsible plan fiduciary or plan administrator in order to comply with the reporting and disclosure requirements of Title I of ERISA and the requirements thereunder.

- Finally, the contract must require the service provider to comply with its obligations under the contract or arrangement as described in the proposed regulations.

No specific rules are proposed regarding the manner in which such disclosures should be presented to the plan fiduciary or the specific time period prior to entering into the contract or arrangement for receipt of the required disclosures (other than requiring a statement by the service provider that the disclosures have been made prior to the parties entering into the contract). The DOL stated that written disclosures may be provided in separate documents from separate sources and may be provided in electronic format. Thus, a prospectus or a Form ADV that includes some of the indirect fee or conflict of interest information that a service provider would be required to disclose under the proposed regulations may be incorporated by reference.

If a service provider fails to comply with these regulations, a plan fiduciary may avoid liability for any resulting ERISA prohibited transaction, under a proposed class exemption published by the DOL in connection with the proposed regulations. Subject to certain conditions, this proposed class exemption would provide relief from ERISA's prohibited transaction rules for a responsible plan fiduciary when a contract or arrangement fails to be "reasonable," through no fault of the responsible plan fiduciary, but due to a service provider's failure to satisfy its disclosure obligations under this regulation.

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at www.dechert.com/employeebenefits.

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