

DOL Issues New Regulation Imposing Fee Disclosure Rules on Service Providers to ERISA Retirement Plans

The U.S. Department of Labor (“DOL”) published an interim final regulation on July 16, 2010 (the “Regulation”) that expands the disclosure obligations that service providers must satisfy in order to qualify for the exemption for service contracts or arrangements between a plan and a party in interest under Section 408(b)(2) of ERISA (and the corresponding provisions of the Internal Revenue Code). Section 408(b)(2) of ERISA exempts such 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 for the services (the “Service Exemption”). While not all contracts or arrangements may need to comply with the Service Exemption, it is common for such contracts or arrangements to do so and it is required where the service provider provides multiple services to a plan. This new Regulation is intended to assist plan fiduciaries in assessing the reasonableness of contracts or arrangements, including the reasonableness of a service provider’s compensation and potential conflicts of interest that may affect a service provider’s performance.

Effective Date/Comment Period

In view of the importance of the Regulation and the potentially significant effects that it may have on plan fiduciaries and service providers, the DOL published the Regulation as an “interim final regulation” and requested further comments by August 30, 2010. The Regulation is effective as of July 16, 2011 (one year from its publication).

Covered Service Providers

The Regulation only applies to service providers to retirement plans (such as a 401(k) plan or profit sharing plan subject to ERISA). It uses the term “covered plan” to refer to these plans. The Regulation does not cover arrangements for health and welfare benefit plans, nor does the

Regulation cover arrangements between service providers and IRAs (or simplified employee plans or SIMPLE plans).

In general, a service provider is a “covered service provider” subject to the Regulation if it enters into a contract or arrangement with a covered plan and reasonably expects \$1,000 or more in direct or indirect compensation to be received in connection with providing one or more of the following services:

- *Services as a fiduciary or registered investment adviser.* Services provided directly to the covered plan as a fiduciary, services provided as a fiduciary to a “plan assets” vehicle and in which the covered plan has a direct equity investment or services provided directly to the covered plan as a

registered investment adviser. A direct equity investment does not include investments made by the plan assets vehicle in which the covered plan invests, thus there is no “look through” to second tier investment vehicles.

- *Certain plan recordkeeping or brokerage services.* Recordkeeping services or brokerage services provided to a participant-directed retirement plan that is an individual account plan (such as a “401(k) plan”) and that permits participants to direct the investment of their accounts, if one or more designated investment alternatives¹ will be made available (e.g. through a platform or similar mechanism) in connection with such recordkeeping services or brokerage services.
- *Other services for indirect compensation.* Accounting, auditing, actuarial, appraisal, banking, consulting (i.e., consulting related to the development or implementation of investment policies or objectives, or the selection or monitoring of service providers or plan investments), custodial, insurance, investment advisory (for plan or participants), legal, recordkeeping, securities or other investment brokerage, third party administration, or valuation services provided to the covered plan, for which the covered service provider, an affiliate, or a subcontractor reasonably expects to receive indirect compensation or compensation paid among related parties.

Two important limitations on “covered service provider” should be noted. First, an entity is a covered service provider regardless of whether such services will be performed, or such compensation received, by the covered service provider, an affiliate,² or a subcontractor,³ however, such affiliates and subcontractors will not

¹ A designated investment alternative is generally defined as an investment alternative designated by a fiduciary into which participants and beneficiaries may direct the investment of assets held in their individual accounts, but not including brokerage windows or similar plan arrangements.

² A person’s or entity’s “affiliate” directly or indirectly (through one or more intermediaries) controls, is controlled by, or is under common control with such person or entity; or is an officer, director, or employee of, or partner in, such person or entity. An “affiliate” generally refers to an affiliate of the covered service provider.

³ A subcontractor is generally defined as any person or entity (or an affiliate) that is not an affiliate of the covered service provider and that, pursuant to a contract or arrangement with the covered service provider or an affiliate, reasonably expects to receive \$1,000 or more in compensation for performing one or more services described be-

themselves be considered covered service providers. Second, no person will be a “covered service provider” solely by providing services to a plan assets vehicle, other than services as a fiduciary.

Initial Disclosure Requirements

The covered service provider must disclose the following information to a responsible plan fiduciary in writing. (While these disclosures must be in writing, the Regulation does not require a formal contract).

- *Services.* A description of the services to be provided to the covered plan (but not including non-fiduciary services provided to a plan assets vehicle).
- *Status.* If applicable, a statement that the covered service provider, an affiliate, or a subcontractor will provide services either (i) directly to the covered plan (or to a plan assets vehicle in which the covered plan has a direct equity investment) as a fiduciary or (ii) directly to the covered plan as a registered investment adviser.
- *Compensation,*⁴ A description of the compensation (direct and indirect) that a covered service provider, an affiliate, or a subcontractor reasonably expects to receive in connection with the services:
 - *Direct compensation.* All compensation received directly from the covered plan (“direct compensation”), either in the aggregate or by service.
 - *Indirect compensation.* All compensation received from any source other than the covered plan, the plan sponsor, the covered service provider, its affiliate, or a subcontractor (“indirect compensation”). The services for which the indirect compensation will be received must be described and the payer of the indirect compensation must be identified.

low provided for by the contract or arrangement with the covered plan).

⁴ Compensation is defined as anything of monetary value (for example, money, gifts, awards, and trips), but does not include non-monetary compensation valued at \$250 or less, in the aggregate, during the term of the contract or arrangement.

- *Compensation paid among related parties.* Any compensation that will be paid among the covered service provider, an affiliate, or a subcontractor, in connection with the services if it is set on a transaction basis (e.g., commissions, soft dollars, finder's fees, etc.) or is charged directly against the covered plan's investment and reflected in the net value of the investment (e.g., Rule 12b-1 fees). The services for which such indirect compensation will be paid must be described and the payers and recipients of such compensation must be identified. This compensation must be disclosed regardless of whether it is also required to be disclosed elsewhere by these Regulations.
- *Termination Fees.* Any compensation in connection with termination of the contract or arrangement, and how any prepaid amounts will be calculated and refunded upon such termination.

Recordkeeping Services

If recordkeeping services will be provided to the covered plan, then the provider must describe all direct and indirect compensation that the covered service provider, an affiliate, or a subcontractor reasonably expects to receive in connection with such recordkeeping services.

The DOL believes that recordkeeping services and costs are so significant or present the potential for conflicts of interest that information concerning such services and costs must be disclosed without regard to whether they are furnished as part of a bundle or package. Therefore, if the covered service provider reasonably expects recordkeeping services to be provided, in whole or in part, without explicit compensation for such recordkeeping services, or if compensation for recordkeeping services is offset or rebated based on other compensation received by the covered service provider, an affiliate, or a subcontractor, then the provider must give a reasonable and good faith estimate of the cost to the covered plan of such recordkeeping services.

Manner of Receipt

A covered service provider must describe the manner in which the compensation will be received, such as whether the covered plan will be billed or the compensation will be deducted directly from the covered plan's account(s) or investments.

Investment Disclosure: Fiduciary Services

The following additional information with respect to each "plan assets" investment vehicle in which the covered plan has a direct equity investment must be disclosed by an organization providing fiduciary services to the vehicle.

- 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 (e.g., sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, account fees, and purchase fees);
- 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).

As compared to the disclosures that are required for Schedule C to Form 5500 (the Annual Return/Report of Employee Benefit Plan), the disclosures that are required by the Regulation are more circumscribed. For example, unlike Schedule C to Form 5500, the Regulation does not require disclosure with respect to fees paid in a mutual fund or other non-plan assets investment vehicle.

Investment Disclosure: Recordkeeping and Brokerage Services

Providers of recordkeeping and brokerage services to a participant-directed individual account plan must disclose additional investment-related fee and expense information if they make available one or more designated investment alternatives for the plan ("platform providers").

This requirement may be satisfied by passing through to the responsible plan fiduciary copies of any state or federally regulated disclosure materials (e.g., prospectuses) of the issuer of the designated investment alternative; provided, that such issuer is not affiliated with the platform provider and the platform provider does not know that any of the information contained in such materials is incomplete or inaccurate.

Therefore, the providers of recordkeeping and brokerage services cannot satisfy these disclosure requirements regarding compensation received from affiliated funds on a platform simply by providing the responsible plan fiduciary with a prospectus. This requirement stems, at least in part, from the DOL's desire for plan fiduciaries to receive clearer and more meaningful information about potential conflicts of interest.

Timing of Initial Disclosure Requirements, Changes

A covered service provider must generally disclose the information set forth under "Initial Disclosure Requirements" above to the responsible plan fiduciary reasonably in advance of the date the contract or arrangement is entered into, and extended or renewed. A change to such information must be disclosed as soon as practicable, but generally not later than 60 days from the date on which the covered service provider is informed of such change.

Ongoing Disclosure Requirements to Plans

Upon request, the covered service provider must furnish (generally within 30 days after receipt of such request) any other information relating to the compensation received in connection with the contract or arrangement that is required for the covered plan to comply with the reporting and disclosure requirements of Title I of ERISA and the regulations, forms and schedules issued thereunder (for example, Schedule C to the plan's Form 5500).

In contrast to the Form 5500, Schedule C rules, the Regulation places an obligation directly on service providers to provide information to plans.

Disclosure Errors

No contract or arrangement will fail to be reasonable solely because the covered service provider, acting in good faith and with reasonable diligence, makes an error or omission in disclosing information, provided that the covered service provider discloses the correct information to the responsible plan fiduciary as soon as practicable, but not later than 30 days from the date on which the covered service provider knows of such error or omission.

Exemption for Responsible Plan Fiduciary

The Regulations also contain a final prohibited transaction class exemption that provides relief from the prohibited transaction rules for plan fiduciaries that enter into contracts or arrangements with service providers upon a mistaken belief that they have received all of the required disclosures. Upon discovering that a covered service provider failed to disclose all of the required information, the responsible plan fiduciary must take reasonable steps to obtain such information, including requesting in writing that the covered service provider furnish the information and notify the DOL if the service provider fails to comply with the written request within 90 days.

Difference from Proposed Regulation

The Regulation differs from the proposed regulation in a number of significant respects, including that the Regulation (i) does not require a formal written contract or arrangement (though the required disclosures must still be in writing), (ii) does not apply to welfare plans or IRAs (although the DOL reserved welfare plan coverage for the future), and (iii) does not contain specific requirements regarding narrative conflict of interest disclosure.

However, like the proposed regulation, the Regulation retains the provision from the existing Service Exemption regulation that a contract or arrangement is not reasonable unless it permits the plan to terminate the contract without penalty on reasonably short notice.

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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