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Service Provider Compensation Disclosure under Section 408(b)(2) of ERISA

On July 16, 2010, the U.S. Department of Labor (the "DOL") issued an interim final rule (the "Rule") requiring the disclosure of compensation paid in connection with the performance of services to an employee pension plan. Compliance with the Rule is a condition to the statutory exemption from the prohibited transaction rules under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), for the provision of services to pension plans. The Rule will likely require many service providers to pension plans, in particular fiduciaries to "plan asset" investment funds and recordkeepers, to make significant changes in their disclosure practices. The Rule is effective July 16, 2011.

THE BASICS

- Disclosure must be provided by entities defined in the Rule as "covered service providers." Covered service providers fall into three broad categories: (1) fiduciaries, (2) recordkeepers for participant-directed individual account plans and (3) specified service providers who receive indirect compensation in connection with providing services to a plan.
- Covered service providers must disclose the following:
  - Information regarding the services and the direct and indirect compensation that the covered service provider, its affiliates and its subcontractors[1] (referred to as "related parties") reasonably expect to receive in connection with the services provided and, with respect to indirect compensation, the identity of the payer.

[1] A person's or entity's "affiliate" is a person or entity that directly or indirectly (through 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. A "subcontractor" is any person or entity (or an affiliate of such person or entity) 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 that a covered service provider would provide pursuant to its arrangement with a pension plan.

  - Compensation among "related parties" in connection with the services provided by the covered service provider if the compensation is set on a transaction basis or is charged directly against a plan's investment and reflected in the net asset value of the investment.
  - Fiduciaries to plan asset funds and recordkeepers to individual account plans that make alternative investment options available to participants must disclose expense ratio and other fee information (*e.g.*, sales loads, redemption fees, wrap fees) regarding the investments for which they act as a fiduciary or provide recordkeeping services.
- Disclosure must be written but need not be in any particular form or in a single document. There is no requirement that plans and service providers enter into formal written contracts setting out disclosure obligations or provide narrative conflict of interest disclosure, as contemplated by an earlier version of the Rule proposed by the DOL.
- The Rule includes a class exemption that offers relief to plan fiduciaries if the required disclosures are not provided.

IMPLICATIONS FOR PLAN ASSET FUNDS

- While investment advisers to funds whose assets are considered plan assets are fiduciaries and thus, covered service providers subject to the Rule, investment advisers of non-plan asset funds generally will not be required to provide the disclosures required by the Rule.
- The requirement that fiduciaries to plan asset funds disclose indirect compensation and compensation among related parties will likely require investment advisers to those funds to provide additional and more detailed and specific disclosure in their offering documents regarding the services that will be provided to the plan asset fund, the cost of those services, the source of the compensation (*e.g.*, from the assets of the fund) and the identity of the payer.

IMPLICATIONS FOR RECORDKEEPERS

Recordkeepers for defined contribution plans are considered covered service providers under the Rule. If the recordkeeper reasonably expects to provide recordkeeping services without direct compensation, or if compensation for recordkeeping services is offset or rebated based on other compensation received by the recordkeeper (or a related party), the recordkeeper must provide the plan fiduciary with a reasonable and good faith estimate of the cost of the recordkeeping services.

IMPLICATIONS FOR RESPONSIBLE FIDUCIARIES

Responsible plan fiduciaries have the obligation to determine whether they have sufficient information regarding the contract or arrangement to determine whether the cost is reasonable. As a result, plan fiduciaries will need to identify covered service providers and be prepared to contact them so that they receive disclosure required by the Rule in a timely manner. Plan fiduciaries will need to analyze the information they receive, follow up with service providers to obtain additional information, if necessary, and evaluate whether to retain or change service providers based on the information provided.

THE DETAILS

The furnishing of goods, services, or facilities between a plan and a "party in interest" to the plan is prohibited under Section 406(a)(1)(C) of ERISA. ERISA defines party in interest broadly. Thus, absent an exemption, many ordinary services provided to pension plans would be prohibited transactions. However, Section 408(b)(2) of ERISA exempts certain arrangements between plans and service providers that would otherwise be prohibited transactions under Section 406. In particular, Section 408(b)(2) provides relief from ERISA's prohibited transaction rules for service contracts or arrangements between a plan and a party in interest 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 Rule significantly expands the requirements for a contract to qualify as "reasonable" by mandating the disclosure of specified information to a responsible plan fiduciary. A "responsible plan fiduciary" is defined as the fiduciary with authority to cause the plan to enter into or extend or renew a contract or arrangement for the provision of services to the plan.

What Plans Are Covered by the Rule?

The Rule only covers defined benefit plans and defined contribution plans. The DOL has indicated that it will, subject to ERISA, develop separate, more specifically tailored disclosure requirements for welfare benefit plans. Additionally, individual retirement accounts are not subject to the Rule.

Who Must Provide Disclosure?

"Covered Service Providers"

The disclosure must be provided by a covered service provider. A "covered service provider" is a service provider that enters into a contract or arrangement with the covered plan and reasonably expects to receive $1,000 or more in compensation, direct or indirect, in connection with providing one or more specified services. The definition only captures the party directly responsible to the covered plan for the provision of services under the contract or arrangement, even though some or all of the services may be performed by a related party. Notably, although covered service providers have the disclosure obligation, they are required to disclose not only the compensation they receive but also compensation received by related parties and certain other fees that affect the value of a plan's investment.

- ***Fiduciaries***. Three categories of fiduciaries are considered covered service providers under the Rule: (1) ERISA fiduciaries that provide services directly to the covered plan; (2) ERISA fiduciaries that provide services to an investment contract, product, or entity that holds plan assets (as defined in DOL Regulation 29 C.F.R. Section 2510.3-101, as modified by Section 3(42) of ERISA) and in which the covered plan has a direct equity investment; and (3) investment advisers registered under either the Investment Advisers Act or any State law that provide services directly to the covered plan. The second category includes fiduciaries of the investment fund or other investment vehicle in which the plan makes a direct investment but does not include fiduciaries of investment vehicles in which the first vehicle invests, even if the second vehicle also holds plan assets.
- ***Recordkeepers***. A covered service provider includes providers of recordkeeping or brokerage services to a covered plan that is an individual account plan under ERISA (*e.g.*, a 401(k) plan) and that permits participants and beneficiaries to direct the investment of their accounts, if one or more designated investment alternatives will be made available (*i.e.*, through a platform) in connection with those recordkeeping or brokerage services. This category includes both recordkeepers that select or maintain a platform of investment alternatives for a covered plan and recordkeepers for covered plans where the investment alternatives are selected by a responsible fiduciary for the plan. This category does not include brokerage windows, self-directed brokerage accounts and similar arrangements.
- ***Specified Categories of Service Providers Who Receive Indirect Compensation***. This category includes service providers providing specified services to the covered plan where the service provider or a related party reasonably expects to receive indirect compensation or certain payments from related parties. The services included in this category are 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 the plan or participants), legal, recordkeeping, securities or other investment brokerage, third party administration, or valuation services provided to the covered plan.

Service Providers Not Covered

The following would not be considered covered service providers under the Rule:

- Entities solely providing services as an affiliate or a subcontractor of a covered service provider.
- Investment managers or advisers of investment funds whose assets are not considered plan assets.
- Entities solely providing non-fiduciary services to plan asset vehicles.
- ERISA fiduciaries (investment advisers) of a plan asset fund in which its only pension fund investors are other plan asset funds.

What Must Be Disclosed?

The Rule does not require that there be a formal written contract or arrangement obligating the service provider to make the required disclosures. The Rule also does not require the covered service provider to make disclosures in any particular manner or format. For instance, the covered service provider could provide the disclosure using different documents from separate sources as long as the documents collectively contain all of the required information.

Description of Services/Status as a Fiduciary

The Rule requires a description of services that will be provided to the covered plan pursuant to the contract or arrangement. There are no specific rules regarding the level of detail that is required; the Rule contemplates that the level of detail will vary depending on the circumstances. The Rule requires a statement as to whether a covered service provider or a related party expects to provide services to the covered plan as a fiduciary, as an investment adviser registered under either the Investment Advisers Act or any State law or both.

We note that the scope of what constitutes a fiduciary service may be difficult to assess. For plan asset funds, there is generally no separate contract with the plan investor engaging the investment adviser as a fiduciary; rather, the contract is memorialized by the plan signing a subscription agreement after reviewing the fund's offering memorandum. Similarly, investment advisory agreements between plans and fiduciaries frequently provide for the provision of services other than discretionary investment advice. Further, although the Rule states that the description of services need not include an explanation of services provided to an investment fund or other vehicle in which a covered plan invests (other than services as a fiduciary to a plan asset fund), many services may nevertheless need to be disclosed in connection with the obligation to provide information regarding indirect compensation and compensation paid among related parties.

Compensation Disclosures

The Rule adopts a broad definition of the compensation that must be disclosed and requires a description of the manner in which the compensation will be paid.

- ***Direct Compensation***. Covered service providers must disclose all direct compensation—compensation received directly from the covered plan—that the covered service provider or a related party reasonably expects to receive in connection with the services. The description of the compensation may be expressed as a monetary amount, formula, percentage of the covered plan's assets or a *per capita* charge for each participant or beneficiary or, if the compensation cannot reasonably be expressed in those terms, by any other reasonable method.
- ***Indirect Compensation***. Covered service providers must describe all indirect compensation that the covered service provider and related parties reasonably expect to receive in connection with the services to be provided. The

covered service provider must also identify the services for which the indirect compensation will be received and the payer of the indirect compensation.

Indirect compensation is defined as compensation received from any source, other than the covered plan, the plan sponsor, the covered service provider and its related parties, that the covered service provider and its related parties reasonably expect to receive in connection with the services to be provided. Indirect compensation would generally include amounts paid to a covered service provider and its related parties from the assets of a plan asset fund. One of the more challenging issues that a covered service provider is likely to face under the Rule will be determining whether compensation is received "in connection with" the services it provides.

- ***Compensation Paid Among Related Parties***. Covered service providers must describe any compensation that will be paid among the covered service provider and its related parties, if it is paid on a transaction basis (*e.g.*, commissions) or is charged directly against the covered plan's investment and reflected in the net asset value of the investment. Covered service providers must identify the services for which compensation will be paid and the payers and recipients of such compensation, including the status of each payer or recipient as an affiliate or subcontractor. Compensation under this provision must be disclosed regardless of whether it is also disclosed as direct or indirect compensation or as part of the investment disclosures discussed below.
- ***Compensation for Termination of Contract or Arrangement***. Covered service providers must describe any compensation that they or their related parties reasonably expect to receive in connection with termination of the contract or arrangement and how any prepaid amounts will be calculated and refunded upon termination.

Recordkeeping Services Compensation Disclosures

Recordkeepers must furnish a reasonable and good faith estimate of the cost of the recordkeeping services to the covered plan, along with a detailed description of the recordkeeping services provided, if the recordkeeper reasonably expects to provide recordkeeping services without direct compensation, or if compensation for recordkeeping services is offset or rebated based on other compensation received by the recordkeeper or a related party. The estimate must describe the methodology and assumptions used and must take into account the rates that would be charged to third parties or prevailing market rates. The DOL has indicated that the purpose of this disclosure is intended to provide plan fiduciaries with meaningful disclosure of the cost of recordkeeping services, in view of the variety of methods through which recordkeepers are compensated for their services.

Investment Disclosures

Covered service providers must disclose compensation information concerning the investments for which they are a fiduciary or provide recordkeeping or brokerage services. This disclosure is in addition to the disclosure of the compensation information in connection with the services they provide (*i.e.*, as fiduciary or recordkeeper). Disclosures related to investments are not limited to compensation received by the covered service provider and its related parties but, rather, broadly cover all compensation related to investment in the vehicle.

- ***Fiduciary Services***. If the covered service provider is a fiduciary to a plan asset fund, it will need to provide additional information regarding the expenses associated with investing in the fund. This includes: (1) 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 fund (*e.g.*, sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, amount fees, and purchase fees); (2) a description of the annual operating expenses (*e.g.*, expense ratio); and (3) a description of any ongoing expenses (*e.g.*, wrap fees, mortality and expense fees).

- ***Recordkeeping and Brokerage Services***. Covered service providers providing recordkeeping or brokerage services who make available investment alternatives for participant-directed individual account plans must disclose investment-related compensation information with respect to each designated investment alternative for which recordkeeping services or brokerage services will be provided. A covered service provider may comply with this requirement by providing to the responsible plan fiduciary current disclosure materials of the issuer of the designated investment alternative (*e.g.*, mutual fund prospectuses).

When and How Must Information Be Disclosed?

A covered service provider must disclose the required information to the responsible plan fiduciary reasonably in advance of the date the contract or arrangement is entered into, extended or renewed. The Rule does not contain any specific requirement regarding the number of days in advance of entering into a contract or arrangement that the disclosures must be provided. Changes to initial disclosures must be disclosed as soon as practicable but not later than 60 days following the date on which the covered service provider is informed of such change, absent extraordinary circumstances beyond the covered service provider's control. Upon the request of the responsible plan fiduciary, the covered service provider must furnish 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. Such information must be provided within 30 days of the covered service provider's receipt of the written request, absent extraordinary circumstances.

Penalties for Non-Compliance and Prohibited Transaction Class Exemption

Disclosure Errors

An inadvertent mistake in disclosure will not automatically result in a prohibited transaction. The Rule provides that a contract or arrangement will not violate the Rule solely because the covered service provider, acting in good faith and with reasonable diligence, makes an error or omission in disclosing the information required, 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 after the covered service provider knows of the error or omission.

Class Exemption

The Rule also includes a class exemption from ERISA's prohibited transaction rules that is designed to protect plan fiduciaries, if they discover an error or other deficiency in the disclosure provided by the service provider. The class exemption provides relief to a responsible plan fiduciary, notwithstanding any failure by a covered service provider to comply with its disclosure obligations, as long as the following conditions are met:

- The responsible plan fiduciary did not know that the covered service provider failed or would fail to make the required disclosures and reasonably believed that the covered service provider disclosed the required information.
- The responsible plan fiduciary, upon discovering that the covered service provider failed to disclose the required information, requests in writing that the covered service provider furnish such information.
- If the covered service provider fails to comply with such written request within 90 days of the request, the responsible plan fiduciary notifies the DOL of the covered service provider's failure.
- The notice is filed with the DOL not later than 30 days following the earlier of: (1) the covered service provider's refusal to furnish the information requested or (2) the date that is 90 days after the written request to the covered service provider is made.

- The responsible plan fiduciary, following discovery of the covered service provider's failure to disclose, determines whether to terminate or continue the contract or arrangement. In making such a determination, the responsible plan fiduciary must evaluate the nature of the failure, the availability, qualifications, and cost of replacement service providers, and the covered service provider's response to the notification of the failure.

Deadlines

Written comments on this Rule must be received by the DOL by August 30, 2010. Disclosures for new contracts or arrangements that are entered into on or after the Rule's July 16, 2011, effective date must satisfy the Rule; disclosure with respect to existing contracts or arrangements must also be provided in compliance with the Rule by the effective date.

Service providers to pension plans, as well as the responsible plan fiduciaries, should starting developing a plan for compliance with the Rule now. Service providers that determine they are "covered service providers" under the Rule should review what compensation is paid and received under their contracts or arrangements, what needs to be disclosed under the Rule, whether all or part of it is already disclosed and, if so, where it is disclosed. Once the applicable information is gathered, covered service providers should determine how best to present the information to responsible plan fiduciaries taking into account the Rule, as well as disclosure requirements under the Advisers Act and the Investment Company Act, for example, by consolidating it in a single document, by sending a communication that refers responsible fiduciaries to other documents that contain the information or by revising fund offering memoranda. Responsible plan fiduciaries should similarly review their contracts and arrangements, determine what additional information they believe they should be receiving and be prepared to contact and follow up with their service providers before the effective date of the Rule.

Finally, although the Rule does not require that information be provided in any particular manner or format, the DOL is considering imposing such a requirement. Thus, covered service providers will need to continue to follow DOL changes and guidance to the Rule.

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