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New Dol Service Provider Fee Disclosure Regulations – Taking The Arrangement From Opaque Or Translucent To Transparent

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The DOL's section 408(b)(2) regulations will require some retirement plan service providers, such as third party administrators and investment advisors, to disclose certain information to plan fiduciaries about the services they provide and what their anticipated fees will be. The regulations are meant to help plan fiduciaries assess the reasonableness of the service provider fees and to reveal any potential conflicts of interest that could influence the service provider's decision-making process. Plan fiduciaries and service providers need to comply with these new regulations by April 1, 2012.

Odd as it may seem, an arrangement between an ERISA plan (whether it is a pension plan or a welfare plan) and a service provider is a prohibited transaction, unless the arrangement satisfies an exemption from the prohibited transaction rules. Effective April 1, 2012, every arrangement between an ERISA pension plan and certain service providers must comply with new DOL regulations that require much more disclosure in order for the arrangement to be exempt. The plan's fiduciaries and the plan's service providers must make certain that their arrangements are transparent – being opaque or translucent is not an option (and perhaps never was – but that is a subject for another day).

BACKGROUND

Both ERISA and the Code treat an arrangement between a plan and a service provider as a prohibited transaction unless the transaction is exempt. Fortunately, each statute provides an exemption for reasonable arrangements for services that are necessary for the establishment or operation of the plan if no more than reasonable compensation is paid by the plan.

Until recently, the DOL's regulations explained the exemption simply by providing that (i) services are "necessary" if they are appropriate and helpful in carrying out the plan's purpose, (ii) the reasonableness of the arrangement is determined by the ability to terminate the arrangement and the costs associated with such termination, and (iii) whether the compensation is reasonable is a facts and circumstances determination. In mid 2010, the DOL published new regulations requiring additional disclosures by certain service providers to pension plan fiduciaries in order for their arrangements to be reasonable. Effective as of April 1, 2012, no contract or arrangement for services between a "covered plan" and a "covered service provider" will be "reasonable" under the statutory exemptions for service providers unless the service provider makes certain disclosures to a responsible plan fiduciary.

WHAT ARRANGEMENTS ARE COVERED?

In order to be subject to these regulations, the plan must be a "covered plan." A "covered plan" is an employee pension benefit plan other than (i) a church plan that has not elected to become subject to ERISA, (ii) a governmental plan, (iii) a simplified employee pension (SEP), (iv) a simple retirement account, or (v) an IRA. (Employee welfare benefit plans stay tuned – the DOL is working on similar regulations for you!)

In order to be subject to these regulations, the service provider must be a "covered service provider." A "covered service provider" is a service provider that enters into an arrangement with a covered plan and reasonably expects $1,000 or more in compensation, direct or indirect, from the plan, for providing one or more of the covered services listed below, whether the services will be performed, or such compensation received, by the covered service provider, an affiliate or a subcontractor. The covered services are:

- Services provided as an ERISA section 3(21) fiduciary (e.g., a person who renders investment advice for a fee), services as a fiduciary to an investment contract, product or entity that holds plan assets and in which the covered plan has a direct equity investment, or services provided directly to the covered plan as a registered investment adviser (RIA).
- Recordkeeping services or brokerage services to an individual account plan, but only if (i) the plan permits participants or beneficiaries to direct the investments of their accounts under the plan and (ii) one or more of the designated investment alternatives will be made available through a platform offered in connection with the recordkeeping services or brokerage services, even if the designated investment alternatives are independently selected by the responsible plan fiduciary and added to the menu (designated investment alternatives do not include brokerage windows, self-directed brokerage accounts or similar arrangements).
- Services performed by certain other service providers (e.g., accounting, auditing, actuarial, appraisal, legal, recordkeeping and third party administration services), or by an affiliate or a subcontractor, who expects to receive indirect compensation (i.e., from any source other than the plan, the plan sponsor or a covered service provider) or certain payments from related parties (e.g., commissions, soft dollars, finder's fees or Rule 12b-1 fees).

Note that all arrangements between a covered plan and a covered service provider must comply with the new requirements by the deadline. Existing arrangements are not exempt!

REQUIRED DISCLOSURES

The covered service provider must disclose, in writing, certain aspects of the arrangement to the responsible plan fiduciary. The regulations require no particular format for the disclosure (although the DOL may require a summary of the disclosures as part of future guidance). The disclosures need not be part of the contract for services.

What must be disclosed? The extent of the disclosures depends in part on the services being rendered. In general, the covered service provider must disclose (consult the regulations for full details):

- Services to be provided – the level of detail must be sufficient to allow the responsible plan fiduciary to determine whether the cost of the services is reasonable;
- Status as a fiduciary or RIA if applicable;
- Compensation – both direct compensation from the plan (but not from the plan sponsor) and indirect compensation – including compensation in connection with the termination of the arrangement;

- If recordkeeping services will be provided, a description of all direct and indirect compensation – if either (i) there is no explicit compensation for the recordkeeping services or (ii) the compensation for the recordkeeping services is offset or rebated based on other compensation, the disclosure must include a reasonable good faith estimate of the cost to the covered plan of the recordkeeping services with an explanation of the methodology and assumptions used;
- The manner in which the compensation will be received (e.g., the plan will be billed or it will be deducted directly from the plan's accounts or investments); and
- If the services are provided as a fiduciary to an investment contract, product or entity that holds plan assets, or if the services provided are recordkeeping or brokerage services, the disclosure must include (i) compensation charged directly against the amount invested in connection with acquisition or sale (e.g., sales loads and surrender charges), (ii) annual operating expenses if the return is not fixed), and (iii) other ongoing expenses (e.g., wrap fees).

TIME OF DISCLOSURE

The disclosure must be reasonably in advance of the date of the arrangement or any extension or renewal. The covered service provider must disclose any change to the information required to be disclosed – regardless of whether the change is "material" – as soon as practicable, but not more than 60 days after the covered service provider knows of the change.

When an investment contract, product, or entity is determined not to hold plan assets upon the covered plan's direct equity investment, but subsequently is determined to hold plan assets while the covered plan's investment continues, the information must be disclosed as soon as practicable, but not later than 30 days from the date on which the covered service provider knows that such investment contract, product, or entity holds plan assets. Similarly, a service provider of recordkeeping or brokerage services must make disclosures relating to any investment alternative that is not designated at the time the contract or arrangement is entered into as soon as practicable, but not later than the date the investment alternative is designated by the responsible plan fiduciary.

ADDITIONAL DISCLOSURES

Upon request of the responsible plan fiduciary or the plan administrator, the covered service provider must furnish any other information relating to the compensation received in connection with the arrangement that is required for the covered plan to comply with ERISA's reporting and disclosure requirements (e.g., Form 5500 Schedule C). The covered service provider must provide the required information not later than 30 days after receipt of the written request unless disclosure is precluded due to extraordinary circumstances beyond the covered service provider's control.

DISCLOSURE FAILURES

An arrangement does not fail to be "reasonable" solely because the covered service provider makes an error or omission in disclosing the required information. However, in order for such an error or omission not to result in a prohibited transaction, the covered service provider (i) must have been acting in good faith and with reasonable diligence and (ii) must disclose the correct information as soon as practicable, but not later than 30 days after discovery of the error or omission.

Otherwise, any failure to comply with the disclosure requirements results in the arrangement not being "reasonable" – this results in a prohibited transaction by the covered service provider! The covered service provider must correct the transaction (likely refunding the full amount paid under the contract plus earnings to the plan) and pay the applicable prohibited transaction excise taxes.

Does the responsible plan fiduciary also engage in a prohibited transaction by entering into an arrangement that does not comply with the disclosure requirements? No, not if the responsible plan fiduciary satisfies the prohibited transaction exemption requirements contained in the DOL's regulations. These require the following (consult the regulations for full details):

- The responsible plan fiduciary did not know of the failure and reasonably believed that the covered service provider had complied.
- Upon discovery of the failure, the responsible plan fiduciary must make a written request to the covered service provider for disclosure.
- If the covered service provider fails to comply within 90 days, the responsible plan fiduciary must notify the DOL, by providing the DOL with detailed information about the plan, the covered service provider and the failure to disclose, not later than 30 days following the earlier of (i) the covered service provider's refusal to furnish the information or (ii) 90 days after the written request is made (the DOL has posted a sample notification on its web site).
- The responsible plan fiduciary must decide whether to terminate or continue the arrangement after discovery of the failure by evaluating the nature of the failure, the availability, qualifications and cost of replacement service providers, and the covered service provider's response to notification of the failure.

FIDUCIARIES BEWARE!

Note that compliance with the regulations does not necessarily equate to compliance with a fiduciary's obligations under ERISA. A plan fiduciary may have an obligation to request more information beyond what is required in the regulations. In addition, a plan fiduciary must also determine that (i) the services are necessary for the establishment or operation of the plan and (ii) no more than reasonable compensation is paid by the plan for such services. Furthermore, the DOL has taken the position that satisfying the statutory exemption requirements for such services is not an exemption from the prohibition against a fiduciary's self-dealing.

Plan fiduciaries should also beware that the failure to comply with these regulations could result in a fiduciary breach under ERISA and personal liability for any resulting losses. In addition, note that providing the required notice to the DOL of a covered service provider's failure to comply with the regulations does not relieve the plan administrator of the obligation to report a prohibited transaction on Form 5500 without regard to whether the covered service provider furnishes the information in response to the responsible plan fiduciary's request.

WHAT TO DO

Both plan fiduciaries and service providers need to make certain that their existing arrangements comply with the requirements by the deadline and that all new arrangements comply as well. We have provided you with a checklist (below) of the steps that plan fiduciaries need to take both before and after the deadline. The rules are complex – we recommend that both plan fiduciaries and service providers consult with benefits counsel for assistance.

BEFORE THE APRIL 1, 2012 DEADLINE

- Identify your covered plans
- Identify the responsible plan fiduciary(ies) for each covered plan
- Familiarize them with the requirements under the new regulations
- Identify each covered service provider for each covered plan
- Categorize each covered service provider as either (i) a fiduciary or RIA, (ii) a record keeper or broker (individual account plans that allow participant direction of accounts only), or (iii) one of the other covered service providers listed in the regulations
- Determine what disclosures are required for each covered service provider
- Analyze the disclosures from each covered service provider to make certain that all disclosures have been made, they are sufficiently detailed, and any other appropriate information has been obtained
- Determine if the arrangement is necessary (i.e., the services are appropriate and helpful in carrying out the plan's purpose)
- Determine if the compensation for the services is reasonable
- What To Do – After The April 1, 2012 Deadline
- Go through the process again for each new arrangement, for any extension or renewal of an existing arrangement, and for any changes
- If a disclosure failure is discovered, follow the steps in the prohibited transaction exemption, to include notifying the DOL if appropriate, reporting the failure on Form 5500, and deciding whether to terminate the arrangement with the covered service provider.