

February 2012 / Special Alert

A legal update from Dechert's Financial Services and Employee Benefits and Executive Compensation Groups

DOL Issues Final ERISA 408(b)(2) Regulations and Delays Effective Date

The U.S. Department of Labor ("DOL") published final regulations on February 3, 2012 (the "Regulation") regarding the disclosure obligations that service providers to covered plans must satisfy in order for an arrangement to be reasonable and therefore 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).¹

The Regulation's effective date has been extended by three months to July 1, 2012 (from April 1, 2012) to allow additional time for compliance. Therefore, covered service providers must now provide initial disclosures to covered plans prior to July 1, 2012.

The Regulation generally retains the basic structure and content of the interim final regulations and a summary of the Regulation, as now modified, is below. Notable changes to the Regulation include:

- Changes to investment-related disclosures for recordkeeping/brokerage services must be provided at least annually instead of within 60 days of a change.
- New requirements apply to recordkeepers and brokers that disclose investment-related fee and expense information for designated investment alternatives by

passing through copies of disclosure materials of the issuer of the designated investment alternative.

- The initial disclosure requirements with respect to indirect compensation now require a description of the arrangement made between the payer and covered service provider pursuant to which the indirect compensation is paid.
- Additional descriptions of annual operating expenses of "designated investment alternatives" are now required.

No Summary of Initial Disclosures Is Required

The final Regulation does not contain a requirement that covered service providers furnish a "summary" disclosure statement that would include an overview for the responsible plan fiduciary of the information required to be disclosed. However, the DOL is continuing to study this issue and has indicated that it will publish a proposed regulation in the near future that would, if adopted, require covered service providers to separately furnish a guide or similar tool designed to enable plan fiduciaries to locate compensation information disclosed through multiple or complex documents.

In the meantime, the DOL encourages voluntary use of a "Sample Guide" that it has provided and that it believes will assist plan fiduciaries with their review of the required disclosures.

¹ Section 408(b)(2) of ERISA exempts 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. While not all contracts or arrangements may need to comply with this 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.

The Sample Guide contains a two-column chart. The left column states each item of required information (e.g., description of services provided) and the right column states the location of that item by identifying the document, section number and page number at which that item may be found.²

Covered Service Providers

The Regulation only applies to service providers to pension 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 between service providers and health and welfare benefit plans, IRAs (or simplified employee plans or SIMPLE plans), or **NEW** in the final Regulation, certain 403(b) annuity contracts or custodial accounts issued to a current or former employee before January 1, 2009.

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

Such services include 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

Such services include 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 alternatives³ will be made available

² The Sample Guide may be found at 77 Fed. Reg. 5659.

³ 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

(e.g. through a platform or similar mechanism) in connection with such recordkeeping services or brokerage services.

Other Services for Indirect Compensation

Such services include 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.

The following 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 affiliate⁴, or a subcontractor⁵; however, such affiliates and subcontractors will not 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.

not including brokerage windows or similar plan arrangements.

- ⁴ 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.
- ⁵ 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 below provided for by the contract or arrangement with the covered plan).

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

It must provide 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

It must provide, 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

It must provide a description of the compensation⁶ (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 or its affiliate is “indirect compensation,” as is all compensation received from a subcontractor unless it is received in connection with services performed under the subcontractor’s arrangement to provide recordkeeping or brokerage services.
 - The services for which the indirect compensation will be received must be described, the payer of the indirect compensation must be identified, and, **NEW** in the final Regulation, a description must be given of the arrangement made between the payer and covered service

provider pursuant to which the indirect compensation is paid.

- Such descriptions are intended to help a responsible plan fiduciary analyze why the payer is compensating the covered service provider in connection with the covered service provider’s arrangement with the covered plan.
- If information is unknown at the time disclosures are made, the description need not identify the specific payer in advance of the service arrangement but may express the indirect compensation in general terms that are sufficient to permit a responsible plan fiduciary to evaluate the reasonableness of such compensation in advance of the service 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

It must describe any compensation in connection with termination of the contract or arrangement, and how any prepaid amounts will be calculated and refunded upon such termination.

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.

The Regulation states that a description of compensation or cost 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 or cost cannot reasonably be expressed in such terms, by any other reasonable method. **NEW** in the final Regulation is that the description may

⁶ 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.

include a reasonable and good faith estimate if the covered service provider cannot otherwise readily describe compensation or cost and the covered service provider explains the methodology and assumptions used to prepare such estimate.

Recordkeeping Services

If recordkeeping services will be provided to the covered plan, then the covered service 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 such a 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 covered service provider must give a reasonable and good faith estimate of the cost to the covered plan of such recordkeeping services.

Investment Disclosure: Platform Providers

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 disclosure materials (e.g., prospectuses) of the issuer of the designated investment alternative that is not affiliated with the platform provider. Whereas the interim final regulation focused on whether the disclosure materials themselves were regulated, **NEW** in the final Regulation are the requirements that:

- the issuer be a registered investment company, an insurance company, an issuer of a publicly traded security, or a financial institution supervised by a state or federal agency; and

- the covered service provider must act in good faith, without knowledge that the materials are incomplete or inaccurate, and must furnish the responsible plan fiduciary with a statement that the covered service provider is making no representations as to the completeness or accuracy of such materials.

Also **NEW** is that the DOL confirmed that covered service providers may pass through disclosure materials from affiliated issuers. However, the DOL stated that covered service providers will be responsible for the content of the affiliated materials (whereas covered service providers will not be responsible for the content of non-affiliated materials if the requirements above are satisfied).

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 a covered service provider providing fiduciary services to the vehicle.

- A description of any compensation that will be charged directly against an investment (e.g., sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, account fees, and purchase fees) and that is not included in the annual operating expenses of the investment;
- A description of the annual operating expenses (e.g., expense ratio) if the return is not fixed and any ongoing expenses in addition to annual operating expenses (e.g., wrap fees, mortality and expense fees) or, **NEW**, for an investment vehicle that is a designated investment alternative, the total annual operating expenses expressed as a percentage and calculated in accordance with the DOL’s participant-level disclosure regulations; and
- **NEW**, for an investment vehicle that is a designated investment alternative, any other information or data about the designated investment alternative that is within the control of, or reasonably available to, the covered service provider and that is required for the covered plan administrator to comply with the DOL’s participant-level disclosure obligations.
 - These changes are designed to facilitate disclosure of information under this Regulation that also will have to be disclosed under the participant-level disclosure regulations.

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.

Timing of Initial Disclosure Requirements; Changes

A covered service provider must generally make the required initial disclosures to the responsible plan fiduciary reasonably in advance of the date the contract or arrangement is entered into, and extended or renewed. Except as described below, 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.

NEW in the final Regulation is that changes to investment-related disclosures for services provided as a fiduciary and changes to investment-related disclosures for recordkeeping/brokerage services must be provided at least annually instead of disclosed within 60 days. The DOL stated that the need to constantly furnish notices of even minor changes to investment information could be burdensome and that a non-stop stream of such notifications is inconsistent with its goal of ensuring that responsible plan fiduciaries receive useful and meaningful disclosures.

Ongoing Disclosure Requirements to Plans

Upon request in writing, 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 and the regulations, forms and schedules issued thereunder (for example, Schedule C to the plan's Form 5500). **NEW** in the final Regulation is that this information must be furnished reasonably in advance of the date upon which the responsible plan fiduciary

states that it must comply with the applicable reporting or disclosure requirement.

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 (or, **NEW** in the final Regulation, a change to 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 Regulation also contains 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 notifying the DOL if the service provider fails to comply with the written request within 90 days. **NEW** in the final Regulation is a requirement that, if the covered service provider fails to comply with a written request for information within 90 days of such request, the responsible plan fiduciary must determine whether to terminate or continue the arrangement consistent with its duty of prudence. If the requested information relates to future services and is not disclosed promptly after the end of the 90 day period, then the responsible plan fiduciary must terminate the arrangement as expeditiously as possible, consistent with its duty of prudence.

Practice group contacts

For more information, please contact one of the attorneys listed, or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/financial_services and www.dechert.com/employee_benefits.

Susan M. Camillo

Boston
+1 617 728 7125
susan.camillo@dechert.com

Marc D. Nawyn

New York
+1 212 698 3560
marc.nawyn@dechert.com

Shannon Rushing

Philadelphia
+1 215 994 2949
shannon.rushing@dechert.com

David F. Jones

Philadelphia
+1 215 994 2822
david.jones@dechert.com

Drew A. Picciafoco

Boston
+1 617 728 7109
drew.picciafoco@dechert.com

Stephen W. Skonieczny

New York
+1 212 698 3524
stephen.skonieczny@dechert.com

Young Eun Lee

New York
+1 212 641 5634
youngeun.lee@dechert.com

Eric B. Rubin

Philadelphia
+1 215 994 2946
eric.rubin@dechert.com

Kathleen Ziga

Philadelphia
+1 215 994 2674
kathleen.ziga@dechert.com