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LEGAL ALERT

July 20, 2010

DOL Issues New ERISA Disclosure Requirements for Retirement Plan Service Providers

On July 16, 2010, the Department of Labor (DOL) published "interim" final regulations, proposed in December 2007, imposing new disclosure and related requirements under ERISA for certain service providers to retirement plans. The key elements of the final regulation are as follows:

Who is Affected?

- ERISA fiduciaries, and investment advisers registered under either the Investment Advisers Act of 1940 or any state law, that provide services directly to certain types of retirement plans
- ERISA fiduciaries that provide services to "plan asset" vehicles in which a covered plan holds a direct equity interest
- Recordkeepers and brokers for participant-directed individual account plans, if one or more designated investment alternatives will be made available in connection with those services
- Service providers that do or may receive "indirect compensation or fees" in connection with enumerated types of services provided to a covered plan

What Types of Plans are Covered?

- Service arrangements with 401(a)/401(k) retirement plans and 403(b) plans subject to ERISA
- Service arrangements with the following plans are not covered: IRAs, SEPs, simple retirement accounts, and other plans not subject to Title I of ERISA

How Does the Final Regulation Differ from the Proposal?

- Modifies the types of arrangements subject to the new requirements
- Does not require a written service agreement
- Does not require disclosure of potential conflicts of interest
- Requires more granular disclosure of indirect compensation
- Reserves for future guidance disclosure rules for welfare benefit plans
- Requires separate disclosure of costs related to bundled recordkeeping services

What is the Effective Date?

- July 16, 2011. Required disclosures must be made by this date for covered service arrangements already in existence; no grandfathering is provided

Why is the Final Regulation "Interim"?

- DOL invited comments on the final regulation, due August 30, 2010

This final regulation is the second of four regulatory projects DOL has initiated primarily to deal with indirect compensation in the employee benefit market.

- DOL has already promulgated revisions to Form 5500, and in particular Schedule C, that expand reporting of indirect compensation to and among service providers. These new rules are effective for the 2009 Form 5500, which generally is in the process of being prepared at this time.

- DOL also intends to require additional disclosure (i) to participants in retirement plans, which was proposed in July 2008 and is scheduled to be finalized later this year, and (ii) by service providers to welfare benefit plans, which is slated for proposal in Spring 2011.

This final regulation with respect to service providers includes a class exemption for responsible plan fiduciaries. DOL also issued a fact sheet and press release in connection with the publication of the regulation.

Background. Under ERISA, any person providing services to a plan or its participants will become a "party in interest" to the plan by reason of providing those services. ERISA §406(a), in turn, prohibits a party in interest from providing services to the plan. The solution to this problem in circularity lies in §408(b)(2), which permits a party in interest to provide necessary (*i.e.*, appropriate and helpful) services to the plan provided that, under regulations issued in 1977:

- The arrangement permits termination of the services by the plan without penalty on reasonably short notice. A contractual provision that permits the service provider to recoup reasonable start-up costs or other loss on early termination is permissible; and
- As determined by an independent fiduciary, the plan pays no more than reasonable compensation (a facts and circumstances determination) for the services.

Comment: Not all service arrangements for plans involving parties in interest rely on the §408(b)(2) necessary services exemption.

- Since the enactment of ERISA, there has been an unresolved question whether a §406(a) prohibited transaction arises (and thus relief like §408(b)(2) is required) in every service arrangement, or only in "multiple services" situations where the plan receives a second service from (or perhaps renews the initial service with) an existing service provider. Common practice has evolved, however, to observe §408(b)(2) in structuring a service provider's initial arrangement with the plan, as well as for any subsequent renewal or modification, and for any agreement for additional services.
- Perhaps more significantly, there are other exemptions for specific service arrangements – for example, the §408(b)(6) statutory exemption for ancillary services provided by banks – that, where applicable, can independently provide prohibited transaction relief without resorting to §408(b)(2) and complying with its conditions. DOL declined to provide guidance on the interaction of the final regulation with these other exemptions.

Covered Service Providers. The final regulation imposes detailed compensation disclosure obligations on certain enumerated types of service providers, termed "covered service providers," that reasonably expect to receive $1,000 or more in compensation from providing services to a covered plan. All other service providers may continue to qualify for §408(b)(2) relief by complying with only the reasonable termination and compensation conditions. The final regulation provides for three broad categories of covered service providers, with important refinements in coverage under each category.

Category 1: ERISA Fiduciaries and Registered Investment Advisers
First, a covered service provider includes a fiduciary under ERISA or an investment adviser registered under either the Investment Advisers Act of 1940 or any state law. The final regulation clarifies that this category includes (1) ERISA fiduciaries and/or registered investment advisers providing services directly to the covered plan, and (2) ERISA fiduciaries providing services to an investment contract, product or entity that holds "plan assets" (within the meaning of the usual ERISA definition) and in which the covered plan has a direct equity investment ("Investment Vehicle Covered Providers"). Thus, the following service providers to investment vehicles are *not* covered service providers under the final regulation:

- Non-fiduciary service providers to investment vehicles, regardless of whether such vehicles hold plan assets within the meaning of ERISA §§3(42) and 401 and DOL Reg. §2510.3-101;
- Service providers to non-plan asset vehicles (e.g., mutual funds, real estate operating companies, venture capital operating companies and funds in which benefit plan investors own less than 25% of each class of equity interests); and
- Service providers to investment vehicles, including plan asset vehicles, if the covered plan holds only an indirect equity interest in the vehicle. The final regulation thus distinguishes between the investment vehicle in which a covered plan directly invests and any underlying investments.

Comment:

- DOL's announced intention to propose an expansion in the definition of ERISA fiduciaries potentially could bring additional service providers within the scope of Category 1.
- Other than as described above, service providers to investment vehicles are not covered service providers, nor are affiliates or subcontractors of covered service providers.

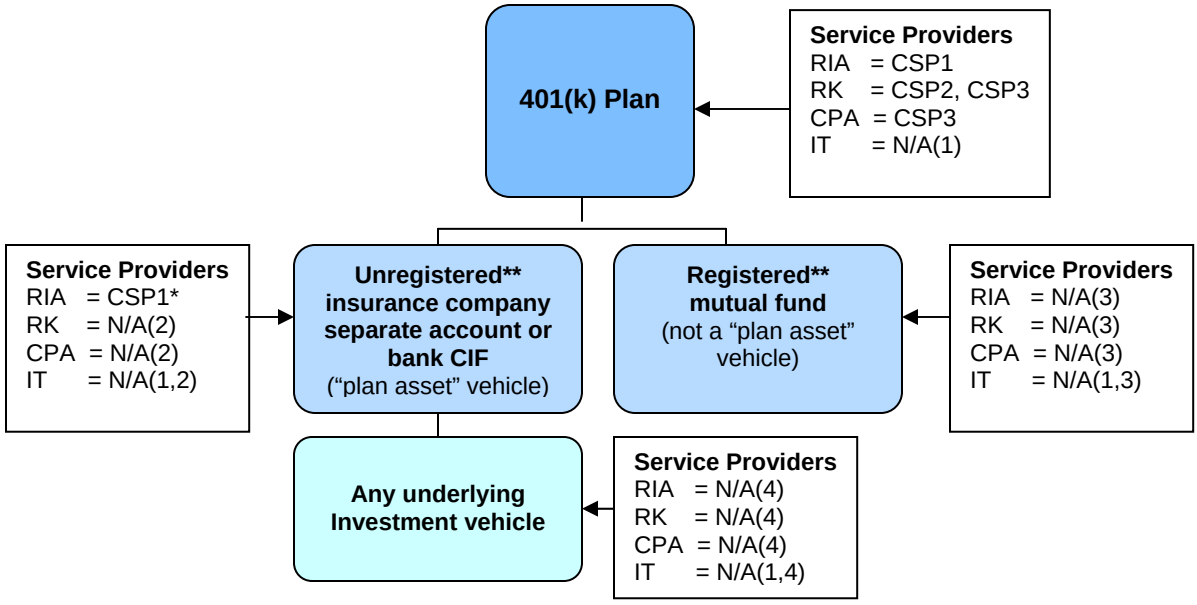
Category 2: Recordkeepers and Brokers for Individual Account Plans
Second, providers of recordkeeping (defined in the regulation) or brokerage (undefined) services to a covered, participant-directed individual account plan (e.g., most 401(k) plans) are treated as covered service providers if they offer, as part of their agreement or arrangement with the plan, one or more designated investment alternatives, such as a platform of investment options ("Recordkeeper/Broker Covered Providers").

Comment:

- DOL made a determination that Investment Vehicle Covered Providers and Recordkeeper/Broker Covered Providers are well-positioned to obtain additional compensation information from the investment vehicles to which they provide services and to relay that information to covered plans. The final regulation imposes special disclosure obligations (discussed below) on these service providers.
- Because of the way the disclosure rules operate, it may be that compensation received by a non-covered service provider will have to be disclosed by an affiliated covered service provider; e.g., if a recordkeeper is affiliated with service providers to an investment vehicle that is neither a direct investment nor a "plan asset" vehicle. If so, it is unclear how this would work in the case of fixed-return bank and insurance products.
- There will no doubt be characterization questions, at least on the margins, with respect to the listed services in Categories 2 and 3.

Category 3: Certain Service Providers Receiving Indirect Compensation
Third, covered service providers include any service provider that (itself or an affiliate or a subcontractor) does or reasonably expects to receive indirect compensation in connection with accounting, auditing, actuarial, appraisal, banking, consulting (related to the development or implementation of investment policies or the selection or monitoring of service providers or plan investments), custodial, insurance, investment advisory (plan or participant), legal, recordkeeping, securities or other investment brokerage, third-party administration and/or valuation services. The preamble clarifies that investment advisers thus may be covered service providers under either Category 1 (registered investment advisers receiving direct or indirect compensation) or Category 3 (investment advisers, whether or not registered, that reasonably expect to receive compensation that is indirect or paid from related parties).

Example: By way of example, consider the differing status under the final regulation of firms providing registered investment adviser (RIA), non-fiduciary recordkeeping (RK), non-fiduciary accounting (CPA) and non-fiduciary technology support (IT) services, depending in part on the point in the plan's investment structure they provide their services.



* If a fiduciary **Under the Investment Company Act of 1940

CSP1	Category 1 covered service provider
CSP2	Category 2 covered service provider, if designated investment options are offered with the services
CSP3	Category 3 covered service provider, if indirect compensation is received
N/A	Service provider not required to provide disclosure
	(1) Not a covered service category
	(2) Services, while a covered category, are non-fiduciary and are not provided at the plan level
	(3) While a direct investment vehicle, treated as not holding "plan assets"
	(4) Not a direct investment vehicle

Covered Plans. Covered plans under the final regulation include all employee pension benefit plans under ERISA §3(2)(A) that are subject to Title I of ERISA. DOL explicitly stated that IRAs, SEPs, and simple retirement accounts are not covered plans. Additionally, the final regulation does not apply to welfare plans like group life insurance and health plans; instead, a portion of the regulation has been reserved to provide future guidance on disclosure obligations with respect to welfare plans.

Disclosure Requirement. Unlike the proposal, the final regulation does not compel covered providers to provide their services only pursuant to a written agreement; instead, only certain written disclosures are required. The final regulation also abandons the proposal's requirement that service providers furnish a description of potential conflicts of interest; instead, it requires more detailed disclosure of indirect compensation.

Thus, under the final regulation, a covered service provider to a covered plan must include the following information in a written disclosure to responsible plan fiduciaries:

- A description of the covered services (e.g., not including non-fiduciary services to investment vehicles) to be provided to the plan. DOL indicated that the level of detail required to satisfy this obligation will depend on the individual needs of the responsible plan fiduciaries.

Comment: This subjective approach is potentially hard on service providers, who need to be able to determine their compliance with the exemption, and is inarguably uneconomic if carried to its logical extreme. The preamble suggests, however, that DOL does not intend this approach to require burdensome deviations from common understandings of service arrangements, and the regulation expressly preserves exemptive relief in the event of good-faith disclosure failures (discussed below). Consequently, it will be incumbent on DOL in its enforcement activities to accept service descriptions written to plausibly anticipate the needs generally of the plans receiving those services.

- The compensation reasonably expected to be received by the covered service provider, its affiliate or a subcontractor for each service. "Compensation" is defined broadly to include money or any other thing of monetary value. The covered service provider may express compensation as a formula, asset charge, or per capita charge so long as the description permits the plan fiduciary to evaluate the reasonableness of the compensation. The final regulation identifies four categories of compensation that must be disclosed:
    - Direct compensation, expressed either by service or in the aggregate (except for recordkeeping services, as provided below);
    - Indirect compensation, including identification of the services for which the indirect compensation will be received by the covered service provider (or its affiliate or subcontractor) and identification of the payer and the services for which that indirect compensation is received;
    - Compensation that will be paid among the covered service provider, an affiliate, or a subcontractor if such compensation is set on a transaction basis (e.g., commissions, soft dollars, finder's fees) or is charged directly against the plan's investment and reflected in the net value of the investment (e.g., 12b-1 fees). The service provider must identify the services for which such compensation will be paid, as well as the payers and recipients of such compensation; and

Comment: Since the services for which indirect compensation is provided can take on a differing complexion when viewed from the perspective of the plan or that of the array of service providers to the plan, at least some initial uncertainties in implementing this element are to be expected.

  - Compensation that the covered service provider, an affiliate or a subcontractor reasonably expects to receive in connection with termination of the contract or arrangement, and how any prepaid amounts will be calculated and refunded upon such termination.

- If recordkeeping services are bundled with other services, a separate description of the cost of the recordkeeping services. This is the only "unbundling" requirement in the final regulation;
- The manner of receipt of compensation, e.g., direct billing, deduction from plan accounts, or charge against plan investments; and
- If applicable, a statement that the service provider (or affiliate or subcontractor) will or reasonably expects to provide services as a fiduciary within the meaning of ERISA and/or as a registered investment adviser under the Advisers Act or any state law.

Additionally, an Investment Vehicle Covered Provider must disclose the following compensation information with respect to the investments for which they provide services (unless otherwise disclosed by a Recordkeeper/Broker Covered Provider as described below): all sales loads, redemption fees and other compensation that will be charged directly against the plan's investment in connection with the acquisition or withdrawal of interests from the investment vehicle; the annual operating expenses of the investment vehicle; and any other ongoing expenses associated with the investment vehicle, such as wrap fees.

- A Recordkeeper/Broker Covered Provider has a comparable obligation for each designated investment option included in its service arrangement, but can satisfy that obligation (without liability for any errors) by providing the current disclosure materials of the investment issuer so long as that issuer is not an affiliate, the disclosure materials are subject to federal or state regulation, and the covered provider does not know that the materials are incomplete or inaccurate.

The final regulation mandates no particular format for the required disclosure. DOL requested comments, however, on the possibility of requiring a "summary" disclosure statement that would provide responsible plan fiduciaries with an overview of the required disclosures and explain where to get more detailed information.

Timing of Disclosure. In the case of existing arrangements, disclosure must be provided by the July 16, 2011, effective date. Starting on that date, the required disclosures must be made reasonably in advance of the date that the service arrangement is entered into or renewed. For a new investment option, the information must be disclosed before the investment is added to the plan. Two exceptions apply:

- If an investment vehicle is a non-plan asset vehicle at the time the covered plan invests, but later becomes a plan asset vehicle while the plan still owns a direct equity interest, the Investment Vehicle Covered Provider must furnish the disclosure as soon as practicable but no more than 30 days after the date that it knows that the investment vehicle has become a plan asset vehicle.

- If an investment alternative is not a designated option at the time an arrangement with a participant-directed plan is entered into, an Recordkeeper/Broker Covered Provider must provide the required disclosure as soon as practicable but not later than the date the investment alternative is designated by the responsible plan fiduciary.

The covered service provider must disclose any change (not just a material change) in the information contained in the prior disclosure to a responsible plan fiduciary as soon as practicable, but generally no later than 60 days after acquiring knowledge of the change.

Form 5500 Information. A covered service provider must provide all information related to the arrangement and compensation received thereunder that is requested by the responsible plan fiduciary or plan administrator to comply with ERISA reporting or disclosure requirements, generally within 30 days of receipt of the request. Among other things, this requirement closes the loop for the Schedule C initiative.

Comment: In the proposal, this obligation was one of the terms of the required written agreement between the service provider and the plan. In the final regulation, which does not require a written agreement, this obligation is recast as an affirmative regulatory requirement for covered service providers.

Inadvertent Disclosure Errors. The final regulation provides that a contract or arrangement will not fail to qualify for §408(b)(2) relief due to a covered service provider's error or omission in disclosing required information, so long as the covered service provider (i) acted in good faith and with reasonable diligence; and (ii) disclosed the correct information as soon as practicable, but no later than 30 days after it knew of such error or omission.

Class Exemption: Protection for Plan Fiduciaries. If the service provider does not comply with the disclosure requirements of the final regulation – thereby potentially creating personal legal exposure for the plan fiduciary responsible for that service arrangement, who is also relying on §408(b)(2) for relief – the class exemption provides prohibited transaction relief for that fiduciary if:

- The 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 complied with its disclosure obligations;
- The plan fiduciary, upon discovering the failure, requests in writing that the service provider furnish the required information, if the plan fiduciary has not already received such information;
- The plan fiduciary notifies DOL if the service provider does not comply with the written request within 90 days. A model form for this notification is provided; and
- The plan fiduciary, upon discovery of the failure, makes a determination whether to terminate or continue the service arrangement.

IRC §4975. The final regulation clarifies that it applies, in respect of covered plans, for purposes of the parallel prohibited transaction rules under IRC §4975. Thus, a covered service provider that fails to comply with the final regulation may be subject to applicable excise taxes under the Internal Revenue Code

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Next Steps. Coming into compliance with the final regulation will require the following implementation steps, among others.

- Both plans that utilize and businesses that provide the enumerated classes of services should survey and identify their arrangements that may be subject to the new rules. It seems probable that the law of unintended consequences will be in effect here.
- The development and dissemination of disclosures compliant with the new rules will be a substantial undertaking.
- An even more substantial project will be the development of processes and systems by service providers that will identify and capture all the compensation required to be disclosed. While the systems implemented for Schedule C compliance will be helpful for providers serving plans with more than 100 participants, (i) the final regulation affects a much larger universe of providers and (ii) the data collection and reporting requirements for Schedule C and §408(b)(2) are not identical.
- Finally, many service providers will need to build an internal training program around these requirements and the procedures necessary for compliance.

The comment period on the interim final regulations, which runs until August 30, 2010, will cloud these efforts at least initially and may end up putting pressure on the time period for coming into compliance.

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If you have any questions about this development, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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