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PRIVATE INVESTMENT FUND

N E W S L E T T E R

Department of Labor Proposes Amendments to Regulation Interpreting Multiple Services Exemption

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This newsletter outlines the new disclosure and contract requirements applicable to service arrangements with plans that have been proposed by the Department of Labor ("DOL") by amendment to its regulation interpreting the statutory multiple services exemption under Section 408(b)(2) of ERISA (the "Multiple Services Exemption"). The proposal is one of several related DOL initiatives, described below. The other related initiatives will be covered in separate Mayer Brown client newsletters.

As discussed more fully below under "*Effective Date*," the new requirements will become effective 90 days after publication of the final amendments. The amendments would require enhanced disclosures regarding direct and indirect fees and potential conflicts of interest. If the amendments are adopted as proposed, they will also likely require amendments to a wide range of affected service contracts with ERISA-governed plans, including, for example, administrative service agreements, recordkeeping agreements, trust and custody agreements, investment management agreements, consulting agreements and brokerage agreements, etc., to conform to the new requirements. ERISA fiduciaries, including managers of investment funds deemed to hold plan assets,[1] such as bank collective trusts, insurance company separate accounts, and certain hedge funds and funds of funds that have significant investment by ERISA-governed plans will also need to consider whether compliance with the proposed new Multiple Services Exemption requirements is necessary, or whether the service arrangements with the fund are eligible for alternative exemptions (*see, "Alternative Exemptions for Service Contracts,"* below). In addition, in light of the DOL's recent emphasis on the need for ERISA fiduciaries to obtain and review the types of information described in the proposed amendments before entering into a service contract, it may be advisable for fiduciaries of ERISA-governed plans and funds to consider requesting enhanced disclosures and representations from service providers even before the effective date of the proposed amendments.

Background

On November 16, 2007 the DOL published a revised form of annual report (Form 5500) applicable to most ERISA plans, as well as accompanying regulations. The revised Form 5500 is the first of three regulatory projects intended to increase transparency of fees and expenses paid directly or indirectly by plans. Among other changes, the Schedule C to the Form 5500 will require significantly expanded reporting of direct and indirect compensation received by (i) service providers to the plan, (ii) any other person, if the person's eligi-

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bility for a payment or the amount of the payment is based, in whole or in part, on services that were rendered to the plan or on a transaction or series of transactions with the plan, and (iii) service providers to mutual funds, private investment funds, bank collective trusts and insurance company separate accounts in which a plan holds an interest (regardless of whether the fund is deemed to hold plan assets of the plan). The revised Form 5500 is generally applicable beginning with the 2009 plan year.

On December 13, 2007 the DOL issued proposed amendments to its regulation under Section 408(b)(2) of ERISA, the statutory prohibited transaction exemption that permits a plan to retain and pay reasonable compensation to a service provider that is a party in interest to the plan. The proposed amendments complement the revised Form 5500 reporting rules by requiring extensive disclosures of direct and indirect compensation received by the service provider and specifies certain requirements, representations and covenants that must be included in a written contract with the service provider. The proposed amendments will become effective 90 days after publication of the final amendments.

Both releases are part of the DOL's recent focus on increasing transparency regarding fees and expenses paid by ERISA plans and ensuring that plan fiduciaries obtain the information they need to assess the compensation paid for services rendered to the plan, taking into account revenue-sharing arrangements among plan service providers and potential conflicts of interest. They also reconfirm the DOL's recent public statements that gifts received by plan fiduciaries in connection with their duties for a plan could subject the fiduciaries to liability under ERISA as well as criminal prosecution.

DOL is also working on proposed revisions to the regulations under Section 404(c) of ERISA. Whereas the first two pieces of guidance focus on the reporting of information by service providers to plan fiduciaries, and from plan administrators to the federal government, the final regulatory project will focus on disclosures that must be made to plan participants as a condition of obtaining the limited relief from fiduciary liability provided by Section 404(c) to plan sponsors who maintain participant-directed plans.

Application of Prohibited Transaction Rules to Service Arrangements

The prohibited transaction rules under ERISA prohibit fiduciaries from causing a plan to enter into a transaction (including the provision of services) with a person who is a party in interest with respect to the plan, unless an exemption is available for the transaction. If a service contract constitutes a non-exempt prohibited transaction, the service provider is subject to excise tax penalties under the Internal Revenue Code.[2]

Why is an Exemption Necessary to Enter into a Service Arrangement with an Unrelated Party? A "party in interest" is defined to include, among other persons, any person who provides services to a plan. Accordingly, if a prospective service provider is not otherwise a party in interest, it would become a party in interest as soon as it entered into a service arrangement with a plan. Because the provision of services is an ongoing transaction, the party in interest status of a service provider could arguably cause the transaction to *become* a prohibited transaction (in the absence of an exemption) the moment it is entered into.

Proposed Amendments to Regulation Interpreting Multiple Services Exemption

ERISA includes a statutory exemption under Section 408(b)(2) for service transactions between a plan and a party in interest, provided that (i) the contract or arrangement is reasonable, (ii) the services are necessary for the establishment or operation of the plan, and (iii) no more than reasonable compensation is paid for the services. A regulation promulgated by the DOL in 1977 provides guidance on the application of each of the conditions of ERISA Section 408(b)(2). In the case of the reasonableness of a contract or arrangement, the existing regulation merely requires that the contract must allow the plan to terminate it without penalty on reasonably short notice under the circumstances to prevent the plan from being locked into an arrangement that has become disadvantageous. Most fiduciaries and service providers to plans have relied primarily upon the statutory exemptive relief afforded by the Multiple Services Exemption because of its fairly straightforward conditions.

Although the statute does not, by its terms, authorize the DOL to impose additional conditions for relief under Section 408(b)(2), such as specific contract terms, the DOL's proposed amendments to the Section 408(b)(2) regulation would accomplish that result by interpreting the statutory term "reasonable contract or arrangement." The proposed amendments do not modify or provide new guidance on any other aspect of Section 408(b)(2), such as what termination provisions are considered reasonable, although DOL is soliciting public comments on whether additional guidance is needed on these points.

Similar to the amendments to Schedule C of the Form 5500, referenced above, the primary focus of the proposed amendments to the Section 408(b)(2) regulation is to significantly expand the required disclosures from service providers regarding potential conflicts of interest and fees and other compensation received directly and indirectly by the service provider and its affiliates.

Service Providers Covered by New Disclosure Requirements. The new requirements will only apply to the following Covered Service Providers:

- *ERISA Fiduciaries.* Any service provider providing services as an ERISA fiduciary. This would include persons who (i) exercise any discretionary authority or control respecting management of the plan or exercise any authority or control respecting management or disposition of its assets; (ii) render investment advice for a fee or other compensation, direct or indirect, with respect to property of the plan or have any authority or responsibility to do so; or (iii) have any discretionary authority or discretionary responsibility in the administration of the plan.
- *Investment Advisors.* Any service provider who provides services to the plan as a fiduciary under the Investment Advisers Act of 1940.
- *Providers of Certain Specified Services.* Any service provider who provides any one or more of the following services:
  - banking
  - consulting
  - custodial
  - insurance
  - investment advisory (to the plan or to participants)
  - investment management
  - recordkeeping
  - securities or other investment brokerage
  - third party administration.

- *Certain Recipients of Indirect Compensation*. Any service provider who receives indirect compensation or fees in connection with the provision of accounting, actuarial, appraisal, auditing, legal or valuation services. Indirect compensation means any compensation received by the service provider or its affiliate other than from the plan, the plan sponsor or the service provider.

In the case of fiduciaries, there is nothing in the proposed amendments that indicates that the scope of Covered Services Providers is intended to be limited to fiduciaries who are not part of, or affiliated with, the plan sponsor. Accordingly, inside fiduciaries (for example, in-house administrative committee members) should consider whether compliance with the requirements under the amended exemption may be necessary, and if so, how the new conditions might apply.

The "banking" category could impact a broad range of service arrangements that plans maintain with banks, such as benefits disbursements, checking and automatic roll over IRAs. To the extent that any of the banking services are provided in connection with trustee or other fiduciary services provided by a bank, they may be covered the statutory exemption under Section 408(b)(6) of ERISA for ancillary services provided by a bank fiduciary.

The "custodian" category could extend to collateral and custodial arrangements maintained in connection with brokerage or derivatives transactions.

The "indirect compensation" category should primarily impact service providers in the identified categories that are part of bundled service arrangements. However, it is not limited to such arrangements. Consequently, persons who provide these types of services and who are retained or paid by a third party to provide services in connection with an ERISA-governed plan or fund even if retained or paid by a third party, should make sure that it is clear who their client is, (e.g., the plan or fund itself or the plan sponsor), and if the plan or fund is the client, evaluate the need for compliance with the conditions under the Multiple Services Exemption.

New Disclosures Required. Under the proposed amendments, prior to entering into or renewing or extending a contract between a plan and a Covered Service Provider, the service provider must provide the responsible plan fiduciary with written disclosure regarding the matters listed below:

- *Services and Compensation.* All services to be provided under the contract, with respect to each service, the compensation to be received by the service provider (or any of its affiliates) in connection with the contract, and the manner of receipt of such compensation. If the services are offered as a bundle that is priced as a package, except as described below, only the aggregate direct and indirect compensation must be disclosed. Regardless of whether included in a bundle, all transaction-based compensation, such as brokerage commissions, finder's fees and soft dollars, and all compensation received from third parties, such as management fees paid by a mutual fund, float revenue, Rule 12b-1 distribution fees, wrap fees and shareholder servicing fees, must be separately disclosed.

- *Fiduciary Status.* Whether the service provider (or an affiliate) will provide any of the services as a "fiduciary" within the meaning of Section 3(21) of ERISA or under the Investment Advisers Act of 1940.

- *Participation in Transaction.* Whether the service provider (or an affiliate) expects to participate in or otherwise acquire an interest in any transaction to be entered into by the plan in

connection with the service arrangement, and a description of such transaction and the service provider's interest.

- *Conflicts of Interest.* Whether the service provider (or an affiliate) has any material financial, referral or other relationship with any person that creates or may create a conflict of interest for the service provider in performing its services under the contract, such as with a money manager, broker, other client of the service provider or other service provider to the plan, and, if so, a description of such relationship(s).

- *Ability to Impact Compensation.* Whether the service provider (or an affiliate) will be able to effect its own compensation without prior approval by an independent plan fiduciary (for example as a result of incentive, float or other contingent compensation), and if so, a description of the nature of such compensation.

- *Policies and Procedures.* Whether the service provider (or an affiliate) has any policies or procedures that address actual or potential conflicts of interest, and if so, an explanation of such policies or procedures and how they address such conflicts of interest.

A Covered Service Provider must also disclose on a continuing basis any material change to the information described above within 30 days from the date on which the service provider acquires knowledge of such change.

There is no prescribed method for delivery of the required disclosures. For example, the disclosures could be contained in an SEC-registered investment adviser's SEC Form ADV,[3] an offering memorandum or prospectus, or a combination of any of these plus supplemental disclosures, as necessary.[4]

Note that the disclosures generally require information regarding the service provider *and* each of the service provider's affiliates (defined as the service provider's officers, directors, agents, employees and partners, and persons that are controlling, controlled by or under common control with the service provider).

Definition of Compensation. Similar to the approach taken in the DOL's Form 5500 amendments, compensation is defined very broadly to include money or anything of monetary value received by the service provider or its affiliate in connection with the service provided to the plan or the financial products in which the plan's assets are invested, including, for example, gifts, awards, trips for employees, research, finder's fees, placement fees, commissions, sub-transfer agent fees, Rule 12b-1 distribution fees, soft dollar payments, float income, etc. Note that there is no exclusion for *de minimis* gifts or entertainment.

Specific Contract Requirements. The proposed amendments require that the service arrangement be governed by a written contract, and sets forth a number of specific representations and covenants that must be included in the written contract:

- *Agreement to Provide Disclosures.* The terms of the contract must obligate the service provider to provide, to the best of the service provider's knowledge, the required disclosures and include a representation from the service provider that before the contract was entered into (or renewed or extended) all of the required disclosures were provided to the responsible plan fiduciary.

- *Agreement to Notify of Material Changes.* The terms of the contract must include an agreement from the service provider to disclose to the responsible plan fiduciary any material change to

the information required to be disclosed not later than 30 days from the date on which the service provider acquires knowledge of the material change.

- *Agreement to Provide Information.* The terms of the contract must require the service provider to disclose all information related to the contract that is requested either by the responsible plan fiduciary *or the plan administrator* (even if the fiduciary responsible for the contract is an investment manager or other outside fiduciary) in order to comply with the reporting and disclosure requirements under ERISA, including the information required to be filed under Form 5500.

Application to Plan Asset Funds. The general partner, manager or other fiduciary of a plan asset fund is considered to be a fiduciary, and therefore, a service provider, with respect to the assets of the ERISA investors in the fund. As a result, sponsors and ERISA investors in plan asset funds must be sure that the Multiple Services Exemption or another prohibited transaction exemption is available for such deemed service transaction between the fund fiduciary and the investing ERISA entities. The disclosures required under the proposed amendments, if and when they become effective (*see "Effective Date,"* below), could be included in the private placement memorandum for the fund. To the extent the requisite disclosures are not sufficiently covered in the private placement memorandum, or if the fund has already closed, the private placement memorandum may be supplemented by a side letter or other document. The fund documents will also need to include the requisite representations and covenants from the fund fiduciary. These could be added to the operating agreement for the fund, subscription agreement or side letter.

It is possible that an ERISA investor may be eligible for one or more other exemptions that would cover the deemed service transaction between the ERISA investor and the fund fiduciary. For example, as discussed below under "*Alternative Exemptions for Service Contracts,"* the fiduciary of an ERISA investor may be a QPAM or INHAM and eligible for the exemptive relieve afforded by those exemptions. If the fund is a collective trust, insurance company separate account or other pooled investment fund maintained by a bank or insurance company, the deemed service transaction may also be eligible for the exemptive relief afforded under Section 408(b)(8) of ERISA.

Fiduciaries of private investment funds that are deemed to hold plan assets under ERISA must also ensure that service contracts entered into on behalf of the fund either comply with the Multiple Services Exemption or another prohibited transaction exemption.

Effective Date

The requirements under the proposed amendments will become effective 90 days after publication of the final amendments (although the DOL has invited comments on whether the final amendments should be made effective on a different date). Unless another exemption is available for a service contract (*see* discussion below), the new requirements must be satisfied for each new service contract entered into between a plan and a Covered Service Provider and each extension or renewal of such service contract. In addition, services between a plan and Covered Service Provider that are not currently provided pursuant to a written contract will need to be documented in a written contract that meets the new Multiple Services Exception requirements by the effective date. It does not appear that existing contracts are required to be amended or otherwise comply with the new requirements until

the first time on or after the effective date the contract is extended or renewed. However, if a contract is terminable at will by the plan, it could be viewed as "extended" on each day that it is not terminated. Accordingly, parties to such contracts that are relying on the Multiple Services Exception should take steps to comply with the new requirements upon the effective date.

The DOL emphasized in the preamble to the proposed amendments that notwithstanding the need to comply with the exemption, in its view, a plan fiduciary would in all cases need to engage in an objective process designed to elicit the information necessary to assess the reasonableness of the compensation to be paid for the services and all other relevant information and to monitor the services on an ongoing basis in order to satisfy its basic duties under Section 404 of ERISA to act prudently and solely in the best interest of the plan's participants and beneficiaries.[5] In the DOL's view, the disclosures required in the proposal are the minimum that a fiduciary would need to obtain to satisfy its duties. Accordingly, even before the effective date of the proposed amendments, ERISA fiduciaries will need to re-evaluate their procedures for retaining and monitoring service providers in light of the guidance included in the proposal.

In addition, even if the Multiple Services Exemption is determined not to be necessary because of the availability of another exemption (*see "Alternative Exemptions for Service Contracts*," below) plan fiduciaries may need to request disclosure of much of the same information in order to meet their enhanced reporting requirements under Form 5500.

New Service Provider Exemption Requirements Not Required for Certain Contracts and Arrangements

Compliance with the extensive disclosure and contract requirements under the proposed amendments are not required (i) if a service contract is covered by another prohibited transaction exemption, (ii) if the service is provided to a fund or vehicle that is not deemed to hold plan assets, or (iii) if the contract is not with a Covered Service Provider.

As discussed above, even if not required for exemption purposes, ERISA fiduciaries may seek to obtain the information described in the proposal in order to avoid prudency questions. In addition, simultaneously with its publication of the proposed amendments, the DOL published a proposed class exemption affording safe harbor relief to plan fiduciaries that enter into service contracts in reliance on the Multiple Services Exemption in the event that the disclosure requirements are not fully satisfied due to a failure by the service provider.[6] ERISA fiduciaries that wish to avail themselves of the protection afforded by the new class exemption might seek to require the service provider to comply with the disclosure and contract requirements under the proposed amendments, even if another exemption is available.

Alternative Exemptions for Service Contracts. There are a number of other exemptions that could provide relief for a service contract, depending on the nature of the responsible plan fiduciary or the type of service. For example:

- QPAM exemption, if a fiduciary that meets the requirements of a "qualified professional asset manager" under PTE 84-14 negotiates and causes the plan to enter into the service contract pursuant to that exemption.

- INHAM exemption, if a fiduciary that qualifies as an "in house asset manager" under PTE 96-23 negotiates and causes the plan to enter into the contract pursuant to that exemption.
- Bank collective trust exemption, if the service contract is entered into with a bank collective trust pursuant to PTE 91-38.
- Insurance company separate account exemption, if the service contract is entered into with an insurance company separate account pursuant to PTE 90-1.
- Insurance company general account exemption, if the service contract is entered into with an insurance company general account pursuant to PTE 95-60.
- The exemption available under Section 408(b)(6) of ERISA if the services are ancillary to fiduciary services provided by a bank to a plan.
- Part I(b) & (c) of PTE 75-1 if the services provided are brokerage and related services, including effecting securities transactions as an agent, the performance of clearance, settlement or custodial functions in connection with the transactions, the provision of advice and analysis with respect to the value of securities or other property or the advisability of investing in securities or other property.
- The exemption available under Section 408(b)(8) of ERISA permitting, among other things, a bank or insurance company to receive reasonable compensation in connection with services to a pooled investment fund maintained by the bank or insurance company.

However, a QPAM or other responsible fiduciary eligible for one of the exemptions described above for service contracts it enters into on behalf of the plan may still need to rely on the Multiple Services Exemption for *its* service contract with the plan.

Exemption Not Required for Services Provided to Non-Plan Asset Funds and Vehicles. Compliance with Section 408(b)(2) of ERISA is also not required for services that are provided solely to a fund or vehicle in which a plan has an interest if the fund or vehicle is not deemed to hold plan assets under ERISA. For example, if an ERISA plan invests in a mutual fund (which is statutorily exempt from ERISA), or in a hedge fund, real estate fund or private equity fund that is eligible for a plan asset exception, transactions entered into by the mutual fund or private investment fund are not subject to the prohibited transaction rules of ERISA.

However, if the investment in a non-plan-asset fund or vehicle is made pursuant to a service arrangement with a plan, the service provider may be required to disclose information regarding compensation it or its affiliates receives at the fund level. For example, if an investment adviser to a plan causes the plan to invest in an affiliated mutual fund in reliance on PTE 77-4, the investment adviser would be required to include in its Section 408(b)(2) disclosures information regarding fees paid by the mutual fund to the investment adviser or any of its affiliates. As discussed above, the disclosure obligation may be satisfied through disclosures otherwise provided to the responsible plan fiduciary, such as in the mutual fund prospectus or the disclosures provided for compliance with PTE 77-4.

New Disclosure Requirements Not Necessary for Service Providers Other Than Covered Service Providers. The proposed new disclosure and contract requirements under the Multiple Services Exemption do not have to be satisfied for service

contracts between a plan and a service provider that is not a Covered Service Provider. However, such contracts would need to continue to comply with the other requirements of the Multiple Services Exemption if they were entered into in reliance on that exemption. In addition, ERISA fiduciaries should consider whether enhanced disclosure may, nevertheless, be prudent.

Comment Period

The DOL is currently accepting comments from interested parties regarding the proposed amendments. Written comments must be submitted on or before February 11, 2008.

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The discussion and conclusions of any federal tax matters in this newsletter are limited to the specific federal tax issues addressed herein. Additional federal tax issues may exist that could affect the federal tax treatment of any transaction that is the subject of this newsletter. This newsletter does not consider or provide any conclusion with respect to any such additional issues. With respect to any federal tax issues that are not addressed by this newsletter, this newsletter was not written, and cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on any taxpayer under U.S. tax law.

More Information

If you have any questions regarding this memorandum or would like us to advise you as to your specific situation, please telephone the member of our ERISA Department who regularly advises you or Laura Bader (312.701.7929), Herbert W. Krueger (312.701.7194), Lennine Occhino (312.701.7966) or Linda Shore (202.263.3284).

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[1] A regulation under ERISA provides guidance on when the assets of an investment fund in which an ERISA plan invests will be deemed to include plan assets of the ERISA plan, *see* 29 C.F.R. § 2510.3-101. If an investment fund is deemed to hold plan assets, the general partner or manager of the fund is deemed to be an ERISA fiduciary with respect to the assets of the plan invested in the fund, and the investments, transactions (including service transactions) and operations of the investment fund are subject to ERISA's fiduciary and prohibited transaction rules.

[2] *See* Section 4975 of the Internal Revenue Code of 1986, as amended (the "Code"). The DOL was granted authority to interpret Section 4975 of the Code pursuant to Reorganization Plan No. 4 of 1978, 43 Fed. Reg. 47713 (Oct. 17, 1978). Curiously, the DOL did not specifically invoke its authority under the Reorganization Plan to amend the regulations interpreting Section 4975 of the Code, raising a question as to whether a failure to comply with the proposed amendment would result in the transaction being prohibited for Code Section 4975 purposes. If not, the service provider would not incur any excise tax penalties as a result of the failure to comply with the new requirements.

[3] SEC registered investment advisers must deliver Part II of the SEC Form ADV (which includes disclosures regarding compensation and conflicts) to clients prior to entering into an advisory contract.

[4] 72 Fed Reg. 70988, 70990 (Dec. 13, 2007).

[5] *Id.* at 70993.

[6] *See id.* at 70893. The proposed amendments also require ERISA fiduciaries to report the service provider's failure to disclose to the DOL and to evaluate, in light of the service provider's failure to comply, the prudency of maintaining the contract with the service provider.