Department of Labor Expands Annual Reporting Requirements for Service Provider Compensation

On November 16, 2007, the Department of Labor (DOL) published a revised Form 5500 applicable to most plans governed by the Employee Retirement Income Security Act of 1974 (ERISA), as well as accompanying regulations. Among other changes, the new Form 5500 includes a revised Schedule C that requires significantly expanded reporting of direct *and indirect* compensation received by (i) service providers to the plan, (ii) other persons, if eligibility 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. The revised Form 5500 is generally applicable beginning with the 2009 plan year. The DOL has supplemented (and to some extent modified) the instructions and other guidance published with the revised Schedule C through two sets of "Frequently Asked Questions" issued or updated in July 2008, October 2009, and February 2010. Some of this guidance has been incorporated into the instructions for the forthcoming 2010 Schedule C.

Related Initiatives. As discussed in more detail in our newsletter of January 2008 entitled *Department of Labor Proposes Amendments to Regulation Interpreting Multiple Services Exemption*, the DOL released a second significant regulatory initiative intended to increase transparency regarding fees and expenses paid by ERISA plans to service providers. On January 8, 2008, the DOL proposed amendments to the regulations under Section 408(b)(2) of ERISA, the statutory exemption that permits a plan to retain and pay reasonable compensation to a service provider that is a party in interest to the plan. Although final regulations were not published prior to the start of the Obama Administration, the new administration has continued the project. We understand that final regulations (possibly interim regulations) are likely to be issued later this year. As proposed, the amendments would complement the revisions to Schedule C of Form 5500 by requiring disclosures of direct and indirect compensation received by the service provider. Together, these two initiatives can be expected to increase the burdens on not only plan fiduciaries who are responsible for ensuring the reasonableness of service provider fees and expenses and reporting such amounts on the Form 5500, but also on plan service providers who will be subject to increased disclosure obligations and increased risk of prohibited transaction excise tax penalties if the expansive disclosure requirements are not fully satisfied.

On July 23, 2008, the DOL proposed regulations under Section 404(a) of ERISA that would obligate plan fiduciaries to provide additional disclosures, including disclosure of direct and indirect fee arrangements, to participants in participant-directed individual account plans. This project has also continued under the Obama Administration, and we expect final regulations to be published later this year.

These 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 public statements by senior DOL officials that plan fiduciaries who accept gifts risk potential ERISA liability as well as criminal prosecution.

In part, the DOL initiatives appear to be in response to congressional concern about the lack of transparency of fees which directly and indirectly impact the net returns available from various investment alternatives provided to participants in 401(k) plans. *See*, for example, H.R. 2989, "401(k) Fair Disclosure and Pension Security Act of 2009," which as of this writing remains under consideration by the House Committee on Ways and Means. The initiatives also reflect the DOL's concerns about consultants and other service providers who have undisclosed relationships which may present conflicts of interest.

This update focuses on the revisions to Form 5500 that increase disclosure obligations relating to direct and indirect compensation paid to direct and indirect service providers in connection with ERISA plans.

Expansion of Service Providers Subject to Compensation Disclosure. Schedule C of Form 5500 previously required plan administrators to report only the plan's 40 most highly compensated service providers who received at least $5,000 from the plan during the plan's reporting year. The revised Form 5500 extends a plan administrator's reporting obligation to *all* persons[1] who directly *or indirectly* received $5,000 or more in total compensation in connection with services rendered to the plan or the person's position with the plan. However, payments made by the plan sponsor that are not reimbursed by the plan are not treated as direct or indirect compensation for purposes of the Schedule C reporting requirements.

In addition, plan administrators must report information regarding the source from which certain identified "key service providers" received $1,000 or more of reportable indirect compensation. This enhanced conflict of interest reporting applies to service providers who meet the $5,000 reportable compensation threshold and who are plan fiduciaries, as well as to contract administrators, consultants, custodians, investment advisors, investment managers, brokers and recordkeepers, regardless of whether such service providers are fiduciaries to the plan. The details that must be reported include the identity of the payor, the payor's relationship to the service provider, the amount paid and the nature of the compensation.

Application to Employees and Officers of the Plan Sponsor. The revised Schedule C does not require reporting of salaries or other compensation of individual employees of the plan sponsor or other business entity where the plan sponsor or business entity is itself reported on the Schedule C as a service provider, provided that the employee did not separately receive reportable direct or indirect compensation in relation to the plan. However, in-house personnel who perform services for the plan may be required to report meals, travel, and other "gifts" received from other plan service providers, as described in greater detail below under "Reporting of Gifts."

Broad Scope of "Indirect" Compensation. Indirect compensation is defined to include compensation received from sources other than directly from the plan or plan sponsor if the compensation was received in connection with services rendered to the plan during the year or the person's position with the plan. The instructions state that for this purpose, compensation is considered to have been received in connection with the person's position with the plan or for services rendered to the plan *"if the person's eligibility 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."*[2] For example, reportable indirect compensation could include:

- Finders' fees, placement fees and solicitation fees paid in connection with transactions involving the plan
- Float revenue received by a plan trustee or custodian
- Brokerage commissions, regardless of who retains or pays the broker or whether the broker has trading discretion, as a result of a transaction involving the plan
- Soft dollar research or other services received by an investment manager from a broker-dealer or other third party as a result of plan transactions
- Other transaction-based fees received in connection with transactions or services involving the plan, regardless of whether they are capitalized as investment costs.

However, reportable indirect compensation would not include "compensation that would have been received had the service not been rendered or the transaction not taken place and that cannot be reasonably allocated to the services performed or transaction(s) with the plan."

Furthermore, in the case of an "investment fund," which the DOL has broadly defined to include not only commingled investment funds but also single customer managed accounts, ordinary operating expenses such as attorneys' fees, accountants' fees, printers' fees, and brokerage costs and other expenses associated with effecting transactions within the investment fund portfolio are not reportable indirect compensation.

Implication of Definition of Indirect Compensation to Definition of Service Provider. As noted above, the instructions to the new Form 5500 provide that:

- Compensation which is not paid by the plan or the plan sponsor is reportable as indirect compensation if the compensation was received in connection with services rendered to the plan during the year or the person's position with the plan.
- Compensation is considered to have been received in connection with the person's position with the plan or for services rendered to the plan "if the person's eligibility 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."[3]

Although not entirely clear, it appears that the DOL not only intends to expand the scope of *compensation* received by service providers that is reportable, but also to expand the types of *service providers* whose compensation may be reportable to include service providers to non-plan asset entities and persons who receive compensation in connection with plan transactions.

Compensation Received by Service Providers to Private Investment Funds Which Hold Plan Assets and in Which a Plan Has an Interest. The new Schedule C requires reporting of fees paid to service providers to bank commingled trusts, insurance company pooled separate accounts and other pooled investment funds in which the plan invests to the extent that the fees are charged against the fund and are reflected in the value of the plan's investment.[4]

The new rules appear to require a plan administrator to report, on the plan's Schedule C, the plan's pro rata share of fees paid to a service provider to any such fund in which the plan has an interest if the fees are charged against the fund and reflected in the value of the plan's investment, and the amount of the fee is impacted by the amount of the plan's investment in the fund.

For example, fund-related reportable indirect compensation could include fees paid to the investment manager, subadvisers and other service providers who are paid asset-based fees from the fund, unless the fund is a Direct Filing Entity (DFE) described in DOL Regulation 2510.103-12.[5] If a fund holding plan assets is a DFE under DOL Regulation 2510.103-12, such payments would be reflected on the Form 5500 filed by the fund, and would not need to be reported again on a plan investor's Form 5500.[6] However, pooled separate accounts and bank commingled trusts that act as DFEs are not required to file a Schedule C as part of their annual reports. For these funds, it is generally understood that fee information will be required to be reported on the Schedule C filed by each investing plan.

Compensation Received From Mutual Funds in Which a Plan Has an Interest. The instructions to the new Schedule C indicate that reportable indirect compensation includes fees and expense reimbursements received from mutual funds in which plans have invested. Examples are advisory fees, sub-transfer agency fees, shareholder servicing fees, account maintenance fees and 12b-1 distribution fees.

The instructions do not specifically provide that the disclosure of such fees and expense reimbursement received from mutual funds is limited to persons who provide services to a plan. If intended to cover all persons who receive any fees or expense reimbursements from a mutual fund, the legal and conceptual underpinnings to this reporting requirement are not clear.

By statute, the assets of mutual funds are not deemed to be plan assets for ERISA purposes.[7] Therefore, a person providing services to a mutual fund is not, solely because of those services, generally treated as providing services to a plan that purchases shares of the mutual fund.

Mutual funds are, however, integral to the design and servicing of typical 401(k) plans. Revenue sharing from mutual funds is often used to compensate providers of recordkeeping, advisory and other services to the plan itself. However, in many instances, mutual fund fees are not received by any person who provides services to the plan. These situations might include, for example, investments by defined benefit pension plans. Even in these instances, fees paid by the mutual fund to its advisor may be reportable compensation, though it may be permissible to use the alternative reporting mechanism described below for these fees.

Application to Other Investment Funds That Do Not Hold Plan Assets. Many hedge funds, private equity funds and other alternative investment funds are not deemed to hold plan assets because they operate in reliance on one or more of the plan asset exceptions set forth under ERISA and DOL regulations.[8] The Schedule C reporting rules with respect to such private investment funds vary depending on whether the fund qualifies as an operating company, including a venture capital operating company or a real estate operating company, or rely on another plan asset exemption. With respect to venture capital operating companies and real estate operating companies, the DOL has indicated that compensation received in connection with the management and operation of such funds is not reportable compensation for Schedule C purposes.[9] However, fees or commissions received by the manager or general partner of a fund that qualifies as an operating company in connection with a plan's investment in the fund would be reportable compensation.[10] With respect to investment funds relying on one of the other plan asset exceptions, such as the exception for funds with less than 25 percent of benefit plan investors, the plan administrator will need to identify all reportable compensation paid to providers of services to the funds.[11]

Alternative Reporting for Eligible Indirect Compensation. Any compensation that qualifies as "eligible indirect compensation" may be reported on the new Schedule C in an abbreviated manner, described below. If a person also receives direct compensation or any ineligible indirect compensation, the simplified alternative reporting is not available with respect to such compensation.

If compensation qualifies as eligible indirect compensation, in lieu of reporting the details on the identity of the recipient, the amount or formula for calculating compensation and type of compensation, etc. the plan fiduciary may simply report the name, employer identification number (EIN) or address of the person who provided the plan with the requisite disclosures, discussed below (which may be a person other than the person who received the compensation).

For indirect compensation to be eligible for the abbreviated reporting, the indirect compensation must be of a certain specified type, and the plan administrator must have received certain specified disclosures.

Types of Eligible Indirect Compensation. The compensation that is eligible for the alternative reporting option is limited to fees or expense reimbursements that are not paid directly by the plan or plan sponsor, but that are charged to an investment fund in which the plan has an interest and reflected in the value or return on the plan's investment, or that are for distribution, investment management, recordkeeping or shareholder services; commissions and finders' fees paid to persons providing direct or indirect services to the participating plans; soft dollar revenue; float revenue; or other transaction-based fees for transactions or services involving the plan that were not paid directly by the plan or plan sponsor regardless of (whether or not they are capitalized as investment costs). As noted above, DOL guidance indicates that single customer/separately managed accounts are treated as investment funds for this purpose.[12]

Attorneys' fees, accountants' fees, printers' fees, brokerage costs and other expenses associated with effecting transactions within the investment fund portfolio are treated as ordinary operating expenses and not reportable indirect compensation.

Types of Required Disclosures. In order for compensation to be eligible for the alternative reporting option, the plan administrator must obtain full disclosure of all relevant information, including: (i) the existence of the indirect compensation, (ii) the services provided for the indirect compensation, (iii) the amount of the compensation or the formula used to calculate or determine the compensation, (iv) in the case of a bundled compensation arrangement, a description of each element of indirect compensation, and (v) the identity of the party or parties paying and receiving the compensation.

The disclosure requirement may be satisfied through any written disclosure that contains the requisite information and that is provided to the plan administrator. In addition, the disclosure need not be contained in a single document. For example, the disclosure requirement regarding an investment manager's receipt of soft-dollar services could be satisfied by the plan administrator receipt of the manager's SEC Form ADV,[13] supplemented, as necessary, with specific written disclosures included in the investment management agreement. Similarly, the disclosure requirement with respect to 12b-1 fees received by a plan's recordkeeper could be satisfied through the plan administrator's receipt of the mutual fund's prospectus supplemented, as necessary, with specific written disclosures in the recordkeeping contract.

Disclosures that are delivered to a fiduciary other than the plan administrator would not satisfy the alternative reporting disclosure requirement. For example, the provision of disclosures to a fund-of-funds manager regarding soft dollar services received by a portfolio fund's investment manager generally would not satisfy the disclosure requirement unless such disclosures are, in turn, delivered to the plan administrator.

Bundled Service Arrangements. The new Schedule C reporting rules allow compensation directly paid by the plan for a bundled service arrangement to be reported as a single service arrangement. In this case, the plan does not need to also report indirect compensation allocated to affiliates or subcontractors utilized by the bundled service provider that are included in the fee paid by the plan.

A bundled service arrangement is defined as an arrangement pursuant to which the plan retains one company to provide a range of services, directly or through affiliates or subcontractors, which are priced to the plan as a single package. For example, if the plan enters into an arrangement with an investment advisor pursuant to which the plan receives investment advisory, recordkeeping and custodial services for a single asset-based fee, the plan administrator only needs to report the asset-based fee paid directly to the investment advisor, and not any portion of the compensation that may be indirectly allocated among the bundled service providers, regardless of whether the various bundled service providers are affiliated with the advisor.

However, the bundled service rule does not extend to any indirect compensation charged to and reflected in the net value of a plan's investment in a fund. All such indirect compensation paid to service providers to a mutual fund or private investment fund must continue to be reported separately (subject to the alternative reporting option for eligible indirect compensation described above), even if part of a bundled service arrangement.

In addition, subject to the alternative reporting option described above, any person involved in a bundled service arrangement who is a fiduciary to the plan or provides one or more of the following services to the plan — contract administration, consulting, investment advisory, investment management, securities brokerage or recordkeeping — and receives amounts as commissions (including finders' fees), soft dollars or other non-monetary compensation, float revenue or transaction-based fees (e.g., brokerage commissions), must be separately reported on Schedule C, even if such person is affiliated with the other members of the bundled service group.

Reporting of Gifts. The compensation that must be reported on the new Schedule C includes business meals, gifts, promotional items and other similar non-monetary forms of compensation paid to any person from any source as long as the person's eligibility for the non-monetary compensation is based, in whole or in part, on services rendered to the plan or on a transaction or series of transactions with the plan. Non-monetary indirect compensation generally does not qualify for the alternative reporting option offered for eligible indirect compensation.

Gifts or meals of insubstantial value which are tax deductible by the person providing the gift or meal, and which are not taxable income to the recipient, may be excluded from a plan's Schedule C. In order to qualify for the exclusion, the gift must be valued at less than $50, and the aggregate value of gifts from one source (for this purpose, gifts given from multiple employees of a single entity are treated as originating from a single source) in a calendar year must be less than $100. However, meals and gifts provided to multiple employees of a single entity need not be aggregated for purposes of determining whether the $50 or $100 limit is exceeded. In addition, gifts and gratuities with a value of less than $10 need not be counted toward the $100 aggregate threshold, and need not be reported even if the $100 aggregate threshold is exceeded.

Although, subject to the exclusion described above, the value of gifts received is counted in determining whether a person meets the $5,000 minimum reportable compensation threshold, a plan administrator is not required to report gifts on its Schedule C in the first place unless the recipient of the gift meets the $5,000 aggregate compensation threshold.

The DOL cautions that the thresholds established are for Schedule C reporting only, and gifts or gratuities of any amount paid to or received by plan fiduciaries may violate ERISA and give rise to civil liabilities and criminal penalties, reinforcing recently reported public statements by senior DOL officials.

Duty to Report Service Provider's Failure to Provide Requisite Information. ERISA imposes specific reporting obligations only on plan administrators, as well as insurance companies and banks or similar institutions that hold plan assets. The DOL has no statutory authority to require other plan service providers to provide information to the plan administrator for the Schedule C. To encourage plan service providers to provide this information, however, the amended Schedule C requires the plan administrator to report the name and other identifying information of any service provider who refused or failed to disclose information requested by the plan administrator in order to fully comply with its reporting obligation.

The DOL has announced that, for the 2009 reporting year, it will not enforce this requirement with respect to service providers who provide a statement to the plan administrator to the effect that the service provider made a good faith effort to make any necessary recordkeeping and information system changes in a timely fashion, and that, despite such efforts, the service provider was unable to complete the changes for the 2009 plan year. We expect that many plan service providers will provide this statement, even if they attempt to provide all of the required information. However, the DOL has indicated that it expects plan administrators who receive such statements to follow up with those service providers to ascertain the steps that the service provider is taking to ensure that it will be able to provide the information required by the plan administrator in future years.[14]

In light of the emphasis placed by the DOL on a fiduciary's duty to obtain the information he or she needs to assess the compensation paid for services rendered to the plan and potential conflicts resulting from compensation arrangements, a service provider's failure to provide the information required for Form 5500 reporting should also trigger enhanced scrutiny by the plan fiduciary regarding the continued prudence of such service arrangement.

It is unclear whether this reporting obligation extends to persons who received only indirect compensation in connection with plan services and transactions. The Form 5500 instructions specifically instruct plan administrators that, before reporting service providers as persons who failed or refused to provide information, the administrator must contact such service providers to request the necessary information and notify them that their failure will be reported on the plan's Schedule C.[15] In light of the broad range of persons who may be picked up under the indirect compensation reporting obligation, it is unlikely that plan administrators would be able to identify and contact all such persons to request the information required to be reported on Schedule C. However, plan administrators may be expected to demand that the plan's direct service providers furnish information relating to identifiable indirect service providers.

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More Information

If you have any questions regarding this update or would like us to advise you as to your specific situation, please telephone the member of our Employment and Benefits Department who regularly advises you or one of the lawyers listed below.

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Endnotes

1 The DOL believes that it is "generally sufficient" to treat an affiliate group as a single person and identify that affiliate group in Part I if Schedule C as the party receiving compensation from the plan for rendering services for the plan. *See*, 72 Fed. Reg. 64731, 64741 (Nov. 16, 2007). However, it is unclear whether all reportable direct and indirect compensation received by members of an affiliate group must be aggregated for purposes of the $5,000 threshold.

2 *Id.* at 64825.

3 *Id.* at 64825.

4 *See* 72 Fed. Reg. 64731, 64825.

5 DOL regulation 29 C.F.R. Section 2520.103-12 permits, but does not require, certain investment funds that are deemed to hold "plan assets" for ERISA purposes to directly file their own Form 5500 return/report, including Schedule C.

6 *See* 72 C.F.R. at 64817.

7 *See* ERISA Section 401(b)(1).

8 *See* 29 C.F.R. 2510.3-101 and ERISA Section 3(42).

9 *See* DOL Frequently Asked Questions, FAQ-7. However, the DOL has stated that this exception does not apply to private funds that rely on the plan asset exception under which less than 25 percent of the total value of each class of equity interests in such fund are held by benefit plan investors. *See* DOL Supplemental FAQs, FAQ-6.

10 *See* DOL Frequently Asked Questions, FAQ-7.

11 However, where a plan invests in a private investment fund (top tier fund) that invests in another investment fund (lower tier fund), fees received by persons at the lower tier fund level in connection with the top tier fund's investment in the lower fund generally would not be reportable compensation. See DOL Supplemental FAQs, FAQ-5.

12 *See* DOL Frequently Asked Questions, FAQ-3.

13 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.

14 *See* DOL Supplemental FAQs, FAQ-10.

15 *See* 72 Fed. Reg. 64731, 64745.