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Legal Update
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Emerging Issues under Interim Final Regulation on Plan Service Provider Fee Disclosure

On July 16, 2010, the US Department of Labor (DOL) issued an interim final regulation (the Regulation) amending its longstanding regulations interpreting the statutory exemption for the provision of plan services under Section 408(b)(2) of the Employee Retirement Income Security Act (ERISA). The Regulation, which will become effective on April 1, 2012 (the Effective Date) for all new and existing service provider relationships covered by the Regulation, will require certain Covered Service Providers that provide services to ERISA-governed retirement plans to provide additional disclosures as a condition of obtaining an exemption under Section 408(b)(2). The new disclosures are intended to help plan fiduciaries evaluate the reasonableness of the service provider's total compensation and whether the service provider is subject to conflicts of interest that may affect the service provider's performance.

The Regulation is the second part of the DOL's three-part regulatory initiative to require enhanced disclosures relating to direct and indirect service provider compensation. The revised Form 5500, including a revised Schedule C that significantly expands plan administrators' reporting requirements for service provider arrangements, is already in effect. On October 20, 2010, the DOL completed the three-part initiative by issuing final regulations that impose additional disclosure obligations on fiduciaries of participant-directed plans effective for plan years beginning after October 31, 2011.

All of these initiatives 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. Although 401(k) plans and other participant-directed plans appear to be the primary focus of these initiatives, the Regulation and the new reporting rules also apply to other types of plans.

Covered Service Providers will be required to comply with the new requirements in order to avoid a prohibited transaction under ERISA, unless the service arrangement is covered by another prohibited transaction exemption. Although certain service provider relationships may be eligible for alternative exemptions (see "Alternative Exemptions for Service Contracts" below), the DOL is considering whether additional changes are necessary to impose similar disclosure requirements on arrangements that may currently be covered by alternative exemptions.

Background

The prohibited transaction rules under ERISA prohibit fiduciaries from causing a plan to enter into certain types of transactions (including the provision of services) with persons who are parties in interest with respect to the plan. Parties in interest are defined to include any person who provides services to a plan. Section 408(b)(2) of ERISA provides a statutory exemption to permit parties in interest to provide services to a plan 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. If a service contract constitutes a nonexempt prohibited transaction, the service provider is subject to excise tax penalties under Section 4975 of the Internal Revenue Code of 1986, as amended (the Code).

In 1977, the DOL published regulations under Section 408(b)(2) to provide additional guidance on the scope of the exemptions. (The Department of Treasury published corresponding regulations under the parallel provisions in Section 4975 of the Code at the same time.) Those regulations provide guidance on the application of each of the conditions of ERISA Section 408(b)(2). In the case of the "reasonable contract" requirement, 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. To date, most fiduciaries and service providers to plans have relied primarily upon the statutory exemption afforded by Section 408(b)(2) because of its fairly straightforward conditions.

On December 13, 2007, the DOL published proposed amendments to its regulation under Section 408(b)(2) of ERISA (the Proposal), primarily to enhance a Covered Service Provider's disclosure requirements in order for the arrangements to be considered reasonable. The Proposal would have required Covered Service Provider contracts to include specified terms and required Covered Service Providers to make specific disclosures of direct and indirect compensation arrangements, fiduciary status and conflicts of interests.[1] The Proposal was not intended to modify or provide new guidance on any other aspect of Section 408(b)(2), such as what termination provisions are considered reasonable.

The Proposal would have applied to a broad range of plan service providers with respect to all plans subject to ERISA or Section 4975 of the Code. In addition, it would have required contracts for the provision of services to incorporate certain specific terms, and would have required covered service providers to provide detailed disclosures of information extending beyond current industry norms. The Proposal would also have required Covered Service Providers to disclose detailed information regarding potential conflicts of interest as well as any policies and procedures designed to address such conflicts. The DOL posted more than 100 public comments on the Proposal on its website, many of which were critical of the Proposal's scope and breadth.

Interim Final Regulation

The Regulation limits or omits many of the more controversial aspects of the Proposal while also restricting its scope. For example, the Regulation applies only to service provider relationships with certain employer-sponsored pension and retirement plans. The DOL also decided to omit requirements that service providers disclose extensive conflict of interest information, instead opting to require disclosures of compensation among related parties, which would allow responsible plan fiduciaries to discern potential conflicts of interest. Like the Proposal, however, the Regulation significantly expands the required disclosures from service providers regarding direct and indirect fees and other compensation received by service providers (and their affiliates and subcontractors) to covered pension and other retirement plans.

Because the Regulation differs substantially from the Proposal, the DOL issued the Regulation as an interim final regulation and has solicited additional public comments on the Regulation. The DOL is also considering whether and to what extent additional disclosures should be provided to welfare benefit plans and other plans that are not covered by the Regulation. The DOL may publish final amendments to the regulation under Section 408(b)(2) before the Regulation takes effect.

PLANS COVERED BY THE REGULATION

The Regulation applies only to service provider relationships with certain Covered Plans. Covered Plans are defined to include employer-sponsored pension and retirement plans (other than individual retirement accounts (IRAs), SIMPLE IRAs and simplified employee pensions (SEPs)) that are not otherwise exempt from ERISA. Commenters have asked the DOL to exempt nongovernmental 403(b) plans (for educational institutions and certain non-profit organizations) from being treated as Covered Plans.

SERVICE PROVIDERS COVERED BY THE REGULATION

The new requirements will only apply to certain service providers to Covered Plans. Covered Service Providers are service providers that expect to receive $1,000 or more in direct or indirect compensation (including non-monetary compensation such as gifts, entertainment and travel, subject to a $250 aggregate *de minimis* threshold)[2] in connection with providing such services, whether such services are actually performed or such compensation actually received by the Covered Service Provider, an affiliate or a subcontractor. Covered Service Providers include:

- **ERISA Fiduciaries.** Any service provider that provides services as an ERISA fiduciary directly to a plan or to a fund or other entity that is deemed to hold plan assets for ERISA purposes and in which the plan holds a *direct* equity interest. 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 direct or indirect compensation 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.
- **Registered Investment Advisers.** Any service provider that provides services directly to the plan as an investment adviser registered under the Investment Advisers Act of 1940 (the Advisers Act) or state law. In a change from the Proposal, a registered investment adviser's status as a Covered Service Provider will not depend on whether the investment adviser acts as a fiduciary under the Advisers Act or state law. (For ease of reference, fiduciaries described above and registered investment advisers that are Covered Service Providers will be collectively referred to as "Fiduciary Service Providers.")
- **Providers of Certain Recordkeeping or Brokerage Services to Participant-Directed Individual Account Plans (Platform Providers).** Any service provider that provides recordkeeping or brokerage services to a participant-directed plan (such as a 401(k) plan) is a Covered Service Provider if one or more of the designated investment alternatives offered under the plan (other than a self-directed brokerage window) is "made available (e.g., through a platform or similar mechanism) in connection with" the recordkeeping or brokerage arrangement. This category appears to focus on the role that such record keepers or brokers may play in the plan fiduciary's selection of investment options to be offered under the plan where the record keeper or broker may derive fees or other compensation from the investment options.

- **Certain Direct Service Providers Who Receive Indirect Compensation (Direct/Indirect Service Providers).** Direct/Indirect Service Providers are any persons that receive indirect compensation or fees in connection with the provision of certain specified services: accounting, actuarial, appraisal, auditing, banking, consulting related to investment policies or selection of plan investments or service providers, custodial, insurance, investment advisory, legal, recordkeeping, securities or other investment brokerage, third-party administration or valuation services *provided directly to a Covered Plan.* Indirect compensation means any compensation received by the service provider or its affiliate *other than* from the plan, the plan sponsor or certain affiliates or subcontractors of the service provider. Persons who provide services indirectly to plans, for example to funds or other entities in which plans invest, do not fall into this category of potential Covered Service Providers, even if the fund is deemed to hold plan assets.

The Regulation's definition of Covered Service Providers presents several interpretive difficulties when applying the definition to the marketplace. For example, it is unclear whether an entity that has multiple lines of business and offers a variety of services through separate agreements with a plan would be treated as a Covered Service Provider with respect to all such agreements if it acts as a Covered Service Provider under one agreement. In addition, there is nothing in the Regulation that definitively excludes fiduciaries that are employed by or affiliated with the plan sponsor from becoming Fiduciary Service Providers. Some commenters have asked the DOL to confirm that inside fiduciaries are not Covered Service Providers, but until such guidance is issued, inside fiduciaries (for example, in-house administrative committee members) should consider whether compliance with the Regulation may be necessary, and if so, how the new conditions might apply.

Commenters have also sought clarification on a variety of specific issues, such as whether a record keeper would be treated as a Platform Provider if it provides some services in connection with a third-party platform but does not maintain the platform.

The scope of the Direct/Indirect Service Provider definition has also attracted criticism in submitted comments. The DOL declined, in the Regulation, to clarify its definition with respect to the sorts of services that might make one a Direct/Indirect Service Provider, taking its chosen terms to have accepted industry meanings. The DOL has otherwise indicated, however, that it intends the list of services to be comprehensive. Thus, service providers should take a fairly generous approach when determining whether the services for which they receive indirect compensation make them Direct/Indirect Service Providers. For example:

- **Banking.** The banking category could impact a broad range of non-fiduciary service arrangements that plans maintain with banks, such as benefits disbursements, tax processing, participant loan processing, performance measurement, custody and checking, to the extent that the bank receives indirect compensation for such services. 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.
- **Custodial Services.** The custodial services category could extend to custodial arrangements maintained in connection with brokerage or derivatives transactions. It could also extend to collateral or margin accounts, to the extent that such accounts contain plan assets.
- **Investment Brokerage.** Investment brokerage could include real estate brokerage and services provided by futures commissions merchants. Some commenters have also asked

the DOL to clarify whether brokerage of insurance contracts purchased for investment purposes would be included under this heading.

- **Recordkeeping.** The Regulation defines recordkeeping services to include services related to plan administration and monitoring of plan and participant and beneficiary transactions (e.g., enrollment, payroll deductions and contributions, etc.) as well as to the maintenance of Covered Plan and participant and beneficiary accounts, records and statements. Plan record keepers who do not maintain a platform through which investments are provided but do receive indirect compensation from, for example, one or more of the plan's investment options, would likely fall within this category of Direct/Indirect Service Provider. However, this definition appears to include a broader range of administrative service providers, prompting some commenters to ask DOL to confirm that this category was intended to pick up only those service providers generally considered to be "record keepers" in the benefit industry (and not, for example, service providers that provide Covered Plan participants the same record or account maintenance services they would offer other retail investors).

INITIAL DISCLOSURE

The Regulation requires a Covered Service Provider to provide certain initial disclosures to a plan fiduciary with the authority to cause each Covered Plan to enter into the service arrangement (the responsible plan fiduciary). The disclosures are not required to be separate from the service contract and general disclosure provided in connection with the service arrangement. Generally speaking, the initial disclosures must be provided prior to entering into a contract or arrangement between the Covered Plan and the Covered Service Provider (or, in the case of existing contacts, prior to the effective date of the Regulation) and must describe the following:

Nature of Services to be Provided. The initial disclosures must include a description of the services to be provided pursuant to the contract or arrangement. The Regulation does not require any specific level of precision when describing such services other than that necessary to enable a responsible plan fiduciary to evaluate the reasonableness of the fees the Covered Plan will pay for them. Thus, in circumstances where it is well understood that a service would really consist of several "sub-services" (e.g., custodial arrangements typically involve settlement, safekeeping, pricing and reporting services) the Regulation does not require each of the sub-services to be specifically disclosed.

Compensation. A Covered Service Provider must disclose compensation that it, as well as any affiliate or subcontractor, reasonably expects to receive in connection with providing the disclosed services. The Regulation distinguishes between four kinds of compensation that all Covered Service Providers must disclose:

- **Direct.** The Covered Service Provider must disclose all compensation the service provider, any affiliate or any subcontractor reasonably expects to receive in connection with providing the services. Direct compensation may be disclosed on an aggregate basis or may be separated out on a service-by-service basis.
- **Indirect.** In addition to disclosing the amount of indirect compensation the Covered Service Provider, an affiliate or a subcontractor reasonably expects to receive, the service provider must also identify the services for which it will receive the compensation as well as the party that will be paying the compensation.
- **Related-Party Compensation.** This is a description of all compensation to be paid among the Covered Service Provider, its affiliates or subcontractors, but only if such compensation is set on a transaction basis

(e.g., commissions, soft dollars, finder's fees) or charged directly against a Covered Plan's investment and reflected in the net value thereof. This disclosure must identify the services for which the compensation is paid as well as each payer and recipient of such compensation (including whether such payer or recipient is an affiliate or subcontractor of the Covered Service Provider). Related-party compensation must be disclosed even if it must also be disclosed under another provision of the Regulation. Thus, this disclosure appears to be intended to assist responsible plan fiduciaries in evaluating potential conflicts of interest, which the DOL may view as particularly important in light of its decision not to require specific disclosures of potential conflicts of interest as provided in the proposal.

- **Termination Compensation.** If the Covered Service Provider, an affiliate or a subcontractor reasonably expects to receive compensation in connection with a termination of the contract or agreement, this compensation must be disclosed, including a description of how any prepaid amounts will be calculated and refunded upon termination.

Manner of Receipt. The Covered Service Provider must describe the manner in which the compensation will be received (e.g., whether it will be billed to the plan or deducted from an account maintained on behalf of the plan).

In addition to the disclosures described above, certain Covered Service Providers must also disclose the following information in their initial disclosures:

Status. If a Fiduciary Service Provider (or an affiliate or subcontractor) reasonably expects to provide the disclosed services either as a fiduciary under ERISA or as a registered investment adviser, it must disclose this fact, unless the service provider will be providing services only as a registered investment adviser to an entity that holds plan assets. In such a case, the registered investment adviser does not need to disclose its status with respect to such services. However, it is not entirely clear when a person that is a registered investment adviser will be deemed to be providing services as a registered investment adviser for purposes of the Regulation.

Fiduciary Services to Plan Asset Entities. If a Fiduciary Service Provider acts as an ERISA fiduciary to a fund or other entity that holds plan assets and in which a Covered Plan holds a direct equity investment, the initial disclosure must include (i) a description of any compensation that will be charged directly against the plan's investment in the entity in connection with the purchase, sale, transfer of or withdrawal from the fund or entity (e.g., redemption fees); (ii) a description of annual operating expenses if the return is not fixed and (iii) any other ongoing expenses.

The Regulation does not address the situation where a return might be fixed, but periodically reset (e.g., many guaranteed investment contracts), or where there are no operating expenses to disclose. Commenters have asked the DOL to clarify the initial disclosure requirements in these circumstances. The Regulation does not require disclosure of the amount of expenses. So, in the case of investment funds that have no operational history on which to base any quantification of expenses at the time the initial disclosure is made, the types of expenses that will be charged to the fund should be clearly disclosed. The DOL has indicated in informal discussions, that the ultimate goal behind the disclosure of expenses is to provide responsible plan fiduciaries with a basis for an "apples-to-apples" comparison of expenses among investment options. In light of this, fiduciaries making these additional disclosures for an entity without an operational history should take into account customary industry practices with respect to disclosing such expenses.

Recordkeeping Services. If a Covered Service Provider will be providing recordkeeping services, whether as a Platform or Direct/Indirect Service Providers Service Provider, the initial disclosure must include a description of all direct and indirect compensation that the service provider, an affiliate or a subcontractor reasonably expects to receive in connection with such recordkeeping services. This compensation must be disclosed whether the compensation is paid through direct charges for such services or through other fees or compensation received by the Covered Service Provider, an affiliate or a subcontractor. If the recordkeeping services are expected to be provided without explicit compensation for the services, or if recordkeeping compensation is to be offset or rebated based on the receipt of other compensation received by the Covered Service Provider, an affiliate, or a subcontractor, the description must include a reasonable good faith estimate of the cost to the plan of the recordkeeping services, including an explanation of the methodology used to derive the good faith estimate.

Recordkeeping and Brokerage Services to Participant-Directed Plans. Platform Service Providers must provide additional disclosures regarding each designated investment alternative for which recordkeeping or brokerage services will be provided, regardless of whether the investment alternatives are plan asset entities (excluding brokerage windows, self-directed brokerage accounts, and similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated). With respect to each such investment alternative, the initial disclosure must include a description of any compensation that will be charged directly against the plan's investment in the entity in connection with the purchase, sale, transfer of, or withdrawal from the fund or entity (e.g., redemption fees); the annual operating expenses (e.g., expense ratio) if the return is not fixed (e.g., preferred stock), and any other ongoing expenses.

The Regulation provides that this initial disclosure requirement may be satisfied by providing to the Covered Plan current disclosure materials provided by the issuer of the designated investment alternatives, but only (i) if the issuer is not an affiliate, (ii) the disclosure materials are regulated by a state or federal agency and (iii) the Platform Service Provider is not aware of any deficiency or inaccuracy in the issuer's disclosure. Commenters have criticized this limited safe harbor on various grounds. For example, in some cases, providing prospectuses for dozens of investment options made available on an investment platform would not result in meaningful disclosure for responsible plan fiduciaries, who often would not have the resources to evaluate the disclosures fully. In addition, it is not clear what policy bases justify the exclusion from the safe harbor of affiliated issuers and issuers whose disclosure materials are not regulated, since Platform Service Providers will have little alternative but to rely on their disclosure materials anyway. Finally, commenters have asked the DOL to clarify that the contemplated disclosures can be made through the use of third-party service providers that collect the required information and provide informative summaries of that information.

CONTINUING DISCLOSURE OBLIGATIONS

After the initial disclosures have been made and the contract or arrangement has been entered into, the Regulation requires Covered Service Providers to provide additional disclosures in order to continue to qualify for the exemption available under Section 408(b)(2). These continuing disclosure obligations arise in three circumstances:

Responses to Requests. Upon written request by the responsible plan fiduciary, a Covered Service Provider must provide any other information relating to the compensation received in connection with the contract or arrangement that is required for the plan to comply with any reporting and disclosure requirements imposed under Title I of ERISA (including any regulations, forms and schedules) within 30 days of the request (unless extraordinary circumstances beyond the service provider's control preclude the service provider from providing the information within that time, in which case it must be provided as soon as practicable).

If, for example, a Covered Service Provider fails to provide all of the information required by the plan administrator to satisfy the enhanced reporting requirements in Schedule C within 30 days of a written request made at any time, it appears that the DOL could take the position that the provision of services is not covered by Section 408(b)(2). Since many Covered Service Providers' systems are set up to provide this information on a regular, annual basis, rather than upon request, such an interpretation could be quite problematic. Several commenters have asked the DOL to provide further guidance that would give Covered Service Providers at least 120 days after the end of a plan year to respond to Schedule C-related requests. Pending further guidance, Covered Service Providers might seek agreements with responsible plan fiduciaries that they will request such information only at upon agreed upon times and only as reasonably necessary for the satisfaction of their own disclosure and reporting obligations.

Although most commenters focused on the obligation to respond to requests in connection with Schedule C, the requirement actually extends to any reporting or disclosure obligation imposed under Title I. This may include the new requirements that plan fiduciaries provide certain fee and other investment disclosures to plan participants in participant-directed plans.[3]

Changes. If any changes to the information subject to the initial disclosures occur, then the Covered Service Provider must disclose such changes not later than 60 days from the date on which the Covered Service Provider is informed of the change, unless extraordinary circumstances preclude such disclosure, in which case the information must be provided as soon as practicable. Unlike the Proposal, the Regulation does not predicate the obligation to update information on the materiality of the changes, which prompted a number of negative comments. Many who submitted comments noted that this ongoing disclosure requirement risks prodigious amounts of useless disclosure of changes, such as changes to expense ratios, that might occur frequently during the course of a service relationship.

Consistent with their initial disclosure obligations, Platform Service Providers have ongoing disclosure obligations with respect to investment alternatives that are added to the Covered Plan's platform after it enters into the contract or arrangement with the Service Provider. The Regulation requires the Platform Service Provider to provide additional disclosures with respect to such investment alternatives "as soon as practicable" but in any case *before* the designation of the investment alternative. Commenters have uniformly rejected the timing of such disclosures as impracticable, because such investment alternatives are often "designated" by responsible plan fiduciaries before the record keepers or brokers have any relationship with the issuers of the investment alternatives.

Correction of Inadvertent Errors and Omissions. If a Covered Service Provider, acting in good faith and with reasonable diligence, makes an error or omission in its initial disclosures or in a response to a responsible plan fiduciary's request, it can still qualify for the exemption available under Section 408(b)(2) if it provides the correct information within 30 days from the date on which the Covered Service Provider knows of the error or omission.

Exemption for Responsible Plan Fiduciary. The Regulation affords responsible plan fiduciaries special exemption in the event of the failure by a Covered Service Provider to disclose the information required if the responsible plan fiduciary did not know of the omission, and if, upon discovering the omission, the responsible plan fiduciary takes steps to obtain the information, and reports to the DOL any Covered

Service Provider who fails to comply with requests within 90 days after the request is made.

SPECIAL CONSIDERATIONS FOR PRIVATE INVESTMENT FUNDS

The general partner, manager or other fiduciary of a fund that is deemed to hold plan assets will be a Fiduciary Service Provider, with respect to the ERISA investors in the fund. As a result, the fiduciaries responsible for investing in such funds will be required to ensure that Section 408(b)(2) or another prohibited transaction exemption is available for the provision of services by such persons. The disclosures required under Section 408(b)(2) could be included in the private placement memorandum for the fund, or in a supplemental side letter or other document.

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 qualified professional asset manager (QPAM) or in-house asset manager (INHAM) and eligible for one of 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 exemption 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 Section 408(b)(2) or another prohibited transaction exemption. However, the new disclosure requirements under the Regulation only apply to fund-level service providers who are fiduciaries or investment advisers.

In addition, the disclosure requirements in the Regulation apply only to plan asset funds in which the plan holds a *direct* equity interest and does not apply to other funds in which that entity may invest, even if the underlying funds hold plan assets. The Regulation thus clearly does not apply to the underlying fund managers in familiar fund-of-fund arrangements. In such arrangements, only the manager of the top-tier fund is a Covered Service Provider. The Regulation's application in feeder and blocker-fund contexts is less clear, however. For example, fund managers often manage both a main fund and, either directly or through an affiliate, one or more feeder funds into the main fund. Because of the breadth of the disclosure requirements, such fund managers may be required to provide disclosures with respect to their management of the main fund if they or their affiliate are Covered Service Providers to the feeder funds in which Covered Plans invest.

WHO IS AN AFFILIATE?

The Regulation defines the affiliates of any Covered Service Provider to include any person or entity that directly or indirectly controls, is controlled by, or is under common control with the Covered Service Provider, as well as any officer, director, employee of or partner in the Covered Service Provider.

WHO IS A SUBCONTRACTOR?

A subcontractor is a person or entity, other than an affiliate of the Covered Service Provider, that reasonably expects to receive at least $1,000 in compensation for (i) performing one or more of the Covered Services on behalf of the Covered Service Provider pursuant to a contract or arrangement with the Covered Service Provider or an affiliate, or for (ii) performing one or more of the Covered Services contemplated by the Covered Service Provider's contract or arrangement with a Covered Plan. A subcontractor would not itself become a Covered Service Provider by reason of providing Covered Services on behalf of a Covered Service Provider and thus would not become directly subject to the new disclosure requirements. However, the Covered Service Provider will be required to disclose whether the subcontractor will provide services as a registered investment adviser or a fiduciary and to describe any transaction-based compensation or fees charged against the plan's investment that will be paid to the subcontractor. For example, the manager of a fund that holds plan assets might retain an unaffiliated investment manager to manage cash or a sub-portfolio of the fund. Unless it is specifically contemplated in the fund documents that cash management will be delegated to a third-party manager, the cash manager would be a subcontractor to the manager, who would be a Covered Service Provider.

DISCLOSURE OBLIGATIONS OF AFFILIATES AND SUBCONTRACTORS

Subcontractors and affiliates of Covered Service Providers do not have any independent disclosure obligations, even if they provide services that would have made them Covered Service Providers in their own right had they contracted directly with a Covered Plan. The Regulation generally requires a Covered Service Provider to make the requisite disclosures regarding the Covered Service Provider *and* each of the service provider's affiliates and subcontractors. A Covered Service Provider's failure to deliver all of the requisite disclosures regarding its affiliates and subcontractors who provide services in connection with the arrangement will not cause the affiliates or subcontractors to be in a prohibited transaction.

INITIAL DISCLOSURES

After the Effective Date, the Regulation will require Covered Service Providers to provide the required initial disclosures reasonably in advance of the date that a contract or arrangement for the provision of services is entered into, extended or renewed. Commenters have found this "entered into" criterion to be vague in some circumstances. For example, is it the date the contract is first signed, the services are first rendered, or compensation first paid? Some asked the DOL to provide, in further guidance, that a contract or arrangement is "entered into" once a contract is executed or compensation is first paid. Until further guidance is provided, however, Covered Service Providers should provide their initial disclosures reasonably in advance of the earliest point at which an exemption will be required.

NO GRANDFATHERING OF EXISTING CONTRACTS OR ARRANGEMENTS

The Regulation will apply to contracts or arrangements that are already in existence on the Effective Date. Accordingly, Covered Service Providers must satisfy the disclosure requirements with respect to contracts or arrangements entered into prior to the Effective Date. If a contract or arrangement is entered into prior to the Effective Date, the initial disclosures must be made by the Effective Date (rather than in advance of the commencement of the service-provider relationship).

FORMAT OF DISCLOSURE

Unlike the Proposal, the Regulation does not require that the arrangement for the provision of services be incorporated in a written agreement; however, the required disclosures must be provided in writing. The Regulation does not require a service provider to provide the required disclosures in any specific form, as long as the required information is included in written materials delivered to the plan fiduciary. For example, the disclosures could be contained in an investment adviser's SEC Form ADV,[4] an offering memorandum or prospectus, or a combination of any of these plus supplemental disclosures, as necessary.[5]

That said, the DOL is considering whether to require, in further guidance, a separate concise summary document containing all of the disclosures required by the Regulation along with a "road map" indicating where more detailed disclosures can be found in other documents provided by the service provider. While most commenters have advised against requiring a separate summary document, the consensus view among them is that requiring a separate “road map” document would not be unduly onerous. Many also asked the DOL to provide an optional model document that would, if used, at least presumptively satisfy the Covered Service Provider’s initial disclosure obligations under the Regulation.

In the preamble to the Proposal, the DOL suggested that electronic disclosures would satisfy the Regulation’s requirements, but the Regulation itself does not address such a possibility. Many commenters have asked the DOL to clarify that electronic disclosures would be permitted and to address whether sufficient disclosure can be provided by providing a link to a website containing the required information.

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. This includes, for example, gifts, awards, trips for employees, research, finder’s fees, placement fees, commissions, sub-transfer agent fees, Regulation 12b-1 distribution fees, soft dollar payments, float income, etc. The only exclusion from the definition is for non-monetary compensation valued at $250 or less, in the aggregate, during the term of the contract or arrangement.

Some commenters have noted that the prospective disclosure of several kinds of non-monetary compensation is unrealistic. They have asked the DOL either to clarify how it expects the initial disclosure of compensation such as gifts and awards to be achieved or, in the alternative, to eliminate any prospective disclosure requirement of such compensation.

CONSEQUENCES FOR FAILURE TO COMPLY

If a Covered Service Provider must rely on Section 408(b)(2) in order to provide services to a Covered Plan but fails to satisfy all of its disclosure obligations, including any of its continuing obligations, the exemption afforded by Section 408(b)(2) will no longer apply to the service-providing arrangement. The arrangement would then become a prohibited transaction, potentially subjecting the plan fiduciary to liability for breach of fiduciary duty, and the Covered Service Provider to excise taxes under Section 4975 of the Code. This much is clear; what is not clear is how such excise taxes would be assessed on the prohibited transaction.

For example, it is not clear whether failing to satisfy the Regulation with respect to a request for information would render the entire course of the service relationship a prohibited transaction or if only providing services after such a failure would constitute a prohibited transaction. In addition, the excise tax is based upon a Code-defined amount involved which, in the case of the parallel Code provision to Section 408(b)(2) of ERISA, means just the excess compensation paid for the services. Nothing in the Regulation changes the manner in which the excise tax penalty is calculated under Section 4975 of the Code. Accordingly, where the compensation paid for services is not excessive, it does not appear that the resulting prohibited transaction would trigger any excise tax penalties for the service provider.

Comparison with Schedule C Requirements

Like the Regulation, Schedule C is designed to help responsible plan fiduciaries make informed decisions about the service providers they retain for their plans. Accordingly, there are many general similarities between the two, even though the two disclosure regimes are ultimately very different.

As an initial matter, the DOL has clearly stated that, while there may be some overlapping concepts between the two regimes, they are to apply independently of one another. Thus, for example:

- Covered Service Providers may have to disclose indirect compensation under the Regulation that would not be reportable by a plan administrator under Schedule C.
- Compensation that would be indirect for Schedule C purposes may be direct for purposes of the Regulation.
- Not all Covered Plans are covered by the Schedule C, and not all service providers whose compensation must be reported on Schedule C are Covered Service Providers.
- Written disclosures required to qualify for alternative reporting under Schedule C may not be sufficient for initial disclosure purposes (and vice versa).

The two regimes are also fundamentally different, in that Schedule C is retrospectively oriented, while the Regulation contemplates the disclosure of compensation prospectively. Several commenters have argued that it would make sense to align the two regimes more closely, which would also minimize compliance burdens. For example, like the Regulation, Schedule C requires the reporting of compensation received only if it exceeds certain *de minimis* amounts over the course of a plan year, but these *de minimis* amounts are different than similar amounts are in the Regulation (namely, they are significantly higher). In addition, the Regulation in some cases requires prospective disclosure of information that is more feasibly disclosed on a retrospective basis (the receipt of gifts, for example), so that it might make sense to shift certain disclosure requirements in their entirety from the Regulation to Schedule C.

Prior to the promulgation of the Regulation, most Covered Service Providers (other than managers of certain direct filing entities) did not have any direct obligation to provide information required on Schedule C. Such Covered Service Providers have generally complied with requests for information from plan fiduciaries, however, because, among other reasons, the fiduciaries would be required to report them if they did not comply. Thus, many Covered Service Providers have already implemented procedures for recording and providing information that must be reported on Schedule C.

The Regulation significantly changes this dynamic, however, because it now incorporates, as a condition for relief under Section 408(b)(2), a requirement that the Covered Service Provider disclose, on request, any information that is required for the fiduciary of the Covered Plan to comply with its reporting and disclosure requirements. Because the new disclosure obligation does not extend beyond information that is required, Covered Service Providers that have already developed compliance procedures for Schedule C purposes will probably find that further procedures are not necessary to gather such information. However, the Regulation threatens to significantly impact the timing of such procedures, because responsible plan fiduciaries could request the "required" information at any time. As discussed above, this is one feature of the Regulation that has generated significant concern from commenters.

New Prohibited Transaction Exemption for Plan Fiduciaries for Certain Disclosure Failures

The Regulation provides a prohibited transaction exemption for plan fiduciaries (the Fiduciary Exemption) to address situations in which a Covered Service Provider fails to satisfy the new disclosure requirements. Under Section 406 of ERISA, a responsible plan fiduciary who causes the plan to enter into a transaction that the fiduciary knows, or should know, constitutes a prohibited transaction is subject to fiduciary liability. The Fiduciary Exemption is subject to the following conditions:

- The responsible plan fiduciary must have reasonably believed that the service provider satisfied the disclosure requirements under the Regulation.
- Upon discovering the disclosure failure, the plan fiduciary must request in writing that the service provider furnish the required information.
- If the service provider fails to comply with the written request within 90 days of the request, the plan fiduciary must provide a detailed written notification to the DOL of such failure no later than 30 days following the service provider's failure or refusal to provide the information.
- Taking into account the nature of the disclosure failure and the service provider's response to notification of the failure, as well as the availability, qualifications, and cost of replacement service providers, the plan fiduciary must determine whether to terminate or continue the service arrangement.

Disclosures Not Required for Certain Contracts and Arrangements

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

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, the parties to a service contract might be able to rely on one of the following:

- The QPAM Exemption, if a fiduciary that meets the requirements of a qualified professional asset manager under prohibited transaction exemption (PTE) 84-14 negotiates and causes the plan to enter into the service contract pursuant to that exemption.
- The 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.
- The bank collective trust exemption, if the service contract is entered into with a bank collective trust pursuant to PTE 91-38.
- The insurance company separate account exemption, if the service contract is entered into with an insurance company separate account pursuant to PTE 90-1.
- The 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.
- 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 bank, insurance company or registered investment adviser 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 Section 408(b)(2) for *its own* service contract with a Covered Plan. In addition, ERISA fiduciaries may seek to obtain the information described in Regulation in order to avoid prudency questions, even if not required to satisfy Section 408(b)(2). ERISA fiduciaries that wish to avail themselves of the protection afforded by the new class exemption might also seek to require the service provider to comply with the Regulation, even if another exemption is available.

The DOL is also considering the extent to which it should condition the availability of exemptions that cover service transactions, such as those described above, on disclosures akin to those imposed by the Regulation. The DOL has not signaled the progress it has made in this respect or which exemptions it would amend first, however.

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, a Covered Service Provider may be required to disclose information regarding compensation it (or its subcontractors or 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 deliver Section 408(b)(2) disclosures 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 new disclosure requirements under the Regulation do not have to be satisfied for service contracts between a plan and a service provider that is not a Covered Service Provider. Such contracts entered into in reliance on Section 408(b)(2) would, however, need to continue to comply with the other requirements of the exemption.

No Preemption of State Law

The Regulation clarifies that it is not intended to supersede any provision of state law that governs disclosures by parties that provide Covered Services, except to the extent that the state law would prevent the application of a requirement of the Regulation.

Endnotes

1 *See* Section 4975 of 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 in the proposal. However, in response to comments questioning whether a failure to comply with the proposed amendment would result in the transaction being prohibited for Code Section 4975 purposes, the DOL added a provision to the Regulation indicating that references to Section 408(b)(2) and the regulations thereunder should be deemed to refer to Section 4975(d)(2) and the parallel regulations thereunder.

2 The Regulation does not define the term over which these *de minimis* thresholds apply; absent further guidance, the amount appears to apply to the entire term of a contract, even if indefinite in duration. Most commenters on the subject have assumed, and have urged the DOL to clarify, that the *de minimis* amounts are to be evaluated on an annual—either calendar or plan year—basis. In addition, several commenters have asked the DOL to raise the *de minimis* thresholds to be consistent with the *de minimis* rules used for purposes of Schedule C reporting.

3 *SEC* 29 C.F.R. § 2550.4404a-5, published at 75 Fed. Reg. 64910 (October 20, 2010).

[4] 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.

[5] 72 Fed Reg. 70988, 70990 (Dec. 13, 2007). Though still far-reaching, the new requirements imposed by the Regulation are significantly narrower than those the DOL had proposed on December 31, 2007.

If you have any questions regarding the interim final regulation or any other matter raised in this Legal Update, please contact your regular Mayer Brown lawyer or any of the following lawyers. For information on more publications of interest, please visit:

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