TAX MANAGEMENT COMPENSATION PLANNING JOURNAL

DOL Proposed Regulations Regarding Service Provider Disclosures: A New and Improved (?) Way of Doing Business for Both Service Providers and Plan Sponsors

by Bernard ("Brian") F. O'Hare, Esq.[*]

BACKGROUND

On December 13, 2007, the U.S. Department of Labor (DOL) issued proposed regulations under the Employee Retirement Income Security Act of 1974 (ERISA) that set forth new disclosure requirements for certain service providers to employee benefit plans.[1] The proposed regulations are in response to enhanced complexities in compensation arrangements for providing services to employee benefit plans, which have made it difficult for plan fiduciaries to understand the precise costs associated with specific services and whether conflicts of interest exist among service providers. The proposed regulations are intended to introduce transparency to service providers' fees and potential conflicts of interest, so as to provide plan fiduciaries with sufficient information to be able to make informed decisions about services and costs, and will require major changes in how service providers operate as well as impact employers who contract for those services. The regulations would take effect 90 days after publication of the final regulations.

PROPOSED REGULATIONS

Fiduciaries to employee benefit plans are obligated under ERISA to act prudently and solely in the interest of plan participants and beneficiaries and for the exclusive purpose of providing benefits and defraying reasonable administrative expenses. Accordingly, ERISA

[*] Mr. O'Hare is a partner at the New York City firm of Patterson Belknap Webb & Tyler LLP, where he concentrates in employee benefits and executive compensation. Mr. O'Hare would like to thank his employee benefits colleague, Meridith Bogart Krell, for her valuable assistance in the preparation of this article. These materials are intended as general information only and not specific legal advice.

[1] 72 Fed. Reg. 70988 (12/13/07).

§408(b)(2) requires employee benefit plan fiduciaries to make a ''reasonable'' contract or arrangement when selecting plan service providers. The current regulations under ERISA §408(b)(2) merely provide that a ''reasonable'' contract or arrangement permits the plan to terminate without penalty on reasonably short notice.[2] The proposed regulations would amend the §408(b)(2) regulations by adding detailed disclosure requirements to the reasonableness standard.

Service Providers Covered by the New Rules

The proposed regulations target service contracts or arrangements between employee benefit plans and the following service providers: (1) providers of fiduciary services (either within the meaning of ERISA or the Investment Advisers Act of 1940); (2) providers of banking, consulting, custodial, insurance, investment advisory (plan or participants), investment management, recordkeeping, securities or other investment brokerage or third-party administration services; or (3) service providers who receive or may receive indirect compensation or fees for accounting, actuarial, appraisal, auditing, legal or valuation services.

Disclosure Requirements

The proposed regulations would require a covered service provider to provide services to an employee benefit plan pursuant to a written contract. To meet the ''reasonableness'' test under ERISA §408(b)(2), such written service contract must provide for written disclosure, prior to the time the contract is signed, of the specific items concerning compensation/fees and conflicts of interest set forth below. In addition to the specific enumerated disclosures, the proposed regulations would require a service provider to comply with any requests by the plan fiduciary or plan administrator for information related to the service contract that pertains to complying with ERISA reporting and disclosure requirements.

Compensation and Fee Disclosures

The proposed regulations would require disclosure of the following compensation and fee information:

(1) All services to be provided to the employee benefit plan;

(2) The compensation and fees for each service. This includes money or any thing of monetary value (e.g., gifts, awards, trips) received or to be received directly from the plan or plan sponsor or indirectly by the service provider or its affiliate in connection with the services to be provided. Compensation or fees may be expressed in terms of a monetary amount, formula, percentage of plan assets, or per capita charge per participant or beneficiary; and

(3) The manner in which compensation or fees will be received (i.e., whether the service provider will bill the plan, deduct fees directly from plan accounts, or reflect a charge against plan investments). A description of how any prepaid fees will be calculated and refunded when a contract or arrangement terminates must also be included.

If a service provider offers bundled services to the plan as a package (rather than on a service-by-service basis), then only the service provider offering the bundled services must provide the required disclosures. The service provider must disclose all services and the aggregate compensation or fees to be received, directly or indirectly, by the service provider and any affiliate, subcontractor or third party in connection with the bundled services. The service provider need not disclose the allocation of such compensation or fees among its affiliates, subcontractors or other parties (except if such party receives or may receive compensation or fees that are separately charged directly against the plan's investment reflected in the new value of the investment or that are set on a transaction basis (i.e., finder's fees, brokerage commissions, soft dollars)).

Conflicts of Interest Disclosures

The proposed regulations also would require the following disclosures with respect to conflicts of interest:

(1) Whether the service provider or an affiliate will provide any services to the plan as a fiduciary within the meaning of ERISA or the Investment Advisers Act of 1940;

(2) Whether the service provider or an affiliate expects to participate in or otherwise acquire any financial or other interest in any transaction to be entered into by the plan in connection with the contract or arrangement;

(3) Whether the service provider or an affiliate has any material financial, referral or other relationship or arrangement with a money manager, broker, other client of the service provider, other service provider to the plan, or any other entity that creates or may create a conflict of interest for the service provider in performing services under the contract or arrangement;

(4) Whether the service provider or an affiliate will be able to affect its own compensation or fees

[2] *See* 29 CFR §2550.408b-2(c).

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without the prior approval of an independent plan fiduciary; and

(5) Whether the service provider or an affiliate has any policies or procedures that address actual or potential conflicts of interest or that are designed to prevent the compensation, fees, relationships or arrangements mentioned above from adversely affecting services provided to the plan.

The disclosure requirements generally must be met whenever a new contract is executed or a current contract is extended or renewed. Any material change to required disclosure information must be updated within 30 days from the date the service provider has knowledge of the material change. Additionally, the service provider contract must include a representation by the service provider that all required disclosures were provided to the plan fiduciary prior to the contract being executed (or extended or renewed, as applicable). The proposed regulations would maintain the requirement found in the current regulations that a contract or arrangement must be terminable by the employee benefit plan upon reasonably short notice without penalty to the plan.

Notably, the proposed regulations do not prescribe the manner in which disclosures should be presented to the plan fiduciary. The DOL does provide, however, that all required disclosures need not be contained in one document, and written disclosures may be provided in separate documents from separate sources and may be provided in electronic format.

PROHIBITED TRANSACTION EXEMPTION

Failure to comply with the proposed regulations would create a prohibited transaction under ERISA. Recognizing that plan fiduciaries may unwillingly enter into noncompliant contracts or arrangements, the DOL proposed a related class exemption to relieve plan fiduciaries of the prohibited transaction that would result from a service provider's failure to comply with the proposed regulations.[3]

Plan fiduciaries who enter into (or extend or renew) a contract or arrangement that does not comply with the regulations would be able to use the proposed exemption under the following conditions:

(1) The plan fiduciary reasonably believed that the contract or arrangement met the requirements of the proposed regulations and did not know (or have reason to know) that the service provider failed or would fail to comply with its disclosure obligations;

(2) The plan fiduciary, upon discovering the service provider's noncompliance with its disclosure obligations, requests in writing that the service provider furnish the required information;

(3) If the service provider fails to comply with the plan fiduciary's request for required information within 90 days, the plan fiduciary notifies the DOL of the service provider's failure; and

(4) Upon discovering that the service provider failed to comply, the plan fiduciary determines whether to terminate or continue the contract or arrangement. The plan fiduciary must consider, among other factors, the availability, qualifications and costs of potential replacement service providers and the responsiveness of the service provider in furnishing the required information.

ADDITIONAL INITIATIVES

Revised Form 5500

Complementing the proposed regulations, the DOL (along with the Treasury Department and the Pension Benefit Guaranty Corporation) also implemented changes to the information required to be reported on the Form 5500 Annual Report concerning certain service provider compensation.[4] The changes are reflected in Schedule C of the Form 5500 and will generally take effect for the 2009 plan year. Plans covering 100 or more participants will be required to report detailed information regarding fees paid to plan service providers, including the following information:

(1) The identity of each person who received, directly or indirectly, $5,000 or more in total compensation in connection with services rendered to the plan or their position with the plan;

(2) A breakdown of the compensation paid directly by the plan to the service provider and amounts the service provider received indirectly from sources other than the plan or plan sponsor in connection with the service provider's position with the plan or services provided to the plan; and

(3) The types of services and fees provided by service providers (using a list of expanded service and fee codes).

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[3] 72 Fed. Reg. 70893 (12/13/07).

[4] 72 Fed. Reg. 64731 (11/16/07).

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For certain service providers whose compensation arrangements present conflict of interest concerns, more detail on indirect compensation will be required, including an indication of each source that provides $1,000 or more in indirect compensation to the service provider.

Additionally, there are new rules for reporting compensation paid under ''bundled'' service arrangements. Although shared revenue generally will not need to be broken out among members of the bundled group, certain compensation will need to be separately reported, including: (1) fees charged separately against a plan's investment (e.g., investment management fees, float revenue, other asset-based fees); and (2) commissions, soft dollars, other nonmonetary compensation, float revenue or transaction-based fees to any person in the bundle who is a plan fiduciary or who provides contract administrator, consulting, investment advisory, investment management, securities brokerage or recordkeeping services if their total compensation is $5,000 or more.

The new Schedule C will also require plan administrators to identify each service provider that failed or refused to provide the necessary information.

Legislative Initiatives & Participant Fee Disclosures

In addition, Congressional proposals have been introduced that would make defined contribution plan fees more transparent. For example, there are several proposals in Congress to enhance fee disclosures to participants (and the DOL is also said to be working on participant fee disclosure initiatives). However, the viability of such proposals and timing of any action thereon remains unclear.

SOME QUESTIONS AND COMMENTS ARISING FROM THE PROPOSED REGULATIONS

The proposed regulations leave some unanswered questions, including the following:

(1) What is the impact on existing contracts if they are evergreen contracts?

(2) What impact, if any, will this have on plan private equity investments which meet the venture capital operating company (VCOC) rules and the underlying investments are not plan assets? Do those fees need to be disclosed?

(3) What if services are to the employer and not directly to the plan? (Presumably, if plan assets are charged, the rules will be triggered.)

(4) What relationship will these proposed rules have to any pending fee disclosure legislation which is ultimately adopted?

In addition, two distinguished sources have submitted comments to the DOL in response to the proposed regulations: (1) the American Benefits Council (the ''Council''), and (2) key Democrats from (a) the House of Representatives Committee on Education and Labor, (b) the Senate Committee on Health, Education, Labor and Pensions (''HELP''), and (c) the Senate Special Aging Committee (collectively, the ''Congressmen''). These comments display the many open questions, varied interpretations, potential gaps and interesting issues surrounding the proposed regulations. The key remarks submitted by each of these noteworthy commenters are summarized below.[5]

The Council, which is a public policy organization representing Fortune 500 companies and other organizations that assist employers in providing benefits to employees, raises a number of suggestions concerning the proposed regulations, particularly with regard to the scope of the proposed rules. The Council recognizes the need for the broad application of the proposed disclosure rules to all employee benefit plans, but suggests that the proposed regulations be finalized in three separate parts: (1) defined contribution plan disclosure, (2) defined benefit plan disclosure, and (3) health and welfare plan disclosure. The Council reasons that each component is ''an enormous undertaking and very different from the other two components . . . each type of plan is sold and serviced very differently and the fee structures are entirely different.'' [6] Application of fee disclosure rules to plans other than defined contribution plans, especially the application to health and welfare plans, is new and perhaps unexpected, and the Council points out that the viewpoints and needs of those working with plans other than defined contribution plans have not been properly vetted. The Council argues that without input from such groups, it is inevitable that the regulations will be flawed.

The Council also raises questions on other aspects of the proposed regulations as follows:

- *Interaction with the prohibited transaction rules of §4975 of the Internal Revenue Code of 1986, as amended (the Code):* The proposed regulations are silent on whether they apply to arrangements that are covered by the prohibited transaction rules of §4975 of the Code but that are not covered by ERISA. The Council strongly recommends that the DOL clarify that individual retirement accounts and annuities (collectively,

[5] The viewpoints expressed in these comment letters do not necessarily reflect the views or opinions of the author of this article.

[6] *See* the Council's letter dated Feb. 11, 2008, signed by Jan M. Jacobson, Senior Counsel, Retirement Policy.

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"IRAs"), health savings accounts ("HSAs"), Coverdell education savings accounts ("ESAs"), and owner-employee plans are not subject to the disclosure requirements of the proposed regulations.

- *The fiduciary safe harbor and correction mechanisms:* The Council believes that, in addition to the proposed class exemption, which only provides protection from prohibited transaction consequences, additional protection for fiduciary consequences is appropriate. Also, the Council suggests that because the proposed regulations imply that any violation of the requirements, no matter how minor, will result in a prohibited transaction excise tax, there should be a correction mechanism that allows for dealing with reasonable errors without draconian penalties.
- *Application of the regulations to investment providers:* The Council recommends that the disclosure requirements apply with respect to investments only to the extent the underlying assets of the investment are plan assets, and thus, only investment providers performing service with respect to plan assets would be subject to the disclosure requirements.
- *Application to fully insured products:* The Council believes that the disclosure rules of the regulations should not apply to fully insured arrangements. The Council provides several reasons for exempting insured plans, including that (1) the line between a plan service and a plan benefit blur in the context of insured products, and the DOL has long recognized that the issuance of insurance by itself does not cause an issuer to be a service provider; (2) insurance products are highly regulated by state insurance laws and do not require additional regulation; and (3) many disclosure requirements already exist with respect to insurance, which include many of those listed in the proposed regulations, so there is little need to expand such requirements.
- *Employer payments to service providers from general assets:* The Council believes that the regulations should not apply to the extent an employer contracts to be responsible for specified plan fees. It strongly recommends clarifying that the regulations do not apply when plan services are paid for entirely out of the employer's general assets (i.e., rather than paid for by the plan).
- *Bundled services:* The Council requests clarification on how the bundling exception (which permits a service provider that offers a bundle of services to report aggregate compensation) would work in a few common situations: (1) it recommends that the disclosures from the "bundled" service provider exclude any arrangements that involve separate negotiations between the plan fiduciary and another service provider; (2) it urges the DOL to clarify the definition of a "bundled" arrangement because the current proposal could lead to duplicate reporting, and suggests that multiple bundlers should only be responsible for reporting the compensation under their bundled arrangement; and (3) it recommends that the special disclosure rules for bundled services be further clarified to provide that vendors who render services to the service provider rather than to the plan (i.e., printers used to prepare plan information and programmers to develop computer systems) need not be identified.
- *Scope of service:* The Council provides that its members are concerned that the requirement for service providers to disclose "all services" is overly broad and could be interpreted to mean identification of every single service in excruciating detail. The Council suggests some alternative disclosure systems based on categories of services (e.g., nondiscrimination testing, participant distribution administration and participant service center).
- *Fiduciary status:* With respect to the proposed requirement that plan service providers indicate whether they will be performing services as a fiduciary, the Council requests that the final regulations clarify that the required fiduciary representation can provide that the service provider is a fiduciary only with respect to certain aspects of its services. It also suggests that the rules provide guidance regarding the consequences, for both plan fiduciaries and the service provider, if the service provider makes a reasonable error in identifying its fiduciary status.
- *Conflicts of interest:* With respect to the conflict of interest disclosures in the proposed regulations, for lack of a plausible interpretation of the proposed language, the Council recommends deleting the requirements to disclose (1) whether the service provider or an affiliate will be able to affect its own compensation or fees without the prior approval of an independent plan fiduciary, and (2) any relationship that creates or may create a conflict of interest for the service provider in performing services pursuant to the contract or arrangement.
- *Gifts:* To avoid an overly broad interpretation of the requirement to disclose in-kind gifts, the Council recommends that disclosure be required only when (1) there is a clear and direct relation-

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ship between the "gifts" and the plan, and (2) when a gift exceeds a de minimis threshold (e.g., $50). This, it suggests, would avoid disclosure of every logo pen, sandwich, etc.

- *Method of disclosure:* The Council requests clarification that methods such as formulas and percentages can be utilized without regard to whether dollar amounts could be determined.
- *Updates:* With respect to the proposed regulation's requirement to report material changes in compensation arrangements within 30 days of the change, the Council requests a clarification of the meaning of "material change" that includes a de minimis concept, recommends an increase in the time period to 90 days, and recommends that the DOL clarify the beginning date for determining when the report must be provided.
- *Consulting services:* In response to the broad use of "consulting" as one of the categories of services that trigger disclosure requirements without providing any further description of what kind of consulting is intended, the Council recommends narrowing covered "consulting" services to consulting with regard to investments or management of assets, such as the consultant that helps the fiduciaries select and monitor its asset managers, financial advisors, etc.
- *Contract requirement:* The Council recommends that the final regulations clarify that the disclosure requirement may be satisfied outside the four corners of the services contract in appropriate circumstances.
- *Effective date:* The Council recommends that the final regulations be generally effective for new service contracts and material modifications of existing service contracts entered into on or after the first day of the year beginning at least 12 months following publication of final regulations. The proposed regulations contain an effective date of 90 days after publication of the final regulations.
- *Participant disclosure:* The Council urges the DOL not to include the types of service provider-to-employer disclosures provided by the proposed regulations in its anticipated forthcoming proposed participant disclosure regulations. It argues that such disclosures would be overwhelming to most plan participants.

Providing a rather different viewpoint than that of the Council, the Congressmen's comment letter urges the DOL "to act promptly to more seriously monitor 401(k) plan operations." [7] Their letter urges the DOL to:

- more fully consider the unique nature of participant-directed plans and focus the regulations on protecting participants who are neither informed nor protected by employer decision-making;
- more fully exercise its authority to monitor pension plan operations and make that information widely available so that policymakers can monitor the adequacy of existing policies and practices;
- more actively work with other federal and state agencies to monitor investment products that are marketed and sold to pension plans; and
- regularly review the documents that are being provided to pension plans and participants to ensure that financial service firms are providing needed information in understandable terms.

The Congressmen also comment on certain specific elements of the proposed regulations as follows:

- *Class exemption for fiduciaries who fail to receive required disclosures:* Rather than excusing failures of fiduciary responsibilities, the Congressmen suggest that the DOL provide additional rules and model documents to clarify fiduciary responsibilities.
- *Bundled services:* With the intent of ensuring that pension plan fiduciaries understand all of the components they are purchasing from a bundled provider, the Congressmen argue that plan fiduciaries should be expected to be aware of the value of each service they purchase as well as potential hidden incentives (such as revenue sharing charges) and suggest a more comprehensive rule to this extent.
- *Disclosure of information:* The Congressmen request clarification in the proposed rules to ensure that all disclosure information is "in advance, prominent, clear and understandable." They also suggest that the final rule provide that all disclosure information should be available to plan participants and beneficiaries.

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[7] *See* the letter dated Feb. 14, 2008, to Assistant Secretary of Labor Bradford Campbell that is signed by the following Congressmen: George Miller, Chairman, Committee on Education and Labor; Edward M. Kennedy, Chairman, Committee on Health, Education, Labor, and Pensions; Rob Andrews, Chairman, Subcommittee on Health, Education, Labor and Pensions; Tom Harkin, Senator, Committee on Health, Education, Labor, and Pensions; and Herbert H. Kohl, Chairman, Special Aging Committee.

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- *Termination penalties:* The Congressmen indicate that some service providers, primarily in the insurance industry, include termination penalties (i.e., ''surrender charges'') for contract terminations and/or changes in investment options, which could be in violation of the DOL's existing regulations. They urge the DOL to examine existing practices and contracts and impose penalties for any violations.

These are but only two comments submitted to the DOL in response to the proposed regulations, but they provide an interesting example of the varied and contentious viewpoints surrounding the proposed regulations. Also, they suggest, potentially, that the final regulations may look very different from the proposed regulations.

The reader should stay tuned for further regulatory and perhaps additional legislative actions, if not in this Congress, then perhaps in the next.

ISSN 0747-8607