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New ERISA 408(b)(2) Regulations

Mastering Detailed Requirements for Service Provider Fee Disclosures

WEDNESDAY, JANUARY 26, 2011

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Executive Compensation
& Benefits

August 17, 2010

Department of Labor Issues Final Regulations on Fee Disclosures for Pension Plans

by Susan P. Serota and Kathleen D. Bardunias

On July 16, 2010, the Department of Labor ("DOL") published interim final regulations under section 408(b)(2) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") requiring certain retirement plan service providers to disclose fee-related information to plan fiduciaries. These new disclosure obligations are intended to assist retirement plan fiduciaries in assessing the "reasonableness" of the contract or arrangement in connection with the ERISA section 408(b)(2) prohibited transaction exemption. The interim final regulations are effective for all applicable service provider arrangements as of July 16, 2011 (including new and existing arrangements). Plan fiduciaries and retirement plan service providers should begin reviewing service agreements now to ensure timely fee and compensation disclosure in compliance with the new regulations.

The goal of the regulations is to make it easier for plan fiduciaries to assess whether the compensation paid to plan service providers is "reasonable" and if there are any conflicts of interest between the plan and the service provider. Although the regulations are final, the DOL has requested comments because substantial changes were made from the proposed regulations that were published in 2007. All comments to the interim final regulations are due by August 30, 2010. The regulations have been deemed "interim" because they may be subject to revision based on any comments received; however, the final regulations will be effective for all pre-existing and new service arrangements as of July 16, 2011. It is not clear whether any additional revisions based on the comments received will also have an effective date of July 16, 2011, or a later date.

Background

Section 408(b)(2) of ERISA provides an exemption from the ERISA prohibited transaction rules if the arrangement and compensation paid to a service provider of an employee benefit plan is "reasonable."[1] For the exemption to apply (1) the services must be necessary for the establishment or operation of the plan, (2) no more than reasonable compensation can be paid to the service provider, and (3) the services must be provided under a "reasonable" contract or arrangement. Prior to the final regulations, DOL Regulation section 2550.408b-2(c) only provided that a contract was considered to be "reasonable" under this third prong if the arrangement could be terminated without penalty upon reasonably short notice. The final regulations add to paragraph (c) of the regulation additional fee disclosure obligations on the part of the service provider for certain contracts before the contract or arrangement can be deemed "reasonable" under the third prong of this test.

Covered Plans

In contrast to the broad scope of the proposed regulations, the final regulations currently only apply to "covered service providers" of defined contribution and defined benefit plans. Service provider arrangements with welfare plans, individual retirement accounts and simple retirement accounts are not subject to these fee disclosure regulations. The DOL did, however, reserve a dedicated subsection within the final regulations to address welfare plans and requested comments on how the fee disclosure rules should apply to such plans. It is likely that the DOL will begin addressing these rules in connection with welfare plans in the near future.

Covered Services

The final regulations provide that only arrangements with "covered service providers," where the service provider expects to receive at least $1,000 in direct or indirect compensation in connection with the services described below, are subject to the fee disclosure regulations. A "covered service provider" includes the following three categories:

1. **Plan Fiduciaries or Investment Advisors:** includes those who provide services directly to the plan as an ERISA fiduciary or as an investment advisor (registered under state law or the Investment Advisors Act of 1940) or fiduciary services provided to an investment contract, product or entity that holds plan assets and in which the plan has a direct equity investment.[2]

2. **Recordkeepers and Brokers:** includes services provided to an individual account plan where plan participants direct their account investments (such as a 401(k) plan), and designated investment alternatives are available to the participants in connection with the recordkeeping or brokerage services.

3. **Other Service Providers:** includes service providers (including subcontractors and affiliates) who reasonably expect to receive indirect compensation for a broad range of services, such

[1] Section 4975(d)(2) of the Internal Revenue Code of 1986, as amended (the "Code") provides a similar exemption to the Code section 4975(c) prohibited transaction rules, which are substantially similar to the ERISA rules.

[2] Thus, for example, there is no disclosure obligation under the final regulations with respect to mutual funds and other investment entities that are not deemed to hold plan assets under DOL Regulation section 2510.3-101 and ERISA section 3(42), such as venture capital operating companies, real estate operating companies and investment entities in which less than 25% of the total value of any class of equity interests in the entity is held by "benefit plan investors."

as accounting, auditing, banking, actuarial, consulting, legal and third party administration, among others.

Required Disclosures

In a change from the proposed regulations, the obligation to provide the required disclosures does not need to be a part of a formal written contract, although the fee disclosure must still be made in writing. All necessary disclosures (described below) must be disclosed reasonably in advance of the effective date of the final regulations (for existing arrangements) or in advance of the date the contract is entered into, extended or renewed. In general, all covered service providers must disclose to the plan fiduciary (i.e., the fiduciary with the authority to enter into the contract or arrangement) the following:

- A description of the services to be provided to the plan;
- If applicable, a statement that the service provider (including any affiliates or subcontractors) will be providing services as a fiduciary or a registered investment advisor (registered under the Investment Advisors Act of 1940 or state law);
- A description of all compensation the service provider (or an affiliate or subcontractor) reasonably expects to receive, including:
  - Direct compensation (except for certain recordkeeping services, as described below, the compensation may be disclosed as an aggregate number);
  - Indirect compensation (such disclosure must identify the services for which the indirect compensation will be received and the payer of the indirect compensation);
  - Compensation payable in connection with the termination of the contract or arrangement; and
- A description of the manner in which the compensation will be received (e.g., invoice provided to the plan or compensation deducted directly from the plan's investments).

The final regulations deleted the requirement from the proposed regulations that the service provider must separately disclose potential conflicts of interest. However, the indirect compensation disclosure requirement will require any such relationships involving compensation to be disclosed.

A covered service provider who is providing recordkeeping services must also disclose all direct and indirect compensation that an affiliate or subcontractor expects to receive in connection with such services. If an arrangement does not generally provide for a separate charge for recordkeeping services or such services are offset based on other compensation received under the arrangement, then a reasonable and good faith estimate of the compensation received for the recordkeeping services must be broken out and disclosed to the plan fiduciary.

As mentioned above, there is no required timeline for the initial disclosure of the required information; however, such information must be disclosed reasonably in advance of entering into the contract or arrangement. If the covered service provider experiences a change to any of the information previously provided to the plan fiduciary, such change must be disclosed as soon as practicable, but not later than 60 days after the date the service provider has knowledge of the change. This reflects a change from the proposed regulations, which required notice within 30 days for material changes only. Lastly, the final regulations do not relieve service providers from the obligation to disclose information upon request in order to comply with the reporting and disclosure requirements of Title I of ERISA.

Plan Fiduciary Exemption

If the service provider fails to adequately disclose all necessary information, the plan fiduciary may still be able to qualify for the prohibited transaction exemption as long as the following requirements are met:

- The plan fiduciary must not have actual knowledge or reason to know of the service provider's inadequate disclosure;
- Upon discovering the failure, the plan fiduciary must request, in writing, that the service provider disclose the missing information; and
- If the service provider does not provide adequate disclosure within 90 days of this written request, the plan fiduciary must notify the DOL of the failure in accordance with the regulations.

Additionally, the plan fiduciary must reassess the contract or arrangement with the service provider in light of the disclosure failures and make a determination whether to terminate or continue the contract or arrangement under such circumstances.

Next Steps

Failure to comply with the final regulations will cause the plan and service provider arrangement to be a prohibited transaction and subject the service provider to certain excise taxes under Code section 4975. Plan fiduciaries and all "covered services providers" should begin reviewing existing arrangements in light of these new regulations and developing and documenting a process for providing adequate written fee disclosure for all service arrangements with defined benefit and defined contribution plans going forward. In light of the DOL's intention to include welfare plans under these regulations in the future, it may be wise for service providers and plan fiduciaries to begin reviewing any service provider arrangements under these plans as well.

If you have any questions about the content of this client alert, please contact the Pillsbury attorney with whom you regularly work or any of the members of the Executive Compensation & Benefits group.

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