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DOL Proposes Regulations Requiring Fee Disclosures to Plan Fiduciaries

The DOL has issued proposed regulations requiring service providers to disclose information regarding fees, direct and indirect compensation and conflicts of interest to fiduciaries of Section 401(k) and other employee benefit plans. Coupled with the sweeping changes to Form 5500 annual reporting, these new regulations continue the DOL's focus on increasing disclosure of indirect compensation received by providers of services to employee benefit plans.

Background

ERISA generally prohibits the provision of goods, services, or facilities between an employee benefit plan (including pension plans and health and welfare plans) and a party in interest (e.g., service provider). However, Section 408 exempts certain contracts or arrangements for essential services (e.g., actuarial or investment management services) between service providers and plans if the arrangement and compensation paid for services are "reasonable." Under current regulations, a reasonable arrangement is one that can be terminated on short notice without penalty so that the plan can avoid being locked into a "disadvantageous" arrangement.

DOL Proposed Regulations

The DOL has now issued proposed regulations on what constitutes a reasonable contract or arrangement under ERISA Section 408, which retain the current termination provisions and add certain fee and conflict of interest disclosure requirements. The regulations would require service providers to include disclosures in their contracts sufficient to allow plan fiduciaries to assess the reasonableness of service providers' fees and other direct and indirect compensation. (Indirect compensation is defined as money or anything else of value received from any person other than the plan or the plan sponsor.) Among other things, plan service providers would have to disclose the identities of third parties from whom they directly or indirectly receive fees or compensation in connection with plan services and other potential conflicts of interest.

Failure to comply with the proposed regulations could result in an otherwise reasonable arrangement being deemed a prohibited transaction under ERISA Section 406, giving rise to fiduciary liability. In tandem with the proposed regulations, the DOL issued a proposed class exemption that would provide relief to plan fiduciaries when service providers fail to satisfy their new disclosure obligations. Relief for plan fiduciaries would be conditioned on a request for disclosure by the plan fiduciary upon discovery of the service provider's failure to disclose and consideration of terminating the contract. Also, the fiduciary would be required to notify the DOL if the service provider does not comply with the disclosure requirement within 90 days of the request.

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Service Providers Affected

Not all plan service providers would be covered by the new rules as the DOL believes fiduciaries can judge the reasonability of compensation for some service providers without disclosure. The disclosure requirements would apply only to service providers of service contracts or arrangements with employee benefit plans that fall within one or more of three listed categories – i.e., those who –

- provide services as plan fiduciaries under ERISA or under the Investment Advisers Act of 1940
- provide banking, consulting, custodial, insurance, investment advisory, investment management, recordkeeping, securities or other investment brokerage, or third party administration services
- receive any *indirect* compensation in connection with accounting, actuarial, appraisal, auditing, legal or valuation service.

BUCK COMMENT. *Given the breadth of these categories, virtually all entities providing basic or essential plan services could be subject to these new requirements.*

As noted in the preamble, a contract or arrangement between a plan and service provider that falls within one of these three categories will be deemed reasonable only if the compensation and conflicts disclosure requirements are satisfied, regardless of the nature of any other services provided.

Under the proposed regulations, the DOL's long-standing authority to regulate participation by parties in interest in prohibited transactions with plans or their fiduciaries would effectively be expanded to non-fiduciary service providers. Non-fiduciary service providers, such as actuarial or legal service providers who receive indirect compensation in connection with plan services, would have to comply with all disclosure rules, including disclosure of direct compensation as well as actual and potential conflicts of interest. However, providers receiving only direct fees or compensation would seem to fall outside the enhanced disclosure requirements. Nonetheless, the DOL cautions that plan fiduciaries would still have to satisfy their general fiduciary obligation to prudently select and monitor these plan service providers through appropriate disclosures.

Written Disclosure Required

The proposed regulations place the burden of disclosure with respect to plan administration and investments on the service provider. A service provider subject to the new disclosure rules would have to disclose in writing (which can be in electronic format) a detailed description of the services to be provided, as well as direct and indirect fees for those services, prior to entering into a contract for services. Although the proposed regulations detail what must be disclosed, they do not impose a specific form or timeframe for disclosure. They would permit required disclosures to be contained in a single document or in multiple documents, and necessary information to be incorporated by reference (e.g., a prospectus that contains indirect fee or conflict of interest information).

Along with these initial disclosure requirements, service providers would have ongoing disclosure obligations under the proposed regulations. Thus, service providers would have to notify plan fiduciaries of any material change to previously provided information within 30 days of the change. For this purpose, the preamble defines a

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material change as information that “would be viewed by a reasonable plan fiduciary as significantly altering the ‘total mix’ of information … or as significantly affecting a reasonable plan fiduciary’s decision to hire or retain the service provider.” Upon request by the plan fiduciary or administrator, service providers would also have to disclose compensation or other contract information needed to satisfy ERISA reporting and disclosure requirements (e.g., Form 5500 filing).

Compensation Disclosures

The service provider would have to disclose all compensation that will be received directly from the plan or indirectly from parties other than the plan or plan sponsor, including fees received by the service provider’s affiliates from third parties. The service provider must also disclose the manner in which it will receive fees or compensation (e.g., by billing the plan, by deducting fees from plan accounts, by charging fees against plan investments) and explain how pre-paid fees would be calculated and refunded upon contract termination. The proposed regulations take an expansive view of compensation or fees to be disclosed, including such items as trips, gifts, awards, research, finder’s fees, placement fees, commissions, soft dollar payments, and float income. Compensation could be disclosed as a specific monetary amount, or by using a formula, a percentage of plan assets, or per capita charge for each plan participant or beneficiary. The compensation description would, however, have to be sufficiently clear and detailed to allow the plan fiduciary to assess the reasonableness of the fees.

Conflict of Interest Disclosures

In addition to requiring disclosure of how much the plan is being charged for a service, the proposed regulations would require disclosure of other entities paying the service provider (whether or not the service provider is acting in a fiduciary capacity) to allow the plan fiduciary to assess conflicts of interest. Under the proposed regulations, service providers must initially disclose information about interests or relationships that raise actual or potential conflicts of interest for the service provider in providing plan services, including –

- whether the service provider or affiliate will provide services as a fiduciary under ERISA or the Investment Advisors Act of 1940
- financial or other interests the service provider has in transactions in which the plan will be involved
- material financial, referral or other relationships with various parties (such as investment professionals brokers or other service providers)
- whether the service provider can receive compensation without prior approval by an independent fiduciary
- policies or procedures in place to protect against conflicts of interest.

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Bundled Services

With respect to bundled service providers, the proposed regulations generally track the disclosure requirements in the recent revisions to Form 5500 Schedule C. (See our December 19, 2007 *For Your Information*.) When a group of services is provided and priced as a package (i.e., bundled arrangement), only the provider of the bundle would generally be required to make the necessary disclosures, including listing all services to be provided along with the aggregate direct compensation or fees that will be paid. The regulations do not require the bundled service provider to break down compensation or fees for the individual services or, generally, to disclose the allocation of revenue-sharing or other payments among affiliates or subcontractors. Separate reporting, however, would be required for fees or compensation charged on a transaction basis (e.g., finder's fees, brokerage commissions or soft dollar payments), but not on a flat rate or percentage of assets basis. Soft dollar payments include those for research or other products or services received from a broker-dealer or other third party in connection with securities transactions. The preamble clarifies that bundled service providers must also disclose separately management fees paid by mutual funds to their investment advisers, float revenue, and other asset-based fees such as 12b–1 distribution fees, wrap fees, and shareholder servicing fees if charged in addition to the investment management fee.

Effects of Noncompliance

Service providers that do not comply with the regulations would have to pay excise taxes under Internal Revenue Code Section 4975. Plan fiduciaries that have noncompliant service providers and do not qualify for the class exemption would be subject to liability for engaging in prohibited transactions with such service providers.

Effective Date

The proposed regulations are slated to go into effect 90 days after they are published in final form. Numerous comments on the proposed regulations, which are requested by February 11, 2008, are expected.

Conclusion

The new disclosure requirements in the proposed regulations will likely unveil costs previously unknown by fiduciaries. While proposed legislation requiring fee disclosure has focused on defined contribution retirement plans, these regulations cover all employer-sponsored plans, such as defined benefit and health and welfare plans. It is hoped that these increased disclosures will allow fiduciaries to better manage their plans, ultimately resulting in reduced fees for plan sponsors and participants.

Buck's consultants would be pleased to discuss the effect of these proposed reporting requirements on your plans.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.

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