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Department of Labor Advances Fee Disclosure Initiatives for ERISA Plan Service Providers

By Susan Katz Hoffman and Lisa A. Taggart

Concerns over the lack of fee-related disclosures by ERISA plan service providers have been reflected in recent regulatory action by the Department of Labor. On November 16, 2007, the Department of Labor, Employee Benefits Security Administration (DOL) issued revisions to Form 5500, which require more detailed disclosure of fee information in connection with a plan's annual reporting requirements. On December 13, 2007, the DOL proposed a new rule that would require ERISA plan service providers to fully disclose any fee or alternative compensation arrangements to plan fiduciaries.

What fee-related changes were made to Form 5500 as part of the recent revisions?

The fee disclosure revisions have been incorporated into Schedule C, which generally must be attached to the Form 5500 filed by a large plan to report compensation totaling $5,000 or more received by any one service provider for plan services. As part of the revisions, Part I of Schedule C now requires *direct* compensation paid by a plan and *indirect* compensation (compensation received from sources other than the plan or plan sponsor) to be reported on separate line items.

What is the purpose of the DOL's distinction between "direct" and "indirect" compensation?

Indirect compensation generally includes gifts, awards, trips for employees, research, finder's fees, soft dollar payments, and float income. In large part, the revision is designed to identify indirect compensation that has previously been hidden from the plan's fiduciaries because they are not charged directly against the plan's assets, but that the DOL believes have the effect of reducing the plan's investment return.

What other changes have been made to Schedule C?

The revised Schedule C also requires disclosure of revenue sharing from one service provider to another, even if such sharing includes kickbacks that are illegal under federal law. In addition, codes used to identify the types of services performed and types of fees received have been expanded for greater detail. A new Part II has been added, which requires identification of each service provider that failed or refused to provide the information necessary to complete Part I.

The guidance also provides an alternative reporting option with respect to service providers whose compensation in relation to the plan is limited to "eligible indirect compensation" (certain common investment-related fees), so long as specific written disclosures are made to the plan administrator. Under the alternative, a plan may simply identify the individual(s) who supplied the plan administrator with the specific written disclosures.

Finally, more detailed information is now required for other indirect compensation or eligible indirect compensation for which the above referenced written disclosures were not provided. For certain key service providers receiving indirect compensation from a single source that totals $1,000 or more during the plan year, this requirement includes information regarding the payor of such compensation.

How are the Form 5500 revisions and proposed rule related?

Although both promote greater transparency of fee information, the proposed regulation involves disclosing fee information during the process of choosing service providers and before any fees are paid. The Form 5500 revisions pertain to disclosing retrospective fee information as part of a Plan's annual reporting requirements.

How does the proposed rule impact current rules, which regulate the service provider relationship?

The proposed regulation would be added to the existing regulation permitting plan service providers to enter into a contractual relationship provided the contract is reasonable, the services are necessary to the establishment or operation of the plan, and no more than reasonable compensation is paid by the plan for the services. The new regulation would further define "reasonable" contract to require that specific information be disclosed to the plan fiduciary making the independent decision to enter into the contract. The plan fiduciary is directed to consider these disclosures in assessing the reasonableness of the compensation for services and the potential for conflicts of interest.

What is the plan fiduciary's responsibility if a service provider does not disclose fees or compensation?

The DOL has also proposed a new class exemption, so that plan fiduciaries will not be charged with prohibited transactions if a service provider does not disclose the fees or compensation, so long as the plan fiduciary takes prompt and appropriate action once the fees and compensation are discovered.

Which service providers are subject to the proposed regulation?

The new regulation applies to service providers in three categories:

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

The proposed regulation covers all contracts between these types of service providers and any ERISA plan – defined benefit plans, defined contribution plans, and welfare benefit plans. But the proposed regulation would not apply to contracts between service providers and those who actually deliver services to participants (such as contracts between a health maintenance organization and network physicians).

What fees and compensation must be disclosed under the proposed regulation?

Generally, each service provider must disclose (in writing) all compensation it will receive under the contract, directly or indirectly, and any conflicts of interest that might arise in the course of providing the services under the contract. The disclosure must include an affirmative representation that all such compensation and conflicts are being disclosed. If some compensation is already included in another document (such as a prospectus), that document can be incorporated by reference.

The disclosure must include *all* compensation, including gifts, awards, trips for employees, research, finder's fees, soft dollar payments, float income, etc. The disclosure must also include compensation to be received by affiliates of the service provider as a consequence of the service arrangement with the plan.

The service provider must also describe (in writing) all services that will be provided under the arrangement. If the service provider is offering a "bundled" arrangement of services to be provided by others, the bundler can make all disclosures on behalf of the group. The bundler generally is not required to disclose the specific compensation arrangements within the group, but must disclose fees charged against the investment, such as mutual fund fees of all types, float revenue, 12b-1 fees, and transaction-based fees.

The disclosure must specify how the fees will be paid – whether they will be billed to the plan, deducted from plan assets, or charged to participant accounts.

What are the potential conflicts of interest that must be disclosed?

First, the service provider must disclose whether it will be acting as a fiduciary, under either ERISA or the Investment Advisers Act of 1940.

Second, the service provider must disclose any financial interest in any transaction involving the plan that will be occurring in connection with the service arrangement.

Third, the service provider must disclose any material financial, referral, or other relationship it has with any other parties that creates or may create a conflict of interest under the service contract, and whether the service provider has the ability to affect its own compensation without the prior approval of the plan fiduciary (such as float compensation).

The service provider must also indicate

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whether it has policies and procedures in place to manage these real or potential conflicts of interest and explain those procedures.

Are there ongoing disclosure obligations?

Yes. The proposed regulation requires the service contract to require that the service provider disclose any material changes to the information disclosure during the term of the contract, within 30 days of the change.

The contract also must require the service provider to furnish all information with respect to services and fees that is requested by the plan administrator to comply with the Form 5500 disclosure requirements.

If the plan fiduciary obtains this information, is that sufficient?

Not necessarily. The DOL encourages plan fiduciaries to engage in an objective process to obtain not only the fee and compensation information, but also information sufficient to assess the qualifications of the service provider and the quality of the services that will be provided. No one factor is predominant, and it may be prudent (depending on the size and scope of services) to engage in a solicitation of bids and interviews of providers. Also, the DOL notes that the least expensive provider is not necessarily the most appropriate provider.

What are the consequences if the regulation is finalized and the disclosure requirements are not satisfied?

If the contract fails to include the disclosure requirements, the contract would not be reasonable and would not be eligible for the statutory exemption. Both the contracting fiduciary and the service provider would have committed a prohibited transaction and would be required to report the transaction and to pay the appropriate sanctions or excise taxes.

If the contract includes the disclosure requirements, but the service provider does not properly disclose the required information, the contract again would not be reasonable and would not be eligible for the statutory exemption. The contracting fiduciary would be eligible for the proposed class exemption, however, if the contracting fiduciary was unaware of the non-disclosure and takes appropriate steps to address the failure. In order to be eligible for the class exemption under these circumstances:

- The contracting fiduciary must have had a reasonable belief that the contract was reasonable and that the disclosures were proper.
- Upon discovering that the disclosures are insufficient, the contracting fiduciary must request the required information in writing (if it has not already been provided).
- If the information is not provided within 90 days of the written request, the contracting fiduciary must notify the DOL. The contracting fiduciary must notify the DOL within 30 days if the service provider expressly refuses to provide the information.
- Once the proper information is provided, the contracting fiduciary must consider whether to terminate or continue the contractual arrangement, taking into account all the appropriate facts and circumstances.

Even if the contracting fiduciary meets the above conditions and is eligible for the class exemption, the service provider still will have committed a prohibited transaction and will be responsible for the appropriate filings and penalties.

How are comments concerning the proposed regulation submitted?

Comments on the proposed regulation can be submitted by email to e-ORI@dol.gov or though the Federal eRulemaking portal at http://www.regulations.gov. Those preferring to submit comments by mail should include at least three copies and send them to: Office of Regulations and Interpretations, Employee Benefits Security Administration, Attn: 408(b)(2) Amendment, Room N-5655, U.S. Department of Labor, 200 Constitution Avenue, NW., Washington, DC 20210. All comments are available to the public, without charge, at http://www.regulations.gov and http://www.dol.gov/ebsa.

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