

Department of Labor Finalizes Form 5500 Fee Disclosure Rules and Proposes Guidance for Contracts Between Plans and Service Providers Under ERISA 408(b)(2)

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On November 16, 2007, the Department of Labor (DOL) issued the final rule concerning revisions to the Form 5500 Schedule C fee disclosure for employee benefit plans. This final rule essentially adopted the proposed rule and is effective for plan years beginning on or after January 1, 2009. Following this final rule, the DOL released a proposed regulation along with a proposed prohibited transaction class exemption on December 13, 2007 that provides guidance for arrangements between employee benefit plans and service providers. The DOL anticipates that these proposals will aid plan fiduciaries in accessing the reasonableness of compensation paid to service providers and any potential conflict of interests that may arise. These releases are the first two of three plan fee disclosure projects that the DOL had planned to issue. The final project concerns the disclosures by plan sponsors to participants and is expected in early 2008.

Form 5500 Schedule C Fee Disclosure

Reportable Compensation

The final rule indicates that reportable compensation under Schedule C includes money and any other thing of value (e.g., gifts, awards, trips) that a service provider receives directly or indirectly from the plan for services provided to the plan. The DOL asserts that the definition of “service provider” includes both persons who receive direct and indirect compensation and persons providing services directly and indirectly to the plan. The DOL also states that such definition is broader than the party in interest definition under ERISA as the former includes providers with indirect service relationships. Payments to such persons must be disclosed if the service provider has received \$5,000 or more in reportable compensation for a particular transaction or service to the plan. Previously, plans were required to disclose fees only with respect to the plan’s 40 highest-paid service providers. Consequently, this may require large plans (plans with more than 100 participants) to disclose hundreds of service providers. Furthermore, plan administrators will be required not only to report compensation paid to service providers but also compensation paid to service providers by any third parties related to the employee benefit plan. For example, an investment manager’s fees received directly from the plan as well as indirect soft-dollar benefits received from a broker-dealer would have to be reported on Schedule C. In circumstances in which service providers receive indirect compensation from multiple

plans, the plan administrator may utilize the service provider's allocation method for determining individual plan fees.

The compensation items that are required to be disclosed include gifts, awards, trips, brokerage commissions and fees (regardless of whether the broker is granted discretion), Rule 12b-1 fees, finder's fees, soft-dollar payments, and float income. Although Schedule C requires that the plan administrator complete the filing, it does not require that the requested items necessarily be furnished to the administrator by the party receiving the fee or commission. This means that the plan administrator will probably need to coordinate with the service provider (e.g., investment manager) to compile this information. The plan administrator should report to the DOL any service provider who fails or refuses to provide this information.

Identification of Fiduciaries and Certain Service Providers

Plan administrators are also required to identify plan fiduciaries and certain enumerated service providers receiving, directly or indirectly, more than \$1,000 from a source other than the plan or a plan sponsor. The enumerated service providers consist of the following functions: contract administrator, securities brokerage, insurance brokerage or agent, custodial, consulting, investment advisory, investment or money management, recordkeeping, trustee, appraisal, or investment evaluation. The following information must be provided on Schedule C for plan fiduciaries and enumerated service providers: (i) the payor of such indirect compensation, (ii) the payor's relationship with the plan or services provided to the plan by the payor, (iii) the amount paid, and (iv) the nature of the compensation. In response to comments received by the DOL, the final rule limits the identification of enumerated service providers to those compensation arrangements that are more likely to present conflict-of-interest concerns. This identification process may be burdensome for two reasons. First, the plan sponsor must track compensation in excess of \$1,000 from indirect sources to fiduciaries and enumerated service providers. Second, it is unclear by what standard a plan sponsor should ascertain which enumerated service providers are more likely to present conflict-of-interest issues.

Revenue-Sharing Arrangements

For revenue sharing among members of bundled service arrangements, the individual services do not need to be disclosed, but the person or persons in the bundle receiving separate fees from the plan must be reported. Additionally, any person in the bundle that is a fiduciary to the plan or provides services directly to the plan must also be reported if their reportable compensation equals or exceeds \$5,000. Affiliated groups receiving indirect compensation under these bundled service arrangements will also each be treated as a single person and should be disclosed accordingly. Schedule C also includes an alternative method for certain expenses deemed to be eligible indirect compensation.

Proposed Regulation Regarding Reasonable Arrangements with a Party in Interest Under ERISA 408(b)(2)

Background

Section 408(b)(2) of ERISA provides an exemption from the ERISA-prohibited transaction concerning the furnishing of goods, services, or facilities between the plan and a party in interest where the contract or arrangement between these parties provides for reasonable compensation. The current regulation provides that a contract or arrangement is reasonable as long as it permits the plan to terminate the

arrangement on short notice. The proposed regulation, as well as the proposed prohibited transaction class exemption, attempt to detail what constitutes a reasonable contract or arrangement under Section 408(b)(2) and to require additional written disclosures by service providers.

Scope of the Proposal

The DOL limited the scope of compensation arrangements to the following categories of services that are considered the most susceptible to conflicts of interest:

- Service providers that provide services to employee benefits plans as a fiduciary under ERISA or the Investment Advisers Act of 1940
- Service providers that supply any of the following services: banking, consulting, custodial, insurance, investment advisory, investment management, recordkeeping, securities or other investment brokerage, or third-party administration services
- Service providers receiving indirect compensation in connection with accounting, actuarial, appraisal, auditing, legal, or valuation services

Specific Disclosures in the Contract or Arrangement

The proposed regulation requires the following concerning compensation and services between the plan and service providers in the contract or arrangement:

- The contract or arrangement must be in writing.
- The contract or arrangement must require the service provider to disclose services to be provided to the plan and any compensation that it will receive in connection with its services. Examples of the compensation to be disclosed are provided above in the summary of reportable compensation for Form 5500 Schedule C reporting. Under certain circumstances, if it is not feasible for the service provider to disclose a monetary amount, the service provider may alternatively disclose the formula utilized, the percentage of the plan's assets, or a per capita charge for each participant or beneficiary. Additionally, if a service provider offers a bundled arrangement, then only the service provider actually providing the bundle must make the required disclosure in the contract or arrangement, subject to certain exceptions.
- The service provider must explain the method by which the service provider will receive its fees from the plan in the contract or arrangement, including a description of how prepaid fees will be calculated and refunded when the contract or arrangement ends.
- There must be a representation in the contract or arrangement made by the service provider that the service provider has provided complete and accurate required disclosure information. If the service provider fails to satisfy this representation, a plan fiduciary may be able to seek relief under the proposed class exemption discussed below.

The proposed regulation also requires certain disclosures that are intended to inform the plan fiduciary about the service provider's relationships that could result in a conflict of interest with the plan. Below are the required service provider disclosures within the contract or arrangement:

- Identification as to whether the service provider will provide services as a fiduciary, either under ERISA or the Investment Advisers Act of 1940
- Disclosure of any financial or other interest in any transaction that the plan will be involved with in connection with the contract or arrangement
- Disclosure of any relationships with other parties that may result in a conflict of interest, including any material financial, referral, or other relationship that the service provider has with other parties
- Identification as to whether the service provider can alter its receivables from the plan without the prior approval of the plan fiduciary (e.g., float income) as well as a description of the nature of this compensation
- Indication as to whether the service provider possesses any processes to manage real or potential conflicts of interest

As part of the service provider's ongoing disclosure obligations, the proposed regulation requires that the contract or arrangement also provide that (i) the service provider notifies the plan fiduciary of any material changes within 30 days of the service provider's knowledge of the change, and (ii) the service provider warrants that it will furnish information requested by the plan fiduciary to comply with the plan's annual Form 5500 requirements.

Consequences of Failing to Comply with the Proposed Regulation—Proposed Class Exemption

If the requirements outlined in this LawFlash are not met, the contract or arrangement will be considered unreasonable under ERISA 408(b)(2) and therefore will result in a prohibited transaction, subjecting the plan fiduciary and service provider to penalties and excise taxes. The plan fiduciary can avoid this if it falls under the proposed class exemption that provides relief to plan fiduciaries where the service provider fails to satisfy its disclosure obligations. In order to qualify under the proposed class exemption, upon discovery by the plan fiduciary of the service provider's failure, the plan fiduciary must request in writing the required disclosures from the service provider. Additionally, the plan fiduciary should consider whether under the circumstances it is necessary to terminate or continue the relationship with the service provider. If the service provider fails to comply with the plan fiduciary's written request within 90 days, the plan fiduciary must notify the DOL.

The DOL requests written comments on the proposed regulation and class exemption under ERISA 408(b)(2) by February 11, 2008. These proposals would be effective 90 days after publication of the final regulation in the Federal Register.

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