Advisory

Executive Compensation
& Benefits

March 23, 2012 (Updated)[1]

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

by Susan P. Serota and Kathleen D. Bardunias

On February 2, 2012, the Department of Labor ("DOL") released the 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 final regulations are effective for all applicable service provider arrangements as of July 1, 2012 (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.

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."[2]

1 This Advisory, which was originally issued on August 17, 2010, has been updated to reflect the changes made to the ERISA Section 408(b)(2) final regulations, including the updated July 1, 2012 effective date. The effective date of the service provider disclosure final regulations impacts the effective dates of the participant-level fee disclosures.

2 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.

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

The final regulations only apply to "covered service providers" of defined contribution and defined benefit plans. Service provider arrangements with welfare plans, individual retirement accounts, simple retirement accounts, and certain "frozen" 403(b) plans where, among other requirements, the annuity contract or custodial account was issued to a current or former employee before January 1, 2009, 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.[3]

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

[3] 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."

Required Disclosures

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 "responsible plan fiduciary" (i.e., the fiduciary with the authority to enter into the contract or arrangement) (the "RPF") the following:

- A description of all 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, a description and explanation of the arrangement between the payer and covered service provider, 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).

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.

Sample Guide. The final regulations include an Appendix with a "sample guide" that covered service providers can provide to RPFs. The guide is intended to enable to the RPF to locate compensation information that is disclosed in multiple or complex documents. While use of this guide is "strongly encouraged" by the DOL, it is not currently required. However, the preamble to the final rule states that the DOL intends to issue a proposed regulation that would require covered service providers to use such a guide to assist RPFs in locating required information.

Designated Investment Alternatives ("DIA"). Under the final rule, covered service providers must disclose additional information for any investment that is a DIA under a participant-directed 401(k) or similar plan. Such disclosures include: (1) the total annual operating expenses for the DIA (expressed as a percentage and calculated in accordance with the participant-level fee disclosure rules) and (2) any other information that is within the control of, or reasonably available to, the covered service provider and is required to be disclosed as investment-related information under participant-level fee disclosure rules.

Covered service providers may generally rely on investment-related disclosures of the issuer of the DIA so long as the issuer is one of several regulated entities specified under the rule.

Deadlines to Provide Disclosures. There is no required timeline for the initial disclosure of the required information; however, such information must be disclosed reasonably in advance of the initial effective date of the final regulations or 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 (other than investment-related information), 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. Changes to investment-related information must be provided at least annually. The final regulations do not relieve service providers from the obligation to disclose information reasonably in advance of the date a plan must comply with rules upon request in order to comply with the reporting and disclosure requirements of Title I of ERISA. If the covered service provider makes an error or omission in disclosing changes to previously disclosed information, such error or omission can be corrected within 30 days after the covered service provider knows of the error.

Plan Fiduciary Exemption

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

- The RPF must not have actual knowledge or reason to know of the service provider’s inadequate disclosure;
- Upon discovering the failure, the RPF 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 RPF must notify the DOL of the failure in accordance with the regulations.

Additionally, the RPF 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. If the covered service provider’s failure to disclose is related to future services, the RPF must terminate the applicable service provider arrangement as “expeditiously” as possible.

The DOL released a model form for the notification that can be used by the RPF to disclose the covered service provider’s failure to the DOL.

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 the July 1, 2012 deadline, 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.

New York

Susan P. Serota (bio)
+1.212.858.1125
susan.serota@pillsburylaw.com

Peter J. Hunt (bio)
+1.212.858.1139
peter.hunt@pillsburylaw.com

Scott E. Landau (bio)
+1.212.858.1598
scott.landau@pillsburylaw.com

John J. Battaglia (bio)
+1.212.858.1738
john.battaglia@pillsburylaw.com

Mark C. Jones (bio)
+1.212.858.1430
mark.jones@pillsburylaw.com

Kathleen D. Bardunias (bio)
+1.212.858.1905
kathleen.bardunias@pillsburylaw.com

Bradley A. Benedict (bio)
+1.212.858.1523
bradley.benedict@pillsburylaw.com

Washington, DC / Northern Virginia

Howard L. Clemons (bio)
+1.703.770.7997
howard.clemons@pillsburylaw.com

San Diego—North County

Jan H. Webster (bio)
+1.858.509.4012
jan.webster@pillsburylaw.com

Daniel N. Riesenberg (bio)
+1.858.847.4130
daniel.riesenberg@pillsburylaw.com

Kenneth E. Bonus (bio)
+1.858.847.4206
kenneth.bonus@pillsburylaw.com

Lori Partrick (bio)
+1.858.509.4087
lori.partrick@pillsburylaw.com

San Francisco

Christine L. Richardson (bio)
+1.415.983.1826
crichardson@pillsburylaw.com

Silicon Valley

Cindy V. Schlaefer (bio)
+1.650.233.4023
cindy.schlaefer@pillsburylaw.com

Grace Chen (bio)
+1.650.233.4873
grace.chen@pillsburylaw.com