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July 1 Deadline Approaches for Disclosure of Compensation and Fees to ERISA Plans

Retirement plan fiduciaries and service providers to retirement plans are coming up to the July 1, 2012, deadline for service providers to deliver disclosures of compensation to be received from their service arrangements with plans. We have prepared this review of the rules as a reference for those who are giving or getting these disclosures. Many of the questions that arise in connection with these requirements are fact-specific, so the following should not be regarded as advice with respect to any particular person or situation.

Putting the Disclosure Requirement in Context

The Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code of 1986 (the Code) each contain rules about “prohibited transactions” involving employee benefit plans. (These rules are similar, but not identical, in the two statutes.) Under ERISA, a fiduciary is prohibited from engaging in a prohibited transaction, to the point of having to unwind it, and the Code imposes excise taxes on the transaction. As a result, avoiding prohibited transactions is an important part of plan administration and providing services to plans. ERISA and the Code contain a number of statutory exemptions for categories of transactions that would otherwise be prohibited transactions.

The definitions of “prohibited transactions” in ERISA and the Code are broad. Under them, a fiduciary may not, among other things, cause a plan to receive services from or transfer plan assets to a “party in interest.” “Parties in interest” include a number of categories of persons and entities with ownership, financial or functional relationships to a plan or its sponsoring employer. (The Code uses the term “disqualified person” rather than “party in interest”; the definitions are similar, but not identical. We will use the ERISA term in this review.) One category of parties in interest is service providers to a plan.

ERISA § 408(b)(2) provides an exemption from the prohibited transaction rules for a party in interest to provide services to a plan if there is:

- (1) a “reasonable contract or arrangement” (2) for “necessary services” (3) for which not more than “reasonable compensation” is paid.

The new disclosure of compensation requirement in the regulations under § 408(b)(2) is an obligation of the service provider in order for there to be a “reasonable contact or arrangement.” Without these disclosures, the § 408(b)(2) exemption is unavailable and, unless another exemption is available, the providing of services to the covered plan by a party in interest for compensation will constitute a prohibited transaction.¹

¹ Code § 4975(d)(2) contains a parallel exemption, and the § 408(b)(2) regulations also apply to it. When the term “the regulations” is used in this review, it refers to the final § 408(b)(2) regulations, § 2550.408b-2(c).

For more information, please contact your Katten Muchin Rosenman LLP attorney, or any of the following members of Katten’s **Employee Benefits and Executive Compensation and Executive Employment Practices**.

Hannah C. Amoah
212.940.6458 / hannah.amoah@kattenlaw.com

Evan A. Belosa
212.940.6529 / evan.belosa@kattenlaw.com

Gregory K. Brown
312.902.5404 / gregory.brown@kattenlaw.com

Christopher K. Buch
312.902.5509 / christopher.buch@kattenlaw.com

Steven G. Eckhaus
212.940.8860 / steven.eckhaus@kattenlaw.com

Russell E. Greenblatt
312.902.5222 / russell.greenblatt@kattenlaw.com

Gary W. Howell
312.902.5610 / gary.howell@kattenlaw.com

Ann M. Kim
312.902.5589 / ann.kim@kattenlaw.com

Daniel B. Lange
312.902.5624 / daniel.lange@kattenlaw.com

William E. Mattingly
312.902.5266 / william.mattingly@kattenlaw.com

Overview of the Disclosure Requirement

Here is a summary of the rule:

For a services contract or arrangement with a covered plan to be reasonable, each covered service provider that expects to have at least \$1,000 of compensation paid to it or an affiliate or subcontractor for performing such services must provide descriptions of the compensation expected to be received (and, in some cases, information about designated investment alternatives provided to the plan) to the responsible plan fiduciary of the covered plan.

The scope and application of this rule flow from the definitions of the underlined terms.

A covered plan is a pension, profit sharing, 401(k), ESOP or other retirement plan that is subject to ERISA. Among the types of retirement arrangements that are not covered plans are individual retirement accounts (IRAs), governmental plans and foreign plans. In addition, “welfare plans” (plans providing benefits like health care coverage, life insurance and disability insurance) are not covered plans. The terms “covered plan” and “plan” are used interchangeably in the rest of this review, unless otherwise indicated.

A covered service provider (CSP) has any of the following relationships to a covered plan:

- Provides services as a fiduciary² directly to the plan (Fiduciary CSP).
- Provides services as a registered investment adviser registered under either the Investment Advisers Act of 1940 or state law (RIA) directly to the plan (RIA CSP).
- Provides services as a fiduciary to an investment vehicle in which the plan invests and whose assets are treated as plan assets (e.g., a collective investment trust, insurance company separate account or a non-registered fund where benefit plan investors own 25% or more of any class of equity interests) (Plan Asset CSP). A provider of non-fiduciary services to the investment vehicle in which the plan invests (for example, custody or audit services provided to an investment fund) is not a Plan Asset CSP.
- Provides recordkeeping or brokerage services to a plan that permits participants to direct investments in their individual accounts (such as a typical 401(k) plan), as part of an arrangement in which investment alternatives (such as mutual funds or collective funds) are also provided (Bundled Services CSP).
- Provides one or more listed services³ to the plan for which it, an affiliate or a subcontractor expects to receive “indirect compensation” (as defined below) (Listed Services CSP). If no “indirect compensation” is received in connection with providing listed services (for example, an accountant or auditor whose fees are paid by the plan or the plan sponsor), the service provider is not a Listed Services CSP.

A person or entity is an affiliate of a CSP if it controls, is controlled by or is under common control with the CSP, or if it is an officer director, employee or partner of the CSP.

A person or entity is a subcontractor of a CSP if it is not an affiliate, but has a contract or arrangement with the CSP to perform any of the services described in the definition of a CSP (fiduciary services, RIA services or listed services) for the covered plan, and expects to receive at least \$1,000 of compensation for performing those services. For example, if an investment manager, which is a Fiduciary RSP because it manages plan assets, opens a brokerage account for the plan’s account, the broker is a subcontractor of the Fiduciary CP if it expects to receive at least \$1,000 of compensation as a broker for the plan’s account.

Compensation is anything of value received during the term of the CSP’s contract or arrangement with the plan, excluding non-monetary compensation with an aggregate value of not more than \$250. Direct compensation is compensation received directly from the covered plan. Indirect compensation is compensation received other than from the covered plan, the plan sponsor (i.e., the employer that maintains the plan), the CSP or an affiliate of the CSP.

² An entity or person is a fiduciary “to the extent” it exercises discretionary authority or control respecting management of a plan, exercises any authority or control respecting management or disposition of a plan’s assets, provides investment advice for a fee or other compensation (direct or indirect) with respect to money or other property of a plan or has authority or responsibility to do so, or has discretionary authority or responsibility respecting administration of the plan.

³ The listed services are accounting, auditing, actuarial, appraisal, banking, consulting, custody, insurance, investment advisory, legal, recordkeeping, brokerage, third party administrator and valuation.

Designated investment alternatives are investment alternatives, such as specific mutual funds or collective funds, that are made available under a plan that permits participants to direct investments in their individual accounts.

The responsible plan fiduciary to whom the disclosures are to be made is the RSP fiduciary of the covered plan that has authority to cause the plan to enter into the contract or arrangement with the CSP.

Providing Information to the Responsible Plan Fiduciary

It is important to remember that the purpose of this disclosure requirement is to give the responsible plan fiduciary enough information about the services that the CSP will perform and how the CSP (and its affiliates and subcontractors) will be compensated for those services so that the fiduciary can make a determination whether the plan has a reasonable contract or arrangement with the CSP, that is, whether the compensation is appropriate for the services performed. The information that the CSP must provide will vary, depending on which type of CSP relationship it has with the plan.

All CSPs must provide descriptions of:

Services to be provided to the plan under the CSP's contract or arrangement by the CSP and its affiliates and subcontractors. According to the preamble to the final § 408(b)(2) regulations the description of services must be "clear and understandable," but a detailed description may not be needed where the parties already understand the nature of the services. If the CSP or its affiliate or subcontractor will provide services as a fiduciary or RIA, this must be stated separately.

Compensation expected to be received under the contract or arrangement:

- All direct compensation that is expected to be received by the CSP or an affiliate or subcontractor for the services described above.
- All indirect compensation that is expected to be received by the CSP or an affiliate or subcontractor for the services described above, including (1) the services for which it will be received; (2) identification of the payer; and (3) description of the arrangement under which it will be paid.
- Any direct or indirect compensation that will be paid among the CSP, an affiliate or a subcontractor in connection with the services described above, but only where the compensation is (1) set on a transaction basis (e.g., commissions, soft dollars), or (2) charged directly against the plan's investment and reflected in the value of its investment. This disclosure must include the services for which the compensation is received and identification of the payer and the recipient.
- Any compensation that the CSP or an affiliate or subcontractor expects to receive upon termination of the arrangement (such as an early termination fee).

The regulations are flexible as to how compensation may be described, including as a dollar amount, formula, percentage of plan assets or by any other reasonable method, or in the form of a reasonable, good faith estimate if the methodology and assumptions for the estimate are explained.

Bundled Services CSPs who provide recordkeeping services must (a) provide descriptions of any direct or indirect compensation that the CSP, an affiliate or a subcontractor expects to receive in connection with the recordkeeping services, and (b) if the recordkeeping services are offset or subsidized, such as in a "revenue sharing" arrangement, provide a reasonable, good faith estimate of the actual cost of the recordkeeping services.

Bundled Services CSPs must provide, for every designated investment alternative provided in connection with the CSP's recordkeeping or brokerage services, (a) a description of any compensation charged directly against the plan's investment, such as commissions, or management or performance fees; (b) unless the investment vehicle has a fixed return, a description of the investment vehicle's annual operating expenses or expense ratio; and (c) any additional information that the plan needs to make the participant-level disclosures about designated investment vehicles that are required later this year. A Bundled Services CSP may comply with this requirement by providing prospectuses or similar disclosure documents of non-affiliate designated alternatives.⁴

⁴ An arrangement such as a "brokerage window" that permits participants to choose investments other than the plan's designated investment alternatives is not a designated investment alternative. However, a CSP that provides such an arrangement to a plan must make all disclosures otherwise required by the regulations with respect to the services it provides and the compensation that it, its affiliates and its subcontractors receive in connection with that arrangement.

Plan Asset CSPs must provide, for an investment vehicle in which the plan invests and whose assets are treated as plan assets, (a) a description of any compensation charged directly against the plan's investment, such as commissions, or management or performance fees; (b) unless the investment vehicle has a fixed return, a description of the investment vehicle's annual operating expenses or expense ratio; and (c) if the investment vehicle is a designated investment vehicle, any additional information that the plan needs to make the participant-level disclosures about designated investment vehicles that are required later this year, if such information is under the control of or "reasonably available" to the CSP.

With respect to any description of compensation, the CSP must describe how the compensation will be received, for example, billed directly, deducted from the plan's account or otherwise.

Format of the Disclosure

The regulations do not require disclosure in any particular format and provide considerable flexibility. The use of different documents from different sources is permitted, so long as, taken together, all required information is provided. For example, an RIA CSP, in describing indirect compensation received as "soft dollars," might reference its Form ADV for a description of the services for which it receives soft dollars and a description of the soft dollar arrangement, and supplement it with a list of brokers from whom it reasonably expects to receive soft dollars in connection with the covered plan's account.

There is an Appendix to the regulations that provides a sample disclosure format, which consists of a cover sheet that identifies the information being furnished and references various other documents that contain the specific information.⁵

Timing of the Disclosure and Additional Disclosures

For any existing contract or arrangement between a CSP and a covered plan, the information required by the § 408(b)(2) regulation must be provided to the responsible plan fiduciary by July 1, 2012.

Going forward, the § 408(b)(2) disclosures are to be provided "reasonably in advance of" the date a CSP enters into or renews a contract with a covered plan. If an investment vehicle that has not been deemed to hold plan assets is deemed, at some point, to hold plan assets (such as by reason of investments or withdrawals by investors), such that its fiduciary becomes a Plan Asset CSP, disclosure must be made as soon as practicable, but not later than 30 days after the CSP is aware of the investment vehicle's "plan asset" status. Updates are also required with respect to new designated investment vehicles, and with respect to changes or updates of information that is required to be disclosed by a CSP, or a CSP's discovery of errors in a disclosure.

Finally, the regulations provide that upon written request of a covered plan's responsible plan fiduciary or plan administrator, the CSP must provide any other information about the CSP's compensation under its contract or arrangement with the plan that the plan's responsible plan fiduciary or plan administrator identifies as necessary for the plan to comply with ERISA's reporting and disclosure requirements, for example, Schedule C to Form 5500. The CSP must provide the requested information reasonably in advance of the date that the written request identifies as the date by which the responsible plan fiduciary or plan administrator states that it must comply with the reporting or disclosure requirement. A CSP's failure to timely respond to such a request, like a failure to provide other information required by the regulation, can cause the § 408(b)(2) exemption to be unavailable for the CSP to provide services to the plan.

⁵ This is available at 77 Fed. Reg. 5658-59 (Feb. 3, 2012), and is attached to this review.

Katten

www.kattenlaw.com

Katten Muchin Rosenman LLP

CHARLOTTE CHICAGO IRVING LONDON LOS ANGELES NEW YORK OAKLAND SHANGHAI WASHINGTON, DC

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Appendix—Sample Guide to Initial Disclosures

ABC Service Provider, Inc. (ABC) Guide to Services and Compensation Prepared for the XYZ 401(k) Plan

The following is a guide to important information that you should consider in connection with the services to be provided by ABC to the XYZ 401(k) Plan. Should you have any questions concerning this guide or the information provided to you concerning our services or compensation, please do not hesitate to contact *[enter name of person and/or office]* at *[enter phone number and/or email address]*.

| Required Information | Location(s) |
|---|---|
| Description of the services that ABC will provide to your Plan. | Master Service Agreement § 2.4, p. 1 |
| A statement concerning the services that ABC will provide as <i>[an ERISA fiduciary]</i> <i>[a registered investment adviser]</i> . | Master Service Agreement § 2.6, p. 2 |
| Compensation ABC will receive from your Plan (“direct” compensation). | Master Service Agreement § 3.2, p. 4 |
| Compensation ABC will receive from other parties that are not related to ABC (“indirect” compensation). | Master Service Agreement § 3.3, p. 4 Stable Value Offering Agmt § 3.1, p. 4 |
| Compensation that will be paid among ABC and related parties. | Master Service Agreement § 3.5, p. 6 |
| Compensation ABC will receive if you terminate this service agreement. | Master Service Agreement § 9.2, p. 11 |
| The cost to your Plan of recordkeeping services. | Master Service Agreement § 3.4, p. 5 |
| Fees and Expenses relating to your Plan’s investment options. <i>*Total Annual Operating Expenses</i> | <p>(1) Capital and Income Fund Trans. Fees: InvestCo Prospectus, Fund Summary, p. 2 TAOE:* InvestCo Prospectus, Fund Summary, p. 2</p> <p>(2) International Stock Fund Trans. Fees: www.weblink/ABCProspInv2/trans.com TAOE: www.weblink/ABCProspInv2/taoe.com</p> <p>(3) Small Cap Fund Trans. Fees: www.ABCweblink/ProspInv3/trans.com TAOE: www.weblink/ABCProspInv3/taoe.com</p> <p>(4) Bond Market Index Fund Trans. Fees: www.weblink/ABCProspInv4/trans.com TAOE: www.weblink/ABCProspInv4/taoe.com</p> <p>(5) Stable Value Fund Trans. Fees: Stable Value Offering Agmt, § 2.4, p. 3 TAOE: Stable Value Offering Agmt, § 2.3, p. 3</p> <p>(6) Money Market Fund Trans. Fees: www.weblink/ABCProspInv6/trans.com TAOE: www.weblink/ABCProspInv6/taoe.com</p> |

Source: Department of Labor, February 3, 2012.