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The Department of Labor Fee Transparency Initiatives: Part 2 - Mandatory Service Provider Fee Disclosures

For a number of years, the Department of Labor has been concerned about the amount of fees and expenses charged to tax-deferred retirement plans and the transparency of fee and expense information available to plan fiduciaries and plan participants to assess their reasonableness and effect on investment return. In response, the Department commenced three separate initiatives to improve the transparency of fee and expense information. In this *Benefits Brief*, we will provide a general overview of the second of those initiatives--regulations requiring service providers to defined benefit plans and defined contribution plans (like profit sharing and 401(k) plans) to provide detailed fee and expense information to the plan's fiduciaries.[1]

Background and Overview

At the outset, the Department of Labor had to overcome a very real impediment to mandating fee and expense disclosure by brokers, investment advisors, recordkeepers and other parties providing service to a plan -- it had a no statutory authority over those service providers. Its solution was to do so indirectly via the prohibited transaction rules. Those rules generally subject all non-exempt transactions between a plan and certain parties with a close relationship to the plan (e.g., the plan sponsor, officers, directors and key owners of the plan sponsor, and service providers) to an excise tax. Among the numerous exemptions from those rules is one for "reasonable" arrangements for services necessary for the establishment or administration of the plan. Under the DOL's regulations, an arrangement with a service provider will no longer be considered to be "reasonable" unless the specified disclosures are made.

Simply stated, the regulations provide that a contract or arrangement for services between a "covered plan" and a "covered service provider," including extensions or renewals, will not be considered reasonable (and thereby qualify under the exemption to the prohibited transaction rules) unless the covered service provider provides a written summary to the "responsible plan fiduciary"[2]

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[1] Department of Labor Reg. § 2550.408b-2. The first of those initiatives mandated additional disclosures on the Form 5500 (the annual informational return filed with the Department of Labor) for retirement plans with more than 100 participants and was first effective for Forms 5500 filed for the 2009 plan year. The last of those projects mandates the investment and fee and expense information that must be provided by plan administrators to participants in participant-directed retirement plans. The participant fee disclosure regulations were issued in October, 2010, and are generally effective in plan years beginning on or after November 1, 2011. A discussion of the participant fee disclosure regulations will be the subject of a later *Benefits Brief.*

[2] The responsible plan fiduciary is the party authorized under the plan to enter into, or to renew or extend, a contract with a covered service provider.

of the services to be provided, the "compensation" reasonably expected to be received in connection with the plan, and, where required, the additional special disclosures. These disclosures are required beginning January 1, 2012.

Covered Plans

A "covered plan" for purposes of these rules is a pension plan within the meaning of the labor code provisions of the Employee Retirement Income Security Act of 1974 (or "ERISA"). For the most part that definition includes defined benefit and defined contribution plans (i.e., 401(k), profit sharing, money purchase pension and employee stock ownership plans) of private employers and Section 403(b) tax sheltered annuities and profit sharing and 401(k) plans of tax-exempt employers; excluded are primarily governmental plans; plans of churches which have not elected to be covered by ERISA; individual retirement accounts and annuities, including simplified employee pensions (or SEPs) and "SIMPLE" IRAs; and plans covering only a sole business owner, a sole business owner and his or her spouse, a self-employed individual, or self-employed individuals and their spouses.[3]

The Department of Labor specifically rejected suggestions that plans below a certain level of participants or plan assets be exempted from these requirements. Instead, so long as the services are provided by a person or entity who is a "covered service provider," the disclosures must be made.

Covered Service Providers

A "covered service provider" is a service provider that enters into a contract with a covered plan and reasonably expects $1,000 or more in compensation, direct or indirect, to be received in connection with providing one or more specified services, whether the services will be performed or the compensation received by the covered service provider, an affiliate or a subcontractor of the covered service provider. The $1,000 threshold is to be measured by reference to the term of the arrangement. Note that the required disclosures only apply to services paid from plan assets, not with respect to any services which are paid by the plan sponsor.

The specified services to be considered a covered service provider are:

Fiduciary or *Registered Investment Adviser Services*: These services include: (1) services provided directly to the plan as a fiduciary under ERISA; (2) services as a fiduciary to an investment contract, product or entity that holds plan assets and in which the plan has a direct equity interest; or (3) services provided directly to a covered plan as an investment adviser subject to regulation under federal or state law. Examples of this second category include investment managers of collective investment trusts in which plan assets are invested and managers of non-publicly traded, non-mutual fund investments in which "benefit plan investors" own 25% or more of the fund by value.

Certain Recordkeeping or Brokerage Services: Recordkeeping or brokerage services provided to an

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[3] Although the regulations do not apply to certain types of plans, the provision of these disclosures may become the de facto standard for determining whether a fiduciary has properly discharged his or her fiduciary duties. Accordingly, fiduciaries of exempted plans should consider the desirability of requiring these disclosures in their contracts with plan service providers.

individual account plan that permits participant investment direction if one or more designated investment alternatives (i.e., a core line up of funds) will be made available (e.g., through a platform) in connection with the recordkeeping or brokerage services.

Other Services for Indirect Compensation: Accounting, auditing, actuarial, appraisal, banking, consulting (i.e., related to development or implementation of investment policies, or the selection or monitoring of service providers or plan investments), custodial, insurance, investment advisory services for the plan or participants (including services by broker-dealers, even if the broker-dealer not considered a fiduciary), legal, recordkeeping, securities or investment brokerage, third party administration or valuation services provided to the covered plan, for which the service provider, an affiliate, or a subcontractor reasonably expects to receive indirect compensation or compensation from related parties.

Required Disclosures

The covered service provider must provide the following information in writing to the responsible plan fiduciary:

Services: A description of the services to be provided to the covered plan.

Status: If applicable, a statement that the service provider, an affiliate, or a subcontractor will provide or reasonably expects to provide fiduciary services (as described above) pursuant to the contract.

Compensation: A description of all direct and indirect compensation to be received, compensation paid among related parties, and contract termination compensation.[4] For this purpose, compensation means anything of monetary value but excludes non-monetary compensation valued at $250 or less, in the aggregate, during the term of the contract.

As the name connotes, direct compensation refers to amounts received directly from the covered plan. Indirect compensation means compensation from any source other than the plan, the plan sponsor, the covered service provider, an affiliate or a subcontractor, such as amounts paid by a mutual fund in which the plan is invested (e.g., 12b-1 fees). The description of indirect compensation must identify the services for which the compensation will be received and the payer of that compensation.

Compensation paid among the covered service provider and an affiliate or subcontractor must be described if it is set on a transaction basis (e.g., commissions, soft dollars, finder's fees or similar incentive compensation based on the amount of business placed or retained) or is charged directly against the plan's investment and reflected in the net value of the investment (e.g., 12b-1 fees). It must identify both the services for which the compensation will be paid and the payer(s) and recipient(s) (including the status of a payer or recipient as an affiliate or subcontractor). The greatest impact of the indirect compensation disclosure will likely be on bundled providers (i.e., a

[4] The proposed regulations would have required the covered service provider to also provide a written narrative of its conflicts of interest but that requirement was not included when the regulations were finalized. The required disclosures are designed to provide sufficient information to enable the responsible plan fiduciary to identify those conflicts.

single provider or related providers that provide the investment funds and handle the recordkeeping, participant communications, and reporting and disclosure obligations).

Compensation reasonably expected to be received upon termination of the contract must also be described, including how any prepaid amounts will be calculated and refunded upon termination. The greatest impact of this disclosure will be on insurance companies that issue group annuity contracts with surrender charges.

Compensation may be expressed as a monetary amount, formula or percentage of assets, or a per capita charge, or, if it cannot be reasonably expressed in those terms, in any other reasonable manner. Any description or estimate must contain sufficient information to permit an evaluation of its reasonableness.

Manner of Receipt: A description of the manner in which the compensation will be received -- whether the plan will be billed or the compensation deducted from the plan's account or investments.

Special Rules for Recordkeeping Services: If recordkeeping services are to be provided to the plan, the description must include a description of all direct or indirect compensation that the covered service provider, an affiliate or subcontractor reasonably expects to receive. If the service provider expects that recordkeeping service will be provided (even in part) without explicit compensation, or when compensation for recordkeeping services is offset or rebated based on other compensation received, the disclosure must include a reasonable good faith estimate of the cost of the recordkeeping services, including an explanation of the methodology and assumptions used to prepare the estimate and a detailed explanation of the recordkeeping services to be provided. In other words, the covered service provider must disclose what the service provider would charge for similar services for which it received no indirect compensation and no proprietary investment funds were utilized.

Special Rules for Investment Fiduciaries, Recordkeepers and Brokers: If fiduciary services will be provided to the plan, the fiduciary to an investment contract, product, or entity that holds plan assets and in which the plan has a direct equity interest must provide the following information: (1) a description of any compensation that will be charged directly against the amount invested in connection with the acquisition, sale, transfer of, or withdrawal from the contract, product, or entity (e.g., sales loads and charges, redemption fees, surrender charges, and exchange and purchase fees); (2) a description of the annual operating expenses (e.g., expense ratio) if the rate of return is not fixed; and (3) a description of any ongoing expenses in addition to annual operating expenses (e.g., wrap fees and mortality and expense charges). Similar disclosure rules apply to recordkeepers and brokers who are considered covered service providers because they provide designated investment alternatives with respect to the plan, although coordination rules are in place to avoid duplicate disclosure obligations.

Format, Timing and Special Rules

All required disclosures must be made in writing. At this date, no particular format is mandated for these disclosures, and service providers may utilize multiple documents to satisfy their obligations.[5] It will be incumbent upon the responsible plan fiduciary to determine whether sufficient information has been provided.

The covered service provider must make the required disclosure reasonably in advance of the date the contract or arrangement is entered into, extended or renewed, subject to limited exceptions. If there are changes in the information, the covered service provider must provide updated disclosures as soon as practicable but not more than sixty days from the date the service provider is informed of the change.

Special rules apply to protect against unintentional errors or omissions. As a general rule, a violation will not be deemed to occur if the covered service provider, acting in good faith, makes an error or omission in disclosing the required information, provided the correct information is provided to the responsible plan fiduciary as soon as practicable but not later than thirty days after the date the covered service provider knows of the error of omission.

Aside from these disclosures, a covered service provider must also provide to the responsible plan fiduciary or plan administrator the information required for the plan to comply with the reporting and disclosure obligations under ERISA (e.g., the information required to be reported on the Form 5500). This information must be provided within thirty days of the written request, subject to limited exceptions.

Consequences of Failure to Provide Disclosures

A failure to provide the required disclosures will constitute a prohibited transaction for which the covered service provider will be responsible for the applicable excise tax until it is "corrected." This excise tax is self assessing and is not subject to the discretion of the Internal Revenue Service. The burden of proof in establishing that these disclosures are made falls on the covered service provider, not the IRS.

A fiduciary of a plan for which the required disclosures are not provided may be considered to have breached his or her fiduciary duties and could be personally liable for any losses resulting to the plan (for example, if fees were determined to be excessive). The fiduciary could also be responsible for a breach of fiduciary duty penalty assessed by the Department of Labor.

Special rules apply to protect plan fiduciaries who act reasonably but to whom the required disclosures are not provided. Among other requirements for this relief, the fiduciary must make written requests on the covered service provider and notify the Department of Labor of the failure. It will also be incumbent on the fiduciary to determine whether termination of the contract is appropriate in light of the failure to provide the required information.

Suggested Plan Fiduciary Actions

The most immediate compliance burdens are on covered service providers, especially those who regularly provide services through affiliates or subcontractors; at this stage, they will need to put in place systems or procedures to accumulate, verify and distribute the relevant information.

[5] The Department of Labor regulations were issued as interim final regulations to permit public comment. The Department of Labor specifically requested comment on whether a summary document should be required. It is anticipated that the DOL will mandate a summary form once these regulations are finalized.

The responsible plan fiduciary should ascertain the covered service providers who are providing services to its plan and may be covered by these regulations. As it gets closer to the deadline, the plan fiduciary should inquire of those service providers of the anticipated date the required disclosures will be provided.

Plan fiduciaries will also need to develop procedures to track, review and evaluate required disclosures to ensure that the requirements of the regulations have been satisfied. All such due diligence should be contemporaneously documented by the plan fiduciaries in writing.

Finally, although not legally required under these regulations, plan fiduciaries should consider the prudency of requiring a written agreement with each service provider. Among the benefits should be a clear delineation of responsibilities between the plan sponsor or fiduciary and the service provider, thereby minimizing the risk of errors or omissions, or at the very least, misunderstandings.

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