New ERISA Fee Disclosure Rules

Background

The exemption under Section 408(b)(2) of the Employee Retirement Income Security Act of 1974 ("ERISA") from ERISA's prohibited transaction rules permits a service provider to an employee benefit plan to receive compensation for the services if no more than "reasonable compensation" is paid for "necessary" services under a "reasonable" arrangement. Regulations of the U.S. Department of Labor (the "DOL") promulgated in 1977 elaborated on the circumstances in which the exemption would be available.

The world has changed quite a bit since 1977, and the DOL has now issued long-awaited interim final regulations under Section 408(b)(2) requiring increased disclosure of compensation in the case of certain services provided to retirement plans. Under the new regulations, where applicable, an arrangement for providing services to a retirement plan will be treated as "reasonable" only if the service provider discloses to the plan specified compensation-related information.[*] The new requirements are subject to a delayed effective date, applying to arrangements entered into on or after, or otherwise in effect after, July 16, 2011. These new regulations do not apply to medical and other "welfare" plans, and the DOL is expected to issue additional rules applicable to those plans.

A failure to meet the requirements for the Section 408(b)(2) exemption could cause the payment of compensation to a provider of services to an employee benefit plan to be a prohibited transaction under ERISA and the corresponding provisions of the U.S. tax code. The consequences of a prohibited transaction can include punitive excise taxes, disgorgement of fees and other potential liabilities on the service provider, and liability for the plan fiduciary. It will be critical for service providers and plan fiduciaries subject to the new rules to make sure they are in compliance with the new regulations, once they take effect.

Who is Affected?

The new rules may require action by certain investment managers and other financial services companies that (i) act as fiduciaries to ERISA pension, profit-sharing or other retirement plans or "plan assets" entities subject to ERISA (i.e., entities the assets of which are deemed to be assets of ERISA plans that hold equity or equity-like interests in the entity), or (ii) make investment alternatives available under "401(k)" and similar plans in connection with recordkeeping or brokerage services.

[*] The new regulations are part of a more comprehensive effort to address the level of fee-related disclosure available to fiduciaries and plan participants and beneficiaries. Recently, the DOL extensively revised the information relating to compensation that plan administrators are required to report annually on the "Form 5500," and previously issued proposed regulations that would affect the disclosure of fees charged in connection with participant-directed "401(k)" and other plans.

Specifically, the rules apply to a "covered service provider," which is defined to mean a service provider that enters into a contract or arrangement with a plan and reasonably expects the contract to result in the receipt of $1,000 or more in compensation, direct or indirect, whether by the service provider itself or by an affiliate or subcontractor, in connection with the provision of any of the following services:

- Services as a fiduciary or registered investment adviser –
  - provided directly to a plan in a fiduciary capacity, or
  - provided to an investment contract, product or entity that holds plan assets and in which a plan has a direct equity investment.
- Recordkeeping or brokerage services provided to a plan with participant-directed investments, if designated investment alternatives are made available in connection with such services.
- Other services for which compensation is expected to be received indirectly from a source other than the plan, including accounting, auditing, actuarial, appraisal, banking, consulting, custodial, insurance, investment advisory, legal, recordkeeping, securities or other investment brokerage, third party administration or valuation services.

A number of issues have begun to arise in the market regarding the scope of the new rules. For example, in the context of a plan-assets private-equity or hedge fund that uses a master-feeder structure (where the master is a plan-assets entity), there is the question of whether services provided to the master by a fiduciary or registered adviser may escape the application of the new rules, if the services are not viewed as being "direct" services with respect to plans investing in a feeder. These and other questions will need to be monitored in the case of affected service providers and fiduciaries so that compliance strategies can be developed before the rules become effective.

What Must be Disclosed?

The rules will require disclosure in writing, generally in advance, of the following information:

- The services to be provided, described in sufficient detail to permit the particular plan fiduciary to assess the reasonableness of the arrangement;
- Whether services are expected to be provided in a fiduciary capacity or as a registered adviser;
- All compensation expected to be received, including by affiliates and subcontractors, whether the compensation is direct or indirect (such as "12b-1" fees or soft dollar research);
- Compensation paid to related parties, if charged on a transaction basis or reflected in the value of the investment, together with the services for which such compensation is paid and the identities of payer and recipient;
- Compensation that would be payable on termination of the arrangement, including terms of any prepaid amounts and refunds; and
- How compensation is billed or otherwise charged.

In addition, for recordkeeping services provided together with the offering of designated investment alternatives, the following disclosures must be made:

- A description of all direct and indirect compensation expected to be received by the recordkeeper or any affiliate or subcontractor;
- If services are provided without explicit compensation, a reasonable and good faith estimate of what the services will actually cost the plan, with a detailed explanation of how the estimate was made, taking into account prevailing market rates or rates that would be charged to similar third parties; and
- Fees and expense ratios for each designated investment alternative, and any additional operating expenses.

In some cases, the extent to which the rules apply may not be obvious. For example:

- A person charged with overseeing a plan-assets feeder may need to consider whether the services being performed are in a fiduciary or non-fiduciary capacity.
- A recordkeeper estimating the cost of recordkeeping services may need to decide on a method that will be recognized as reasonable and that will give plan administrators enough information to make a reasonable assessment of the arrangement.
- Service providers will have to judge how much information a particular plan fiduciary will need to assess the reasonableness of an arrangement.
- Plan fiduciaries will have to decide whether they have been given enough information to determine whether all compensation is reasonable.

While the rules are not effective until mid-2011, interpretive questions like these may need to be considered well in advance.

When Must Disclosure be Made?

Disclosures generally must be made in writing "reasonably in advance" of the date the contract or arrangement is entered into, renewed, or extended. Special rules apply in certain circumstances:

- Any changes must be disclosed as soon as practicable, but not later than 60 days from the date the service provider is aware of the change.
- If a non-plan asset fund comes to hold plan assets, disclosure must be made as soon as practicable, but not later than 30 days from the date the service provider is aware that the fund holds plan assets.

Also, if a plan administrator requests compensation information that is required to comply with the plan's reporting and disclosure obligations under ERISA, the information must be provided within 30 days of receipt of the request, or as soon as practicable if that deadline cannot be met due to extraordinary circumstances beyond the service provider's control.

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What Happens if Required Disclosures are Not Made?

As noted above, a failure to comply with the new regulations on or after July 16, 2011 can cause an arrangement for services to be treated as a prohibited transaction, unless an exception or exemption applies.

- An exception for inadvertent errors or omissions is available, if the service provider has acted in good faith and with reasonable diligence and discloses the correct information as soon as practicable and not later than 30 days from discovering the failure. The regulations focus exclusively on the service provider's actions in this circumstance. Although the plan fiduciary too faces risk if it imprudently engages in a non-exempt prohibited transaction, it is not clear how a fiduciary would know whether its service provider used reasonable diligence, or whether a failure has been corrected within 30 days of its being discovered.
- An exemption is available for plan fiduciaries, if the fiduciary (i) reasonably believed that all required information had been disclosed, (ii) requests the information in writing upon discovering the failure, (iii) if the information is not provided within 90 days, reports the failure to the DOL within the next 30 days, and (iv) makes a determination whether to terminate or continue the arrangement. It is not necessary to terminate an arrangement where a failure to disclose has not been remedied, but it may be asked how a plan fiduciary would justify continuing to maintain an arrangement for services once the fiduciary has reported it as a prohibited transaction, even if the fiduciary regards the arrangement as otherwise reasonable and advantageous for the plan.

We have noted a number of issues above that have been identified under the DOL's new Section 408(b)(2) regulations. There are a number of additional potentially difficult issues that may arise under the new regulations depending on the specific circumstances of particular service providers that may need to be considered before the regulations become effective. It is also possible that the DOL will further clarify, or even change, the manner in which the new regulations apply, before they become effective.

Please feel free to contact any member of Ropes & Gray's Benefits Practice Group with any questions about the new requirements.

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