Final ERISA Fee Disclosure Rules

On February 2, 2012, the Department of Labor (the "DOL") released its long-awaited final rule under Section 408(b)(2) of the Employee Retirement Income Security Act of 1974 ("ERISA") regarding fee disclosures by service providers to ERISA plans. The final rule contains certain changes, summarized below, from the interim final rule published on July 16, 2010. **The final rule also postpones the effective date of the new requirements from April 1, 2012 to July 1, 2012. As a consequence, the requirements of the DOL's related participant-level fee disclosure rule will not take effect until August 30, 2012.**

The exemption under Section 408(b)(2) of ERISA 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. Under the new rule, where applicable, an arrangement for providing services will be treated as reasonable only if the service provider discloses to the plan specified compensation-related and other information. 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 Internal Revenue Code. The consequences of a prohibited transaction can include punitive excise taxes, disgorgement of fees and other potential liabilities on the service provider, as well as liability for the plan fiduciary. Therefore, it is critical for service providers, including managers that provide advice to private funds or hedge funds that hold plan assets, and plan fiduciaries that are subject to the final rule to make sure they are in compliance by **July 1, 2012**.

What has Changed from the Interim Final Rule?

The final rule is similar, but not identical, to the interim final rule (which we described in a prior alert). The changes include:

- *Sample Guide to Disclosure.* The DOL has included as an Appendix to the final rule (although not as part of the rule itself) a sample "guide" that can be used by service providers to indicate where compensation and other information can be found in relevant documents. Use of the guide is recommended by the DOL but not required. The preamble to the final rule indicates that the DOL intends to issue a proposed regulation that would require use of a guide or similar tool.
- *Designated Investment Alternative Disclosures.* For any investment that is a designated investment alternative under a participant-directed 401(k) or similar plan ("DIA"), service providers must now also provide to the plan:
    - Total annual operating expenses of the DIA, expressed as a percentage and calculated in accordance with the DOL's participant-level fee disclosure rules; and
    - Any other information relating to DIAs within the control of or reasonably available to the service provider, if the information is required for the covered plan administrator to comply with the new participant-level fee disclosure rules.
- *Requirements for Class Exemption.* The final rule adds another requirement to the class exemption available to fiduciaries that rely on disclosed information that later turns out to be inadequate. Now, if a service provider fails to provide requested information within 90 days, and the information relates to future services, the plan fiduciary is required to terminate the contract as expeditiously as possible.

- *Descriptive Explanation of Indirect Compensation*. The final rule requires an explanation of any arrangement between the covered service provider and a third party under which indirect compensation is expected to be paid.
- *Pass-Through Relief*. Recordkeepers and brokers may now generally rely on certain disclosure provided by the issuer of a DIA so long as the issuer is one of several enumerated regulated entities, including a registered investment company.
- *Time to Disclose Changes*. The final rule allows changes in certain investment-related information to be disclosed "at least annually," rather than within 60 days following the change.
- *Time to Provide Requested Information*. After a plan alerts the service provider that certain information is needed in order to comply with the applicable reporting and disclosure requirements, the service provider now must disclose such information "reasonably in advance" of the date by which the plan must comply with the applicable reporting or disclosure requirement, rather than within 30 days of a written request.
- *Covered Plans*. Certain frozen annuity contracts and custodial accounts described in Section 403(b) of the Internal Revenue Code will not be subject to the requirements.

Who is Affected?

The final rule requires 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, including certain hedge funds or private funds, 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.

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 certain services, including services as a fiduciary, registered investment adviser, recordkeeper or broker.

What Must be Disclosed?

The final rules require disclosure in writing (generally in advance) of certain information, including a description of the services provided by the service provider, the capacity in which such services are expected to be provided, the type and amount of compensation received for such services, whether direct or indirect, and amounts paid to related parties. As noted above, the final rule also requires an explanation of the arrangement between the payer and the covered service provider under which indirect compensation is paid.

In addition, for recordkeeping services provided together with the offering of DIAs, service providers must disclose all direct or indirect compensation reasonably expected to be received. If services are provided without explicit compensation, service providers must disclose 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.

As described above, service providers to plans must now also provide a total annual operating expense percentage to any DIA, calculated in accordance with the DOL's recent participant-level fee disclosure rules. This means that investment vehicles that are not mutual funds will now be required to make the fee and expense disclosures similar to those required of mutual funds. Further, in what could be a significant change, service providers now have an obligation to disclose any other information relating to DIAs within the control of, or reasonably available to, the service provider, if the information is required for the covered plan administrator to comply with the new participant-level fee disclosure rules.

Service providers that provide fiduciary services to contracts, products or entities that hold plan assets must disclose certain investment-related information, such as any compensation charged against an investment, annual operating expenses of an investment if the return on the investment is not fixed, or, for DIAs, the total annual operating expenses of the investment. The same information must be provided by service providers that provide recordkeeping or brokerage services with respect to DIAs, although this requirement can generally be satisfied by passing along information received from certain regulated issuers, including mutual funds, to plan fiduciaries.

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 cases where information changes, where an investment contract, product or entity to which services are provided is subsequently determined to hold plan assets, and in certain other cases. As noted above, the final rule calls for changes in certain investment-related information to be disclosed "at least annually," and for certain information requested by fiduciaries to be provided reasonably in advance of applicable compliance deadlines.

How Must Disclosure be Made?

The final rule does not specify a particular form of disclosure. However, the DOL has released a "guide," recommended by the DOL but not required, that can be used by service providers to indicate where specified information can be found in existing documents. The preamble to the final rule indicates that the DOL intends to issue a proposed regulation in the near future that would require the use of a similar guide or summary.

What Happens if Required Disclosures are Not Made?

A failure to comply with the rules 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 regulation focuses exclusively on the service provider's actions in this circumstance.
- In the case of a failure to disclose, an exemption from the prohibited transaction rules 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. If the information requested relates to future services, then the service arrangement generally must be terminated.

How does the Rule Affect the Participant-Level Fee Disclosure Rules?

As noted above, the DOL has also issued final regulations under Section 404(a) of ERISA that require plan administrators to disclose to participants fees and other information in connection with participant-directed 401(k) and other plans. Initial disclosures under the new participant-level fee disclosure rules (described in our prior alert), which rely on the disclosures to be provided under the new Section 408(b)(2) disclosure rules, must now be provided no later than **August 30, 2012**.

How do these Rules Apply to "Plan Asset" Vehicles?

The rules may apply to services provided through an investment vehicle the assets of which are considered "plan assets" for purposes of ERISA. In such a case, whether the rules will apply to a particular service provider, and the manner in which disclosure will be required, will depend on the details relating to the vehicle and to the services.

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Please feel free to contact any member of Ropes & Gray's benefits practice group with any questions about the new requirements.