

Tips on Complying With U.S. Department of Labor Fee Disclosure Rules

Revisions to Schedule C of Form 5500 and newly proposed regulations granting relief from ERISA's prohibited transaction ban will greatly affect retirement practices of benefit plan administrators, human resources (HR) managers and executives

24

Ronald E. Richman and Erica E. Frank

During the latter part of 2006, class action suits proliferated against employee benefit plan sponsors and administrators based on fees charged to 401(k) participant accounts. Plaintiffs began claiming breaches of fiduciary duty under the Employee Retirement Income Security Act of 1974, as amended, due to allegedly excessive fees imposed on 401(k) (ERISA) retirement accounts and plan administrators' failure to disclose those fees to participants. Accordingly, service provider fees and fee disclosure have become a major concern of the U.S. Department of Labor (DOL).

The DOL created a fee transparency initiative to address concerns about fees imposed on defined contribution plans. The initiative involves three different aspects of fee disclosure: first, disclosure from plan sponsors to the government; second, disclosure from service providers to plan sponsors; and third, disclosure from plan sponsors to plan participants. Specifically, the three prongs of the initiative are:

- 1) revision of Form 5500 to require plan administrators to obtain detailed information on service provider fees and report the same on the plan's annual Form 5500;
- 2) amendments to the regulations promulgated under ERISA's statutory prohibited transaction exemption, requiring service providers to provide plan administrators with increased disclosure or risk prohibited transaction penalties; and
- 3) revision of ERISA Section 404(c) rules to require disclosures to plan participants for plan fiduciaries to receive certain protection against fiduciary liability.

By the end of 2007, DOL already had completed the first prong with a final revision to Schedule C of Form 5500 and had taken major steps on the second project with proposed amendments to its regulations under ERISA Section 408(b)(2). Both of these initiatives will significantly increase the disclosure of fees associated with defined contribution plans within the next few years. This chapter details the Schedule C revisions and the

Ronald E. Richman is the co-chair of the employment and employee benefits department at Schulte Roth & Zabel LLP and Erica E. Frank is an associate in the department. The authors would like to thank David M. Cohen for his assistance in preparing this chapter. Richman and Frank may be contacted at ronald.richman@srz.com and erica.frank@srz.com, respectively.

proposed ERISA regulations, explain why these changes are so important and provide suggestions on how plan administrators, HR managers and executives can comply with the changes.

Why Is More Fee Disclosure Necessary?

Before more fully explaining DOL's proposed fee disclosure rules, it is important to understand the role disclosure plays in the legal framework of employee benefit plans. Every employee benefit plan must have at least one named fiduciary. In addition to the named fiduciary, all individuals who exercise discretion in connection with a plan's assets are deemed fiduciaries. This includes the trustees or the members of an administrative committee or committees that retain service providers to assist the plan, select investment vehicles and make benefit claim determinations. Fiduciaries of an employee benefit plan control the plan's administration.

Under ERISA, plan fiduciaries have a responsibility to act solely in the interest of plan participants and beneficiaries and with the exclusive purpose of providing benefits to them. Plan fiduciaries must also act prudently when making decisions that affect plan assets, such as determining investment options to be offered under a typical 401(k) plan and negotiating the agreements with plan service providers under which it offers those options. This standard is often referred to as the "prudent expert rule," because fiduciaries must act with the skill, care, prudence and diligence of a prudent person in a like capacity who is familiar with such matters.

Fiduciaries usually retain service providers to provide investment advice, recordkeeping and administrative services. In retaining a service provider, fiduciaries must assess and understand the services that will be provided, their cost and the quality and experience of the service provider; they also must compare costs and services that may be available to the plan.

Factor in Hiring a Service Provider

One element of the fiduciary decision is the fee the fiduciaries agree to pay a service provider out of plan assets. It is important to note that DOL considers fees to be one of several important factors fiduciaries must consider when hiring a service provider. In this regard, DOL has made it increasingly clear that it expects a hiring fiduciary to understand and assess the various components of each fee a plan pays and not just the overall cost. ERISA requires that fees charged to plan assets must be "reasonable." One of the main problems plan fiduciaries face, however, is that many of the fees service providers charge are hidden, in that they are not specifically disclosed. See the box on the next page for examples of hidden fees often charged to 401(k) plans investing in mutual funds.

In the recent rash of class actions challenging the fees paid to service providers, many plaintiffs argued that fiduciaries have failed to investigate properly and/or disclose these fees. Fiduciaries cannot disclose fees they do not know the plan is being charged. This point lies at the heart of DOL's recent fee disclosure initiatives. The DOL contends that a full understanding of the fees service providers charge is essential for a plan fiduciary to carry out its duties. Plan fiduciaries are not likely to make a prudent decision unless they are aware of the full cost of services and what their impact on the plan is.

Common 401(k) Hidden Fees	
SEC Rule 28(e) “Soft Dollar” Arrangements	Arrangements that provide the mutual fund’s investment manager with research and certain other services in exchange for brokerage commissions above pure execution only rates.
Sub-Transfer Agent Revenue Sharing	Fees the mutual fund pays to a third-party administrator, bank or trust recordkeeping service or some other entity tracking the number of shares held for the benefit of a specific plan participant within an individual account plan. These agents are generally paid at a per-participant rate. It is often unclear who is receiving the payments or whether the payments fairly represent the value of services rendered.
12b-1 Fees, Service Fees	Mutual fund marketing fees paid to a broker-dealer or other entity through which the plan invests in mutual fund shares. Even so-called “no load funds” can charge a 25-basis-point service fee.
Shelf Space or Supermarket Fee	A type of revenue sharing a mutual fund pays out of management and/or 12b-1 fees to compensate the mutual fund platform provider (such as broker-dealer or major mutual fund complex) for allowing portfolio fund to be “on the shelf.”
Wrap Fees	Fees paid for investment products that provide a number of services and generate several fees that are wrapped up into one aggregate fee (such as investment consulting, brokerage and recordkeeping fees), so it is difficult to determine the unbundled cost of each service.

DOL Concerns

The DOL has two main concerns regarding fees: (1) fees charged are excessive or unreasonable and; (2) fees third parties (that is, not the plan or plan sponsor) pay to plan service providers may create conflicts of interest that prevent service providers from being objective when advising plans. The DOL hopes to lessen these concerns through increased fees disclosure. Increased disclosure permits fiduciaries to make better decisions about the actual fee charged and helps to uncover possible conflicts of interest, the agency reasons.

Changes to Form 5500 Schedule C

On Nov. 16, 2007, DOL published finalized revisions to the Form 5500 annual return/report for plan years beginning in 2009. These revisions created new reporting requirements for plan fees listed on Schedule C, “Service Provider Information.” The changes apply only to large plans (that is, employee benefit plans with 100 or more participants or beneficiaries) and only apply to service providers that receive at least \$5,000 in direct and/or indirect compensation. The changes do not take effect until plan years beginning on or after Jan. 1, 2009.

Previously, large plans only had to disclose the plan’s 40 most highly paid service providers that received at least \$5,000 in direct compensation. The revised Schedule C will require a plan to report all persons or entities receiving at least \$5,000 in direct and/or indirect compensation (both money and any other thing of value). For each such service provider, the plan must identify the service provider, describe the relationship of the service provider to the plan sponsor or any party-in-interest, list the total compensation paid to the service provider and state whether any indirect compensation was received.

Expanded Definitions

Within this revision to Schedule C, DOL has expanded both the definition of a service provider and the categories of compensation that must be reported. Service providers will include not just entities providing services to a plan but also: (1) other persons receiving commissions or other indirect fees based in whole or in part on services provided to the plan, and (2) service providers to mutual funds, private investment funds, bank collective trusts and insurance company separate accounts in which the plan holds an interest.

Reportable compensation will include both direct and indirect compensation. Direct compensation is compensation the plan or plan sponsor pays to the service provider. Indirect compensation is compensation a plan service provider receives from any source other than the plan or the plan sponsor, if such compensation was received in connection with services rendered to the plan or that person's position with the plan. Payments the plan sponsor makes but the plan does not reimburse are not considered reportable compensation for Schedule C purposes.

Here are some examples of indirect compensation that must be reported that largely mirror the examples of fees discussed above (see box).

Examples of Indirect Compensation That Must Be Reported Under Revised Schedule C

- fees and expense reimbursements received from mutual funds such as advisory, sub-transfer agency, shareholder servicing, account maintenance and 12b-1 distribution fees;
- finders', placement and solicitation fees paid in connection with transactions involving the plan;
- float revenue, brokerage commissions and soft dollar fees such as research or other services an investment manager receives from a broker-dealer or a third party; and
- other transaction-based fees received in connection with plan-related transactions or services.

Any fees paid to service providers of pooled investment funds, bank commingled trusts or insurance company separate accounts must be reported if the fees are charged against the fund and are reflected in the value of the plan's investment.

Match Compensation Element to Service Code

All compensation, both direct and indirect, must be reported on Schedule C. The exact amount of the fee does not have to be reported as long as the formula or calculation used for determining the compensation is provided. Because reportable compensation has been expanded significantly, DOL has also added a large number of new codes for describing all of the services associated with such compensation. Each element of compensation should be accompanied by a corresponding service code.

Alternative Reporting Method

The new Schedule C also has an alternative reporting method for "eligible indirect compensation," which can be reported in an abbreviated manner if certain conditions are met regarding the type of indirect compensation and required disclosures. If a service provider receives only eligible indirect compensation, and meets the disclosure requirements, the plan administrator does not have to report the amount of eligible indirect

compensation the service provider receives. Only the name, employer identification number or address of the person who provided the required disclosures must be reported. In essence, the plan administrator may simply report that a certain service provider received eligible indirect compensation and then identify the person who provided the disclosures discussed below.

To take advantage of the alternative method for eligible indirect compensation, plan administrators must receive specific written disclosures from service providers. The service provider must notify the plan administrator of:

- the existence of indirect compensation;
- the services that are provided for the indirect compensation;
- the amount of indirect compensation or the formula used to calculate it;
- a description of each service provided in bundled service arrangements, if applicable; and
- the identity of the persons paying and receiving the indirect compensation.

These disclosures can be made in a single document or multiple documents that can be incorporated by reference if necessary. Disclosures can also come from multiple parties as long as separate disclosures taken as a whole include all the necessary information.

What Is 'Eligible Indirect Compensation'?

Only certain types of indirect compensation are considered “eligible indirect compensation”:

- 1) fees or expense reimbursements the plan or plan sponsor does not pay directly but are charged to an investment fund in which the plan has an interest and are reflected in the value of the plan’s investment;
- 2) fees associated with investment management, recordkeeping or shareholder services; and
- 3) finders’ fees and commissions, soft dollar revenue, float revenue or other transaction-based fees.

Basically, eligible indirect compensation includes all indirect compensation that is not received for administrative, legal, accounting, property management or other asset valuation services.

There are also specific rules for compensation paid to bundled service providers, that is, a service provider that provides plans with an array of services – such as investment management and recordkeeping, either directly or through subcontractors or affiliates – but charges only a single fee. Compensation paid directly to a bundled service provider can be reported as a single service arrangement. Plan administrators do not need to specifically list compensation paid from the service provider to each subcontractor or affiliate unless such compensation is transaction-based or is charged against the value of the plan’s investment in a fund. Compensation reflected in the plan’s investment must be disclosed separately as indirect compensation to the subcontractor or affiliate. Moreover, any person within the bundled service arrangement must be separately reported who: (1) is a fiduciary to the plan or (2) provides contract administration, consulting, investment advisory, investment management, securities brokerage or recordkeeping services.

Non-monetary indirect compensation does not qualify for this alternative reporting method and must be reported separately. If the non-monetary compensation consists of gifts or meals that are of insubstantial value and are tax deductible, however, they can be excluded. Each individual gift or meal must be less than \$50 and the aggregate yearly value of such gifts and meals may not exceed \$100 to any service provider.

Heightened Reporting Requirements

The DOL says some service providers pose a higher risk for conflicts of interest. Heightened reporting requirements apply to service providers who are: (1) plan fiduciaries under either ERISA or the Investment Advisers Act of 1940; or (2) contract administrators, consultants, custodians, investment advisers, investment managers, brokers and record-keepers. For these service providers, plan administrators must report on the source from which the service provider received \$1,000 or more in indirect compensation.

To report all this information, plan administrators must ask service providers to disclose the relevant data. It is the plan administrator's duty to request such information. Plan administrators must notify DOL of the name and other identifying information of any service provider that fails or refuses to disclose information the plan requests. In most cases, plan administrators will not be able to identify all entities receiving indirect compensation but should request that service providers disclose such information.

Because the changes to Schedule C do not take effect until plan years beginning on or after Jan. 1, 2009, most plan administrators will not be affected until July 2010 (or October 2010 with an extension) when they must file the plan's 2009 Form 5500.

Proposed Amendments to 408(b)(2) and Class Exemption

The DOL's proposed amendments to the regulations under ERISA Section 408(b)(2) complement its revisions to Schedule C. While the changes to Schedule C involve increased disclosures from plan administrators to the government, the proposed amendments to Section 408(b)(2) regulations require increased disclosures from service providers to plan administrators. This is designed to help plan administrators meet their new Schedule C obligations.

Parties-in-Interest and Permitted Exemptions

To protect the assets of participants and beneficiaries, ERISA Section 406(a)(1) prohibits certain transactions with individuals or entities that may try and exercise improper influence over a plan. These parties are called "parties-in-interest." The plan sponsor, plan fiduciaries and anyone who provides services to a plan is considered a "party-in-interest." A party-in-interest may not engage in a transaction with a plan, including providing services, unless an exemption permits it. Therefore, to promote efficiency in the operation of employee benefit plans, Congress provided statutory exemptions that permit parties-in-interest to provide services to employee benefit plans under certain conditions.

ERISA Section 408(b)(2) provides one such exemption. Current DOL regulations promulgated under Section 408(b)(2) allow plans to hire service providers as long as the services provided are appropriate and helpful to plan operation, the contract for services is considered reasonable and no more than reasonable compensation is paid for the services. Currently, a contract is considered reasonable as long as the plan may terminate the contract without penalty on reasonably short notice.

Expanded Definition of 'Reasonable' Contract

The amended regulations DOL proposed on Dec. 13, 2007 would significantly change the definition of a "reasonable" contract. A contract for services would be considered "reasonable" only if a service provider makes certain disclosures to plan fiduciaries before entering, amending, renewing or making material changes to a contract. The DOL's proposal calls for three types of disclosures: (1) disclosure of services and fees; (2) disclosure of conflicts of interest; and (3) ongoing disclosures. The amended regulations will take effect 90 days after they are published in final form in the *Federal Register*, which could occur by the end of 2008.

Highest Potential for Conflict of Interest

The DOL's proposal would apply to certain service providers that the DOL believes have the biggest potential for conflicts of interest. These are service providers that: (1) are fiduciaries under ERISA or the Investment Advisers Act of 1940; (2) provide banking, consulting, custodial, insurance, investment advisory, investment management, recordkeeping, securities or other investment brokerage, or third-party administration services; or (3) receive indirect compensation for accounting, actuarial, appraisal, auditing, legal or valuation services.

The proposed disclosure requirements would not apply to service providers that furnish benefits directly to plan participants or beneficiaries. Existing regulations would continue to cover other service providers. It should be noted that the proposal also does not address transition issues regarding existing service provider contracts.

The proposal would apply whenever a plan enters into, extends or renews a contract with a covered service provider, or when a material change occurs to information the service provider previously disclosed. A material change is a change that significantly alters the "total mix" of information made available to the plan fiduciary, or significantly affects the fiduciary's decision to hire or retain the service provider (see box).

Requirements for Service Provider Contracts

Contracts with a covered service provider must:

- 1) be in writing;
- 2) require the service provider to disclose all services that will be provided, the total compensation and fees for such services and how such compensation will be received (that is, will the service provider bill the plan, deduct fees from plan accounts or charge against plan investments?);
- 3) obligate the service provider to disclose conflict of interest information (described below);
- 4) contain a representation that all such disclosures were provided to the plan before entering into the contract;
- 5) compel the service provider to notify the plan of any material change in the above information within 30 days of knowledge of such change;
- 6) require the service provider to comply with any informational requests from plan fiduciaries necessary for plan fiduciaries to fulfill reporting and disclosure requirements under ERISA; and
- 7) permit termination of the contract without penalty on reasonably short notice.

Under the proposal, “compensation and fees” would include anything of monetary value the service provider receives in connection with rendering services to the plan. For example, compensation and fees include commissions, finder’s fees, 12b-1 fees, float income, soft dollar fees, gifts, meals and trips. Indirect compensation received from any party other than the plan or the plan sponsor must also be included. This is true even if the payments are not made with plan assets. For instance, although ERISA provides that the assets of a mutual fund are not plan assets, the proposed regulations would require a recordkeeper to disclose all fees it received from the mutual funds in which the plan invests and also from service providers to such mutual funds, such as their investment managers and principal underwriters. In addition, service providers would have to include any compensation an affiliate receives (that is, entities the service provider controls or has common control over) as well as compensation to any officer, director, agent or employee. This requirement is designed to ensure that disclosure cannot be avoided by simply paying an affiliate instead of the service provider. If a service provider does not know the exact amount of compensation and fees it will receive under the contract, compensation can be expressed in any way that permits the plan to evaluate the reasonableness of the fee – such as a formula, a percentage of assets or a per capita charge.

Bundled Service Arrangements

For bundled service arrangements, the bundled service provider may make all required disclosures, even if one of its affiliates or subcontractors actually provides some of the services. The bundled service provider need only disclose the aggregate direct and indirect compensation received. It does not have to break down how compensation is divided within the bundle unless payments to an underlying party are reflected in the net value of the plan’s investment in the fund or are charged on a transactional basis.

Conflict-of-Interest Disclosures

The proposal would also require service providers to make conflict of interest disclosures (see box).

Mandatory Conflict-of-Interest Disclosures

Under the proposal, services providers would have to disclose:

- whether the service provider will be a fiduciary to the plan under ERISA or the Investment Advisers Act of 1940;
- any financial interest in any transaction the plan enters into in connection with the service arrangement;
- all material financial, referral or other relationship with other parties such as investment professionals, service providers or clients that may create a conflict of interest;
- whether the service provider can affect its own compensation without prior approval from the plan administrator, and if so, the nature of such compensation; and
- whether the service provider has any existing policies or procedures for managing conflicts of interest, and if so, a description of such policies or procedures.

The proposed regulations do not prescribe a particular method for making the required disclosures. The contract itself between the plan and the service provider does not need to include any or all of the disclosures. The contract must obligate the service provider to furnish the information, but the disclosures can be made in separate documents and/or

incorporated by reference. Nevertheless, the contract should at least describe the documents containing the disclosures. The proposal also does not state a specific deadline for completing the disclosures; only that the information should be provided before entering into the contract.

Burden on Service Providers and Plan Fiduciaries

The proposal places a burden on both service providers and plan fiduciaries. If a service provider fails to make the required disclosures, a contract may be deemed unreasonable. Entering into an unreasonable contract means that the service provider and the fiduciary engaged in a prohibited transaction, which exposes plan fiduciaries and service providers to personal liability and excise taxes, respectively.

Class Exemption for Unknowing Conflicts of Interest

To avoid unwarranted penalties against plan fiduciaries who have attempted to comply with the proposed regulation in good faith, DOL has also proposed a class exemption for plan fiduciaries that unknowingly enter into unreasonable contracts because of a service provider's failure to comply with the required disclosures. A plan fiduciary would be relieved from liability for the prohibited transaction as long as the fiduciary reasonably believed that the contract was reasonable and had no reason to know or suspect that the service provider would fail to fulfill its contractual disclosure obligations. Upon discovering that the service provider failed to comply with the contract by failing to provide the required disclosures, the plan fiduciary must contact the service provider and make a written request for the required information. If the service provider fails to comply with such a request within 90 days, the plan fiduciary must notify DOL. The plan fiduciary must then also re-evaluate its relationship with the service provider, taking into account the service provider's failure to provide the disclosures required under the contract and the availability, qualifications and cost of potential replacements, and determine whether the plan should terminate the relationship.

Make Compliance Preparations Now

The DOL considers understanding and assessing service provider fees to be integral to the fiduciary duty owed to participants and beneficiaries. All plan fiduciaries responsible for the investment and management of plan assets should make every reasonable effort to discover and evaluate all service provider fees charged to their plan. Even though the revised Form 5500 Schedule C will not be used until 2009 plan years and the amendments to Section 408(b)(2) regulations are simply proposals at this point, plan administrators should begin preparations for compliance. Final Section 408(b)(2) regulations are likely to closely resemble the proposal and will be effective a mere 90 days after DOL issues them.

By implementing the necessary procedural changes now, plan fiduciaries can ensure that contracts with service providers are not considered prohibited transactions. In addition, by receiving increased fee disclosures from service providers, more thoroughly investigating the fees charged and complying with the prudence requirements of ERISA Section 404(c), plans can protect themselves from future litigation claiming breaches of fiduciary duties to participants.

Fiduciaries and plan administrators responsible for plan investments and selecting plan service providers should consider taking some or all of the following actions listed on the next page.

Compliance Tips for New Fee Disclosure Rules

- 1) For current service providers:
 - make efforts to uncover and review all fees paid out of participant accounts and plan investments, such as shares of mutual funds, including all revenue sharing arrangements;
 - consider hiring an expert or a consultant to assist in evaluating service provider fees, as long as engaging a consultant is prudent and feasible based on plan size;
 - ask service providers to provide written, detailed descriptions of all fees and expenses;
 - analyze whether such fees are prudent and reasonable – in doing so, look at the fees charged for each individual service, not just the total fee;
 - compare your plan's fees to those other service providers charge; and
 - periodically reevaluate whether fees are reasonable.
- 2) When hiring a service provider:
 - look at a number of competing service providers – be sure to provide each service provider with the exact same information to obtain a true comparison;
 - consider using DOL's Model Plan Fee Disclosure Form, available at <http://www.dol.gov/ebsa/pdf/401kfefm.pdf>;
 - attempt to negotiate lower fees;
 - when assessing bundled service arrangements, be sure that all included services are necessary and try to eliminate services that are unnecessary;
 - if choosing a service provider with a higher fee than competitors, be sure to document the basis for that decision – you do not have to choose the lowest cost provider but you should document the reason(s) you did not do so; these may include higher quality service, experience or preferable investment record;
 - be sure to understand how fees will be assessed – are fees asset-based, transaction-based, per capita or flat rate?;
 - obtain a written contract from each service provider; and
 - require service providers to make binding representations regarding all fee information that would be required under the proposed amendments to 408(b)(2) regulations.
- 3) Document everything – both the hiring process and any periodic reviews.
- 4) If a service provider engages in revenue sharing, attempt to negotiate for some portion of the fee to be rebated to the plan.
- 5) Disclose all fee information to plan participants with documentation that explains all the expenses associated with different investment options.
- 6) Remember that fees and fee disclosure are only one element of a fiduciary decision. Make sure the transaction as a whole is prudent and is for the exclusive benefit of participants and beneficiaries!