The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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December 17, 2007

DOL Proposes Regulation and Proposed Class Exemption on Disclosure of Service Provider Compensation

[22054]

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TO: PENSION COMMITTEE No. 40-07
PENSION OPERATIONS ADVISORY COMMITTEE No. 41-07
BANK, TRUST AND RECORDKEEPER ADVISORY COMMITTEE No. 58-07 RE: DOL PROPOSES REGULATION AND PROPOSED CLASS EXEMPTION ON DISCLOSURE OF SERVICE PROVIDER COMPENSATION

The Department of Labor has proposed a regulation regarding the information that plan fiduciaries must receive, and service providers must provide, in order for a service contract or arrangement to be considered reasonable under ERISA § 408(b)(2) and not result in a prohibited transaction. [1] DOL also proposed an administrative class exemption that would provide relief for fiduciaries if a service provider fails to meets its contractual disclosure obligations. [2]

Comments on the two proposals are due February 11, 2008.

The Institute will hold a conference call on Monday, January 7, 2008, at 1:00 PM Eastern Time to discuss the proposal and identify issues on which the Institute should comment. If you would like to participate in the call, please complete the attached response form and fax or e-mail it to Brenda Turner at 202/326-5841 or bturner@ici.org by 10:00 AM on Monday, January 7, 2008. To participate, please dial 1-888-793-1765 and enter passcode 64036. As a reminder, because all lines are open to facilitate discussion, please remember to place your line on mute when not speaking and do not place the call on hold.

Proposed Regulation

DOL proposes to amend [3] its regulation implementing ERISA § 408(b)(2) to require that any contract or arrangement between an employee benefit plan and certain service

providers must obligate the service provider to disclose the direct and indirect compensation the service provider will receive and to disclose certain information regarding possible conflicts of interest the service provider may have.

Covered service providers

The proposed new disclosure requirements would apply to three categories of service providers:

- A service provider that provides or may provide services to the plan as a fiduciary either within the meaning of section 3(21) of ERISA or under the Investment Advisers Act of 1940;
- A service provider that provides one of the following services pursuant to the contract or arrangement: banking, consulting, custodial, insurance, investment advisory (plan or participants), investment management, recordkeeping, securities or other brokerage, or third party administration; and
- A service provider that receives indirect compensation in connection with providing one or more of the following services to the plan pursuant to the contract or arrangement: accounting, actuarial, appraisal, auditing, legal, or valuation.

Contractual disclosure

Generally, the proposed regulation requires a contract or arrangement to be in writing and to obligate the service provider to make certain disclosures to the best of the service provider's knowledge. These disclosures must be made before the contract is entered into, extended or renewed. The contract must include a representation by the service provider that the required information was provided to the fiduciary with the authority to enter into the contract or arrangement (called the "responsible plan fiduciary").

The contract or arrangement must require that any material changes to the information required be disclosed by the service provider no later than 30 days from the date the service provider acquires knowledge of the material change.

The proposed regulation also requires that the service provider in fact complies with its contractual disclosure obligations.

Disclosures regarding services and compensation

Under the proposed regulation, the service provider must disclose the services to be provided pursuant to the contract or arrangement; with respect to each service, the compensation or fees received by the service provider; and the manner of receipt of the fees or compensation. [4] Compensation or fees include anything of monetary value received directly from the plan or plan sponsor or indirectly by the service provider or its affiliate [5] in connection with services to be provided pursuant to the contract or arrangement or because of the provider's or an affiliate's position with the plan. [6]

Compensation or fees may be expressed in terms of a monetary amount, formula, percentage of plan assets, or per capita charge, provided that the manner in which the compensation or fees are expressed contains sufficient information to enable the plan fiduciary to evaluate the reasonableness of the compensation or fees.

The proposed regulation provides that if a service provider offers a bundle of services priced as a package, then only the service provider offering the bundle of services must

provide the required disclosures. The bundling service provider must disclose all services and the aggregate compensation or fees received by the service provider and any affiliates, subcontractors, or other parties in connection with the bundle. The service provider is not required to disclose the allocation of compensation or fees among affiliates, subcontractors, or other parties except to the extent a party receives compensation or fees that are a separate charge directly against the plan's investment reflected in the net value of the investment [7] or that are set on a transaction basis, such as finder's fees, brokerage commissions, and soft dollars. [8]

Disclosure regarding fiduciary status and conflicts

Under the proposed regulation, the service provider must disclose whether it or an affiliate will provide any services to the plan as a fiduciary within the meaning of ERISA or the Investment Advisers Act of 1940.

The proposed regulation also requires a number of disclosures regarding actual or potential conflicts of interest. The service provider must disclose:

- Whether the provider or an affiliate expects to acquire a financial or other interest in any transaction to be entered into in connection with the contract or arrangement, and if so, a description of the transaction and the service provider's interest.
- Whether the service provider or an affiliate has a material relationship with a money manager, broker, client, service provider to the plan, or any other entity that creates or may create a conflict of interest in performing services under the contract or arrangement, and if so, a description of the relationship.
- Whether the service provider or an affiliate will be able to affect its own compensation or fees without the prior approval of an independent plan fiduciary and if so, a description of the nature of the compensation.
- An explanation of any policies or procedures the service provider or an affiliate has to address actual or potential conflicts of interest.

Information for Title I reporting

Under the proposed regulation, the contract or arrangement must require the service provider to disclose all information regarding the contract and its compensation that is requested by the responsible plan fiduciary or the plan administrator in order to comply with reporting under Title I of ERISA. [9]

Proposed Class Exemption

DOL proposes to issue a class exemption to provide relief from ERISA § 406(a)(1)(C) for any plan fiduciary that takes the steps outlined in the exemption. DOL states that there may be circumstances where a plan fiduciary enters into a contact that appears to meet the requirements of the regulation but unbeknownst to the fiduciary the service provider failed to provide the required disclosure. In order for the relief to apply, the plan fiduciary must have reasonably believed that the contract or arrangement met the requirements of the regulation and did not know or have reason to know that the service provider failed or would fail to comply with its disclosure obligations.

The proposed class exemption would require that the plan fiduciary, upon discovering that the service provider failed to make the required disclosures, request in writing that the disclosures be made, [10] and if they are not made within 90 days, notify DOL. Notification

to DOL must be made not later than 30 days following the end of 90 day period (or, if earlier, 30 days after the service provider refuses to provide the required disclosure).

Proposed Effective Date

DOL proposes to make the regulation and class exemption effective 90 days after publication of final rules in the Federal Register, and specifically asks for comment on whether the regulation should be effective on a different date.

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Associate Counsel

Attachment

endnotes

[1] A copy of the proposed regulation can be found here: http://www.dol.gov/ebsa/regs/fedreg/proposed/2007024064.pdf.

[2] A copy of the proposed class exemption can be found here: http://www.dol.gov/ebsa/regs/fedreg/notices/2007024063.pdf.

[3] Currently, 29 C.F.R. § 2550.408b-2 generally only requires that a service contract or arrangement permit the plan to terminate without penalty on reasonably short notice.

[4] A description of the "manner" of receipt of compensation or fees must state whether the service provider will bill the plan, deduct fees directly from plan accounts, or reflect a charge against the plan investments. The description also must describe how any prepaid fees will be calculated and refunded when a contract or arrangement terminates.

[5] "Affiliate" means any person directly or indirectly through one or more in intermediaries controlling, controlled by, or under common control with the service provider, or any officer, director, agent or employee of, or partner with, the service provider.

[6]

The preamble states that while an investment in plan assets or the purchase of insurance is not, in and of itself, compensation to a service provider, persons or entities that provide investment management, recordkeeping, participant communication and other services to the plan as a result of an investment of plan assets will be treated as providing services to the plan.

[7] In the preamble, DOL provides the following examples: "management fees paid by mutual funds to their investment advisers, float revenue, and other asset-based fees such as 12b-1 distribution fees, wrap fees, and shareholder servicing fees if charged in addition to the investment management fee."

[8] The preamble states that fees charged on a transaction basis must be separately disclosed even if paid from mutual fund management fees or other similar fees.

[9] The final Form 5500 rules require a plan administrator to report on Schedule C significant information regarding compensation and fees of service providers, and requires the plan administrator to report to DOL any service provider that fails to provide information sufficient to complete Schedule C. See Memorandum to Pension Members No. 68-07 [21958], dated November 19, 2007.

[10] The plan fiduciary also would be required to determine whether to terminate or continue the contract, taking into account factors such as the availability of replacement service providers and the responsiveness of the service provider in furnishing missing disclosures.
