The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 24432

July 16, 2010

DOL Releases Interim Final Regulation on Disclosure of Service Provider Compensation

ACTION REQUESTED

[24432]

July 16, 2010

TO: PENSION MEMBERS No. 29-10
BANK, TRUST AND RECORDKEEPER ADVISORY COMMITTEE No. 21-10
OPERATIONS COMMITTEE No. 18-10
TRANSFER AGENT ADVISORY COMMITTEE No. 37-10 RE: DOL RELEASES INTERIM FINAL REGULATION ON DISCLOSURE OF SERVICE PROVIDER COMPENSATION

The Department of Labor issued an interim final 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 under ERISA. [1] The interim final rule amends the existing regulation under ERISA § 408(b)(2) to require that certain disclosures be made by a covered service provider with respect to a contract or arrangement to provide services to a covered employee benefit plan. The interim final rule includes an administrative class exemption that provides relief for fiduciaries if a service provider fails to meets its disclosure obligations.

The interim final rule differs in several respects from the proposal. [2] DOL addressed many of the concerns the Institute raised in our comment letters [3] and testimony [4] on the proposal, especially with regard to the application of the regulation to mutual funds and service providers to mutual funds. The interim final rule is effective July 16, 2011, but DOL invites written comments on the interim final rule, due August 30, 2010.

Covered plans

The rule defines a "covered plan" as any employee pension benefit plan within the meaning of section 3(2)(A) of ERISA. The rule does not apply to health and other welfare plans, [5] plans excluded from Title I of ERISA by section 4(b) (e.g., governmental and church plans), IRAs, [6] SEPs, and SIMPLE IRAs.

Covered service providers

To be covered by the rule, a service provider must enter into a contract or arrangement with a covered plan and reasonably expect $1,000 or more in compensation, direct or indirect, to be received in connection with providing one or more of certain covered services:

- *Fiduciary services to the plan.* Providing services directly to the plan as a fiduciary within the meaning of section 3(21) of ERISA.
- *Fiduciary services to a plan asset investment.* Providing fiduciary services to an investment contract, product, or entity that holds plan assets and in which a plan has a direct equity investment (referred to hereafter as a "plan asset investment").
- *Investment adviser services.* Providing services directly to the covered plan as an investment adviser registered under either the Investment Advisers Act of 1940 or any State law. [7]
- *Recordkeeping or brokerage services.* Providing recordkeeping or brokerage services to a covered plan that is a participant-directed individual account plan, if one or more designated investment alternatives (defined below) will be made available (e.g., through a platform or similar mechanism) in connection with the recordkeeping services or brokerage services.
- *Other services for indirect compensation.* Providing accounting, auditing, actuarial, appraisal, banking, consulting, [8] custodial, insurance, investment advisory (for plan or participants), legal, recordkeeping, securities or other investment brokerage, third party administration, or valuation services, for which the covered service provider, an affiliate, or a subcontractor [9] reasonably expects to receive indirect compensation or certain compensation among related parties (see below).

DOL states that no person or entity is a covered service provider (a) solely by providing services as an affiliate or subcontractor or (b) solely by providing services to an investment contract, product, or entity in which the plan invests other than fiduciary services to plan asset investments.

Based on the foregoing, it appears that service providers to a registered mutual fund (which does not hold plan assets [10]), including the fund's adviser, portfolio brokers, transfer agent, custodian, and similar entities, are not treated as a "covered service provider" solely because a plan invests in the mutual fund. [11]

Timing and format of disclosure

The disclosures required by the rule must be made to the "responsible plan fiduciary" (i.e. a fiduciary with authority to cause the plan to enter into, or extend or renew, the contract or arrangement). Generally the disclosures must be made reasonably in advance of the date the contract or arrangement is entered into, extended, or renewed, with two exceptions. First, if an investment is initially determined not to hold plan assets but subsequently is

determined to hold plan assets, the disclosure must be made as soon as practicable, but not later than 30 days from the date on which the covered service provider knows that the investment holds plan assets. Second, in response to comments from the Institute and others, information related to a plan investment option that is not designated at the time the contract or arrangement is entered into must be disclosed as soon as practicable, but not later than the date the investment option is designated by the responsible plan fiduciary.

A covered service provider must disclose a change in the information previously disclosed as soon as practicable, but not later than 60 days from the date the covered service provider is informed of the change, unless this disclosure is precluded due to extraordinary circumstances beyond the covered service provider's control, in which case the information must be disclosed as soon as practicable.

A description or an estimate of compensation may be expressed as a monetary amount, formula, percentage of the plan's assets, or a per capita charge for each participant or, if the compensation cannot reasonably be expressed in these terms, by any other reasonable method. Any description or estimate must contain sufficient information to permit evaluation of the reasonableness of the compensation. In response to comments from the Institute and others, DOL clarified in the preamble that formulas and percentages can be used even if it is possible to disclose the amount in dollars.

Required disclosures

Services. The covered service provider must provide a description of the services to be provided to the plan pursuant to the contract or arrangement. DOL specifically excludes services provided to plan investments (except fiduciary services provided to plan asset investments).

Fiduciary status. The covered service provider must disclose, if it is the case, that the covered service provider, an affiliate, or a subcontractor will provide, or reasonably expects to provide, services pursuant to the contract or arrangement directly to the covered plan (or to a plan asset investment in which the plan has a direct equity investment) as a fiduciary or provide services directly as an investment adviser registered under either the Investment Advisers Act of 1940 or any State law.

Direct compensation. The covered service provider must disclose all direct compensation, either in the aggregate or by service, that the covered service provider, an affiliate, or a subcontractor reasonably expects to receive in connection with the covered services. Direct compensation means compensation received directly from the covered plan (and does not include compensation received from the plan sponsor).

Indirect compensation. The covered service provider must disclose all indirect compensation that the service provider, an affiliate, or a subcontractor reasonably expects to receive in connection with covered services. The disclosure must include an identification of the services for which the indirect compensation will be received and identification of the payer of the indirect compensation. Indirect compensation means compensation received from any source other than the covered plan, the plan sponsor, the service provider, an affiliate, or a subcontractor. [12]

Compensation paid among related parties. The covered service provider must include a description of any compensation that will be paid "among" the covered service provider, an

affiliate, or a subcontractor in connection with covered services if it is "set on a transaction basis (e.g., commissions, soft dollars, finder's fees or other similar incentive compensation based on business placed or retained) or is charged directly against the covered plan's investment and reflected in the net value of the investment (e.g., Rule 12b-1 fees)." The disclosure must include an identification of the services for which the compensation will be paid and identification of the payers and recipients of the compensation (including the status of a payer or recipient as an affiliate or a subcontractor). The disclosure applies even if the compensation is otherwise disclosed. It does not apply, however, to compensation received by an employee from his or her employer on account of work performed by the employee.

Termination compensation. The covered service provider must disclose any compensation that the covered service provider, an affiliate, or a subcontractor reasonably expects to receive in connection with termination of the contract or arrangement, and how any prepaid amounts will be calculated and refunded upon the termination.

Separate recordkeeping cost disclosure. If recordkeeping services are provided to the plan, the covered service provider must disclose all direct and indirect compensation that the covered service provider, an affiliate, or a subcontractor reasonably expects to receive in connection with the recordkeeping services. In addition, if the covered service provider reasonably expects recordkeeping services to be provided, in whole or in part, without explicit compensation for the recordkeeping services, or when compensation for recordkeeping services is offset or rebated based on other compensation received by the covered service provider, an affiliate, or a subcontractor, the service provider must provide a reasonable and good faith estimate of the cost to the plan 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 that will be provided to the plan. The estimate must take into account, as applicable, the rates that the covered service provider, an affiliate, or a subcontractor would charge to, or be paid by, third parties, or the prevailing market rates charged, for similar recordkeeping services for a similar plan with a similar number of participants. "Recordkeeping services" is defined to include services related to plan administration and monitoring of plan and participant transactions (e.g., enrollment, payroll deductions and contributions, offering designated investment alternatives and other covered plan investments, loans, withdrawals and distributions); and the maintenance of covered plan and participant accounts, records, and statements.

Manner of receipt. With respect to the two previous disclosures (payments among related parties and the separate recordkeeping disclosure) the covered service provider must disclose the manner in which the compensation will be received, such as whether the plan will be billed or the compensation will be deducted directly from the plan's accounts or investments.

Investment disclosure for fiduciaries of plan asset investments. A service provider who is a fiduciary of a plan asset investment must disclose (a) 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 investment (e.g., sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, account fees, and purchase fees); (b) a description of the annual operating expenses (e.g., expense ratio) if the return is not fixed; and (c) a description of any ongoing expenses in addition to the annual operating expenses (e.g., wrap fees, mortality and expense fees).

Investment disclosure for mutual funds and other non-plan asset investments. In the case

of a recordkeeper or broker providing services to a participant-directed individual account plan, the covered service provider must disclose, with respect to each designated investment alternative for which recordkeeping services or brokerage services will be provided, the same three pieces of information as required for plan asset investments, namely: (a) 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 investment (e.g., sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, account fees, and purchase fees); (b) a description of the annual operating expenses (e.g., expense ratio) if the return is not fixed; and (c) a description of any ongoing expenses in addition to the annual operating expenses (e.g., wrap fees, mortality and expense fees). The service provider may comply with this requirement by providing current disclosure materials of the issuer of the designated investment alternative that include the required information, provided that the issuer is not an affiliate, the disclosure materials are regulated by a State or federal agency, and the service provider does not know that the materials are incomplete or inaccurate. [13] "Designated investment alterative" is defined to mean any investment alterative designated by a fiduciary into which participants may direct the investment of assets held in, or contributed to, their individual accounts. It does not include brokerage windows, self-directed brokerage accounts, or similar plan arrangements that enable participants to select investments beyond those specifically designated.

Disclosure to comply with Title I reporting and disclosure. Upon request of the responsible plan fiduciary or plan administrator, a covered service provider must furnish any other information relating to the compensation received in connection with the contract or arrangement that is required for the covered plan to comply with the reporting and disclosure requirements of Title I of ERISA and the regulations, forms and schedules issued thereunder. According to the preamble to the interim final rule, this is not limited to Form 5500 reporting but includes other disclosures required under Title I such as disclosures required to be made to plan participants. The covered service provider must disclose this information not later than 30 days following receipt of a written request from the responsible plan fiduciary or plan administrator, unless the disclosure is precluded due to extraordinary circumstances beyond the covered service provider's control, in which case the information must be disclosed as soon as practicable.

Correction of inadvertent errors

In response to comments from the Institute and others, the interim final regulation provides that a contract or arrangement will not fail to be reasonable solely because the covered service provider, acting in good faith and with reasonable diligence, makes an error or omission in disclosing the information required, provided that the covered service provider discloses the correct information to the responsible plan fiduciary as soon as practicable, but not later than 30 days from the date on which the covered service provider knows of the error or omission.

Prohibited transaction class exemption for fiduciaries

The interim final rule provides that the restrictions of section 406(a)(1)(C) and (D) [14] of ERISA will not apply to a responsible plan fiduciary even if a covered service provider fails to disclose the required information, if certain conditions are met. The responsible plan fiduciary must not have known that the covered service provider failed or would fail to make required disclosures and reasonably believed that the covered service provider

disclosed the required information. In addition, the responsible plan fiduciary, upon discovering that the covered service provider failed to disclose the required information, must request in writing that the covered service provider furnish the missing information.

If the covered service provider fails to comply with the written request within 90 days, then the responsible plan fiduciary must notify DOL of the failure. The notification must be filed not later than 30 days after the earlier of the date the service provider refused to provide the requested information or 90 days after the request was made. The notification must include certain information described in the exemption, and DOL has developed a sample notice. [15]

The exemption requires the responsible plan fiduciary, following discovery of a failure to disclose required information, to determine whether to terminate or continue the contract or arrangement. In making this determination, the responsible plan fiduciary must evaluate the nature of the failure, the availability, qualifications, and cost of replacement service providers, and the covered service provider's response to notification of the failure.

Coordination with Code section 4975

The proposal did not explain the rule's interaction with the parallel provisions in section 4975 of the Internal Revenue Code. The Institute requested confirmation that compliance with the regulations would provide a service provider with protection from excise taxes in Code section 4975(a) and (b). The interim final rule states that references to section 408(b)(2) should be read to include reference to the parallel provisions of section 4975(d)(2) of the Internal Revenue Code. [16]

Effective date

The interim final rule is effective on July 16, 2011. For contracts and arrangements entered into prior to July 16, 2011, the disclosures must be provided no later than that date.

Because the rule is an interim final rule, it is effective "as is" unless amended by DOL. The DOL invites comments on all aspects of the interim final rule, and specifically requests comments on a few items:

- The scope of service providers covered by the rule
- The $1,000 threshold
- The usefulness of requiring a "summary" disclosure statement, for example limited to one or two pages, that would include key information intended to provide an overview for the responsible plan fiduciary of the information required to be disclosed.

As stated earlier, comments on the interim final regulation are due by August 30, 2010.

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endnotes

[1] A copy of the interim final regulation can be found here: http://edocket.access.gpo.gov/2010/pdf/2010-16768.pdf.

[2] See Memorandum to Pension Members No. 75-07 [22053], dated December 17, 2007.

[3] See Memorandum to Pension Members No. 8-08, Bank, Trust and Recordkeeper Advisory Committee No. 6-08, Statistical Advisory Group and Transfer Agent Advisory Committee No. 8-08 [22232]. dated February 13, 2008.

[4] See Memorandum to Pension Members No. 19-08, Bank, Trust and Recordkeeper Advisory Committee No. 10-08 and Transfer Agent Advisory Committee No. 18-08 [22385], dated April 2, 2008.

[5] DOL reserved a section of the regulation for future regulations specifically addressing ERISA welfare plans.

[6] The Institute's comment letter recommended that the Department confirm that IRAs are not subject to the regulation.

[7] In response to a comment from the Institute, DOL clarified that this does not apply to persons who fall within the definition of "investment adviser" in the Advisers Act, but who are exempt from registration.

[8] DOL clarified in the interim final rule that consulting services refers to consulting related to the development or implementation of investment policies or objectives, or the selection or monitoring of service providers or plan investments.

[9] Subcontractor is defined to mean any person or entity (or an affiliate of the person or entity) that is not an affiliate of the covered service provider and that, pursuant to a contract or arrangement with the covered service provider or an affiliate, reasonably expects to receive $1,000 or more in compensation for performing one or more covered services provided for by the contract or arrangement with the plan.

[10] See ERISA section 401(b)(1).

[11] This is the result that the Institute urged in its comment letter.

[12] In response to comments from the Institute and others, DOL eliminated detailed "conflict of interest" disclosure requirements in the proposal. The Institute's comment letter argued that these conflict of interest disclosures were duplicative of the requirement to disclose indirect compensation received from others.

[13] In the case of a recordkeeper offering recordkeeping services with respect to a platform of unaffiliated funds, it appears the effect of this provision is that the recordkeeper could provide a current prospectus or summary prospectus of the plan's designated investment alternatives. Because of the reference to the issuer not being an affiliate, it is not clear whether a recordkeeper could use this approach in the case of proprietary mutual funds. DOL defines affiliate as follows: "A person's or entity's 'affiliate' directly or indirectly (through one or more intermediaries) controls, is controlled by, or is under common control with such person or entity; or is an officer, director, or employee of, or partner in, such person or entity."

[14] The Institute had requested that the exemption cover not only subparagraph (C) but also subparagraph (D).

[15] This sample notice will be available on DOL's website at:

http://www.dol.gov/ebsa/DelinquentServiceProviderDisclosureNotice.doc.

[16] Even though IRAs, Archer MSAs, HSAs, and Coverdell ESAs are subject to Code section 4975, as noted earlier, these accounts are not considered “covered plans” under this regulation.
