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DOL Releases Additional Guidance on Mutual Fund Issues for Schedule C of Form 5500

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TO: PENSION MEMBERS No. 51-09
BROKER/DEALER ADVISORY COMMITTEE No. 58-09
BANK, TRUST AND RECORDKEEPER ADVISORY COMMITTEE No. 49-09
OPERATIONS COMMITTEE No. 22-09
TRANSFER AGENT ADVISORY COMMITTEE No. 79-09
SEC RULES COMMITTEE No. 63-09 RE: DOL RELEASES ADDITIONAL GUIDANCE ON MUTUAL FUND ISSUES FOR SCHEDULE C OF FORM 5500

The Department of Labor released 25 FAQs on the new reporting obligations for plan administrators on Schedule C of Form 5500, [1] supplementing FAQs issued by DOL in July 2008. [2] These new FAQs address a number of issues related to reporting of compensation earned with respect to a plan's investment in a mutual fund. [3]

Fund of funds and other tiered investments

A number of questions had been raised about reporting implications when a mutual fund or other pooled investment product used in a plan invests in another fund, such as in many target retirement date funds. DOL states that if a top tier investment fund makes an investment in another fund, fees received by persons in the lower tier fund would not be reportable for Schedule C purposes, except with respect to compensation received by persons at the top tier fund from the lower tier fund in connection with the investment of ERISA plans. [4]

Redemption fees and CDSLs

DOL clarifies that redemption fees described in SEC Rule 22c-2, which are used to defray fund costs associated with a shareholder's redemption and paid directly to the mutual fund, are not compensation to a service provider reportable on Schedule C.

On the other hand, contingent deferred sales loads are generally considered compensation to the person receiving the CDSL. DOL states that if the CDSL is paid by the plan or charged to the plan or participant's account, the CDSL is treated as direct compensation. If it is charged against the fund and reflected in the value of the plan's investment, it could be treated as eligible indirect compensation if the required disclosures are made. DOL states a similar analysis would apply to account maintenance fees, "exchange fees" imposed to transfer to another fund within the same fund group, and "purchase fees" imposed to defray the cost associated with a purchase of fund shares.

Payments from mutual funds and fund companies

DOL's previous guidance raised a number of questions about the proper treatment of various payments from mutual funds and their advisers and affiliates, including 12b-1 fees, sub-transfer agent fees, and shareholder servicing fees. [5] First, DOL states that fees disclosed in a mutual fund prospectus will be considered to be charged against the mutual fund assets and reflected in the value of the fund shares for purposes of the definition of eligible indirect compensation. For example, the fact that a 12b-1 fee is received by a recordkeeper not directly from the mutual fund but through a conduit fund agent like the fund's distributor would not prevent the fee from being treated as eligible indirect compensation. The fact that a revenue sharing fee that a broker pays to a recordkeeper, however, might have ultimately been derived from a 12b-1 fee does not mean that the payment is eligible indirect compensation.

Second, the guidance addresses payments that pass through a "chain" of service providers. DOL states that if an intermediary fund agent is merely a conduit for the transmission of revenue sharing to the ultimate recipient, the conduit would not itself be receiving any reportable compensation by acting as the conduit. On the other hand, DOL states that one purpose of the Schedule C reporting structure is to provide plan fiduciaries with better information on the flow of amounts that represent fees received in connection with services provided to the plan. It is possible that a person could receive a fee that would constitute reportable indirect compensation and pass some of that fee on to another person for whom the fee also represents reportable indirect compensation. DOL states that the information reported could include a description of the total fee received and the portion of the fee passed on to the next level. DOL also points out that the consolidated bundled fee reporting option could be used.

DOL states that for purposes of the eligible indirect compensation disclosures, a broker may not provide a range of payments over multiple funds (such as "from all these funds we get between 25 and 45 basis points and/or up to 15 dollars per position"). If the compensation with respect to any given fund may fluctuate over a range that would be difficult to

describe with more precision than a range of basis points, however, it would be permissible to set forth for each separate fund such a range to describe the formula used to determine the broker's indirect compensation.

Soft dollar disclosure

Significant confusion continues to exist over the extent to which mutual funds and investment advisers must supplement the disclosure made regarding soft dollar arrangements in the Statement of Additional Information and/or Form ADV. DOL states that if the securities law disclosures do not include the information necessary to meet the eligible indirect compensation reporting option, additional information would be required. DOL states that plans and service providers have substantial flexibility in establishing systems to provide the necessary disclosures; there is no specific form or method of disclosure required and the disclosures do not need to come from a particular party.

ERISA fee recapture accounts

The guidance includes a Q&A involving "ERISA fee recapture accounts" where payments from funds and fund companies are deposited into an account and used to pay plan administrative expenses. DOL states that if the recordkeeper is merely serving as a conduit between the fund company and the plan trust, the amounts that flow through the recordkeeper to the trust do not need to be reported as indirect compensation received by the recordkeeper. If the amount deposited is net of the recordkeeper's fees, the amount the recordkeeper retains would be reportable indirect compensation. Amounts paid to persons out of the ERISA fee recapture account for services to the plan would be direct compensation to the recipient. Similarly, if the recordkeeper retains revenue sharing income but reflects it as a "credit" to the plan, payments by the recordkeeper to other persons for rendering services to the plan would be reportable indirect compensation to the recipients.

Additional guidance on non-monetary compensation

The guidance includes three detailed questions and answers on the proper reporting of non-monetary compensation:

- Promotional gifts such as coffee mugs which display a company logo (FAQ 2);
- Free business meals and entertainment not based on ERISA plan business (FAQ 3);
- Expenses in connection with educational conferences (FAQ 4).

Good faith reporting relief for 2009 plan year

The previous guidance had provided limited relief for plan service providers for the 2009 plan year. DOL had stated that a plan administrator will not be required to list a service provider on its 2009 Form 5500 if the plan administrator receives a statement from the

provider that despite a good faith effort to make any necessary recordkeeping and information system changes in a timely fashion, the service provider was unable to complete the changes for the 2009 plan year.

DOL clarified in this new guidance that it will not reject a 2009 Form 5500 or impose penalties if the Schedule C does not include information and the plan receives the required statement from a service provider. DOL states that it expects that a service provider will provide the information that it was able to collect and that plans will communicate with service providers regarding the steps being taken to provide the necessary information for future Schedule Cs.

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endnotes

[1] The new FAQs are available here: http://www.dol.gov/ebsa/faqs/faq-sch-C-supplement.html.

[2] See Memorandum to Pension Members No. 40-08, Broker/Dealer Advisory Committee No. 19-08, Bank, Trust and Recordkeeper Advisory Committee No. 21-08, Operations Committee No. 10-08, and Transfer Agent Advisory Committee No. 32-08 [22698], dated July 16, 2008.

[3] For more information about the new Schedule C for the 2009 plan year, see Memorandum to Pension Members No. 69-07 [21958], dated November 19, 2007.

[4]

Thus, it appears that the adviser of a target date fund that uses proprietary funds would report advisory fee compensation received from the underlying proprietary funds.

[5] Part of the confusion comes from Q&A-8 of the previous FAQs, which could have been read to prevent any payment from being treated as eligible indirect compensation solely because it passed through a fund distributor or other fund agent before being paid to its recipient.