New DOL Guidance on Fee Disclosure – Overview

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Three phases of recent guidance on fee and expense disclosure issued by the U.S. Department of Labor, Employee Benefits Security Administration (the "DOL"), and one additional "expense-related" item.

In chronological order, the disclosure guidance addresses:

1. Form 5500 reporting (under ERISA Section 103)
2. To plan fiduciaries (under ERISA Sections 404(a) and 408(b)(2))
3. To participants in participant-directed plans (under ERISA Sections 404(a) and 404(c))

The other item is the recent DOL Enforcement Guidelines for its "Fiduciary Investigations Program"

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FORM 5500 REPORTING

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- Background on Form 5500
  - Generally, ERISA plans are required to file an annual report with the DOL on Form 5500 regarding their financial condition, investments, and operations, including disclosures of compensation paid by the plan to its service providers.
  - On November 16, 2007, the DOL finalized revisions to the Form 5500 requirements significantly affecting a plan's reporting obligations relating to compensation received directly or indirectly from the plan by a service provider to that plan.
  - These changes primarily apply to "Schedule C" of Form 5500.

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Form 5500 Changes

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- These changes in Form 5500 reporting are effective for plan fiscal years beginning on or after January 1, 2009. For calendar year plans, the first such Form 5500 is due July 31, 2010 (without extensions).
- Schedule C is required only for "large" plans (100 or more participants)
- While it is the ERISA plan's obligation to complete the Form 5500, ERISA plans and investment managers trading on their behalf will likely look to the financial firm to disclose certain information relating to its compensation. Service providers that fail or refuse to provide information necessary for the completion of a plan's Form 5500 may be specifically listed on the form submitted to the DOL.

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Form 5500 Changes

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- <u>Changes to Schedule C – Disclosure of Direct and Indirect "Reportable Compensation:"</u> On the revised Schedule C, eligible ERISA plans must identify all persons receiving $5,000 or more of total compensation (money or anything else of monetary value), **directly or indirectly,** in connection with services provided to the plan.
  - <u>Reportable "direct compensation"</u> generally includes direct payments by the plan out of a plan account, direct charges to participant individual accounts and charges to forfeiture accounts. It does <u>not</u> include amounts paid by the plan sponsor.
  - <u>Reportable "indirect compensation"</u> generally means compensation received from sources other than directly from the plan or plan sponsor. Indirect compensation is broadly defined to encompass a wide range of compensation the firm may receive, regardless of whether fees or compensation are received, or whether or not the source of the payments is a plan or an investment vehicle (even if not subject to ERISA) if an ERISA plan invests in such vehicle.

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Form 5500 Changes

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- <u>"Eligible Indirect Compensation:"</u> There is a more limited reporting requirement for what the DOL classifies as "eligible indirect compensation" which generally means indirect compensation that currently is received by pooled vehicles in which ERISA plans invest, so long as the investing plans receive disclosure on the types of such compensation before the initial investment and periodically thereafter. Although not covered by the current Schedule C requirements, it is possible that this limited reporting of "eligible indirect compensation" would be extended by the DOL to apply not only to pooled accounts, but to other types of individual accounts (e.g., separately managed accounts).

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Form 5500 Changes

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- <u>Reach of Schedule C Changes</u>: The instructions to Schedule C indicate that "reportable indirect compensation" includes fees and compensation received from mutual funds, but also goes beyond mutual funds to include non-ERISA "plan asset" vehicles (such as below 25% investment hedge funds) which are not subject to ERISA regulation but may have one or more ERISA plan investors that are subject to Schedule C reporting.
  - While it is clear the revised Form 5500 provides for significant changes in the disclosure/reporting of service provider compensation, there are a number of uncertainties regarding the scope of required disclosure that various industry groups are pursuing with the DOL
  - On July 14, 2008, the DOL issued 40 frequently asked questions (the "**FAQs**"), intended to help plan administrators and service providers comply with the requirements for reporting service provider fees and compensation.
  - *It is unclear whether revenue received from funds structured as "venture capital operating companies" or "real estate operating companies" is reportable.*

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Form 5500 Changes

- In response to concerns expressed by service providers trying to make changes to their recordkeeping and information management systems in order to provide plans with the required fee and compensation information, the DOL has issued a reprieve that would excuse plan administrators from reporting service providers on Part II on the 2009 Schedule C as failing to provide fee and compensation information if the service provider furnishes the plan administrator with a written statement that:

  (i) the service provider made a good faith effort to make any necessary recordkeeping and information system changes in a timely fashion; and

  (ii) despite such efforts, the service provider was unable to complete the changes for the 2009 plan year. (FAQ 40)

Disclosure to Fiduciaries under ERISA Sections 404(a) and 408(b)(2)

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- Prohibited Transactions: Under ERISA Section 406(a), a plan fiduciary is prohibited from causing plan assets to be transferred to a "party in interest," which includes a service provider to the plan.
- Statutory Prohibited Transaction Exemption: ERISA Section 408(b)(2) provides an exemption for otherwise prohibited transfer of plan assets to service providers, as long as the terms of the service provider arrangement and compensation received are **reasonable**, "necessary" and appropriate for the services provided and approved by an independent party on behalf of the plan.
- NOTE: ERISA Section 404(a) imposes a "prudence" requirement on plan fiduciaries, and also restricts a plan to "defraying **reasonable** expenses of administering the plan."

Disclosure to Fiduciaries under ERISA Sections 404(a) and 408(b)(2)

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- Proposed Regulations: On December 13, 2007, the DOL issued proposed regulations under ERISA Section 408(b)(2) that significantly expands the contractual requirements and fee and conflict of interest disclosures required of certain service providers.

- The DOL anticipates that this rule will become final and effective January 1, 2009.

- The DOL's position is that a fiduciary cannot enter into a "reasonable" contract if the fiduciary has not been provided sufficient information about

  -- the total compensation the service provider will receive; and

  -- any actual or potential conflicts of interest under which the provider might be operating.

- Disclosure: The proposed regulations require disclosure with respect to the following:
  - a service provider providing services as a fiduciary under ERISA or under the Investment Advisers Act of 1940 ("Advisers Act");
  - a service provider providing securities or other brokerage, consulting, investment advisory, investment management, custodial, recordkeeping, banking, insurance or third party administration services; or
  - a service provider who receives indirect compensation or fees for accounting, actuarial, appraisal, auditing, legal or valuation services.

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Disclosure to Fiduciaries under ERISA Sections 404(a) and 408(b)(2)

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- Contract Requirements: The contract or arrangement with these service providers must satisfy the following requirements:
  - The contract or arrangement must be in writing;
  - The terms must specifically require the service provider to disclose:
    - all services it provides to the plan;
    - all compensation or fees it or its affiliates will receive (directly or indirectly) in connection with such services;
    - the manner of the receipt of such compensation or fees (e.g., directly bill the plan or reflected as a charge against the plan's investment);
    - whether the service provider will provide any services as a fiduciary under either ERISA or the Advisers Act;
    - interest the service provider may have in any transactions with the plan
    - whether it has material financial, referral or other arrangement with money managers, brokers or other service providers who may create a conflict of interest in rendering the services; and
    - whether the service provider can affect its own compensation or fees.
  - The service provider must agree to furnish all information requested by the plan in order to allow the plan to comply with its reporting and disclosure requirements, such as all information necessary to complete the Form 5500.

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Disclosure to Fiduciaries under ERISA Sections 404(a) and 408(b)(2)

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- Proposed Prohibited Transaction Class Exemption: The proposed class exemption provides relief for a fiduciary who enters into a contract satisfying the requirements of the proposed regulations with a service provider which then fails to make the disclosures required by the proposed regulation.
  - The exemption requires that, once the plan fiduciary discovers that the proper disclosures were not made, the fiduciary request that the disclosure be made and, if not made, report the service provider to the DOL.
- Enforcement: If the service provider fails to disclose the required information (or the contract does not require such disclosure) and the fiduciary does not take the corrective action outlined above:
  - the proposed exemption does not provide relief for the plan fiduciary which hired the service provider and,
  - unless another exemption is satisfied, the service arrangement would result in a non-exempt prohibited transaction (carrying potential excise tax liability to the service provider, among other things).
- Effective Date: It seems likely the exemption will have the same effective date as the final Section 408(b)(2) guidance.
  - It is possible the exemption, when issued, also will provide retroactive relief for existing contracts.

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Disclosure to Participants under ERISA Sections 404(a) and 404(c)

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- On July 23, 2008, the DOL proposed a third fee-related rule that would require the disclosure of certain plan and investment-related information, including fee and expense information, to participants in participant-directed individual account plans (e.g., 401(k) plans).
- The DOL anticipates that this rule will become final and effective January 1, 2009.
- This rule is intended to ensure that participants in participant-directed individual account plans have the information they need to make informed decisions about the management of their individual accounts and the investment of their retirement savings.
- This rule applies even if the plan is not intended to comply with ERISA Section 404(c).

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Disclosure to Participants under ERISA Sections 404(a) and 404(c)

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- There recently has been a spate of class action litigations regarding allegedly inadequate monitoring and disclosure of plan fees in 401(k) plans. The DOL guidance appears to respond to this litigation in several ways.
- First, it clarifies how disclosure relates to the requirements that must be satisfied in order for fiduciaries to receive protection under ERISA Section 404(c).
- Second, it clarifies that, even if Section 404(c) relief is not being sought, such disclosure is part of a fiduciary's general obligation under ERISA Section 404(a).
- Finally, the DOL included in the guidance a model chart that can be used for making the required disclosures of investment information to participants.
- The provision of the model chart is a very helpful act by the DOL, as issuance of such a chart by the plan will be presumed to signify compliance with the disclosure requirements.

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Disclosure to Participants under ERISA Sections 404(a) and 404(c)

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- The comment period for this latest guidance will not expire until early September. It would not be surprising if there were comments both as to the mechanical and procedural aspects of the required disclosure, as well as to the substantive aspects.
- A large portion of the preamble to the proposed regulations was devoted to a cost-benefit analysis, and comments may address both whether the substantial anticipated costs are an understatement and whether the anticipated benefits are an overstatement.
- In any event, this guidance may undergo significant modification before it becomes final.

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Disclosure to Participants under ERISA Sections 404(a) and 404(c)

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- The rule establishes two categories of disclosures, plan information and investment information.
- Plan information includes:
  - Circumstances under which the participant can give investment directions;
  - Limits on the ability to give investment directions, such as restrictions on transfers between investment options;
  - Voting, tender and other rights with respect to an investment option; and
  - Identification of the plan's "designated investment alternatives," as well as any designated investment managers. For this purpose, "designated investment alternatives" include only "core" investment options, and specifically excludes self-directed brokerage windows.
  - The plan must provide updated information within 30 days after adoption of a material change.

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Disclosure to Participants under ERISA Sections 404(a) and 404(c)

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- The plan also must provide information about certain administrative expenses that may be charged to participant accounts. These expenses include only those legal, accounting or recordkeeping expenses (e.g. account maintenance fees) that are not netted against the return of the plan's investment options.
- The plan must provide a description of these expenses, including the basis on which participants will be charged.
- The information must be provided on or before the date of plan eligibility, and at least annually thereafter.
- The plan also must provide a statement at least quarterly of the actual (plan-wide) expenses charged to each participant's account, but the expenses need not be itemized.

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Disclosure to Participants under ERISA Sections 404(a) and 404(c)

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- The plan also must provide information about transaction-based or individual expenses that may be charged to participant accounts. These expenses are based on actions the participant took or services the participant utilized (e.g. loan processing fees, QDRO processing fees and fees for individual investment advice).
- The plan must provide a description of these expenses, including the basis on which participants will be charged.
- The information must be provided on or before the date of plan eligibility, and at least annually thereafter.
- The plan also must provide a statement at least quarterly of the actual (individualized) expenses charged to each participant's account, and these expenses must be itemized.

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Disclosure to Participants under ERISA Sections 404(a) and 404(c)

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- The plan also must provide information about the investment options for participants available under the plan. Some information is to be provided automatically, and some only upon request. Information provided automatically includes:
- Identifying information about each designated investment option, including the name of the investment, an internet website that provides supplemental information about the investment (including the name of the investment provider, the strategies and risks of the investment, the portfolio holdings, and performance and fee information), the investment's category, and whether the investment is actively or passively managed.
- The Department of Labor has requested comments on the requirement to provide an internet website address for further information about an investment option.

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Disclosure to Participants under ERISA Sections 404(a) and 404(c)

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- Performance data in a comparative format, showing average annual total return for one-, five- and 10-year periods. This data must be provided both for each designated investment option and for a companion broad-based securities index.
- The index must be maintained by an entity independent of the investment option's provider, adviser or underwriter, unless the index is widely recognized and used.
- The requirement to disclose a companion broad-based securities index may be difficult for certain investment options (e.g., target retirement funds do not yet have widely accepted companion indices).

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Disclosure to Participants under ERISA Sections 404(a) and 404(c)

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- Fee and expense information, including "shareholder-type" fees, which include sales loads, redemption fees, and the like; an expense ratio; and a statement that fees and expenses are only one of several factors a participant should consider in selecting an investment option.
- The information must be provided on or before the date of plan eligibility, and at least annually thereafter.
- This information is not required to be continuously updated throughout the year.
- The plan may provide the annually updated disclosure to new participants as they join the plan.
- Upon request from a participant, the plan must also provide for each investment option a prospectus (or short-form prospectus), financial statements or reports, a statement of the value of a share or unit of the option, and a list of the assets comprising the option's portfolio. *Query how this would apply to a bank collective fund, or insurance company separate account, which are not subject to the same SEC disclosure requirements as are mutual funds.*

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Disclosure to Participants under ERISA Sections 404(a) and 404(c)

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- How Must the Information Be Provided
- The required disclosure of general information may be included in the SPD, as long as the SPD is provided with sufficient frequency.
- The expense information may be provided with participant statements which, in a participant-directed plan, must be furnished at least quarterly.
- As noted above, the DOL has provided a model chart that is a safe harbor for compliance with the investment information disclosure requirements.
- *Query how/whether the plan administrator can delegate responsibility for maintaining updated investment information.*

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FURTHER DEVELOPMENTS

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- **Congressional Action**

  Congressman George Miller, chairman of the Education and Labor Committee of the U.S. House of Representatives, has been quoted as saying that the DOL proposal would continue to permit financial firms to "hide many fees" they charge to 401(k) participants' accounts and has introduced legislation (the "401(k) Fair Disclosure for Retirement Security Act") going well beyond the DOL's requirements.

  Although such legislation currently is "off the table" as the current Congressional session winds down, Congressman Miller has promised to re-introduce the legislation when the new Congress convenes next January.

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FURTHER DEVELOPMENTS

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- **DOL Enforcement Guidelines**
  - In early August 2008, the DOL posted on its website new guidelines under its "Fiduciary Investigations Program" relating, in part, to gifts, meals, entertainment or expenses for educational conferences provided to fiduciaries of ERISA plans. The concern is possible violations of ERISA Section 406(b)(3), the "anti-kickback" rule, which forbids a plan fiduciary to "receive any consideration for his personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan."
  - DOL investigators are instructed to inquire whether there is a written policy governing the receipt of items or services from persons dealing with the plan.
  - The annual receipt of items totaling less than $250 and made in accordance with the written policy generally should not be treated as Section 406(b)(3) violations.
  - Additional rules apply to reimbursement (by a party dealing with the plan) of a plan representative's expenses for attendance at an educational conference, generally including pre-approval by a plan fiduciary other than the attendee.

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The DOL's ERISA Fee Transparency Initiative:
<u>A Brave New World Beckons</u>

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- **Reference Information:**
- Form 5500 Reporting: Fed. Reg. Vol. 72, No. 221 (Fri. Nov. 16, 2007) pp. 64710-64730
- Proposed Rules under ERISA Section 408(b)(2): Fed. Reg. Vol. 72, No. 239 (Thurs. Dec. 13, 2007) pp. 70988-71005
- Proposed Class Exemption for Plan Fiduciaries When Plan Service Arrangements Fail to Comply with ERISA Section 408(b)(2): Fed. Reg. Vol. 72, No. 239 (Thurs. Dec. 13, 2007) pp. 70893-70896
- Request for Information regarding Disclosure in Participant-Directed Individual Account Plans: Fed. Reg. Vol. 72, No. 79 (Wed. April 25, 2007) pp. 20457-20460
- Proposed Rules regarding Disclosure in Participant-Directed Individual Account Plans: Fed. Reg. Vol. 73, No. 142 (Wed. July 23, 2008) pp. 43014-43044
- FAQs on Schedule C reporting: http://www.dol.gov/ebsa/faqs/faq_scheduleC.html
- Fiduciary Investigations Program: http://www.dol.gov/ebsa/oemanual/cha48.html

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