

Department of Labor Issues Interim Final 408(b)(2) Regulations Requiring Disclosure of Service Provider Compensation

August 25, 2010

On July 16, 2010, the Department of Labor (“DOL”) issued an interim final regulation (the “Regulation”) that amends existing regulations defining what constitutes a “reasonable” service contract or arrangement for purposes of Section 408(b)(2) of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”).* Under the Regulation, certain service contracts and arrangements between a pension plan and a party in interest will not be considered reasonable for purposes of Section 408(b)(2) unless the service provider discloses to the plan’s fiduciary certain information regarding the compensation that will be received in connection with the provision of services to the plan.

The primary purpose of the Regulation is to ensure that plan fiduciaries are provided with the information they need to prudently select and monitor service providers. The Regulation is part of a broader initiative by the DOL to increase the transparency of fee arrangements that has also included expanding the reporting of service provider compensation on Schedule C to the Form 5500 Annual Report and issuing a proposed regulation requiring the disclosure of administrative and investment-related fee and expense information to participants and beneficiaries in participant-directed individual account plans.

The Regulation differs from the proposed regulation issued on December 13, 2007 in several significant respects. Most notably, unlike the proposed regulation:

- the Regulation does not apply to contracts and arrangements involving the provision of services to welfare plans, which will be addressed in a separate regulation to be issued by the DOL;
- the Regulation does not apply to contracts or arrangements under which service providers receive a *de minimis* amount of compensation;
- the Regulation does not require that a contract or arrangement for the provision of services to a plan be set forth in a written document; and

* The text of the Regulation is available [here](#).

- the Regulation does not require service providers to make narrative disclosures regarding potential conflicts of interest.

The Regulation is effective July 16, 2011. As the Regulation has been issued as an interim regulation, it remains subject to further revision prior to the effective date.

Statutory Background

The provision of services to an employee benefit plan by a “party in interest” with respect to such plan is generally prohibited under ERISA and parallel provisions of the Internal Revenue Code of 1986, as amended (the “Code”). As every person providing services to a plan is considered a party in interest with respect to the plan, any contract or arrangement involving the provision of services to a plan would be prohibited under ERISA absent a prohibited transaction exemption. However, Section 408(b)(2) of ERISA provides an exemption for the provision of services to a plan by a party in interest, provided that:

- the services are provided pursuant to a contract or arrangement that is reasonable;
- the services are necessary for the establishment or operation of the plan; and
- no more than reasonable compensation is paid for such services.

The DOL has previously issued regulations providing that a service contract or arrangement will not be considered reasonable unless it can be terminated by the plan without penalty on reasonably short notice. The Regulation augments these regulations by providing that certain service contracts or arrangements with pension plans will not be considered reasonable unless the service provider has disclosed specified information to the fiduciary having the authority to cause the plan to enter into, or extend or renew, the contract or arrangement (the “Responsible Fiduciary”).

Affected Service Contracts and Arrangements

The Regulation applies only to service contracts or arrangements between a “Covered Plan” and a “Covered Service Provider” (each as described below) where the Covered Service Provider reasonably expects \$1000 or more in direct or indirect compensation to be received in connection with the provision of one or more of the services described below (“Covered Services”), regardless of whether the Covered Services will be performed, or such compensation received, by the Covered Service Provider, an affiliate or a subcontractor.

For these purposes, “compensation” includes anything of monetary value (such as money, gifts, awards, and trips), other than non-monetary compensation with an aggregate value of \$250 or less that is received during the term of the contract or arrangement. “Direct compensation” is defined under the Regulation as compensation received directly from the Covered Plan. “Indirect compensation” is defined as compensation received from any source other than the Covered Plan, the Covered Plan’s sponsor, the Covered Service Provider, an affiliate of the Covered Service Provider, or a subcontractor (if the subcontractor receives such compensation in connection with the performance of Covered Services).

Covered Plans

The term “Covered “Plan” generally includes any pension plan that is subject to Title I of ERISA, regardless of whether the plan is a defined benefit plan or defined contribution plan, and regardless of the number of participants covered under the plan. The Regulation, however, expressly excludes from the definition of “Covered Plan” simplified employee pensions, simple retirement accounts, individual retirement accounts and individual retirement annuities.

Covered Service Providers

The term “Covered Service Provider” includes any service provider that enters into a contract or arrangement with a Covered Plan under which the service provider is directly responsible for providing any of the following services:

- services provided directly to a Covered Plan as a fiduciary;
- services provided directly to a Covered Plan as an investment adviser registered under the Investment Advisers Act of 1940, as amended (the “Investment Advisers Act”), or any State law;
- recordkeeping services or brokerage services provided directly to a Covered Plan that is an individual account plan which permits participants and beneficiaries to direct the investment of their accounts, if one or more designated investment alternatives (other than investments selected through brokerage windows or similar arrangements) are made available in connection with such recordkeeping or brokerage services; or
- accounting, auditing, appraisal, banking, consulting (with respect to the development or implementation of investment policies or objectives, or the selection or monitoring of service providers or plan investments), custodial, insurance, investment advisory (for either

the Covered Plan or its participants), legal, recordkeeping, securities or other investment brokerage, third party administration, or valuation services provided directly to a Covered Plan if the service provider, an affiliate thereof, or a subcontractor reasonably expects to receive either (i) indirect compensation or (ii) compensation paid by a “related party” (i.e., as applicable, the service provider, an affiliate thereof, or a subcontractor) that is either transaction-based or is charged directly against a Covered Plan’s investment and reflected in the net value thereof.

No person will be considered a Covered Service Provider solely as a result of providing services as an affiliate or subcontractor of a Covered Service Provider.

Service Contracts and Arrangements with Investment Funds

A service contract or arrangement entered into between a service provider and an investment vehicle (such as a fund of funds, insurance company separate account, or bank collective investment fund) that holds “plan assets” of a Covered Plan (a “Plan Asset Vehicle”) will be subject to the Regulation only if:

- the Covered Plan has a direct equity interest in the Plan Asset Vehicle;
- the service provider provides services to the Plan Asset Vehicle as a fiduciary; and
- the service provider reasonably expects \$1000 or more in compensation to be received in connection with the provision of such fiduciary services.

The Regulation does not apply to service contracts or arrangements with Plan Asset Vehicles in which Covered Plans only have indirect equity interests. For example, if a Plan Asset Vehicle, such as a fund of funds, in which one or more Covered Plans have made a direct equity investment (the “Upper-Tier Vehicle”) invests in another Plan Asset Vehicle (the “Lower-Tier Vehicle”), the Regulation would apply to contracts or arrangements for the provision of fiduciary services that are entered into by the Upper-Tier Vehicle, but would not apply to similar contracts or arrangements entered into by the Lower-Tier Vehicle unless one or more Covered Plans have made a direct equity investment in the Lower-Tier Vehicle. Furthermore, any disclosures required with respect to fiduciary services provided to the Lower-Tier Vehicle would need to be made only to Responsible Fiduciaries of those Covered Plans investing directly in the Lower-Tier Vehicle, and not to Responsible Fiduciaries of Covered Plans investing through the Upper-Tier Vehicle.

Required Disclosures

Initial Disclosure

A Covered Service Provider that enters into a service contract or arrangement with a Covered Plan, including a service provider that enters into a contract or arrangement for the provision of fiduciary services to a Plan Asset Vehicle in which the Covered Plan has a direct equity interest, is required to disclose the following information to the Responsible Fiduciary of the Covered Plan:

- a description of the services to be provided to the Covered Plan pursuant to the contract or arrangement (other than non-fiduciary services provided to a Plan Asset Vehicle in which the Covered Plan has a direct equity interest);
- a description of 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 services provided to the Covered Plan pursuant to the contract or arrangement;
- a description of all indirect compensation that the Covered Service Provider, an affiliate, or a subcontractor reasonably expects to receive in connection with services provided to the Covered Plan pursuant to the contract or arrangement (other than non-fiduciary services provided to a Plan Asset Vehicle in which the Covered Plan has a direct equity interest), including identification of the services for which indirect compensation will be received and identification of the payer of the indirect compensation;
- a description of any compensation that will be paid among the Covered Services Provider, an affiliate, or a subcontractor, if such compensation is set on a transaction basis or is charged directly against the Covered Plan's investment and reflected in the net value thereof (e.g., 12b-1 fees), including identification of the services for which such compensation will be paid and identification of the payers and recipients of such compensation (including their status as an affiliate or subcontractor);
- a description of any compensation that the Covered Service Provider, an affiliate, or a subcontractor reasonably expects to receive in connection with the termination of the contract or arrangement, and the manner in which any prepaid amounts will be calculated and refunded upon termination;

- a description of the manner in which compensation will be received, such as whether the Covered Plan will be billed or whether the compensation will instead be deducted directly from the Covered Plan's accounts or investments;
- if applicable, a statement 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 Vehicle in which the Covered Plan has a direct equity interest) as an ERISA fiduciary; and
- if applicable, a statement 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 as an investment adviser registered under the Investment Advisers Act or any State law.

The Regulation provides that compensation may be expressed as a monetary amount, formula, percentage of the Covered Plan's assets, or per capita charge for each participant or beneficiary of the Covered Plan. If compensation cannot reasonably be expressed in such terms, the Regulation permits compensation to be described using any other reasonable method, as long as the description provides the Responsible Fiduciary with sufficient information to evaluate the reasonableness of the compensation.

Additional Disclosure Regarding Compensation Received from Investment Funds

A Covered Service Provider that is a fiduciary to a Plan Asset Vehicle in which a Covered Plan has a direct equity interest is required to include in its initial disclosure the following additional information:

- a description of any compensation that will be charged directly against the amount invested by the Covered Plan in the Plan Asset Vehicle in connection with the acquisition, sale, transfer, or withdrawal of interests,
- if the investment return is not fixed, a description of the annual operating expenses of the Plan Asset Vehicle; and
- a description of any ongoing expenses in addition to annual operating expenses.

This disclosure will not be required if the Plan Asset Vehicle is a designated investment alternative and the information is disclosed to the Responsible Fiduciary by a Covered Service Provider providing recordkeeping or brokerage services to the Covered Plan in

connection with such designated investment alternative, as described below.

Additional Disclosure Regarding Compensation Received for Recordkeeping or Brokerage Services

A Covered Service Provider that provides recordkeeping or brokerage services in connection with one or more designated investment alternatives is required to include in its initial disclosure the following additional information with respect to each designated investment alternative for which the services will be provided:

- a description of any compensation that will be charged directly against the amount invested by the Covered Plan in the designated investment alternative in connection with the acquisition, sale, transfer or withdrawal of interests therein;
- if the Covered Plan's investment return is not fixed, a description of the annual operating expenses of the designated investment alternative; and
- a description of any ongoing expenses in addition to annual operating expenses.

A Covered Service Provider can satisfy this disclosure requirement by furnishing to the Responsible Fiduciary current disclosure materials of the issuer of the designated investment alternative containing the necessary information, provided the issuer is not an affiliate of the Covered Service Provider and the Covered Service Provider does not know that the materials are incomplete or inaccurate.

A Covered Service Provider that provides recordkeeping services is also required to include in its initial disclosure a description of all direct and indirect compensation that the Covered Service Provider, an affiliate, or a subcontractor reasonably expects to receive in connection with these services. If the recordkeeping services are to be provided, in whole or in part, without explicit compensation, or if the compensation for such services is to be offset or rebated based on other compensation received by the Covered Service Provider, an affiliate, or a subcontractor, this disclosure must include a good faith estimate of the cost of the recordkeeping services to the Covered Plan, including an explanation of the methodology and assumptions used.

Form of Disclosure

Although a Covered Service Provider must furnish the required disclosures in writing, the Regulation does not prescribe any particular form of disclosure. However, as noted in the preamble to the Regulation, the DOL is considering adding a requirement that Covered Service Providers furnish a summary disclosure statement on a

prescribed form that would provide Responsible Fiduciaries with a general overview of the information that is required to be disclosed. The DOL has invited interested persons to submit comments regarding the likely cost to Covered Service Providers of complying with such a requirement, the anticipated benefits to Responsible Fiduciaries, and the recommended format for the summary disclosure statement.

Timing of Initial Disclosure

Any existing service contract or arrangement must provide the initial disclosure by July 16, 2011. In the case of service contracts and arrangements entered into on or after July 16, 2011, a Covered Service Provider must make the initial disclosure to the Responsible Fiduciary “reasonably in advance” of the date the contract or arrangement is entered into, extended, or renewed.

Where a Covered Plan acquires a direct equity interest in an investment vehicle and, subsequent to the acquisition date, such investment vehicle is determined to be a Plan Asset Vehicle, an Indirect Fiduciary Service Provider is required to make the initial disclosure as soon as practicable but not later than 30 days from the date on which the service provider learns that the investment vehicle is a Plan Asset Vehicle.

Another special timing rule applies to the disclosure of information regarding designated investment alternatives. Where an investment alternative is not designated at the time a service contract or arrangement is entered into, an Investment Platform Service Provider will be required to disclose information with respect to the investment alternative as soon as practicable but not later than the date on which the investment alternative is designated by the Responsible Fiduciary.

Reporting and Disclosure Information

In addition to the information contained in the initial disclosure, a Covered Service Provider is required to provide, upon the request of the Responsible Fiduciary or plan administrator of a Covered Plan, any other information relating to compensation received in connection with the service contract or arrangement that is required in order for the Covered Plan to comply with the reporting and disclosure requirements under Title I of ERISA (such as the Form 5500 Schedule C reporting requirements). A Covered Service Provider is required to furnish this information not later than 30 days following receipt of a written request from the Responsible Fiduciary or plan administrator, unless such disclosure is precluded due to circumstances beyond the Covered Service Provider’s control (in which case the updated information must be disclosed as soon as practicable).

Updating and Correcting Disclosed Information

Once an initial disclosure has been made, a Covered Service Provider is required to disclose to the Responsible Fiduciary any change to the information previously furnished. The updated information is required to be disclosed as soon as practicable, but not later than 60 days from the date on which the Covered Service Provider is informed of the change, unless such disclosure is precluded due to extraordinary circumstances beyond the Covered Service Provider's control (in which case the updated information must be disclosed as soon as practicable).

If a Covered Service Provider discovers errors or omissions in the information previously disclosed, the Covered Service Provider must provide the Responsible Fiduciary with the correct information as soon as practicable, but not later than 30 days from the date the Covered Service Provider discovered the error or omission. As long as the error or omission is timely corrected, and the Covered Service Provider acted in good faith and with reasonable diligence in connection with the initial disclosure, the Covered Service Provider will be deemed to have complied with the Regulation's disclosure requirements.

Consequences of Noncompliance

If a Covered Service Provider fails to make the disclosures required under the Regulation, the service contract or arrangement between the Covered Plan and the Covered Service Provider will not be considered "reasonable," and the exemptive relief provided under Section 408(b)(2) of ERISA will not be available. If no other prohibited transaction exemption is applicable, the Responsible Fiduciary that caused the Covered Plan to enter into the contract or arrangement will have violated ERISA, and the Covered Service Provider will be subject to an excise tax imposed under the Internal Revenue Code on parties in interest that participate in prohibited transactions.

Exemption for Responsible Fiduciaries

Under a prohibited transaction class exemption set forth in the Regulation, a Responsible Fiduciary will not itself violate Section 406(a) of ERISA as a result of a Covered Service Provider's failure to make the required disclosures, provided the following conditions are satisfied:

- the Responsible Fiduciary did not know that the Covered Service Provider failed, or would fail, to make the required disclosures and reasonably believed that the Covered Service Provider had made all required disclosures;

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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- the Responsible Fiduciary, upon discovering the Covered Service Provider's failure to make the required disclosures, requests in writing that the Covered Service Provider furnish the required information;
- if the Covered Service Provider fails to furnish the requested information within 90 days, the Responsible Fiduciary notifies the DOL not later than 30 days following the earlier of (i) the Covered Service Provider's refusal to furnish the requested information and (ii) the 90th day following the date of the written request (the DOL has provided a sample notice); and
- after discovering the Covered Service Provider's failure to make the required disclosures, the Responsible Fiduciary determines whether to terminate or continue the service contract or arrangement, taking into account the nature of the failure, the availability, qualification, and costs of replacement service providers, and the Covered Service Provider's response to the notification of the failure.

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