Proposed DOL Rules Require Plans' Service Providers to Disclose Fees and Conflicts of Interest

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1. Background and Overview.

On December 13, 2007, the DOL issued its long-awaited proposed rule on the subject of 401(k) fee disclosures. The Department issued this rule against a backdrop of increased Congressional attention and media scrutiny, and it is likely to be contentious. This Article explains the key features of the proposed rule.

ERISA §408(b)(2) provides relief from ERISA's prohibited transaction rules for service contracts or arrangements between a plan and a party in interest if the contract or arrangement is reasonable, the services are necessary for the establishment or operation of the plan, and no more than reasonable compensation is paid for the services. The DOL has proposed amending the regulations under ERISA §408(b)(2) to (i) clarify what constitutes a "reasonable contract or arrangement" and (ii) require more comprehensive written disclosures concerning plan contracts with service providers.

Currently, the regulations under DOL Reg. §2550.408b-2(c) state only that a contract or arrangement is not reasonable unless it permits the plan to terminate without penalty on reasonably short notice. The DOL now proposes to add that, in order for a contract or arrangement for services to be reasonable, it must require a service provider to disclose (i) the compensation it will receive, directly or indirectly, and (ii) any conflicts of interest that may arise in connection with its services to the plan.

Comment: The rules are proposed to take effect 90 days after being finalized. It is unclear at this point as to how the rules will be applied to existing contracts or arrangements.

Comment: The DOL's proposed rules are the second of three fee-related regulations that will be issued. The first set of regulations have already been released and govern disclosures to the government (via the Form 5500), and the third set of regulations will govern disclosures to participants.

2. Scope.

a. *Limited to 3 Types of Service Providers*. The proposed rules are limited to contracts or arrangements to provide services by service providers who: (i) provide services as a fiduciary under ERISA or under the Investment Advisors Act of 1940; (ii) provide banking, consulting, custodial, insurance, investment advisory (plan or participants), investment management, recordkeeping, securities or other investment brokerage, or third party administration services, regardless of the type of compensation or fees they receive; and (iii) receive any indirect compensation in connection with accounting, actuarial, appraisal, auditing, legal or valuation services.

The DOL believes the compensation arrangements for service providers in the first two categories are most likely to give rise to conflicts of interest. Note that service providers in the third category only have to comply if they receive indirect compensation (e.g., revenue sharing) from the arrangement.

If the service provider falls within one of the above categories, then the contract or arrangement must satisfy the disclosure requirements in order to be deemed reasonable regardless of the nature of any other services provided or whether the plan is a pension plan, group health plan, or other type of welfare benefit plan. The DOL cautions that plan fiduciaries still need to satisfy their general fiduciary obligations with respect to the selection and monitoring of all service providers, including obtaining and considering appropriate disclosures before contracting with service providers.

b. *Limited to Services to Employee Benefit Plans*. The rules apply only to contracts or arrangements for services to employee benefit plans. They do not apply to contracts or arrangements with entities that are merely providing plan benefits to participants and beneficiaries, rather than providing services to the plan itself (e.g., if a fiduciary contracts on behalf of a welfare plan with an HMO, the doctor that is part of the network is not considered a service provider to the plan).

3. Disclosure Requirements.

If a service provider falls within one of the three above-referenced categories, in order for a contract or arrangement to be reasonable within the meaning of ERISA §408(b)(2) and the regulations, the service provider must disclose to the plan fiduciary, in writing, to the best of its knowledge, the following:

a. *Services and Compensation*. The service provider must disclose all services to be provided to the plan and, with respect to each such service:

i. the compensation or fees ("Compensation or fees" include money or any other thing of monetary value (e.g., gifts, awards, and trips) received or to be received, directly from the plan or plan sponsor or indirectly (i.e., from any source other than the plan, the plan sponsor, or the service provider) by the service provider or its affiliate in connection with the services to be provided pursuant to the contract or arrangement or because of the service provider's or affiliate's position with the plan.

(ii) to be received by the service provider (expressed in terms of a monetary formula, percentage of the plan's assets, or per capita charge for each participant or beneficiary of the plan), and iii the manner of receipt of such compensation or fees that states:

(A) whether the service provider will bill the plan, deduct fees directly from plan accounts, or reflect a charge against the plan investment, and

(B) how any prepaid fees will be calculated and refunded when a contract terminates.

Furthermore, if a service provider offers a bundle of services to the plan that is priced as a package, rather than on a service-by-service basis, then only the service provider offering the bundle of services must provide the required disclosures. However, this service provider is not required to disclose the fee allocation unless the fees are separately charged against a plan's investment (e.g., management fees paid to mutual fund advisors) or on a transaction basis (e.g., brokerage commissions, soft dollars).

b. *Conflicts of Interest*. The service provider must disclose information about different types of relationships or interests that raise conflicts of interests for the service provider in performing plan services. For example, service providers must disclose whether they:

(i) expect to participate in, or otherwise acquire a financial or other interest in, any transaction to be entered into by the plan pursuant to the contract and, if so, a description of the transaction and the service provider's participation or interest therein;

(ii) will provide any services to the plan as a fiduciary either within the meaning of ERISA §3(21) or under the Investment Advisors Act of 1940;

(iii) have any material financial, referral, or other relationship or arrangement with other parties (e.g., a money manager, broker) that creates or may create a conflict of interest, and if so, a description of such relationship or arrangement;

(iv) will be able to affect its own compensation or fees, from whatever source, without the prior approval of an independent plan fiduciary; and

(v) have any policies or procedures that address actual or potential conflicts of interest or that are designed to prevent either compensation or fees or the relationships or arrangements from adversely affecting the provision of services, and if so, an explanation of these policies or procedures.

The contract or arrangement must include a representation by the service provider that, before the contract or arrangement is entered into, all the above required information has been provided to the responsible plan fiduciary. All of the required disclosures need not be contained in the same document and may be provided in electronic format. In addition, there is no specified timeframe to disclose the information other than prior to entering the contract.

During the term of the contract, any "material" change to the previously furnished information must be disclosed within 30 days knowledge of such change.

4. <u>Prohibited Transaction Exemption</u>.

Although the proposed rules shift the burden from the plan sponsor to the plan service providers, failure to comply with the proposed regulations will result in a prohibited transaction, which will impact the plan sponsor. As a result, the DOL has also proposed a class exemption that would provide relief for a plan fiduciary that enters into a contract that is not "reasonable," because, unknown to the fiduciary, the service provider failed to comply with its disclosure obligations under the proposed regulations. To qualify for relief, plan fiduciaries must:

(i) have entered the contract or arrangement reasonably believing that it met regulatory requirements;

(ii) take corrective steps with the service provider after discovering the problem by requesting in writing the disclosure information; and

(iii) notify the DOL of uncooperative service providers not later than 30 days following the earlier of:

(A) the service provider's refusal to furnish the requested information; or

(B) the date which is 90 days after the date the written request is made.

The notice to the DOL must contain the following information: (i) plan's name and number; (ii) plan sponsor's name, address, and EIN; (iii) plan fiduciary's name, address, and telephone number; (iv) service provider's name, address, phone number, and if known, EIN; (v) description of the services provided to the plan; (vi) description of the information that the service provider failed to furnish; (v) date on which such information was requested in writing from the service provider; and (vi) a statement as to whether the service provider continues to provide services to the plan.

In addition, the fiduciary must also determine whether to terminate or continue the contract or arrangement by evaluating the nature of the particular disclosure failure and determining the extent of the actions necessary under the facts and circumstances. Factors to consider, among others, are: the availability, qualifications, and costs of potential replacement service providers, and the responsiveness of the service provider in furnishing the missing information.

The exemption will be effective 90 days after the publication of the final exemption.

> **Comment**: There is currently no requirement for non-fiduciary service providers to supply any specific types of information to plan fiduciaries. Now, the DOL is proposing to make service providers disclose extensive information, including the identity of third parties from whom it indirectly receives fees or compensation as a result of having a connection with the plan. Bottom line: Non-fiduciary service providers are going to be regulated by the DOL.

It is unclear at this point how the proposed rules will be applied to current contracts and arrangements, and the DOL will need to provide clarification. If current contracts are impacted, there is a short timeframe for compliance (90 days after the final rules are issued). Plan sponsors and service providers should begin preparing now to meet the required disclosure requirements.

The fee and conflict of interest disclosures represent significant internal tracking and communication challenges for large/complex companies. In addition, the ongoing obligation to meet the 30-day disclosure deadline of material changes, will also result in similar challenges.

While the controversy around 401(k) fees clearly drove the DOL's promulgation of these regulations, all ERISA-covered plans, including health and welfare plans, would be affected.

5. Conclusion.

Law firms must advise their clients that sponsor plans of these proposed rules, as plan sponsors must start modifying their pension plan arrangements with service providers accordingly. Law firms should also determine what they should do regarding their plans in light of these new standards.

Marcia S. Wagner is a specialist in pension, employee benefits and executive compensation. Ms. Wagner is recognized as an expert in a variety of employee benefits issues and executive compensation matters, including qualified and non-qualified retirement plans, and welfare benefit arrangements. For information regarding The Wagner Law Group, please visit www.erisa-lawyers.com.

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