Department of Labor Adopts Final ERISA Fee Disclosure Rules

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WHO SHOULD READ THIS ALERT?

This alert discusses some important new rules that apply to persons providing services to pension plans and to the managers of certain types of investment funds in which pension plans invest. Any person providing services to a pension plan or managing an investment fund in which pension plans invest should read this alert.

On February 3, 2012, the Department of Labor published final rules (the "408(b)(2) Disclosure Rules") under Section 408(b)(2) of the Employee Retirement Income Security Act of 1974 ("ERISA") requiring fee disclosure by persons providing services to most ERISA pension plans and by certain of the entities in which pension plans invest, effective as of July 1, 2012. For the affected service providers, it will be necessary to assess whether their service relationships are subject to the 408(b)(2) Disclosure Rules and if so, whether existing fee disclosures are sufficient to comply with the rules, or whether new disclosures will be necessary. As described more fully below, in addition to service arrangements with ERISA plans, the 408(b)(2) Disclosure Rules will also apply to service arrangements with entities considered to be holding assets of plans subject to ERISA (a "plan asset fund"). The 408(b)(2) Disclosure Rules generally do not apply to fees charged indirectly to investors in investment funds which are not plan asset funds.

WHY WERE THESE RULES ADOPTED?

The furnishing of services between a plan and a party in interest to the plan, which includes service providers to such plan, is generally prohibited under Section 406(a)(1)(C) of ERISA. Consequently, a service relationship between a plan and a service provider will generally be a prohibited transaction because any person providing services to the plan is a "party in interest" to the plan under ERISA. Section 408(b)(2) of ERISA provides relief from ERISA Section 406'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 "Service Provider Exemption").

Before the 408(b)(2) Disclosure Rules, there were no specific disclosures plan fiduciaries needed to receive in order to conclude that a service arrangement with a plan was reasonable. However, under the new rules, fee arrangements between plans and parties in interest will not be treated as reasonable, and consequently, the Service Provider Exemption would not be available, unless the 408(b)(2) Disclosure Rules are satisfied.

WHAT TYPES OF PLANS ARE COVERED BY THE NEW RULES?

The new rules apply to service arrangements with most pension plans (defined benefit and defined contribution, including 401(k)) that are subject to ERISA, but not to health and welfare plans. Certain plans maintained by tax exempt entities, IRAs, governmental plans, church plans, foreign plans and excess benefit plans are not subject to the new rules.

WHAT TYPES OF SERVICE ARRANGEMENTS ARE COVERED BY THE 408(b)(2) DISCLOSURE RULES?

Arrangements under which there is an expectation that $1,000 or more in compensation will be paid in connection with services to a covered plan or a plan asset fund are subject to the rules. The rules apply whether the compensation is paid by the plan or plan asset fund or whether the compensation is received from a source other than the plan or plan asset fund. The rules also apply when the services are actually performed by an affiliate of or subcontractor to the covered service provider which entered into the services agreement with the plan or fund. Likewise, the rules apply even if the compensation is received by an affiliate of or subcontractor to the covered service provider.

The rules cover three groups of arrangements:

1. Services provided as a fiduciary or registered investment advisor to a plan or a plan asset fund;
2. Recordkeeping or brokerage services provided to a plan; and
3. Other services provided to a plan for indirect compensation.

While the new rules apply to plan asset funds, they do not apply to investment/fund entities whose underlying assets do not constitute "plan assets" for purposes of ERISA (e.g., those which operate as a venture capital operating company (VCOC), real estate operating company (REOC) or an entity which passes the "25% test").[1] However, the new rules can still apply in connection with an ERISA plan's investment in a non-plan assets fund if an investment manager, or other party, is otherwise providing services directly to an ERISA plan. Plan asset funds subject to the new rules may find that their existing disclosures largely satisfy the new requirements (as discussed below), but those funds will need to study the new requirements and their existing disclosures to make sure they have met all the requirements before July 1, 2012.

WHAT HAPPENS IF THE RULES APPLY BUT ARE NOT FOLLOWED?

Covered arrangements can give rise to prohibited transactions under ERISA and trigger excise taxes for the parties in interest if no disclosure is given to plan fiduciaries. Plan fiduciaries can

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1 The "25% test" is generally satisfied by entities whose ERISA investors hold less than 25% of each class of equity interests in the entity (determined in a manner consistent with the Department of Labor plan assets regulation).

also be liable for penalties if the disclosures are inadequate unless they take affirmative steps, including requesting the needed disclosures, notifying the Department of Labor when the disclosures are not provided and determining whether or not to terminate the arrangement.

TIMING OF DISCLOSURES

To the extent a fund or the manager of a fund, or other service provider, is subject to the disclosure rules, they will need to make sure the disclosure rules are followed by July 1, 2012, in the case of existing service arrangements subject to the rules, and prospectively before new covered service arrangements are established with a plan (or plan asset fund, as applicable). In the case of a fund that was originally determined not to hold plan assets (e.g., because it had passed the 25% test or qualified as a VCOC or REOC), but later is determined to hold plan assets, the disclosures need to be provided within 30 days after the entity is determined to hold plan assets. Managers need to provide changes to the disclosures within 60 days after changes to the arrangements are made.

DISCLOSURE FORMAT

Although the disclosure requirements are very broad when applicable, there is currently no specific format a covered service provider needs to follow (though the Department of Labor has indicated that in the future it might require a specific disclosure format), and most of the required content should be in the disclosure materials funds are already providing to their investors. One likely exception is the new requirement to disclose gifts and payments in kind received by fund managers in excess of $250 in the aggregate over the term of the arrangement. Fund managers will need to check their offering memoranda and subscription documents to see which of the disclosures required under the new rules still need to be made. The Department of Labor encourages the use of a summary guide directing pension plan fiduciaries to the specific disclosures found in the fund's offering memoranda and subscription documents.

MANNER OF DISCLOSURE

Any covered service provider needs to make the disclosure to the plan fiduciary, even if the services to the plan or plan assets fund are provided by an affiliate or subcontractor. The disclosure needs to be in writing, but it may be delivered electronically.

CONTENT OF DISCLOSURE

The disclosure must include a statement that the covered service provider, affiliate or subcontractor will provide services as an ERISA fiduciary or as an investment advisor to the covered plan or the plan asset fund. The disclosure needs to describe (1) any services provided to a plan asset fund as a fiduciary or as an investment advisor, (2) all the direct compensation (i.e., any fees a covered service provider, affiliate or subcontractor can take directly from a plan's investment, including any annual operating expenses if there is no fixed return, the fund's expense ratio, sales loads, account fees, wrap fees, mortality and expense fees, etc.), (3) all indirect compensation (e.g., fees received from other sources, such as soft dollars, finder's fees, gifts, etc.) which the covered service provider, affiliate or subcontractor reasonably expects to receive in respect of covered services, (4) the services for which the indirect compensation will be received, and (5) the payer and recipient of any indirect compensation, together with an explanation of who is an affiliate or subcontractor. However, compensation paid to an employee for services performed as an employee of a covered service provider, affiliate or subcontractor does not need to be disclosed.

The disclosure must describe any compensation to be paid in connection with the termination of a contract or arrangement, including how any available refunds for prepaid amounts will be determined.

Compensation can be expressed in the required disclosure as a monetary amount, a formula, a percentage of the covered plan's assets or as a per capita charge. If none of those methods are practicable, the disclosure may express the compensation using any reasonable method.

NEW FORM 5500 SCHEDULE C REQUIREMENTS

Separate and apart from the new ERISA 408(b)(2) Disclosure Rules, covered service providers (including the managers of funds that pass the 25% test but not VCOCs or REOCs) already need to provide plan administrators with the direct and indirect fee information those plan administrators require to complete Schedule C on the plan's annual report on Form 5500. The relevant disclosure information needs to be provided before the date on which the plan administrator is required to file the plan's annual report with the Department of Labor and the IRS.

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