New Department of Labor Disclosures Requirements

Part I

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The steady movement away from defined benefit plans (such as a traditional pension plan) toward participant-directed defined contribution plans (like today's self-directed 401(k)) has for years generated lots of debate over whether participants have sufficient information to make informed investment choices. The debate has centered on both how to deliver investment advice without a plan sponsor exposing itself to additional fiduciary liability and, more recently, how to disclose the true cost of those investment choices so participants are able to make more informed choices.

On July 23, 2008, the United States Department of Labor (DOL) issued proposed regulations that would require additional plan-related disclosures to participants. This is the third of three sets of regulations the DOL has issued on investment and fee-related disclosures. On November 16, 2007, the DOL issued its first set of regulations requiring additional investment fee related disclosures on the Schedule C to the Form 5500.[1] On December 13, 2007, the DOL issued its second set of proposed regulations that amended a key statutory exemption[2] for service provider-related prohibited transactions and also issued a proposed administrative prohibited transaction class exemption that would cover plan administrators in the event that a service provider fails to disclose the requisite information to exempt the transaction from prohibited status.

All these new disclosure provisions apply to PEO-sponsored employee benefit plans. This article will summarize the new requirements beginning with the Schedule C requirements and ending with the most recently issued participant disclosure proposed regulations.

Final Rules for Form 5500 Schedule C

The proposed Form 5500 regulations amend several schedules, but for purposes of this article the focus is exclusively on the amendments to the Form 5500. Schedule C must generally be filed by large plans to report service provider compensation of more than $5,000. The amendments do not affect the large plan application or the $5,000 threshold. The key goal in the amendments is to require more transparency of service provider compensation, including indirect compensation, which may have gone unreported in the past. The Schedule C now consists of three parts.

Part 1 requires, subject to an alternative reporting option, the identification of each person that was paid, directly or indirectly, $5,000 or more in total compensation, i.e., money or anything of value, for services to a plan. The final Schedule C requires that direct compensation be reported on a separate line item from indirect compensation paid from sources other than the plan. In addition, the Codes identifying the sources of payment have been expanded to better reflect the variety of sources from which indirect compensation may be paid. The final Schedule C includes an alternative form of filing for those service providers whose only source of indirect compensation is limited to "eligible indirect compensation" (certain specified types of common investment-related fees) provided certain written disclosures are furnished to the plan administrator, including in electronic form, pertaining to amount of compensation, the services provided, and the parties paying for the compensation. Part II of the new Schedule C requires plan administrators to identify each service provider that failed or refused to provide the information necessary to complete Part 1. Part III is the current Part II requiring termination information on plan accountants and enrolled actuaries.

On July 26, 2008, the DOL released frequently asked questions about the 2009 Form 5500 Schedule C and also announced a one-year compliance delay with the new disclosure requirements provided that plan administrators obtain a statement from the service provider that in spite of good faith efforts to make necessary systems changes to comply with the new regulations, it was unable to complete the changes. For a copy of the DOL's July 24, 2008, FAQs on Schedule C, go to *www.dol.gov/ebsa/ faqs/faq_scheduleC.html*.

Proposed Regulations Amending Requirements for the Application of ERISA § 408(b)(2) Exemption

Employee Retirement Income Security Act (ERISA) § 406(a) sets forth a series of prohibited transactions between a plan and persons who have close relationships to the plan, referred to as "parties in interest." The transactions set forth in ERISA § 406(a) are intended to be *per se* prohibited unless an exemption applies. There are many

1 72 Fed. Reg. 64710.
2 ERISA §408(b)(2) proposed change at 72 Fed. Reg. 70988.

exemptions, both statutory and administrative. Without these exemptions, plans would literally be unable to transact any business. ERISA § 406(a)(1)(C) generally prohibits the furnishing of goods, services, or facilities between a plan and a party in interest. Without an exemption, this provision would render all services between a plan and a service provider prohibited because virtually all service providers to a plan are defined parties in interest to a plan.[3] ERISA 408(b)(2) exempts transactions otherwise prohibited by ERISA § 406(a)(1)(C) if the contract or arrangement between the plan and party in interest is reasonable, the services are necessary for the establishment or operation of a plan, and no more than reasonable compensation is paid for the services. Existing DOL regulations shed some light on all three requirements.[4] The proposed amendments intend to clarify the meaning of "reasonable" contract or arrangement. Currently, the regulations only state that a contract or arrangement is reasonable if the plan is able to terminate the arrangement without penalty and on reasonably short notice.[5]

The proposed regulation adds a new paragraph to the existing regulations that generally requires that, to be reasonable, any contract or arrangement between an employee benefit plan and certain service providers must require the service provider to disclose the compensation it will receive, directly or indirectly, and any conflicts of interest that may arise in connection with its services to the plan. The regulation is striking because it shifts the disclosure burden to the service provider irrespective of whether or not the service provider is a fiduciary to the plan.

Understanding that not all service providers are equal, the regulations are limited to three broad categories of service providers: a fiduciary either within the meaning of ERISA or under the Investment Advisers Act of 1940; a service provider that provides any one or more of the following services to the plan pursuant to the contract or arrangement: banking, consulting, custodial, insurance, investment advisory, investment management, recordkeeping, securities, or other investment brokerage, or third party administration; or a service provider who receives or may receive indirect compensation or fees in connection with providing any one or more of the following services to the plan: accounting, actuarial, appraisal, auditing, legal, or valuation. In other words and by way of example, a plan's printer may be omitted from the new requirements.

Under the proposed revisions to the regulations, no contract or arrangement will be considered reasonable unless:

- The contract or arrangement is in writing;
- The service provider must disclose in writing to the appropriate fiduciary all compensation direct and indirect that it will receive for the services it is providing;
- Compensation or fees include money or other things of monetary value received or to be received directly from the plan or plan sponsor, or indirectly to the service provider or its affiliate from any other source in connection with the services to be provided;
- If the services are bundled, only the service provider providing the bundled services must make the disclosures. The service provider shall not be required to disclose the allocation of its fees to affiliates, subcontractors, or other parties, unless any one of these other entities is receiving compensation for additional unrelated services;
- A description of the manner of receipt of the fees or compensation, i.e., bill the plan, or deduct directly from plan accounts;
- Whether the service provider will provide services as a fiduciary;
- Whether the service provider expects to acquire a financial or other interest in any transaction to be entered by the plan in connection with the contract or arrangement;
- Whether the service provider or affiliate has any material financial, referral, or other relationship or arrangement with a money manager, broker, client of the service provider, other service provider to the plan, or any other entity that might create a conflict in performing services under the contract or arrangement;
- Whether the service provider will be able to affect its own compensation without prior approval of another fiduciary, i.e., performance-based compensation;
- Disclosures of material changes related to compensation and fee disclosures no later than 30 days from the date on which the service provider acquires knowledge of those changes; and
- The terms of the contract shall include a requirement that the service provider must disclose all compensation.

Another important point on the issue of fees and compensation is that they may be expressed in terms of a monetary amount, formula, percentage of the plan's assets, or per capita charge for each participant or beneficiary. Whatever form is used, the goal is to ensure that the responsible fiduciary has sufficient information by which to evaluate the reasonableness of the fees. Thus, there is lots of flexibility on how fees and compensation can be paid, provided that the resulting payments are reasonable and the fiduciary understands what is being paid.

This proposal has generated a lot of comments and on April 1, 2008, the DOL held a public hearing to dialogue with the regulated community on these new and very critical regulations. The DOL is likely to make some changes to the final regulations in response to the public comments, but more disclosure is unquestioningly the wave of the future.

Next time: Fiduciary Requirements for Disclosure in Participant-Directed Account Plans.●

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3 See ERISA §3(14)(B).
4 See 29 C.F.R. §2550.408b-2.
5 See 29 C.F.R. §2550.408b-2(c).