

A WORLD IN FLUX: THE CHANGING LANDSCAPE OF 401(K) PLAN FEE DISCLOSURE RULES

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It's a beautiful Friday afternoon in April, and a business acquaintance invites you for a round of golf. Will you go? What if the cost of the game has to be reported to your employer, your customers, and the United States Department of Labor ("DOL")? If you provide services to an employee benefit plan that is subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), there are important developments you should be aware of regarding your compensation.

By far the changes with the greatest immediate effect on ERISA plans and plan service providers are the initiatives of DOL regarding:

- reporting of service provider compensation by plan administrators to the government on the plan's Form 5500 Annual Return/Report (the "Form 5500"); and
- disclosure of compensation by service providers to their plan customers.

Before discussing the nuts and bolts of the new disclosure rules, it might be helpful to list a few of the items that will likely have to be reported and/or disclosed under the new rules. (Some of the rules are final and others are only proposed.)

- Meals, entertainment and gifts received by a plan service provider are likely to be treated as "compensation" paid indirectly from the plan to the service provider. Because of this, plan service providers will be asked to disclose to plans, and plans will be asked to report to the government, the value of virtually every lunch, dinner, golf outing, baseball ticket, theater ticket, educational conference, award or trip that the service provider receives if any part of the service provider's eligibility for the outing is attributable to the services provided to the plan or the service provider's position with the plan. Employees of a plan sponsor who work on plan matters may be considered plan service providers.
- Brokers who help plan sponsors locate recordkeepers and investment providers and become the "broker of record" for the plan will be required to have a written agreement with the plan outlining the services provided and disclosing the 12b-1 fees and similar compensation received from the plan's investments.
- Banks providing recordkeeping and directed trustee services for plans that outsource certain functions (i.e., back-office services) will be required to disclose the fees received by the bank's subcontractors.
- Plan recordkeepers may be required to disclose to plan administrators the investment fees paid to advisors to mutual funds that are plan investment

alternatives and the brokerage commissions paid by the mutual funds for trades in the mutual fund portfolio.

- Anyone who provides services to a plan and earns float will have to disclose the amount of float attributable to the plan.

From the examples above, it should be clear that the changes to the rules governing disclosure of service provider compensation have the potential to significantly alter how plans pay for and receive services. This article reviews how the current system of service provider compensation developed and the events that have brought attention to service provider compensation in recent years. We then discuss recent actions by the DOL that have significantly expanded the scope of disclosure required in the context of plan fees. Finally, the article offers a few observations on the magnitude of the changes taking place in this area and their possible effect on plan service providers and fiduciaries.

I. How did we get here?

Our sure sign that big changes are afoot in the ERISA world is when every arm of the federal government is focused on a single area. This was the case in 2007 with respect to fees and expenses paid by ERISA plans. Courts, regulators and even Congress set their sights squarely on the fees paid in connection with the investment of plan assets held in individual account, participant directed plans, such as 401(k) plans. The interest in plan fees did not develop overnight. Instead, it was the culmination of a remarkable series of events that transpired over a number of years.

Over the last 10-20 years, defined contribution plans, such as 401(k) plans, have taken the place of traditional defined benefit pension plans as many American's primary source of retirement income. As these plans have grown and evolved, so has the market for the provision of plan investment-related and administrative services. Due in part to the regulations governing registered investment companies, such as mutual funds, the 401(k) service industry developed a compensation structure through which a significant portion of total compensation was paid indirectly through the plan's investment options.

In the 1990s, plan service providers became concerned that indirect compensation might violate ERISA's "anti-kickback" provision, which prohibits plan fiduciaries from receiving "consideration" for their own personal account from any party dealing with the plan in connection with a plan transaction.¹ To address this concern, the 401(k) plan services industry asked DOL for "permission" to accept indirect compensation from plan investment providers.² DOL agreed that where a plan service provider is paid for services provided to the plan, the fact that the payment is made by a plan investment

¹ ERISA §406(b)(3)

² DOL Adv. Op. 97-15A (May 22, 1997); DOL Adv. Op. 97-16 (May 22, 1997).

provider does not render the payment a "kickback."³ In its guidance, DOL noted that a plan fiduciary hiring service providers and approving their receipt of indirect compensation must have "sufficient information" regarding the compensation to make an "informed decision" that the compensation is reasonable, but the guidance was not specific about the required disclosures. For example, DOL indicated that disclosure of the fact that a service provider receives fees from a mutual fund and the "rate" of the fees would be sufficient.⁴

With the door open for indirect compensation, many plan fiduciaries gravitated towards accepting systems of indirect service provider compensation because they either felt that plan participants would be confused by direct account level charges or they liked the fact that as the market loses money, participants pay lower fees because of the asset-based nature of indirect compensation. As 401(k) plans continued their rapid expansion, service provider fees flew largely under the radar until several major scandals put plan fees in the spotlight.

The dawning of a new millennium brought the dramatic collapse of energy giant Enron and turbulence in the equity markets caused by the tech-bubble burst. Both events had a profound effect on 401(k) plans and participant account balances. The plaintiffs' bar was quick to step in and file a number of suits against plan fiduciaries for participant losses, and just as the first cases began to be litigated, New York Attorney General Eliot Spitzer focused on investment industry practices that eventually uncovered the mutual fund late-trading and market timing scandals.

These events drew the attention of regulators to the "imperfect" practices of the investment industry, and practices that had been industry standard for years were called into question by regulators and plaintiffs attorneys alike. The Securities and Exchange Commission issued the Staff Report Concerning Examinations of Select Pension Consultants,⁵ which identified disclosure of fees by pension consultants as an issue of importance,⁵ and DOL quickly followed suit, issuing its own guidance identifying consultant fees and the status of consultants as ERISA fiduciaries as areas of DOL interest.⁶

It was only a matter of time before the plaintiffs' bar, fresh from its recent ERISA litigation experience with the "stock-drop" cases that emerged after the collapse of Enron, jumped into the fray by filing several lawsuits against plans, plan fiduciaries, and service providers. In late 2006 and 2007, a number of lawsuits were filed attacking investment-related fees paid to plan service providers. The complaints specifically targeted revenue

³ The Department noted that plan fiduciaries receiving indirect compensation would be required to offset, on a dollar-for dollar basis, any direct compensation by the amount of the indirect compensation. DOL Adv. Op. 97-15A (May 22, 1997). However, if the service provider is not a fiduciary, an offset is not required. DOL Adv. Op. 97-16A (May 22, 1997).

⁴ DOL Adv. Op. 97-16A (May 22, 1997).

⁵ Staff Report Concerning Examinations of Select Pension Consultants, Securities and Exchange Commission, Office of Compliance Inspections and Examinations (May 16, 2005), *available at* <http://www.sec.gov/news/studies/pensionexamstudy.pdf>.

⁶ Selecting and Monitoring Pension Consultants, Dept. of Labor, Employee Benefits Security Administration (May 31, 2005), *available at* <http://www.dol.gov/ebsa/newsroom/fs053105.html>.

sharing arrangements between plans, investment providers, and plan service providers. The plaintiffs alleged that 401(k) plans had been charged excessive and improper fees and that there had been a failure to disclose fees and “revenue sharing” payments to participants in violation of ERISA. The plaintiffs' basic claim was that plan fiduciaries were not adequately informed about the indirect fees plan service providers received from plan investment alternatives. They also alleged that these fees should have been disclosed to plan fiduciaries.

The 401(k) plan fee issue has also reached the Congressional floor where several competing bills have been proposed. Under the 401(k) Fair Disclosure for Retirement Security Act of 2007, proposed by Representative Miller, plan administrators would have to disclose all fees charged to accounts and potential conflicts of interest to participants and plan sponsors.⁷ Like the Miller Bill, the Defined Contribution Plan Fee Transparency Act of 2007, proposed by Representative Neal, would require new 401(k) fee disclosures.⁸ It would compel plan sponsors to provide participants with additional disclosures regarding plan investments fees and would require service providers to provide fee information to plan administrators in advance of a contract for plan services. Similar legislation sponsored by Senators Harkin and Kohl is also pending in the Senate.⁹

As the plan fee-related litigation winds its way through the justice system and as Congress holds hearings and considers legislation, the DOL reacting to pressure from Congress and the public, has been crafting new rules designed to increase disclosure of indirect compensation arrangements. These new rules are discussed below.

II. What is Happening Now?

A. Form 5500 Changes

All 401(k) plans must file an annual return and report disclosing the financial condition of the plan and detailing its investments and operations. Every year, DOL, the Pension Benefits Guarantee Corporation, and the Internal Revenue Service issue Form 5500, which plans use to fulfill all of their ERISA reporting duties. Schedule C of Form 5500 generally requires plans with more than 100 participants to report compensation paid to plan service providers. For years, the Schedule C instructions have literally required reporting of “indirect” compensation received by plan service providers, including “finder’s fees” and other fees and commissions received in connection with plan transactions. But these fees have typically not been reported.

Recently, DOL issued final regulations and a revised Form 5500 that significantly reformed the reporting and disclosure of indirect compensation on the Schedule C.¹⁰ DOL dramatically revamped and expanded this schedule so that in addition to compensation paid directly by a plan to a service provider, the new Schedule C requires

⁷ H.R. 3185, 110th Cong. § 2 (2007).

⁸ H.R. 3765, 110th Cong. § 2 (2007).

⁹ S. 2473, 110th Cong. § 2 (2007).

¹⁰ 72 Fed. Reg. 64710 (Nov. 16, 2007).

the reporting of "indirect compensation" paid to those who directly or indirectly provide services to the plan. Specifically, the plan administrator must identify all persons receiving \$5,000 or more of total compensation. For each person, the Schedule distinguishes between direct and indirect compensation. The Schedule requires additional information for any service provider receiving more than just "Eligible Indirect Compensation," (defined below) who is a fiduciary or provides contract administrator, consulting, custodial, investment advisory, investment management, broker or recordkeeping services ("Enumerated Provider"). For each Enumerated Provider, the plan administrator must report (1) the name, EIN (or, if none, address) of any source (payor) of \$1,000 or more of indirect compensation, and (2) either the amount, estimated amount, or formula used to calculate the amount of compensation.

DOL adopted an "alternative reporting option" for certain types of indirect compensation. The administrator may report "eligible indirect compensation" under an alternative method that does not require the reporting of exact dollar payments on Schedule C. Eligible Indirect Compensation is (1) fees charged against investment funds and reflected in the value of the investment or return on the investment, finder's fees, float, brokerage, soft dollars, and other transaction-based fees paid for transaction or services involving the plan (whether or not capitalized), (2) for which the required written disclosure was provided to the plan administrator. The written disclosure provided to the administrator must include:

- the existence of the indirect compensation;
- the services provided or purposes of payment;
- the amount of the fee, an estimate of the fee or the formula used to calculate the fee; and
- the identity of the party paying and receiving the fee.

It is expected that existing regulatory disclosures may be used to meet these requirements (e.g., prospectus, Form ADV) if they meet the requirements described above. If a service provider receives only Eligible Indirect Compensation, the administrator need only identify the service provider on the Schedule. However, if the service provider receives both Eligible Indirect Compensation and any other compensation (direct or ineligible indirect), the provider must be identified, but the plan administrator may still rely on the alternative reporting option to report the Eligible Indirect Compensation received by the provider.

All of this seems fairly complicated, and it is. The bottom line is that DOL is intent on ensuring that most forms of indirect compensation are reported. In addition, the reporting requirements are not limited to persons who have a direct service relationship with the plan. Rather, any person who receives direct or indirect compensation or directly or "indirectly" provides services to the plan is covered. This includes, for instance, advisers to mutual funds and many types of subcontractors to plan services providers. Meals, entertainment and gifts received by plan service providers are also viewed as "compensation" for purposes of Schedule C. For those providers who fail to forward to

plan administrators the necessary information, there is a special "tattle tale" provision wherein the administrator reports information about the provider to the DOL.

The final changes to the Form 5500 were published November 16, 2007 and will take effect for plan years beginning after January 1, 2009.

B. Amendments to the Service Provider Exemption

The DOL also recently proposed rules that will require plan service providers to disclose information about fees and compensation they and their affiliates receive before the service provider enters into a contract with an ERISA plan.¹¹ Under ERISA, a plan fiduciary is prohibited from causing a benefit plan to engage certain related parties, known as "parties in interest", to provide services to the plan. Virtually identical prohibitions appear in the Internal Revenue Code (the "Code"). In addition, the Code includes a self-assessing confiscatory excise tax on the "amount involved" in a prohibited transaction. This tax is generally payable by the "party in interest" (although the Code uses the term "disqualified person") who provides the prohibited services to the plan. Since every service provider to a plan is a "party in interest," the only way for a plan to legally engage a service provider and for the service provider to avoid paying an excise tax, is to comply with the terms of a statutory exemption.

The most pertinent exemption, contained in section 408(b)(2) of ERISA, generally requires that the services are necessary for the establishment or operation of the plan, that the compensation paid for the services is reasonable, and that the services arrangement is reasonable.

As proposed, the disclosure requirements would apply to three categories of service providers:

- Service providers who are fiduciaries (either under ERISA § 3(21) or under the Investment Advisers Act of 1940);
- Service providers who provide or may provide banking, consulting, custodial, insurance, investment advisory, investment management, recordkeeping, securities or other investment brokerage or other third party administration services; and
- Service providers who receive or may receive indirect compensation or fees in connection with providing accounting, actuarial, appraisal, auditing, legal or valuation services to a plan pursuant to a contract or arrangement.

The proposed regulations require that service arrangements be in writing and impose an affirmative obligation on service providers to disclose certain information, including the services to be provided, the compensation or fees received by the service provider with respect to each service and the manner of receipt of compensation or fees.

¹¹ The proposed regulatory amendments were published at 72 Fed. Reg. 70988 (Dec. 13, 2007).

The proposed regulations define "compensation or fees" as money or any other thing of monetary value. Under the proposal, gifts, awards, and trips received by a service provider are considered to be received from a plan and must be disclosed.

As in the new Form 5500 Schedule C reporting requirements, the proposal includes special disclosure rules for providers of "bundled" services. A "bundle" is described as a set of services priced as a package, rather than on a service-by-service basis. A bundle may be delivered by more than one service provider, although the responsible plan fiduciary negotiates only with a single service provider. The service provider offering the bundle must disclose the allocation of compensation or fees that are either a separate charge directly against the plan's investment reflected in the net value of the investment or that are fees set on a transaction basis (such as finder's fees, brokerage commissions, and soft dollars). Compensation under a bundled arrangement that does not fit into these two categories does not have to be unbundled or allocated among the service providers in the bundle.

The proposed rule requires additional disclosures focused on potential conflicts of interest, including:

- Whether the service provider will provide services to the plan as a fiduciary;
- Any participation or interest the service provider may have in plan transactions;
- Any material financial, referral or other relationship that creates or may create a conflict of interest for the service provider;
- Whether the service provider will be able to affect its own compensation or fees without prior approval of an independent plan fiduciary; and
- Any policies or procedures in place to address potential conflicts of interest.

In contrast to the recently filed Form 5500 Schedule C rule, which requires disclosure on the annual Form 5500 at the end of the plan year, the proposed service provider exemption regulations require that a service provider disclose the required information prior to entering into a contract or arrangement. The proposed regulation also requires that the written contract include a representation from the service provider that the required information was in fact disclosed before the parties entered into the agreement.

It appears that DOL intends for these regulations to apply directly to persons who don't actually provide "services" to plans, i.e., mutual fund advisers or subcontractors to plan service providers. This is particularly troubling in the context of the 408(b)(2) exemption because as a legal matter, the exemption is only necessary if there is a prohibited transaction, and no prohibited transaction can occur without "services" to a plan by a plan service provider. We expect DOL to clarify this as part of the proposal in the final regulations.

C. Proposed Prohibited Transaction Class Exemption

The DOL also proposed a class exemption from ERISA's prohibited transaction rules that provides relief for a plan fiduciary who enters into, extends, or renews a contract with a plan service provider that fails to provide disclosures in compliance with the new section service provider exemption requirements, provided certain conditions are met.¹²

The relief provided under the exemption would be available to a plan fiduciary only if the fiduciary was not aware of the failure to disclose at the time it occurred and entered into the service arrangement with a reasonable belief that the arrangement met the disclosure requirements. After discovering the failure, the fiduciary must request the missing information in writing. The plan fiduciary is also required to determine whether to terminate or continue the arrangement with the service provider. This determination must be made based on the facts and circumstances and consistent with the fiduciary's duties under ERISA.

The proposed exemption would also place a burden of notification on plan sponsors to help DOL enforce the disclosure requirements in the proposed regulations. If the service provider refuses to disclose the requested information or fails to provide the requested information within 90 days, the fiduciary must notify the DOL of the service provider's failure to disclose. The notice must contain the name of the plan, the three digit plan number used in the plan's annual report, identifying information for the plan sponsor and the service provider, the name and contact information for the plan fiduciary, a description of services provided to the plan, a description of the information the service provider failed to furnish, the date the information was requested in writing, and a statement as to whether the service provider continues to provide services to the plan.

III. How Big a Deal is This?

Having briefly looked at the some of the events and factors that led DOL to issue sweeping new rules and proposals, and at these rules and proposals themselves, it is now possible to consider the potential effect of the new Schedule C and the Department's proposals regarding ERISA section 408(b)(2).

One observation is that the changes are so sweeping that many (indeed most) in the retirement services industry have not yet realized the magnitude of the impact on plans and plan service providers. To begin to get an understanding of what we are in for in the next several years, it may be helpful to list just some of the very fundamental changes occurring through these proposals:

- Plan service providers, even those who are not fiduciaries and therefore are not subject to ERISA's standards of care and of loyalty to ERISA plan participants, now effectively have a legal duty to disclose to their customers virtually all fees and compensation they receive.

¹² 72 Fed. Reg. 70988 (Dec. 13, 2007).

- Non-fiduciary plan service providers also have a legal duty to disclose relationships and financial interests that could place their own economic self-interest in conflict with that of their customers.
- If a service provider and its customer disagree about the scope of the required disclosure, the service provider risks not only losing the customer, but also investigation by the DOL and a self-assessing excise tax (not to mention possible private litigation).
- Any gift, meal or outing received by a plan service provider will be treated as "compensation" paid indirectly by the plans the service provider works for.
- Plan fiduciaries have a duty to know about every company that has a hand in helping to service the plan and must report to the Federal government the names and identifying information of companies that fail to submit certain information to the plan, even where the plan and the company have no contractual relationship.
- Plan fiduciaries who think their service providers have not disclosed specifically mandated information (even if the fiduciary thinks the service provider is doing a good job and the information is unnecessary) must choose between risking having committed a breach of fiduciary duty and causing the plan to engage in a prohibited transaction and applying for an exemption that will require them to identify to the DOL specific information about the service provider and its failure to provide information.

What are plans and service providers doing about this? Some service providers are considering whether to remain in the 401(k) business (the new rules generally do not apply to IRAs, so, for instance, an advisor who already focuses primarily on the IRA market may simply decide not to work with 401(k) plans). Many are gearing up for the required changes as they would for any other regulatory change – identify the legal rules and applying them to operations. Still others are starting to consider whether a completely new approach to services or pricing is called for. For instance, some 401(k) plan recordkeepers may cease to offer unaffiliated investment alternatives. Others may decide to stop accepting certain kinds of indirect payments and instead collect a greater percentage of fees directly from plans. Others may focus attention only on large plans, or only on small plans, where plan fiduciaries may not adopt as aggressive a view of new disclosure requirements. Plan fiduciaries may decide that all forms of indirect compensation are suspect and simply charge plan participants directly for all plan services, and effectively forbid plan service providers from accepting indirect payments.

Of course, the real question is whether, after final rules are announced and implemented, will plan participants be better or worse off?

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