GROOM LAW GROUP

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MEMORANDUM TO CLIENTS

RE: New FAQs re Schedule C Reporting of PBM Compensation

In its ongoing effort to provide guidance to plan sponsors and service providers in completing the revamped Schedule C of the Form 5500, [1] on February 4, 2010, the Department of Labor ("DOL") issued two frequently asked questions that specifically address whether certain direct and indirect compensation earned by pharmacy benefits managers ("PBMs") are reportable for Schedule C purposes (see attached FAQs). Because the DOL's new FAQs are not completely clear, we discussed several open issues with senior officials of the Office of Regulations and Interpretations responsible for the drafting of the new Schedule C. We summarize below the new guidance.

A summary of the key points –

- DOL continues to characterize PBMs as plan service providers (and not simply the providers of drugs).[2]

- Compensation received by a PBM from a plan is reportable as direct compensation and this will include dispensing fees received by the PBM, whether or not the PBM passes these fees through to a network pharmacy.

- DOL has provided meaningful, if perhaps temporary reporting relief, for significant sources of PBM income, including manufacturer rebates and discounts, and its guidance may reasonably be read to extend to certain other indirect compensation received by PBMs.

Direct Compensation

- FAQ 26 confirms that compensation received by a PBM directly from an ERISA plan is reportable on Schedule C as "direct compensation." Specific PBM services for which plan payments would be reportable include recordkeeping, data management and information reporting, formulary management, participant health desk services, benefit education, utilization review, claims adjudication, participant communications, reporting services, website services, prior authorization, clinical programs, pharmacy audits and other services.

- One example of direct compensation cited by DOL is dispensing fees charged by the PBM for each prescription filled by its mail-order pharmacy, specialty pharmacy, or a retail

[1] The two sets of FAQs, including new FAQ 26 and 27 are available on the DOL website, www.dol.gov/ebsa.

[2] DOL stated in the preamble to its proposed regulations under section 408(b)(2) of ERISA that a PBM hired to manage the plan's prescription drug program would qualify as a plan service provider. 72 Fed. Reg. 70988, 70989 (Dec. 13, 2007).

pharmacy in its network. Dispensing fees are typically added to the cost of the drug that is covered by the health plan and, while the fee may be collected by the PBM from the health plan, the fee is often paid to a participating pharmacy rather than retained by the PBM. As such, we had thought that there was a good argument that the fee is not compensation for PBM services, but part of the cost of the drug being purchased by the plan (and a payment to the pharmacy), which is generally treated as medical provider payment rather than an administrative expense potentially reportable on Schedule C. However, in our conversations about this FAQ with DOL, officials confirmed that regardless of the ultimate recipient of the dispensing fee, DOL believes it should be reported as compensation to the PBM, and does not believe that it needs to shown as received by the retail pharmacy.

- In a related point, DOL officials confirmed to us that the Department is aware that PBMs may earn "spread" on dispensing fees (the difference between the dispensing fee the PBM charges the health plan and the dispensing fee the PBM pays a network pharmacy) and apparently does not view the "spread" or "mark up" on dispensing fees as separately reportable compensation to the PBM, but instead views the entire dispensing fee itself as reportable.

- Significantly, FAQ 26 doesn't address the typical arrangement in which a PBM provides services to an ERISA plan as a subcontractor to the plan's TPA. The FAQs leave open the question of whether and how the dispensing or other fees paid by the TPA to the PBM out of the PMPM fee should be reported on the plan's Schedule C.

Indirect Compensation

- DOL gets down to business in FAQ 27, announcing potentially significant reporting relief for certain types of indirect compensation earned by PBMs. DOL explained that "discount and rebate revenue" paid to PBMs by drug manufacturers need not be reported on a plan's Schedule C as indirect compensation pending further guidance while the DOL considers the extent to which they should be reported.

- Margin/Spread: FAQ 27 doesn't specifically identify "margin" or "spread" as non-reportable. A common type of margin compensation is generated when a PBM guarantees an ERISA plan a specific price for a specific drug (e.g., AWP-14% for brand name drugs), but negotiates deeper discounts with its network pharmacies (e.g., AWP-16% for brand name drugs). To the extent that there is a difference (spread) between the price paid by the plan to the PBM and the price the PBM pays to the pharmacy, the PBM may keep that difference. The FAQ provides relief for "discounts from pharmaceutical manufacturers," and states that "discount and rebate revenue received by PBMs from pharmaceutical companies" need not be reported on Schedule C until further notice, but it does not clearly address margin that is unrelated to drug company rebates or discounts. When we asked DOL if it intended to cover this type of margin compensation, officials stated informally that FAQ 27 was intended to cover a broad range of indirect compensation retained by PBMs and that it supports the non-

reporting of margin compensation. Further, DOL pointed to prior DOL Schedule C guidance as consistent with not reporting margin compensation.[3]

- Like FAQ 26, FAQ 27 does not address arrangements under which the PBM acts as a subcontractor to a TPA. In such cases, the PBM may pay all or a portion of the drug rebates it receives to the TPA, creating the issue of the extent to which these rebates would be reportable compensation to the TPA. The DOL officials with whom we spoke had not been aware that TPAs often receive some or all of the PBM's drug rebates in connection with an ERISA plan's business. So, at this point, the Department's position on the reporting required in this situation is unclear.

- Although welcome, the relief under FAQ 27 comes with three caveats -

    1. Rebate and discount income (including earnings on rebates and discounts held by the PBM) would be reportable indirect compensation if the plan and the PBM agree that such revenue is used to compensate the PBM for managing the plan's prescription drug coverage, dispensing prescriptions or providing other services. We understand that, for a variety of reasons, including a desire to avoid fiduciary status, many PBMs include language to this effect in their agreements today.

    2. The relief might be temporary -- it is available "in the absence of further guidance," while DOL considers the extent to which they may be classified as compensation in connection with plan services. DOL could change its reporting position later.

    3. At the end of Q27, DOL explicitly limits the guidance to Schedule C reporting and provides that "nothing in this answer should be read as expressing a view on the application of any other provision of Title I of ERISA." DOL could be referring to applying ERISA's prohibited transaction provisions (such as the anti-kickback rule) and the statutory exemption for services, section 408(b)(2), to PBM services arrangements.[4]

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[3] In Q23 from DOL's 2008 list of FAQs, DOL concluded that spread earned by a securities broker on principal transactions involving ERISA plans would not be eligible indirect compensation. DOL's reference to Q23 in this context supports the conclusion that, in Q23, DOL concluded that spread is not only not eligible indirect compensation, it is not compensation at all. In any event, it is surprising to us that the DOL would view this guidance as a basis for not reporting margin in connection with retail pharmacy prescription sales. First, profit on a sale from a broker's own inventory is distinguishable from retail pharmacy spread because the PBM never takes legal title to drugs sold by retail pharmacies. Moreover, Q23 appears narrowly drafted to address spread on securities transactions and to conform with securities rules. Nonetheless, DOL made clear that DOL views Q23 as expressing its view that mark up or margin on the sale of goods in connection with a services arrangement is not reportable on Schedule C.

[4] Department officials have recently indicated in public speeches that the final section 408(b)(2) regulations expected out shortly will not cover welfare plans and that the Department will instead develop a separate regulation for these plans.

A Reminder About Another Important Reporting Exception

Keep in mind that the Schedule C need not be filed by plans that meet the conditions of DOL regulation 29 C.F.R. § 2510.104-44, including certain section 125 "cafeteria plans" plans subject to DOL's Technical Release 92-1. Many large and small plans are maintained as cafeteria plans (providing for pre-tax contributions by employees) and these plans will not be required to deal with these difficult Schedule C reporting issues.

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If you have any questions about the new guidance or other aspects of the Form 5500, please contact your regular Groom contact or any of the attorneys listed below:

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TEXT OF NEW FAQS

Q26: Pharmacy Benefit Managers (PBMs) provide services to plans and are compensated for these services in various ways. How should this compensation be reported?

PBMs often act as third party administrators for ERISA plan prescription drug programs and perform many activities to manage their clients' prescription drug insurance coverage. They are generally engaged to be responsible for processing and paying prescription drug claims. They can also be engaged to develop and maintain the plan's formulary and assemble networks of retail pharmacies that a plan sponsor's members can use to fill prescriptions. PBMs receive fees for these services that are reportable compensation for Schedule C purposes. For example, dispensing fees charged by the PBM for each prescription filled by its mail-order pharmacy, specialty pharmacy, or a pharmacy that is a member of the PBM's retail network and paid with plan assets would be reportable as direct compensation. Likewise, administrative fees paid with plan assets, whether or not reflected as part of the dispensing fee, would be reportable direct compensation on the Schedule C. Payments by the plan or payments by the plan sponsor that are reimbursed by the plan for ancillary administrative services such as recordkeeping, data management and information reporting, formulary management, participant health desk service, benefit education, utilization review, claims adjudication, participant communications, reporting services, website services, prior authorization, clinical programs, pharmacy audits, and other services would also be reportable direct compensation.

Q27: PBMs may receive rebates or discounts from the pharmaceutical manufacturers based on the amount of drugs a PBM purchases or other factors. Do such rebates and discounts need to be reported as indirect compensation on Schedule C?

Because formulary listings will affect a drug's sales, pharmaceutical manufacturers compete to ensure that their products are included on PBM formularies. For example, PBMs often negotiate discounts and rebates with drug manufacturers based on the drugs bought and sold by PBMs or dispensed under ERISA plans administered by a PBM. These discounts and rebates go under various names, for example, "formulary payments" to obtain formulary status and "market-share payments" to encourage PBMs to dispense particular drugs. The Department is currently considering the extent to which PBM discount and rebate revenue attributable to a PBM's business with ERISA plans may properly be classified as compensation related to services provided to the plans. Thus, in the absence of further guidance from the Department, discount and rebate revenue received by PBMs from pharmaceutical companies generally do not need to be treated as reportable indirect compensation for Schedule C purposes, even if the discount or rebate may be based in part of the quantity of drugs dispensed under ERISA plans administered by the PBM. If, however, the plan and the PBM agree that such rebates or discounts (or earnings on rebates and discounts held by the PBM) would be used to compensate the PBM for managing the plan's prescription drug coverage, dispensing prescriptions or other administrative and ancillary services, that revenue would be reportable indirect compensation notwithstanding that the funds were derived from rebates or discounts.

This guidance is for Schedule C reporting purposes only. Nothing in this answer should be read as expressing a view on the application of any other provision of Title I of ERISA.