GROOM LAW GROUP

MEMORANDUM TO CLIENTS

October 30, 2009

RE: DOL Issues Supplemental FAQs About the 2009 Schedule C

On October 23, 2009, the Department of Labor's Employee Benefits Security Administration ("DOL") published on its website much anticipated supplemental "FAQs" addressing the 2009 Form 5500 Schedule C reporting rules (available at http://www.dol.gov/ebsa/faqs/faq-sch-C-supplement.html) ("2009 FAQs"). The new FAQs supplement FAQs issued by DOL in July 2008 ("2008 FAQs") and the final amendments to regulations, forms and instructions governing the Schedule C, which were published in November 2007. We discuss the new guidance below.

Investment Fees: In the new FAQs, DOL addressed the reporting of a number of investment-related fees:

- "Market value adjustments or similar surrender or termination charges that are adjustments to the value of the investment in accordance with the contract would not be reportable compensation for Schedule C purposes where the market value adjustment or surrender charge reflects only the contractual difference in the value of the plan's investment *because it was not held for the stated duration of the contract*." (Q 11).

- Contingent deferred sales charges (*e.g.*, back-end or deferred sales loads) charged on the redemption of mutual fund shares or other investments are reportable compensation. The compensation is "direct" when paid by the plan or charged to the plan's or participant's account and "indirect" when charged against an investment fund and reflected in the value of the plan's interest in the fund. The same treatment would apply to mutual fund exchange fees, account fees or purchase fees. While reportable, these fees could qualify as eligible indirect compensation ("EIC") if the required disclosures are made. (Q 11)

- Redemption fees charged by mutual funds under Rule 22c-2 and similar fees imposed by other investment funds to discourage short-term trading are not reportable compensation *to the extent that they are returned directly to the investment fund itself*. (Q 12).

- General Account Contracts: The cost and expenses associated with an insurance company general account investment contract are not reportable compensation if the investment contract is not combined with any plan services. (Q 9) DOL contrasted this type of contract with the contract described in 2008 FAQ 22, under which the crediting rate was reduced to pay for "plan recordkeeping, trusteeship, and similar services." However, in the new FAQ, DOL cautioned that reporting could not be avoided simply by incorporating compensation for plan services into the crediting rate on the investment. And, commissions and other payments to agents, brokers and others in connection with the placement or retention of the contract would be reportable (either on Schedule A or Schedule C) even if characterized as part of the contract's "mortality and expense" charge used to establish a crediting rate.

- Hedge Funds v. Operating Companies: For Schedule C reporting, persons who manage hedge funds and other investment funds in which plans invest are treated as indirectly providing services to their investor plans, whether or not the investment fund "holds plan assets." In new Q 6, DOL confirmed the reporting distinction it drew in 2008 FAQ 7 between "operating companies" and investment funds that avoid plan assets status in some other way. The only investment funds not subject to Schedule C reporting are "operating companies," including VCOCs and REOCs. Thus, even though not directly subject to ERISA, the manager of a hedge fund that limits benefit plan investment to less than 25% or a mutual fund that doesn't hold plan assets will receive reportable compensation. Consistent with 2008 FAQ 4, DOL did note that not all amounts paid by an investment fund would be reportable "compensation." For example, property management fees paid by the real estate fund in connection with underlying properties could be viewed as non-reportable ordinary operating expenses.

Other Types of "Reportable Compensation":

- Look-Through Vehicles: In Q 5, DOL addressed how far the plan administrator must "look through" the plan's investment funds to identify reportable fees. It concluded that where an investment fund (a "top tier fund") invests in another fund ("lower tier fund"), fees received by persons at the lower tier fund level in connection with the investment of the top tier fund are not reportable compensation for Schedule C purposes. This "pass" on lower tier fund reporting is not available where "the top tier fund is a separately managed account that contains assets of an individual plan, a master trust, or is merely a vehicle through which participants in a participant directed plan make investments in lower tier funds." It appears that the exception for lower tier fees is not available where the top tier fund is really not a separate investment fund but instead is a vehicle for investment in a lower tier fund. DOL also confirmed in Q 5 that, even if the lower tier fees are not reportable, payments *received* by top tier fund persons from lower tier fund persons in connection with the ERISA plan's investment are potentially reportable.

- "Chains" of Providers: In Q 7 and Q 8, DOL discusses how indirect compensation is reported when that compensation may flow through a "chain" of service providers, using the concept of a "conduit." For example, if a recordkeeper receives a 12b-1 or other fee disclosed in a mutual fund prospectus, the fact that the fee flows though a "conduit" mutual fund agent would not prevent the fee from being treated as EIC received by the recordkeeper. In addition, so long as the mutual fund agent is merely a conduit for transmission of the fees to the ultimate recipient, *i.e.*, the recordkeeper, the mutual fund agent would not receive compensation reportable for Schedule C purposes. On the other hand, when service providers receive revenue sharing or other indirect compensation and pass on some of that compensation to another person, both recipients in the chain may receive reportable compensation for Schedule C purposes. For example, if a broker receives 12b-1 fees and then pays a portion to the recordkeeper, both the broker and recordkeeper would include amounts received in their total indirect compensation, and the fee received by the recordkeeper would not be treated as EIC.

- "ERISA budgets" or "fee recapture accounts" offered by 401(k) plan recordkeepers are becoming more common. In Q 13, DOL discusses how to report fees paid through fee recapture accounts or ERISA budgets on Schedule C, using two scenarios. First, DOL confirms that if a recordkeeper (merely serving as a conduit) deposits the revenue sharing it receives on behalf of the plan in the plan's trust account, the amounts deposited to the plan need not be reported as compensation received by the recordkeeper, and payments made from amounts deposited to the plan are treated as "direct" payments to the recipient on Schedule C. Amounts retained by the recordkeeper must be reported as indirect compensation, and if the recordkeeper is paid by a combination of revenue sharing received from investment funds and direct plan payments, the Schedule C would show the recordkeeper as receiving both direct and indirect compensation (Q 14). Alternatively, a recordkeeper may not deposit any revenue sharing into the plan's trust account but instead establishes a "budget"' or recordkeeping account and pays other plan providers up to the budgeted amount. Amounts paid by the recordkeeper to other plan providers from the "budget" should be reported as indirect compensation to those providers. DOL did not specifically address in Q 13 whether the recordkeeper's reportable indirect compensation should include the entire amount allocated to the budget, or only that portion of the revenue sharing that the recordkeeper ultimately retains. In other contexts (*e.g.*, Q 8), DOL has been untroubled by "double counting" of compensation paid through a "chain" of plan service providers, so it is possible that DOL expects that revenue sharing received by a recordkeeper and allocated to an "outside-the plan" ERISA budget should be reported differently than the revenue sharing immediately deposited by a recordkeeper into the trust, even though, in both scenarios the recordkeeper ultimately retains none of the payment for its own account.

Eligible Indirect Compensation: The 2009 FAQs provide additional guidance on the alternative reporting option for "eligible indirect compensation" (EIC). Indirect compensation will be treated as EIC if the required disclosures are provided to the plan administrator *and* the compensation is (a) charged against the investment fund and reflected in its value, or (b) "transaction-based," or (c) one of the following: finders fees, soft dollar revenue, float revenue or brokerage commissions.

- Charged Against the Investment Fund: As noted, Q 7 discusses the concept of a "conduit" for purposes of the EIC rule. Specifically, DOL stated that it would treat fees disclosed in a mutual fund prospectus, such 12b-1, shareholder servicing or sub-TA fees, received by a plan recordkeeper as charged against the mutual fund and reflected in the value of the plan's shares and thus EIC, and the fact that these amounts might flow through a "conduit mutual fund agent" would not prevent the fee from being treated as EIC. With this explanation, DOL softened somewhat its position in 2008 FAQ 8, which suggested that amounts received by a recordkeeper through fund agents could not be treated as EIC. However, the new Q 7 may not significantly improve a recordkeeper's ability to rely on the EIC reporting alternative for revenue sharing because Q 7 also states that that a "revenue sharing" payment received by a recordkeeper from a broker would not be EIC simply because it has its source in 12b-1 fees received by the broker. Accordingly, it may be that the "conduit" analysis in Q 7 is available only if the entire 12b-1 fee or other fee as stated in the mutual fund prospectus is paid over to the recordkeeper by the conduit mutual fund agent. However, in many cases the fee received by a recordkeeper may be derived from a 12b-1 fee or other fee described in a prospectus, but it is a different amount than the amount described in the prospectus.

- <u>Disclosure Deadline</u>: DOL confirmed that there is no specific deadline for the provision of the required EIC disclosures to the plan administrator, but that the disclosure should be made sufficiently in advance of the plan's filing so that the administrator may review it and determine whether the EIC exception is available. Note that banks, insurance companies and plan sponsors have long-standing special deadlines under DOL regulations (within 120 days of the end of the plan year) for providing Form 5500 information to plan administrators. (Q 17)

- <u>Scope of Disclosure</u>: In the new FAQs, DOL reiterated that reliance on the EIC exception requires complete disclosure, which must be received by the plan administrator. For example, soft dollar disclosure meeting applicable securities law requirements will not satisfy the EIC rule unless it contains the required EIC elements, including identification of each broker that pays soft dollars and the formula or criteria for the payment. (Q 22) Also, DOL states that sending broker confirmations to participants who use a self-directed brokerage window (rather than to the plan administrator) will not satisfy the EIC disclosure requirements (Q 20). Lastly, a provider's EIC disclosure must include a description of the services provided and must provide the formula or estimate of compensation by source of payment. It would not be sufficient, for example, for a broker that receives 12b-1 fees from multiple investment funds to simply disclose a fee range for those funds (*e.g.*, 25-45 basis points from all funds or up to $15 per position). DOL did confirm that, where the fees paid by one fund vary over time, it may be permissible to use a range for that fund. (Q 21)

<u>Bundled Arrangements</u>: In the 2009 Schedule C Instructions and the 2008 FAQs, DOL provided a special reporting exception for certain payments among providers in a "bundled services" arrangements. A "bundle" includes any service arrangement where the plan hires one company to provide a range of services either directly from the company, through affiliates or subcontractors, or through a combination, which are priced to the plan as a single package rather than on a service-by-service basis. Direct payments by the plan to a bundled service provider are reported as direct compensation to the bundled service provider. However, the plan's payments do not need to be allocated among affiliates and subcontractors in the bundle and also reported as indirect compensation to them unless (1) the payment is a commission or other transaction-based fee, a finder's fee, float, and other non-monetary compensation received by a recordkeeper, contract administrator or other key provider or (2) the fee is charged against the assets of an investment fund and reduces the fund's rate of return. A transaction-based fee or a fee charged against an investment fund must be separately reported regardless of whether it is earned within a bundled arrangement. 72 Fed. Reg. at 64826; 2008 FAQ 14.

- A number of questions have arisen regarding the "bundle" rule. For example, does it technically require a sub-contracting relationships or is an "alliance" eligible for the bundle rule? Does a bundle exist where the provider contracting with the plan provides a single service to the plan (i.e., investment management) which it then sub-contracts to a third party? Does the plan provider create a bundle when it doesn't contract with the plan to provide a service but instead provides "access" to the services of others?

- In 2009 Q 16, DOL provided an example of an "alliance" under which Provider A includes "access to the Provider B [participant advice] program" in the services it provides to a plan for its $5,000 fee. Provider A pays a flat fee of $20,000 to Provider B, which is unaffected by whether any of its client plans use Provider B's service and $1,000 for each plan that does. DOL concluded that the $1,000 that Provider A pays to Provider B need not be separately treated as indirect compensation to Provider B, if the access to the Provider B service is described as part of a bundle. Presumably, DOL believed that a bundle may be found in this arrangement, even though the arrangement is described as an "alliance" rather than a sub-contracting relationship, and the bundled provider provides "access" to another service provider but is not responsible itself for those services.

- While DOL didn't specifically state in Q 16 that the $20,000 flat fee was not reportable as received by Provider B, it did state that "assuming Provider B does not receive any other direct or indirect compensation related to Plan Z, Provider B would not be required to be separately listed on Plan Z's Schedule C." Had DOL thought the $20,000 to be reportable, we would have expected it to explain why. There are two grounds on which this payment might be excepted from reporting: (1) it is part of a bundle and is not transaction-based, or (2) it was not allocable to any particular plan in the first place because not paid in connection with Provider B's position with the plan or services provided to a plan. Unfortunately, DOL does not describe how fees in this type of alliance arrangement would be reported if the arrangement is not a bundle for Schedule C reporting purposes (or if the recordkeeper does not wish to rely on the bundled reporting exception), so it is impossible to know whether the $20,000 (as well as the $1,000) payment would be reportable if the bundled reporting exception is not applied.

<u>Gifts & Entertainment</u>: DOL made clear in the 2009 Schedule C Instructions that gifts and entertainment could constitute non-monetary compensation reportable on Schedule C and provided rules and exceptions for reporting gifts and entertainment. The 2008 FAQs addressed gifts and entertainment. 2008 FAQs, Q 33, 34 and 35. In the 2009 FAQs, DOL provided further guidance –

- The Instructions established a $10 de minimis exception for non-monetary gifts or entertainment. According to DOL, "traditional" promotional gifts with a company logo (*e.g.*, a coffee mug, calendars, trophies) generally may be treated as having a value of $10 or less, and therefore need not be included in calculating the value of gifts received for Form 5500 reporting purposes. Nonetheless, DOL cautioned that an item whose value would "clearly" exceed $10 would not qualify for the reporting exception merely because it carries a company logo. (Q 2)

- One of the biggest challenges under the 2009 Schedule C is determining when gifts (including meals and entertainment) provided to a plan provider or official are reportable on Schedule C. In 2008 FAQ 35, DOL stated that where the eligibility for or amount of a gift is based on a book of business, including ERISA plans, a pro rata share of the gift is reportable to the ERISA plans. DOL discussed a holiday gift basket provided by a broker to a manager with whom it had a business relationship and suggested that the value of the gift had to be allocated to the manager's small percentage of ERISA plan clients for reporting purposes. subject to the de minimis rule. In new Q 3, DOL revisited the issue, stating that not all business meals and entertainment received by persons who have business relationships with ERISA plans are compensation to the recipient for Schedule C purposes. "[I]f the eligibility for the invitation or the value of gifts provided is not based, in whole or in part" on whether the recipient "does business with ERISA plans or on the value or amount of business conducted that includes ERISA covered plans," the gift is not compensation. This standard suggests that if a gift is provided to a recipient without regard to whether (or how much) it services ERISA plans, it may not be reportable. DOL provided two potentially significant examples of non-reportable gifts: (1) if an investment provider hosts a hospitality suite at an *ERISA* conference and invites all attendees to the suite, the value of the entertainment is not reportable to the people who visit simply because they may hold a plan position or provide services to the plan, and (2) if a broker invites employees of an investment manager to a conference it is hosting (and pays their travel, lodging and meals), these expenses are not compensation to the manager or its employees so long as their eligibility for the invitation is not based, in whole or in part, on whether they do business with ERISA plans or the value of that business. (Q 3)

- In 2009 Q4, DOL confirmed that if a service provider pays expenses of a plan official to attend an educational conference, the expenses may be "reportable" compensation to the recipient for Schedule C purposes. However, DOL extended to the Schedule C the "educational conference" exception that it recently adopted for fiduciary conflicts. (See DOL Enforcement Manual, Chapter 48, sec. 12.) Educational expenses need not be reported on Schedule C if a plan fiduciary other than the recipient determines in advance and in writing that, among other things, the plan could prudently pay the expenses of the recipient's attendance. This would presumably require a determination that the recipient's attendance at the conference would be in the plan's interest.

"Nuts and Bolts"- Completing the Form

- A recordkeeper may receive, and should report, both indirect compensation (*i.e.*, revenue sharing) and direct compensation (*i.e*., hard dollar fees). (Q 14)

- If a provider is required to be identified on line 2 or 3 of Part I of Schedule C, appropriate codes must be assigned to the services it provides and the compensation it receives (e.g., 16 – consulting, 50 –direct plan payments, 62 - float). Especially for those who provide multiple services, assigning the codes can be tricky. In Q 15, DOL indicated that it will not reject a plan's Form 5500 simply because it might have used a different service or fee code, provided that a "reasonable good faith effort" was used to select the code.

- If a provider is required to be identified on Part I, line 2, either the provider's EIN or its address must be provided. In Q 18, DOL stated that, where the provider is part of an affiliated group of companies, the parent's EIN may be used on the Schedule C so long the same EIN is used for that provider across all schedules and years.

- Fees and expenses relating to assets invested in a master trust investment account ("MTIA") may be reported on the Schedule C for the MTIA and, if reported there, need not also be reported on the plan's Schedule C (Q 19). DOL recognized that a single master trust may have more than one MTIA filing, and cautioned that the fees expenses must be properly allocated among the MTIAs for both reporting and payment purposes.

- Under the transition rule described in 2008 FAQ 40, for 2009 only, plan administrators are not required to identify service providers on Part II, line 4 as failing to provide Schedule C information if the plan administrator receives a statement from the provider that it made a good faith effort to timely modify its systems to gather the information, and despite such efforts, the provider was unable to complete the necessary systems changes. In new Q 10, DOL confirmed that it will not reject the Form 5500 filing or impose penalties on a plan that has failed to include compensation information relating to a provider that has provided the "good faith" statements described in 2008 FAQ 40. DOL does expect the provider to provide the information that it is able to collect. DOL also expects a plan administrator who receives a good faith statement to inquire of the provider as to the steps it is taking to ensure that the provider can provide the information for future Schedules C.

We are continuing to review the new FAQs, particularly how they may advance or hinder positions taken to date on some of the more difficult reporting issues. Please call us if you have questions or comments. We look forward to hearing from you.

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Please call one of the following, or the Groom attorney you regularly contact, if you have any questions about this or any other matter.

Jenny Eller	jeller@groom.com	(202) 861-6604
Steve Saxon	ssaxon@groom.com	(202) 861-6609
Andrée St. Martin	astmartin@groom.com	(202) 861-6642
Roberta Ufford	rufford@groom.com	(202) 861-6643