IRALERT

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TO: IRA Group Distribution

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RE: Proposed Service Provider Exemption Regulations

The Department of Labor ("DOL") recently published proposed revisions to its regulations under section 408(b)(2) of ERISA ("Proposed Regulations"), which would broadly require that certain service providers to ERISA plans disclose direct and indirect compensation they receive in connection with providing services. 72 Fed. Reg. 70988 (Dec. 13, 2007). The agency also proposed a new class exemption which would relieve plan fiduciaries of prohibited transaction liability in connection with hiring a service provider where the new requirements are not met ("Proposed Class Exemption"). 72 Fed. Reg. 70893 (December 13, 2007). We have confirmed with DOL staff that the Proposed Regulations presently are ***not*** intended to apply to IRAs and other non-ERISA Code section 4975 plans, but whether this will remain the case is not entirely certain.

Proposed Regulations

Section 406(a)(1)(C) prohibits plan fiduciaries from entering into services arrangements with "parties in interest," and section 408(b)(2) provides a "statutory exemption" that allows services arrangements to occur between ERISA plans and parties in interest if its conditions are met. The conditions imposed by section 408(b)(2) requires that: (1) services arrangements be reasonable; (2) services be necessary for the establishment or operation of the plan; and (3) the ERISA plan pays no more than reasonable compensation for the services.

The DOL issued regulations under section 408(b)(2) back in 1977, and it is these regulations which are being revised. In particular, 29 C.F.R. § 2550.408b-2(c), which defines "reasonable contract or arrangement" is being significantly rewritten. Currently, the operative language focuses only on ensuring that contracts with ERISA plans do not include penalties or other provisions that lock ERISA plans into disadvantageous contractual relationships. The regulations do not require the disclosure of fee terms, and make no reference to the disclosure of indirect compensation that is commonly retained by service providers in connection with plan services in today's marketplace.

The proposed changes would re-interpret the requirements of what is a "reasonable contract or reasonable arrangement" by requiring that certain types of service provider contracts include a variety of new disclosures. The Proposed Regulations focus on the disclosure of fees as well as the disclosure of conflicts of interest. As relevant here, the types of contracts covered would include most financial services arrangements.

Simultaneously, DOL released the Proposed Class Exemption to provide relief for a plan fiduciary who enters into, extends, or renews a contract with a plan service provider who fails to provide disclosures in compliance with the new requirements of the Proposed Regulations, if certain conditions are met. (This would protect hiring fiduciaries from secondary liability and breaches of fiduciary duty.) The relief would be available to a hiring fiduciary as long as the fiduciary was not aware of the failure to disclose at the time it occurred and entered into the services arrangement with a reasonable belief that the arrangement met the disclosure requirements. After discovering the failure, the hiring fiduciary must request the missing information in writing. The hiring 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 hiring fiduciary's duties under ERISA section 404(a).

The proposed exemption also requires a hiring fiduciary to notify DOL if the service provider refuses or fails to provide the requested information within 90 days. Among other things, the notification must identify the plan, the plan sponsor, the service provider and the information the service provider failed to furnish.

Application of the Proposed Regulation to IRAs

IRAs (other than SEPs and SIMPLEs) generally are not subject to the prohibited transaction rules of ERISA section 406(a). They are, however, subject to the parallel prohibited transaction excise tax rules in section 4975 of the Internal Revenue Code of 1986, as amended (the "Code"), including a parallel service provider exemption in section 4975(d)(2).

In 1977, concurrent with DOL's 408(b)(2) regulations, the Treasury Department issued mirror regulations under section 4975. Subsequently, pursuant to Reorganization Plan No. 4 of 1978, jurisdiction to interpret Code section 4975(d)(2) – and to issue regulations thereunder – was transferred to DOL. Although it appears to have authority to do so, DOL has ***not*** proposed to amend the section 4975 regulations at this time. Nonetheless, the preamble to the Proposed Class Exemption notes that a failure to comply with the Proposed Regulations would result in a prohibited transaction under the Code because the transaction would not satisfy the parallel requirements of Code section 4975. How DOL can reach this conclusion is not clear, nor is it clear how DOL could "interpret" the existing section 4975 regulations to impose new disclosure obligations on ERISA plans – but ***not*** extend that same analysis to IRAs. Nonetheless, DOL staff informally have suggested to us that it is precisely their intent to interpret section 4975 to impose excise tax penalties on transactions with ERISA plans that violate the Proposed Regulations, while at the same time leaving IRAs and other non-ERISA plans under the old rules.

Discussion

We suspect that DOL may come under pressure to rethink its position and formally propose changes to the section 4975 regulations. It has already been suggested that DOL has no authority simply to "re-interpret" the existing section 4975 regulations without following proper notice-and-comment rulemaking procedures. If DOL *does* work with Treasury and propose formal amendments to the section 4975 regulations, staff members have implied that they might not retain the distinction between ERISA and non-ERISA plans, whether to create certainty, to avoid controversy, or to head off some of the potential legislative disclosure "fixes" that are pending on Capitol Hill. It is also possible that – absent a clear statement of intent by DOL to treat IRAs differently from ERISA plans – a court might seize on DOL's interpretation of what is "reasonable" in the ERISA context and extend it to IRAs.

Although some service providers may find it administratively convenient to provide identical disclosures to both IRA and 401(k) plan customers, we anticipate that in most cases extending the Proposed Regulations to IRAs would be enormously burdensome both for the financial institution and for its IRA customers. Thus, financial institutions with large IRA customer bases should carefully monitor developments and may wish to comment on the Propose Regulations. Comments are due by February 11, 2008.