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EBEC (Employee Benefits / Executive Compensation) Law Update

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SUMMARY OF FOUR DIFFERENT RULES (OR PROPOSED RULES) RELATING TO 401(K) FEE DISCLOSURE OR INVESTMENT ADVICE GUIDANCE

Recent guidance – some proposed and some final – relate to 401(k) plan fee disclosure and investment advice, as described further below:

- Service provider disclosure on Form 5500 Schedule C is now required for both direct and indirect compensation. This became effective with the 5500s for the 2009 plan years.
- Fee disclosure by service providers to responsible plan fiduciaries to show reasonableness of contract (required by service-provider exemption of ERISA § 408(b)(2)) as specified in interim final DOL regulations published in July of this year will become effective July 16, 2011.
- Fee disclosure by fiduciaries to participants for participant-directed 401(k) plans regarding investment options with a comparative chart of investment options and with the administrative expenses of each option is required under DOL regulations proposed in July 2008 and finalized in Oct. 2010.
- Regulations regarding investment advice arrangements that are permitted by the Pension Protection Act where there is level-fee or computer model arrangements have been repropose in March 2010. They were originally finalized in January 2009 but were later withdrawn. The repropose regulations are similar to the original regulations but with certain changes as described below.

1. Schedule C Service Provider Reporting – Effective for 2009 Plan Years

Final guidance for revised Form 5500 Schedule C disclosure provides for expanded requirements for service providers reporting of direct and indirect compensation, and requires fiduciaries to review and approve expenses, effective for 5500s relating to plan years beginning in 2009.

- For Schedule C purposes, reportable compensation includes cash and any other items of value (e.g., gifts or awards) received from the plan (including fees charged as a percentage of assets and deducted from investment returns) in connection with services rendered to the plan.

- Indirect compensation is compensation received from sources other than the plan or plan sponsor, in connection with services rendered to the plan, and would include, for example, fees and expense reimbursement payments received from a mutual fund, account maintenance fees, 12b–1 distribution fees, etc.¹

2. Fee Disclosure for Service Providers – Interim Final Regulations Effective July 16, 2011

ERISA § 406 generally prohibits transactions between an ERISA plan and a party in interest. A service provider to a plan would be a party in interest, making the arrangement a prohibited transaction. However, under the service-provider exception, ERISA § 408(b)(2) exempts service contracts or arrangements between a plan and a party in interest if (i) the contract or arrangement is reasonable, (ii) the services are necessary for the establishment or operation of the plan, and (iii) no more than reasonable compensation is paid for the services.²

DOL regulations § 2550.408b-2, proposed in December 2007³ and substantially revised as interim regulations in July 2010⁴ amends DOL Reg. § 2550.408b–2 to clarify the meaning of a “reasonable” contract or arrangement.

Under the interim DOL regulations, to be a reasonable contract, a “covered service provider” (as defined below) must disclose in writing to the “responsible plan fiduciary” (the fiduciary with authority to cause the plan to enter into or renew the contract) certain information.

- This disclosure is in order for the fiduciary to be able to determine that the services are reasonable.

A “covered service provider” is a service provider that enters into a contract or arrangement with a covered plan (which is defined as an ERISA pension plan) and reasonably expects \$1,000 or more in direct or indirect compensation to be received in connection with providing certain enumerated services, which are services provided as a fiduciary to an investment contract, product or other entity holding plan assets, services provided as an investment advisor to the plan, certain recordkeeping and brokerage services and other services for which service provider, affiliate or subcontractor expect to receive indirect compensation. DOL Reg. § 2550.408b-2(c)(1)(iii).

The disclosure must describe:

¹ [72 Fed. Reg. 64710](#) (Nov. 16, 2007), amending DOL Reg. §§ 2520.103-1 & 2520.104-46.

Note that the various references to regulations or proposed regulations in the footnotes below are hyperlinked to the original texts in the Federal Register.

² A related rule also added by the Pension Protection Act of 2006 adds ERISA § 408(b)(17) provides that if a person is a party-in-interest solely by reason of providing services to the plan, and is not an investment advisor to the plan, then transactions under ERISA § 406(a)(i)(A), (B) or (D) (sale, exchange, lease or loan) will not be prohibited, so long as the plan pays no more than, and receives no less than adequate consideration. There are currently no regulations regarding § 408(b)(17).

³ [72 Fed. Reg. 70988](#) (Dec 13, 2007). The proposed regulations had been put on hold in connection with President Obama’s January 2009 sixty day regulatory moratorium for proposed regulations and regulations not yet effective. [74 Fed. Reg. 4435](#) (Jan. 26, 2009).

⁴ [75 Fed. Reg. 41600](#) (July 16, 2010).

- services to be provided (but not including non-fiduciary services to an investment contract or plan investment);
- if applicable, status as a fiduciary or investment advisor;
- any direct or indirect compensation the service provider, affiliate, or subcontractor expects to receive, or in certain cases any compensation that will be paid between the service provider, affiliate and a subcontractor in connection with the services (e.g., bundled services such as commissions, 12b-1 fees, soft dollar fees, etc.);
- compensation expected in connection with termination of the contract;
- with regard to recordkeeping services a description of direct and indirect compensation that is expected to be received;
- whether the plan will be billed or the compensation will be deducted directly from the plan's individual accounts;
- for fiduciary service providers with respect to plan assets, any compensation that will be charged directly against the amount invested in connection with the acquisition, sale, or withdrawal of the investment (e.g., sales charges, loads, redemption fees, surrender charges, etc.) and operating expenses; and
- for certain recordkeeping and brokerage services with respect to each designated investment alternative, current accurate disclosure materials of the issuer of the designated investment alternative that includes the information in the previous bullet.⁵

The service provider must disclose any additional information relating to compensation to the responsible plan fiduciary within the following time periods: (i) reasonably in advance of the date of contract or renewed, (ii) within 30 days of when the investment holds plan assets, and (iii) as soon as an investment alternative is designated.⁶ Changes in the disclosed information must be communicated no later than 60 days from the date of change.⁷

Upon request, the service provider must furnish other information relating to the compensation received in connection with the contract.⁸ Good faith errors or omission in disclosing the information required will not cause there to be a failure, as long as the service provider discloses the correct information as soon as practicable and no later than 30 days after the service provider knows of such error or omission.⁹

⁵ DOL Reg. § 2550.408b-2(c)(1)(iv).

⁶ DOL Reg. § 2550.408b-2(c)(1)(v).

⁷ Id.

⁸ DOL Reg. § 2550.408b-2(c)(1)(vi).

⁹ DOL Reg. § 2550.408b-2(c)(1)(vii).

There is an exemption in the form of a prohibited transaction class exemption, and also incorporated into the interim regulations, for the responsible plan fiduciary from the prohibited transaction restrictions for a party in interest providing goods and services to or receiving assets from the plan, for any failure by a covered service provider to disclose the information required above, provided that the following conditions are met: (i) the plan fiduciary did not know that the service provider failed or would fail to make required disclosures and reasonably believed that the covered service provider disclosed the information required above, (ii) the plan fiduciary requests the additional information in writing and notifies the DOL, and (iii) the service provider terminates the arrangement or complies with the request within 90 days. DOL Reg. § 2550.408b-2(c)(1)(ix). The above administrative class exemption was proposed in December 2007¹⁰ and finalized in July 2010.¹¹

The interim regulations also require that for the contract to be reasonable, it must permit termination of the contract without penalty other than for reasonable start-up costs and expenses.¹²

The interim regulations will not be effective until July 16, 2011. The rules will then apply to all contracts or arrangements, regardless of whether entered into before or after the effective date.

3. Fee Disclosure for Participants – Final Regulations (Generally Effective 1/1/2012)

Generally. The Department of Labor has issued regulations – proposed in 2008¹³ and finalized in 2010¹⁴ – requiring fiduciaries of individual account plans to provide specific disclosures to participants concerning plan investment options including fee and expense information. The concern is that participants in individual account plans be given sufficient information on investment choices including fees and expenses.¹⁵

The regulations provide that when a plan allocates investment responsibilities to participants under a participant directed individual account plan, the plan administrator must make sure that participants are made aware of their rights and responsibilities with respect to the investment of assets, and that sufficient information is provided regarding the plan and the plan's investment options including fee and expense information to make informed decisions how to invest their accounts.¹⁶

The plan administrator must provide participants certain plan-related information and certain investment-related information, as described below.¹⁷

Plan-Related Information. The plan-related information that must be disclosed includes:

¹⁰ [72 Fed. Reg. 70893](#) (Dec. 13, 2007).

¹¹ [75 Fed. Reg. 41600](#) (July 16, 2010).

¹² DOL Reg. § 2550.408b-2(c)(3).

¹³ DOL Reg. §§ 2550.404a-5 and 2550.404c-1, [73 Fed. Reg. 43014](#) (July 23, 2008).

¹⁴ DOL Reg. §§ 2550.404a-5 and 2550.404c-1, [75 Fed. Reg. 64910](#) (Oct. 20, 2010).

¹⁵ Preamble to regulations, 75 Fed. Reg. at 64910.

¹⁶ DOL Reg. § 2550.404a-5(a).

¹⁷ *Id.*

- general plan information about structure and mechanics of plan, such as how to give investment instructions, list of plan's current investment options, description of any "brokerage windows" or similar arrangement that enables the selection of investments beyond those designated by the plan, etc;¹⁸
- administrative expenses information about fees and expenses for general plan administrative services that may be charged to individual accounts, such as fees and expenses for legal, accounting, and recordkeeping services;¹⁹ and
- individual expense information including fees and expenses that may be charged to individual account of participant, such as fees for plan loans and for processing QDROs.²⁰

This information must be given to participants on or before the date they can direct their investments, and then annually thereafter.²¹

Statements must be furnished to participants at least quarterly showing the dollar amount of the plan-related administrative and individual fees and expenses actually charged to the individual accounts, as well as a description of the services. These disclosures may be included in quarterly benefit statements required under ERISA § 105.²²

Investment-Related Information. In addition to plan-related information, investment-related information must also be disclosed under the regulations.²³ This includes:

- performance data, with historical investment performance; one, five and ten-year returns must be provided for investment options that do not have fixed rates of return (such as mutual funds), and for investment options that have a fixed rate of return the annual rate of return must be provided;²⁴
- benchmark information for investment options that do not have a fixed rate of return, with the returns of an appropriate broad-based securities market index over one-, five-, and ten-year periods (investment options with fixed rates of return are not subject to this requirement);²⁵
- fee and expense information, which for investment options that do not have a fixed rate of return requires total annual operating expenses expressed as both a percentage of assets and as a

¹⁸ DOL Reg. § 2550.404a-5(c)(1).

¹⁹ DOL Reg. § 2550.404a-5(c)(2).

²⁰ DOL Reg. § 2550.404a-5(c)(3).

²¹ DOL Reg. § 2550.404a-5(c)(1)(i), (c)(2)(i) & (c)(3)(i).

²² DOL Reg. § 2550.404a-5(c)(2)(ii) & -5(c)(3)(ii).

²³ DOL Reg. § 2550.404a-5(d).

²⁴ DOL Reg. § 2550.404a-5(d)(1)(ii).

²⁵ DOL Reg. § 2550.404a-5(d)(1)(iii).

dollar amount and any shareholder-type fees or restrictions on the participant's ability to purchase or withdraw from the investment; for investment options that have a fixed rate of return, any shareholder-type fees or restrictions on the participant's ability to purchase or withdraw from the investment is required;²⁶

- Internet website address must be included for investment-related information, which will provide participants access to specific additional information about the investment options if more current information is desired;²⁷ and
- a glossary of investment-related terms to understand the plan's investment options, or an Internet website address that provides access to such a glossary.²⁸

Comparative Format Requirement. Investment-related information must be furnished on or before the date participants can first direct their investments, and annually thereafter; this information must be furnished in a chart format to facilitate comparison of investment options. The regulations include an appendix with a model comparative chart.²⁹

Effective Dates. The final regulations become effective on December 20, 2010. They become applicable to covered individual account plans for plan years beginning on or after November 1, 2011.³⁰

4. Eligible Investment Advice Arrangements by Fiduciary Advisors Under Pension Protection Act – Regulations Withdrawn and then Reproposed

Under ERISA § 408, as amended by the Pension Protection Act of 2006, a prohibited transaction statutory exemption is added for the provision of investment advice by a “fiduciary advisor” to participants of participant-directed plans through an “eligible investment advice arrangement.” ERISA §§ 408(b)(14) & 408(g).

In January 2009 the Department of Labor finalized regulations implementing the provisions of the statutory exemption for eligible investment advice arrangements for level-fee or computer model arrangements (as described below).³¹ The DOL also provided an administrative class exemption in DOL Reg. § 2550.408g-1(d), pursuant to which the fee-leveling or computer model requirements would be liberalized. The effective

²⁶ DOL Reg. § 2550.404a-5(d)(1)(iv).

²⁷ DOL Reg. § 2550.404a-5(d)(1)(v).

²⁸ DOL Reg. § 2550.404a-5(d)(1)(vi).

²⁹ DOL Reg. § 2550.404a-5(d)(2).

³⁰ DOL Reg. § 2550.404a-5(j).

³¹ [74 Fed. Reg. 3822](#) (Jan. 21, 2009) (DOL Reg. § 2550.408g-1 & -2), originally proposed in [73 Fed. Reg. 49896](#) (Aug 22, 2008).

date was to have been March 23, 2009. The effective date was delayed several times.³² The DOL withdrew these regulations entirely effective January 19, 2010 (before the extended effective date of the regulations).³³

The regulations were repropounded in March of 2010.³⁴ Repropounded DOL Reg. § 2550.408g-1 follows the requirements of ERISA § 408(g) that must be satisfied in order for the investment advice-related arrangements to be exempt from the prohibited transaction restrictions of § 406.

“Eligible investment advice arrangements” must either: (i) be based on generally accepted investment theories, taking into account fees and expenses and the participants’ age, other assets, risk tolerance and preferences, and must also provide that fees received by fiduciary advisors providing investment advice do not vary on the basis of the investments chosen (level fee arrangements);³⁵ or (ii) use a computer model that provides generally accepted investment theories, use relevant information about participants, take into account fees and expenses, use appropriate objective criteria, not favor investment options of the advisor and take into account all of the investment options of the plan, and in addition, the computer model must be certified by an eligible investment expert.³⁶

A plan fiduciary must expressly authorize the investment advice program, and an annual audit of the arrangement must be made.³⁷

The fiduciary advisor must disclose to participants prior to the initial investment advice the following: (i) the role of any party that has a material affiliation, (ii) past performance of the investment options, (iii) fees or compensation that the advisor or affiliate receives for the advice or for a transaction or rollover involving the investment, (iv) any material affiliation the fiduciary or affiliate has in the funds, and (v) certain other matters.³⁸

³² It was delayed 60 days to May 22, 2009, [74 Fed. Reg. 11847](#) (March 20, 2009), per President Obama’s regulatory moratorium ([74 Fed. Reg. 4435](#) (Jan. 26, 2009)), it was deferred another 180 days to November 18, 2009, [74 Fed. Reg. 23951](#) (May 20, 2009), and it was deferred another 180 days until May 17, 2010, [74 Fed. Reg. 59092](#) (Nov. 17, 2009).

³³ [74 Fed. Reg. 60156](#) (Nov. 20, 2009).

³⁴ [75 Fed. Reg. 9360](#) (March 2, 2010).

³⁵ Prop. DOL Reg. § 2550.408g-1(b)(3). See similarly, ERISA § 408(g)(2).

The repropounded regulations provide that, as stated in [DOL Field Assistance Bulletin 2007-01](#) (Feb. 2, 2007), the receipt by a fiduciary adviser of any payment from any party or used for the benefit of such fiduciary adviser that is based on investments selected by participants would be inconsistent with the fee-leveling requirement of the exemption.

³⁶ Prop. DOL Reg. § 2550.408g-1(b)(4). See similarly, ERISA § 408(g)(3).

The repropounded regulation also provide, in connection with investment advice arrangements that use computer models, that a computer model shall be designed and operated to avoid investment recommendations that inappropriately distinguish among investment options within a single asset class on the basis of a factor that cannot confidently be expected to persist in the future.

³⁷ Prop. DOL Reg. § 2550.408g-1(b)(5) & (6). See similarly, ERISA § 408(g)(4) & (5).

³⁸ Prop. DOL Reg. § 2550.408g-1(b)(7). See similarly, ERISA § 408(g)(6).

The Appendix to Prop. DOL Reg. § 2550.408g-1 contains a model disclosure form that may be used to satisfy this disclosure requirement.

A “fiduciary advisor” is a registered investment advisor, bank, insurance company, registered broker dealer or an affiliate or employee of any of the above.³⁹

The proposed regulations address the requirements for electing to be treated as the only fiduciary and fiduciary advisor by reason of developing or marketing a computer model or an investment advice program used in an eligible investment advice arrangement.⁴⁰

A prohibited transaction class exemption in the original 2009 regulations would have permitted follow-up individual advice subsequent to the computer model, and would have also permitted varying fees as long as the individual employee providing the advice met the level fee requirements. However, in response to comments questioning the potential for self-dealing, the class exemption has been eliminated in the repropoed regulations.

The regulations will most likely be effective 60 days after finalization and publication of the final regulations in the Federal Register.⁴¹

IRS Circular 230 Disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter that is contained in this document.

³⁹ Prop. DOL Reg. § 2550.408g-1(c)(2). See similarly, ERISA § 408(g)(11).

⁴⁰ Prop. DOL Reg. § 2550.408g-2.

⁴¹ Pending final regulations the statutory exemption for investment advice provided by the PPA is still in effect (for advice after 2006), and a good faith compliance should suffice until regulations are refinalized. The withdrawal of the regulations and exemption does not negate the statutory exemption in ERISA §§ 408(b)(14) & 408(g) provided for by the PPA for eligible investment advice arrangements. Note that the guidance in DOL Field Assistance Bulletin 2007-01 can also be be relied upon pending final regulations.