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SERVICE PROVIDER FEE DISCLOSURES

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SERVICE PROVIDER FEE DISCLOSURES

By: Jonathan M. Cerrito, Esq.

I. OVERVIEW OF PLAN FEE DISCLOSURE

A. INTRODUCTION

Currently the United States Department of Labor, Employee Benefits Security Administration ("Department") has taken the lead to improve the transparency of fee and expense information to participants, plan sponsors, fiduciaries, government agencies and the public; however, the Securities and Exchange Commission ("SEC") is also working to review the disclosure that mutual funds provide to plan investors. Additionally, members of Congress have been vocal in expressing their concern for enhancing disclosure. Some congressional members have introduced legislative bills and, on May 28, 2010, the House of Representatives passed the American Jobs and Closing Tax Loopholes Act (H.R. 4213) which, in part, would mandate certain fee disclosure.

There has been some tension between Congress and the Department on whether legislation is needed to fully address fee disclosures or whether the Department has the legal authority to issue regulations that will "cover the waterfront."[1] The Department has advised Congress that legislation could disrupt the regulatory fee disclosure efforts currently underway. Efforts, which the Department says, are nearing their final stages. On May 24, 2010, Louis Campagna, chief of the Fiduciary Interpretations Division at the Department, stated "[w]e're going forward with our regulation [mandating service providers to disclose compensation and fees received as well as potential conflicts of interest to the responsible plan fiduciaries under ERISA § 408(b)(2)] at this point," notwithstanding legislation on fee disclosure.

On November 16, 2007, the Department issued <u>final</u> regulations requiring additional public disclosure of fee and expense information on Schedule C of the Annual Report Form 5500. With the release of the final regulations, Assistant Secretary of Labor for the Department, Bradford P. Campbell, noted "[t]oday's action completes the first component of [the Department's] fee transparency initiative for employee benefit plans." The Department

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[1] Bradford P. Campbell, Assistant Secretary of Labor, testimony before the U.S. House of Representatives Ways and Means Committee on October 30, 2007.

issued additional Schedule C guidance, on July 14, 2008 and October 23, 2009 (updated in February 2010), in the form of 67 questions and answers.

B. SUMMARY OF REGULATORY AND LEGAL FRAMEWORK

Although contributions and earnings increase retirement savings, fees and expenses charged to a participant's account can substantially reduce that growth. This fact combined with recent, but not new, litigation surrounding service provider fees has prompted increased scrutiny of fees and expenses.

1. U.S. Department of Labor. The Department has undertaken the following four projects concerning fees and expenses:

   - Amendments to Form 5500, Schedule C. The Department issued final regulations, on November 16, 2007, amending Schedule C of Form 5500. The final regulations require plan administrators to disclose the identification of each person who received, directly or indirectly, $5,000 or more in total compensation in connection with services rendered to the plan or their position with the plan during the plan year. The regulation also provides plans with an alternative reporting option for service providers that receive only certain types of compensation. The revised Schedule C must be filed with respect to plan years beginning on or after January 1, 2009.

   - Disclosure to Self-Directed Participants. The Department is currently reviewing the rules, under the Employee Retirement Income Security of 1974, as amended ("ERISA"), that are applicable to the disclosure of plan administrative and investment-related fee and expense information to participants and beneficiaries in participant-directed defined contribution plans. Phyllis Borzi, assistant secretary of labor for the Department, indicated on May 11, 2010 that the regulation has not yet been finalized but is "hoping it will be out in a couple of months."

   - Amendments to Prohibited Transaction Regulations. The Department, on December 13, 2007, issued proposed regulations defining a "reasonable contract or arrangement" under ERISA § 408(b)(2). The proposed regulations require service providers to make certain disclosure to responsible plan fiduciaries prior to entering into a contract for services. These proposed regulations, when adopted in final form, should assist plan fiduciaries in determining whether arrangements with and

compensation paid to service providers are reasonable. The Department has narrowed the scope of this regulation to pension plans and has indicated it will next address welfare plans. On May 24, 2010, Louis Campagna, chief of the Fiduciary Interpretations Division at the Department, indicated that these regulations could be released "any day now."

- Enforcement. The Department is investigating whether plan consultants and advisers use their authority as plan fiduciaries to enrich themselves.

2. U.S. Securities and Exchange Commission. In addition, the SEC is working with the Department to review the disclosure that mutual funds provide to individual account plan investors. The SEC's planned review of Section 12b-1 fees was put on hold as a result of the financial credit crisis, SEC official Robert E. Plaze said November 14, 2008.

3. U.S. Congress. Not to be undone, as the regulatory agencies were in the process of implementing their initiatives, members of Congress began vocalizing their concern for enhancing disclosure and providing transparency of fee and expense information to participants and plan sponsors of defined contribution plans. After the introduction of various bills,[2] on May 28, 2010, the House of Representatives passed the American Jobs and Closing Tax Loopholes Act (H.R. 4213) which, in part, would provide:

- simple and complete fee disclosure to participants in defined contribution plans;

- fees for each plan investment option to be expressed in dollars or as a percentage of the investment; and

- disclosure of all plan administration and recordkeeping fees, investment management fees, and all other fees assessed on participants' accounts.

[2] On July 26, 2007, U.S. House of Representative George Miller (D-CA) introduced the 401(k) Fair Disclosure for Retirement Security Act of 2007 (H.R. 3185)—a bill designed to disclose "hidden fees" and "conflicts of interest." Miller reintroduced the bill in substantially similar form on April 21, 2009 as H.R. 1984. On October 4, 2007, U.S. House of Representative Richard E. Neal (D-MA) introduced the Defined Contribution Plan Fee Transparency Act of 2007—a bill that amends the Internal Revenue Code of 1986 to provide transparency with respect to fees and expenses charged to participant-directed defined contribution plans.

II. FORM 5500, SCHEDULE C

A. OVERVIEW

Under Titles I and IV of ERISA, and the Internal Revenue Code ("Code"), as amended, pension and other employee benefit plans are generally required to file an annual return with the Secretary of Treasury, an annual report with the Secretary of Labor and certain information with the Pension Benefit Guaranty Corporation. However, a plan satisfies the reporting requirements with respect to each agency by filing a Form 5500, Annual Return/Report of Employee Benefit Plan ("Form 5500") with the Department. A Form 5500 consists of a primary form and various schedules and includes the information required to be filed with all three agencies.

An employee benefit plan covering 100 or more participants must attach a Schedule C to the Form 5500 to report, in part, any person who rendered services to the plan that received directly or indirectly $5,000 or more in compensation from the plan during the plan year.[3] The Department has concluded that more information should be disclosed on the Form 5500 regarding plan fees and expenses. The Department notes that its conclusion is consistent with the recommendations of the council in 2004 and the GAO in 2006. Thus, the Department seeks to apply recommendations pertaining to participant-directed defined contribution plans to any employee benefit plan required to file Schedule C. As a result, the Department emphasized that the final amendments to Schedule C of Form 5500 apply to any employee benefit plan (pension or health) that covers more than 100 participants and not merely participant-directed defined contribution plans.

B. REVISIONS AND FINAL AMENDMENTS TO SCHEDULE C

1. Purpose. The Department determined that it was appropriate to modify the Schedule C reporting requirements in an effort both to clarify the reporting requirements and to ensure that plan officials obtain the information they need to assess the reasonableness of the compensation paid for services rendered to the plan, taking into account revenue sharing and other financial relationships or arrangements and potential conflicts of interest that might affect the quality of those services. The changes to Schedule C are effective for plan years beginning on or after January 1, 2009.

2. Overview of Revisions and Amendments. Schedule C and the

[3] Schedule C is also used to report terminated accountants and actuaries.

accompanying instructions have been revised to clarify the requirements regarding reporting of direct and indirect compensation received during the plan year in connection with services rendered to the plan or the person's position with the plan. Plan administrators must detail all service providers who receive total compensation of $5,000 from the plan. In addition, plan administrators must also detail indirect compensation of $1,000 or more paid to certain service providers. This new requirement forces disclosure of compensation that certain key service providers receive in excess of $1,000 from parties other than the plan or the plan sponsor.

C. STRUCTURE OF FINAL SCHEDULE C

Schedule C consists of three parts: Parts I, II and III.

1. Part I. Part I requires identification of each person who receives, directly or indirectly, $5,000 or more in total compensation (money or anything else of value) in connection with services rendered to the plan or their position with the plan during the plan year. The final regulations do not limit this requirement to the forty highest paid service providers. Alternatively, the final regulations provide for an alternative reporting option for service providers whose only compensation in relation to the plan is limited to "eligible indirect compensation" (certain types of common investment related fees). Furthermore, "to provide more informative disclosures about the types of fees being paid to or received by service providers," Schedule C requires direct compensation to be reported on a separate line item from indirect compensation.

   Additionally, under Part I:

   - Filers would have to indicate for all service providers whether the service provider received compensation attributable to the person's relationship with or services provided to the plan from a party other than the plan or plan sponsor, and the person's eligibility for a payment or the amount of the payment is based, in whole or in part, on services that were rendered to the plan or on a transaction or series of transactions with the plan ("indirect compensation").

   - If a fiduciary to the plan or any of an enumerated list of service providers received, directly or indirectly, $5,000 or more in total compensation and also received more than $1,000 in indirect

compensation — generally compensation from a person other than the plan or plan sponsor — then Schedule C would have to provide information identifying the payor of the compensation, the relationship or services provided to the plan by the payor, the amount paid and the nature of the compensation.

- Enumerated service providers are contract administrator, securities brokerage (stocks, bonds, commodities), insurance brokerage or agent, custodial, consulting investment advisory (plan or participants), investment or money management, recordkeeping, trustee, appraisal or investment evaluation.

- Under the alternative form of reporting, instead of providing information on the service provider, the Schedule C may report identifying information on the person or persons who provided the plan with certain written disclosures.

2. Part II. Part II provides a place for plan administrators to identify each service provider that failed or refused to provide the information necessary to complete Part I.

3. Part III. Part III is used for reporting termination information on accountants and enrolled actuaries. This is the old Part II of Schedule C and the information required to be placed thereon was not altered by the final regulations.

D. WHAT IS REPORTABLE COMPENSATION FOR PURPOSE OF SCHEDULE C?

Under the final regulation, reportable compensation consists of direct and indirect compensation.

1. Direct Compensation. Direct compensation is compensation that a service provider receives from the plan or plan sponsor.

2. Indirect Compensation. Indirect compensation is compensation that a service provider receives in connection with that person's position with the plan or services rendered to the plan and the person's eligibility for a payment or the amount of the payment is based, in whole or in part, on services that were rendered to the plan or on a transaction or series of transactions with the plan.

   Indirect compensation includes gifts, awards and trips as well as brokerage commissions and fees charged to the plan on purchase,

sale and exchange transactions regardless of whether the broker is granted discretion. Of particular importance is the fact that the Department no longer believes that continuing the current exemption from Schedule C reporting for brokerage fees and commissions is appropriate. Instead, the Department believes that an annual review of such expenses is part of a plan fiduciary's on-going obligation to monitor service provider arrangements with the plan. The Department intends for the requirement to report this information to emphasize that monitoring function.

3. Examples of Indirect Compensation.

- Soft-dollar payments. In a "soft-dollar" arrangement, an investment manager purchases brokerage and research services[4] from a broker-dealer with a portion of the commissions paid to that broker for executing securities transactions.[5]

- 12b-1 Fees. 12b-1 fees are fees paid by a mutual fund out of fund assets to cover distribution expenses and, at times, shareholder service expenses. Distribution fees include fees paid for marketing and selling fund shares, such as compensating brokers and others who sell fund shares. Distribution fees also include fees paid for advertising, printing and mailing of sales literature and prospectuses to the new investors (i.e. promotional costs). The SEC rule permits a fund to pay distribution fees out of fund assets only if the fund has adopted a plan (12b-1) authorizing their payment.

- Shareholder Services Expenses. Shareholder service fees are paid to persons to respond to investor inquiries and provide investors with information about their investments. A mutual fund may pay shareholder service fees without adopting a 12b-1 plan or some 12b-1 plans may authorize and include shareholder service fees. The only difference is how shareholder service

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[4] Section 28(e) of the Securities Exchange Act of 1934 establishes a safe harbor that allows a manager to use client commissions to purchase "brokerage and research services" for its managed accounts without breaching any fiduciary duty imposed by state or federal law. On July 24, 2006, the SEC issued a final release narrowing the types of services that would qualify as "brokerage and research services" within the safe harbor.

[5] See Statement on Policies Concerning Soft Dollar and Directed Commission Arrangements, ERISA Technical Release No. 86-1 (May 22, 1986); see also ERISA Advisory Council, Reporting of the Working Group on Soft Dollars/Commission Recapture (November 3, 1997) (defining "soft dollars" as "payment for brokerage firm services, other than trade execution, through commissions generated from investment trades").

expenses are categorized within the prospectus—either as part of the 12b-1 fees or as "other expenses."

- Finders' Fees/Placement Fees. Finders' fees and placement fees are fees paid to advisers and brokers to attract investors for the mutual fund. Although often discussed separately, these fees fall within the definition of a 12b-1 fee.

- Float Income. Float income is interest earnings on plan assets that is retained by the service provider as compensation.

4. Eligible Indirect Compensation. Eligible indirect compensation is a type of indirect compensation that may be reported using an alternative option provided that (i) the service provider's only compensation in relation to the plan is eligible indirect compensation and (ii) the service provider makes written disclosure to the plan administrator of:

   - the existence of eligible indirect compensation;

   - the services provided for the eligible indirect compensation or the purpose for payment of the eligible indirect compensation;

   - the amount or estimate of the compensation or a description of the formula used to calculate or determine the eligible indirect compensation; and

   - the identity of the party or parties paying and receiving the eligible indirect compensation.

Where a service provider that receives only eligible indirect makes the above disclosure, instead of having to provide information on the service provider, Schedule C may be satisfied by identifying the person or persons that provided the plan with the required written disclosure.

E. REVENUE SHARING AND BUNDLED SERVICES

1. Revenue Sharing and Bundled Services. When a plan requires a unified package or bundle of services from a provider, and the amount paid for the package or bundle reflects the amount paid for all services included within the package or bundle, direct compensation would include only the aggregate amount paid by the plan to the provider of the package or bundle of services. In such

cases, it would not be necessary to break out or report amounts on a service-by-service basis.

2. Similarly, amounts paid by the provider of the bundled services to other service providers to the plan would not be reported on Schedule C unless: (1) the plan is also paying the provider directly for services in addition to those included in the package or bundle; or (2) the recipient of such compensation is a fiduciary to the plan or one of the other listed service providers from whom additional information is required to be reported, if the provider receives compensation in excess of $1,000 from a person other than the plan or plan sponsor.

F. ALLOCATING BETWEEN DIRECT AND INDIRECT COMPENSATION

1. To address the burdens associated with allocating revenue-sharing income and third-party payments to individual plans, Schedule C provides that indirect compensation could be reported as an actual amount or an estimate of the compensation received during the reporting period. If any part of the compensation is an estimate, then Schedule C will also require an explanation of the formula used for calculating the payments.