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## SHORE TOMPKINS

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# The Final Fee Disclosure Regulations Have Arrived

Nearly five years in the making, the Department of Labor (DOL) has published its long-awaited plan sponsor fee disclosure regulations under ERISA section 408(b)(2). With these new regulations taking effect on July 1, 2012, plan sponsors and service providers alike will be scrambling to prepare.

## Why is Fee Disclosure such a Big Deal?

The Employee Retirement Income Security Act (ERISA) is one of the main federal laws that govern the operation of employer-sponsored retirement plans. Among the many topics it covers, ERISA sets forth the rules that apply to plan fiduciaries. Generally speaking, plan fiduciaries include those who have discretion over the administration or assets of a plan as well as those who provide investment advice to a plan for a fee. Since its passage in 1974, ERISA has included a requirement that a plan can only pay reasonable fees for required services such as record-keeping, compliance or government reporting. If a plan pays fees that are not reasonable, such payments are prohibited transactions subject to penalties by the DOL and IRS.

While this requirement may seem, well... reasonable, service providers have not been legally obligated to disclose their compensation. That was not as much of a challenge in 1974 when the predominant type of retirement plan was the defined benefit plan. However, as the retirement plan world shifted from defined benefit to defined contribution daily-valued, participant-directed 401(k), the platforms and financial products became more sophisticated and complex. Service providers began receiving compensation via expenses built into plan investments rather than by directly billing plan sponsors. Some providers began marketing their services as no- or low-cost since their fees were being subsidized by the investments rather than being billed to the plan or the plan sponsor.

Having a plan automatically pay to operate itself might be convenient, but it may result in plan fiduciaries who are unable to dissect complex fee structures to determine how much each service provider is being paid. If fiduciaries do not know the amount of the fees, there is no way they can determine whether those fees are reasonable. With fee structures differing from provider to provider, it has also become difficult for fiduciaries to compare the fees and services of multiple vendors to determine which offers the best value.

## What is the Solution?

Recognizing this growing disconnect, the DOL embarked on a three-pronged initiative to help ensure that fiduciaries have access to information they need to fulfill the reasonableness requirement. First is the expanded fee reporting on Form 5500, Schedule C, which was

effective for plan years beginning in 2009 and is generally required for plans with more than 100 participants. The second prong is the required disclosure to plan participants at various times throughout the year.

Third is the requirement for service providers to disclose fee and service information to plan sponsors. Regulations implementing this requirement were first proposed in December 2007. After being revoked, re-proposed and semi-finalized, the sponsor-level fee disclosure regulations were finalized in February of this year.

## Are all Service Providers Required to Comply?

The short answer is “No.” The regulations coin a new term “Covered Service Provider” (CSP) to describe those subject to the rules. CSPs fall into three general categories:

1. Registered Investment Advisors and other fiduciary advisors;
2. Those who provide a plan investment platform; and
3. Service providers who receive indirect compensation, e.g. revenue sharing, commissions, etc.

These might seem straightforward, but the devil is in the details. Let’s consider several examples to help clarify.

### Investment Professionals

The first category clearly indicates that Registered Investment Advisors and other fiduciary advisors are CSPs. But, what about those who are non-fiduciary brokers? Such individuals do not fit into the first category; however, since they typically receive commissions, they are CSPs under the third category.

### Platform Providers

This group seems relatively clear-cut. Any vendor, regardless of how it is compensated, that provides the investment platform to a participant-directed, defined contribution plan is a CSP. However, there are some nuances. Assume an investment professional provides the investment platform and partners with a separate firm who provides recordkeeping. In this case, the investment professional, not the recordkeeper, is likely the platform provider; therefore, the recordkeeper would probably not be a category 2 CSP. However, since most recordkeepers receive revenue sharing payments, they will typically be category 3 CSPs.

### Third Party Administrators

TPAs cannot be classified as a group because their services and compensation arrangements can vary widely. Consider a TPA that provides annual compliance testing and government reporting services but does not provide recordkeeping. If all fees are paid by the plan sponsor or directly from the plan, that TPA is not a CSP and is not subject to the new fee disclosure requirements. This is due to the fact that all fees are being paid directly and are, presumably, readily identifiable.

However, assume that the same firm regularly partners with an insurance company for record-keeping services. The insurance company pays the TPA a marketing allowance based on the combined assets of all mutual clients. That marketing allowance is indirect compensation, making the TPA a category 3 CSP.

### Other Providers

Whether other providers are CSPs depends largely on how they are compensated. Attorneys and accountants generally will not be CSPs since their typical compensation structures do not include indirect compensation. The regulations require that the fees paid to affiliates or subcontractors of a CSP must also be disclosed, so it is important to consider the relationships service providers may have with other companies. Since those affiliates often have no direct relationship with the plan, the CSP must include their compensation with its disclosure.

Regardless of the category, a service provider must have a reasonable expectation that its fees will be \$1,000 or more under the life of its contract with the plan in order for it to be a CSP.

## What must be Disclosed?

There is quite a list of information a CSP must provide to a covered plan. It is all designed to help plan fiduciaries understand the fees being paid and the services to which they relate. In addition, full disclosure of all compensation will help highlight any potential conflicts of interest in the recommendations that service providers make to their clients.

**Who:** The CSP must identify itself and, if applicable, provide a written statement that it will provide services as a fiduciary or a Registered Investment Advisor.

**What:** The CSP must identify the services it provides to a plan under the contract or arrangement.

**How:** The CSP must describe how it will receive each category of compensation. For example, some fees may be directly billed to the plan, while others may be deducted from investment returns or paid via revenue sharing.

**How Much:** The CSP must report all direct and indirect compensation paid to itself and/or any affiliates and should include anything of monetary value, e.g. gifts, trips, etc. The fees should be tied to the services to which they relate, and for indirect compensation, the payer must also be identified. If recordkeeping is part of a bundle of services and the CSP is unable to determine the portion of total compensation related to that service, the CSP must provide a reasonable, good-faith estimate or use the prevailing market rate for similar services. If there are any fees related to the termination of the agreement, the CSP must disclose those in addition to providing a description of how any pre-paid amounts will be pro-rated and refunded.

In addition to the above, fiduciary CSPs are required to provide general information about the investment options offered under the plan, including expense ratios, wrap fees, historical rates of return, comparisons to benchmarks, etc.

## When must the Information be Disclosed?

The goal of the regulations is to ensure plan fiduciaries have the information to determine if a service provider's fees are reasonable in advance of making the hiring decision. If a plan has already hired a service provider that is a CSP, the CSP must provide the initial disclosures no later than July 1, 2012. For all future arrangements, the CSP must disclose "reasonably in advance of the date the contract is entered into, extended or renewed." The inclusion of the words "extended or renewed" can present a trap for the unwary. It is not uncommon for a contract to expire (after one or two plan years) and automatically renew each year thereafter. In those instances, the disclosures must be provided each year prior to the renewal date.

In many situations, the investment menu is not determined until after the contract is signed. How can the CSP provide all the investment disclosures in advance? If this circumstance occurs, the investment information must be provided no later than 30 days after the CSP knows which platform, funds, etc., will be used.

When any of the previously disclosed information changes, the CSP must communicate those changes as soon as possible but no later than 60 days after becoming aware of the change.

## What are the Consequences of Non-Compliance?

The DOL has made compliance an integral part of the reasonable fee requirement; therefore, if there is no disclosure, the fees are automatically deemed unreasonable. That means there is

a prohibited transaction. The non-disclosing CSP is subject to an excise tax equal to 15% of the amount involved and may be required to unwind the arrangement by returning the fees collected.

Prohibited transaction penalties usually apply to all parties involved, which means the plan representative making the hiring decision (the responsible plan fiduciary) may also be on the hook. However, the regulations provide some relief if the responsible plan fiduciary did not know the CSP was non-compliant and, immediately upon discovering the failure, made a written request to the CSP for the required disclosures. If the CSP does not respond to the request within 90 days, in order to avoid liability for the prohibited transaction, the responsible plan fiduciary must notify the DOL in writing of the CSP's failure and may be required to fire the CSP.

### **When are the New Rules Effective?**

The service provider fee disclosure rules are effective on July 1, 2012. In addition, since the participant-level fee disclosure rules are so closely linked, their effective date has also been pushed back to July 1st. For existing service provider arrangements, plan sponsors should expect to receive the required disclosure information no later than that date. The initial annual participant disclosure is due August 30, 2012 (60 days after the effective date) and the initial quarterly participant disclosure is due November 14, 2012 (45 days after the close of the first quarter after the effective date).

It will be interesting to see how these new rules unfold. But one thing is for sure... plan sponsors and participants will not have any shortage of reading material by the end of this year.

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