

**EMPLOYEE BENEFITS & EXECUTIVE COMPENSATION/
ERISA LITIGATION ADVISORY**

December 19, 2007

**Proposed Labor Regulations Would Require
Greater Disclosures of Fees, Compensation and Conflicts
of Interest for Employee Benefit Plan Service Providers**

On December 13, 2007, the Department of Labor (“DOL”) issued proposed regulations that would require fiduciaries of employee benefit plans to obtain from certain service providers specific information on fees, compensation and conflicts of interest. 72 Fed. Reg. 70988. The proposed regulations pertain to pension plans, group health plans and all other types of welfare plans. In conjunction with the proposed regulations, the DOL also proposed a class exemption that would (under specific circumstances) relieve plan fiduciaries from prohibited transaction liability if a fiduciary discovers that a service provider failed to disclose the required information. 72 Fed. Reg. 70893.

The regulations rest on a counter-intuitive provision of ERISA that prohibits a fiduciary from allowing the conveyance of money, goods or services between a plan and a “party in interest” unless the transaction qualifies for an exemption. Because the definition of “party in interest” includes *all* service providers, the result of this provision is that *any* provision of services to a plan is a prohibited transaction unless it qualifies for an exemption. Further, both the fiduciary and the service provider are responsible for preventing prohibited transactions and both face consequences if the transaction is not exempt. Under the proposed regulations, a fiduciary must contractually obligate the service provider to disclose information about fees and potential conflicts in order for the transaction to qualify for an exemption.

The regulations proposed on December 13 are the second in a series of three the DOL intends to issue pertaining to disclosure of plan service provider fees and compensation. The DOL issued the first group of regulations, augmenting the annual reporting and disclosure requirements for employee benefit plans on Form 5500 (particularly revised Schedule C, clarifying the requirements for reporting service providers’ direct and indirect compensation), on November 16, 2007. 72 Fed. Reg. 64710; 72 Fed. Reg. 64731. DOL intends to issue the third group of regulations, concerning disclosures from plans to participants, in the future.

Proposed Disclosure Regulations

The December 13 proposals would require that a service provider be obligated to disclose (and actually disclose) to plan fiduciaries information about the service provider’s fees and compensation and existing or potential conflicts of interest. Specifically, under the proposed regulations, a contract between a plan and a service provider is not “reasonable” (and not exempted from being a prohibited transaction under ERISA § 408(b)(2)) unless the contract requires the service provider to disclose its direct and indirect compensation and potential conflicts of interest connected to its services to the plan.

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The broad range of service providers affected by the proposed regulations includes providers of banking, consulting, custodial, insurance, investment management or advisory, recordkeeping, brokerage and third-party administration services to plans. It also includes providers who receive *indirect* compensation in connection with legal, actuarial, accounting or auditing services. Indirect compensation encompasses fees that plan service providers receive from entities other than the plan, plan sponsor or service provider. The proposed regulations do not affect the majority of providers of legal, accounting and auditing services who are compensated directly and who receive no indirect compensation. The proposed regulations also do not extend to contracts with entities providing plan benefits to participants, rather than services to the plan.

Compensation and Fees. The purpose of the proposed compensation and fee disclosure requirements is to provide plan fiduciaries enough information to determine the reasonableness of the provider's fees and compensation. The DOL therefore proposes that every contract with a plan service provider require the provider to describe in writing all services it will provide to the plan and all compensation it (or any affiliate of the provider) will receive in connection with its services. If a provider cannot state a specific dollar amount for its services, then it could disclose its compensation and fees by using a formula, a percentage of plan assets or a per-participant charge.

A service provider offering "bundled" services, a package of various services provided to the plan directly or indirectly through affiliates or subcontractors, would have to disclose all services provided in the bundle, regardless of which entity provides them. The bundled provider would also have to disclose aggregate direct compensation or fees paid for the bundle, as well as indirect compensation received from third parties by the service provider, its affiliates or subcontractors. But the provider would not need to break down aggregate compensation or fees among the various service components of the bundle. The bundled provider would also not have to disclose the allocation of revenue sharing among affiliates or subcontractors within the bundle. The bundled provider would, however, have to disclose separately the compensation or fees of any entity receiving separate fees charged against plan investments (such as management fees paid to mutual funds or 12b-1 distribution fees) or fees set on a transaction basis (such as brokerage commissions).

Finally, a service provider contract under the proposed regulation must require the provider to disclose any information related to the contract and the provider's fees and compensation that is required by the fiduciary to comply with reporting and disclosure obligations of Title I of ERISA.

The proposed regulations emphasize that "responsible plan fiduciaries must continue to monitor service arrangements and the performance of service providers," and that fiduciaries may ask service providers for any additional information they believe is necessary to evaluate the reasonableness of provider fees and compensation. 72 Fed. Reg. at 70993.

Conflicts of Interest. The December 13 proposed regulations also require service providers to disclose to plan fiduciaries actual or potential conflicts of interest. Under the proposals, a service provider would have to describe: (1) its participation or interest in transactions to be entered into by the plan pursuant to the service contract; (2) material relationships with other parties with the potential to cause a conflict of interest; (3) compensation it may receive that the provider can affect without prior approval by an independent fiduciary; and (4) the provider's policies and procedures to address potential conflicts of interest.

Material Changes. Finally, if any of the information disclosed by the provider changes materially, the proposed regulations require service provider to disclose those changes to fiduciaries within 30 days of the change.

Proposed Class Exemption

The December 13 proposals emphasize that a service contract or arrangement failing to require disclosure of the fees, compensation and conflict of interest information described in the proposed regulation will not be “reasonable.” The contract or arrangement will therefore not qualify for exemption from ERISA’s prohibited transaction rules. The plan’s fiduciaries will have participated in a prohibited transaction, and the provider will be subject to excise taxes under Internal Revenue Code § 4975.

Reasoning that “in certain circumstances, a responsible plan fiduciary should not be held liable for a prohibited transaction that results when a service provider, unbeknownst to the plan fiduciary, fails to satisfy its disclosure obligations as required by the proposed regulation,” 72 Fed. Reg. at 70993, the DOL also proposed a class exemption from the prohibited transaction rules. To take advantage of the proposed exemption, a fiduciary learning that a provider has failed to disclose required information must request that information in writing from the provider. If the provider fails to disclose the information within 90 days, the fiduciary must notify the DOL within 30 days thereafter. The fiduciary must then decide whether to terminate or maintain the plan’s contract with the provider.

Impact on Current Litigation

It is unclear what impact, if any, the proposed regulations could have in the current spate of fiduciary litigation challenging as excessive or unreasonable the fees received by providers of services to defined contribution plans. On one hand, as proposed regulations, they are not binding. Further, the December 13 proposals do not provide any guidelines for determining whether the amounts of fees or compensation are, in and of themselves, reasonable. The proposed regulations are instead procedural in nature, proscribing a set of steps fiduciaries must take in entering into and maintaining service contracts for employee benefit plans. Finally, the December 13 proposed regulations do not reach disclosure obligations of fiduciaries to plan participants with regard to service provider fees, compensation and conflicts of interest. It is likely the DOL will specifically address these subjects when it issues the third set of proposed regulations in the future.

On the other hand, even if the proposed regulations are not directly pertinent to the primary claims in the 401(k) fee actions (challenging the merits of provider fees), evidence that plan fiduciaries were taking steps akin to those proposed by the DOL to inform themselves of provider fees, compensation and conflicts of interest is arguably relevant to whether the fiduciaries were carrying out their fiduciary responsibilities. It is unlikely that any plan sponsors have obtained contractual obligations of the type that would be required by these proposed regulations. However, the proposed regulations could be cited by defendants who would argue that such procedures and disclosures are not required under current law. This argument is suggested by *Hecker v. Deere Corp.* (a 401(k) fee action in the western district of Wisconsin, dismissed for failure to state a claim in the complaint) in which the court considered proposed regulations relevant to fiduciary duty claims and concluded that regulatory proposals to require disclosure of revenue sharing payments indicated that such disclosure was not already required by law. *Hecker v. Deere Corp.*, 496 F. Supp. 2d 967, 974 (W.D. Wis. 2007). The district of Connecticut in *Taylor v. United Technologies* also adopted this reasoning. *Taylor v. United Techs. Corp.*, No. 3:06-CV-1494, 2007 WL 2302284, at *5 (D. Conn. Aug. 9, 2007).

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