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The DOL's Proposed 408(b)(2) Regulation: Impact on Independent Recordkeepers

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This is the third in our series of Bulletins about the Department of Labor's (DOL) proposed 408(b)(2) regulation. (Our firm has also written an article for the ASPPA Journal on the impact of the proposed regulation on third party administrators.) That regulation will mandate disclosures of "comprehensive, straight forward and helpful information concerning [a] service provider's compensation and possible conflicts of interest." Our first two Bulletins discussed the likely impact of the proposed regulation on independent registered investment advisers and on broker/dealers [http://www.reish.com/publications/pdf/proposed408ria.pdf and http://www.reish.com/publications/pdf/proposed408b-d.pdf]. Here, we discuss the impact on independent recordkeepers, that is, plan recordkeepers that do not offer proprietary investment products either directly or through an affiliate. For purposes of this discussion, we have also excluded recordkeepers that may provide investment advice through an affiliated entity.

The proposed regulation contains special provisions related to the disclosure of services and compensation by "bundled providers" who offer an array of services that are priced as a package. While some independent recordkeepers may offer such a package of services, we do not discuss the "bundled provider" issues here, but we expect to do so in the next Bulletin in this series.

As in our prior Bulletins, we focus on 401(k) plans, though service providers for all types of ERISA pension and welfare benefit plans, including ERISA-covered private sector 403(b) plans, will be impacted in much the same way.

PLANSPONSOR's 15 Legends of the Retirement Industry

Fred Reish was selected as one of the 15 "Legends of the Retirement Industry." In our newsletters and bulletins, we will be featuring the other Legends that were also selected by *PLANSPONSOR*. These 15 "Legends" are individuals who have, in the past decade and a half, made a lasting contribution to the nation's retirement security.

Bill Chetney, President and CEO of National Retirement Partners (NRP), was selected for his "leadership in crafting a business model that has transformed the role of independent advisers." He has successfully built a network that provides both support and independence for the retirement industry.

Background

To summarize what we assume most readers know by now, the proposed regulation defines the requirement in ERISA section 408(b)(2) that contracts and arrangements with service providers must be "reasonable" in order to avoid being prohibited transactions. Once the proposed regulation becomes final—which we anticipate will be January 1, 2009—almost all service providers will be required to have written agreements and to disclose, before the arrangement is entered into, all of their direct and indirect compensation and specified potential conflicts of interest. (For additional details on the background of the proposed regulation, see our first Bulletin dated February 4, 2008, at the link above.)

Failure to comply with the detailed requirements of the regulation will cause a service provider's arrangement with a plan to be a prohibited transaction under ERISA and the Internal Revenue Code. Regardless of intent, good faith, reasonable efforts to comply and the like, this will mean that the service provider will have to restore to the plan the "amount involved"—which apparently would be the compensation the recordkeeper and any affiliates received—and that the service provider will have to pay an excise tax equal to 15% of that amount for each year of the transaction. (In comments we provided to the DOL regarding the proposed regulation, we suggested that they add a "substantial compliance" or overall "materiality" standard in order to mitigate what some may argue is a harsh penalty; but, under the existing proposal, the consequences we have described would appear to be required.)

Overview

Comment: The impact of the proposed regulation on independent recordkeepers, while not insignificant, is not as meaningful as for certain other service providers, such as broker-dealers and financial advisers. In our experience, most recordkeepers already have extensive written agreements that address many of the disclosure requirements of the proposed regulation. Further, recordkeepers for medium and large plans are often selected after an RFP process, which usually includes disclosures regarding services and compensation (but which, in some cases, may not include full disclosure of all indirect compensation or of conflicts of interest). On the other hand, the proposed requirement that disclosures be made in advance will likely require changes in business practices in

the small plan market. Perhaps the most significant change, however, will be in connection with the disclosure of financial arrangements and relationships that present potential conflicts of interest. We discuss each of these requirements in greater detail below.

Applicability

If adopted as proposed, the regulation will apply to any service provider who:

1. is a fiduciary under ERISA *or* the Investment Advisers Act of 1940 (the "`40 Act");
2. provides banking, consulting, custodial, insurance, investment advisory, investment management, recordkeeping, securities or other investment brokerage, or third party administration services; or
3. receives indirect compensation and provides accounting, actuarial, appraisal, auditing, legal, or valuation services.

These are referred to as "covered service providers."

Impact on Independent Recordkeepers: Since recordkeeping is specifically referenced in the second category, there can be no doubt that entities providing this service and other related services, such as plan administration and consulting, will be subject to the requirements of the regulation. The only real question is what steps they must take in order to comply.

If a service provider is covered by the proposed regulation, the requirements of the regulation (discussed below) apply to all of its services, not just those in the "covered" category. In the preamble to the proposed regulation, the DOL states:

> "If a contract or arrangement meets the threshold scope requirement in paragraph (c)(1)(i) [which identifies the covered service providers], then the terms of such contract or arrangement must satisfy the proposal's disclosure requirements in order to be reasonable for purposes of paragraph (c)(1), *regardless of the nature of any other services provided*…." [Emphasis added]

Specific Requirements

1. Contract Must Be in Writing

The proposed regulation requires (1) that there be a contract or arrangement between the plan and the service provider, (2) that the contract or arrangement be in writing and (3) that the contract or arrangement be approved by a "responsible plan fiduciary," *i.e.*, by a fiduciary who is independent of the service provider and who has the authority to enter into the arrangement on behalf of the plan. (This latter requirement means that covered service providers must identify—perhaps by reviewing the plan document—the fiduciary who has the authority to hire the provider on behalf of the plan.) There is no requirement in the proposed regulation that the "contract or arrangement" be signed by either a fiduciary of a plan or the service provider. That said, in our experience, recordkeepers use written contracts and have them signed by the client at the time they begin providing services to a plan. As a result, recordkeepers should revise their contracts to provide for signature by the responsible plan fiduciary. (For ease of reference, for the rest of this Bulletin we use the term "contract" instead of the proposed regulation's use of "contract or arrangement.")

General Comments: All covered service providers will need a written contract with the responsible plan fiduciaries for any new, renewed or extended contracts entered into on or after the effective date of the final regulation. It is unclear what steps must be taken, if any, to comply with the disclosure requirements of the regulation for existing contracts. We assume that this will be clarified in the final regulation and that, to the extent compliance is required, that service providers will be given a transition period to complete the task.

The proposed regulation does not mandate any specific time period for making the disclosures prior to entering into the contract. Indeed, the DOL states:

> "The proposal also does not designate any specific time period prior to entering into the contract or arrangement for receipt of the required disclosures, other than requiring a representation by the service provider that all information was provided in writing before the parties entered into the contract."

Thus, the only guidance is that the disclosures be given sufficiently in advance to enable the fiduciary to make an informed decision. Prudence suggests that the service provider obtain a written acknowledgement (which could be in the contract itself) that the disclosures were received and reviewed by the responsible plan fiduciary in advance of entering into the contract. Indeed, one of the requirements of the proposed regulation is that the service provider in the contract represent that it has made the disclosures prior to entering into the contract—that is, the service provider must both make the disclosures and state in the contract that it has made the disclosures—so the acknowledgment from the fiduciary would essentially be the flip side of that requirement.

Impact on Independent Recordkeepers: As noted above, in our experience, recordkeepers have detailed written contracts for 401(k) plans. Thus, this aspect of the regulation will have little impact. However, under the proposed rules recordkeepers will be required to make the mandated disclosures in advance of entering into the contract. Further, the disclosures must be made to, and the contract approved by, a responsible plan fiduciary. Generally, we anticipate that this will be accomplished—at least for large- and mid-sized plans—through the RFP process, where the disclosures are made in advance and reviewed by plan fiduciaries, for example, by a plan committee. This may require changes in procedures in the smaller plan market, however, to ensure that the advance disclosure steps have been properly completed.

In more concrete terms, the advance disclosure requirement may require recordkeepers to deliver their form contract, and the related schedules and policies, earlier in the sales process, rather than after the new plan client has made its decision to employ the recordkeeper. This is because it is unclear when an "arrangement" is actually entered into, and it could be costly for the recordkeeper if it is determined after the fact that the disclosures were made too late. We believe that the better reasoning is that the disclosures must be given before there is any "irrevocable" commitment by the responsible plan fiduciary. Obviously, that means that the disclosures must be made before the contract is signed. Less obviously, that would likely include any transfer of money or the possible imposition of any penalty or charge for not completing the transaction. More broadly, though, an arrangement could occur when it would take any significant effort or cost to the plan, the plan sponsor or the fiduciaries if they refuse or fail to proceed.

As a general comment, the duty of the service provider is to deliver the disclosure materials before the contract is entered into. Then, it is the responsibility of the plan fiduciary to review, understand and weigh that information. The failure of the fiduciary to do so (*e.g.*, by signing the documents without reading them) should not be imputed to the service provider and, thus, the arrangement should not be a prohibited transaction because of the failure of the responsible plan fiduciary to review and evaluate the disclosures or the contract.

2. Services and Compensation

The proposed regulation requires that various disclosures be made in writing before the contract is entered into or before a contract is extended or renewed. The disclosures must be made to the "best of the service provider's knowledge" and must be provided to the fiduciary with the authority to cause the plan to enter into, extend or renew the contract on behalf of a plan (referred to by the DOL as the "responsible plan fiduciary"). Additionally, the contract must affirmatively require the service provider to make these disclosures.

There are four types of disclosures that must be made:

a. All services to be provided to the plan under the contract.

General Comments: The proposed regulation does not specify how the services are to be described. However, in both the preamble (where the DOL explained much of its thinking) and the proposed regulation, the DOL generally used the term "services" broadly. Further, the disclosure is not limited to the covered service. As noted earlier, the DOL indicated in the preamble that "A service provider must describe all services that it will provide, *regardless of whether such services are described in the proposal's applicable scope provision*. For example, if a plan consultant will provide appraisal, legal, and administrative services to the employee benefit plan in addition to its consulting services, then all of these services must be described." [Emphasis added]

The DOL also indicated in the preamble that the written contract may incorporate other materials by reference, but only if they are adequately described and explained. As a result, it would be possible to describe some or all of the services in a separate document and then incorporate that document by reference. However, the separate document would need to be provided to the responsible plan fiduciary prior to entering into the contract. Further, the contract would need to describe that separate document and explain the relevance of the information it contained.

Impact on Independent Recordkeepers: Recordkeepers should have little concern with this requirement. While it would theoretically be possible for the recordkeeper to state that it is providing "recordkeeping services" without further detail, in our experience recordkeeping contracts describe the services to be provided in considerable detail, and clearly in more detail than is required in the regulation. In our view, this is a good practice, and there is no reason to change the contracts merely because the regulation does not mandate more.

The regulation permits incorporation of other documents for making the disclosures. The DOL states in the preamble to the proposed regulation that it "expects that the service provider will clearly describe these additional materials and explain to the responsible plan fiduciary the information they contain." In recordkeeping contracts we review, we often see certain policies, such as float, loan documentation, distribution processing and privacy issues addressed in separate attachments to the basic agreement (or, in some cases, in separate materials). This aspect of the regulation may require some recordkeepers to make changes in their procedures. That is, it may be necessary for the recordkeeper to separately provide the information contained in the schedules in advance of entering into the contract, rather than after the plan has made the "buy" decision and is presented with the contract for signature. Again, however, if there is no detriment to reversing the decision to use the provider (*i.e.*, recordkeeper), we believe the better reasoning is that the contract and the disclosures can be presented to the responsible plan fiduciary after a tentative decision has been made but before the arrangement is entered into (*e.g.*, before it is binding or implemented). As a practical matter, though, the competitive marketplace may force the compensation and conflict disclosures to be made early in the process, at least where there is a competitive process (*e.g.*, an RFP).

b. For each service, the direct and indirect compensation to be received by the service provider and its affiliates and the manner of calculation of the compensation.

General Comments: This requirement does not mean that a service provider is required to separately price each of the services that it describes in its contract, only that it specify any fees that may be imposed for specific types of services, such as loan processing or distributions. Nevertheless, for risk management purposes, it is important for covered service providers to adequately describe their services (1) because the failure to do so may cause the arrangement to be a prohibited transaction (that is, the description of services does not satisfy the regulatory requirement)—and the compliance burden is on the service provider—and (2) the descriptions may be used by the DOL and/or plaintiffs' attorneys who later challenge the reasonableness of the service provider's compensation.

The definition of compensation includes both money and "any other thing of monetary value (for example, gifts, awards and trips)" and covers amounts received directly from the plan or plan sponsor and amounts received indirectly (*i.e.*, from a source other than the plan or the plan sponsor). With respect to the non-monetary items, the proposal does not specify how to value the items. However, as a general premise, service providers must disclose whether compensation is a fixed amount, a formula, a percentage based on plan assets, a per participant charge or any of the above. The proposed regulation does not offer other alternatives for how the disclosure might be made, such as an hourly charge or transaction-based fee (although those may be included in a broad definition of "formula"). Nevertheless, the information about the calculation of fees must be specific enough that the responsible plan fiduciaries can determine whether the fees are reasonable.

Finally, the disclosure must include amounts received by the service provider or any affiliates of the service provider.

Impact on Independent Recordkeepers: In our experience, in most cases this requirement will not present a significant issue for recordkeepers because they describe their fee in detail.

However, to the extent a recordkeeper receives or may receive indirect compensation (such as float income, revenue sharing payments from mutual funds, or bonus or other payments in connection with changes in other service providers, such as a custodian), these will need to be disclosed in advance (or, if it is not known in advance, it will need to be disclosed when it occurs under the 30-day provision discussed later in this Bulletin). It will not be possible to use a generic form of disclosure without including the specific formula or other basis on which the amount of indirect compensation is determined. To deal with the variability of compensation, it will probably be necessary for the recordkeeper to use a chart (or other descriptive materials) on a fund-by-fund or provider-by-provider basis. In an open architecture context, this would probably require updating and sending out a new chart from time to time (under the 30-day disclosure provision discussed later) as funds or providers change.

While a number of recordkeepers already provide these types of disclosures, in our experience it is sometimes necessary for the plan sponsor or fiduciaries to specifically ask for it. Waiting to be asked will no longer be possible under the regulation, however, so some recordkeepers may need to change their upfront disclosures to ensure that the probable forms of compensation are identified to the responsible plan fiduciary in advance.

The definition of compensation also includes non-monetary items. The proposed regulation gives examples of gifts, trips or awards received or to be received by the service provider in connection with services to be provided under the contract. In our experience, this is generally not an issue for independent recordkeepers, though if it is, advance disclosure will be required (or, alternatively, disclosure will need to be made under the 30-day provision discussed later in this bulletin).

This disclosure requirement also applies to compensation received by affiliates. (There is a partial exception for bundled providers. We will discuss the bundled disclosure issues in a subsequent bulletin.)

Finally, the requirement to disclose the compensation to be received by affiliates may require certain changes in recordkeeper contracts or other forms of disclosure. For example, if a recordkeeper has an affiliated investment adviser that provides advisory services to client plans, the recordkeeper will need to disclose that its affiliate receives compensation for these services, though it may be able to incorporate its affiliate's disclosure materials by reference (since the affiliate will have its own disclosure obligations as a covered service provider).

c. The method for calculating and repaying any prepaid compensation if the contract terminates.

Impact on Independent Recordkeepers: We do not anticipate that this requirement will have a significant impact on independent recordkeepers, since in our experience they are generally not paid in advance.

d. The manner of receipt of the compensation.

General Comments: The proposed regulation requires that a service provider disclose the manner in which it will receive its compensation, for example, whether it will bill the plan, deduct fees from plan accounts or reflect a charge against the plan investments.

Impact on Independent Recordkeepers: This disclosure should not present a significant issue inasmuch as the method of payment is generally now made clear in the contract. To the extent that any indirect compensation is not now disclosed, it will need to be in the future and the manner of payment should be a part of that disclosure.

3. Conflicts of Interest: Fiduciary Status

The proposed regulation would require a service provider to disclose whether it or an affiliate will provide any services to the plan as a fiduciary as defined under either ERISA §3(21) or the Investment Advisers Act of 1940 (the '40 Act). Regarding this requirement, the DOL stated in the preamble that "The Department believes it is important for the responsible plan fiduciary and the service provider to understand at the outset of their relationship whether or not the service provider considers itself a fiduciary and how this status affects the nature of the services to be provided." The preamble also indicates that this disclosure requirement applies to both acknowledged and functional fiduciaries, that is, a person who meets the definition of a fiduciary under ERISA because of his activities (a "functional" fiduciary) rather than because he is selected or appointed as, and agrees to be, a fiduciary (an "acknowledged" fiduciary).

General Comments: A person or entity is a fiduciary under ERISA to the extent it exercises discretionary authority or control over management of the plan, exercises any authority or control over management or disposition of plan assets, provides investment advice for compensation or has any discretionary authority or responsibility over plan administration. Under this requirement (and subject to the "best of the service provider's knowledge" provision), a covered service provider will be required to acknowledge–in writing–whether he (or it) is an ERISA fiduciary, even if the contract does not spell out that the service provider falls within one of the definitions. The failure to do so would cause the arrangement to be a prohibited transaction. That is problematic for service providers who do not ordinarily acknowledge that they are fiduciaries, but who may be functional fiduciaries.

The proposed regulation may be read to require only that a fiduciary state that it is functioning as such and, thus, not to require an affirmative statement that it is not a fiduciary. However, silence on that issue will be the equivalent of a statement that the service provider is not acting as a fiduciary (and we generally recommend that a contract state affirmatively, where appropriate, that the service provider is not acting as a fiduciary and does not have or exercise any discretion over the plan or provide investment advice to the plan or its participants). Because of that, if a covered service provider is acting as a fiduciary and the contract does not say so, the arrangement will be a prohibited transaction with the attendant remedies and penalties.

Impact on Independent Recordkeepers: This disclosure should not present an issue for most recordkeepers. In our experience, independent recordkeepers generally neither have nor exercise any discretion over management or administration of a plan or its assets, so they will not need to make this disclosure. (One exception is where the recordkeeper is a bank trust department or a trust company that acts as a directed trustee for the record kept plans, or is affiliated with such an entity. This is because the DOL takes the position that, under ERISA, a trustee is always a fiduciary, even if its duties are limited. For example, the DOL position is that even a directed 401(k) trustee has a fiduciary duty to hold the assets in trust and to protect those assets. *See* Field Assistance Bulletin 2004-03. As a result, in such an arrangement the recordkeeper will need to disclose its limited fiduciary status.)

While most independent recordkeepers operate in an open architecture environment, some have a limited lineup of investments and periodically make changes to that lineup. In those situations, there is some controversy (and pending litigation) over whether (and under what circumstances) a recordkeeper that has the ability to remove and replace investment options from its platform is a fiduciary to the plans it serves. A complete review of this issue is beyond the scope of this Bulletin (for a discussion in some detail, *see* Revenue Sharing Litigation: A Threat to 401(k) Plans by Fred Reish and Bruce Ashton, which appeared in the Autumn 2007 issue of the *Journal of Pension Benefits* [http://www.reish.com/publications/article_detail.cfm?ARTICLEID=704]. Where a recordkeeper has this authority, it will need to make a business decision on whether it is a fiduciary and whether to acknowledge fiduciary status (in order to avoid the adverse consequences if it is later determined that it is but failed to disclose it) or adopt (or, at least, review its) procedures to avoid that status. One approach for avoiding fiduciary status would be to follow the process described by the DOL in Advisory Opinion 97-16A. There, the DOL said that if the service provider gave a reasonable advance notice of a possible change in an investment option, allowed the plan sponsor (*i.e.*, the responsible plan fiduciary) a reasonable period in which to object to the change or it would be deemed to have agreed to the change, and gave the plan another reasonable period to terminate the arrangement with the service provider without penalty, the service provider would not be exercising discretion and would not become a fiduciary by virtue of the change. This is sometimes referred to as the "Aetna Process." One of the key elements of that process is the

"deemed approval" provision if the responsible plan fiduciary fails to respond to a recommended change.

Because of the requirement to disclose fiduciary status of the service provider and its affiliates, if a recordkeeper is affiliated with an investment advisory firm that is providing services to the same plan, the recordkeeper will need to disclose that the investment adviser is a fiduciary under the '40 Act—and may need to disclose that it is a fiduciary to the plan under ERISA as well, depending on whether its advice falls under the ERISA fiduciary definition.

4. Conflicts of Interest: Financial or Other Interest

Service providers will need to disclose whether they or an affiliate will have any financial or other interest in any transaction to be entered into by the plan in connection with covered services. If they will have such an interest, they would need to provide a description of the transaction and their participation or interest in it. The example given by the DOL in the preamble is assistance in the sale of property in which an affiliate of the service provider has an interest. Of course, that would apply to the sale or purchase of any asset.

General Comments: This requirement appears to be very broad. If a service provider engages in any transaction (as a principal or intermediary) or co-invests with a plan, it would seem to fall under this item and would need to be disclosed. Note that there is not a materiality standard; as a result, it would apply to any participation or interest in a transaction with a plan, no matter how small.

Impact on Independent Recordkeepers: This would seem to have little impact on most independent recordkeepers. In our experience, it would be unusual for an independent recordkeeper or an affiliate to have an interest—other than through the receipt of compensation for services provided—in transactions engaged in by plan clients. That said, the next potential conflict issue would appear to have significant issues for recordkeepers, as it does for the vast majority of covered service providers.

5. Conflicts of Interest: Other Relationships or Arrangements

The proposed regulation requires a service provider to disclose whether it or an affiliate has any material financial, referral or other relationship or arrangement with a money manager, broker or other service provider to the plan, or other person or entity, that creates or may create a conflict of interest in performing services for the plan. The preamble explains that the service provider is required to disclose any "material financial, referral or other relationship" with third parties and states that, "If the relationship between the service provider and this third party is one that a reasonable plan fiduciary would consider to be significant in its evaluation of whether an actual or potential conflict of interest exists, then the service provider must disclose the relationship." The DOL goes on to give some of its thinking behind this requirement:

> "The proposal also provides that a reasonable contract or arrangement must require the service provider to disclose its relationships with other parties that may give rise to conflicts of interest. Specifically, subsection (D) obligates the service provider to describe any material financial, referral, or other relationship it has with various parties (such as investment professionals, other service providers, or clients) that creates or may create a conflict of interest for the service provider in performing services pursuant to the contract or arrangement. If the relationship between the service provider and this third party is one that a reasonable plan fiduciary would consider to be significant in its evaluation of whether an actual or potential conflict of interest exists, then the service provider must disclose the relationship."

General Comments: Even though the disclosure requirement only applies to "material" relationships or arrangements, the concept of materiality is from the perspective of the responsible plan fiduciary and not the service provider. Thus, a broader range of disclosures may be required than one might otherwise anticipate. The DOL described its concern in the preamble as follows:

> "As service arrangements have become more complex, so have the ways that service providers are compensated, as well as the relationships among different players in the plan service provider industry. Plan fiduciaries must know of these relationships and indirect sources of compensation because they may impact the manner in which the provider performs services for the plan. There may be other, oftentimes subtle, influences on the service provider or its affiliates that may be relevant to a plan fiduciary's assessment of the objectivity of a service provider's decisions or recommendations."

The question has come up about whether the disclosure must specifically state whether the relationships are conflicts of interest. We do not believe this is required. However, the description must be clear enough that a reasonable plan fiduciary could identify and evaluate the existence of the potential conflict.

It is possible that the service provider will be required to make three separate disclosures, since there are three different relationships referred to in the regulation:

- Financial relationships will presumably not be hard to identify. If a service provider receives any form of "compensation" as defined from a third party in connection with the services it provides to a plan, the existence of that relationship will need to be identified (subject to the materiality standard). However, to the extent the compensation has already been addressed in the description of the service provider's compensation (as would ordinarily be the case), in our view, no additional description would need to be provided under this item.
- The meaning of a referral relationship is less clear. One interpretation is that it refers to a situation in which one party compensates a third party (with money or items that have monetary value) for referrals, *e.g.*, a finder's fee. Another would include a "cross-referral" relationship where two service providers refer significant amounts of business to each other, even if it is not *quid pro quo*. Certainly, the first referral relationship must be disclosed; perhaps the second does also. Put another way, this would seem to require disclosure where the person receiving the referral is indebted in some way to the person making it and/or that the person making the referral may be compensated in some way for making the referral. In either case, to the extent the existence of this type of relationship might affect the impartiality of the contracting service provider's service to the plan, disclosure will be required. (Since the regulation will be an exemption, or exception, to a prohibited transaction, the burden will be on the service provider to prove that it complied. As a result, service providers may have no practical choice but to disclose everything that might be required and that may reasonably be viewed as material.)
- The "other relationship" requirement is so open-ended that it may be something of a trap. Keep in mind that the relationship has to be material and also has to be one that "creates or may create a conflict of interest in performing services for the plan." Whether a relationship that is not financial or referral would fall meet this requirement may be difficult to identify, since the concept of a "conflict of interest" itself is not clear. Indeed, in comments

provided to the DOL on this issue, we requested clarification by way of example of what the DOL was considering.

Impact on Independent Recordkeepers: The extent to which this requirement will require new disclosures for recordkeepers is not entirely clear. Presumably, their financial relationships will be disclosed in connection with their compensation disclosures. As to the second category, recordkeeping firms have many referral relationships that yield significant amounts of business (and thus may be viewed as "material.") However, whether those relationships are such that they "create or may create a conflict of interest in performing services for the plan" is far from clear. And in any case, the "relationship" must be such that it could give rise to a conflict with respect to the specific plan to which the disclosure is being made.

Clearly, the conservative view is to disclose anything that might fall within this item to avoid having the arrangement be treated as a prohibited transaction.

6. Conflicts of Interest: Ability to Affect Own Compensation

Under the proposed regulation, a service provider would need to disclose whether it or an affiliate would be able to affect its compensation without the prior approval of an independent plan fiduciary. The DOL provides as examples "incentive, performance-based, float, or other contingent compensation." If the service provider can affect its compensation without prior approval, it would need to describe that fact and the nature of the compensation.

Impact on Independent Recordkeepers: There are a number of ways in which this requirement could affect a recordkeeper. One would be if the recordkeeper reserves the right in the contract to increase its annual fee, participant charge or charges for specific services either materially or by giving notice to the client, but without getting the fiduciary's approval. Unless the contract provides for "deemed approval" through a process similar to the Aetna Process discussed above, this type of provision gives the recordkeeper the ability to increase its compensation without approval. While there is no restriction on the right to do so (so long as the service provider is not a fiduciary), we presume that the statement is not one that most recordkeepers would feel comfortable making. (Also, since the ability to set the compensation of a service provider is a fiduciary activity, it is possible that, under some circumstances, a service provider may become a fiduciary by virtue of setting its own compensation. However, we doubt that would be the outcome for changes in fees where the change was fully disclosed to the responsible plan fiduciary with adequate notice.) However, to clearly be safe, consideration should be given to either adding the Aetna Process or requiring that in order for a fee increase to become effective, the client must approve it.

Another way in which this disclosure might arise is in connection with float income. (In fact, the DOL uses float as an example in the preamble to the proposed regulation.) In our experience, some recordkeepers receive interest on float amounts which are contributed to the plan without adequate allocation instructions or on distributions where the payment amounts are held in the recordkeepers general account until the participant (or transferee plan or IRA custodian) cashes the check. While some recordkeepers already have a float policy in which disclosure of the circumstances under which they receive income on the float amounts is made, this issue will need to be addressed for any that do not. It does not appear that the recordkeeper will have to state explicitly in its float policy that it has the ability to affect its own compensation so long as the policy itself is clear that this is the case. (In the common circumstances, the recordkeeper cannot control the amount of funds that constitute "float," but it can affect its compensation by how, and in some cases how long, the funds are invested pending allocation or payout.) As a result of these 408(b)(2) proposals, recordkeepers need to develop adequate float policies (if they have not already done so) and disclose the polices as part of this process or, alternatively, include them in the recordkeeping agreements.

As a practical matter, recordkeepers need to examine every source of revenue and to determine if, under any circumstances, they can affect the levels of those revenues without prior approval of a responsible plan fiduciary. If so, that will need to be disclosed in writing before the contact is entered into.

It is unclear from the proposed regulation how detailed the disclosure of any of these potential conflicts would have to be, that is, whether a simple disclosure that the compensation of the recordkeeper will vary based on its relationship with one or more providers is sufficient or whether something more specific is required. We believe that the better reasoned position is to disclose enough that the responsible plan fiduciary is aware of the potential conflict of interest and is thus alerted of the possible need to protect the plan from any likely consequences of the conflict. It would then be up to the fiduciary to decide if it needs additional information to fully assess the potential conflict. (Of course, where the conflict involves compensation that is received by the recordkeeper—as most conflict disclosures will—the responsible plan fiduciary must be given sufficient information to be able to evaluate the reasonableness of the compensation.)

7. Conflicts of Interest: Policies to Address Conflicts of Interest

The proposed regulation requires disclosure of whether a service provider or an affiliate has any policies or procedures that address actual or potential conflicts of interest. If a service provider has such policies or procedures, the contract or related disclosure materials must explain them to the responsible plan fiduciary and describe how they address conflicts of interest or prevent an adverse effect on the plan. For example, a procedure for offsetting revenue sharing or other indirect payments would need to be disclosed. However, service providers are not required to develop any such policies or procedures if they do not already have them.

General Comments: This requirement will impact some service providers, but not others. It will depend primarily on whether the members of a particular industry commonly have such policies. Service providers are advised to review their corporate ethics and conflicts of interest policies as a part of their compliance with this requirement.

Interestingly, the fact that an offset policy would need to be disclosed implies that the receipt of revenue sharing is a potential conflict of interest that needs to be disclosed as such. Our view is that the disclosure of revenue sharing under the compensation disclosure requirements would, in most cases, be adequate to also satisfy the conflict of interest disclosure requirement. That is, where the same activity constitutes both compensation and a potential conflict, a single disclosure, if adequate, will satisfy both conditions. Further, the description in connection with the compensation disclosure of how the offset policy works would also appear to satisfy this requirement.

Impact on Independent Recordkeepers: To the extent a recordkeeper has written conflict of interest policies, a description of the relevant portions of such policies must be provided to the responsible plan fiduciary in advance of entering into the contract.

8. Material Changes

The terms of the contract must require that the service provider disclose, in writing, any material change to the responsible plan fiduciary not later than 30 days from the date on which the service

provider acquires knowledge of the material change. (The proposed regulation does not explicitly require that the disclosure be in writing. However, we believe the regulation may reasonably be interpreted to impose that requirement, since it is in effect a modification of a contract that itself is required to be written. In any event, a material change should be disclosed in writing as evidence of compliance.)

General Comments: The short time period for notifying clients of a material change could be problematic. In comments we have made to the DOL on the proposed regulations, we recommended that the time frame be extended to longer than 30 days. Others have suggested that the final regulation permit annual (*i.e.*, once-a-year) updates.

"Material" in this context refers to items that a reasonable plan fiduciary would view as "significantly altering the 'total mix' of information made available to the fiduciary, or as significantly affecting [the] fiduciary's decision to hire or retain the service provider," not items that are material to the business of the service provider.

Impact on Independent Recordkeepers: We do not anticipate that this requirement will impact independent recordkeepers more than other service providers. As noted earlier, however, in the open architect context, this may require periodic re-circulation of the chart of available funds and revenue sharing paid by each. That is because any change in a plan's investments (*e.g.*, mutual funds) may change the revenue sharing (*e.g.*, sub-transfer agency fees) being received by the recordkeeper.

In any case, the 30-day provision will require the establishment of procedures to identify and then disclose any changes in information on a timely basis.

9. Reporting Assistance

The proposed regulation requires a service provider to disclose "all information related to the contract and any compensation received thereunder" if it is requested by the responsible plan fiduciary or plan administrator in order to comply with ERISA's reporting and disclosure requirements. This would arise most frequently in the context of reporting information on Schedule C to the Form 5500 for large plans (*i.e.*, as a general rule, plans with 100 or more participants).

General Comments: Service providers need to be aware of their obligation to provide this information. The failure to do so could convert a "reasonable" contract into a prohibited transaction. Further, the burden is likely to increase in the future when the DOL issues a new regulation concerning the information that must be given to participants about fees and expenses.

Impact on Independent Recordkeepers: This condition should not have a material impact on independent recordkeepers in the sense that most already prepare the Form 5500 for their clients and, as a result, are already providing the information needed for that Form.

Having said that, though, the Form 5500 2009 Schedule C requires much greater reporting of service provider compensation. That could, in and of itself, increase the work needed to complete the 5500 Form, *e.g.*, because of the need to report revenues of other plan service providers and to classify it as direct compensation, eligible indirect compensation and other (or "ineligible") indirect compensation.

10. Actual Disclosure

The proposed regulation requires that, in order for the exemption to apply: (i) the service provider must have a written contract that requires it to make the disclosures described in this Bulletin; and (ii) that it actually make these disclosures.

Impact on Independent Recordkeepers: This item should not present any issues separate from those discussed elsewhere in this Bulletin.

Effective Date

See our February 4, 2008 Bulletin for a discussion of the effective date. In our view, recordkeepers should begin working on compliance now, since it appears that the final regulation will be upon us no later than the end of this year and, in our experience, the establishment of new procedures and adoption of new forms of contracts or other disclosures may require an extensive internal review process and the development of new disclosure procedures.

Conclusion

For some independent recordkeepers, the proposed regulation may require certain changes in business practices, but in general should not have a significant impact on the documentation of their relationships with their clients other than the timing of disclosures.

For other independent recordkeepers, changes will require greater disclosure of both indirect compensation and conflicts of interest.❖

Around the Firm

Speeches: On June 11th, **Marty Heming** presented "How to Avoid Liability in a Post *LaRue* World" to the Sacramento Chapter of NIPA in Sacramento. On June 12th, **Fred Reish** presented "Promises and Arrangements, and the Transparent Provider: A (Fee) Mystery Unraveled" at the Defined Contribution Symposium in San Francisco. He also presented "Hot Topics/ Top Fiduciary Concerns" and "Duty Bound: Best Practices for Plan Fiduciaries" at the Plansponsor Plan Designs Conference in Chicago, IL on June 18th-19th.

Articles: In the June issue of *PLANSPONSOR* magazine, **Fred** wrote a column entitled "For Better or Worst." In the June issue of the *Pension Plan Fix-It Handbook*, **Nick White** wrote the article "ERISA Section 404(c) Protection: A Reminder of What it Is...and Isn't."

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