IMPORTANT PENSION CHANGES FROM D.C. - WHAT DO YOU NEED TO KNOW?

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I. Broader "Fiduciary" Definition

The fiduciary standards under ERISA are "the highest known to the law."[1] And unlike securities laws which generally allow you to mitigate conflicts of interest through disclosure, ERISA requires you to either eliminate the conflict or satisfy the strict conditions of a prohibited transaction exemption. Consistent with the Obama Administration's campaign to reduce conflicts of interest in the 401(k) plan industry, on October 21, 2010, the DOL released its proposed regulations to modify the existing regulatory definition of an "investment advice fiduciary." These rules, if adopted, would broaden the existing regulatory definition of "investment advice" under ERISA considerably.

A. Overview of Existing Regulatory Definition

Under the current regulation, a person is deemed to provide fiduciary investment advice if:

(1) such person renders advice to the plan as to the value or advisability of making an investment in securities or other property
(2) on a regular basis,
(3) pursuant to a mutual agreement or understanding (written or otherwise)
(4) that such services will serve as a primary basis for investment decisions, and
(5) that such person will render advice based on the particular needs of the plan.

It should be noted that this 5-factor definition of "investment advice" is much more narrow than the definition under federal securities law. For example, the Investment Advisers Act of 1940 has a rather expansive view of the advisory activity that is subject to regulation as investment advice.

B. Two Specific Changes to Existing Regulatory Definition

The proposed regulations, if adopted, would make two specific changes to the existing definition of "investment advice." Under the existing rule, advisors are deemed to provide investment advice if, among other requirements:

- there is a "mutual" understanding or agreement that the advice will serve as the "primary basis" for plan investment decisions, and

- the advice is provided on a "regular basis."

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[1] Donovan v. Bierwirth, 680 F.3d 263 (2d Cir.), cert. denied, 459 U.S. 1069 (1982).

However, under the DOL's proposed rulemaking, an advisor is deemed to provide investment advice if there is any understanding or agreement that the advice "may be considered" in connection with a plan investment decision, regardless of whether it is provided on a regular basis. Under both the existing and the proposed rules, advice will constitute "investment advice" only if it is individualized advice for the particular plan client.

C. Safe Harbor for Avoiding Fiduciary Status

In addition to broadening the existing "investment advice" definition, the proposal effectively introduces a safe harbor that advisors would need to follow to avoid fiduciary status.

Generally, to avoid being characterized as an investment advice fiduciary under the proposed regulations, an advisor must be able to "demonstrate" that the plan client knows, or reasonably should know, that (a) the advice or recommendations are being made by the advisor in its "capacity as a purchaser or seller" of securities or other property, and (b) the advisor is not undertaking to provide "impartial investment advice." The proposal generally does not specifically require a written disclosure to be provided to the plan client, but the proposal clearly contemplates and encourages written disclaimers.

D. Two Specific Activities Exempted Under Safe Harbor

The proposed rules further state that investment education within the meaning of the DOL's longstanding guidance on non-fiduciary education, as provided under Interpretive Bulletin 96-1, shall not constitute investment advice.

Furthermore, investment advice shall not include a platform provider's marketing or making investment alternatives available to a plan (without regard to individual needs of a plan) or providing general financial information to assist a plan fiduciary's selection or monitoring of such investment alternatives, so long as the platform provider discloses in writing that it is not providing impartial investment advice.

E. Potential Impact on Financial Advisors

If the proposed regulations were finalized in their current form, brokers currently advising 401(k) plan sponsors and participants in a non-fiduciary capacity would undoubtedly need to change their service model and re-define their role as plan advisors. To avoid fiduciary status, they would effectively be forced to furnish written disclaimers to plan clients, stating that they are not providing impartial advice, as contemplated under the proposed DOL guidance.

If they failed to provide any disclaimer, a broker could be viewed as an "investment advice fiduciary" and any variable compensation, such as 12b-1 fees, received by the broker would trigger a non-exempt prohibited transaction under ERISA. The penalties for a prohibited transaction generally include a right of rescission by the plan client, a "first tier" 15%-per-year excise tax and a "second tier" 100% excise tax, and a 20% civil penalty on any amounts recovered through DOL action.

Alternatively, a broker serving as a plan fiduciary could avoid these penalties by becoming a dual-registered investment adviser. This action would enable it to charge an asset-based fee (such as a wrap-fee), eliminating the problems associated with variable compensation.

F. Potential Impact on Other Providers

The proposed regulations, by their terms, would impact platform providers directly. To comply with the proposed safe harbor, they would need to disclose in writing that they are not providing impartial investment advice. This may have a substantial impact on platform providers that deliver advisory services regarding the selection of plan investment alternatives, especially those delivering such services in exchange for any type of direct or indirect compensation. Like brokers, platform providers offering advisory services could provide non-conflicted advice by adopting an asset-based fee, although this change would similarly require the provider to become registered as an investment adviser.

Similarly, TPAs that also provide advisory services in exchange for variable compensation would need to either provide the required disclaimers, or register as investment advisers in order to provide their advisory services for a level fee in a non-conflicted manner.

G. Outlook for DOL Proposed Regulations

This regulatory proposal is consistent with the Administration’s aim to reduce conflicts in the 401(k) plan industry, and it aims to impose ERISA’s fiduciary standards on a large segment of financial professionals who do not currently hold themselves out as fiduciaries. If adopted, the proposed regulations would force them to adopt fee-leveling, change the nature of their services so that they are not viewed as providing fiduciary advice, or otherwise eliminate any perceived conflicts of interest. Given the significance of the DOL’s rulemaking, the proposed regulations are expected to draw heavy comments. Written comments on the proposed regulations may be submitted to the DOL on or before February 3, 2011. Due to the considerable interest expressed by various segments of the employee benefits and financial services communities, the DOL is also holding a public hearing on March 1, 2011.

H. New Fiduciary Standard for Brokers Under The Dodd-Frank Act.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which was enacted on July 21, 2010, is expected to impact the standard of conduct of those financial advisors who provide their services as registered representatives of broker-dealers. Although these rules under the Dodd-Frank Act are unrelated to the DOL's regulatory initiative to broaden the "fiduciary" definition under ERISA, they are expected to impact the standard of care that brokers must adhere to when advising their clients, including retirement plan clients.

Under the powers conferred by the Dodd-Frank Act, the U.S. Securities and Exchange Commission (the "SEC") is authorized to issue regulations that will impose on broker-dealers the same fiduciary standard that applies to investment advisers under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). Under the Advisers Act, investment advisers have a fiduciary duty to act solely in the best interests of the client and to make full and fair disclosures of all material facts, including conflicts-related disclosures. However, under current law, brokers are generally only subject to a duty of "suitability," which requires the broker to recommend investments that are suitable for the specific investor. The recommended investment does not have to be in the best interests of the client. Many brokers who advise plan clients do so in a non-fiduciary capacity, so they are not subject to ERISA's fiduciary standards under current DOL regulations. Thus, non-fiduciary advisors are allowed to make recommendations which are conflicted, skewed to investments that generate higher fees, without any restriction under ERISA or the Advisers Act.

As required under the Dodd-Frank Act, on January 21, 2011, the SEC's staff published its study on the different standards of conduct that currently apply to broker-dealers and investment advisers. In sum, the SEC staff's report recommended that the SEC consider rulemakings consistent with the authority already granted to the SEC under the Dodd-Frank Act, to create a uniform fiduciary standard that would apply to both brokers and investment advisers when they provide personalized investment advice to retail customers. The report did not provide any guidance on the extent to which plan clients would be viewed as retail customers. Of the 5 commissioners serving on the SEC, the 2 Republican appointees released a separate statement, criticizing the report and making the following points: (i) the SEC staff's report does not reflect the views of the SEC or its individual commissioners, (ii) the report failed to properly evaluate the existing standards of care applicable to broker-dealers and investment advisers as required by the Dodd-Frank Act, and (iii) additional study, rooted in economics and data, is required to support any recommendation for a uniform fiduciary standard.

No Congressional approval is necessary for the SEC to proceed with its rulemaking, and it is somewhat unclear if the SEC staff will conduct any type of follow-up study. Depending on how the SEC decides to exercise its rulemaking authority under the Dodd-Frank Act, brokers who advise plan clients and participants may be significantly impacted and may be subject to

new conflicts-related disclosure requirements. These changes would be in addition to any future regulatory changes imposed by the DOL concerning when and how a broker could be viewed as providing fiduciary "investment advice" for ERISA purposes.

II. Fee Disclosures to Participants

On October 14, 2010, the DOL finalized its regulations concerning the fee and investment-related disclosures that must be provided to participants in 401(k) plans and other defined contribution plans with participant-directed investments. The final regulations are generally consistent with the DOL's 2008 proposed rules, reflecting modest changes based on comments received by the agency.

In its press release announcing the issuance of these final rules, the DOL explained that existing law did not require plans to provider workers with "the information they need to make informed investment decisions regarding the investment of their retirement savings," such as fee and expense information. However, the new rules would enable the estimated 72 million affected participants "to meaningfully compare the investment options under their plans."

A. Types of Plans Covered

The new participant disclosure requirements only apply to participant-directed individual account plans, such as 401(k) plans, and they do not apply to defined contribution plans with employer-directed investments.

Many participant-directed plans are designed to comply with the requirements of ERISA Section 404(c), a provision which relieves plan sponsors of any fiduciary responsibility for the investment allocation decisions of individual participants. However, the new participant disclosure requirements cover all participant-directed plans, even if they are not designed to comply with ERISA Section 404(c). The fiduciary obligation to provide the mandatory disclosures is generally imposed on the plan sponsor.

B. Coverage of Participants

The new disclosure requirement applies to all eligible employees, and not merely participants who have actually enrolled in the plan. Thus, the entire eligible employee population will need to receive the relevant disclosures on an ongoing basis. The required disclosures include both plan-related information and investment-related information.

C. Annual and Quarterly Disclosure of Plan-Related Information

Under the DOL's final regulations, participants must be furnished general information about the plan annually, including an explanation of how participants may give investment

allocation instructions and information concerning the plan's investment menu. Plan participants must also receive an annual explanation of the *general administrative service fees* which may be charged against their accounts as well as any *individual expenses* charged for individualized services (*e.g.*, plan loan processing fee). With respect to new participants, this information must be provided before they can first direct investments under the plan.

Participants must also receive certain information on a quarterly basis. They must receive statements that include the quarterly dollar amounts actually charged to their plan accounts as general administrative service fees and as individual expenses, as well as a description of the relevant services.

The annual and quarterly fee disclosures for general administrative services and individual expenses only apply to the extent such fees are not already reflected in the total annual operating expenses of the plan's investments. For example, if a service provider is wholly compensated through indirect compensation flowing from a plan's investment funds (*i.e.*, the provider's fees are already reflected in each fund's per-share market value or "NAV"), the provider's fees and services would not be subject to these annual and quarterly fee disclosures. However, if any portion of the fees for general administrative services are paid from the total annual operating expenses of any of the plan's investments (*e.g.*, through revenue sharing or 12b-1 fees), an explanation of this fact must be included in the quarterly statements.

D. Annual Disclosure of Investment-Related Information

Plan participants must receive certain fee and performance-related information relating to the plan's various investment alternatives in a comparative format, for which the DOL has created a "model comparative chart." This information must be provided on or before the date on which a participant can direct investments, and annually thereafter.

The comparative information which must be provided includes: (a) the name and type of investment option, (b) investment performance data, (c) benchmark performance data, (d) fee information, including both the *total annual operating expenses* of each investment alternative and any *shareholder-type fees* which are not reflected in the total annual operating expenses, such as commissions and account fees, and (e) the internet website address at which additional information is available.

E. Information That Must Be Available Upon Request

Upon request, participants must be provided copies of fund prospectuses (or other corresponding documents) as well as any shareholder reports and related financial statements provided to the plan.

F. Form of Disclosure

The annual disclosures required under the DOL's regulations may be provided separately or as part of the plan's summary plan description ("SPD") or participant benefit statements. The required quarterly statements may also be provided separately or as part of the plan's participant benefit statements. All disclosures must be written in a manner calculated to be understood by the average participant.

G. Impact on Plan Sponsor's Other Fiduciary Duties

As expressly provided in the new DOL regulations, a plan sponsor's compliance with the new disclosure rules will not relieve it of its fiduciary duty to prudently select and monitor the plan's providers and investments.

The new regulations modify the DOL's existing regulations under ERISA Section 404(c). As discussed above, a plan sponsor can be relieved of any responsibility over the investment allocation decisions of individual participants, provided that the regulatory conditions under Section 404(c) are satisfied. To comply with the applicable investment-disclosure requirements under the 404(c) regulations, as modified by the DOL's new rules, participants simply need to receive the annual and quarterly disclosures required under the new regulations.

H. Effective Date

Although the DOL's participant disclosure regulations have been finalized, they have a delayed application date. The new disclosure requirements will be imposed on plan sponsors for plan years beginning on or after November 1, 2011. In the case of calendar year plans, they will go into effect on January 1, 2012.

I. Potential Impact on Administrative Service Providers

The new regulations will clearly have the greatest impact on third party administrators ("TPAs") and bundled service providers. Given the fact that the DOL's final regulations are generally consistent with its 2008 proposed rulemaking, providers that have already modified their systems based on the DOL's proposed rules are likely to require modest changes only.

There will be one administrative advantage under the new participant disclosure regime. Under existing 404(c) regulations, participants generally must receive a copy of a fund's prospectus prior to the participant's initial investment in such fund. As a practical matter, this burdensome requirement forced recordkeepers to deliver copies of all the plan's fund prospectuses to all new participants. However, as modified by the new rules, prospectuses will only need to be provided upon request by a participant.

J. Potential Impact on Financial Advisors

Under the new regulations, there is no special disclosure requirement for the fees and services of brokers receiving indirect compensation only (*e.g.*, 12b-1 fees and other types of revenue sharing payments). If the broker's compensation is fully reflected in the total annual operating expenses of the plan's investments, the annual and quarterly fee disclosures of plan-related information, as discussed above, would not apply. To the extent the broker's advisory services were deemed general administrative services, an explanation that a portion of the fees for such services were being paid from the total annual operating expenses of the plan's investments would have to be included in the quarterly statements. However, whether a broker's advisory services should be characterized as general administrative services is somewhat unclear under the new regulations.

With respect to registered investment advisers ("RIAs"), it is similarly unclear if a RIA's separate advisory fee (unrelated to the total annual operating expenses of the plan's investments) should be characterized as a general administrative service fee or a shareholder-type fee. If the advisory fee is deemed to be a general administrative service fee, it would need to be reflected in both the annual and quarterly disclosures, although the RIA's advisory fee would not have to be separately itemized. If the RIA's advisory fee can be categorized as a shareholder-type fee, they presumably would not have to be reflected in the quarterly disclosures as a general administrative service fee.

Even if the impact of the new regulations on many financial advisors will be indirect, it is likely to be significant. Given the detailed level and comparative nature of the disclosures that will be provided to participants, many will scrutinize their respective plan's investments and fees. The enhanced disclosures may also prompt them to pressure plan sponsors, asking "hard" questions about the performance of the plan's investments as well as the size of plan fees. This pressure is likely to reinforce the heightened scrutiny of 401(k) fees that is already being applied in the retirement plan market.

III. 408(b)(2) Disclosures from Service Providers

A. "Hidden" Fees and Conflicts of Interest

There has been a great deal of discussion surrounding the so-called "hidden" payments flowing from the plan's investments to its service providers (e.g., recordkeeper, pension consultant). Plan sponsor are undoubtedly aware of the "hard dollar" fees invoiced directly to the plan or the employer, but they may not necessarily understand that the service provider can also receive indirect compensation from the plan's investment funds and the managers of such funds. The hidden payments made to a plan's service provider might include shareholder servicing fees (as well as 12b-1 fees and sub-transfer agency fees) paid from the plan's investment funds or revenue sharing payments made directly from the fund managers. Thus, a

plan sponsor could conceivably select what appears to be a "free" administrative service for the plan, without understanding that the provider's compensation was being passed on to plan participants in the form of higher embedded costs in the plan's investment funds.

A plan sponsor's ignorance of the fact that administrative service providers can receive such indirect compensation creates a potential conflict of interest for the administrative service provider. By steering plan clients to the arrangement with the highest level of indirect compensation, the provider is presumably able to receive fees in excess of what plan clients would otherwise agree to if they knew the true cost of services. Ironically, the arrangement with the highest level of indirect compensation may be the most attractive to an uninformed plan client, because it would have lower "hard dollar" fees, creating the false impression that this service arrangement was the cheapest for the plan.

For example, let's assume that an employer is looking for a provider of administrative services to its 401(k) plan. The provider offers the plan sponsor two options: (1) the employer can order services *a la carte* with no restriction on the combination of services and investment funds available for an annual fee of $10,000, and (2) the employer may choose pre-packaged services with a limited investment menu for an annual fee of $4,000. If the plan sponsor does not realize that the provider is receiving "hidden" compensation from the plan's investment funds and fund managers, the plan sponsor may prematurely conclude that the second option is the best choice for the plan and its participants. Unfortunately, the total compensation payable to the provider under the pre-packaged option may greatly exceed $10,000 (*i.e.*, the cost of the first option), and the hidden cost would be directly or indirectly borne by the plan's participants.

Revenue sharing among a plan's investment and service providers is not prohibited under ERISA. But without full disclosure of the indirect compensation paid to the plan's service providers, the plan and its participants might end up paying fees that are unreasonable, resulting in a breach of its fiduciary duties under ERISA.

B. Retirement Security Initiative – Improving Transparency.

To address these concerns, the Obama Administration wants to improve "the transparency of 401(k) fees to help workers and plan sponsors make sure they are getting investment, record-keeping, and other services at a fair price."[2] Consistent with this policy objective, the Administration published interim final regulations on July 16, 2010 requiring service providers to provide specific discloses with respect to fees.

[2] *Annual Report of the White House Task Force on the Middle Class*, February 2010.

It should be noted that the Administration's policy objective to improve fee transparency in the 401(k) plan industry is based on political momentum which has been growing for several years. The U. S. Government Accountability Office (GAO), which is also known as the "investigative arm of Congress," laid much of the groundwork in its reports.

- The November 2006 report by the GAO, *Private Pensions: Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better Information on Fees*, reported that the "problem with hidden fees is not how much is being paid to the service provider, but with knowing what entity is receiving the compensation and whether or not the compensation fairly represents the value of the service being rendered."

- The GAO had concluded in its July 2008 report, *Fulfilling Fiduciary Obligations Can Present Challenges for 401(k) Plan Sponsors*, that plan sponsors were unable to satisfy their fiduciary obligations without disclosure of the "hidden" compensation flowing from the plan's investments to its service providers (e.g., recordkeeper, pension consultant).

- In its March 2009 report, *Private Pensions: Conflicts of Interest Can Affect Defined Benefit and Defined Contribution Plans*, the GAO concluded that there is a "statistical association between inadequate disclosure of potential conflicts of interest and lower investment returns for ongoing plans, suggesting the possible adverse financial effect of nondisclosure" of indirect compensation arrangements.

In addition, the DOL's fee disclosure rules for service providers are actually the second part of a three-pronged "reg project" designed to increase fee transparency.

- The first part involved improving a plan's fee disclosures on Form 5500, Schedule C. The DOL has already issued final regulations on the revised Schedule C and they apply starting with the 2009 plan year [3].

- The second part involves requiring service providers to give mandatory disclosures to plan sponsors under ERISA Section 408(b)(2). The interim final regulations were published on July 16, 2010.

- The third part involves mandatory disclosures from the plan sponsor to the plan's participants. As discussed earlier, the final regulations were released on October 14, 2010.

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[3] 72 Fed. Reg. 64710 (Nov. 16, 2007).

The three sets of fee-related disclosure regulations are the current installment in the 401(k) fee saga that began more than a decade ago. In 1997, the DOL held a hearing on 401(k) plan fees, which appeared to have been in response to several consumer magazines criticizing the size of such fees.[4] In 1998, the DOL published a 19-page booklet, "A Look At 401(k) Plan Fees," for plan participants and a 72-page report, "Study of 401(k) Fees and Expenses," for plan sponsors.[5] Unfortunately, the DOL's efforts to persuade plan sponsors and plan participants to ask the right questions about 401(k) fees has apparently failed. In light of that failure, the DOL is now requiring service providers to disclose the answers to questions that the DOL believes plan sponsors should have been asking.

C. Background – Prohibited Transaction Rules Under ERISA.

The prohibited transaction rules under ERISA cover a broad spectrum of activities. In addition to banning transactions that involve fiduciary conflicts of interest, the prohibited transaction rules also prohibit the use of plan assets with respect to many other activities (other than the payment of benefits). Fortunately, there is a specific exemption that allows the use of plan assets to pay fees for reasonable services.

ERISA Section 408(b)(2) provides relief from ERISA's prohibited transaction rules for the use of plan assets to pay for services between a plan and a party in interest (e.g., recordkeeper). The conditions of this statutory exemption are satisfied if:

- the contract or arrangement is reasonable,
- the services are necessary for the establishment or operation of the plan, and
- no more than reasonable compensation is paid for the services.

In addition to the above requirements under the statute itself, the current DOL regulations interpreting the statute impose only one other significant additional requirement. The plan must be able to terminate the service contract or arrangement without penalty on reasonably short notice.[6] Neither ERISA nor the current regulations impose a significant administrative burden on service providers nor expose them to significant risk of legal liability.

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[4] "Protect Yourself against the Great Retirement Rip-off," *Money Magazine* (April 1997). "Your 401(k)'s Dirty Little Secret," *Bloomberg Personal* (September 1997).

[5] A Look at 401(k) Plan Fees" is posted at http://www.dol.gov/ebsa/publications/401k_employee.html. The Study of 401(k) Fees and Expenses is posted at: http://www.dol.gov/ebsa/pdf/401kRept.pdf.

[6] 29 CFR 2550.408b-2(c).

D. Interim Final 408(b)(2) Regulations

1. Statute and Prior Regulations

ERISA §408(b)(2) provides relief from ERISA's prohibited transaction rules for service between a plan and a party in interest (e.g., a plan service provider) if the contract or arrangement is reasonable, the services are necessary for the establishment or operation of the plan, and no more than reasonable compensation is paid for the services. The prior regulations said little as to when a service provider contract or arrangement was reasonable.

2. Proposed Regulations

In December 2007, the U.S. Department of Labor ("DOL") proposed amending its regulations to provide that certain service provider contracts would be reasonable only if the covered service provider discloses to a responsible plan fiduciary specified information about the services to be performed, the compensation to be received and potential conflicts of interest of the service provider. The intent of the proposal was to enable plan fiduciaries to assess the reasonableness of compensation paid for plan services.

3. Interim Final Regulations

On July 16, 2010, the DOL released a revised version of the fee disclosure regulations. The effective date for these interim final regulations was recently pushed back from July 16, 2011 to January 1, 2012.[7] Thus, the final regulations will apply to existing services arrangements as of January 1, 2012 as well as to new arrangements entered into on or after that date. The one-year lead time is intended to accommodate the costs and burden of transition to the new disclosure regime. However, because the regulations are interim as well as final, new requirements may be added before the effective date. It is not clear whether any additional changes will have an extended effective date for compliance.

4. Covered Plans

Under the proposed regulations, all employee benefit plans subject to Title I of ERISA were subject to the regulation's disclosure requirements. The final regulations retrench by defining a covered plan to mean an employee pension plan. Excluded from

[7] EBSA News Release, February 11, 2012 (announcing DOL's intent to delay effective date to January 1, 2012).

this definition and, therefore, not affected by the disclosure requirements of the final regulation are:

a. IRAs,
b. Simplified employee pensions, and
c. Simple retirement accounts.

5. Covered Service Providers.

The final rule is limited to service providers that reasonably expect to receive $1,000 or more in compensation (direct or indirect) from providing plan services that fall under one of the following categories:

a. Services as a fiduciary under ERISA or as a registered investment adviser. Such services include:

i. Provider of Fiduciary Services. Services provided directly to a covered plan in the capacity of an ERISA fiduciary.

ii. Investment Product Fiduciary. Services provided as a fiduciary to an investment contract, product or entity that holds plan assets. To be included in this new category, the plan must have a direct equity investment in the contract, product or entity. Fiduciary services provided to underlying investments (i.e., to second tier investment vehicles) are not taken into account.

(A) Mutual funds are not considered to hold plan assets and, therefore, fund investment advisers are excluded from the definition of a covered service provider. Accordingly, mutual funds are not subject to the general disclosure obligation.

(B) Insurance products providing a fixed rate of return are generally considered not to hold plan assets. Thus, products, such as GICs, general account investments and deferred fixed annuities will not result in the insurer becoming a covered service provider. However, a variable annuity based on a separate account that may be treated as a plan asset could give rise to compensation subject to disclosure.

(C) Fiduciaries to plan asset vehicles, such as collective trusts, hedge funds and private equity funds are potentially subject to the fee disclosure rules.

iii. Registered Investment Adviser. Services provided directly to the covered plan as an investment adviser registered under either the Investment Advisers Act of 1940 or state law.

b. Recordkeeping or brokerage services provided to individual account plans that permit participants to direct the investment of their accounts. This category assumes that one or more designated investment alternatives have been made available through an investment platform. As discussed in items VI.D and E, the final regulations expand the disclosure obligation of such recordkeepers and brokers to compensation information regarding each designated investment alternative.

c. Services within a broad list of categories that are reasonably expected to be paid for by indirect compensation or compensation paid among related parties. Service categories include investment consulting, accounting, auditing, actuarial, appraisal, development of investment policies, third party administration, legal, recordkeeping and valuation services.

6. Required Disclosure

a. General. A covered service provider must disclose in writing to the plan sponsor or similar plan fiduciary all services to be provided to the plan, not including nonfiduciary services. Service providers must also disclose whether they will provide any services to the plan as a fiduciary either within the meaning of ERISA §3(21) or under the Investment Advisers Act of 1940.

i. Formal Contract No Longer Required. Unlike the proposed regulations, the final regulation does not require a formal written contract delineating the disclosure obligations.

ii. Disclosure of Conflicts No Longer Required. In addition, the final rule eliminates required disclosure of conflicts of interest on the part of service providers. The reasoning for this change is that the expanded disclosure of compensation arrangements with parties other than the plan will be a better tool to assess a service arrangement's reasonableness, as well as potential conflicts of interest.

b. Distinction Based on Direct or Indirect Compensation. Different rules apply to the receipt of direct and indirect compensation, with the latter thought more likely to implicate conflicts of interest.

i. Direct compensation is defined as compensation received from the plan.

ii. Indirect compensation is defined as compensation received from a source other than the plan, the plan sponsor, the covered service provider or an affiliate or subcontractor in connection with the services arrangement. For example, indirect compensation generally includes fees received from an investment fund, such as 12b-1 fees, or from another service provider, such as a finder's fee.

iii. Non-monetary compensation valued at $250 or less, in the aggregate, during the term of the contract, is disregarded.

c. Disclosure of Compensation. Covered service providers are required to disclose all direct and indirect compensation that the service provider, an affiliate or a subcontractor expects to receive from the plan. In the case of indirect compensation, the service provider must identify the services for which the indirect compensation will be received as well as the payer of the indirect compensation.

i. Format. Compensation may be expressed as a dollar amount, formula, percentage of covered plan assets, a per capita charge, or by any other reasonable method that allows a plan fiduciary to evaluate the reasonableness of the compensation.

ii. Manner of Receipt. Disclosure must include a description of the manner in which the compensation will be received, such as whether it will be billed or deducted directly from participants' accounts.

iii. Transaction-Based Fees Received by Affiliates or Subcontractors. Compensation set on a transaction basis (e.g., commissions or soft dollars) or charged directly against the plan's investment (e.g., 12b-1 fees) and paid among the covered service provider, an affiliate or a subcontractor must be separately disclosed. The services for which the compensation is to be paid, the recipient and the payer must be identified. Other types of compensation do not require separate disclosure.

iv. Bundled Services. Except for the special rules discussed below, there is no requirement to unbundle service pricing.

d. Special Rules for Recordkeepers. A person who provides recordkeeping services must provide a description of the direct and indirect compensation that the service

provider (and its affiliates and subcontractors) expects to receive for recordkeeping services.

i. If there is no explicit fee for recordkeeping services, a reasonable, good faith estimate of the cost to the plan of such services must be provided. The estimate may take into account the rate that the service provider would charge to a third party or prevailing market rates for similar services.

ii Disclosing a de minimis amount of compensation for recordkeeping when the amount has no relationship to cost will not be regarded as reasonable.

e. Special Rule for Platform Providers. Recordkeepers and brokers that make designated investment alternatives available must provide basic fee information for each such alternative for which recordkeeping or brokerage services are provided. This information is in addition to information regarding the recordkeeper's or broker's own compensation. The information to be provided includes the expense ratio, ongoing expenses (e.g., wrap fees), as well as transaction fees (e.g. sales charges, redemption fees and surrender charges) that may be charged directly against the amount invested.

i. Pass-Through of Information on Investment Products. A recordkeeper or broker may satisfy its disclosure obligations for unaffiliated mutual funds by passing through the fund prospectus without having the duty to review its accuracy, provided that the disclosure material is regulated by a state or federal agency.

ii. Responsibility of Other Service Providers. If there is no recordkeeper or broker to provide the required information as to the fees associated with a designated investment alternative that holds plan assets, such responsibility passes to the fiduciary of the investment contract, product or entity.

iii. Exclusion for Brokerage Windows. Open brokerage windows are not subject to the disclosure requirements for platform providers.

7. Timing of Disclosures

Disclosure of information regarding compensation or fees must be made reasonably in advance of entering into, renewing or extending the contract for services. All of the required disclosures need not be contained in the same document and may be provided in electronic format.

a. During the term of the contract, any change to the previously furnished information must be disclosed within 60 days (expanded from 30 days under the proposed regulations) of the service provider's becoming informed of the change.

b. In contrast to the proposed regulation, the final rule provides that a service contract will not fail to be reasonable (i.e., there will not be a prohibited transaction) solely because the service provider makes an error, provided that the service provider has acted in good faith and with reasonable diligence. Errors or omissions must be disclosed within 30 days of the service provider's acquiring knowledge of the error or omission.

c. When an investment contract, product or entity is initially determined not to hold plan assets but this fact changes, if the covered plan's investment continues, disclosures are required as soon as practicable, but not later than 30 days from the date on which the service provider acquires knowledge that the investment vehicle holds plan assets.

8. Curing Disclosure Failures: Prohibited Transaction Exemption

a. Relief for Plan Sponsor. As under the proposed 408(b)(2) regulations, the final rule provides that a service provider's failure to comply with the disclosure obligations results in a prohibited transaction. Because the prohibited transaction could adversely affect the plan sponsor or similar plan fiduciary, the DOL had proposed a separate class exemption that would have provided relief for the plan fiduciary. This exemption is now incorporated into the final regulation. There is no relief for a service provider that fails to comply with the disclosure requirements.

b. Corrective Action. Relief would be provided if the plan sponsor or similar plan fiduciary enters into a service contract under the reasonable belief that the service provider has complied with its disclosure obligations under the final regulations. To qualify for relief, the plan sponsor or similar fiduciary must take corrective steps with the service provider after discovering the disclosure problem by requesting in writing the correct disclosure information. If the service provider fails to comply within 90 days of such request, the plan fiduciary must notify the DOL not later than 30 days following the earlier of the service provider's refusal to furnish the requested information; or the date which is 90 days after the date the written request is made.

c. Termination of Service Contract. As under the proposed regulations, the plan sponsor or similar fiduciary must also determine whether to terminate or continue the service contract by evaluating the nature of the particular disclosure failure and determining the extent of the actions necessary under the facts and circumstances. Factors to consider, among others, include the responsiveness of the service provider in furnishing the missing information, and the availability, qualifications, and costs of potential replacement service providers.

9. Immediate Impact and Issues

Currently, service providers need not disclose specific types of information to plan sponsors or similar fiduciaries. The interim final disclosure regulations require service providers to disclose extensive amounts of information, including the identity of third parties from whom a service provider receives fees as a result of providing services to the plan.

While conflict of interest disclosures have been eliminated, required fee disclosure will present significant internal tracking and communication challenges for large/complex companies. The ongoing 60-day disclosure deadline for information changes will result in similar challenges.

The final regulation clarifies that the new rules will apply to contracts in place when the regulation becomes effective on January 1, 2012. Service providers should begin preparing now to meet the new disclosure requirements, but should be prepared for possible changes to the rules due to the interim status of the regulation.

Through a live web chat hosted by the DOL on January 4, 2011, it was announced that the DOL was planning to "finalize" its interim 408(b)(2) regulations by April 2011. With respect to finalizing these rules, the DOL is expected to proceed in one of two ways: (1) it may simply indicate that its interim rule will become the final rule "as is" without any modifications, or (2) the final rule may reflect changes based on the feedback provided by the public on the interim rule. On February 11, 2011, the DOL announced that it would be pushing back the effective date of these rules from July 16, 2011 to January 1, 2012 to ensure that it has sufficient time to "finalize" them and to ensure that providers have sufficient time to comply with the finalized rules.

IV. Establishing A Game Plan for Clients

The DOL's new rules on 408(b)(2) fee disclosures and participant-level fee disclosures will go into effect shortly, and it is likely that the DOL's proposed rules (which relate to the "investment advice fiduciary" definition and target date disclosures) will be finalized before the Obama Administration ends its current term on January 13, 2013. Given the likelihood that

these changes will impact many (if not all) plans, financial advisors should strongly consider developing a "game plan" to help plan clients make sense of these rule changes.

A. 408(b)(2) Fee Disclosures

The new 408(b)(2) fee disclosure rules will require covered service providers to furnish detailed information about their compensation to plan sponsors on or before January 1, 2012. Although the 408(b)(2) fee disclosure rules will have an obvious impact on providers, it will also have a direct impact on plan sponsors. Plan fiduciaries have always had a duty to prudently monitor each provider's compensation and to ensure that the plan's fees are reasonable. Thus, once plan sponsors begin to receive the newly mandated fee disclosures, they will have a duty to review such information and to prudently evaluate both the direct and indirect compensation disclosed. Unfortunately, due to the complexity of many plan arrangements (which involve multiple parties, subcontractors and different types of indirect compensation), plan sponsors will need help understanding this information. Financial advisors can play a key role, helping plan sponsors "interpret" the disclosures included in their providers' 408(b)(2) fee disclosures. A qualified advisor can help a plan sponsor determine if its fees are unreasonably high in light of the quality of the services provided, and the advisor can assist the plan sponsor investigate alternatives plan service and investment arrangements, as necessary or appropriate.

B. Fee Disclosures to Participants

There is a good chance that a significant number of plan participants will be "caught off guard" by the new fee disclosures delivered to them, once the new rules go into effect. Additionally, as a result of the anticipated feedback from participants and their ongoing scrutiny of the plan's fees, plan sponsors may also become more sensitive to the level of the plan's fees. Fortunately, plan sponsors have roughly a year to prepare for the new disclosure regime. For calendar year plans, the DOL's participant disclosure rules will not take effect until January 1, 2012. During this critical interim period, advisors should help plan sponsors prepare for this change. Advisors can discuss the new disclosure rules with the plan's recordkeeper, to determine the extent to which the newly mandated fee disclosures are (or are not) already being provided to participants. The advisor can also meet with participants to discuss the new fee disclosures, and integrate a review of this information into investment education sessions with participants. If the plan sponsor is concerned with the potential reaction and scrutiny from participants, advisors can remind the sponsor that a prudent review of the plan's investments and services is the best defense against fiduciary liability, and that the sponsor can always strengthen its fiduciary review process if it has any concerns.

C. Target Date Disclosures. Although the DOL has not yet finalized its proposal concerning the required disclosures for target date funds, it is clear that there is a concern that participants are not getting the appropriate information and education. As a "best practice," advisors can help provide meaningful information about the plan's target date funds to

participants right now. Participants need to focus on the key features of a target date investment, such as its glide path, landing point and its potential volatility. While educating participants about target date funds, advisors should also work with plan sponsors to ensure that they are prudently evaluating the target date fund series in the plan's menu, especially if it is being utilized as a QDIA. In light of the level of investment losses sustained by all types of target date funds in recent years, plan sponsors should pay particular attention to the expected volatility and equity/fixed income mix of target date funds intended for participants who are already in or nearing retirement (e.g., 2015 Retirement Fund).

D. Broader "Fiduciary" Definition. The DOL's proposal to broaden its "investment advice fiduciary" definition is likely to "shake up" the retirement plan industry, forcing many (if not all) retirement plan advisors to provide their services in a fiduciary capacity for a level fee. If the DOL's proposal is adopted in its current form, any advisor that is unwilling to advise plan clients on these terms may, as a practical matter, be forced out of the retirement plan business in its entirety. Given the significance of this anticipated change, financial advisors should evaluate and re-consider their business model for ERISA plan clients, especially those who do not currently hold themselves out as plan fiduciaries.

Recordkeepers are constantly adapting and developing new types of arrangements, and they may be able to offer assistance with the problems associated with variable compensation (which in the case of a fiduciary advisor is prohibited under ERISA's prohibited transaction rules.) For example, working with recordkeeping platforms that are able to offer level payouts may be one possible approach. Advisors can also explore the use of ERISA budget accounts (also known as ERISA fee recapture accounts) as a means for leveling the compensation payable to the advisor. Advisory firms that currently receive variable compensation may also wish to consider providing investment advice to ERISA plans as a dual-registered RIA, which would enable the firm to charge a level asset-based fee. There are no "one size fits all" solutions for all firms, especially since every advisor's service model will need to be fully compliant with both ERISA and securities law. However, financial advisors and advisory firms should strongly consider the potential impact of the DOL's proposal in the near future, and investigate potential and possible solutions in the days ahead.