New Form 5500 Rules Greatly Increase Information Required To Be Disclosed About Compensation Received By Service Providers To Plans Subject To ERISA

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On November 16, 2007, the Department of Labor, Internal Revenue Service and Pension Benefit Guaranty Corporation jointly issued new rules that require greatly expanded disclosure of compensation received by persons who provide services to employee benefit plans subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The new rules are generally applicable to those plans having 100 or more participants and to pooled investment vehicles that directly file reports with the Department of Labor – so called "Direct Filing Entities."[1] The new rules are effective for plan years beginning on or after January 1, 2009. The new rules are contained in revisions to Schedule C (Service Provider Information) of Form 5500 (Annual Return/Report of Employee Benefit Plan), a copy of which (along with relevant instructions) is attached.

The new rules require plan administrators to report all compensation received, ***directly or indirectly***, by service providers to a plan ***in connection with services rendered to the plan***,[2] with certain limited exceptions. All types of compensation are generally required to be reported, including compensation related to the management or

[1] These Form 5500 rules do not apply to governmental plans, individual retirement accounts or "top hat" plans. References to reporting by plan administrators in the remainder of this memorandum should be understood to also concern the reporting requirements applicable to financial institutions that maintain Direct Filing Entities.

[2] 72 FR 64824 (Nov. 16, 2007). The formulation of the reporting standard is slightly different in different portions of the instructions. For example, the instructions state, in regard to the rules for reporting indirect compensation, that "compensation received from sources other than directly from the plan or plan sponsor is reportable on Schedule C as indirect compensation from the plan if the compensation was received in connection with services rendered to the plan . . . Examples of reportable indirect compensation include fees and expense reimbursement payments received by a person from mutual funds, bank commingled trusts, insurance company pooled separate accounts and pooled investment funds in which the plan invests that are charged against the fund or account and reflected in the value of the plan's investment (such as management fees paid by a mutual fund to its investment adviser . . .). Other examples of reportable indirect compensation are finders' fees, float revenue, brokerage commissions . . . . and other transaction based fees received ***in connection with transactions or services involving the plan*** whether or not they are capitalized as investment costs" (emphasis added). (Specific Instructions for Schedule C, Part I, 72 FR 64825 (Nov. 16, 2007).)

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distribution of pooled investment vehicles (such as mutual funds), finders' fees, placement fees, float revenue, brokerage commissions, soft dollars and the value of gifts and entertainment provided to employees of service providers. Generally, compensation is deemed to be received ***directly*** if it is received by the service provider from a plan, and compensation is deemed to be received ***indirectly*** if it is received from any other person, such as an investment fund in which the plan has invested or from another service provider.

✓ ***Action Item***: Financial institutions, especially those that provide a variety of types of services to plans, should as a matter of a priority promptly begin to:

- ***identify types and amounts of reportable direct and indirect compensation received by them***;
- ***identify types and amounts of reportable direct and indirect compensation paid by them; and***
- ***consider how responsibility should be allocated among plan administrators and service providers for compiling the required new compensation information, and take action to effect that allocation of responsibility***.

The January 1, 2009 effective date gives plan administrators and service providers only a year to set up the procedures necessary to capture the additional required information. We expect that many financial institutions will need to take full advantage of the time allotted in light of the extent and nature of the information required.

I. Policy and Regulatory Background

The stated purpose of the additional required Form 5500 disclosure is to help plan fiduciaries fulfill their obligation to oversee the management and operation of plans.[3] The Department of Labor has focused upon this issue because of a concern that the opportunities for retirement savings provided by tax-favored pension arrangements are not being fully realized by participants because of hidden fees and costs incurred by many plans.[4] The new disclosure rules were adopted largely as proposed in 2006, notwithstanding

[3] "Plan administrators, the Department [of Labor] and the public will be better able to monitor the compensation arrangements of plan service providers, better able to understand the impact of fees on plan assets, and better able to evaluate the value of purchased services. In addition, it is expected that plan administrators should be better able to negotiate fair prices for necessary plan services." 72 FR 64719 (Nov. 16, 2007).

[4] The new rules reflect concern that both the amount of fees ***and potential conflicts arising from the fee structures*** are not being adequately considered. ("The Department continues to believe that it is appropriate to modify the Schedule C reporting requirements . . . to ensure that the Form . . . serves a role in helping plan

critical comments submitted by members of the financial services industry, some of whom expressed the view that the financial costs of meeting the new obligations would negate any transparency gains created thereby.

The new disclosure requirements are one part of three announced parts of the Department of Labor's regulatory approach to these issues. In addition to the Schedule C reporting obligations, on December 13, 2007, separate but related regulations were proposed under Section 408(b)(2) of ERISA. Section 408(b)(2) provides a very widely used exemption from the prohibited transaction rules of ERISA for the provision of necessary services to plans.[5] Such relief would be conditioned upon a service provider's agreement to disclose all compensation or fees received that is requested by the plan administrator or sponsor in order to comply with these new Form 5500 reporting requirements. The effect of the proposed regulations would be to impose additional material adverse consequences on service providers that fail to provide the necessary information to plans subject to ERISA.

In addition, the Department of Labor has announced another rulemaking initiative under Section 404(c) of ERISA. Section 404(c) of ERISA provides important protections to fiduciaries of 401(k) and other similar plans in which participants are given the discretion to allocate their account balances among different investment alternatives. Generally, Section 404(c) may relieve fiduciaries of the plan from responsibility for the investment choices made by participants. A condition for the availability of that relief is that participants be provided with adequate information to make their investment choices. The new rulemaking initiative involves review of participant-level disclosure to "ensure that participants and beneficiaries in individual account plans are provided the information they need, including information about fees and expenses" [6] to make informed investment decisions.[7]

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officials obtain the information they need to assess the reasonableness of the compensation paid for services rendered to the plan, taking into account revenue sharing and other financial relationships or arrangements and potential conflicts of interest that might affect the quality of those services" (72 FR 64738-39 (Nov. 16, 2007)).)

[5] 72 FR 70988 (Dec. 13, 2007). Under the ERISA statutory framework, a person who is a service provider to a plan may not provide additional services to the plan without an exemption. Section 408(b)(2) provides that exemption, in most cases routinely (i.e., without specific attention to the need for the exemption).

[6] 72 FR 64738 (Nov. 16, 2007).

[7] The three approaches – Form 5500 reporting, the Section 408(b)(2) exemption and the Section 404(c) framework for limiting liability for participant investment decisions – target the same issue in different ways. For example, non-plan asset vehicles such as mutual funds may not have reason to be concerned about the negative effects of being identified as not providing information on Forms 5500 or about the unavailability of the Section 408(b)(2) exemption, but might be more sensitive to the loss of Section 404(c) status.

✓ ***Important Note Concerning Annual Review of Plan Expenses by Plan Administrators***. The release accompanying the new rules includes the statement that the Department of Labor believes that "an annual review of plan fees and expenses . . . is part of a plan fiduciary's obligation" under ERISA.[8] Accordingly, in addition to reporting requests from plan administrators arising from the new Schedule C reporting requirements, many service providers may expect requests from plan clients designed to assist them in meeting this annual review obligation. In addition, some service providers may be requested by plan clients to elaborate on information provided to them in connection with the Form 5500 process, particularly since certain of the Schedule C information, in the manner required to be presented on Schedule C, may be duplicative or otherwise not very useful or informative. For example, service providers may be requested to break out aggregate amounts of compensation attributable to different types of services for which the service provider and its affiliates have been compensated. (See Part III.D below.)

II. Allocation of Responsibility and Penalties

The new rules make it clear that it is the legal responsibility of plan administrators to report the compensation data. The revised Form 5500 includes a requirement that plan administrators and sponsors sign a statement under penalty of perjury that the information included in Schedule C is to the best of the signers' knowledge and belief true, correct and complete. Failure to provide complete and accurate information carries potential administrative, civil and criminal penalties.

However, the new rules do not dictate which of the multiple parties involved in the provision of services to a plan should produce the required information. We strongly expect that plan administrators will look to service providers to produce the data to be reported. Under the new rules, plan administrators and sponsors are directed to report in Part II of Schedule C the names of service providers who have failed or refused to provide requested information (and to provide the omitted information themselves, presumably as obtained from other sources).[9]

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[8] 72 FR 64738 (Nov. 16, 2007).

[9] The need for coordination among service providers is readily illustrated in connection with reporting brokerage commissions. If a plan has five investment managers, all of whom execute trades through the same broker, it should be determined ahead of time who will be responsible for calculating the aggregate brokerage commissions received by the broker during the year – the investment managers, the brokers or the plan's custodian. Absent such coordination, it seems reasonable to expect that if a plan administrator at the end of the year asks both the investment managers and the brokers for the aggregate amount of commissions paid during the year, the amounts provided will not always perfectly match up and efforts may be duplicated.

The risk of potential adverse publicity to service providers from the disclosure of an omission to provide information may be significant, and the reporting of such an omission may also be used as a source of enforcement efforts for the Department of Labor. In addition, as noted above, the recently proposed regulations under Section 408(b)(2) of ERISA would condition such exemption's availability upon compliance with disclosure requirements. Future proposals under Section 404(c) of ERISA may include a similar new condition.

There are many reasons that it may be difficult for a given service provider to provide all of the information requested by a plan administrator:

- The allocation of certain compensation among plans may not always be known by the service provider; in some cases, it may be known only by the person who pays the service provider. For example, a broker-dealer may receive fees for distribution of mutual fund shares to participants in a group of 401(k) plans for which a third party is the trustee, custodian and recordkeeper, and the broker-dealer may not receive information allocating its fees among the different plans.

- There may often be more than one reasonable approach to allocating compensation among multiple plans (see Part III.I below).

- The technology for tracking the amount of compensation allocable to plans, generally, or to any particular plan, may not be built out for a particular business.

- Multiple affiliates within a group of companies may receive compensation in connection with services provided to a given plan, without any coordination or knowledge among the affiliates.

None of these facts provides a basis for not reporting information in accordance with the rules.

✓ ***Action Item***: Service providers may seek to contractually limit their obligations to provide the necessary data, requiring custodians or other service providers to provide the data. We believe that it would be prudent for service providers to commence discussions promptly among the various parties involved with a plan for the purpose of allocating responsibility for producing the new required information for that plan.

III. Information to Be Reported

Generally, the information required to be reported by the plan administrator in the Form 5500 includes:

- the identity of all service providers receiving payments of more than $5,000;
- subject to the exceptions noted below, the amount of direct and indirect compensation received by each such service provider;
- one or more service codes describing the type of services rendered;
- any relationship of the service provider to any known party in interest to the plan; and
- the source of indirect compensation received by the service provider in excess of $1,000.

Parts III and IV of this memorandum discuss the type of information and compensation that are required to be reported, generally, under the new rules. There are two potentially important exceptions to these general requirements, which are discussed in Part V below:

- An exception that permits the plan administrator not to disclose payments made to subcontractors and affiliates by a service provider that provides services (itself and through subcontractors or affiliates) to a plan under a so-called "bundled service arrangement."
- An exception that permits limited information reporting – i.e., just the identity of the service provider – for "eligible indirect compensation" received by a service provider if (i) the compensation is of a type permitted by the rules (fees or expense reimbursement payments charged to investment funds and reflected in the value of the investment or return on investment of the participating plan or its participants that constitute finders' fees, soft dollar revenue, float revenue and/or brokerage commissions or other transaction-based fees for transaction or services involving the plan)[10] and (ii) certain information (including the amount or an estimate of the amount or a formula for determining the amount of compensation received) is disclosed to the plan administrator.

[10] 72 FR 64826 (Nov. 16, 2007). See footnote 27 below.

These exceptions may prove very useful ***in certain factual settings***, but care must be taken in relying on these exceptions because they are subject to limitations and conditions that make them inapplicable in many other factual settings.

A. Identity of the Service Provider

Service providers who receive compensation of more than $5,000 must be identified in Part I of Schedule C. Only persons who provide services, ***directly or indirectly***, to the plan (and not for example persons who provide services to a plan counterparty in connection with a transaction involving the plan) must be reported. Reporting is no longer limited to the "top 40" service providers. The $5,000 threshold can be exceeded based on an aggregation of compensation received from multiple sources involving unrelated services to the plan.

Except as discussed in Part V below in connection with bundled service arrangements, it is generally sufficient for Schedule C reporting purposes to treat an affiliated group of persons as a single person and to identify that affiliated group as the party receiving compensation from the plan.[11]

It may be difficult for the plan administrator or any of the individual service providers to identify all service providers who receive compensation indirectly in connection with transactions or services involving a plan. Nevertheless, the Department of Labor has stated that it "does not agree with the commenters who argued that only those persons with 'direct service relationships' with the plan should be treated as providing services to the plan."[12] As a result, for example, assume that a defined contribution plan hires a plan prototype provider. Assume that the prototype provider in turn hires a recordkeeper, and that the recordkeeper hires an IT consulting firm to adapt the plan sponsor's human resources IT systems to the recordkeeper's systems. Subject to the exceptions discussed in Part V below, it would seem that the IT consulting firm must be identified, and its compensation disclosed, in Schedule C.[13]

[11] 72 FR 64741 (Nov. 16, 2007). Accordingly, it would appear that service providers who report information to plan administrators on an affiliated group basis should not be subject to identification as persons who have failed or refused to provide requested information.

[12] 72 FR 64739 (Nov. 16, 2007).

[13] *See*, *also*, footnote 16 below concerning indirect services and indirect compensation.

B. Source of Compensation

If the service provider is a fiduciary or a person providing contract administration, consulting, investment advisory (plan or participant), investment management, securities brokerage or recordkeeping services (a "Specified Person"), and the service provider received indirect compensation (other than eligible indirect compensation), then the plan administrator must also report each source from whom such service provider received such indirect compensation of more than $1,000. As a practical matter, "Specified Person" will in many circumstances principally exclude only legal, accounting and actuarial service providers. For providers of other types of services who receive indirect compensation, the source of the compensation received by them will generally not be required to be reported.

C. Relationship between Service Provider and Parties in Interest

Schedule C requires a description of the relationships between the identified service providers and known parties in interest to the plan. The types of the relationships required to be identified are not clear - i.e., it is not clear whether familial, director, minority ownership, service provider or other remote relationships might be captured by this requirement. The instructions merely provide that the plan sponsor must "enter any relationship of the person identified in element (a) to the plan sponsor, to the participating employer or employee organization, or to any person known to be a party-in-interest, for example, employee of employer, vice-president of employer, union officer, affiliate of plan recordkeeper, etc."[14]

D. Service Codes

The Department of Labor provides 58 different codes with which to describe the type of service, the type of entity providing the service and the location of the entity providing the service. The instructions state that all relevant codes must be entered. There is no requirement that the amount of compensation reported as having been received by a service provider be divided up and associated with different service codes. Accordingly, for example, the Schedule C might report that a service provider received $100,000 of compensation in connection with services provided to a plan, and might include 10 different service codes as being relevant to the services provided, without indicating what portion of the aggregate compensation amount corresponds to which service codes. We question whether the service code information will prove to be useful.

[14] 72 FR 64827 (Nov. 16, 2007).

E. Timing of Filing Requirement

Forms are generally required to be filed by the last day of the seventh calendar month following the end of the plan year with respect to which the filing is made (i.e., July 31, 2010 for full plan years beginning January 1, 2009).[15] A one-time automatic extension for filing Form 5500 until the due date of the Federal income tax return of the employer (generally, for calendar year taxpayers, September 15) will be granted if the plan year and the employer's tax year are the same, the employer has been granted an extension of time to file its Federal income tax return and a copy of the application for extension of time to file the Federal income tax return is attached to the Form 5500. Plans may also obtain a one-time extension for up to two and one-half months (i.e., for calendar year plans, until October 15) by filing an application on IRS Form 5558.

F. Direct Compensation Paid By the Plan

Direct compensation paid to the service provider must be reported. As stated above, compensation is generally deemed to be received directly if it is received by the service provider from a plan. Direct compensation includes payments made directly by the plan, whether from a plan account or an individual participant's account. Direct compensation does not include payments made by the plan sponsor that are not reimbursed by the plan, which are not required to be reported in the Form 5500. Charges to plan forfeiture accounts and fee recapture accounts are considered compensation paid by the plan. (A "fee recapture account" is an account to which an executing broker rebates to the plan a portion of its commissions.)

The fee paid under a bundled service arrangement (or transaction) in which a plan hires a company to provide a range of services either directly from the company, or indirectly (e.g., through affiliates or subcontractors), or both, and pays a single bundled fee for the services is reportable as direct compensation paid to the bundled service provider in the Form 5500. Whether amounts paid by the bundled service provider to the other service providers are also separately reported depends on the special rule for bundled service arrangements discussed in Part V below.

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[15] Plans may have short plan years in certain limited circumstances, in which case the first Form 5500 filing reflecting the rules described herein may be required to be made prior to July 31, 2010.

G. Indirect Compensation

Indirect compensation includes any compensation received from sources other than directly from a plan. Indirect compensation does not include amounts that would have been received had the service not been rendered or had the transaction not taken place and that cannot be reasonably allocated to a service or transaction involving the plan.[16]

It may not always be easy to determine whether indirect compensation has been received. For example, in an agency cross trade, where the broker receives a commission from the counterparty to the trade with the plan, is such a commission deemed indirect compensation for services rendered to the plan, or is the commission not reportable either because it is not compensation for services rendered ***to the plan*** or because the broker may have executed the trade with another customer had the plan not been involved?

Indirect compensation may not be required to be separately reported, if it is either part of a bundled service arrangement or if it is eligible indirect compensation, as discussed in Part V below.

H. Transactions with a Plan

An investment of plan assets is not, in and of itself, reportable service provider compensation.[17] Accordingly, for example, if a plan enters into a swap transaction with a broker-dealer for the purpose of enabling the plan to hedge its exposure to certain assets or markets, payments to the broker-dealer under the swap should not constitute reportable compensation. Similarly, a dealer mark-up in connection with a principal trade in securities should not constitute service provider compensation. However, if a transaction is entered into in connection with or as compensation for rendering services, then the transaction may give rise to reportable service provider compensation.

- ✓ ***Action Item***: "Persons that provide investment management, recordkeeping, participant communication, brokerage and other services to the plan as part of an investment

[16] It is clear that compensation must be reported even if the services are not rendered directly to the plan and if the compensation is not received directly from the plan. ("The Department [of Labor] does not agree with the commenters who argued that only those persons with 'direct service relationships' with the plan should be treated as providing services to the plan for Schedule C reporting purposes." 72 FR 64739 (Nov. 16 2007).) In addition, it is clear that compensation must be reported even if eligibility for the compensation or the amount of the compensation is based on a transaction not involving "plan assets." ("One of the goals of the Schedule C changes is to improve fee disclosure to plan fiduciaries, especially where they do not have a role in determining the compensation paid to parties that are receiving fees ***for a transaction or service involving the plan***." (emphasis added)) Id.

[17] 72 FR 64739 (Nov. 16, 2007).

contract with the plan"[18] should in the Department of Labor's view be treated as service providers. Accordingly, for example, if the counterparty to a plan earns float in connection with holding custody of plan assets incident to a transaction with the plan, that float might be viewed as reportable compensation. It has been customary in many transactional settings for broker-dealers to require plan counterparties to represent that the broker-dealer is not a fiduciary to the plan in connection with the transaction. In order to avoid characterization of the transaction as giving rise to reportable compensation, it may be prudent in similar transactional settings for the broker-dealer in the future to require the plan counterparty to represent that the broker-dealer has not provided any service to the plan in connection with the transaction.[19]

I. Allocation of Compensation Among Plans

Plan administrators and service providers may use reasonable allocation methodologies in circumstances in which a service provider receives fees in exchange for services provided to multiple plans.[20] The use of different methodologies by different service providers could give rise to significant confusion. For example, if a broker invites employees of an asset manager to dinner, the broker and the manager may allocate the value of the dinner differently as between their common clients: the broker might allocate pro rata to commissions received from the different accounts and the manager might allocate pro rata to the assets under management. In addition, the rules permit plan administrators to use either a cash or accrual basis for reporting compensation, as long as one method is used "consistently."[21]

✓ ***Action Item***: Service providers may seek to contractually bind their clients to accept the allocation and accounting methodologies utilized by the service provider.

[18] 72 FR 64825 (Nov. 16, 2007).

[19] *See*, *for example*, Thomas, Head & Greisen Employees Trust v. Buster, 24 F.3d 1114 (9th Cir. 1994), cert. den'd, 115 S. Ct. 935 (1995) in which a mortgage broker selling deed of trust notes to a plan was deemed to have been compensated for advisory services through its commissions and profits earned on the sales.

[20] 72 FR 64826 (Nov. 16, 2007).

[21] 72 FR 64824 (Nov. 16, 2007). It is not clear whether the rules would permit plan administrators to switch methodologies, for example incident to a change in service providers if the prior service provider provided the administrator with the information on one basis and the new service provider proposes to provide it on the other basis.

IV. Types of Compensation that Must Be Captured

Subject to the potentially important exceptions for bundled service arrangements and eligible indirect compensation, all compensation is generally required to be reported. This Part IV provides a non-exclusive list of types of compensation that financial institutions may need to identify and allocate among its plan clients.

A. Examples of Direct and Indirect Compensation

There are numerous examples of the types of compensation that may be subject to separate reporting, many of which are referred to in the new rules. Each service provider will have to identify for itself what types and forms of compensation it receives and pays in connection with services or transactions involving plans.

The types of compensation that may be required to be reported include the following:

- finders' and placement fees;
- float revenue;
- brokerage commissions;
- soft dollars;
- securities lending agency fees;
- structuring fees;
- transition management fees; and
- sales loads, redemption fees, surrender charges and 12b-1 fees.

B. Compensation Paid by Investment Funds Generally

Compensation paid by an investment fund in which a plan has invested, which payment reduced the value of the fund, is generally reportable. Such compensation may include investment management fees (and expense reimbursements) received from mutual funds, bank commingled trusts, insurance company pooled separate accounts and other separately managed accounts and pooled investment funds in which plans invest, as well as fees paid by a mutual fund to its investment adviser, sub-transfer agency fees, shareholder servicing fees, account maintenance fees, and 12b-1 distribution fees.

✓ ***Important Note Concerning Non-Plan Asset Funds, Including 25% Test Non-Plan-Asset Funds, VCOCs and REOCs:*** It is clear, on the one hand, that the Department of Labor intended the new regulations to apply to compensation paid by non-plan asset investment fund vehicles, such as mutual funds. On the other hand, it is also clear that these new regulations do not apply to fees paid by an operating company, such as for example a car manufacturer or other producer of goods or services, even if a plan owns substantially all of the equity of the operating company involved.

There are many types of investment fund vehicles, other than mutual funds, that are designed not to be deemed to hold plan assets by virtue of compliance with the so-called 25% test included in the Department of Labor's plan asset regulations,[22] including for example domestic and foreign equity funds, private equity funds and venture capital funds that do not seek to qualify as "venture capital operating companies", asset backed securities funds and collateralized bond obligation vehicles. It seems clear that compensation paid by these types of vehicles is covered by the new rules.

Although not clearly addressed in the rules, it is hoped that the Department of Labor will clarify that compensation paid by entities that are not plan asset entities because they constitute venture capital operating companies (VCOCs) or real estate operating companies (REOCs) is not required to be reported. Although VCOCs and REOCs have some features that might be similar to investment funds, they are operating companies under the Department of Labor's plan asset regulations and therefore arguably should be treated as such for purposes of these disclosure rules. If the rules do apply to these entities, then the answers to the questions (discussed below) concerning the scope of the exception for eligible indirect compensation and bundled service arrangements will become crucial to determining the nature of the disclosure required for compensation paid by such entities.

C. Gifts and Entertainment

Non-monetary compensation (such as gifts or meals) other than compensation with a value of less than $50 and an aggregate annual value from any one source of less than $100 is reportable. In calculating the $100 limit, gifts with a value less than $10 are not counted, but if the $100 limit is exceeded, all gifts must be included. There is no apparent reason that the de minimis exceptions for Schedule C reporting were not set at the same levels, or made subject to the same calculation rules, as were adopted by the Department of Labor in 2006 in connection with its new reporting rules under Form LM-10 for gifts paid to union officials.

[22] Department of Labor Regulation §2510.3-101.

For purposes of determining whether non-monetary compensation is reportable, employees of an organization who provide a benefit are treated as one source, but employees of an organization who receive a benefit are treated as separate persons. For example, if an employee of a broker-dealer sends one bottle of wine valued at $20 to each of six employees of an investment adviser, then no part of the value of the wine would have to be reported as compensation. However, if six employees of a broker-dealer each send a bottle of wine to a single employee of an investment adviser, then the $120 value of the six bottles of wine would be included in the reported compensation.

- ✓ ***Important Note Concerning Gifts and Entertainment***. Gifts and entertainment expenses received by fiduciaries of a plan may be prohibited under the self-dealing provisions of Section 406(b) of ERISA. While the new rules provide a reporting exemption for small gifts, they do not provide any exemption from the prohibited transaction rules.[23] We believe that many service providers do not currently have processes for capturing this information, and the nature of the data suggests that capturing the data will be a challenge. Significant attention must be paid to the issues of gifts and entertainment expenses because of the self-dealing implications and the impact on the exemption provided by Section 408(b)(2) of ERISA from the prohibited transaction rules of ERISA (discussed in Part I above).

- ✓ ***Action Item***: Service providers should review and consider revising their gift and entertainment policies in light of the low de minimis reporting amounts and the clear statement in the instructions to Schedule C concerning potential violations of ERISA's prohibited transaction rules in connection with the receipt of gifts.

D. Insurance Policies (other than Insurance Investment Contracts)

Compensation by an insurer for services provided to a plan in fulfillment of its obligations under an insurance policy issued to a plan (other than an insurance investment contract) where there is no direct or indirect charge for such services to the plan other than insurance premiums is not required to be reported.[24] This exception does not cover compensation incidental to the sale or renewal of a policy such as finders' fees or insurance brokerage commissions and fees.

[23] The Schedule C Specific Instructions provide that the de minimis amounts set forth above "are for purposes of Schedule C reporting only. Filers are strongly cautioned that gifts and gratuities of any amount paid to or received by plan fiduciaries may violate ERISA and give rise to civil liabilities and criminal penalties." 72 FR 64825 (Nov. 16, 2007).

[24] 72 FR 64739 (Nov. 16, 2007).

V. Exceptions for Eligible Indirect Compensation and Bundled Service Arrangements

The release accompanying the new rules discussed two related aspects of the new rules that commenters specifically identified as extremely burdensome and two related special exceptions from the new reporting rules to deal with those aspects of the new rules.

- First, in connection with a discussion of the difficulty of reporting indirect compensation, the release reviewed commenters' statements concerning omnibus accounting, under which a service provider maintains omnibus trading accounts with investment-related service compensation based upon a percentage of the total assets in an investment fund. Commenters asserted that omnibus accounting practices were efficient from the perspective of plan investors. In response to these comments, the Department of Labor modified its proposed rules to contain an exception for "eligible indirect compensation."

- Second, the release accompanying the new rules states that "in a similar vein," commenters expressed concern about the reporting of revenue sharing among members of a bundled service arrangement – that is, generally, an arrangement under which two or more affiliated or non-affiliated entities jointly provide services to a plan for a single fee.[25]

A. Eligible Indirect Compensation

The amount of "eligible indirect compensation" received by a service provider is not required to be separately reported on Schedule C.[26] Compensation qualifies as eligible indirect compensation only if:

- it constitutes fees or expense reimbursement payments charged to investment funds and reflected in the value of the investment or return on investment of the participating plan or its participants and represents finders' fees, soft dollar

[25] The motivation to provide the exception was in part generated by potentially disparate treatment for bundled service arrangements in which all of the service providers are affiliates (and under which therefore the fees could be reported in the aggregate under the general principle regarding affiliates described above) and for bundled service arrangements in which not all of the service providers are affiliates. However, this aspect of the rule, which is described in the release, is not relevant for understanding the actual reporting requirements that were adopted.

[26] Although there is some language in the release that could be read to suggest that this treatment ***is only*** available for service providers who receive **only** eligible indirect compensation, Schedule C itself is clear that compensation that qualifies as eligible indirect compensation is not required to be separately reported, even if the service provider also received direct or other indirect compensation. See column 2(g) of Schedule C.

revenue, float revenue and/or brokerage commissions or other transaction-based fees for transactions or services involving a plan;[27] and

- the plan administrator must have received written materials that disclose and describe the following information: (a) the existence of the indirect compensation, (b) the services provided for the compensation or the purpose for the payment of the indirect compensation, (c) ***the amount or an estimate of the amount of the compensation, or a description of the formula used to calculate or determine the compensation***[28] and (d) the identity of the parties paying and receiving the compensation.

✓ ***Action Item***: It is not clear whether the disclosure for eligible indirect compensation must be provided prior to the services being provided. Prudence dictates that service providers intending to rely on the exception for eligible indirect compensation for services rendered during 2009 should provide the required disclosure prior to the beginning of that year.

Although the rules concerning eligible indirect compensation are not useful in connection with compensation paid directly by a plan or a separate account holding plan assets, they may be very useful in circumstances involving investment funds in which plans invest. In practice, the utility of the exception for eligible indirect compensation would seem to depend on the meaning of clause (c) above, and particularly on how precise the formula for determining the amount of compensation must be. If the service provider is a registered investment adviser, some of this information, particularly investment management fees, may be contained in a combination of the adviser's Form ADV and the services agreement. However, for transaction-based compensation, such as commissions, the formula for determining the amount of compensation will not always be precise. For example, the amount of float to be paid to a service provider may depend on market conditions across a range of eligible investments. Similarly, the amount of commissions

[27] 72 FR 64826 (Nov. 16, 2007). It is not clear whether this list is intended to be exclusive or only illustrative. If it is intended to be exclusive, it is not clear why certain fees – such as for example legal and accounting fees – are excluded, particularly because such fees may be excluded under the rules for bundled service arrangements. Furthermore, the list of types of eligible indirect compensation set forth in the release accompanying the new rules is broader than the list in the Schedule C instructions (e.g., it includes "investment management" fees). There appears to be an inadvertent omission of language in the instructions. 72 FR 64742 (Nov. 16, 2007).

[28] If bundled services are provided to an investment fund, then the amount, estimate or formula must be stated separately for each service provider in order for the compensation to be omitted from Schedule C as eligible indirect compensation. 72 FR 64826 (Nov. 16, 2007).

may depend on the availability of the securities being acquired or sold. The Department of Labor recognized and addressed this issue in the release, as follows:

> The Department recognizes that it may not be practicable to provide a formula or estimate to calculate the value of certain types of "soft dollar" non-monetary compensation at the plan level, particularly so-called "proprietary" soft dollar arrangements, such as access to information from certain research specialists. In such circumstances, a description of the eligibility conditions sufficient to allow a plan fiduciary to evaluate them for reasonableness and potential conflicts of interest would satisfy the "amount of compensation" prong of the disclosure alternative.[29]

The standard implied by this language seems to permit reliance on the exception for eligible indirect compensation if the plan administrator is given sufficient information to assess the reasonableness of the compensation and the potential for conflicts of interest, even if the information does not include a precise numerical objective formula.

B. Bundled Service Arrangements

A "bundled service arrangement" is one in which a plan "hires one company to provide a range of services either directly from the company, through affiliates or subcontractors, or through a combination, which are priced to the plan as a single package rather than on a service-by-service basis."[30] Qualifying compensation under a bundled service arrangement should be reported only as direct compensation from the plan, and does not need to be allocated among affiliates or subcontractors and also reported as indirect compensation received by the affiliates or subcontractors. Although the exact parameters of the rule are not perfectly clear,[31] it appears that the reporting rules can be summarized as follows:

- First, compensation paid directly by the plan to the bundled service provider is required to be reported as direct compensation.
- Second, if persons in the bundle receive "separate fees"[32] charged against the plan's investment and reflected in the net value of the investment[33] (e.g.,

[29] 72 FR 64742 (Nov. 16, 2007).

[30] Schedule C Specific Instructions, Part I (72 FR 64825 (Nov. 16, 2007)).

[31] The exceptions are explained primarily in the Specific Instructions to Part I of Schedule C (72 FR 64825-26 (Nov. 16, 2007)) and at 72 FR 64741 (Nov. 16, 2007).

[32] 72 FR 64741 (Nov. 16, 2007).

investment management fees, float revenue and other asset-based fees such as shareholder servicing fees and 12b-1 fees charged against an investment fund in which a plan invests, as well as wrap fees if charged in addition to an investment management fee), then such separate compensation must also be reported in the Schedule C (either as direct or indirect depending on whether the compensation is received directly from the plan or otherwise).

- Third, compensation paid to an affiliate or subcontractor who is a Specified Person must be reported (either as direct or indirect depending on whether the compensation is received directly from the plan or otherwise) if the amount paid to the affiliate or subcontractor is set on a per transaction basis.[34]

In sum, in light of the Department's reasonably flexible interpretation of the requirements relating to compensation formulas, it appears that the exception for eligible indirect compensation will provide useful assistance to service providers that find it impractical to trace sources and recipients of payments made by investment funds in which plans invest. The bundled service arrangement exception may be less generally helpful. In particular, its application to particular plans will depend on whether (i) service providers within the bundled group are compensated on a transactional basis and (ii) there are separate fees (other than the bundled service fee itself) that are shared among members of the bundled group and that are required to be separately traced and reported.

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For additional information, contact any of the lawyers listed in the Employee Benefits section of our website.

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[33] It is not clear whether this language applies only to fees charged against an investment by a plan in an investment fund or might also apply in the context of an investment by a plan through a separate account.

[34] For this purpose, the test of whether compensation is paid on a "per transaction basis" appears to depend on whether the amount of the fee to be paid to the particular service provider that is entitled to the payment is transaction based. Accordingly, if the bundled service provider is entitled to transaction-based fees, but a subcontractor is paid a flat fee per year, then it appears that the payment to the subcontractor is not required to be reported.

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