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Clients&FriendsMemo

Recent Developments Concerning ERISA at the Department of Labor

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This summer has proven to be one of significant activity at the U.S. Department of Labor (the "**DOL**") with respect to the refinement of two significant exemptions to the prohibited transaction provisions of the Employee Retirement Income Security Act of 1974, as amended ("**ERISA**"). In July, the DOL amended Prohibited Transaction Exemption ("**PTE**") 84-14, 75 Fed. Reg. 38837 (July 6, 2010) (the "**QPAM Exemption**") to permit a qualified professional asset manager (a "**QPAM**") to manage an investment fund containing assets of such QPAM's own employee benefit plan. In July, the DOL published an interim final regulation clarifying the disclosure necessary for plan fiduciaries in concluding whether a contract or arrangement is "reasonable" in order to assist such fiduciaries in deciding whether the statutory exemption contained in Section 408(b)(2) of ERISA is available with respect to services provided by a party in interest to a plan.

I. The DOL Adopts Amendment to Prohibited Transaction Exemption 84-14

Introduction

On July 6, 2010 the DOL published in final form an Amendment (the "**Amendment**") to the QPAM Exemption (as amended, the "**Amended Exemption**") to permit a QPAM to utilize the relief provided by the exemption with respect to an employee benefit plan sponsored by the QPAM or any of the QPAM's affiliates. The Amendment was proposed by the DOL on its own motion on August 23, 2005 and will be effective on November 3, 2010 (the "**Effective Date**"); provided, prior to the Effective Date, a QPAM may continue to act as investment manager for its own in-house plan in reliance on the transitional relief provided in the amendment to PTE 84-14 that was published on August 23, 2005.

The Scope of the Amendment

The QPAM Exemption works to exempt a wide range of prohibited transactions under ERISA involving assets of an employee benefit plan managed by a QPAM, provided that, among other conditions, the QPAM is independent of such party in interest (including independence from the plan sponsor). The QPAM Exemption also provides (i) exemptive relief to employers to provide certain limited amounts of goods and services to a managed fund in the ordinary course of such an employer's business, (ii) limited exemptive relief for leases of office or commercial space between managed funds and QPAMs or employers and (iii) relief for transactions involving places of public accommodation owned by the managed fund. As described below, after the Effective Date, a QPAM that is acting as a manager for its own employee benefit plan or that of an affiliate will be deemed to meet the definition of "independent fiduciary" set forth in the QPAM Exemption if the requirements of Part V of the Amended Exemption are met.

Under the Amended Exemption, the relief provided by Parts I (General Exemption), III (Specific Lease Exemption for QPAMs) or IV (Transactions Involving Places of Public Accommodation) of the QPAM Exemption, shall apply to transactions involving the assets of an employee benefit plan sponsored by the QPAM or an affiliate of the QPAM if the following conditions are met:

(1) The QPAM has discretionary authority or control with respect to the plan assets involved in the transaction;

(2) The QPAM adopts written policies and procedures designed to assure compliance with the Amended Exemption;

(3) An independent auditor, who has appropriate technical training or experience and proficiency with ERISA's fiduciary responsibility provisions and so represents in writing, conducts an exemption audit (as described below) on an annual basis. Following completion of the exemption audit, the auditor shall issue a written report to the plan presenting its specific findings regarding the level of compliance: (1) with the policies and procedures adopted by the QPAM; and (2) with the objective requirements of the Amended Exemption. The written report shall also contain the auditor's overall opinion regarding whether the QPAM's program complied (1) with the policies and procedures adopted by the QPAM; and (2) with the objective requirements of the Amended Exemption. The exemption audit and the written report must be completed within six months following the end of the year to which the audit relates; and

(4) The transaction satisfies the applicable requirements set forth in Parts I, III, or IV of the QPAM Exemption (none of which Parts have been substantively modified by the Amendment).

Exemption Audit

For purposes of the Amended Exemption, an "exemption audit" of a plan must consist of the following:

(1) A review of the written policies and procedures adopted by the QPAM for consistency with each of the objective requirements of the Amended Exemption (as described below);

(2) A test of a representative sample of the plan's transactions during the audit period that is sufficient in size and nature to afford the auditor a reasonable basis:

(A) to make specific findings regarding whether the QPAM is in compliance with (i) the required written policies and procedures and (ii) the objective requirements of the Amended Exemption; and

(B) to render an overall opinion regarding the level of compliance of the QPAM with its policies and procedures and the conditions of the Amended Exemption;

(3) A determination as to whether the QPAM has satisfied the definition of an QPAM under the Amended Exemption; and

(4) Issuance of a written report that describes the steps performed by the auditor during the course of its review and the auditor's findings.

Policies and Procedures

For purposes of the foregoing, the required written policies and procedures must describe the following objective requirements of the Amended Exemption and the steps adopted by the QPAM to assure compliance with each of the following:

(1) The definition of a QPAM (which has not been modified by the Amendment);

(2) The conditions of the Amended Exemption regarding the discretionary authority or control of the QPAM with respect to the plan assets involved in the transaction, in negotiating the terms of the transaction and with respect to the decision on behalf of the investment fund to enter into a covered transaction;

(3) For a transaction described in the General Exemption in Part I of the QPAM Exemption:

(A) that the transaction is not entered into with any person who is excluded from relief under Section I(a) (relating to power of appointment and termination and the authority to negotiate the terms of the QPAM's management agreement), Section I(d) (relating to the relationship of the QPAM to the party in interest), or Section I(e) (relating to the 20% "diverse clientele" test) of the Amended Exemption; and

(B) that the transaction is not described in any of the class exemptions listed in Section I(b) (for securities lending, certain mortgage pools and certain mortgage financing arrangements); and

(4) If the transaction is described in Section III of the Amended Exemption:

(A) that the amount of space covered by the lease does not exceed the greater of 7500 square feet or one (1) percent of the rentable space of the property in which the investment fund has the investment; and

(B) that no commission or other fee is paid by the investment fund to the QPAM, any person possessing disqualifying powers with respect to the QPAM or any affiliate of such persons.

Conclusion

In sum, the Amended Exemption serves to remove any residual doubt that may have existed under the QPAM Exemption as to whether and under what circumstances a QPAM may act with respect to the managed assets of its own, or one of its affiliate's, employee benefit plans.

II. The DOL Adopts Interim Final Regulation under ERISA Section 408(b)(2) Relating to Service Provider Fee Disclosures

Introduction

On July 16, 2010 the DOL published an interim final regulation (the "**Interim Final Regulation**") (75 FR 41599) clarifying that a certain level of disclosure with respect to compensation and potential conflicts of interest is necessary in order for a plan fiduciary to determine that a contract or arrangement for services by a party in interest to a plan is "reasonable." The Interim Final Regulation establishes these disclosure rules as part of a statutory exemption from the prohibited transaction rules of ERISA and specifically provides that the requirements set forth therein are independent of the broad fiduciary obligations otherwise set forth in Section 404 of ERISA.

The Interim Final Regulation, which is subject to revision by the DOL in connection with any comments received during the relevant comment period, shall be effective July 16, 2011 after which date all responsible plan fiduciaries[1] must comply with the disclosure requirements set forth therein with respect to all contracts and arrangements for services described therein, whether or not such contract or arrangement was entered into before such date or is entered into, extended or renewed on or after such date.

Background

Section 406(a)(1)(C) of ERISA, prohibits the furnishing of services by a party in interest to an ERISA plan unless there is an applicable exemption. Such an exemption is provided by Section 408(b)(2) of ERISA, which exempts service contracts or arrangements from the prohibited transaction rules if (i) the contract or arrangement is reasonable, (ii) the services are necessary for the establishment or operation of the plan, and (iii) no more than reasonable compensation is paid for the services. The existing regulation issued under ERISA Section 408(b)(2), at 29 CFR § 2550.408b-2 (the "**Regulation**"), states only that a contract or arrangement is not reasonable unless it permits the plan to terminate without penalty and on reasonably short notice. Further, the DOL's regulation at 29 CFR § 2550.408c-2 provides that for purposes of ERISA Section 408(b)(2) the determination as to whether compensation is "reasonable" depends on the particular facts and circumstances of each case. On December 13, 2007, the DOL published a proposed amendment to the Regulation (the "**Proposed Regulation**"), proposing to add that, in order for a contract or arrangement for services to be reasonable, the contract or arrangement must require that the service provider furnish, and the service provider must in fact furnish, certain information to the responsible plan fiduciary.

The Scope of the Interim Final Regulation

The DOL specifies in the Interim Final Regulation that the additional disclosure requirement applies only to "covered service providers" (each, a "**CSP**") that enter into a contract or arrangement with a "covered plan" and reasonably expect $1,000 or more in direct or indirect compensation in connection with providing one or more services listed in the Interim Final Regulation, regardless of whether such services will be performed, or the compensation received, by such CSP, an affiliate[2]

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[1] A "responsible plan fiduciary" is a fiduciary with authority to cause the covered plan to enter into, or extend or renew, the contract or arrangement with a "covered service provider" (a "**CSP**").

[2] A person's or entity's "affiliate" directly or indirectly (through one or more intermediaries) controls, is controlled by, or is under common control with such person or entity; or is an officer, director, or employee of, or partner in, such person or entity. Unless otherwise specified, an "affiliate" refers to an affiliate of the CSP.

or subcontractor.[3] Compensation is anything of monetary value (*e.g.*, money, gifts, awards, and trips), but does not include non-monetary compensation valued at $250 or less, in the aggregate, during the term of the contract or arrangement. "*Direct* compensation" is compensation received directly from the covered plan. "*Indirect* compensation" is compensation received from any source other than the covered plan, the plan sponsor, the CSP, an affiliate, or a certain type of subcontractor. Specifically, a CSP is someone who:

(1) provides services (A) directly to a covered plan as a fiduciary under ERISA, (B) as a fiduciary to an investment contract, product or entity that holds plan assets (as determined pursuant to Sections 3(42) and 401 of ERISA and the DOL's regulation at 29 CFR § 2510.3-101) and in which the covered plan has a direct equity interest (excluding investments made by such investment contract, product or entity in which the covered plan invests) or (C) directly to the covered plan as an investment advisor registered under the Investment Advisers Act of 1940 or any State law;

(2) provides recordkeeping[4] or brokerage services to an individual account plan permitting participants or beneficiaries to direct investments of such accounts if one or more designated investment alternatives will be made available (e.g., through a platform or similar mechanism) in connection with such recordkeeping or brokerage services; or

(3) provides services such as accounting, auditing, actuarial, appraisal, banking, consulting (related to the development or implementation of investment policies or objectives or selection or monitoring of service providers or plan investments), custodial, insurance, investment advisory (for plan or participants), legal, recordkeeping, securities or other investment brokerage, third party administration or valuation services for which the CSP (or any affiliate or subcontractor thereof) reasonably expects to receive indirect compensation.

As drafted, we do not believe that a registered investment advisor of a mutual fund that is registered under the Investment Company Act of 1940, as amended, in which a covered plan invests would be recognized as a CSP solely on the basis of the services it provides to such mutual fund. In

3 A "subcontractor" is any person or entity (or an affiliate of such person or entity) that is not an affiliate of the CSP and that, pursuant to a contract or arrangement with the CSP or an affiliate, reasonably expects to receive $1,000 or more in compensation for performing one or more services covered by the Interim Final Regulation.

4 "Recordkeeping services" include services related to plan administration and monitoring of plan and participant and beneficiary transactions (*e.g.*, enrollment, payroll deductions and contributions, offering designated investment alternatives and other covered plan investments, loans, withdrawals and distributions); and the maintenance of covered plan and participant and beneficiary accounts, records, and statements.

addition, the Interim Final Regulation specifically excludes affiliates and subcontractors of CSPs from the disclosure rules as well as services provided to investment contracts, products or entities in which a covered plan invests (other than in the capacity of a fiduciary as described above).

For purposes of the Interim Final Regulation, a "covered plan" is an "employee benefit pension plan" or "pension plan" within the meaning of ERISA, including defined contribution plans and defined benefit plans, but excluding simplified employee pensions, simple retirement accounts, individual retirement accounts and individual retirement annuities. It should also be noted that the Interim Final Regulation reserves for, but does not include, disclosure rules to be applied to welfare benefit plans subject to ERISA.

The Disclosures Required by the Interim Final Regulation

If a contract or arrangement for services falls within the scope of the Interim Final Regulation, the CSP must comply with the following requirements:

(1) the CSP must disclose, in writing and to the best of its knowledge, the required information. However, it should be noted that (a) the proposal does not prescribe the manner in which such disclosures should be presented to the responsible plan fiduciary and (b) does not require that all of the required disclosures be contained in the same document, as long as the documents, collectively, contain all of the elements of disclosure required by the Interim Final Regulation;

(2) the CSP must disclose all required information to the responsible plan fiduciary reasonably in advance of the date the contract or arrangement is entered into (and extended or renewed), except that when an investment contract, product or entity is determined not to hold plan assets at the time of the covered plan's direct equity investment but subsequently is determined to hold plan assets such disclosure must be made as soon as practicable but no later than 30 days from the date the CSP knows that such investment contract, product or entity holds plan assets or, with respect to recordkeeping and brokerage services relating to any investment alternative not designated at the time the contract or arrangement is entered into, as soon as practicable but not later than the date an affected alternative investment is designated by the responsible plan fiduciary; and

(3) the contract or arrangement must require that the CSP notify the responsible plan fiduciary of any change to previously disclosed information as soon as practicable but, unless precluded by extraordinary circumstances beyond the CSP's control, not later than 60 days from the date that the CSP is informed of such change. Significantly, the DOL eliminated the concept of materiality contained in the Proposed Regulation in favor of requiring all changes be disclosed to the

responsible plan fiduciary. The DOL has stated that the ambiguity surrounding the materiality standard would not improve a CSP's understanding of the types of changes that should be disclosed.

It should be noted that unlike the Proposed Regulation, the Interim Final Regulation does not require that the contract or arrangement with the CSP be in writing.

Disclosure Requirements Relating to Compensation Received and Services Provided by a CSP

To facilitate the responsible plan fiduciary's determination that the CSP will receive no more than reasonable compensation, the CSP must disclose:

(1) a description of all services it will provide to the covered plan;

(2) if applicable, a statement that the CSP, an affiliate of the CSP or a subcontractor will, or reasonably expects to, provide such services directly to the covered plan (or investment contract, product or entity that holds plan assets and in which the covered plan has a direct equity investment) as a fiduciary or investment adviser, or both;

(3) all direct compensation, either in the aggregate or by service, that such CSP, affiliate or subcontractor reasonably expects to receive in connection with the services;

(4) a description of all indirect compensation that the CSP, affiliate or subcontractor reasonably expects to receive in connection with the services, including identification of the services for which the indirect compensation will be received and the payor thereof;

(5) any compensation (direct or indirect) that will be paid among the CSP, any affiliate or a subcontractor if set on a transaction basis (*e.g.*, commissions, soft dollars, finder's fees or similar incentive compensation based on business placed or retained) or charged directly against the covered plan's investment and reflected in the net value of the investment (*e.g.*, 12b-1 fees), including (i) identification of services for which such compensation will be paid and (ii) the identification of the payers and recipients of such compensation (including status as an affiliate or subcontractor),[5] but not including compensation received by employees; and

[5] Compensation received by employees is not to be included in such disclosure.

(6) a description of compensation that a CSP, affiliate or subcontractor reasonably expects to receive upon termination of the contract or arrangement and how prepaid amounts will be calculated and refunded upon such termination.

With respect to compensation received in connection with recordkeeping services provided by a CSP, affiliate or subcontractor pursuant to a contract or arrangement without explicit compensation or if such compensation will be offset or rebated based on other compensation received, the CSP disclosure must include a detailed explanation of the recordkeeping services that will be provided, a reasonable and good faith estimate of the cost to the covered plan for such services[6] and an explanation of the methodology and assumptions used to prepare such estimate, taking into account rates such CSP, affiliate or subcontractor would charge to or be paid by third parties or prevailing market rates.

With respect to compensation received in connection with fiduciary services, a CSP must also provide a description of (i) compensation to be charged directly against the amount invested in connection with the acquisition, sale, transfer of, or withdrawal from an investment contract, product or entity (*e.g.*, sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, account fees and purchase fees); (ii) annual operating expenses (*e.g.*, expense ratio) if the return is not fixed; and (iii) other ongoing expenses (*e.g.*, wrap fees, mortality and expense fees).

With respect to any designated investment alternative, which is any investment alternative designated by a fiduciary into which participants and beneficiaries may direct the investment of assets held in, or contributed to, their individual accounts,[7] information described in clauses (i) – (iii) of the immediately preceding paragraph in connection with such recordkeeping and brokerage services must be provided by the CSP pursuant to the contract or arrangement with the covered plan. A CSP may satisfy its disclosure obligations under the Interim Final Regulation by providing current disclosure materials of the issuer of the designated investment alternative that include such information, provided such issuer is not an affiliate, such disclosure materials are regulated by a State or federal agency and the CSP does not know such materials are incomplete or inaccurate.

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[6] A description or an estimate of compensation may be expressed as a monetary amount, formula, percentage of the covered plan's assets, or a per capita charge for each participant or beneficiary or, if the compensation cannot reasonably be expressed in such terms, by any other reasonable method. Any description or estimate must contain sufficient information to permit evaluation of the reasonableness of the compensation.

[7] The term "designated investment alternative" shall not include brokerage windows, self-directed brokerage accounts, or similar plan arrangements that enable participants and beneficiaries to select investments beyond those specifically designated.

A CSP must provide the information required to be disclosed by the Interim Final Regulation upon the request of the responsible plan fiduciary not later than 30 days following such a request or, in the case of extraordinary circumstances beyond the CSP's control, as soon as practicable. No contract or arrangement will fail to be reasonable solely because the CSP, acting in good faith and with reasonable diligence, makes an error or omission in disclosing the required information, provided the CSP discloses the correct information to the responsible plan fiduciary as soon as practicable, but not later than 30 days from the date such CSP knows of such error or omission.

Consistent with the original Regulation, the Interim Final Regulation provides that no contract or arrangement is reasonable with the meaning of Section 408(b)(2) if it does not permit termination by the plan without penalty on reasonably short notice under the circumstances.

The Interim Final Regulation provides that it shall not supersede any provision of State law governing disclosure by parties providing services described in the Interim Final Regulation, except to the extent such State law prevents application of any provisions of the Interim Final Regulation.[8]

Disclosure Concerning Potential Conflicts of Interest

Unlike the Proposed Regulation, the Interim Final Regulation does not provide that a contract or arrangement must require that the CSP disclose specific information regarding potential conflicts of interest for the service provider in its performance of services for the plan. Rather, the DOL believes that the more detailed disclosure requirements relating to compensation arrangements will provide responsible plan fiduciaries with sufficient information to assess whether any conflicts of interest exist with respect to services provided by the disclosing CSPs.

Additional Reporting and Disclosure Requirements

In addition to the previously covered disclosures, the Interim Final Regulation requires that a reasonable contract or arrangement obligate the CSP to furnish all information related to the contract or arrangement and the receipt by the CSP of compensation or fees thereunder, when such information is requested by the responsible plan fiduciary (or plan administrator) in order to comply with the reporting and disclosure requirements of Title I of ERISA and the regulations, forms, and schedules issued thereunder. This provision would obligate each CSP to furnish information that is necessary for plan administrators to complete a plan's annual Form 5500 and for

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[8] Consistent with Reorganization Plan No. 4 of 1978, 5 U.S.C. App 214 (2000 ed.) transferring authority to promulgate regulations of the type described in the Interim Final Regulations from the Secretary of the Treasury to the Secretary of Labor, the Interim Final Regulation also provides that all references therein to Section 408(b)(2) of ERISA and the regulations thereunder should be read to include reference to the parallel provisions of Section 4975(d)(2) of the Internal Revenue Code of 1986, as amended and the regulations thereunder.

the responsible plan fiduciary to comply with disclosure obligations to plan participants and beneficiaries.

The Consequences of Failure to Comply and the Exemption

Under the Interim Final Regulation, if the CSP fails to disclose the required information, then the contract or arrangement will not be "reasonable" and the provision of the related services will not qualify for the relief from ERISA's prohibited transaction rules unless another exemption provided under ERISA applies.

As a result,

(1) the responsible plan fiduciary, by participating in the prohibited transaction, will have violated Section 406(a)(1)(C) of ERISA's prohibited transaction rules; and

(2) the CSP, as a "disqualified person" under the Internal Revenue Code's prohibited transaction rules, could be subject to the excise taxes on prohibited transactions.

However, the Interim Final Regulation provides for an exemption (as opposed to incorporating a reference to a proposed class exemption, as described in the Proposed Regulation, and providing for a separate class exemption), which provides relief to a responsible plan fiduciary when, unbeknownst to the responsible plan fiduciary, a CSP fails to comply with the disclosure requirements (the "**Exemption**").

Specifically, the Exemption provides relief to a responsible plan fiduciary even though a CSP fails to comply with its disclosure obligations. To avail itself of the relief offered by the Exemption, a responsible plan fiduciary must satisfy the following conditions:

(1) such responsible plan fiduciary did not know that the CSP failed (or would fail) to comply with its disclosure obligations and reasonably believed that the CSP disclosed the required information;

(2) upon discovering that the CSP failed to comply with its disclosure obligations, the responsible plan fiduciary must request in writing that the CSP furnish the required information;

(3) if the CSP fails to comply with such request within 90 days, the responsible plan fiduciary must notify the DOL. Such notification (which must include certain

background information),[9] must be provided no later than 30 days following the expiration of the above-mentioned 90-day period or following the CSP's refusal to comply with the request, whichever is earlier; and

(4) the responsible plan fiduciary must determine whether to terminate or continue the contract or arrangement with such CSP. In making this determination, the responsible plan fiduciary must consider, among other factors, the nature of the particular failure to disclose; the responsiveness of the CSP in furnishing the missing information; and the availability, qualifications, and costs of a potential replacement CSP. It should be noted that this requirement does not abrogate or supersede the duties imposed upon the fiduciary by Section 404(a) of ERISA, which also requires the fiduciary to consider the necessary steps in responding to the CSP's failure to comply with its disclosure obligations.

Cautionary Note

Note that there are other existing exemptions which might exempt the provision of services to a plan by a party in interest, besides Section 408(b)(2) of ERISA. For example, in appropriate circumstances, an exemption may be available under the QPAM Exemption. However, in the Interim Final Regulation the DOL indicated that it is expressing no view at present on the relationship of the Interim Final Regulation to existing statutory and administrative exemptions. The DOL indicated that it will review such issues in the future on a case-by-case and exemption-by-exemption basis.

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9 Such information includes (i) the name and plan number of the covered plan, (ii) the plan sponsor's name, address and EIN, (iii) the name, address and telephone number of the responsible plan fiduciary and CSP, (iii) a description of the services provided and information not disclosed, and (iv) a statement as to whether such CSP continues to provide services to the plan.