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Vendor to Plan Sponsor Fee Disclosure





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New vendor to plan sponsor fee disclosure rules are scheduled to go into effect on April 1, 2012.¹ The new rules apply to most employee benefit plans and will require almost every vendor to disclose significant new information about their fees, compensation and services to plan sponsors. The rules apply to plans that are covered by the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), including 401(k) plans and many 403(b) plans. Governmental 457 plans, most church plans, IRAs, SEPs, SIMPLE plans and some other kinds of plans not subject to ERISA are not covered. The following is a summary of the rules' most significant changes, and their impact and potential implications for plan sponsors and others who will be affected by the changes.

Background

The new disclosure rules are frequently called the 408(b)(2) rules, which refers to the section of ERISA that allows retirement plans to hire and pay vendors to provide services. A plan is allowed to make reasonable arrangements for necessary services if no more than reasonable compensation is paid for them. The necessary services and reasonable compensation requirements are **not** new. However, the new rules add extensive fee and compensation disclosure requirements that must be satisfied in order for the services arrangement to be considered

reasonable. The changes establish an affirmative obligation for service providers to disclose certain fee and compensation information, even if the plan sponsor or other plan fiduciary does not request it. This is a significant change that, as discussed more fully below, addresses one of the Department of Labor's ("DOL's") most significant concerns about plan fees.

Why are the Rules Changing?

The DOL recognized that retirement plan service and compensation arrangements have become very complex since 401(k) plans were first created. Some plan sponsors had reported that information they wanted or needed to understand and evaluate their plan service and compensation arrangements was not readily available or not being provided to them by their service providers, including investment managers. Additionally, the DOL was concerned that under existing rules, a vendor technically may not be obligated to disclose information that a plan sponsor does not request. As a result, the new 408(b)(2) rules were developed and will require specific, comprehensive written disclosure concerning plan compensation and service arrangements. The intended goal of the new regulations is to provide increased transparency so it is easier for plan sponsors to understand and evaluate the compensation received by service providers and to identify any potential conflicts of interest that the service providers may have.

¹ The new rules were originally scheduled to take effect on July 16, 2011, but were recently delayed because of possible changes that the Department of Labor may make to the rules.



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Vendor to Plan Sponsor Fee Disclosure

What are Some of the Important New Requirements?

Some of the specific changes and their implications are detailed on the following pages.²

1. Who must make disclosures?

Service providers that are subject to the rules are defined very broadly so that just about anyone providing services to a plan and who expects to receive \$1,000 or more in compensation either directly or indirectly from the plan must comply. If several related service providers provide services to the plan, the service provider with the direct relationship to the plan is primarily responsible for making disclosures, including disclosures for its affiliates and subcontractors.³ However, a plan sponsor is likely to receive multiple disclosures when it has direct relationships with more than one service provider. Additionally, some providers may give overlapping or duplicative disclosures depending on the nature of their services and relationships with the plan. For example, this could occur in connection with disclosures about investment expenses and “revenue sharing” payments, which are discussed more fully below.

2. What general information must be disclosed?

The disclosures must include a description of the services that will be provided and the vendor must state in writing whether it or any of its affiliates or subcontractors expects to serve as a fiduciary to the plan and/or registered investment

adviser. This requirement addresses another significant issue that the DOL has identified, which is making sure that plan sponsors know whether or not their service providers are acting in a fiduciary capacity and have a legal duty of loyalty under ERISA to the plan. The service provider must also disclose how the compensation will be received - for example if the plan will be billed or the compensation will be received directly from plan assets.

3. What compensation information must be disclosed?

The disclosures must include a description of all compensation that is expected to be paid directly to the service provider by the plan. For example, any amounts that are allocated to and deducted from participant accounts would have to be disclosed (e.g., recordkeeping fees). Additionally, service providers must disclose all of the **indirect** compensation they expect to receive (i.e., anything paid to them by someone other than the plan) and identify the payer of that compensation. This requirement accomplishes another important objective of the DOL, which is ensuring the clear and specific disclosure of revenue sharing payments. Revenue sharing payments generally are payments by an investment fund (or its manager, distributor or another of its affiliates) to a third party for services provide to the fund. For example, amounts paid

²The 408(b)(2) rules are extensive and include many other requirements that are beyond the scope of this brief summary. Plan sponsors and anyone else that may be affected by the rules should contact their advisors and legal counsel, as needed, regarding their specific issues and circumstances.

³Compensation of affiliates and subcontractors only must be disclosed if it is “transactional” or charged directly against a plan investment (e.g., “Rule 12b-1 fees”)



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Vendor to Plan Sponsor Fee Disclosure

to a service provider, such as a recordkeeper, from an investment fund that are used to pay for or subsidize the cost of plan recordkeeping and other services must be disclosed. Additionally, brokers and financial advisors who are paid indirectly from the plan investment funds for the services they provide must fully disclose their compensation from such sources. Requiring brokers and financial advisors to specifically disclose their indirect compensation, describe the services they are providing for the amounts they are paid, and identify who pays them is one of the most significant changes the new rules include and may provide many plan sponsors with new information they did not otherwise have from some providers.

4. Investment fund fees disclosures.

The regulations include a special rule that requires recordkeepers and brokers that offer an investment option platform from which plan sponsors choose their plan investment options to disclose investment fees and expense information for **all** of the investment options used by a plan. The information provided must include the fees charged directly against the investments (e.g., sales loads), annual operating expenses (e.g., expense ratios), and other ongoing fund expenses (e.g., wrap fees). This requirement is intended to identify a single source for plan sponsors to obtain

fee and expense information about plan investment options.

5. How must the disclosures be made?

The rules state that disclosures must be made in writing, and may be made through multiple documents, such as plan service agreements, fee schedules and mutual fund prospectuses; however, it appears the DOL contemplates that disclosures may be delivered electronically. The DOL has not mandated the use of any particular form or format for making the disclosures. However, the DOL may be considering the idea of a summary disclosure form or road map. It is not clear whether any such form, if developed and released, will be mandatory, a safe-harbor model, or merely a sample template that could be used on a voluntary basis. Depending on what the DOL ultimately decides to do on this issue and when they announce their final decision, there is a possibility that the rule's effective could be delayed beyond April 1, 2012. It is unlikely that a decision on this matter will be available to the retirement plan community before October 2011.⁴ Compensation disclosures may be expressed in a formula, a dollar amount, a percentage of assets or a per participant charge.

⁴ The DOL is also considering making changes to other significant parts of the new rules in response to the substantial comments it received in response to its request for feedback from the retirement plan community. Some of the potential changes could impact parts of the rule that are discussed in this summary but, as noted above, it is unlikely that an official announcement about any such changes will be available before October 2011.



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Vendor to Plan Sponsor Fee Disclosure

6. When must disclosures be made?

For existing service arrangements, the disclosures have to be made by the rule's effective date, currently April 1, 2012. For new service arrangements entered into after April 1, 2012, the disclosure generally must be made before the services agreement is entered into. Plan sponsors must also be notified of any changes to the disclosed information as soon as possible, but not later than 60 days after the provider is aware of the change.

Additional Important Implications of the New Rules

Since the new 408(b)(2) rules were first released in July 2010, service providers have been working to modify their systems and procedures.

For some providers, the regulations will require significant changes depending on the types of services they provide, the complexity of their compensation arrangements and, of course, how transparent they were about fees and expenses before the new changes.

1. "Free" Recordkeeping Services

Another significant concern addressed by the DOL in the rules is the practice of marketing recordkeeping services as "free" when, in fact, the services are paid for by participants through the fees and expenses embedded in the plans' investment options. Under the new rules, recordkeepers and brokers that offer investment menus from which a sponsor may choose their plan's investment options that do not charge an

explicit fee for recordkeeping services, and who are paid indirectly through revenue sharing, must provide an estimate of the cost of the recordkeeping services. The new rules do not specify how the estimates are to be calculated and doing so is probably going to be very complicated for many organizations. It is likely that the methodology used to calculate the estimates will be different among institutions with widely ranging results and information. Plan sponsors should be mindful of this as they review recordkeeping fee estimates and consult with their trusted advisors when evaluating them.

2. Contract Termination Fees

The new rules require disclosure of any contract termination compensation, for example, fees that may be incurred in connection with terminating insurance investment products and contracts. This addresses the DOL's concern that potentially significant fees that could impact a plan's ability to change providers or investment options may not have been clearly disclosed to plan sponsors before entering in an arrangement. Plan sponsors should be mindful of this information, which has the potential to be complicated and involve significant fees.

3. Plan Sponsor Due Diligence

The specific requirements in the new 408(b)(2) rules and the increased availability of information from all service providers, regardless of whether they are recordkeepers, mutual fund companies, insurance companies or banks, should make it easier for plan sponsors to evaluate their service



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Vendor to Plan Sponsor Fee Disclosure

providers' fees and the service they are providing. Plan sponsors must evaluate the information they receive and determine that the services are necessary and that the fees are reasonable. These are not new requirements, but the information that will be provided under the new rules should form the foundation of a solid due diligence process, which should include documenting the process and the decisions that are made in selecting and monitoring service providers. Without such a due diligence process, the plan fiduciaries may be subject to potential litigation from unhappy participants or class action attorneys.

ADP welcomes the enhanced disclosure brought about by the new regulations because we have always disclosed our fees and supported increased transparency for all service providers. We believe that the new regulations benefit the entire retirement plan community, including plan participants. The resulting disclosures will presumably put all providers on a level playing field, creating an opportunity for providers to better articulate the value of their services when compared with their competitors.

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For more detailed information on fee disclosure regulations, please see “Vendor to Plan Sponsor Fee Disclosure Q&A document”. To obtain a copy please contact an ADP Retirement Services District Manager at 800-432-401k.