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ADP RETIREMENT SERVICES

Vendor to Plan Fiduciary Investment and Fee/Compensation Disclosure

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New vendor to plan fiduciary disclosure rules are scheduled to go into effect on July 1, 2012.[1] The new rules apply to most retirement plans and will require most vendors of retirement plan services to disclose significant new information about their fees, compensation and services to plan sponsors, as well as certain information about plan investments. The rules apply to retirement 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.[2]

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 disclosure requirements that must be satisfied by "covered" service providers (that is, those listed in the regulation) in order for the services arrangement to be considered reasonable.

The changes establish an affirmative obligation for these 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 expenses.

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 might not be obligated to disclose information that a plan sponsor did 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.

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[1] The new rules were originally scheduled to take effect on July 16, 2011, but were delayed because of changes that the Department of Labor made to the rules.

[2] Under the regulation, disclosure must be made to a "responsible plan fiduciary" who is responsible for causing the plan to enter into arrangements with service providers. In this article, it is assumed that this is the plan sponsor.

What Are Some of the Important New Requirements?

Some of the specific changes and their implications are detailed on the following pages.[3]

1. Who must make disclosures?

Service providers that are subject to the rules are defined very broadly. Persons and companies providing services to a plan who expect to receive $1,000 or more in compensation either directly or indirectly from the plan must comply if they will provide one of the following:

- Recordkeeping or brokerage services that include an investment option platform from which the plan sponsor can select a plan's investments;
- Fiduciary services directly to a plan;
- Management of plan assets held in certain investment vehicles, including bank collective investment trusts;
- Services as a registered investment advisor; and
- Other services for which indirect compensation (that is, generally, paid from a source other than the plan or the plan sponsor) is expected.

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.[4] 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. If a vendor or any of its affiliates or subcontractors expects to serve as a fiduciary to the plan and/or as a registered investment adviser, the vendor must state this. 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 or payable 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 (generally, anything paid to them by someone other than the plan or the plan sponsor), identify the payer of that compensation and the services provided for that compensation, and describe the arrangement. 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

[3] The 408(b)(2) rules are extensive and include other requirements and content that are beyond the scope of this brief summary. Plan fiduciaries 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.

[4] Compensation paid between affiliates and subcontractors must be separately disclosed if it is "transactional" or charged directly against a plan investment and reflected in its net value (e.g., "Rule 12b-1 fees").

services provided to the fund. For example, amounts paid to a service provider, such as a recordkeeper, from an investment fund or fund affiliate for shareholder servicing must be disclosed. Additionally, brokers and financial advisors who are paid indirectly from the plan investment funds for the services they provide must fully disclosure 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, describe the arrangement 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. What investment fund information must be disclosed?

Recordkeepers or brokers that offer an investment option platform (i.e., "Platform Providers") must also provide information about the investment options that the plan sponsor has designated for its plan (i.e., "designated investment alternatives"), such as information about the investments' annual operating expenses and compensation charged in connection with plan transactions. 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) in connection with plan transactions. Platform Providers must also provide certain other information or data about designated investment alternatives that they actually have, or that is reasonably available to them. This would include, for example, information about investment fund performance, benchmarks against which performance may be measured and investments' goals, strategies and risk characteristics. 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 a "covered" service provider is responsible for making disclosures to the plan, including disclosures for its affiliates and subcontractors. These disclosures must be made in writing, and may be made through multiple documents, such as plan service agreements, fee schedules and mutual fund prospectuses. The disclosures may be delivered electronically. The DOL has not mandated the use of any particular form or format for making the disclosures.[5] Compensation disclosures may be expressed in a formula, a dollar amount, a percentage of assets or a per participant charge. If compensation cannot be reasonably described in one of these ways, a narrative description may be used.

6. When must disclosures be made?

For existing service arrangements, the disclosures have to be made by the rule's effective date, July 1, 2012. For new service arrangements entered into after July 1, 2012, the disclosure generally must be made before the services arrangement is entered into. For all plans, after the initial disclosures are made they must be made again whenever the service arrangement is extended or renewed. Generally, 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 service provider is aware of the change (note that changes to investment-related information must be provided at least annually).

[5] The DOL has been considering whether or not it will require service providers to provide a summary disclosure document, which may have to include a "roadmap" describing where to find certain disclosures (or more detail). The DOL instead published a sample template with the final regulation that service providers may use voluntarily. The DOL has stated that it is considering issuing a proposed regulation that is currently scheduled for release in June 2012 that would address this subject.

Additional Disclosure Requirements

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 plan's investment options. Providers of recordkeeping services (as defined in the regulation, and which are the only types of services ADP Retirement Services provides) who either do not receive explicit compensation for those services or who offset or rebate their compensation for recordkeeping based on compensation from other sources are required to provide a reasonable and good faith estimate of the cost to a plan of such services. **Please note:** While ADP Retirement Services takes compensation from other sources into account in setting our fees for services to a plan, we do not explicitly offset or rebate our fees based on compensation from these other sources and accordingly do not provide such an estimate. A plan's total cost for our recordkeeping and administrative services is the total of all compensation we receive directly from the plan sponsor, from the plan, and from third-party sources for services to investment funds and certain other services, all of which we will disclose to plan sponsors.

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.

Implications of the New Rules

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 providers' fees, the service they are providing, and their plan's designated investment alternatives. 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 sponsor may be subject to potential litigation from unhappy participants or class action attorneys.

Implications of the New Rules, continued

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.

ADP Retirement Services 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.

For additional information, please contact an ADP Retirement Services District Manager at 800-432-401k.

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