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Proposed 408(b)(2) Regulations

Disclosing service provider fees to plan sponsors

Coming Soon: Mandated Fee Disclosures to Plan Fiduciaries

It is not so much a question of “if” the regulation will be implemented; rather, it is a question of “how soon.”

In late 2007, the Department of Labor (DOL) proposed regulations designed to address concerns about fees paid to providers of qualified retirement plan services. Those concerns are all about transparency: How much are plans really paying for the services they receive? How can plan fiduciaries compare apples with apples? Are there any conflicts of interest in relationships among service providers?

Since the regulations were proposed, the DOL and industry representatives have continued to discuss the details, but it is widely believed that the regulations will be finalized in some form before the end of 2008.

While the intent of the proposed regulations is to assist plan sponsors in their efforts to benefit employees by providing fee information — a goal The Standard shares — many questions have yet to be answered. This resource will provide you with a general overview of the DOL’s proposed service provider fee disclosure regulation, details about certain disclosure requirements, and a game plan to prepare for compliance.

The Background

The DOL’s proposed regulations will mandate the disclosure of compensation and conflicts of interest by retirement plan service providers to plan fiduciaries. The regulations modify and enlarge on a specific section of the Employee Retirement Income Security Act (ERISA), which requires that contracts and arrangements with service providers be “reasonable” to avoid being considered a prohibited transaction.

Previously, the burden of investigating and understanding the arrangement between a service provider and a plan to determine if it was “reasonable” fell primarily on plan fiduciaries. Fiduciaries, of course, have the legal duty to make sure the plan is always operated in participants’ best interests; the lack of transparency in fee arrangements made this analysis difficult.

Until now, service providers have not been obligated to provide this fee information in any kind of standardized format, making it difficult for plan fiduciaries to compare costs from provider to provider, and to determine which provider’s services best match the plan’s needs and are in the best interests of the plan’s participants.

The proposed regulation is an effort to increase transparency. It requires service providers to have a written contract or arrangement with the plan fiduciaries covering their services as well as to make advanced, detailed disclosures about direct and indirect compensation and any potential conflicts of interest. Any service provided under an agreement between a service provider and a plan that is **not** in writing will be considered a

prohibited transaction, resulting in penalties for the plan and the service provider. It is in the interest of everyone involved to prepare for this added requirement.

The Proposed Regulations in a Nutshell

First, let's summarize the basic requirements of the regulations.

- There must be a written contract or agreement between the service provider and the plan.
- Before a plan sponsor enters into a written contract, certain disclosures must be made to the plan, such as the direct and indirect compensation a service provider will receive for specified services and the manner in which such compensation will be received.
- The service provider must disclose whether it or an affiliate will provide any fiduciary services to the plan and must describe any potential conflicts of interest that may exist in the proposed arrangement.
- The written agreement must require disclosure to the plan within 30 days of any material change to the arrangement described in the agreement.

Non-compliance will result in the service provider's engagement being considered a prohibited transaction for which penalties could be imposed — including restoration of payments made and excise tax.

The effective date will most likely be at least 90 days from publication of the finalized regulations.

Who Must Comply?

If adopted as proposed, the regulations will apply to any service provider who:

- provides fiduciary services under ERISA or the Investment Advisers Act of 1940
- provides banking, consulting, insurance, investment advisory, investment management, recordkeeping, securities or other brokerage and third-party administration services
- receives indirect compensation and provides accounting, actuarial, appraisal, auditing, legal or valuation services

Most registered investment advisors, broker-dealers, registered representatives and independent financial advisors will be subject to the regulation under the second bullet item, and, depending on the services provided, possibly the first.

Because of the time needed to modify agreements, we suggest that firms start reviewing their agreements now and make necessary modifications when the regulation is finalized.

Key Provisions and Their Impact

The four main areas that the regulations address deal with written agreements, timely disclosures, fiduciary status and conflicts of interest.

Written Agreements

The contract must be in writing. While most service providers have written contracts in place, many do not provide detail in the manner and to the level the regulations require. Most service providers' agreements will likely have to be modified to meet the requirements of the final regulation. Because of the time needed to modify agreements, we suggest that firms start reviewing their agreements now and make necessary modifications when the regulation is finalized.

Timely Disclosures

Certain required information must be provided in advance of signing an agreement. Information about all the services provided, any direct or indirect compensation received, and all potential conflicts of interest must be disclosed before a contract is entered into. This will allow plan fiduciaries to compare proposals from competing service providers and make an informed decision on the best fit for their plan. As a practical matter, such disclosures will need to be part of any proposal for service.

The proposed regulations do not contain guidance on the format or organization of the proposed disclosures. This lack has been debated in the retirement plan community, with some declaring that meaningful comparison cannot be made unless competing service providers utilize similar disclosure formats, and others pointing out the difficulty in describing different fee structures in the same format. Many comments have been received by the Department of Labor on this issue; presumably the final regulations will address the topic.

The contract must adequately describe all the services that are being provided under the agreement. The agreement must describe all the services being provided under the agreement, not just those for which the service provider is specifically compensated. Reference may be made to other documents, but care must be taken that those other documents are also clear and easily understood.

All direct and indirect compensation received by the service provider or any of their affiliates in connection with the agreement must be described. For these purposes, compensation is defined as both money and any other thing of monetary value, such as gifts, awards and trips. It includes amounts received directly from the plan or indirectly from a source other than the plan (such as revenue sharing arrangements), and includes any compensation received by an affiliate in connection with the agreement.

The information presented must be clear enough that plan fiduciaries can make a determination of the reasonableness of the compensation. Other documents may be incorporated by reference, but the disclosure still must be clear and concise.

Providers must disclose how the compensation is determined, and how it will be received. The agreement must disclose if the compensation is determined by a formula (for example, based on a percentage of plan assets or a per-participant charge), is a fixed amount, or any combination thereof. Further, the agreement must state if and how the plan will be invoiced and whether fees will be deducted from participant accounts or a charge will be made against plan assets.

For bundled service providers, special rules allow fees to be disclosed without breaking them out by provider, *except* to the extent the provider receives compensation that is a direct charge against plan investments, or is charged on a transaction basis.

Fiduciary Status

Service providers must disclose in advance whether they or any of their affiliates will provide any services to a plan as a fiduciary under either ERISA or the Investment Advisers Act of 1940. The rule applies to named fiduciaries and to persons who become fiduciaries by virtue of the services provided to the plan, such as providing investment advice. The agreement should specifically name those services provided as a fiduciary and those provided as a non-fiduciary.

Conflicts of Interest

A number of disclosures must be made that relate to possible conflicts of interest. Service providers must:

- disclose if they or their affiliates will have any financial or other interest in any plan transaction connected with the services they provide
- describe any material financial, referral or other relationship they have with various parties that may create a conflict of interest
- identify situations under which they can affect their own compensation without the prior approval of an independent plan fiduciary. Note that this disclosure is required whether or not the provider actually does take an action that affects its compensation.
- disclose any policies they have that are designed to prevent any real or potential conflicts of interest. Service providers are not required to develop such procedures, but as a practical matter the marketplace may dictate that providers who do not have such policies develop them.

Additional Key Provisions

Disclosure Upon Request

The regulations require service providers to furnish all information related to the contract that is requested by the responsible plan fiduciary (most commonly, the information the plan fiduciary needs to complete the plan's annual report filing).

Actual Compliance

The regulations specifically require compliance with the regulations on (1) the existence of a written agreement and (2) actual disclosure of all the required information.

Penalties for Non-Compliance

Arrangements that do not comply with the regulations will be considered prohibited transactions, with consequences for both service providers and plan fiduciaries. By law, the service provider will have to pay back to the plan any compensation received and will be subject to excise taxes. The plan fiduciary will have violated the obligations under ERISA's prohibited transaction provisions. However, the DOL also proposed a prohibited-transaction exemption for plan sponsors (not service providers) who unknowingly enter into a non-compliant agreement.

Status of the Proposed Regulations

In mid-February 2008, the DOL held highly attended hearings regarding the proposed regulations, during which many industry experts presented their questions and concerns. Concerns fell into the following broad categories:

- How will a client be able to compare various providers' fees when there are so many different fee arrangements? Many presenters encouraged the DOL to develop a disclosure format that service providers could use.
- The regulations are relatively clear regarding expectations for new contracts, but what about existing arrangements? How will service providers be expected to put this disclosure into existing contracts? Will the final regulations contain a transition period before requiring a compliant written contract for existing arrangements?
- What, exactly, is meant by the terms "conflict of interest" and "indirect compensation"? Many of the presenters expressed the need for more detailed definitions from the DOL.
- The effective date for the regulations is currently set to be 90 days from publication of the final regulations. When the regulations were originally published, most experts thought January 1, 2009, was the likely effective date; however, this time-frame is very short for service providers to become compliant. Many reservations were expressed to the DOL about the time it will take for service providers to develop the necessary disclosures and to implement them.

Get Ready!

So, what's a service provider to do? The overall effect of this regulation will vary from service provider to service provider, but it is safe to say that all retirement plan providers will have to wrestle with the new disclosure requirements in some way. Although the new rules will probably not take effect until sometime in 2009, we're strongly recommending that our partners take action now in preparation for what will soon be the new way to conduct business within the retirement plan industry.

1. Review all existing contracts now for specification of services, fees and terms.
2. Develop procedures for identifying the information that needs to be disclosed to prospective clients, and a methodology for conveying it to them as part of the proposal submission process.
3. Beginning now, all vendor searches and fee renegotiations should consider these new requirements.
4. Develop a plan for updating existing agreements.
5. Be prepared for downward pressure on compensation. More fee disclosure may drive prices down over the long term. Conversely, service providers will incur higher costs to comply with these regulations and its various reporting requirements.
6. Expect more negotiation and competition as a result of the disclosure requirements.

Other non-service related impacts have yet to be seen. For example, we may see more litigation that contends plan fiduciaries did not adequately investigate a plan's service fees. In addition, Congress has periodically taken up this topic, and may do so again. Lastly, in July 2008, the DOL issued proposed regulations dealing with the disclosure of account fees to plan participants.

However, these new regulations could also offer an opportunity for service providers to position themselves as fee experts. Because most plan fiduciaries and plan sponsors are unfamiliar with the language and concepts around revenue sharing, the burden of communication will soon rest upon the service providers. This may be an opportunity for providers to offer assistance to their clients on the subject.

Of course, we will continue to closely monitor these developments and will be working with all of our partners in the months to come in anticipation of the issuance of the final regulations later this year. In the meantime, if you have any questions or concerns, please contact your representative from The Standard.



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Standard Retirement Services, Inc.
1100 SW Sixth Avenue
Portland OR 97204-1093

www.standard.com
retirement.standard.com

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