FIDUCIARY FOCUS:

The New Fee Disclosure Under ERISA

This material is an educational discussion of the new Department of Labor (DOL) rule governing fee disclosure, which provides ideas and suggestions on this topic and should not be construed as legal advice. Advisers, plan sponsors and others should consult their own legal counsel and designated adviser, if applicable, for specific guidance on their particular circumstances.

Executive Summary

During the last ten years, plaintiffs' attorneys have filed numerous complaints related to the fees service providers charge retirement plans. The U.S. Department of Labor (DOL) has now published the long-awaited rule on Employee Retirement Income Security Act of 1974, as amended (ERISA), Section 408(b)(2)—the statutory exemption allowing plan service providers to be compensated for their services without engaging in a prohibited transaction.

If the DOL does not make any additional changes to this rule, it will become final and effective on January 1, 2012.

This paper briefly discusses the new rule and some of the issues that advisers who have retirement plan business should consider.

The new disclosure will require covered service providers to:

- Describe the services they provide;
- Determine whether the services provided are fiduciary services or services under the Investment Advisers Act of 1940 or any similar State law;
- Determine what compensation they are receiving and how it is being received; and
- Provide additional disclosures for investment services, discussed in greater detail on the following pages.

Advisers can prepare for the new rule by:

- Evaluating their exposure;
- Evaluating their disclosure obligations;
- Modifying their service contracts or implementing ones now; and
- Seeking legal advice.

Contents

Background - Prohibited Transactions

What Are They. ERISA prohibits a number of transactions between "parties in interest" and ERISA-covered retirement plans. A party in interest includes persons providing services to such a plan. For example, a registered investment adviser (*RIA*) or stockbroker providing services to a retirement plan is a party in interest. The ERISA prohibitions preclude the furnishing of services between a plan and a party in interest and the transfer of plan assets to a party in interest. Thus, absent an exemption, the plan could not employ the RIA or stockbroker or use plan assets to pay their fees.

What Happens If One Occurs? If a plan engages in a prohibited transaction, the Internal Revenue Code of 1986, as amended, imposes an excise tax of 15% on the amount involved in the prohibited transaction. The excise tax increases to 100% of the amount involved if the prohibited transaction is not corrected. There can also be other consequences, such as lawsuits against the parties who participate in a prohibited transaction.

Exemption. There are, however, exemptions from the prohibited transaction provisions. Under ERISA 408(b)(2), a prohibited transaction will not occur if the contract or arrangement between the plan and the service provider is reasonable, the services are necessary to the plan, and the plan pays only reasonable compensation for the services offered by a service provider. The current DOL regulation explains what constitutes a "reasonable arrangement," "necessary services," and "reasonable compensation." In the past, these requirements have not been particularly difficult to meet, and service providers have been able to avail themselves of the exemption.

New Rule Imposes Additional Requirements to Avoid Prohibited Transactions

The New Rule. The new DOL rule (technically an interim final rule) amends the current regulation to impose an additional requirement on "covered service providers" that offer certain services to "covered plans," namely, extensive disclosure to the plan of the fees and other compensation the covered service provider expects to receive from its services.

Definitions. "*Covered service providers*" are those providers that entered into a contract or arrangement with a covered plan reasonably expecting to receive $1,000 or more in compensation, direct or indirect, in connection with providing certain services to the plan. Those services are:

- fiduciary services provided directly to the plan by a fiduciary;
- services provided directly to the plan by an RIA;

- brokerage services and recordkeeping provided to an individual account plan (e.g., a 401(k) plan) that permits participants to direct investments to their accounts, if one or more designated investment alternatives are made available (through a platform or similar mechanism) in connection with the brokerage services or recordkeeping; and
- services performed for "indirect compensation," including accounting, appraisal, auditing, banking, consulting (i.e., related to development or implementation of investment policies or the selection or monitoring of service providers or plan investments), custodial, insurance, investment adviser (for the plan or its participants), securities brokerage, third-party administration, and valuation services.

A "*covered plan*" includes practically any retirement plan subject to ERISA, other than a simplified employee pension – SEP IRAs, a simple retirement account – SIMPLE IRA, or an individual retirement account (IRA) or individual retirement annuity.

The Format and Timing of Disclosure

Format, Delivery. The covered service provider must provide the required disclosure described below in writing to the "responsible plan fiduciary," the plan official with authority to cause the plan to enter into, extend or renew, a contract or arrangement with a covered service provider. The rule does not require the service provider to make disclosures in any particular format or manner. As a result, the disclosures may be made through multiple documents. However, the DOL may amend the interim final rule to require a short, summary disclosure statement that would include key information and identify where the responsible plan fiduciary could find the more detailed elements of the disclosure that the rule requires.

Timing of Disclosure Requirements. For contracts and arrangements between plans and covered service providers that are in place prior to January 1, 2012, the service provider must provide the required disclosure described below on or before that date. For contracts and arrangements put in place after that date, the service provider must provide the required disclosure to the responsible plan fiduciary reasonably in advance of the date the contract or arrangement is entered into, extended or renewed, with limited exceptions.

Disclosure of Changes. A covered service provider must disclose a change to the information disclosed as soon as practicable, but not later than 60 days from the date on which the service provider is informed of the changes. However, if the disclosure was precluded due to extraordinary circumstances beyond the service provider's control, the information must be disclosed as soon as practicable.

Content of Required Disclosure

The following is a brief summary of the disclosure requirements that will become effective on January 1, 2012. The DOL may change the requirements before that date, so covered service providers should be alert to that possibility.

Services. The covered service provider must provide a description of the services to be provided to the plan pursuant to the contract or arrangement.

Status of Service Provider. If applicable, the covered service provider must state that it (or an affiliate or a subcontractor) will provide, or reasonably expects to provide:

- if applicable, fiduciary services directly to the plan or to an investment contract, entity or product that holds plan assets and in which the plan has a direct equity investment; and/or
- if applicable, services directly to the plan as an investment adviser registered under either the Investment Advisers Act of 1940 or any State law.

Compensation. The covered service provider must describe all of the compensation it, an affiliate, or a subcontractor expects to receive including the following:

- direct compensation
  - compensation paid directly from the covered plan, and
  - can be identified either in the aggregate or itemized service-by-service;
- indirect compensation
  - compensation received from any source other than from the plan, the plan's sponsor, the covered service provider, an affiliate, or a subcontractor;
    - Examples are numerous, and might include float revenue, finder's fees, management fees a mutual fund pays to its investment adviser, shareholder servicing fees, soft dollars from a broker-dealer, sub-transfer agency fees, 12b-1 distribution fees, and brokerage commissions, and
  - the description must identify the services for which the indirect compensation will be received and the payer of the indirect compensation;
- compensation paid among the covered service provider, an affiliate, or a subcontractor
  - disclosure is required only if the compensation is determined on a transaction basis (e.g., on the basis of commissions, finder's fees, or soft dollars) or is charged against the covered plan's investment and reflected in the net value of the investment (e.g., 12b-1 fees), and

- the disclosure must identify the services for which compensation will be paid and the payers and recipients of the compensation; and

- compensation payable to the covered service provider (or an affiliate or a subcontractor) in connection with the termination of contract or arrangement.

Compensation, whether direct or indirect, can be expressed as a fixed dollar amount, a formula, a per capita charge for each participant, a percentage of the covered plan's assets, or if none of these can be used, any other reasonable method. Any expression of compensation must permit the evaluation of the reasonableness of the compensation.

Recordkeeping Services. There are additional disclosure requirements related to recordkeeping services provided to the plan.

Manner of Receipt of Compensation. The disclosures must contain a description of the manner in which the compensation will be received, such as whether the plan will be billed or the compensation will be deducted directly from the plan's account(s) or investments.

Investment Disclosure – Fiduciary Services for Pooled Investments. In the case of a fiduciary who manages a separate contract, entity or product in which the plan has an equity interest (such as a collective investment fund), the following information must be disclosed for each investment in which the plan has the direct equity interest, and for which the fiduciary services will be provided pursuant to the contract or arrangement:

- a description of any compensation that will be charged directly against the amount invested in connection with the acquisition, sale, transfer of, or withdrawal from the investment contract, entity, or product (e.g., account fees, deferred sales charges, exchange fees, purchase fees, redemption fees, sales charges, sales loads, and surrender charges);

- a description of the annual operating expenses (e.g., expense ratio), but only if the investment return is not fixed; and

- a description of any ongoing expenses in addition to annual operating expenses (e.g., mortality and expense fees, wrap fees).

This requirement can be satisfied if a covered service provider who provides brokerage or recordkeeping services gives the information to the responsible plan fiduciary.

Investment Disclosure – Brokerage Services and Recordkeeping. In the case of a person providing brokerage services to an individual account plan (e.g., a 401(k) plan) that permits participants to direct the investment of their accounts, if one or more designated investment alternatives are made available in connection with the brokerage services, the broker-dealer must disclose the same information described in the paragraph above for each designated investment alternative for which brokerage services will be provided pursuant to the contract or arrangement with the plan.

Additional Information on Request. Upon request of the responsible plan fiduciary or plan administrator, the covered service provider must furnish any other information relating to compensation received in connection with the contract or arrangement that is required for the plan to comply with the reporting and disclosure requirements of ERISA and the forms, regulations and schedules issued thereunder. The covered service provider must disclose the information not later than 30 days following receipt of a written request from the responsible plan fiduciary or plan administrator unless such disclosure is precluded due to extraordinary circumstances beyond the service provider's control, in which case the information must be disclosed as soon as practicable.

Disclosure Errors

No contract or arrangement will be deemed unreasonable solely because the covered service provider, acting in good faith and with reasonable diligence, makes an error or omission in disclosing the information if the service provider discloses the correct information to the responsible plan fiduciary as soon as practicable, but not later than 30 days from the date on which the service provider knows it made an error or omission.

Basic Fiduciary Duty

Compliance with the DOL's rule does not absolve the responsible plan fiduciary from exercising basic prudence in the selection of covered service providers to perform for a covered plan.

How to Prepare for the New Rule

The following are a few suggestions you may consider to prepare for the DOL rule and some of the issues you may confront.

Evaluate Your Exposure. Define the extent to which you will be subject to the new rule. For example, the new rule may cover a significant number of unsuspecting RIAs that advise or manage pooled funds such as collective investment funds.

Evaluate the Extent of Your Disclosure Obligation. The new rule will require many RIAs and broker-dealers to disclose forms of compensation that they have never been required to disclose before. You should consider whether you are a covered service provider under more than one of the categories discussed above and identity the different disclosure requirements that apply to each category.

RIAs Should Consider Modifying Their Service Contracts. RIAs should consider developing a model service contract that includes all the disclosures that the DOL's rule requires. This will avoid the necessity for generating a separate disclosure document. Furthermore, the signed model service contract will provide proof that the disclosures were made to the responsible plan fiduciary.

Broker-Dealers Should Consider Using Service Contracts. Many broker-dealers do not use service contracts. They should consider using them for the same reasons discussed above.

Consider Providing the Required Disclosure to All Retirement Plan Clients. As noted above, some types of retirement plans are not considered "covered plans" and are therefore not subject to the new disclosure requirements under the DOL rule. However, covered service providers that serve multiple markets may find it more efficient to establish one disclosure regimen rather than attempting to determine when the disclosures are and are not required.

Identify and Educate the Appropriate Personnel Regarding These New Disclosure Requirements. Depending on the size of your organization, there could be a substantial number of employees involved in gathering and delivering the required disclosure. Identify them and start educating them now.

Seek Legal Advice Now. The new rule is complex and this paper does not attempt to discuss all of its complexities or nuances. You should contact your legal counsel now to begin sorting through the impact of the new rule on your particular situation.

Conclusion - A Great Opportunity

The new fee disclosure rule will level the playing field by allowing plan sponsors to understand the true costs of their plans and fees paid to providers. With this new focus on transparency comes great opportunity for the adviser who has a service model in place that can provide the plan with what the rule requires.

Because fees will now be explicit, it will make it easier for advisers to provide information to clients about products and what they cost. Advisers will be able to make better "apples-to-apples" comparisons of 401(k) products for their clients, utilizing a myriad of fee benchmarking tools such as the one available at www.planadvisortools.com.

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