

K&LNG Alert

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Investment Management/ERISA Fiduciary DOL Proposes Expanded Reporting of ERISA Plan Service Provider Compensation

A proposed U.S. Department of Labor (“DOL”) rule could, if adopted, require investment advisers, hedge fund managers, broker-dealers and a range of other service providers to ERISA plans to provide their ERISA plan clients far more extensive and detailed information about all compensation the service provider receives in connection with providing its services to the plan than is currently required.* While service providers are not required to file anything with the DOL under the proposed rule, their ERISA plan clients will ask service providers to provide the required information and are required to report service providers that fail or refuse to do so.

If adopted, the proposed rule would take effect for plan years beginning on or after January 1, 2008.

Comments on the proposed rule must be received by the DOL on or before September 19, 2006.

IMPLICATIONS

The proposed rule could be interpreted to have far-reaching implications, including the following:

- An investment adviser to an ERISA plan would need to provide information about the amount of indirect compensation it receives in connection with its services to the plan, such as soft dollar benefits.
- An ERISA plan’s broker-dealer would need to provide information about the amount of payments it receives from third parties in connection with its services to the plan, such as payments for order flow, “float” income

received on credit balances, and the distribution or servicing fees or other payments received in connection with the plan’s purchase of mutual fund shares.

- A private fund whose assets are treated as “plan assets” (including a plan assets fund-of-funds) would need to provide to each of the fund’s ERISA plan investors (including insurance company separate accounts, bank collective funds and plan assets funds) information about all compensation received by the manager and each of the fund’s service providers, regardless of whether the compensation was received from the fund or from a third party in connection with services provided to the fund.
- Similarly, if a plan assets fund (such as a plan assets fund-of-funds) invests in another plan assets fund, ERISA plan investors would be required to report all compensation paid to all service providers of each of the funds.

Needless to say, funds and their administrators and managers may have considerable difficulty obtaining such information.

OVERVIEW

The proposed rule includes many revisions to Form 5500, the annual report and schedules required to be filed by plans that are subject to ERISA and certain entities that are deemed to hold plan assets (both referred to as “Plans”). Service

* The proposed rule is included in “Notice of Proposed Revision of Annual Information Return/Report,” 71 Fed. Reg. 41616 (July 21, 2006), issued by the United States Department of Labor, together with the Department of the Treasury and the Pension Benefit Guaranty Corporation.

providers are not required to file anything with the DOL under the proposed rule. However, a Plan would be required to report, on Form 5500 Schedule C, almost all compensation paid to the Plan's service providers, even compensation paid to those service providers by third parties if the payment is related to the Plan. Plans would also be required to report the name of each service provider that fails or refuses to provide this information.

The DOL has repeatedly expressed concern about Plan-related fees and compensation paid to or received by service providers, including undisclosed or partially disclosed compensation, such as 12b-1 fees or commissions. The DOL decided that the Form 5500 revisions are appropriate "in an effort both to clarify the [5500] reporting requirements and to ensure that plan officials obtain the information they need to assess the reasonableness of the compensation paid for services rendered to the plan, taking into account revenue sharing and other financial relationships or arrangements and potential conflicts of interest that might affect the quality of those services." If adopted as proposed, this "clarification" may force many service providers to provide Plans with far more detailed information about compensation than they currently provide (or have the systems to readily do so).

COMPENSATION PAID TO SERVICE PROVIDERS REPORTED ON PROPOSED SCHEDULE C PART I

Currently, a Plan must report on Form 5500 the names of its 40 highest paid service providers, taking into account only fees paid by the Plan or its sponsor. The proposed rule would revise this section of the Form (Schedule C Part I) to require that the Plan identify every service provider that received, "directly or indirectly, \$5,000 or more in total compensation (*i.e.*, money or anything else of value) in connection with services rendered to the plan or their position with the plan."

For example, if an asset manager received fees from a Plan client and soft dollar benefits from a broker-dealer "in connection with" managing that Plan's assets, the proposed rule appears to provide that the investment manager's "total compensation" is both the compensation received directly (the asset management fees) and indirectly (the soft dollar benefits), and the Plan would be required to report the total value of both types of compensation.

For each such service provider, a Plan would be required to provide on Schedule C Part I—and presumably will request from each such service provider—the following information:

- Whether the service provider received any indirect compensation, defined as money or anything else of value received from any person other than the Plan or the Plan's sponsor; and
- For each listed service provider that received \$1,000 or more in indirect compensation from a third party, and that was a fiduciary or contract administrator, securities broker (which includes brokers of stocks, bonds and commodities), insurance broker or agent or that provided custodial, consulting, investment advisory (plan or participants), investment or money management, recordkeeping, trustee, appraisal, or investment evaluation services, the Plan must provide the following information about each third-party payor of indirect compensation:
 - The name, employer identification number and other identifying information;
 - A code or description of the services provided or the relationship between the payor and the Plan; and
 - The amount and nature of the indirect compensation.

The DOL recognizes that there are "possible burdens associated with allocating such revenue-sharing income and third-party payments to individual plans." Accordingly, the proposal permits Plans to report an estimate of the indirect compensation received by a service provider if the Plan receives from the service provider an explanation of the formula used for calculating the payments. For example, if a Plan's investment adviser receives research on a soft dollar basis, it might be permissible for the Plan to accept an estimate from the adviser of the value of that research allocable to the Plan based on the Plan's portion of the commissions used to pay for the research.

The DOL proposal also includes a special rule on reporting compensation paid to a provider of bundled services. First, the Plan must report only the total compensation it (or the Plan sponsor) paid to the

bundled service provider and need not allocate an amount for each included service. Second, the Plan is not required to report (and the bundled service provider would then not need to give the Plan) amounts paid by the bundled service provider to each of the “subsidiary” service providers unless the Plan is (a) paying the subsidiary service provider directly or (b) the subsidiary service provider receives \$1,000 or more in indirect compensation and is a Plan fiduciary or one of the other service providers listed above.

SERVICE PROVIDERS THAT FAIL OR REFUSE TO PROVIDE INFORMATION REPORTED ON SCHEDULE C PART II

Few service providers currently give Plans this level of detail on indirect compensation they may receive. Service providers may take the view that such information is proprietary or otherwise confidential and decline to provide it to Plans, particularly because information filed on Schedule C is publicly available. But, if adopted, Plans would be required to identify to the DOL (by name, EIN, or address as described above) each service provider that fails to provide the required information. This reporting requirement does not exist under the current Schedule C.

CHANGED RULE FOR BROKERAGE COMMISSIONS

Plans are not now required to report brokerage commissions. The proposed rule would change this practice. The DOL’s instructions for the proposed revisions to Schedule C flatly state: “[B]rokerage commissions or fees (regardless of whether the broker is granted discretion) are reportable whether or not they are capitalized as investment costs.”

INCREASED OBLIGATION FOR PLAN FIDUCIARIES TO MONITOR FEES

As noted above, the DOL reiterated that an annual review of service provider compensation is part of a Plan fiduciary’s ongoing obligation to monitor the Plan’s arrangements with service providers. As a result, a Plan fiduciary might take the view that, in light of these fiduciary obligations, the Plan cannot contract with service providers that refuse to provide such information and might address this issue as part of the RFP or proposal process.

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Please contact any of us if you would like to discuss the proposed rule or if you would like to receive a copy of the proposed rule, either electronically or by fax.

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