

Financial Services Alert

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Developments of Note

➤ Recent DOL Actions Increase Obligations of Service Providers

I. Overview

Over the past few years, significant attention has been focused on the compensation paid to entities that provide investment management, recordkeeping, and other services to 401(k) plans and other plans subject to the Employee Retirement Income Security Act of 1974, as amended (“ERISA,” and such ERISA-governed benefit plans, along with entities that are deemed to hold “plan assets” of such plans, “Plans”). Often these service providers offer their products to Plans under bundled arrangements – where a variety of services are provided, sometimes by multiple entities – and those service providers may be compensated directly by the Plan or indirectly through revenue sharing or other arrangements that involve payments from sources other than the Plan (*e.g.*, the investment vehicles in which the Plan invests). A perception has developed that greater fee transparency may be needed to enable fiduciaries of Plans (“Plan Fiduciaries”) to understand the relevant compensation arrangements better in connection with their selection and monitoring of service providers. Recently, the Department of Labor (the “DOL”) has taken two significant steps toward increasing fee transparency in this area by proposing an amendment to its regulation concerning an ERISA prohibited transaction exemption applicable to the provision of services to a Plan, and increasing the information regarding service provider relationships to be included in the annual report (Form 5500) filed by Plans (and in some cases by funds in which Plans invest).

II. Proposed Amendment to Regulation Relating to Service Provider Fee Disclosures

The DOL has proposed an amendment to the regulation under Section 408(b)(2) of ERISA. Section 408(b)(2) of ERISA provides an exemption from ERISA’s prohibited transaction rules for reasonable arrangements with service providers. The proposed regulation would require Plan service providers to disclose to Plan Fiduciaries detailed information regarding fees, compensation and conflicts of interest.

The proposed regulation will apply to the following types of Plan service providers:

- Service providers who are fiduciaries under either ERISA or the Investment Advisers Act of 1940, as amended (the “Advisers Act”);
- Providers of banking, consulting, custodial, insurance, investment advisory or management, recordkeeping, securities brokerage or third-party administration services; and
- Service providers who receive indirect compensation or fees for accounting, actuarial, appraisal, auditing, legal and/or valuation services.

The proposed regulation would require covered service providers to provide their services pursuant to a written contract which must require that the service provider satisfy the disclosure requirements set forth below, to the best of the service provider's knowledge. These requirements are in addition to the existing requirements under ERISA Section 408(b)(2), including requirements that a service provider's compensation be reasonable and that the Plan's arrangement with the service provider be terminable on reasonably short notice without penalty to the Plan. The disclosure requirements, which must be satisfied whenever the contract is entered into, extended or renewed, include the following:

- A description of all services to be provided to the Plan;
- A description of all compensation and fees that will be received by the service provider either directly or indirectly from the Plan or from any other person and the manner in which such compensation or fees will be received by the service provider;
- A statement as to whether the service provider or any affiliate is a fiduciary under ERISA and/or the Advisers Act;
- A statement as to whether the service provider or any affiliate expects to participate or acquire a financial or other interest in any transaction to be entered into by the Plan in connection with the services being provided by the service provider, including a description thereof;
- A statement as to whether the service provider or any affiliate has any material financial, referral or other relationship with a money manager, broker, other client, other service provider of the Plan or any other entity that does or may create a conflict of interest for the service provider in performing its services to the Plan, including a description thereof;
- A statement as to whether the service provider or any affiliate may affect its own direct or indirect compensation, without prior approval of an independent Plan Fiduciary, in connection with the performance of its services, including a description of the nature of any such compensation;
- A statement as to whether the service provider or any affiliate has policies or procedures designed to prevent the disclosed compensation, fees, relationships or conflicts from adversely affecting its services to the Plan, including a description thereof; and
- Any other information requested by the responsible Plan Fiduciary or the Plan administrator to comply with ERISA's reporting and disclosure requirements.

In addition, the service provider must disclose any material changes within 30 days of acquiring knowledge of such material change. The proposed regulation does not provide for any specific format or timing for the required disclosures. However, the service provider must represent in the written agreement that it has provided all of the required disclosures.

Compensation and fees are broadly defined in the proposed regulation to include money or any other thing of monetary value. Where the service provider is not able to describe the compensation or fees in a specific monetary amount, it may provide a formula, percentage of Plan assets, per capita charge or other description provided that the disclosure permits a reasonable Plan Fiduciary to evaluate the reasonableness of the compensation or fees.

There are specific rules for bundled service providers. Where a service provider prices a bundle of services as a package, then only the service provider offering the bundle must provide the required disclosures and such disclosures should be made on an aggregate basis. The service provider is not required to disclose the allocation of compensation or fees among affiliates or other parties except to the extent a party receives compensation or fees that are a separate charge directly against the Plan's investment reflected in the net value of the investment or that are set on a transaction basis, such as finder's fees, brokerage commissions and soft dollar arrangements.

Comments on the proposed regulation are due by February 11, 2008. The proposed regulation would become effective 90 days after being published in final form in the *Federal Register*.

III. Proposed Prohibited Transaction Class Exemption for Failure to Comply with Service Provider Exemption

In addition, the DOL has proposed a new class exemption for situations where, unbeknownst to the Plan Fiduciary, the service provider fails to provide the disclosure required by the proposed regulation. In order for the relief under the proposed class exemption to be available, the Plan Fiduciary must have reasonably believed that the disclosure requirements were satisfied, and did not know or have reason to know that the service provider failed to comply with the disclosure requirements. The proposed exemption would require that the responsible Plan Fiduciary, upon discovering the disclosure failure, request in writing that the disclosures be made, and if they are not made within 90 days, notify the DOL within 30 days following the end of such 90-day period of such failure.

IV. Finalized Changes to Annual Reporting (Form 5500) Requirements Concerning Service Provider Compensation

The DOL has also determined that detailed information regarding the direct and indirect compensation paid to service providers must be reported to the DOL under changes to the Form 5500 annual reporting requirements applicable to Plans covering more than 100 participants and to common and collective trusts, insurance company pooled separate accounts, and other investment funds that are considered to hold Plan assets and that file Form 5500 (collectively, "Direct Filing Entities" or "DFEs").

These new reporting requirements will have a substantial impact on financial services organizations in two ways. First, each financial services organization that sponsors a Direct Filing Entity will have to report information regarding persons or entities that provide services to the DFE. Second, while technically the new requirements do not apply directly to the persons or entities providing services to Plans or Direct Filing Entities, it is anticipated that Plan administrators and DFE sponsors will need to obtain much of the relevant information from the service providers, and any service provider that fails to provide the necessary information must be identified on Form 5500. Consequently, as a practical matter, service providers will have to maintain systems and procedures for capturing and disclosing the relevant information. For Plans, the new reporting requirements will apply with respect to plan years beginning in 2009; for Direct Filing Entities, the changes are applicable for reporting years ending in 2009.

In general, under the new requirements, each service provider that receives \$5,000 or more in direct or indirect compensation in connection with services rendered to the Plan or DFE during the year must be listed on Schedule C to Form 5500, along with certain related information such as the amount of compensation received by the service provider. For this purpose, direct compensation includes amounts received from the Plan or DFE and amounts received from the Plan sponsor for which the sponsor is reimbursed by the Plan. Indirect compensation includes amounts received from any source other than the Plan or the Plan sponsor which are received in connection with services to, or because of the service provider's position with, the Plan. According to the DOL, examples of indirect compensation include fees or expense reimbursements received from mutual funds, collective trusts, or other investment vehicles in which the Plan or DFE invests (*e.g.*, management fees, sub-transfer agency fees, shareholder servicing fees, and 12b-1 fees), finder's fees, float income, brokerage commissions, soft dollars, and other transaction-based fees.

The new requirements include rules for reporting compensation paid under "bundled" service arrangements – *i.e.*, arrangements under which a Plan hires one company to provide, directly or through affiliates or subcontractors, a range of services that are priced as a single package rather than on a service-for-service basis. Payments by the Plan to the bundled services provider are to be reported as the provider's direct compensation. There generally is no requirement to report the allocation of compensation among the provider's affiliates or subcontractors, except where the compensation of the affiliate or subcontractor is determined on a per transaction basis (*e.g.*, commissions or brokerage fees). Separate fees received by affiliates or subcontractors and charged against the Plan's investments must be identified as separate compensation for the recipient. In cases where services are provided by a

fiduciary, or where the services are for contract administration, consulting, investment advice or management, securities brokerage, or recordkeeping, transaction-based fees also must be treated as separate compensation for Schedule C purposes.

However, in cases where compensation paid to a service provider constitutes “eligible indirect compensation,” the amount of compensation need not be included on Form 5500. For indirect compensation to qualify as eligible indirect compensation for this purpose, the Plan must be provided with written disclosures regarding the services to be provided, the amount of compensation (or formula under which it is determined), and the entities paying and receiving the compensation (*e.g.*, an investment fund and a record keeper). While the amount of eligible indirect compensation need not be reported, Schedule C must identify the service provider and indicate the fact that eligible indirect compensation was paid by the Plan or Direct Filing Entity.

In general, the revisions to the Form 5500 reporting requirements relating to service provider compensation are detailed and complicated. Financial services organizations that sponsor DFEs or provide services to Plans will need to review carefully the specific aspects of these new requirements that may affect the compensation they receive and pay, and make appropriate adjustments to their systems and procedures for capturing compensation information and communicating it to customers. Significantly, a DFE which has a reporting year that is different from the calendar year will become subject to these new requirements for the reporting year that begins in 2008. This may present practical difficulties as compliance systems for compiling the necessary information will need to be established within a short time frame.

V. Conclusion

The proposed service provider regulations and the changes to Form 5500 described above reflect an increased focus by the DOL on compensation arrangements affecting Plans. In addition to these developments, the DOL has indicated that it intends to propose revisions to the regulations under ERISA Section 404(c) to enhance fee disclosure requirements applicable to 401(k) plans and other participant-directed retirement plans. The Securities Exchange Commission may also consider regulatory action and Congress is considering legislation in this area. As discussed in some detail in the December 25, 2007 *Alert*, a number of lawsuits filed within the past year challenge revenue sharing arrangements under existing ERISA prohibited transaction rules and other fiduciary requirements. These developments will require financial services organizations to review the products they offer to Plans and DFEs, and the related compensation structures, to determine whether any changes are necessary or appropriate in light of the emerging legal standards in this area.

➤ FINRA Issues Final Guidance Regarding the Review and Supervision of Electronic Communications

FINRA issued principle-based guidance (the “Guidance”) for its member firms to consider when developing supervisory systems and procedures for electronic communications. The Guidance is in substantially the form set forth in the joint proposal made by the NASD and NYSE Member Regulation in June 2007 prior to their consolidation into FINRA. The Regulatory Notice announcing the publication of the Guidance indicates that the Guidance neither creates new supervisory requirements nor requires the review of every communication; rather, it sets forth principles that FINRA believes firms should consider in structuring the supervisory policies and procedures that each firm should have in place to monitor all electronics communications technology used by the firm and its associated persons in order to achieve compliance with applicable federal securities laws and self regulatory organization rules. The Regulatory Notice also points out that firms have a separate, but equally important, obligation to ensure that their use of electronic communication media enables them to make and keep records as required by applicable SEC, NASD and NYSE rules.

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The Guidance itself addresses the following six topics in some detail:

- Written policies and procedures – the need for, and considerations in developing, maintaining and disseminating, clear policies and procedures governing the general use and supervision of electronic communications.
- Types of electronic communications requiring review – (a) policies and procedures regarding the forms of electronic communications employees may use when conducting business with the public, and related monitoring efforts and (b) the extent to which review of internal communications is necessary to properly supervise a firm's business, *e.g.*, to detect when a member's information barriers are not effective.
- Identification of the person(s) responsible for the review of electronic communications.
- Methods of review for correspondence – the use of lexicon-based reviews and random reviews.
- Frequency of review of correspondence.
- Documentation of review of correspondence.

The Guidance concludes by noting that it is not all-inclusive and does not represent all areas of inquiry that a member firm should consider when establishing and maintaining a supervisory system for electronic communications, particularly with respect to any existing and future electronic communications technology that the Guidance does not address. The Guidance further cautions that it does not establish a safe harbor with respect to potential supervisory or compliance deficiencies.