

Department of Labor Issues “Q&A” Guidance on Reporting Service Provider Compensation on Annual Returns

The U.S. Department of Labor (DOL) has issued two sets of guidance, each in “Q&A” format, regarding the reporting of fees and other compensation paid to service providers on Schedule C of the Form 5500 annual report required to be filed for most employee benefit plans.

Background

In late 2007, the DOL published a final regulation and final form revisions, generally effective for plan years beginning on or after January 1, 2009, implementing significant new requirements for reporting compensation paid to service providers. Generally, compensation must be reported on Schedule C if: (i) the plan is a “large plan” – generally, a plan that covered 100 or more participants as of the beginning of the plan year, and (ii) the aggregate amount of compensation paid to the provider for the year is \$5,000 or more.

The reporting requirement applies both to “direct compensation” paid by a plan and “indirect compensation” that is paid by sources other than the plan or plan sponsor: (i) for services rendered to the plan or (ii) because of the provider’s position with the plan. Examples of reportable indirect compensation include brokerage commissions, amounts charged to investment funds for plan recordkeeping services and fees paid by investment funds to investment managers.

Predictably, reporting indirect compensation presents far more challenges to plan administrators than reporting direct compensation. To alleviate the potentially enormous administrative burden, alternative reporting is available for certain amounts, referred to as “Eligible Indirect Compensation” (EIC). EIC consists of amounts charged to investment funds that are reflected in the value of the plan’s investment or investment return. An example of EIC is the asset-based management fee that is paid by most mutual funds to their managers. For EIC, only the name and tax ID number of the service provider who received EIC must be reported on Schedule C. Compensation will only be considered EIC, however, if certain advance disclosures are made to the plan by the service provider.

The DOL's Q&A Guidance

The Q&As – the first set was released in July 2008 and the second set was released last month – are designed to provide guidance on a number of issues that have been raised since the DOL regulation and Schedule C reporting requirements were finalized. Below is a summary of some of the most pertinent topics addressed.

Expenses Charged to Investment Funds that are Reportable Indirect Compensation

The Q&As explain that certain expenses charged to investment funds, including asset-based manager fees, brokerage commissions, charges related to purchases and sales of fund interests, and charges relating to plan services such as recordkeeping, Form 5500 reporting, and participant communications are reportable indirect compensation. Conversely, amounts charged to the fund for ordinary operating expenses, such as fees paid to the fund's lawyer, accountant or printer, need not be reported on Schedule C.

Eligible Indirect Compensation (EIC)

In addition to mutual funds and other "traditional" investment funds, bank common and collective trusts, insurance company pooled accounts and separately managed accounts are also considered "investment funds." Therefore, compensation paid by any of these vehicles to an investment manager or other fund agent will generally be eligible for the alternative reporting for EIC.

Fees charged to a fund by a fund's agent (such as the fund administrator) will no longer be EIC, however, if they are then paid to a plan's record-keeper or another service provider to the plan. The effect of this is that most "revenue sharing" amounts paid to record-keepers and third-party administrators will have to be fully disclosed on Schedule C, except in the context of bundled service arrangements, as described below.

Bundled Service Arrangements

Under a bundled service arrangement, a single company (the "primary provider") is hired to perform a range of services for a plan, such as recordkeeping, administration and investment management, and does so either directly or through affiliates and subcontractors. Under this type of arrangement, which is very common, generally only the compensation paid to the primary provider must be reported on Schedule C, and there is no requirement to report how the amounts are allocated among the various affiliates and subcontractors.

There are two important exceptions, however. First, fees paid to a person in the "bundle" that are separately charged against a plan's investment must be broken out and reported on Schedule C. An example of this is a fee paid by an investment provider to a plan's third-party administrator that is not paid from the provider's overall investment management charge. Second, commissions and other transaction-based fees, finder's fees, float revenue, soft dollar and other non-monetary compensation paid to "conflict of interest sensitive persons" must be separately reported. Conflict of interest sensitive persons are plan fiduciaries and people providing certain services to the plan.

Small Gifts, Meals and Entertainment

Non-monetary compensation of insubstantial value is not reportable so long as each item is worth less than \$50, and less than \$100 worth of such gifts are provided to a service

provider by the same source within one calendar year. Gifts with a value of less than \$10 need not be taken into account. Generally, small promotional items that display a company logo, such as a coffee mug or golf balls, are not reportable indirect compensation.

Meals, entertainment, and other non-cash gifts provided to service providers are also not required to be reported on Schedule C as long as their receipt is not conditioned upon the provider's position with a plan or the extent of the provider's business with one or more plans. For instance, if a brokerage firm reimburses employees of an investment management firm for travel, meals and lodging for attendance at a business conference, the reimbursements are not reportable indirect compensation unless they are conditioned on the employees' dealings with employee benefit plans. If such reimbursements are provided to a plan sponsor's HR personnel, however, the reimbursements would have to be reported on Schedule C because they are provided because of the employees' positions with the sponsor's plan(s).

Open Brokerage Windows

For a participant-directed plan that permits investment in a wide range of products through an "open brokerage window," the reporting requirement extends only to direct and indirect compensation received by the broker (and other brokerage window providers), transaction fees and other plan-related fees. Notably, this means that, when interests in a fund are purchased through the brokerage window, the reporting requirement would not extend to asset-based investment management fees paid to the fund's adviser.

Private Equity Funds and Hedge Funds Holding Less Than 25 Percent Benefit Plan Investments

Under ERISA, the underlying assets of a private equity or hedge fund in which less than 25 percent of the interests are held by "benefit plan investors" do not constitute "plan assets." This allows the investment funds to avoid the application of ERISA standards over their operations. The Q&As clarify that this distinction does not matter for Schedule C reporting purposes. For example, compensation paid to an investment manager by such a fund will be reportable indirect compensation for a plan that invests in the fund. This type of compensation may qualify as EIC if it is reflected in the plan's investment value or return, and the appropriate advance disclosures are made. The same is true for commissions paid to the fund's broker, as well as other "transactional" costs for buying, selling and otherwise managing the fund's assets. This result may differ for investment vehicles that constitute "operating companies," however, as described immediately below.

Operating Companies

As an alternative to staying below the 25 percent threshold described above, private equity funds and other investment vehicles may avoid ERISA coverage if they are "venture capital operating companies" (VCOCs) or "real estate operating companies" (REOCs). For Schedule C reporting purposes, plan investments in VCOCs and REOCs are treated somewhat differently than investment funds that rely on the 25 percent threshold. For VCOCs and REOCs, fees paid to third parties in connection with managing or operating the companies are generally not reportable indirect compensation. For example, fees paid for real estate brokerage services by a REOC are not reportable, even though stock brokerage fees paid by a hedge fund exempt from ERISA by staying below the 25 percent threshold would be reportable.

It is important to note that this rule is limited to expenses for the operation and management of the operating company. It does not, for example, extend to fees or commissions paid to an investment manager in connection with a plan's investment in an operating company.

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