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Reasonable Contract or Arrangement Under Section 408(b)(2)—Fee Disclosure; Proposed Rule

DEPARTMENT OF LABOR

Employee Benefits Security Administration

29 CFR Part 2550

RIN 1210–AB08

Reasonable Contract or Arrangement Under Section 408(b)(2)—Fee Disclosure

AGENCY: Employee Benefits Security Administration, DOL.

ACTION: Proposed regulation.

SUMMARY: This document contains a proposed regulation under the Employee Retirement Income Security Act of 1974 (ERISA) that, upon adoption, would require that contracts and arrangements between employee benefit plans and certain providers of services to such plans include provisions that will ensure the disclosure of information to assist plan fiduciaries in assessing the reasonableness of the compensation or fees paid for services that are rendered to the plan and the potential for conflicts of interest that may affect a service provider's performance of services. The proposed regulation will redefine what constitutes a ''reasonable contract or arrangement'' for purposes of the statutory exemption from certain prohibited transaction provisions of ERISA. The regulation, upon adoption, will affect employee benefit plan sponsors and fiduciaries and the service providers to such plans.

DATES: Written comments on the proposed regulation should be received by the Department of Labor on or before February 11, 2008.

ADDRESSES: To facilitate the receipt and processing of comment letters, the Employee Benefits Security Administration (EBSA) encourages interested persons to submit their comments electronically by e-mail to *e-ORI@dol.gov*, or by using the Federal eRulemaking portal at *http://www.regulations.gov*. Persons submitting comments electronically are encouraged not to submit paper copies. Persons interested in submitting paper copies should send or deliver their comments (preferably at least three copies) to the Office of Regulations and Interpretations, Employee Benefits Security Administration, Attn: 408(b)(2) Amendment, Room N–5655, U.S. Department of Labor, 200 Constitution Avenue, NW., Washington, DC 20210. All comments will be available to the public, without charge, online at *http://www.regulations.gov* and *http://www.dol.gov/ebsa* and at the Public Disclosure Room, N–1513, Employee Benefits Security Administration, U.S. Department of Labor, 200 Constitution Avenue, NW., Washington, DC 20210.

FOR FURTHER INFORMATION CONTACT: Kristen L. Zarenko, Office of Regulations and Interpretations, Employee Benefits Security Administration, (202) 693–8510. This is not a toll-free number.

SUPPLEMENTARY INFORMATION:

A. Background

(1) General

In recent years, there have been a number of changes in the way services are provided to employee benefit plans and in the way service providers are compensated. Many of these changes may have improved efficiency and reduced the costs of administrative services and benefits for plans and their participants. However, the complexity of these changes also has made it more difficult for plan sponsors and fiduciaries to understand what the plan actually pays for the specific services rendered and the extent to which compensation arrangements among service providers present potential conflicts of interest that may affect not only administrative costs, but the quality of services provided.

Despite these complexities, section 404(a)(1) of ERISA requires plan fiduciaries, when selecting or monitoring service providers, to act prudently and solely in the interest of the plan's participants and beneficiaries and for the exclusive purposes of providing benefits and defraying reasonable expenses of administering the plan. Fundamental to a fiduciary's ability to discharge these obligations is the availability of information sufficient to enable the fiduciary to make informed decisions about the services, the costs, and the service provider. In this regard, the Department of Labor (Department) has published interpretive guidance concerning the disclosure and other obligations of plan fiduciaries and service providers under ERISA.[1]

In addition to technical guidance, the Department makes available on its Web site various materials intended to assist plan fiduciaries and others in understanding their obligations, the importance of fees, and the assessment of service provider relationships.[2] The Department's Web site also provides a Model Plan Fee Disclosure Form to assist fiduciaries of individual account pension plans when analyzing and comparing the costs associated with selecting service providers and investment products.[3]

Although the Department has issued technical guidance and compliance assistance materials relating to the selection and monitoring of service providers, the Department nevertheless believes that, given plan fiduciaries' need for complete and accurate information about compensation and revenue sharing, both plan fiduciaries and service providers would benefit from regulatory guidance in this area. For this reason, the Department proposes the amendment described below relating to the conditions for a ''reasonable contract or arrangement'' under section 408(b)(2) of ERISA, as set forth in 29 CFR § 2550.408b–2.[4]

(2) The Statutory Exemption for Services

Section 406(a)(1)(C) of ERISA generally prohibits the furnishing of goods, services, or facilities between a plan and a party in interest to the plan. As a result, absent relief, a service relationship between a plan and a service provider would constitute a prohibited transaction, because any person providing services to the plan is defined by ERISA to be a ''party in interest'' to the plan.[5] However, section 408(b)(2) of ERISA exempts certain arrangements between plans and service providers that otherwise would be prohibited transactions under section 406 of ERISA. Specifically, section 408(b)(2) provides relief from ERISA's prohibited transaction rules for service contracts or arrangements between a plan and a party in interest if the contract or arrangement is reasonable, the services are necessary for the establishment or operation of the plan, and no more than reasonable compensation is paid for the services.[6] Regulations issued by the Department clarify each of these conditions to the exemption.[7]

[1] *See, e.g.*, Field Assistance Bulletin 2002–3 (November 5, 2002) and Advisory Opinions 97–16A (May 22, 1997) and 97–15A (May 22, 1997).

[2] *See http://www.dol.gov/ebsa/publications/undrstndgrtrmnt.html* and *http://www.dol.gov/ebsa/newsroom/fs053105.html*.

[3] *http://www.dol.gov/ebsa/pdf/401kfefm.pdf*. This model form was developed jointly by the American Bankers Association, the Investment Company Institute, and the American Council of Life Insurers.

[4] The Department also implemented changes to the information required to be reported concerning service provider compensation and compensation arrangements as part of the Form 5500 Annual Report. These changes to Schedule C of the Form 5500 complement the amendment proposed in this Notice in assuring that plan fiduciaries have the information they need to monitor their service providers consistent with their duties under section 404(a)(1) of ERISA. *See* 72 FR 64731.

[5] *See* ERISA § 3(14)(B).

[6] *See* ERISA § 408(b)(2).

[7] *See* 29 CFR § 2550.408b–2.

In this Notice, the Department proposes to amend the regulations under ERISA section 408(b)(2) to clarify the meaning of a ''reasonable'' contract or arrangement. Currently, the regulation at 29 CFR § 2550.408b–2(c) states only that a contract or arrangement is not reasonable unless it permits the plan to terminate without penalty on reasonably short notice.[8] In the amendment described below, the Department proposes to add that, in order for a contract or arrangement for services to be reasonable, it must require that certain information be disclosed by the service provider to the responsible plan fiduciary. The Department believes that in order to satisfy their ERISA obligations, plan fiduciaries need information concerning all compensation to be received by the service provider and any conflicts of interest that may adversely affect the service provider's performance under the contract or arrangement. Accordingly, under the proposal, an arrangement would not be reasonable unless the service provider agrees to furnish, and in fact does furnish, the required information to the responsible plan fiduciary. The ''responsible plan fiduciary'' is the fiduciary with authority to cause the plan to enter into, or extend or renew, a contract or arrangement for the provision of services to the plan.

B. Proposed Amendment to Regulations Under ERISA Section 408(b)(2)

(1) Overview of Proposed Regulation

In general, the proposal amends paragraph (c) of § 2550.408b–2 by moving, without change, the current provisions of paragraph (c) to a newly designated paragraph (c)(2) and adding a new paragraph (c)(1) to address the disclosure requirements applicable to a ''reasonable contract or arrangement.'' The new paragraph (c)(1) of § 2550.408b–2 generally requires that, in order to be reasonable, any contract or arrangement between an employee benefit plan and certain service providers must require the service provider to disclose the compensation it will receive, directly or indirectly, and any conflicts of interest that may arise in connection with its services to the plan.

(a) Scope of the Proposal

Paragraph (c)(1)(i) of the proposal describes the scope of the regulation's disclosure requirements. The Department recognizes that responsible plan fiduciaries may not always need all of the required disclosures from every type of service provider in order to evaluate the reasonableness of the service provider's compensation. Thus, this paragraph limits the proposal's application to contracts or arrangements to provide services by service providers that fall within one or more of three categories. The first category, described in paragraph (c)(1)(i)(A), includes within the scope of the regulation service providers who provide services as a fiduciary under ERISA or under the Investment Advisers Act of 1940. Paragraph (c)(1)(i)(B) includes service providers who provide banking, consulting, custodial, insurance, investment advisory (plan or participants), investment management, recordkeeping, securities or other investment brokerage, or third party administration services, regardless of the type of compensation or fees that they receive. Finally, paragraph (c)(1)(i)(C) includes service providers who receive any indirect compensation in connection with accounting, actuarial, appraisal, auditing, legal, or valuation services.

The Department believes that the compensation arrangements for services provided by the service providers enumerated in paragraphs (c)(1)(i)(A) and (B) are most likely to give rise to conflicts of interest. As to the service providers enumerated in paragraph (c)(1)(i)(C), the Department believes that requiring every service contract or arrangement with these providers to satisfy the requirements of the proposed regulation may not be appropriate or yield helpful information to plan fiduciaries. However, the Department believes that these providers perform some of the most important and potentially influential services to plans and, to the extent these service providers receive indirect compensation in connection with their services, similar conflict of interest concerns would be raised, as with other enumerated service providers.

If a contract or arrangement meets the threshold scope requirement in paragraph (c)(1)(i), then the terms of such contract or arrangement must satisfy the proposal's disclosure requirements in order to be reasonable for purposes of paragraph (c)(1), regardless of the nature of any other services provided or whether the plan is a pension plan, group health plan, or other type of welfare benefit plan. Nevertheless, the proposal's application to contracts or arrangements between plans and the listed categories of service providers should not be construed to imply that responsible plan fiduciaries do not need to obtain and consider appropriate disclosures before contracting with service providers who *do not* fall within these categories. Responsible plan fiduciaries must continue to satisfy their general fiduciary obligations under ERISA with respect to the selection and monitoring of all service providers. Further, contracts or arrangements with these service providers must be ''reasonable'' and otherwise satisfy the requirements of section 408(b)(2) of ERISA.

The proposal also applies only to contracts or arrangements for services to employee benefit plans. The proposed regulation, if adopted, would not apply to contracts or arrangements with entities that are merely providing plan benefits to participants and beneficiaries, rather than providing services to the plan itself. For example, a pharmacy benefit manager that contracts with an employee benefit plan to manage the plan's prescription drug program would be covered as a service provider to the plan providing third party administration or recordkeeping, and possibly consulting, services. However, if a fiduciary contracts on behalf of a welfare plan with a medical provider network, for example an HMO, a doctor that is part of the network and that has no separate agreement or arrangement with the plan would not be a service provider to the plan; the doctor merely provides medical benefits to the plan's participants and beneficiaries.

(b) Disclosure Concerning Compensation and Services

If a contract or arrangement for services falls within the scope of the proposed regulation, the contract or arrangement must comply with paragraphs (c)(1)(ii) through (vi) of the proposal. Paragraph (c)(1)(ii) requires that the contract or arrangement be in writing. The proposal requires specific disclosures and representations from the service provider, and the Department believes they must be made in writing to ensure a meeting of the minds between the service provider and the responsible plan fiduciary.

The proposed regulation next provides in paragraph (c)(1)(iii) that the terms of the contract or arrangement must specifically require the service provider to disclose in writing, to the best of its knowledge, the information set forth in the proposal. The Department believes it is important for the responsible plan fiduciary to obtain assurance from the service provider that it has disclosed complete and accurate information. To ensure that the responsible plan fiduciary has the opportunity to consider all required disclosures before entering into a

[8] *See* 29 CFR § 2550.408b–2(c).

contract or arrangement with a service provider to the plan, the proposal requires that the contract or arrangement include a representation by the service provider that, before the contract or arrangement was entered into, all required information was provided to the responsible plan fiduciary.

The proposal does not prescribe the manner in which such disclosures should be presented to the plan fiduciary, other than requiring a statement by the service provider that the disclosures have been made. All of the required disclosures need not be contained in the same document, as long as all of the required information is presented to the responsible plan fiduciary in writing before such fiduciary enters into the contract or arrangement. Written disclosures may be provided in separate documents from separate sources and may be provided in electronic format, as long as these documents, collectively, contain all of the elements of disclosure required by the regulation. For example, a prospectus required by Federal securities laws, or a Form ADV required to be filed by a registered investment adviser, may include some of the indirect fee or conflict of interest information that a service provider would be required to disclose under this proposal. In these circumstances, the contracting parties are free to incorporate such materials by reference. The Department expects that the service provider will clearly describe these additional materials and explain to the responsible plan fiduciary the information they contain. The Department invites comments on whether, and the extent to which, duplicate disclosures can be avoided, while at the same time ensuring that responsible plan fiduciaries receive comprehensive, straightforward, and helpful information concerning the service provider's compensation and possible conflicts of interest.

The proposal also does not designate any specific time period prior to entering into the contract or arrangement for receipt of the required disclosures, other than requiring a representation by the service provider that all information was provided in writing before the parties entered into the contract. The Department believes it would be incumbent on the service provider to furnish current and accurate information to the plan fiduciary. Further, the responsible plan fiduciary, consistent with its general fiduciary obligations under ERISA, must ensure in its negotiations with a service provider that he or she obtains current and accurate information from the service provider sufficiently in advance of entering into the contract or arrangement to allow the fiduciary to prudently consider the information.

To facilitate the responsible plan fiduciary's determination that the service provider will receive no more than reasonable compensation, paragraph (c)(1)(iii)(A) of the proposal provides that the contract or arrangement must require the service provider to disclose the services to be provided to the plan and all compensation it will receive in connection with the services. A service provider must describe all services that it will provide, regardless of whether such services are described in the proposal's applicable scope provision. For example, if a plan consultant will provide appraisal, legal, and administrative services to the employee benefit plan in addition to its consulting services, then all of these services must be described. The subsections that follow in paragraph (c)(1)(iii)(A)(*1*) through (*4*) of the proposal clarify the requirement that the service provider disclose all compensation or fees that it will receive for its services.

Paragraph (c)(1)(iii)(A)(*1*) broadly defines compensation or fees to include money and any other thing of monetary value received by the service provider or its affiliate in connection with the services provided to the plan or the financial products in which plan assets are invested. Examples of compensation or fees that are covered by this definition include, but are not limited to: gifts, awards, and trips for employees, research, finder's fees, placement fees, commissions or other fees related to investment products, sub-transfer agency fees, shareholder servicing fees, Rule 12b–1 fees, soft dollar payments, float income, fees deducted from investment returns, fees based on a share of gains or appreciation of plan assets, and fees based upon a percentage of the plan's assets. The Department believes that an investment of plan assets or the purchase of insurance is not, in and of itself, compensation to a service provider for purposes of this regulation. However, persons or entities that provide investment management, recordkeeping, participant communication and other services to the plan as a result of an investment of plan assets will be treated as providing services to the plan.

Consistent with recommendations of the ERISA Advisory Council Working Group, the Department concludes that plan fiduciaries must receive more comprehensive information about the compensation or fees involved in plan administration and investments, including indirect compensation.[9] Indirect compensation includes fees that service providers receive from parties other than the plan, the plan sponsor, or the service provider.

Service providers also must disclose compensation or fees received by their affiliates from third parties. For purposes of the proposal, an ''affiliate'' of a service provider is defined in paragraph (c)(1)(iii)(A)(*1*) to be any person directly or indirectly (through one or more intermediaries), controlling, controlled by, or under common control with the service provider, or any officer, director, agent, or employee of, or partner in, the service provider. The Department does not intend this requirement to result in any ''double counting'' of compensation. For instance, an employee's salary or a bonus that is paid to an employee from the general assets of his or her employer (i.e., the service provider) would not need to be separately disclosed, even if the employee is paid in connection with services to an employee benefit plan. The proposal merely clarifies that disclosure of any direct or indirect compensation that otherwise is required under the proposal cannot be avoided merely because such compensation is paid to an employee or agent of the service provider or an affiliate, rather than directly to such service provider or affiliate.

The proposal next provides in paragraph (c)(1)(iii)(A)(*2*) that if a service provider cannot disclose compensation or fees in terms of a specific monetary amount, then the service provider may disclose compensation or fees by using a formula, a percentage of the plan's assets, or a per capita charge for each participant or beneficiary. The Department understands that it is not always possible at the time the parties enter into a service contract or arrangement to know the exact amount of compensation, whether direct or indirect, that the service provider will receive for its services. However, the service provider must describe its compensation or fees in such a way that the responsible plan fiduciary can evaluate its reasonableness. For instance, the service provider must clearly explain any assumptions that would be used in determining the compensation or fees according to any such formula or other charge.

Paragraph (c)(1)(iii)(A)(*3*) of the proposed regulation clarifies the nature of disclosures that must be provided

[9] *See* ERISA Advisory Council Working Group report at *http://www.dol.gov/ebsa/publications*.

concerning bundled arrangements. In many cases, administrative and investment services are provided to employee benefit plans in ''bundled'' arrangements, whereby a package or ''bundle'' of services is provided, either directly or through affiliates or subcontractors of a service provider. These bundles are priced to the plan by a single service provider as a package, rather than on a service-by-service basis. For example, rather than hiring separate service providers for investment management, recordkeeping, Form 5500 annual report preparation, participant communications and statement preparation, payroll processing, and other functions, a plan fiduciary may arrange for one service provider to have all of these services performed as a bundle. The provider of the bundle may in turn use other affiliated service providers, or unaffiliated subcontractors, to provide some of the services in the bundle. However, the responsible plan fiduciary obtains a ''package deal'' and will negotiate only with the provider of the bundle.

Under paragraph (c)(1)(iii)(A)(*3*) of the proposed regulation, if a service provider offers a bundle of services, then a contract or arrangement must require only that the provider of the bundle make the prescribed disclosures. This bundled service provider must disclose information concerning all services to be provided in the bundle, regardless of who provides them. Further, the bundled service provider must disclose the aggregate direct compensation or fees that will be paid for the bundle, as well as all indirect compensation that will be received by the service provider, or its affiliates or subcontractors within the bundle, from third parties. Generally, the bundled provider is not required to break down this aggregate compensation or fees among the individual services comprising the bundle. For instance, the service provider would not have to break down the aggregate fee into the amount that will be charged for preparing the Form 5500 annual report and the amount that will be charged for preparing participant statements. Also, the bundled provider generally is not required to disclose the allocation of revenue sharing or other payments among affiliates or subcontractors within the bundle.

There are, however, exceptions to these rules. Specifically, paragraph (c)(1)(iii)(A)(*3*) requires the bundled provider to disclose separately the compensation or fees of any party providing services under the bundle that receives a separate fee charged directly against the plan's investment reflected in the net value of the investment, such as management fees paid by mutual funds to their investment advisers, float revenue, and other asset-based fees such as 12b–1 distribution fees, wrap fees, and shareholder servicing fees if charged in addition to the investment management fee. Also, paragraph (c)(1)(iii)(A)(*3*) requires the separate disclosure of compensation or fees of any service provider under the bundle that are set on a transaction basis, such as finder's fees, brokerage commissions, or soft dollars. Soft dollars include research or other products or services, other than execution, received from a broker-dealer or other third party in connection with securities transactions. Compensation or fees that are charged on a transaction basis must be separately disclosed even if paid from mutual fund management fees or other similar fees. The Department does not believe that disclosure of these fees would require bundled providers to disclose any revenue sharing arrangements or bookkeeping practices among affiliates that could legitimately be classified as proprietary or confidential. Further, the Department believes that investment-based charges, commissions, and other transaction-based fees paid to affiliates are just as likely to be relevant to the responsible plan fiduciary's evaluation of potential conflicts of interest, whether or not they are part of a bundled service arrangement.

Paragraph (c)(1)(iii)(A)(*4*) requires that the service provider also explain the manner of receipt of compensation, for example whether the service provider will bill the plan, deduct fees directly from plan accounts, or reflect a charge against the plan investment. The description also must explain how any pre-paid fees will be calculated and refunded when the contract or arrangement terminates.

(c) Disclosure Concerning Conflicts of Interest

The subsections that follow in (B) through (F) of paragraph (c)(1)(iii) are intended to inform the responsible plan fiduciary of the service provider's relationships or interests that may raise conflicts of interest for the service provider in its performance of services for the plan. As service arrangements have become more complex, so have the ways that service providers are compensated, as well as the relationships among different players in the plan service provider industry. Plan fiduciaries must know of these relationships and indirect sources of compensation because they may impact the manner in which the provider performs services for the plan. There may be other, oftentimes subtle, influences on the service provider or its affiliates that may be relevant to a plan fiduciary's assessment of the objectivity of a service provider's decisions or recommendations.

The Department's attention to service providers' potential conflicts of interest is not new. For example, in 2005 the Department issued guidance with the Securities and Exchange Commission concerning potential conflicts of interest involved in pension consultant relationships.[10] This guidance provides a list of tips and related explanations to help plan fiduciaries obtain the information necessary to ensure that engagement of the pension consultant serves the best interest of the plan's participants and beneficiaries. The Department believes that the engagement of many plan service providers presents similar issues for the plan fiduciary. Accordingly, under the proposal, a contract or arrangement must require that the service provider disclose specific information that will help the responsible plan fiduciary assess any real or potential conflicts of interest.

Subsection (B) of paragraph (c)(1)(iii) requires that the service provider identify whether it will provide services to the plan as a fiduciary, either as an ERISA fiduciary under section 3(21) of ERISA or as a fiduciary under the Investment Advisers Act of 1940. The Department believes it is important for the responsible plan fiduciary and the service provider to understand at the outset of their relationship whether or not the service provider considers itself a fiduciary and how this status affects the nature of the services to be provided.[11]

Subsection (C) requires that the service provider disclose any financial or other interest in transactions in which the plan will partake in connection with the contract or arrangement. For example, if a service provider will be buying (or advising on the purchase of) a parcel of real estate for the plan, and an affiliate of the service provider owns an interest in the real estate, the service provider will

[10] *See* ''Selecting and Monitoring Pension Consultants—Tips for Plan Fiduciaries'' at *http://www.dol.gov/ebsa/newsroom/fs053105.html*.

[11] The Department notes that persons who perform one or more of the functions described in section 3(21)(A) of ERISA with respect to a plan are fiduciaries. *See* 29 CFR § 2509.75–8. Thus, fiduciary status depends on a factual analysis of a person's activities with respect to a plan. Formal agreements stating whether a person is a fiduciary are not dispositive of whether the person actually is a fiduciary under ERISA by virtue of the functions performed.

have to state that it has an interest in the transaction and describe its affiliate's ownership of the real estate. The responsible plan fiduciary can then weigh the nature and extent of the conflict in analyzing the objectivity of the service provider when making the recommendations.

The proposal also provides that a reasonable contract or arrangement must require the service provider to disclose its relationships with other parties that may give rise to conflicts of interest. Specifically, subsection (D) obligates the service provider to describe any material financial, referral, or other relationship it has with various parties (such as investment professionals, other service providers, or clients) that creates or may create a conflict of interest for the service provider in performing services pursuant to the contract or arrangement. If the relationship between the service provider and this third party is one that a reasonable plan fiduciary would consider to be significant in its evaluation of whether an actual or potential conflict of interest exists, then the service provider must disclose the relationship.

Conflicts also may arise when a service provider can affect its own compensation in connection with its services. Under subsection (E) of the proposal, a contract or arrangement must require the service provider to identify whether it can affect its own compensation without the prior approval of an independent plan fiduciary and to describe the nature of this compensation. A common example of this potential conflict of interest is the receipt of ''float'' compensation.[12] If the amount a service provider receives in float compensation will not be approved by an independent plan fiduciary, then the service provider must state that it will receive float compensation and explain the nature of this compensation.[13]

Finally, the Department recognizes that service providers may have policies or procedures to manage these real or potential conflicts of interest. For example, a fiduciary service provider may have procedures for offsetting fees received from third parties (through revenue sharing or other indirect payment arrangements) against the amount that it otherwise would charge a plan client. Accordingly, subsection (F) of paragraph (c)(1)(iii) of the proposal provides that a reasonable contract or arrangement must require service providers to state whether or not any such policies or procedures exist and, if so, to provide an explanation of these policies or procedures and how they address conflicts of interest. The Department views this requirement as an opportunity for service providers to educate plan fiduciaries about how they address potential conflicts of interest.

(d) Material Changes to Disclosed Information

Paragraph (c)(1)(iv) of the proposal provides that a reasonable contract or arrangement must require that, during the term of the contract or arrangement, service providers must disclose to responsible plan fiduciaries any material changes to the information that is required by paragraph (c)(1)(iii), subsections (A) through (F). Changes on the part of a service provider or its employee benefit plan business may occasionally occur and may alter the information previously disclosed by the service provider. If any resulting change to the information previously disclosed to a plan fiduciary would be viewed by a reasonable plan fiduciary as significantly altering the ''total mix'' of information made available to the fiduciary, or as significantly affecting a reasonable plan fiduciary's decision to hire or retain the service provider, then the change is material. To ensure that plan fiduciaries continue to be well-informed concerning the compensation and conflict of interest issues affecting their service provider relationships, a contract or arrangement must require service providers to notify fiduciaries of material changes within 30 days of the service provider's knowledge of the change.

(e) Reporting and Disclosure Requirements

The proposed regulation under paragraph (c)(1)(v) requires that a reasonable contract or arrangement obligate the service provider to furnish all information related to the contract or arrangement and the service provider's receipt of compensation or fees thereunder that is requested by the responsible plan fiduciary or plan administrator in order to comply with the reporting and disclosure requirements of Title I of ERISA and the regulations, forms, and schedules issued thereunder. For example, this provision would obligate the service provider to furnish information that is necessary for the plan administrator to complete the annual report on Form 5500, and information that is necessary for the responsible plan fiduciary to comply with disclosure obligations to plan participants and beneficiaries.

Of course, detailed reporting concerning some service providers may not be required for annual reporting purposes, for example because the amount or nature of the compensation paid to the service provider does not fall within the threshold or other requirements of the annual report on Form 5500. Further, not all employee benefit plans are subject to the same annual reporting requirements, for example small plans and certain self-funded welfare plans. This does not mean that service providers to these plans would not be required to fully satisfy the disclosure requirements of this proposed regulation, assuming they otherwise fall within the scope of the proposal. The Department anticipates that this proposal would apply more broadly to relationships between service providers and employee benefit plans that are not necessarily covered by ERISA's reporting requirements. The primary goal of this proposal—to provide comprehensive and useful information to responsible plan fiduciaries when entering service contracts or arrangements—is different than that of ERISA's annual reporting and disclosure requirements, which provide more limited retrospective financial information on direct and indirect service provider compensation to facilitate and reinforce the broader fiduciary obligations imposed by this proposal.

(f) Compliance by Service Providers

The proposal's final requirement is contained in paragraph (c)(1)(vi). This condition provides explicitly that a service provider must comply with its obligations under the contract or arrangement as described in the proposed regulation. Not only must a contract or arrangement require disclosure from the service provider, but the service provider must actually provide all of the required disclosures in order for the contract or arrangement to be reasonable. Similarly, it is not enough for a service provider to commit in the written contract to later notify the responsible plan fiduciary of material changes to the disclosures contained in the contract; subsection (vi) requires that the service provider in fact provide such notification.

[12] Many financial service providers, such as banks and trust companies, maintain omnibus accounts to facilitate the transactions of employee benefit plan clients. The service provider may retain earnings (''float'') that result from the anticipated short-term investment of funds held in these accounts. These accounts generally hold contributions and other assets pending investment. Plan fiduciaries also may transfer funds to an omnibus account in connection with issuance of a check to make a plan distribution or other disbursement.

[13] For more information concerning ''float'' compensation and the information concerning such compensation that plan fiduciaries should obtain from service providers, see the Department's Field Assistance Bulletin 2002–3 (Nov. 5, 2002) at *http://www.dol.gov/ebsa/regs/fab_2002-3.html*.

Subsection (vi) also refers to relief that may be available to a responsible plan fiduciary when a service provider fails to comply with this requirement. In addition to this proposed regulation, the Department is publishing a proposed Class Exemption in today's **Federal Register**. Subject to certain conditions, this Class Exemption will provide relief from ERISA's prohibited transaction rules for a responsible plan fiduciary when a contract or arrangement fails to be ''reasonable,'' through no fault of the responsible plan fiduciary, but due to a service provider's failure to satisfy its disclosure obligations under this regulation. The proposed Class Exemption is discussed below in paragraph (2), ''Consequences of Failure to Satisfy the Proposed Regulation.''

(g) Relationship Between Disclosures and the Plan Fiduciary's ERISA Section 404(a) Duties

The parties to a service contract or arrangement that falls within the scope of paragraph (c)(1)(i) of the proposal must, at a minimum, satisfy the requirements contained in this proposal and the other conditions to ERISA section 408(b)(2) in order for the provision of services under the contract or arrangement to be exempt from ERISA's prohibited transaction rules. However, the engagement of any particular service provider will not necessarily satisfy the fiduciary's obligations under section 404(a) of ERISA to act prudently and solely in the best interest of the plan's participants and beneficiaries merely because the service provider furnishes the information described in the proposed regulation.

Section 404(a) of ERISA requires that the responsible plan fiduciary engage in an objective process designed to elicit information necessary to assess not only the reasonableness of the compensation or fees to be paid for services, but also the qualifications of the service provider and the quality of the services that will be provided.[14] Although the steps taken by a responsible plan fiduciary may vary depending on the facts and circumstances, solicitation of bids among service providers is a means by which the responsible plan fiduciary can obtain information relevant to the decision-making process. A responsible plan fiduciary should not consider any one factor, including the fees or compensation to be paid to the service provider, to the exclusion of other factors. Further, a fiduciary need not necessarily select the lowest-cost service provider, so long as the compensation or fees paid to the service provider are determined to be reasonable in light of the particular facts and circumstances.

Further, plan fiduciaries are not limited by the disclosures required in this proposal. Plan fiduciaries may ask service providers for any additional information that they feel is necessary to their decision. For example, a responsible plan fiduciary may have questions for a service provider concerning the specific personnel that will be assigned to manage or perform services under the contract or arrangement.

Finally, although this proposal looks to disclosures made at the time a service contract or arrangement is entered into or renewed, responsible plan fiduciaries must continue to monitor service arrangements and the performance of service providers. Receipt of the disclosures described in this proposed regulation at the onset of a service relationship will not relieve plan fiduciaries of this ongoing obligation.

(h) Existing Requirement Concerning Termination of Contract or Arrangement

Paragraph (c)(2) of the regulation continues to require that service contracts or arrangements permit termination by the plan without penalty and on reasonably short notice. This requirement has not been changed, though the Department invites comments from the public as to any practical issues relating to the current regulation's requirements concerning contract termination. Specifically, the Department would like to know whether the current regulatory framework presents practical problems and whether further regulatory or interpretive guidance could address these problems.

(i) Other Statutory Exemptions Concerning Service Providers

The Department understands that, in certain circumstances, plans and service providers to such plans must rely on statutory exemptions other than section 408(b)(2) of ERISA in order to conduct business without violating ERISA's prohibited transaction provisions. Therefore, the Department invites comment on the extent to which the application of the disclosure requirements contained in this proposed regulation will affect, or may be affected by, other ERISA statutory exemptions that may relate to plan service arrangements.

(2) Consequences of Failure To Satisfy the Proposed Regulation

If the contract or arrangement fails to require disclosure of the information described in the proposed regulation, or if the service provider fails to disclose such information, then the contract or arrangement will not be ''reasonable.'' Therefore, the service arrangement will not qualify for the relief from ERISA's prohibited transaction rules provided by section 408(b)(2). The resulting prohibited transaction would have consequences for both the responsible plan fiduciary and the service provider. The responsible plan fiduciary, by participating in the prohibited transaction, will have violated section 406(a)(1)(C) of ERISA's prohibited transaction rules.[15] The service provider, as a ''disqualified person'' under the Internal Revenue Code's (Code) prohibited transaction rules, will be subject to the excise taxes that result from the service provider's participation in a prohibited transaction under Code section 4975.[16]

The Department believes that this significant result will provide incentives for all parties to service contracts or arrangements to cooperate in exchanging the disclosures required by the proposed regulation. However, the Department also believes that, in certain circumstances, a responsible plan fiduciary should not be held liable for a prohibited transaction that results when a service provider, unbeknownst to the plan fiduciary, fails to satisfy its disclosure obligations as required by the proposed regulation. Accordingly, the Department also published a proposed Class Exemption in today's **Federal Register**. The scope of the relief provided by the Class Exemption and the conditions that must be satisfied by a responsible plan fiduciary in order to obtain such relief are discussed in the preamble to the proposed Class Exemption. The Department notes that, in general, the parties seeking to avail themselves of either the statutory exemption provided by ERISA section 408(b)(2), or the administrative exemption provided in the Department's proposed Class Exemption, will bear the burden of establishing compliance with the conditions of these exemptions.

[14] *See, e.g.*, Information Letters to D. Ceresi (Feb. 19, 1998) and to T. Konshak (Dec. 1, 1997).

[15] *See* ERISA § 406(a)(1)(C).

[16] The Internal Revenue Code (Code) also provides statutory relief for transactions between a plan and a service provider that otherwise would be prohibited. Any excise taxes imposed by Code section 4975(a) and (b) for failure to satisfy the statutory exemption are paid by the disqualified person who participates in the prohibited transaction, in this case the service provider, not the plan fiduciary. *See* Code § 4975(a), (b), (c)(1)(C), (d)(2), and (e)(2)(B).

C. Effective Date

The Department proposes that its amendments to regulation section 2550.408b–2(c) be effective 90 days after publication of the final regulation in the **Federal Register**. The Department invites comments on whether the final regulation should be made effective on a different date.

D. Request for Comments

The Department invites comments from interested persons on the proposed regulation and other issues discussed in this Notice. Comments should be submitted electronically by e-mail to *e-ORI@dol.gov*, or by using the Federal eRulemaking portal at *http://www.regulations.gov*. Persons wishing to submit paper copies should address them to the Office of Regulations and Interpretations, Employee Benefits Security Administration, Room N–5655, U.S. Department of Labor, 200 Constitution Avenue, NW., Washington, DC 20210, Attn: 408(b)(2) Amendment. All comments received will be available for public inspection, without charge, at *http://www.regulations.gov* or at *http://www.dol.gov/ebsa* and in the Public Disclosure Room, N–1513, Employee Benefits Security Administration, 200 Constitution Avenue, NW., Washington, DC 20210.

The comment period for this proposed regulation will end 60 days after publication of the proposed rule in the **Federal Register**. The Department believes that this period of time will afford interested persons an adequate amount of time to analyze the proposal and submit comments.

E. Regulatory Impact Analysis

(1) Overview of the Proposal

Under section 406(a)(1)(C) of ERISA's prohibited transaction rules, the furnishing of goods, services, or facilities between a plan and a party in interest to the plan is generally prohibited.[17] A service relationship between a plan and a service provider would thus constitute a prohibited transaction in the absence of regulatory relief, because ERISA defines any person providing services to the plan as a ''party in interest'' to the plan.[18] Section 408(b)(2) of ERISA, however, exempts certain arrangements between plans and service providers that otherwise would be prohibited transactions. To obtain relief under that section, the arrangement must be reasonable, the services must be necessary for the establishment or operation of the plan, and no more than reasonable compensation must be paid for the services.[19] Regulations issued by the Department clarify each of these conditions to the exemption.[20]

To further clarify the meaning of a ''reasonable'' contract or arrangement under section 408(b)(2), the Department proposes to amend the regulation at 29 CFR § 2550.408b–2(c). Under the proposal, a contract or arrangement to provide covered services to a plan would not be reasonable unless it requires the service provider to disclose, in writing, certain information before the contract or arrangement is entered into, extended, or renewed. The Department believes that, in order to satisfy their ERISA obligations, plan fiduciaries need information concerning all compensation to be received by the service provider and any conflicts of interest that may adversely affect the service provider's performance of the contract or arrangement.

The proposal requires that, in order to be considered a reasonable contract or arrangement, the contract must require the service provider to furnish the specified information to the responsible plan fiduciary. The rule also would require that the service provider comply with its contractual obligation and actually furnish the specified information. These disclosures are intended to enable the responsible plan fiduciary to ensure that no more than reasonable compensation is paid to the service provider for the services and to illustrate any actual or potential conflicts of interest that may affect the service provider's judgment.

Once adopted, these requirements will apply to all contracts or arrangements between plans (including pension plans, group health plans, and other types of welfare benefit plans) and service providers who are fiduciaries; who provide banking, consulting, custodial, insurance, investment advisory, investment management, recordkeeping, securities or other investment brokerage, or third party administration services; or who receive indirect compensation for accounting, actuarial, appraisal, auditing, legal, or valuation services to the plan (collectively ''covered services'' or ''covered providers'').

The Department's interest in this proposal stems from concerns about the fees paid for by employee benefit plans, and the ability of plan sponsors and fiduciaries to understand these fees which may be paid directly or indirectly by plans. The Department believes that greater understanding of these fees by the affected parties will increase efficiency and competition in the service provider market and generate benefits to plans and thus to plan participants. Although the Department believes this rule will have the greatest effect on service providers to pension plans, the Department identified other employee benefit plans, such as health and welfare plans, that would be affected by this regulation and could realize benefits from the proposal similar to the benefits realized by pension plans.

In a separate regulatory effort, the Department has revised Schedule C of the annual Form 5500, which is filed by most large plans. Schedule C collects information about plan service providers that were compensated in excess of $5,000. These revisions are intended to improve the reported information on compensation and revenue sharing arrangements of service providers to employee benefit plans. Similar to the proposed revisions under section 408(b)(2) of ERISA, the revisions to Schedule C are intended to help plan sponsors and fiduciaries in determining the reasonableness of the fees they pay to service providers and to help assess any potential conflicts of interest. While the proposed regulation under section 408(b)(2) of ERISA concerns the disclosure of information during the decision-making process, the changes to Schedule C concern the provision of retrospective information as part of a plan's annual reporting obligations.

The Department is also publishing, simultaneously with this regulatory initiative, a proposed class exemption for plan fiduciaries in certain circumstances when plan service arrangements fail to comply with ERISA section 408(b)(2). The exemption is published elsewhere in this issue of the **Federal Register**. In the preamble to the exemption, the Department describes how it has taken into account the availability of conditional relief under the exemption in assessing the economic costs and benefits of the regulation. The Department believes that the exemption is essential to achieve the purposes underlying the regulation.

(2) Executive Order 12866 Statement

Under Executive Order 12866, the Department must determine whether a regulatory action is ''significant'' and therefore subject to the requirements of the Executive Order and subject to review by the Office of Management and Budget (OMB). Under section 3(f) of the Executive Order, a ''significant regulatory action'' is an action that is

[17] *See* ERISA § 406(a)(1)(C).

[18] *See* ERISA § 3(14)(B).

[19] *See* ERISA § 408(b)(2).

[20] *See* 29 CFR 2550.408b–2.

likely to result in a rule (1) having an annual effect on the economy of $100 million or more, or adversely and materially affecting a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local or tribal governments or communities (also referred to as ''economically significant''); (2) creating serious inconsistency or otherwise interfering with an action taken or planned by another agency; (3) materially altering the budgetary impacts of entitlement grants, user fees, or loan programs or the rights and obligations of recipients thereof; or (4) raising novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in the Executive Order. OMB has determined that this action is significant under section 3(f)(1) because it is likely to materially affect a sector of the economy. Accordingly, the Department has undertaken, as described below, an analysis of the costs and benefits of the proposed regulation in satisfaction of the requirements of the Executive Order. The Department believes that the proposed regulation's benefits justify its costs.

(3) Need for Regulatory Action

Employee benefit plans have evolved over the past several years, resulting in changes to both the services provided to the plans and the compensation received by service providers. Fee structures for service providers have, in some cases, become more complex and less transparent for plan sponsors or fiduciaries determining what is actually paid for services. This increased complexity also makes it more difficult to discern the service provider's potential conflicts of interest. It has also become more difficult to determine the impacts of these potential conflicts of interest on the fees paid by, or the quality of the services provided to, the plan.

Despite these complexities, when selecting or monitoring service providers, plan fiduciaries must act prudently and solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits and defraying reasonable expenses of administering the plan. To meet these obligations, it is vital that fiduciaries have enough information to make informed assessments and decisions about the services, the costs and the providers. In this regard, the Department has published interpretive guidance concerning the disclosure and other obligations of plan fiduciaries and service providers under sections 404, 406(b) and 408(b) of ERISA.[21]

To the extent that plan fiduciaries are unable to obtain this information, or unable to use it to choose among service providers in a manner that upholds their fiduciary duty, a failure exists in the market for services for employee benefit plans. This market failure results from information asymmetry between the providers of plan services who possess information about their fee structures and potential conflicts of interest and plan fiduciaries that lack this information but need it to act in the best interest of their plans. The Department believes that both responsible plan fiduciaries and service providers will benefit from this proposed regulation, which will promote the efficiency of plan fiduciaries finding and using the information they need to search for service providers. This action furthers important public policy goals of increased transparency and increased competition in the service provider market.

(4) Regulatory Alternatives

Executive Order 12866 directs Federal Agencies promulgating regulations to evaluate regulatory alternatives. The Department considered the following alternatives: Remaining with the status quo, a general regulatory framework, broad applicability, and a specific framework with limited application. These alternatives are described further below:

• Remain with status quo

The Department weighed the option of remaining with the status quo and relying on the current regulatory framework. ERISA's existing fiduciary duties imposed by sections 404 and 408(b)(2) already require plan fiduciaries to ensure that fees paid to service providers are reasonable. As part of this duty, fiduciaries must obtain information about fees and conflicts of interest. Absent a regulation, the status quo framework relies upon these more general fiduciary requirements to ensure that plans pay reasonable service fees.

The status quo alternative was rejected. Although the Department has issued technical guidance concerning plan fiduciaries' obligations to assess all compensation received by service providers, issues remain concerning the adequacy of current disclosures made to plans. The Department believes that plan fiduciaries would benefit from a clear and uniform regulatory standard for disclosure. Additionally, under the ''status quo'' alternative, it is unclear whether non-fiduciary service providers are obligated by law to provide the information the Department believes fiduciaries need in order to evaluate whether a provider's fees are reasonable.

• General regulatory framework

Second, the Department considered establishing a general regulatory framework requiring service providers to furnish, and plan fiduciaries to obtain, information on fee structures and conflicts of interest. This alternative would not have specified in detail the exact information that must be exchanged, but would have left this up to the parties to the contract or arrangement. The Department rejected this alternative because it believes both responsible plan fiduciaries and service providers would benefit from additional guidance concerning the information that must be exchanged. The Department felt that, although this alternative would create an obligation on the part of the parties to exchange information that relates to the reasonableness of fees, parties may be left with ongoing ambiguity about exactly what information is necessary to fully evaluate a service provider contract or arrangement. The Department therefore believes that this alternative would fail to generate significant benefits in the form of greater efficiency with higher costs than the status quo.

• Broad applicability

Third, the Department considered applying the proposed regulation broadly to all service arrangements that rely on the section 408(b)(2) service provider exemption for relief from ERISA's prohibited transaction rules. Upon further consideration, this alternative was rejected because the Department believed that the proposal's written disclosure requirements should be targeted to a more specifically defined group of service providers. The Department believes that certain service arrangements generally do not involve complex compensation arrangements or conflicts of interest, and therefore need not be separately regulated in order to ensure that compensation information is disclosed. Benefits from this alternative and the proposed rule would be similar and benefits would be accruing primarily to those plans with complex service provider arrangements. This alternative would be more costly than the proposed framework as more service providers would be affected.

• Specific framework with limited application

Lastly, the Department considered, and ultimately has adopted as its

[21] *See, e.g.* Field Assistance Bulletin 2002–3 (Nov. 5, 2002) and Advisory Opinions 97–16A (May 22, 1997) and 97–15A (May 22, 1997).

proposal, a rule requiring that, in order to be reasonable, a contract or arrangement for services must mandate that certain sets of service providers disclose specified information about their compensation and conflicts of interest. The proposal covers typical plan service providers that are most likely to have complex compensation arrangements or conflicts of interest. They include: fiduciary service providers; providers furnishing banking, consulting, custodial, insurance, investment advisory or management, recordkeeping, securities or other investment brokerage, or third party administration services; or providers who receive indirect compensation for accounting, actuarial, appraisal, auditing, legal or valuation services. The Department believes this framework will yield the information that plan fiduciaries need in order to assess the reasonableness of compensation paid for services from these service providers. Absent the regulation, such information may be difficult to obtain. The Department believes that the proposed rule provides the largest benefit among the four alternatives, while also limiting the costs.

(5) Characterization of Affected Entities

(a) Interaction of Affected Entities

The Department considered the costs and benefits of the proposed regulation over a 10-year time frame beginning in 2008. The proposed regulation will apply to all contracts or arrangements between plan fiduciaries and service providers that fall within its scope. The Department believes that other entities also may be affected either directly or indirectly by the proposal, including plan participants and plan sponsors. Using data from plan year 2003 submissions of Form 5500 and Schedule C, the Department developed a detailed industry profile to obtain information on these entities and their growth over the analysis period. The industry profile also describes the interactions among these entities and the influence of the proposed regulation on these interactions.[22]

(b) Growth of Affected Entities Over Time

To estimate the costs of the rule in future years, it is necessary to project the growth of the affected entities. To estimate this growth, the Department calculated a growth rate from past data on pension plans and participants. This growth rate was used to project the numbers of potentially affected entities in future years out to 2020. In the absence of more specific information, the Department assumed a growth in pension plans and participants equal to that of the labor force and the economy. The estimated growth rate was thus based on industry-wide trends in pension plans and participants.

The Department used data from 1985 to 2005 on numbers of defined benefit (DB) and defined contribution (DC) plans.[23] Since 1985, there has been a dramatic increase in the number of 401(k) plans, while other DC and DB plans show a marked decrease. Overall, there are slight increases in the total number of plans and participants. These increases are driven by the growth of 401(k) plans.

The Department estimated a growth rate model based on fitting an exponential curve function through the data points. This growth rate model was then used to predict future numbers of plans and participants. The results showed steady increases in the total number of plans (from about 800,000 in 2010 to 850,000 in 2020) and participants (from around 81,800,000 in 2010 to 90,800,000 in 2020) for the years 2010 through 2020.

(c) Quantitative Characterization of Affected Entities

The Department undertook a quantitative characterization of the benefit plan industry to gain additional information on the entities the Department believes would be affected by the rule. This subset of employer-sponsored plans was used for this characterization due to the availability of data on these types of plans. Data from plan year 2003 submissions of Form 5500, a yearly filing required for many benefit plans, were used for this analysis. The general approach of this characterization was to look at the two major plan types, pension (defined benefit and defined contribution) and welfare, and, where appropriate, subcategories within each plan type.

For plan year 2003, there were around 762,000 benefit plans for which a Form 5500 was filed, 676,000 of which were pension plans and roughly 86,000 of which were welfare plans. This population of benefit plans can be divided into large plans (≥100 participants) and small plans (<100 participants), according to the filing instructions for Form 5500. For plan year 2003, there were nearly 153,000 large plans and nearly 610,000 small plans. Thus, most employee benefit plans have fewer than 100 participants.

The Department made a rough characterization of the plan sponsor population using data collected via Form 5500. For all plans filed that year, there were over 622,000 plan sponsors, with about 86 percent of sponsors having only one benefit plan. Among plans filed for 2003, there were nearly 79,000 sponsors of large plans and over 555,000 sponsors of small plans. The Department believes, however, that these numbers might be slightly overestimated due to some plan sponsors filing under more than one employer identification number.

The Department characterized data for service providers to benefit plans from Schedule C submissions for plan year 2003. Compared to plan sponsor data, the data on service providers was very limited, as only a subset of plans must file Schedule C. For example, data for services and service providers to small plans, which account for over 80 percent of all plans, are not represented in the Schedule C filings. In terms of the number of service providers per plan, almost three quarters (72 percent) of the plans listed using one or two service providers, and 95 percent of the plans used 10 or less service providers. Only 14 plans used 40 or more unique service providers.

The Department also characterized the number of affected services provided by plan type and size (based on the number of participants) for all plans that filed Schedule C for plan year 2003, or the number of plan-provider arrangements. There were nearly 55,000 affected plan-provider arrangements for pension plans, and nearly 31,000 affected plan-provider arrangements for welfare plans. This analysis resulted in an estimate of the number of affected service providers to pension plans as nearly 9,878, and to welfare plans as 7,519, for a total number of about 15,600 affected service providers (providers that service both markets are counted only once). Although this analysis only covered a subset of the service provider market, the Department believes that this analysis included most of the affected service providers. Additional characterizations of service providers in terms of the services provided and compensation received are presented in Technical Appendix A to the 408(b)(2) Regulatory Impact Analysis.

The Department characterized benefit plan participants from Form 5500 submissions for plan year 2003. This analysis showed roughly 151.8 million pension plan participants and 162.7 million welfare plan participants. The totals for pension plans and welfare

[22] See Technical Appendix A to the 408(b)(2) Regulatory Impact Analysis, which is available as part of the public docket associated with this regulation, for details.

[23] Investment Company Institute, *401(k) Plans: A 25-Year Retrospective (Dec. 2006) at 3.*

plans may overlap, as individuals may participate in more than one type of plan.

(6) Benefits

As an example of the kind of benefits that could arise from this rule, the Department considered the possible benefits to defined contribution pension plans. The Department considered these benefits of the proposal from a qualitative perspective due to the ambiguous nature of the benefits arising from the proposal and the difficulty of quantifying them. Primary benefits of the proposal were thought to result from the potential for reduced unit costs incurred by plans for fiduciaries to search for service providers. This potential reduced unit cost of searching would encourage plan fiduciaries to obtain information from a larger set of service providers when they were making decisions about which provider to engage. Additionally, fiduciaries would have fewer barriers to changing service providers if they were not happy with their current fees or the returns they were receiving.

The social benefits arising from the proposal would be the sum of three different possible categories of primary benefits: possible lower fees paid by plans, possible increased efficiency due to reduced conflicts of interest, and possible higher returns due to reduced unit search costs incurred by plans. The magnitude of these benefits would depend in part on the degree to which the proposal actually resulted in lower search costs, and the degree to which different kinds of inefficiency currently exist in the market for service providers. A graphical analysis of these primary benefits is provided in Technical Appendix A to the 408(b)(2) Regulatory Impact Analysis which shows how the proposal lowers the marginal search costs for plans and how this cost reduction results in a greater amount of searching effort performed at a lower cost. The graphical analysis also shows the total net benefits to plans from the increased search effort by fiduciaries and the total societal net benefits of the reduction in unit search costs for service providers.

In addition to the potential primary benefits of the proposal, the Department identified potential secondary benefits due to possible higher rates of investment by participants in defined contribution pension plans. These secondary benefits could potentially arise from increased plan efficiencies and better investment choices by plan fiduciaries, and possibly from increases in plan participants' confidence in their plans as well. With greater transparency of fee structures, plan participants may have increased levels of confidence in their plans and may feel that their investment opportunities are more attractive. This increased confidence and attractiveness of investments could in turn result in a higher rate of investment in plans by plan participants. The existence and magnitude of these secondary benefits would depend on the preferences of employees in trading current for future consumption. Possible increases in rates of investment would be a benefit to society if the rate of return on capital investment were greater than the social rate of time preference between current and future consumption. Both of these issues are covered in Technical Appendix B to the 408(b)(2) Regulatory Impact Analysis.

(7) Costs

The Department estimated costs for the proposal over the 10-year time frame for the analysis. The primary costs of the rule are seen to accrue to service providers.[24] The Department used information from the quantitative characterization of the service provider market presented above as a basis for these cost estimates. This characterization did not account for all service providers, but did provide information on the segments of the service provider industry that are likely to be most affected by the proposal (*i.e.*, those who service pension plans). In addition to the costs to service providers, the Department also considered other potential costs and savings from the proposal, including savings to plan participants and costs to the plan due to its fiduciaries' review of any additional material they receive as part of the required disclosures.

(a) Costs to Service Providers

(i) *Initial costs.* When the Department publishes the proposal, affected service providers will need to evaluate whether their current disclosure practices comply with the proposal and, if not, how their practices must be changed to be compliant. The Department projected this as a cost incurred in the year in which the rule takes effect.

The Department assumed that all affected service providers will incur a cost for rule familiarization, and estimated this cost to be one hour per service provider. The Department assumed that the rule familiarization would be performed by an in-house professional-level employee at a cost of $56 per hour.[25] Using the number of unique service providers identified in the quantitative analysis presented earlier (15,600), this cost was estimated to be about $870,000 (15,600 × 1 × $56).

Although all affected service providers are assumed to incur these initial costs, it is more likely that only service providers with complex fee arrangements and conflicts of interest would find a formal review process to be necessary. The Department assumed that the number of service providers undertaking this kind of formal review is similar to the number of unique service providers who are reported on the Schedule C as having received $1 million or more in compensation (2,100). Assuming that 24 working hours would be required to read the proposal, review a service provider's current disclosure practices, and describe needed changes, if any, the initial cost of legal review is around $5.4 million (2,100 service providers × 24 hours × $106 in-house lawyer rate).

Affected service providers must also develop or update their current disclosure statements. This activity includes developing formulae and algorithms to estimate direct and indirect compensation that will be applied in a pro forma projection for each plan with which the provider will contract. The Department again assumed that the majority of this cost would be incurred by service providers in the first year of the analysis period. The existing amount of disclosure supplied by many service providers is likely to be adequate for compliance with the new rule. For example, a service provider offering unbundled trustee services or unbundled participant communications services is likely to stipulate a single direct payment that is already being adequately disclosed in the absence of the new rule. For this calculation, the Department assumed that the number of unique service providers reported on the Schedule C as having received $1 million or more in compensation (2,100) is a reasonable proxy for the number of service providers that will need to update their current disclosure statements. The Department assumed that 80 working hours would be required to implement changes to disclosure statements, producing a cost of about $9.4 million (2,100 service providers × 80 hours × $56 in-house professional rate).

[24] Costs to service providers might be ultimately borne by plans and their participants.

[25] The hourly wage estimates used in this analysis are estimates for 2007 and are based on data from the Bureau of Labor Statistics National Occupational Employment Survey (May 2005) and the Bureau of Labor Statistics Employment Cost Index (Sept. 2006).

(ii) *Recurring costs.*

In addition to the initial costs identified above, the Department estimated the burden for two recurring costs that would accrue during each subsequent year of the analysis period. The first recurring cost was for service providers entering the market (either for the first time or by re-entry) to provide service to plans after the first year of applicability. These firms incur the initial cost of rule familiarization. The Department has assumed that one-twelfth (1,300 = 15,600 × 1⁄12) of all service providers are new in each year subsequent to the first.[26] Familiarization costs then equal around $73,000 (1,300 service providers × 1 hour × $56 in-house professional rate).

The second recurring cost arises from affected service providers needing to develop the written disclosure statement each time the ''contracts and arrangements entered into,'' are ''extended, or renewed.'' Many contracts between plans and service providers have multi-year terms, automatic annual renewals, or no specific term (having instead a provision for either party to terminate at will).[27] Despite these longer contract terms, though, even these contract types are likely to include, at least annually, material changes to elements such as unit costs. The Department thus estimated one disclosure per year per contract between a plan and service provider.[28] Service providers may provide similar written disclosures as plan administrators ask for multiple bids for a single service or as plan administrators ask for costs for multiple investment or service options from a single provider. These additional written disclosures are not strictly subject to the proposal because they are not directly related to a transaction. For this reason, these additional disclosures were not included in the estimated costs of the rule.

Exhibit 7–1 presents an estimate of the number of contracts using Form 5500 data from plan year 2003. The projection assumes that those who are not Schedule C filers have as many providers on average as Schedule C filers. Firms such as insurance companies that may be service providers for purposes of the proposal may have been reported on Schedule A. These firms are not included in this estimate.

EXHIBIT 7–1.—NUMBER OF DISCLOSURES PER YEAR

Type and number of participants	Number of plans	Schedule C filers	Affected schedule C filers	Affected pro-vider-plan arrangements	Affected pro-viders per plan	Affected service provider arrangements (projected)
Pension (DB, DC) <100 participants	596,641	526	444	613	1.38	823,741
Pension (DB, DC) 100–499 participants	57,961	16,680	15,289	18,846	1.23	71,446
Pension (DB, DC) 500–1,000 participants	8,958	4,774	4,488	7,470	1.66	14,910
Pension (DB, DC) >1,000 participants	12,427	8,478	8,077	28,255	3.50	43,472
All Pension (DB, DC)	675,987	30,458	28,298	55,227	....	953,569
Welfare <100 participants	13,095	801	738	913	1.24	16,200
Welfare 100–499 participants	46,224	7,366	6,736	8,811	1.31	60,463
Welfare 500–1,000 participants	10,475	2,558	2,377	4,286	1.80	18,888
Welfare >1,000 participants	16,670	5,075	4,780	16,946	3.55	59,098
All Welfare	86,464	15,800	14,631	31,025	....	154,649
All Plans	762,451	46,258	42,929	86,692	....	1,108,218

The Department assumed that many written disclosure statements under the proposal could be made routine and automatic. In the absence of good data on the number of easily automated versus not easily automated disclosure statements, the Department estimated that 70 percent are easy and would not require any significant time to produce, and 30 percent are complex, requiring 1 hour and 40 minutes to produce. The weighted average for the time needed is therefore 0.5 hours per written disclosure, yielding a recurring contracting disclosure cost of around $31 million (1,108,000 disclosures × 0.5 hours × $56 in-house professional rate). The Department invites the public to comment on these assumptions.

A summary of the initial and recurring labor costs is shown below in Exhibit 7–2.

EXHIBIT 7–2.—SUMMARY OF INITIAL AND RECURRING LABOR COSTS

	Affected quantity (2003 data)	Hours	Labor rate (2007$s)	Total (2007$s)
Initial Cost 1 (First Year)	15,609	1	$56	$874,104
Initial Cost 2 (First Year)	2,101	24	106	5,344,944
Initial Cost 3 (First Year)	2,101	80	56	9,412,480

[26] Industry growth, and therefore the growth in the number of service providers over time, has been addressed in Exhibit 7–4. For example, in 2009 the Department has assumed that there are 12% more service providers than in 2003.

[27] Please note that 29 CFR 2550.408b–2(c) provides, in part, that a contract or arrangement for services must be terminable, on reasonably short notice, by a plan.

[28] These recurring costs are assumed to accrue every year, starting with the first year.

EXHIBIT 7–2.—SUMMARY OF INITIAL AND RECURRING LABOR COSTS—Continued

	Affected quantity (2003 data)	Hours	Labor rate (2007$s)	Total (2007$s)
Subtotal Initial Cost				15,631,528
Recurring Cost 1 (Subsequent Years)	1, 300	1	56	72,800
Recurring Cost 2 (All Years)	1,108,218	0.5	56	31,030,104

Lastly, the Department estimated annual materials costs attributable to the disclosures required under the proposal. The Department's proposal does not provide detailed guidance on the format of the disclosure. However, the Department previously made available on its Web site (*http://www.dol.gov/ebsa*) a Model Fee Disclosure Form developed in cooperation with industry representatives that reflects similar types of information and runs to 11 pages. The disclosures are thus assumed to add 11 pages to existing written materials in each year. Paper and printing costs are estimated at $0.05 per page. The Department assumed that there would be no significant additional postage costs because the disclosures, in most cases, could be included with other written materials given to the plan before the contract is entered into. [Total material costs are therefore roughly $609,500 ($0.05 per page × 11 additional pages × 1,108,000 disclosures).]

This materials cost was then added to the initial and recurring costs to estimate the total costs of the rule. These calculations are summarized below in Exhibit 7–3.

EXHIBIT 7–3.—SUMMARY OF TOTAL INITIAL AND RECURRING COSTS BY YEAR

	Labor costs	Materials costs	Total costs
First Year: Initial Costs	$15,631,528		
First Year: Recurring Costs 2	31,030,104	$609,520	
First Year: Cost Total	46,661,632	609,520	47,271,152
Subsequent Years: Recurring Costs 1	72,800		
Subsequent Years: Recurring Costs 2	31,030,104	609,520	
Subsequent Years: Cost Total	31,102,904	609,520	31,712,424

Exhibit 7–4 below shows the projection of costs over the 10-year time horizon for the proposal. The number of service providers is expected to grow above the number projected from plan year 2003 Form 5500 data. In order to quantify the increase in affected service providers over time, the Department has used 1997 and 2002 Economic Census data from the U.S. Census Bureau. The growth in ''Portfolio Managers'' (NAICS 523920) between the 1997 and 2002 Economic Census represents a compound annual growth rate of 3.8 percent and was utilized for this analysis as an approximation of the growth rate for all affected service providers. The Department applied a conservative growth rate of half that historical value, 1.9 percent, to the plan year 2003 Form 5500 data. A real discount rate of 7 percent, as recommended in OMB Circulars A–94 and A–4, was applied to the ten-year stream of costs to obtain an estimate of the net present value of the costs. The 7 percent rate is an estimate of the average before-tax rate of return to private capital in the U.S. economy. The analysis is relatively insensitive to the value of the discount rate. Since the benefits of the proposal are not quantified, this net present value of the costs is also equal to the Department's estimate of the quantified net costs of the rule.

EXHIBIT 7–4.—CALCULATION OF NET PRESENT VALUE

Year	Real 2007 dollars	Growth in service providers from 2003	Real 2007 constant dollars with growth	Discount factor	Discounted 2007 dollars
2008	$47,271,152	1.099	$51,950,996	0.935	$48,574,181
2009	31,712,424	1.120	35,517,915	0.873	31,007,140
2010	31,712,424	1.141	36,183,876	0.816	29,526,043
2011	31,712,424	1.163	36,881,549	0.763	28,140,622
2012	31,712,424	1.185	37,579,222	0.713	26,793,986
2013	31,712,424	1.207	38,276,896	0.666	25,492,413
2014	31,712,424	1.230	39,006,282	0.623	24,300,913
2015	31,712,424	1.253	39,735,667	0.582	23,126,158
2016	31,712,424	1.277	40,496,765	0.544	22,030,240
2017	31,712,424	1.301	41,257,864	0.508	20, 958,995
Total					279,950,691

(b) Cost Savings for Plan Participants

The proposal may allow fiduciaries to make even better choices among offers from competing service providers and among options offered by any service provider. Since the fiduciary makes these choices in the best interest of the participants and beneficiaries, cost savings generally accrue to the plan and thus plan participants. The Department cannot directly quantify the amount of savings. The Department can, however, calculate a threshold value for the point at which the cost savings equal the costs identified above.

Because the largest costs to plans generally are investment management costs, it is useful to express the threshold in terms of a percent against assets. Total assets held in private defined benefit and defined contribution plans in 2005 were $4.9 trillion.[29] If more than 8 percent of plans realize expense reductions of 1 basis point (one one-hundredth of a percent), then cost savings will exceed costs. The Department assumes that at least 8 percent of plans will experience a reduction of at least 1 basis point. Therefore, cost savings are expected to exceed costs. These results are summarized below in Exhibit 7–5. The Department invites the public to comment on these assumptions.

EXHIBIT 7–5.—CALCULATION OF THRESHOLD VALUE AT WHICH COST SAVINGS EQUAL COSTS

A	Annuity Equivalent to $280.0 M	$39,858,680
B	Total Assets	$4,861,000,000,000
C	Assets × 1 basis point	$486,100,000
D = A/C	Threshold Percent of Firms	8%

(c) Costs to Plans

Plan fiduciaries already have a fiduciary duty to evaluate the reasonableness of offers from service providers, and they already have access to tools like the Model Plan Fee Disclosure Form to assist them in asking service providers questions in order to encourage disclosure. The proposed changes to the Department's regulation under section 408(b)(2) of the Act attempt to facilitate this duty by providing a framework as to what must be disclosed concerning service arrangements and by requiring service providers to provide such disclosures in order to benefit from the section 408(b)(2) statutory exemption.

On the other hand, some plans may incur costs under the proposal. First, the new written disclosures are likely to become longer and more detailed than what fiduciaries are currently receiving. The prudent fiduciary may spend additional hours reviewing the longer written disclosure document, resulting in costs to their plan. In addition, some fiduciaries may be concerned that the availability of the detailed written disclosures exposes them to potential fiduciary liability. Fiduciaries could go so far as to hire outside consultants to review and evaluate the new written disclosures, which would again result in costs to their plans.

On the whole, the Department projects that the amount of time saved by fiduciaries in gathering data is offset by the additional time spent by them in reviewing additional data. These potential costs to plans were thus not included in the estimates. The amount of time spent by fiduciaries is likely to be similar with or without the proposal, though: As was previously discussed in the benefits section, the time spent under the proposal evaluating and documenting fees as reasonable is likely to be more efficient than in the baseline.

(8) Initial Regulatory Flexibility Analysis

The Regulatory Flexibility Act (5 U.S.C. 601, *et seq.*) (RFA) imposes certain requirements with respect to Federal rules that are subject to the notice and comment requirements of section 553(b) of the Administrative Procedure Act (5 U.S.C. 551, *et seq.*) and which are likely to have a significant economic impact on a substantial number of small entities. Unless an agency determines that a proposal is not likely to have a significant economic impact on a substantial number of small entities, section 603 of the RFA requires that the agency present an initial regulatory flexibility analysis (IRFA) at the time of the publication of the notice of proposed rulemaking describing the impact of the rule on small entities and seeking public comment on such impact. Small entities include small businesses, organizations and governmental jurisdictions.

In response to this request, the Department prepared an IRFA of the proposal because, although the Department considers it unlikely that the rule will have a significant effect on a substantial number of small entities, the Department does not have enough information to certify to that effect.

(a) Reasons for and Objectives of the Proposal

Employee benefit plans have evolved over the past several years, resulting in service providers having more complex compensation arrangements and conflicts of interest. Thus, plan fiduciaries face greater difficulty in assessing whether the compensation paid to their service providers is reasonable. This proposal is intended to help plan fiduciaries get the information they need to negotiate with and select service providers who offer high quality services at reasonable rates.

The reasons for and objectives of this proposed regulation are discussed in detail in Section A of this preamble, ''Background,'' and in section 3 of the Regulatory Impact Analysis (RIA), ''Need for Regulatory Action.'' The legal basis for the proposal is set forth in the ''Authority'' section of this preamble, below.

(b) Estimating Compliance Requirements for Small Entities

The Department estimated the number of small entities that would be required to make disclosures under the proposal by examining 2002 Economic Census data for industries in North American Industry Classification System (NAICS) codes for activities affected by the proposal. Next, the Department used information on firms in the affected NAICS codes to estimate the population of affected firms. From this analysis, the Department estimated that about 14,600 small firms would incur costs under the proposal. Further detail on this estimation procedure is provided in Technical Appendix C to the 408(b)(2) Regulatory Impact Analysis.

To determine the impact of the rule on small entities, the Department examined the initial and recurring costs that would be borne by small firms in further detail. As discussed in Section 7, the initial costs are estimated to amount to $56 for every small entity for rule

[29] Investment Company Institute, *401(k) Plans: A 25-Year Retrospective (Dec. 2006) at 3.*

familiarization, and roughly $7,000 for more in-depth review and changes to disclosure practices for small entities at the larger end of the range, or those with over $1,000,000 in annual revenues. These costs, which are at most less than one percent of a single year's revenues, should be easily affordable for all small entities.

The impact of recurring costs will depend on the number of plans served by each firm, and the fraction of plans requiring complex disclosures. In an attempt to determine the numbers of plans served by small service providers relative to large ones, the Department examined data from Form 5500 filings for plan year 2003. These data showed a strong tendency for smaller service providers (measured in terms of the total number of participants served) to serve plans of smaller average size. The Department found that, if all plans with 5 or fewer participants are served by the smallest of the service providers, it is possible that up around 5,150 small entities could face costs equal to one percent of revenues. Comparing this maximum to the total number of small entities bearing costs under this rule (about 14,600), or roughly one third of affected small entities could possibly bear ongoing costs equal to one percent of revenues as a result of the proposal. Because these magnitudes are above the thresholds commonly used to measure impacts on small entities, the Department considered it inappropriate to certify that the rule would not cause a ''significant impact on a substantial number of small entities.''

In conclusion, the Department believes that the rule is very likely to result in costs that are insignificant in comparison to revenues for all but the smallest affected entities. This conclusion, however, is subject to considerable uncertainty, due largely to a lack of data on both small plans and small service providers. The Department believes that it is at least possible for a substantial number of small entities to bear costs that could be considered significant, and therefore, the Department examined the issue in detail. Additional detail on the Department's analysis of this issue can be found in Technical Appendix C to the 408(b)(2) Regulatory Impact Analysis.

(c) Considered Alternatives

In accordance with the RFA, the Department considered whether several alternatives to the proposed regulation would minimize the economic impact on affected small entities. The Department also considered the anticipated benefits of the proposal for these entities. These alternatives are described further below, followed by a discussion of the Department's chosen alternative.

(i) *Exemption for Small Entities.*

The Department considered exempting from the requirements of the proposed regulation small service providers with a threshold of $6.5 million in annual revenue. The threshold of $6.5 million follows from the Small Business Administration's definition of small firms.[30] An exemption may lessen the burden on small service providers, to the extent such small service providers are not already providing written disclosures that would comply with the requirements of the proposed regulation. The Department believes, however, that such an exemption would not comport with the rule's objectives of providing plan fiduciaries with the information they need to assess the reasonableness of service fees. There is no indication that small service providers are any less likely to have complex fee arrangements or conflicts of interest. Instead, the Department has determined that the likely existence of complex fee structures and conflicts of interest depends more on the nature of the service provided than upon the size of the service provider. Accordingly, the Department has narrowed the proposal's scope to providers of a limited set of services, such as investment advice and management.

The Department believes that small providers and the plans they serve will benefit from the proposal, because it will clarify the information that must be disclosed to responsible plan fiduciaries.

(ii) *Delaying Implementation for Small Service Providers.*

The Department also considered delaying implementation of the proposal for small service providers and small plans. This delay would provide these parties with more time to become familiar with the disclosure requirements, over a period of up to two years beyond the rule's generally applicable effective date. However, similar to the Department's rationale for deciding not to provide an exemption for small entities, the Department believes that plans, large and small, contracting with small service providers need the information required by the proposal in order to determine the reasonableness of service provider fees. Further, the Department does not believe there is any benefit to delaying application of this proposal, because doing so would delay the benefits to all plans of the proposal's required disclosures. Failure to obtain such information could cause plans to pay too much for services.

(iii) *Benefits of the Proposal to Small Plans.*

The Department believes that small plans will benefit significantly from the proposal. Fiduciaries to small plans may sometimes have trouble obtaining complete disclosures from potential service providers. Because the proposal is conditioned on compliance by both responsible plan fiduciaries and service providers, the Department believes that it will assist small plan fiduciaries in obtaining the information they need to make informed decisions when selecting service providers. Additionally, responsible plan fiduciaries for plans, both large and small, will benefit from the clarity that the proposal provides concerning the specific information that the Department believes is relevant to these decisions.

(d) The Selected Alternative

The Department considered and selected a disclosure framework that outlines what disclosures must be included in a ''reasonable'' contract or arrangement. As indicated above, small plans will benefit from this increased information at least as much as large plans will. Because there is no standard form for the disclosure, small service providers with relatively simple compensation arrangements and few, if any, conflicts of interest can provide a relatively simple, short written disclosure. The Department also limited the application of the rule to certain classes of services providers, as discussed above in the ''Scope'' section of the preamble. By limiting the scope of the regulation to contracts or arrangements with service providers that are more likely to have complicated fee structures and conflicts of interest, the Department believes that the proposal will avoid unnecessary burdens on small service providers that will not be subject to its written disclosure requirements.

(e) Duplicative, Overlapping, and Conflicting Rules

The Department identified two rules that potentially overlap or duplicate the proposal: Changes to the Form 5500,

[30] U.S. Small Business Administration, ''Table of Small Business Size Standards Matched to North American Industry Classification System Codes.'' Available online at: *http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sstd_tablepdf.pdf.* For further discussion please see the Technical Appendix Section C which can be accessed at the Department's Web site at *www.dol.gov/ebsa.*

Schedule C, and The Investment Advisers Act of 1940.

(i) *Changes to the Form 5500, Schedule C.*

Recent changes to the Form 5500, Schedule C, clarify the requirements for the reporting of direct and indirect compensation received by service providers. Also, Schedule C requires that the source and nature of compensation in excess of $1,000 received from parties other than the plan or the plan sponsor be disclosed for certain key service providers.

Both the revised Schedule C requirements and the proposal aim to make indirect compensation received by service providers more transparent. The proposal, however, requires disclosure of compensation and fees in advance of contract performance so that the fiduciary can assess their reasonableness before they are paid. The Form 5500 revisions, on the other hand, require disclosure of actual compensation and fees after contract performance.

Small plans need not file the Schedule C, so the rule does not overlap for over 90 percent of plans. In addition, because small plans may tend to use small service providers, the existing relief for small plans from filing the Schedule C also minimizes the burden on small service providers.

(ii) *The Investment Advisers Act of 1940.*

The Investment Adviser's Act of 1940 authorizes the U.S. Securities Exchange Commission (SEC) to regulate investment advisors. The SEC requires SEC-registered investment advisers to disclose compensation and conflicts of interest to clients using the SEC Form ADV.

Some of the information disclosed on Form ADV may be similar to disclosures required by this proposal, which also will elicit information about indirect compensation and conflicts of interest. However, the Department clarifies above in the preamble that parties may satisfy the proposal's disclosure requirements by incorporating other written materials. This flexibility is afforded to parties in order to avoid unnecessary duplication. Thus, the Form ADV may serve as part of the disclosure made by service providers to comply with the proposal. Further, many of the service providers covered by the proposal are not subject to the Investment Advisers Act.

(f) Congressional Review Act Statement

This notice of proposed rulemaking is subject to the Congressional Review Act provisions of the Small Business Regulatory Enforcement Fairness Act of 1996 (5 U.S.C. 801 *et seq.*) and, if finalized, will be transmitted to the Congress and the Comptroller General for review.

(g) Unfunded Mandates Reform Act Statement

For purposes of the Unfunded Mandates Reform Act of 1995 (Pub. L. 104–4), as well as Executive Order 12875, the notice of proposed rulemaking does not include any federal mandate that will result in expenditures by state, local, or tribal governments in the aggregate of more than $100 million, adjusted for inflation, or increased expenditures by the private sector of more than $100 million, adjusted for inflation.

(9) Paperwork Reduction Act

As part of its continuing effort to reduce paperwork and respondent burden, the Department of Labor conducts a preclearance consultation program to provide the general public and Federal agencies with an opportunity to comment on proposed and continuing collections of information in accordance with the Paperwork Reduction Act of 1995 (PRA 95) (44 U.S.C. 3506(c)(2)(A)). This helps to ensure that the public understands the Department's collection instructions; respondents can provide the requested data in the desired format, the reporting burden (time and financial resources) is minimized, and the Department can properly assess the impact of collection requirements on respondents.

Currently, the Department is soliciting comments concerning the information collection request (ICR) included in the Proposed Rule on Reasonable Contract or Arrangement Under Section 408(b)(2). A copy of the ICR may be obtained by contacting the person listed in the PRA Addressee section below. The Department has submitted a copy of the proposal to OMB in accordance with 44 U.S.C. 3507(d) for review of its information collections. The Department and OMB are particularly interested in comments that:

- Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility;
- Evaluate the accuracy of the agency's estimate of the burden of the collection of information, including the validity of the methodology and assumptions used;
- Enhance the quality, utility, and clarity of the information to be collected; and
- Minimize the burden of the collection of information on those who are to respond, including through the use of automated, electronic, mechanical, or other technological collection techniques, e.g., by permitting electronic submission of responses.

Comments should be sent to the Office of Information and Regulatory Affairs, Office of Management and Budget, Room 10235, New Executive Office Building, Washington, DC 20503; Attention: Desk Officer for the Employee Benefits Security Administration. Although comments may be submitted through February 11, 2008, OMB requests that comments be received within 30 days of publication of the Notice of Proposed Rulemaking to ensure their consideration. Please note that comments submitted to OMB are a matter of the public record.

PRA Addressee: Address requests for copies of the ICR to Gerald B. Lindrew, Office of Policy and Research, U.S. Department of Labor, Employee Benefits Security Administration, 200 Constitution Avenue, NW., Room N–5718, Washington, DC 20210. Telephone: (202) 693–8410; Fax: (202) 219–4745. These are not toll-free numbers. ICRs submitted to OMB are also available at reginfo.gov (*http://www.reginfo.gov/public/do/PRAMain*).

(a) The Proposal

The ICRs are contained in paragraph (c)(1)(iii) of the proposal and pertain to the written disclosure requirements that the service provider must make whenever a contract or arrangement is entered into, extended, or renewed as a condition to the relief provided by the proposal. The written disclosure must include a description of the specific services to be provided, the direct and indirect compensation or fees to be received by the service provider, and the manner of receipt of such compensation or fees. It must also include a statement concerning whether the service provider will provide any services to the plan as a fiduciary and statements about the potential for conflicts of interest.

The Department estimates that about 15,600 affected service providers would need to review the rule and their current disclosure practices in the first year. The Department assumed that the rule familiarization would require one hour and be performed by an in-house professional-level employee at a cost of $56 per hour.

In years subsequent to the first year of applicability, the Department estimates that providers newly entering the market for plan services will need to become familiar with the rule. One-twelfth (around 1,300) of all service providers are assumed to be new to the market for plan services in each year subsequent to the first.[31] The Department again assumed that the rule familiarization would take one hour and would be performed by an in-house professional-level employee at a cost of $56 per hour.

The Department assumed that 2,100 affected service providers would have more complex fee arrangements and would therefore need to undertake a more formal review of their disclosure practices in the first year. The Department assumed that this formal review would require 24 working hours and be performed by an in-house lawyer at an estimated cost of $106 per hour. The Department assumed that the same affected providers (2,100) would also need to update templates and processes for disclosure in the first year. This update is assumed to require 80 working hours and be performed by a in-house profession-level employee at a cost of $56 per hour, as described above.

The Department estimates that 1,108,000 contracts or arrangements exist between service providers and plans and that each contract or arrangement will require a written disclosure. It is assumed that contracts or arrangements are either entered into or renewed once in each of the first three years after the regulation would become effective. Preparation and delivery of the required disclosure is assumed to add, on average, one half hour to the process of entering into a contract or arrangement. Preparation and delivery are assumed to be performed by an in-house professional-level employee at a cost of $56 per hour. The average annual burden hours across the first three years is therefore estimated as 633,000 hours. The equivalent cost for this burden hour estimate is about $36,290,000 per year.

In addition to burden hours, the Department has estimated annual materials costs attributable to the disclosure. The Department's proposal does not provide detailed guidance on the content or format of the disclosure. However, the Department makes available a model 401(k) plan fee disclosure form that represents similar types of information and runs to 11 pages. The disclosures are assumed to add 11 pages to existing written contracts in each year. Paper and printing costs were estimated at $0.05 per page. It is assumed that there are no postage costs because, in most cases, the disclosures simply add content to what would generally be a written contract even absent the proposal. For each of the first three years, materials costs are therefore estimated to be roughly $609,500 (1,108,000 disclosures × 11 pages × $0.05 per page cost).

(b) The Proposed Class Exemption

Not only does the proposal provide that the terms of the service contract must require the service provider to disclose its compensation and conflicts of interest, the service provider must also comply with the contract on an on-going basis and actually disclose this information in writing to the responsible plan fiduciary. If the service provider fails to disclose the data, then the provision of services will constitute a prohibited transaction under ERISA section 406(a)(1)(C) because it will not be considered a ''reasonable contract or arrangement'' exempted by ERISA section 408(b)(2). Therefore, in such instances, the responsible plan fiduciary will have violated section 406(a)(1)(C) even if it made every effort to comply with the proposed regulation by entering into, or extending or renewing, a written contract that required such disclosures. The failure to make the required disclosures also would result in a prohibited transaction by the service provider under section 4975(c)(1)(C) of the Internal Revenue Code.

Therefore, as an accompaniment to the proposed regulation, the Department also proposes a Class Exemption that will relieve such fiduciaries from liability for a prohibited transaction under ERISA section 406(a)(1)(C) in cases where the contract or arrangement requires the specified disclosures but the service provider fails to make them. This proposed Class Exemption is published in today's **Federal Register**.

The ICR contained in the proposed exemption requires that the responsible plan fiduciary, upon discovering a service provider's failure to make the required disclosures, must submit a written request to the provider for all information that the provider should have disclosed. It also requires the responsible plan fiduciary to report a service provider's refusal or failure to comply with the request in certain situations. As discussed below, the Department has determined that this ICR imposes a small paperwork burden on responsible plan fiduciaries in addition to the ICR imposed by the proposal.

To estimate this burden, the Department started with the number of disclosures made in the first year of the analysis (1,108,000) and assumed that 10 percent (111,000) of these disclosures would result in a concern by the responsible plan fiduciary after the contract or arrangement was solidified. According to the requirements of the exemption, the responsible plan fiduciary must, upon discovering a failure to disclose, submit a written request to the service provider for all information that it should have disclosed. The Department thus assumed that 111,000 written requests to service providers would be made for additional disclosure in the first year of the analysis. The Department assumed that the number of written requests would decrease in future years as service providers became more accustomed to the new disclosure requirements. Thus, in years two and three of the analysis, it was assumed that only five percent (about 55,500) of the total number of disclosures would be questioned. The Department averaged the number of exemption related requests over three years to obtain an average annual total of roughly 74,000 written disclosures.

Upon receipt of the written request by the responsible plan fiduciary, the service provider then has 90 days to comply with the request. If the service provider fails or refuses to comply with the responsible plan fiduciary's request in this timeframe, the exemption requires the responsible fiduciary to notify the Department of the service provider's failure or refusal. The Department estimates the number of notifications they would expect to receive as ten percent of the total number of written requests received by service providers, or nearly 11,000 the first year and 5,500 in the two succeeding years. Averaging this number of notifications over the three years resulted in an annual number of notifications of around 7,400.

The Department next estimated the total annual hour burden for the additional tasks required of plan fiduciaries under the exemption. The Department assumed that the written request to service providers would take a half hour of a fiduciary's time, resulting in a total annual hour burden of about 37,000 hours (74,000 requests × 0.5 hours). The Department next assumed that a notification to the Department of a service provider's failure or refusal to comply with a written request by the responsible fiduciary would take one hour of the responsible fiduciary's time, resulting in a total annual hour burden of 7,400 (7,400 × 1 hour). Summing the burden of these two tasks resulted in a total annual hour burden estimate for plan fiduciaries of roughly 44,000 hours. The

[31] Industry growth, and therefore the growth in the number of service providers over time, has been addressed in Exhibit 7–4. For example, in 2009 the Department has assumed that there are 12% more service providers than in 2003.

equivalent costs of these annual burden hours are about $2,070,000 ($56 in-house professional labor rate × 37,000 hours) and $783,000 ($106 in-house lawyer rate × 7,400 hours) for a total equivalent cost of around $2,850,000.

In addition to burden hours, the Department has estimated annual materials costs for plan fiduciaries to comply with the requirements of the exemption. Paper and printing costs are estimated at $0.05 per page. The Department assumed that both requests to service providers and notifications to the Department would be two pages. Since 81,300 of these requests and notifications are expected annually, the annual material cost is about $8,100 (81,300 × $0.05 × 2), plus an annual postage cost of $33,300 (83,100 × $0.41), totaling around $41,400.

These paperwork burden estimates are summarized as follows:

Type of Review: New collection (Request for new OMB control number).

Agency: Employee Benefits Security Administration, Department of Labor.

Title: Reasonable Contract or Arrangement Under Section 408(b)(2)—Fee Disclosure.

OMB Control Number: 1210–New.

Affected Public: Business or other for-profit; not-for-profit institutions.

Estimated Number of Respondents: 79,500.

Estimated Number of Responses: 1,189,000.

Frequency of Response: Annually; occasionally.

Estimated Average Annual Burden Hours: 677,000.

Estimated Average Annual Burden Cost: $651,000.

F. Federalism Statement

Executive Order 13132 (August 4, 1999) outlines fundamental principles of federalism and requires the adherence to specific criteria by Federal agencies in the process of their formulation and implementation of policies that have substantial direct effects on the States, the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government. The proposed regulation would not have federalism implications because it has no substantial direct effect on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government. Section 514 of ERISA provides, with certain exceptions specifically enumerated that are not pertinent here, that the provisions of Titles I and IV of ERISA supersede State laws that relate to any employee benefit plan covered by ERISA. The requirements implemented in the proposed regulation do not alter the fundamental provisions of the statute with respect to employee benefit plans, and as such would have no implications for the States or the relationship or distribution of power between the national government and the States.

List of Subjects in 29 CFR Part 2550

Employee benefit plans, Exemptions, Fiduciaries, Investments, Pensions, Prohibited transactions, Reporting and recordkeeping requirements, and Securities.

For the reasons set forth in the preamble, the Department proposes to amend Chapter XXV, subchapter F, part 2550 of Title 29 of the Code of Federal Regulations as follows:

SUBCHAPTER F—FIDUCIARY RESPONSIBILITY UNDER THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

PART 2550—RULES AND REGULATIONS FOR FIDUCIARY RESPONSIBILITY

1. The authority citation for part 2550 continues to read as follows:

Authority: 29 U.S.C. 1135; and Secretary of Labor's Order No. 1–2003, 68 FR 5374 (Feb. 3, 2003). Sec. 2550.401b–1 also issued under sec. 102, Reorganization Plan No. 4 of 1978, 43 FR 47713 (Oct. 17, 1978), 3 CFR, 1978 Comp. 332, effective Dec. 31, 1978, 44 FR 1065 (Jan. 3, 1978), 3 CFR, 1978 Comp. 332. Sec. 2550.401c–1 also issued under 29 U.S.C. 1101. Sec. 2550.404c–1 also issued under 29 U.S.C. 1104. Sec. 2550.407c–3 also issued under 29 U.S.C. 1107. Sec. 2550.404a–2 also issued under 26 U.S.C. 401 note (sec. 657, Pub. L. 107–16, 115 Stat. 38). Sec. 2550.408b–1 also issued under 29 U.S.C. 1108(b)(1) and sec. 102, Reorganization Plan No. 4 of 1978, 3 CFR, 1978 Comp. p. 332, effective Dec. 31, 1978, 44 FR 1065 (Jan. 3, 1978), and 3 CFR, 1978 Comp. 332. Sec. 2550.412–1 also issued under 29 U.S.C. 1112.

2. Section 2550.408b–2(c) is revised to read as follows:

§ 2550.408b–2 General statutory exemption for services or office space.

* * * * *

(c) *Reasonable contract or arrangement*—(1) *Disclosure concerning contract or arrangement.* (i) No contract or arrangement to provide services to an employee benefit plan, nor any extension or renewal of such contract or arrangement, by:

(A) A service provider who provides or may provide any services to the plan pursuant to the contract or arrangement as a fiduciary either within the meaning of section 3(21) of the Act or under the Investment Advisers Act of 1940;

(B) A service provider who provides or may provide any one or more of the following services to the plan pursuant to the contract or arrangement: banking, consulting, custodial, insurance, investment advisory (plan or participants), investment management, recordkeeping, securities or other investment brokerage, or third party administration; or

(C) A service provider who receives or may receive indirect compensation or fees, as described in paragraph (c)(1)(iii)(A)(*1*) of this section, in connection with providing any one or more of the following services to the plan pursuant to the contract or arrangement: accounting, actuarial, appraisal, auditing, legal, or valuation; is reasonable within the meaning of section 408(b)(2) of the Act and Sec. 2550.408b–2(a)(2) unless the requirements of paragraphs (c)(1)(ii) through (vi) of this section are satisfied.

(ii) The terms of the contract or arrangement shall be in writing.

(iii) The terms of the contract or arrangement (including any extension or renewal of such contract or arrangement) shall require the service provider to disclose in writing, to the best of the service provider's knowledge, the information set forth in this paragraph (c)(1)(iii) and shall include a representation by the service provider that, before the contract or arrangement was entered into (or extended or renewed), all such information was provided to the fiduciary with authority to cause the employee benefit plan to enter into (or extend or renew) the contract or arrangement (the "responsible plan fiduciary"):

(A) All services to be provided to the plan pursuant to the contract or arrangement and, with respect to each such service, the compensation or fees to be received by the service provider, and the manner of receipt of such compensation or fees. For purposes of this paragraph (c)(1)(iii):

(*1*) "Compensation or fees" include money or any other thing of monetary value (for example, gifts, awards, and trips) received, or to be received, directly from the plan or plan sponsor or indirectly (i.e., from any source other than the plan, the plan sponsor, or the service provider) by the service provider or its affiliate in connection with the services to be provided pursuant to the contract or arrangement or because of the service provider's or affiliate's position with the plan. An "affiliate" of a service provider is any person directly or indirectly (through one or more intermediaries) controlling, controlled by, or under common control with the service provider, or any officer, director, agent, or employee of, or partner with, the service provider.

(*2*) Compensation or fees may be expressed in terms of a monetary amount, formula, percentage of the plan's assets, or per capita charge for each participant or beneficiary of the plan. The manner in which compensation or fees are expressed shall contain sufficient information to enable the responsible plan fiduciary to evaluate the reasonableness of such compensation or fees.

(*3*) If a service provider offers a bundle of services to the plan that is priced as a package, rather than on a service-by-service basis, then only the service provider offering the bundle of services must provide the disclosures required by this paragraph (c)(1). The service provider must disclose all services and the aggregate compensation or fees to be received, directly or indirectly, by the service provider, any affiliate or subcontractor of such service provider, or any other party in connection with the bundle of services. The service provider shall not be required to disclose the allocation of such compensation or fees among its affiliates, subcontractors, or other parties, except to the extent such party receives or may receive 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 dollars (research or other products or services other than execution in connection with securities transactions).

(*4*) A description of the manner of receipt of compensation or fees shall state whether the service provider will bill the plan, deduct fees directly from plan accounts, or reflect a charge against the plan investment and shall describe how any prepaid fees will be calculated and refunded when a contract or arrangement terminates.

(B) Whether the service provider (or an affiliate) will provide any services to the plan as a fiduciary either within the meaning of section 3(21) of the Act or under the Investment Advisers Act of 1940,

(C) Whether the service provider (or an affiliate) expects to participate in, or otherwise acquire a financial or other interest in, any transaction to be entered into by the plan in connection with the contract or arrangement and, if so, a description of the transaction and the service provider's participation or interest therein,

(D) Whether the service provider (or an affiliate) has any material financial, referral, or other relationship or arrangement with a money manager, broker, other client of the service provider, other service provider to the plan, or any other entity that creates or may create a conflict of interest for the service provider in performing services pursuant to the contract or arrangement and, if so, a description of such relationship or arrangement,

(E) Whether the service provider (or an affiliate) will be able to affect its own compensation or fees, from whatever source, without the prior approval of an independent plan fiduciary, in connection with the provision of services pursuant to the contract or arrangement (for example, as a result of incentive, performance-based, float, or other contingent compensation) and, if so, a description of the nature of such compensation, and

(F) Whether the service provider (or an affiliate) has any policies or procedures that address actual or potential conflicts of interest or that are designed to prevent either the compensation or fees described in paragraph (c)(1)(iii)(A) of this section or the relationships or arrangements described in paragraph (c)(1)(iii)(C), (D), and (E) of this section from adversely affecting the provision of services to the plan pursuant to the contract or arrangement, and, if so, an explanation of these policies or procedures and how they address such conflicts of interest or prevent an adverse effect on the provision of services.

(iv) The terms of the contract or arrangement shall require that the service provider must disclose to the responsible plan fiduciary any material change to the information required to be disclosed in paragraph (c)(1)(iii) of this section not later than 30 days from the date on which the service provider acquires knowledge of the material change.

(v) The terms of the contract or arrangement shall require that the service provider must disclose all information related to the contract or arrangement and any compensation or fees received thereunder that is requested by the responsible plan fiduciary or plan administrator in order to comply with the reporting and disclosure requirements of Title I of the Act and the regulations, forms, and schedules issued thereunder.

(vi) The service provider shall comply with its disclosure obligations under the contract or arrangement as described in this paragraph (c)(1). Prohibited Transaction Class Exemption 2008-XX will provide relief for a responsible plan fiduciary from the prohibitions of section 406(a)(1)(C) of the Act as a result of a service provider's failure to comply with this paragraph (c)(1)(vi).

(2) *Termination of contract or arrangement.* No contract or arrangement is reasonable within the meaning of section 408(b)(2) of the Act and Sec. 2550.408b–2(a)(2) if it does not permit termination by the plan without penalty to the plan on reasonably short notice under the circumstances to prevent the plan from becoming locked into an arrangement that has become disadvantageous. A long-term lease which may be terminated prior to its expiration (without penalty to the plan) on reasonably short notice under the circumstances is not generally an unreasonable arrangement merely because of its long term. A provision in a contract or other arrangement which reasonably compensates the service provider or lessor for loss upon early termination of the contract, arrangement, or lease is not a penalty. For example, a minimal fee in a service contract which is charged to allow recoupment of reasonable start-up costs is not a penalty. Similarly, a provision in a lease for a termination fee that covers reasonably foreseeable expenses related to the vacancy and reletting of the office space upon early termination of the lease is not a penalty. Such a provision does not reasonably compensate for loss if it provides for payment in excess of actual loss or if it fails to require mitigation of damages.

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Signed at Washington, DC, this 7th day of December, 2007.

Bradford P. Campbell,

Assistant Secretary, Employee Benefits Security Administration, Department of Labor.

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