Federal Legislative & Regulatory Report

Nationwide Retirement Solutions
On Your Side

August 2010

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I. Washington Update

Congress has adjourned for its August recess and is not expected to return to work until after the Labor Day holiday. With the few weeks remaining in the 2010 legislative session, it is unlikely that there will be sufficient time to undertake many other issues, including those relating to retirement plans and benefits. However, legislation that has been proposed throughout the year may offer insights into 2011 priorities.

Wall Street Reform and Consumer Protection Act

On Wednesday, July 21, 2010, President Obama signed into law the *Wall Street Reform and Consumer Protection Act* (H.R.4173). This Act mandates more than 170 new rulemaking efforts and provides authority to federal regulators to address approximately 28 other topics. It also includes an estimated 67 studies to be carried out by numerous federal agencies.

There were certain provisions that were a concern for employer-sponsored retirement plans in earlier versions of the financial reform proposals that were addressed in the enacted legislation. For instance, retirement plans are not included in the definition of major swap participant. The Act preserves retirement plans' ability to use swaps by permitting swap dealers to enter into swaps without automatically becoming a fiduciary with respect to the plan. This Act calls for the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission to study stable value contracts to determine whether they should be regulated as swaps and, if so, issue regulations implementing their determination. "Stable value contracts" are defined so that, in the defined contribution context, the term only applies to stable value funds that are "subject to participant direction."

Another change was made in the final bill to clarify the jurisdiction of the newly created Consumer Financial Protection Bureau (CFPB) regarding retirement plan providers. Under this Act, ultimate authority for public and private sector retirement plans remains with the Departments of Treasury and Labor (DOL). CFPB has

been given the authority to initiate a request to regulate plan service providers, but this must be approved by the Treasury and DOL before proceeding.

DOL Service Provider Fee Disclosure Regulations

On July 16, service provider fee disclosure regulations under the Employee Retirement Income Security Act (ERISA) section 408(b)(2) were published in the Federal Register. These are final interim rules with a 45-day comment period and an effective date of July 16, 2011. Although state and local government retirement plans are not subject to ERISA, their sponsors often view it as a best practice.

The rules apply to pension plans covered by ERISA, including defined contribution programs. They identify the disclosures that are required to be made to plan sponsors by certain categories of service providers, including investment advisers, recordkeepers, and brokers who make investment alternatives available to a plan. These disclosures are required to be made in writing; however, they do not need to be part of a formal written contract or arrangement.

In general, the rules require the disclosures to include:

- A description of services and all direct and indirect compensation received by the service provider, its affiliates or subcontractors.
- Potential conflicts of interest for service providers that will be receiving compensation from parties other than the plan (or plan sponsor).
- Unbundled fees for providers of multiple services, to disclose the cost of recordkeeping services.

A fact sheet from the DOL may be found at www.dol.gov/ebsa/newsroom/fsimprovedfeedisclosure.html. The rules as published in the Federal Register may be found at www.dol.gov/federalregister/PdfDisplay.aspx?DocId=24028 (40 pages, 275KB).

More about this Interim Final Rule may be found in Section II of this report.

SEC Proposes to Eliminate 12b-1 Fees

On July 20, the Securities and Exchange Commission voted to propose a new rule and rule amendments that would replace rule 12b-1 under the Investment Company Act. This rule permits mutual funds to use their assets to compensate securities professionals who sell shares of the fund. The SEC proposal is intended to provide a new approach to compensate for sales, distribution and marketing expenses to:

- Protect investors by limiting fund sales charges;
- Improve transparency of fees for investors;
- Encourage retail price competition; and
- Revise fund director oversight duties.

The announcement from the SEC may be found at www.sec.gov/news/press/2010/2010-126.htm. A copy of the proposed rules can be found at www.sec.gov/rules/proposed/2010/33-9128.pdf (278 pages, 1MB). The deadline for submitting comments on the proposed rules to the SEC is November 5, 2010.

More about this proposal may be found in Section III of this report.

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II. DOL Issues Final Service Provider Fee Disclosure Regulation

There have been a number of changes over the years in the way services are provided to employee benefit plans and how service providers are compensated for these services. The complexity of these changes makes difficult for plan sponsors and fiduciaries to understand what the plan actually pays for specific services.

Generally transactions between an interested party such as plan services providers and a retirement plan would be considered a prohibited transaction under ERISA. But, section 408(b)(2) of ERISA exempts certain transactions between retirement plans and service providers that otherwise would be prohibited transactions from the prohibited transaction rules and resulting excise taxes if:

- The service contract or arrangement is reasonable,
- The services are necessary for the establishment or operation of the plan, and
- Compensation for the services must be reasonable.

Background

Under ERISA, plan fiduciaries are obligated to act prudently in selecting service providers and ensure that service providers are paid no more than reasonable compensation (direct and indirect) for their services, otherwise the plan will have engaged in a *prohibited transaction,* subject to excise taxes.

Although ERISA does not apply to government plans, governmental employee benefit plan fiduciaries may want to review this DOL regulation when formulating their own fee disclosure policies.

On July 16, 2010, the Department of Labor (DOL), as part of its three-pronged fee disclosure initiative, published an interim final disclosure regulation requiring covered service providers to disclosure certain information to responsible pension plan fiduciaries of ERISA covered defined benefit and defined contribution plans. These disclosure requirements are intended to help responsible plan fiduciaries assess the reasonableness of service contracts or arrangements, including the reasonableness of the service providers' compensation. This regulation does not apply to:

- Non ERISA plans, IRAs, Simple IRAs, Simplified Employee Pension Plans (SEPs) , non electing church or governmental plans, or
- Welfare benefit plans (separate guidance will provided at later date).

This regulation becomes effective on July 16, 2011 and applies to contracts or arrangements between covered plans and covered service providers including contracts entered into prior to July 16, 2011. Plan fiduciaries, however, must still meet their general fiduciary obligation under ERISA when selecting and monitoring all service providers, or the participant disclosure requirements under ERISA. The following summary outlines some of the major provisions of the final DOL service provider fee disclosure regulation.

Definitions

Responsible plan fiduciary

Under the regulation, a responsible fiduciary is defined as a fiduciary with authority to have the plan to enter into, or extend or renew, a contract or arrangement for providing services to a covered pension plan.

Covered service providers

Covered service providers are service providers who expect to receive at least $1,000 during the term of the service contract in direct or indirect compensation from a covered plan for services provided by the covered service provider, an affiliate or subcontractor for:

- ERISA fiduciary services or registered investment advisory services subject to the Investment Advisers Act of 1940 or any State law. This category is split into three subsections.
    1. ERISA fiduciaries providing services directly to the covered plan;
    2. ERISA fiduciaries providing services to an investment contract, product, or entity that holds plan assets and in which the covered plan has a direct equity investment;* and
    3. Investment advisers that are registered under either the Investment Advisers Act of 1940 or State law, and that are providing services directly to the covered plan.
- Recordkeeping or brokerage services to participant-directed defined contribution plans that offer a platform or similar mechanism related to these services, excluding brokerage windows, self-directed brokerage accounts or similar arrangements; or
- Other services which service providers expect receive indirect compensation from third parties – including commissions, soft dollars , finder's fees and 12b-1 fees – for investment advice services, accounting, actuarial, appraisal, auditing, legal, or recordkeeping, services or other investment brokerage, third party administration, or valuation services, or consulting services.**

* These service providers are ERISA fiduciaries because they provide services to a plan asset investment vehicle, instead of providing services directly to the covered plan. They also have an additional obligation to disclose compensation information about the investment vehicle for which they serve as a fiduciary. This subcategory includes fiduciaries to the initial-level investment vehicle in which the covered plan makes a direct equity investment and which holds plan assets, but does not include fiduciaries to that initial vehicle's underlying investments.

** Consulting services are services related to the development or implementation of investment policies or objectives or the selection or monitoring of service providers or plan investments.

The final rule clarifies that a "covered service provider" does not include a mere provider of services to an investment contract, product, or entity (regardless of whether or not the investment contract, product, or entity holds assets of the covered plan). These providers are not covered under this regulation.

Affiliates of covered service providers

For purpose of this regulation an affiliate of a covered service provider is a person or entity that is directly or indirectly (through one or more intermediaries) controls, is controlled by or is under common control with the service provider or is an officer, director, agent, employee or partner of the covered service provider.

Responsibilities of Covered Service Provider

A covered service provider is directly responsible to the covered plan for providing services under the contract and making the disclosures required under the regulation to the responsible plan fiduciary – even when some or all of these services are performed by an affiliate or subcontractor.

Covered Service Provider Compensation

Service provider compensation is defined as money and any other thing of monetary value that the service provider or its affiliates receive directly or indirectly for services and financial products provided to the plan including but 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 agent fees; and
- Shareholder servicing fees, 12b-1 fees, soft dollar payments, float income, fees deducted from investment returns, fees based on a share of gains or appreciation or plan assets, and fees based on a percentage of plan assets.

Compensation excludes non monetary compensation valued at $250 or less in the aggregate, during the term of the contract.

Types of Service Provider Compensation

There are two types of service provider compensation:

Direct Compensation is compensation that a covered service provider, affiliate or subcontractor receives directly from the plan. Direct compensation may be disclosed either in the aggregate or by service that the covered service provider, affiliate or subcontractor "reasonably expects" to receive for services provided to the plan.

Indirect Compensation is compensation received from any source other than the covered plan, the plan sponsor, the covered service provider, an affiliate or subcontractor. The disclosure must include a description of services being provided and the identification of the payer of the indirect compensation.

If a covered service provider, affiliate or subcontractor expects to provide both fiduciary services and services as a registered investment adviser, the service provider disclosure must include a statement reflecting both these roles.

Compensation for Termination of Service Contracts

Contracts or arrangement are not considered reasonable if the plan cannot terminate the contract without penalty to the plan, on reasonably short notice, to prevent the plan from being locked into a disadvantageous arrangement.

Reasonable compensation paid to a service provider for early contract termination, such as a minimal fee in a service contract that is charged to recover start-up costs, is not considered a penalty for this purpose.

Disclosure Requirements for Recordkeeping Services

Unlike the proposed rule, the final rule requires separate disclosures for both direct and indirect compensation that a covered service provider, affiliate or subcontractor reasonably expects to receive for recordkeeping services.

If recordkeeping fees are to be provided in whole or in part without explicit compensation or if those services are offset or rebated based on other compensation received by the covered service provider, an

affiliate or a subcontractor, the covered service provider must provide a reasonable and good faith estimate of the cost to the plan for these recordkeeping services explaining the methodology and assumptions used to prepare the estimate for these services or the prevailing rates charged for similar recordkeeping services for a plan with a similar number of covered participants and beneficiaries.

Investment Disclosure Obligations of Fiduciaries

Although investment products are not covered under the final rule, certain disclosures must be made for each investment contract or product or entity that holds plan assets for which fiduciary services will be provided to the plan under a service contract unless this information is disclosed by a covered service provider providing record keeping services.

The investment fiduciary must, for each investment contract, product or entity that holds plan assets in which the plan has a direct equity investment, describe:

- Any compensation that will be charged directly against the amount invested for such as sales loads, sales charges, deferred sales charges, redemption fees, surrender fees, exchange fees, account fees and purchase fees;
- Annual operating expenses (expense ratio if the return is not fixed); and
- Ongoing expenses such as wrap fees, mortality and expense fees for the plan's investment.

Covered service providers may comply with investment related disclosure rules by providing the plan fiduciary with the issuer's current disclosure materials for the designated investment that includes the information, described above, provided these materials are:

- Regulated by a State or federal agency and
- The covered service provider believes these materials to complete and accurate.

Disclosure Requirements

The terms of the service contract are not required to be in writing, but the covered service provider must disclose written information including:

- A description of all services to be performed, excluding non-fiduciary services;
- A statement that the covered service provider, affiliate or subcontractor reasonably expects to provide ERISA fiduciary services to plan or to the investment contract or product that holds plan assets and in which the covered plan has a direct equity investment. If applicable, the covered service provider must provide a statement that the covered service provider, affiliate or subcontractor will provide or reasonably expects to provide services directly to the plan as an investment adviser registered under the Investment Advisers Act of 1940 or State law; and
- Disclosures to the responsible plan fiduciary of all compensation that will be received either directly from the plan or indirectly from parties other than the plan or plan sponsor.

Any description or estimate of compensation must contain enough information so that the plan fiduciary can evaluate if the compensation is reasonable. Compensation may be disclosed as a monetary amount, by formula, percentage of the plan assets, or as a per capita charge for each participant or beneficiary. If compensation cannot be reasonably disclosed otherwise, any other reasonable method may be used to disclose compensation.

The covered service provider must also explain how:

- Compensation will be paid – if fees will be billed to the plan, deducted from plan accounts, or reflected in the plan's investment account, and
- Any prepaid fees will be calculated and refunded when the contract terminates.

The final rule eliminates the proposed rule's requirement that service providers disclose a written narrative describing relationships or interests that may cause conflicts of interest for the service provider in performing plan services.

Ongoing Disclosure Obligations

Ongoing disclosure obligations are required for:

Information Changes: During the term of the contract, a service provider must disclose changes to previously furnished information, such as investment information, no later than 60 days before such changes are to be made.

Reporting and Disclosure Requirements: Service providers must disclose within 30 days after receiving a written request for compensation or other information related to the contract or arrangement that is requested by the responsible plan fiduciary or plan administrator in order to comply with ERISA's reporting and disclosure requirements.

Note: The disclosure requirements under the final regulation do not overlap the disclosures required on Schedule C of the annual IRS Informational Return 5500.

Timing for Providing Disclosures

Covered service providers must make required disclosures to the responsible plan fiduciary prior to the date the service contract is entered into, extended or renewed, so that the responsible plan fiduciary has enough time to evaluate the service contract using a prudent process before finalizing it.

Failure to Satisfy Disclosure Requirements

If the contract or arrangement does not satisfy the disclosure requirements of the final regulation, the contract will not be considered reasonable and will not qualify for relief from ERISA prohibited transaction rules and its excise taxes.

Correction Remedies

If the covered service provider, acting in good faith, makes an error or omission in disclosing required information, will not be in violation of the prohibited transaction rules, IF the covered service provider discloses the correct information to the responsible plan fiduciary no later than 30 days after discovering the error or omission.

For plan fiduciaries who unknowingly enter into deficient contracts with service providers that failed to comply with their disclosure obligations, the final regulation provides a class exemption from ERISA's prohibited transactions if:

- The service provider fails to comply with the plan fiduciary's written request for appropriate disclosures within 90 days of the request, and
- The plan fiduciary notifies the DOL within 30 days of the service provider's disclosure failure. At such time the responsible plan fiduciary will be covered by the exemption but the covered service

provider will continue to be engaging in a non-exempt prohibited transaction until the service contract is terminated or the disclosure failure is cured.

The DOL has provided a sample letter the plan fiduciary can use to notify the DOL that service provider has not made the necessary disclosures.

State Law Pre-emption

Nothing in this regulation supersedes any provisions of State law that govern disclosures by service providers described in the regulation unless State law would prevent the application of these requirements.

The DOL participant fee-disclosure requirements are expected to be released later this year. In the meantime, the DOL is accepting additional public comments on this rule until August 30, 2010.

Electronic comments may be submitted to e-ORI@dol.gov, or by using the Federal eRulemaking portal www.regulations.gov (following instructions for submission of comments). Persons submitting comments electronically are encouraged not to submit paper copies.

Paper comments (preferably three copies) may be submitted to:

Office of Regulations and Interpretations, Employee
Benefits Security Administration
Room N-5655
U.S. Department of Labor
200 Constitution Avenue, NW., Washington, DC 20210,
Attention: 408(b)(2) Interim Final Rule

Reference Material

DOL Interim Final Rule
www.dol.gov/federalregister/PdfDisplay.aspx?DocId=24028 (40 pages, 275KB)

Fact Sheet
www.dol.gov/ebsa/newsroom/fsimprovedfeedisclosure.html

Model Delinquent Service Provider Notice
www.dol.gov/ebsa/DelinquentServiceProviderDisclosureNotice.doc (2 pages, 27KB)

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III. SEC Proposes to Replace 12b-1 Fees

According to the Securities and Exchange Commission (SEC), many investors do not know that 12b-1 fees are being deducted from their accounts, who receives these fees or that such costs directly reduce the value of their mutual fund shares. These fees which totaled a few million dollars in 1980 skyrocketed to 9.5 billion dollars in 2009.

Retirement plans have become one of the major avenues investors use to purchase mutual funds. 12b-1 fees are often used to pay to have the fund included on third-party platforms for purchasing mutual funds through employer-sponsored retirement plans and fund supermarkets. They have assumed many of the recordkeeping and ongoing shareholder servicing and support functions for the funds. These services are often paid for, at least partially, through 12b-1 fees. Funds offered as investment options in defined contribution retirement plans also may pay 12b-1 fees (often 50 basis points or more annually) to the plan administrator to offset some of the costs of servicing shareholders who invest through those plans.

What are Mutual Fund 12b-1 Fees?

Mutual fund companies are permitted to charge 12b-1 fees, to cover the costs of marketing and selling mutual fund shares. These fees are deducted from the mutual fund to pay securities professionals who sell shares of the fund.

Last month, the Securities and Exchange Commission (SEC) proposed a new rule and rule amendments that would replace rule 12b-1 under the Investment Company Act of 1940 which permits registered open-end management mutual fund companies to use fund assets to pay for the cost of promoting sales of fund shares.

The proposed rule and amendments would continue to allow:

- Mutual funds to bear promotional costs within prescribed limits, and
- Preserve the funds ability to provide investors with alternatives for paying sales charges (*e.g.,* at the time of purchase, at the time of redemption, or through a continuing fee charged to fund assets).

The current rule 12b-1 would be replaced with the new 12b-2 proposed rules and would also apply to funds used as investment vehicles for insurance company separate accounts that offer variable annuities or life insurance contracts. The underlying funds would be treated like other mutual funds.

The SEC proposal is designed to:

Protect Investors by Limiting Fund Sales Charges

When an investor buys shares of a mutual fund, there is frequently a sales charge (or load) that compensates the broker-dealer who helped sell the shares. Typically, different "classes" of a fund involve different sales charge arrangements – front end charges, ongoing charges or rear end charges. Front end sales changes, are paid from amounts the investor uses to buy fund shares. Rear end charges are paid when the investor cashes out of the fund.

An "asset-based" sales charge is paid over time out of the fund's assets instead of from each individual investor's account. Existing rules currently limit asset-based sales charges to 0.75 percent per year, with no limit on how long a fund can pay these charges if the fund continues to make significant new

sales to investors. Consequently, shareholders may pay asset-based charges through the fund for as long as they own the fund.

The SEC proposal would restrict these "ongoing sales charges" to the highest fee charged by the fund for shares that have no ongoing sales charge. For example, if one class of the fund charges a 4 percent front-end sales charge, another class could not charge more than 4 percent in total to investors over time. The fund would have to keep track of how long investors have been paying ongoing sales charges.

Separately, funds could continue to pay 0.25 percent (25 basis points) per year out of their assets for distribution activities such as marketing and service fees, for expenses such as advertising, sales compensation, participation on a distribution platform such as a fund supermarket, paying trail commission to broker dealers or paying retirement plan administrators for the services they provide to participants which relieve the fund from providing such services. The funds (including no-load funds) may use the marketing and service fee to pay for shareholder call centers, compensation of underwriters, advertising, printing and mailing of prospectuses to shareholders and other traditional distribution activities. The marketing and service fee would be specifically identified and fully disclosed in the fund prospectus fee table as a type of operating expenses. Any charges in excess of 25 basis points would be considered an asset-based sales charge and subject to the overall sales load limitations.

Improve Transparency of Fees for Investors

Currently sales charges and 12b-1 fees are not typically disclosed on investor confirmation statements. The SEC proposal would require the fund to identify and more clearly disclose distribution fees. The fund would have to disclose any "ongoing sales charges" and any "marketing and service fees" in the mutual fund's prospectus, shareholder reports and investor transaction confirmations. Transaction confirmations also would have to describe the total sales charge rate that an investor will have to pay.

These requirements are intended to:

- Make the confirmation a more complete record of the transaction;
- Help investors in mutual fund securities be more fully aware of the sales charges they pay; and
- Assist investors in verifying whether they paid the correct sales charge identified in the fund's prospectus.

The proposed rule would require disclosures related to callable debt securities to inform investors that the bond may be called on a date earlier than the date specified on the confirmation.

Encourage Retail Price Competition

All broker-dealers selling mutual fund shares today must sell those shares under terms established by the fund and disclosed in its prospectus. Consequently dealers cannot compete with each other by reducing sales charges. To foster more competition among broker-dealers, the SEC proposal would:

- Let broker-dealers establish their own sales charges, tailor them to different levels of shareholder service, and charge shareholders directly, like commissions are charged on securities such as common stock, and
- Prevent funds that rely on this exemption from deducting other sales charges from fund assets for that class of shares. This restriction would prevent double-charging.

Revise Fund Director Oversight Duties

The responsibility of mutual fund board of directors' would change under the proposal. Currently, before using fund assets to pay for fund distribution expenses, a fund must adopt a written plan describing the arrangement. The fund's board of directors must initially approve and annually re-approve the plan. The SEC proposal would:

- Set automatic limits on fund fees and charges, and
- Eliminate the need for fund directors to explicitly approve and re-approve fund distribution financing plans giving fund directors more time to devote to other matters.

Directors would still have responsibility for overseeing ongoing sales charges and marketing and service fees in the same manner that they oversee other fund expenses, subject to their general fiduciary duties. The SEC believes that these proposed rules would complement the DOL's fee disclosure initiative. (See preceding article.)

Comments Requested

The SEC is soliciting comments on its proposal. Comments must be received on or before November 5, 2010, using **only** one of the following methods:

Electronic Comments Refer to File Number S7-15-10 in the subject line.	Go to www.sec.gov/rules/proposed.shtml; Send an e-mail to rule-comments@sec.gov.; or Use the Federal eRulemaking Portal (www.regulations.gov). Follow the instructions for submitting comments.
Paper comments Refer to File Number S7-15-10.	Send paper comments in triplicate to Elizabeth Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090

Reference Material

Proposed Regulation
www.sec.gov/rules/proposed/2010/33-9128.pdf (278 pages, 1MB)

Media Release
www.sec.gov/news/press/2010/2010-126.htm

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IV. Keeping watch

You can find the most recent information on issues affecting governmental defined contribution plans, plan sponsors and plan participants on the Employer page of our plan Web site, NRSforu.com. In addition, we report guidance on legislative and regulatory activity relevant to government sector defined contribution plans through:

- *Federal Legislative and Regulatory Report* — distributed monthly and posted on the Legislative / Regulatory tab on the Employer section of NRSforu.com. It's available online and for download.
- *Plan Sponsor Alerts* — published as needed to announce breaking news, and distributed by e-mail and posted in the Plan Sponsor Corner of NRSforu.com.

About this report

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Albrecht is a member of American Society of Pension Professionals and Actuaries (ASPPA), currently serving on its Government Affairs Committee, is past chair of the ASPPA Tax Exempt and Government Plans Subcommittee and is a subject matter expert (SME) for the ASPPA Education and Examinations Committee. She is a current contributor to Aspen Publisher's "457 Answer Book."

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Beasley serves on the Education and Communication Committee for the Profit Sharing / 401k Council of America and is a member of the National Association of Government Defined Contribution Administrators.

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