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Second in a Series

The DOL's 408(b)(2) Regulation: Impact on Registered Investment Advisers (RIAs)

By Fred Reish and Bruce Ashton

This is one of a series of bulletins about the impact on covered service providers of the Department of Labor's (DOL) "interim final" regulation under ERISA §408(b)(2). We have previously sent bulletins about the changes between the proposal and this final regulation [http://www.reish.com/publications/pdf/DOLfinalfeedisc408(b)(2).pdf] and about the general provisions of the regulation [http://www.reish.com/publications/pdf/408(b)(2)regoverview.pdf]. This Bulletin focuses on the impact of the regulation on independent registered investment advisers (RIAs) that provide nondiscretionary advisory services (as opposed to discretionary investment management services) to plan fiduciaries. (By "independent," we mean an RIA that is not affiliated with a broker-dealer, mutual fund management complex, recordkeeper or other entity that provides services to plans or receives compensation from plans.)

Background

The new regulation provides guidance under ERISA and the Internal Revenue Code prohibited transaction exemptions which permit reasonable contracts or arrangements between plans and service providers. (For the sake of simplicity, we will refer to these as "arrangements," since the statutory exemption and the regulation relate to service arrangements and do not require formal contracts between the parties.) Under the prohibited transaction rules, such arrangements are prohibited unless the arrangement and the compensation paid to the service provider are "reasonable."

The 408(b)(2) regulation provides guidance on what is a "reasonable" arrangement. It does so by requiring covered service providers to disclose specified—and important—terms of the arrangement in order to give fiduciaries (the "responsible plan fiduciary," a defined term) the information necessary to determine whether the arrangement is exempt from the prohibited transaction restrictions.[1]

Service providers that fail to comply will engage in prohibited transactions, which result in excise taxes under the Code, and a requirement to correct the violation, which may mean refunding the service provider's compensation, as well as interest on that money. (In addition, if the DOL recovers the money for the plan, an additional 20% penalty may be imposed.)

DOL Speaks: The 2010 Employee Benefits Conference
September 20-21, 2010

Fred Reish and Bruce Ashton will both be participating in this Conference, jointly sponsored by the US Department of Labor, the American Society of Pension Professionals & Actuaries (ASPPA), the Society for Human Resource Management and (SHRM) and the American Bar Association Joint Committee on Employee Benefits (JCEB). The program will feature top officials from the DOL national and regional offices, who will provide updates on current regulatory and enforcement initiatives of the EBSA, and private sector speakers presenting industry and plan sponsor perspectives. Among the topics to be discussed will be 408(b)(2), with Fred as a featured speaker, Plan Governance issues, in which Bruce will participate, and other fiduciary issues, as well as developments in health care reform. For further information and to register for the conference, visit the ASPPA website at www.asppa.org and click on "conferences."

Applicability

In our last Bulletin, we described the terms of the regulation in detail. Nevertheless, we are providing a short summary here to assist the reader.

Covered Plans

The regulation applies to "covered plans," *i.e.*, all ERISA-governed retirement plans other than SEP IRAs and SIMPLE IRAs. (Individual retirement accounts are excluded since they are not ERISA plans.) This means that 401(k) plans, ERISA-covered 403(b) plans, defined benefit pension plans, and non-participant directed profit sharing plans, among others, are subject to the regulation. (This Bulletin, however, focuses on the application of these rules to participant-directed 401(k) and ERISA-covered 403(b) plans.)

[1] ERISA §406(a)(1) says that a "fiduciary with respect to a plan shall not cause the plan to enter into a transaction, if he knows or should know that such transaction constitutes a direct or indirect…(C) furnishing of goods, services or facilities between the plan and a party in interest." §408(b)(2) provides the exemption from this prohibition. Even though the focus is on the fiduciary, under the new regulation, the party charged with engaging in the prohibited transaction for failure to make adequate or proper disclosure is the service provider.

COMMENT: While there are several categories of plans that are not covered by the regulation, such as governmental and non-ERISA 403(b) arrangements and plans subject to the Internal Revenue Code that are not subject to ERISA, the new regulation may be a standard with which service providers want to comply for all of their retirement plan clients. There are several reasons for this.

- First, the laws of some states are virtually identical to ERISA, and it is not hard to imagine that a state court might look to ERISA and the regulations under ERISA to determine compliance with the state law.
- Second, service providers that serve multiple markets may find it more cost-effective and efficient to establish one disclosure regimen rather than trying to determine when the disclosures are required and when they are not.
- Third, the requirement of §408(b)(2) and the parallel provision in Code §4975(d)(2) is that arrangements between plans and service providers are prohibited unless they are "reasonable." That is, the ERISA and Code statutory prohibitions apply to plans and circumstances not covered by the regulation—but there is no guidance for compliance in those cases. Even though the specific requirements of the new regulation do not apply, courts may apply some or all of its criteria in determining whether a prohibited transaction exists.

Covered Service Providers

The regulation applies to "covered service providers" that reasonably expect to receive $1,000 or more in direct or indirect compensation (apparently over the life of the contract, though this is not altogether clear) and that provide "covered services."

For purposes of this Bulletin, there are three categories of services that are the most relevant to independent RIAs:

- Services provided directly to a plan as a fiduciary under ERISA §3(21), which would generally include an RIA providing advisory services to a plan or participants in a plan under §3(21)(A)(ii);
- Services provided directly to a plan as an investment adviser registered under the Investment Advisers Act of 1940 or state law, which would include RIAs providing services that might not constitute fiduciary services;
- Consulting and investment advisory services if the service provider reasonably expects to receive "indirect compensation" (as defined in the regulation). (There are other types of services included in this category that are not relevant here.) "Consulting" services are those that relate to the development or implementation of investment policies or objectives or the selection or monitoring of service providers or plan investments. Arguably, these may be rendered in a manner that they are non-fiduciary services, which presumably accounts for the inclusion of this category of "covered service."

Impact on RIAs: There can be no doubt that RIAs are "covered service providers" under the regulation. They fall into at least two – and possibly all three – of these categories:

- If they provide "direct" investment advice (discretionary or nondiscretionary) as defined under ERISA, they are fiduciaries under ERISA and are in the first group.
- Even if they do not provide fiduciary investment advice, but are registered under the '40 Act or an equivalent state law and are providing services covered by that registration, they come under the second group.
- And, if they receive indirect compensation and provide advisory services or the specified types of consulting services – such as assistance with the development of a plan's investment policy, help with the selection or monitoring of the recordkeeper or providing information to assist the fiduciaries in monitoring a plan's investments – they would fall into the third group.

We are concerned that the regulation may cover a significant number of unsuspecting RIA investment mangers who manage pooled funds such as profit sharing or pension plans, but who are not otherwise involved in the retirement plan community. We have already encountered several such cases.

There is another category of fiduciary service provider that is covered by the regulation—and that, in some cases, may cause RIAs to be covered service providers. This is an entity that provides services as an ERISA fiduciary to an investment contract, product, or entity (i) that holds plan assets and (ii) in which the plan has a direct equity investment. This would include, for example, managers of collective trusts, certain hedge funds and private equity partnerships.

Impact on RIAs: An RIA that provides investment advisory or management services to such a fund or investment vehicle (for example, a collective trust), additional disclosures are required. Since these additional disclosures do not apply to the independent RIA in the normal course, however, we have not described those requirements in this Bulletin.

Specific Requirements

1. *Disclosure Must Be in Writing*

The regulation requires a covered service provider to disclose specified information to the "responsible plan fiduciary" (a defined term) in writing. While the proposed regulation specified that there had to be a written contract or arrangement between the plan and the service provider, the "contract" requirement has not been carried over into the final regulation. Since compliance with the '40 Act already requires that written service agreements meet specified requirements, this change from the proposed regulation would appear to have little practical impact. Also, from a risk management perspective, we recommend that all service providers to ERISA plans have written services agreements detailing the services they are providing and limiting their responsibilities to those services.

2. Compliance Effective Date

The regulation requires that service providers comply with the disclosure requirements for all covered plans before July 16, 2011. This means that, prior to that date, the disclosures will need to be given to all of the RIA's clients, as well as to all new, or extended or renewed contracts entered into after that date. Thus, there are no "grandfathered" clients to whom the disclosures will not need to be made.

Impact on RIAs: During the "transition period" – that is, between now and the compliance effective date – RIAs may develop two approaches to making the disclosures. For new clients, they should develop service agreements that comply with the disclosure rules of the regulation. We say this for two reasons: first, we believe that the most efficient way for RIAs to deliver the disclosures will be through a service agreement; second, from a risk management perspective, having a signed agreement that contains or specifically references the written disclosures will provide needed proof that the disclosures were made.

For existing clients (if the RIA chooses not to enter into a new agreement with those clients), a written disclosure notice could be used. Thereafter, as agreements are renewed, extended or modified because of changes in the terms of the engagement, it would make sense to use the new form of agreement. Of course, if practical, an alternative might be just to develop a new contract form and ask all existing clients to sign the new form.

It would also appear to be most efficient to begin developing a modified service agreement now and begin using it as soon as possible to cut down on the number of clients to which the disclosure notice would need to be provided.

3. Services

The regulation requires the service provider to describe the services it will provide under the contract. The regulation does not specify how the services are to be described, indicating only that the level of detail will vary depending on the needs of the responsible plan fiduciary. And though the format of the disclosure is not specified, the DOL has requested comments on whether it should amend the regulation to require service providers to give a short (*i.e.*, one or two page) summary disclosure to give "a roadmap for the plan fiduciary describing where to find the more detailed elements of the disclosures required by the regulation." (*See* Preamble to the interim final regulation.)

Impact on RIAs: Based on our experience, independent RIAs that already have an ERISA-specific service agreement usually spell out their services in considerable detail. Indeed, from a risk management perspective, we believe this is important to make it clear to the plan exactly what services the RIA will provide – and either explicitly or by implication, the services that it will not provide. RIAs should also describe the scope and extent of their fiduciary services in their agreements, and provide that the fiduciary standard applies only to those services. For RIAs that do not have ERISA-specific agreements, this requirement will have a more significant impact and may require a complete re-writing of their contracts.

Some RIAs may seek to comply with portions of the disclosure obligation by providing Part II of their Forms ADV and incorporating the Forms by reference. Under the regulation, this appears to be acceptable, though the DOL may add other requirements later on. In our view, we believe it would be appropriate (if not now required) to give the fiduciary an indication of where to look for relevant information in the related documents. Having said that, in our experience most ADVs lack adequate disclosures for 408(b)(2) purposes.

Note that if an RIA provides investment advisory services for a model or other vehicle that is used as the QDIA in a plan, the RIA will probably be providing services as a fiduciary under ERISA and must provide the disclosures related to that service.

4. Compensation

The covered service provider must describe the direct and indirect compensation to be received by the service provider and its affiliates and subcontractors. Direct compensation means "compensation" (*i.e.*, anything of monetary value, such as money, gifts, awards and trips, but excluding non-monetary items of $250 or less received during the term of the contract or arrangement) that is received directly from a plan. Indirect compensation is "compensation" that is received from any source other than the plan, the plan sponsor, the covered service provider, an affiliate of the service provider or a subcontractor of the service provider. Note that compensation paid by the plan sponsor is neither direct nor indirect and thus is not technically required to be disclosed.

For indirect compensation, the regulation also requires identification of (i) the services for which it will be received and (ii) the payer of the indirect compensation. The latter requirement – identification of the payer of the indirect compensation – is a new requirement, not found in the proposed regulation. Effectively, this requirement partially replaces the somewhat unworkable provision of the proposed regulation to disclose relationships and conflicts of interest.

Note that the definition of compensation includes both money and "any other thing of monetary value." For non-monetary items, the proposal does not specify how to disclose the value or cost. However, as a general premise, service providers must disclose whether compensation is a dollar amount, a formula based on plan assets, a per participant charge or all of the above. Note that the requirement includes compensation received by affiliates and subcontractors of the service provider.

The regulation also requires that a service provider disclose the manner of payment, *e.g.*, whether it will bill the plan, deduct fees from plan accounts or reflect a charge against the plan investments.

Finally, there is a requirement to disclose any compensation the service provider reasonably expects to receive in connection with termination of the contract (*e.g.*, a surrender charge) and how

prepaid amounts will be calculated and refunded upon termination of the contract (for example, if an RIA charges in advance for a particularly period, *e.g.*, quarterly).

There are a number of additional disclosures applicable to recordkeepers, brokers and certain other plan fiduciaries (that manage certain types of investments in which a plan may invest), but those requirements would not ordinarily be applicable to independent RIAs and are not discussed in this Bulletin.

Impact on RIAs: In our experience, most RIAs with ERISA-specific agreements already provide adequate disclosure of the direct compensation they receive. And, in many cases, those who receive indirect compensation disclose that fact and the fact that they offset such compensation against the fees they charge. (It would be a prohibited transaction under ERISA §406(b)(3) if they do not offset indirect payments related to recommended investments where they are providing fiduciary investment advice. That prohibition is not exempted by the final regulation.)

The change that will affect even these RIAs, however, is the requirement to disclose the amount or formula and the payer of the indirect compensation. Thus, in cases where an RIA has, in the past, made generic disclosure of indirect compensation, but without disclosing the amount of, or formula for, the compensation, and the entity from which the compensation will be paid, more detailed disclosures will be required. In our experience, this type of compensation is not usual for independent RIAs, but does occur occasionally (*e.g.*, an RIA firm that is dually licensed as a broker-dealer may receive 12b-1 fees).

The disclosure requirements apply to all covered services and to all compensation received by an RIA and/or an affiliate, both direct and indirect. As a result, RIAs will need to either cover all of the services in a single contract or enter into separate contracts (with separate disclosures) for each such service. For example, RIAs that have a separate charge for managing a model asset allocation portfolio (often consisting of the plan's core investments) will need to separately describe and disclose that service and the compensation for that service. (Receiving compensation for managing model portfolios may present non-exempted, prohibited transaction issues where, for example, advice is given to participants to invest in those models)

RIAs that are able to deduct their fees from the plan will also need to be careful to comply with – or structure the arrangement to avoid application of – the SEC's recently amended "deemed custody" rule.

The final requirement, regarding termination payments and prepaid amounts, will have varying impacts. In our experience, RIAs do not impose a termination charge and most are paid in arrears for their services. However, for those RIAs that are paid in advance, they will need to include a description of the proration and refund of the advance payment if the contract is terminated before the entire advance payment is earned. Again, in our experience, most RIA contracts already do this.

5. *Fiduciary Status*

The regulation requires a service provider to disclose whether it, or an affiliate or subcontractor, will provide any services to the plan as a fiduciary as defined under either ERISA §3(21)(A) or as an investment adviser registered under the '40 Act (or state law). If both, then both must be disclosed.

Impact on RIAs: RIAs should be careful in how this statement is made, because they may be providing both fiduciary and non-fiduciary services. For example, an RIA would typically not be a fiduciary for participant investment education, provider searches, and consulting on plan design (*e.g.*, automatic enrollment). Thus, as a practical matter, the RIA agreement should distinguish between which are fiduciary services and which are not for risk management purposes, especially since the standard of care for each type of service may vary; and it may be possible for the RIA to obtain an agreement to limit its potential liability for errors in performing non-fiduciary services. This may require some redrafting of RIA agreements.

6. *Other Disclosure Issues*

Changes in Information: A service provider must disclose any change to the required information as soon as practicable but in any case no later than 60 days from the date on which the service provider acquires knowledge of the change. Note that there are two changes in this requirement from the proposed regulation: the requirement that the change must be "material" has been dropped; and the time period has been extended from 30 to 60 days.

There is a provision that allows for additional time in extraordinary circumstances, but it should probably not be relied on unless absolutely necessary.

Impact on RIAs: This may have minimal impact on independent RIAs since they are already required to amend their Form ADV and provide it to clients under the '40 Act in the event of a material change. However, given the fact that the materiality standard has been eliminated, RIAs will need to be more diligent in monitoring changes in information and providing disclosures to their clients.

Reporting and Disclosure Information: The regulation requires a service provider to disclose, upon written request, any other information relating to compensation received in connection with the arrangement, if it is required for the plan to comply with the reporting and disclosure requirements of ERISA and the regulations, forms and schedules issued thereunder. The information must be provided not later than 30 days after receipt of a written request from the responsible plan fiduciary or plan administrator unless the disclosure is precluded due to extraordinary circumstances beyond the service provider's control. In that case, the information must be disclosed as soon as practicable. This would probably arise in the context of reporting information on Schedule C to the Form 5500 for large plans (*i.e.*, plans with 100 or more participants), but the requirement is not limited to that Schedule or Form.

Impact on RIAs: This condition should not pose a problem for independent RIAs, unless, possibly, they receive indirect compensation. However, if they do receive indirect compensation related to plans that file a Schedule C, RIAs will likely be asked for that information.

Disclosure Errors: The final regulation includes a welcome addition: it specifies that no arrangement will be considered unreasonable – *i.e.*, a prohibited transaction – solely because the service provider makes an error or omission in disclosing the information so long as two requirements are met. First, the service provider must have been acting in good faith and with reasonable diligence; second, the service provider must disclose the correct information to the responsible plan fiduciary as soon as practicable, but not later than 30 days from the date on which the service provider knows it made the error or omission. This will protect service providers from innocent mistakes that otherwise could have caused their contract to constitute a prohibited transaction.

Conclusion

The final regulation contains a number of helpful changes from the proposal issued at the end of 2007. In our experience, for most independent RIAs, only a limited number of changes in procedures and contracts will be needed to satisfy these new requirements.

Any tax advice contained in this communication (including any attachments) is neither intended nor written to be used, and cannot be used, to avoid penalties under the Internal Revenue Code or to promote, market or recommend to anyone a transaction or matter addressed herein.

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