REISH & REICHER
A PROFESSIONAL CORPORATION
ATTORNEYS AT LAW

BULLETIN

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The Impact of 408(b)(2) on Service Providers

We have been actively working with our service provider to create or update their service agreements for 408(b)(2) compliance. Most of those service provider clients fall into five categories:

- Broker-Dealers.
- Recordkeepers.
- Registered Investment Advisers (RIAs).
- Third party administrators (TPAs).
- Banks and trust companies.

And, in doing the 408(b)(2) work for these clients, we typically divide their services (and the agreements) into two distinct categories:

- ERISA "fiduciary" services – by virtue of providing investment advice or management.
- ERISA "non-fiduciary" services – by virtue of providing general consulting, brokerage, administrative or educational support, but not in a way that confers "fiduciary status" under ERISA.

As a practical matter, any covered service provider that has not implemented the 408(b)(2) disclosures by July 16th will be precluded from providing services to its ERISA-governed covered plans.

The purpose of this bulletin is to briefly discuss some of the issues that we are encountering with each type of covered service provider.

Broker-Dealers

The 408(b)(2) disclosures for broker-dealers are the most daunting. This is because of the variety and complexity of their relationships with ERISA plans. For example, broker-dealers may have hundreds or thousands of ERISA clients with which they have never used service agreements or provided ERISA disclosures. So, in many cases, they are starting from the ground up.

Most Influential People in Defined Contribution

Fred Reish, founder and shareholder in the firm, was named as one of the 10 most influential persons in the 401(k) industry by a survey conducted by The 401kWire. He was the only practicing attorney listed in the top 10.

Fred has been included in the top 10 in every year of the survey—which allows participants in the retirement plan industry to register their views through a voting process.

We believe that the recognition is based on the quality, depth and breadth of our ERISA legal practice, as well as Fred's activities as a writer, speaker and commentator on developments and trends in the retirement industry...and particularly for 401(k) plans.

To view the complete list, please click on the following link: http://www.401kwire.com/influencers/default.asp?bhcp=1

In doing our work for them, a few of the key issues are:

- Identification of all of their ERISA accounts. Some broker-dealers have not historically tracked all of their accounts that serve ERISA plans. Obviously, in order to comply with 408(b)(2), the broker-dealer needs to have a list of all of its ERISA accounts and needs to have contact information for the responsible plan fiduciary.

  In our experience, broker-dealers provide at least the following five investment vehicles for ERISA plans:

  - Group annuity contracts.
  - Mutual fund platforms (typically with a single-fund family).
  - Third party recordkeepers (where the assets are held away from the broker-dealer). These are typically open architecture arrangements. Depending on the circumstances, the broker-dealer may or may not be the broker of record with the mutual fund distributors.
  - Managed accounts.
  - Brokerage accounts.

Each of those five "vehicles" presents distinct disclosure issues, with group annuity contracts being the least challenging and with brokerage accounts and independently recordkept plans being the most challenging. For example, we are aware of a large broker-dealer that has created a disclosure document for the compensation from all of the investments in its brokerage account . . . and the disclosure document is approximately the size of a phone book for a mid-sized city.

Once a broker-dealer has identified all of its ERISA accounts, it then needs to approach the disclosure issues in the context of each of those five vehicles (in addition to any other investment programs that it may have for delivering investments to ERISA plans).

- Description of services. One of the 408(b)(2) requirements is that the covered service provider describe its services. In most cases, broker-dealers have not previously prepared descriptions of the services that they provide to ERISA plans. (Note that we are distinguishing dual registered broker-dealers, by discussing their non-fiduciary activities in this portion of the bulletin and discussing their fiduciary services under the RIA portion of this bulletin.) The task of describing the broker-dealer services is made more difficult by the expanding definition of fiduciary and particularly by the Department of Labor's newly proposed regulation on fiduciary investment advice. As a result, broker-dealers need to be very careful in describing their services in order to avoid fiduciary status (or even the implication of fiduciary status).

- Revenue sharing disclosure. Broker-dealers typically disclose revenue sharing (and similar programs, such as marketing allowances) on a page on their internet website. We have reviewed those website disclosures for a significant number of our broker-dealer clients and, in most cases, they are inadequate to satisfy the mandated 408(b)(2) disclosures. As a result, their website disclosures will need to be re-written and augmented. We are also analyzing the proper use of electronic media (*e.g.*, e-mail and website) for these purposes with our clients.

- Levelized compensation. Because of the expanding definition of fiduciary status, together with its "functional" application, we are recommending to broker-dealers that they transition as many of their ERISA accounts as possible to levelized compensation. That is, the compensation that the broker-dealer (and all affiliates) receives from the investments should be a level percentage of plan assets or a fixed dollar amount. That includes payments that may not ordinarily be considered, such as revenue sharing amounts. With levelized compensation, if a financial adviser (and, as a result, the broker-dealer) inadvertently become functional fiduciaries by virtue of giving investment advice, they will not have engaged in a prohibited transaction by virtue of setting their own compensation. This can be done, for example, when a third party recordkeeper collects all of the 12b-1 fees, deposits them into an expense recapture account, and then pays a flat percentage to the broker-dealer.

This is not an exhaustive list of the issues that broker-dealers face, and there are other significant ones that have to be dealt with in 408(b)(2) compliance for broker-dealers.

Recordkeepers

Among the major issues facing recordkeepers are:

- Point-of-sale descriptions of indirect compensation including, for example, subtransfer agency fees, shareholder servicing fees, and so on. One issue is the sheer volume of the universe of investments that are available to a plan. However, that can be mitigated, at least to a degree, by the "change notice" provisions in the 408(b)(2) regulation.

- Similar issues exist for disclosures about the designated investment alternatives and their expenses.

- Recordkeepers need to develop programs with levelized compensation for broker-dealers (see the discussion under the broker-dealer section above). We believe that recordkeepers who provide levelized compensation to broker-dealers (through, *e.g.*, an expense recapture account) will have a competitive advantage under the new 408(b)(2) rules and as the definition of fiduciary expands.

There are a host of other issues for recordkeepers, as well. However, compliance with 408(b)(2) is generally more straightforward than for broker-dealers.

Registered Investment Advisers (RIAs)

Most RIA firms have, in our experience, well-developed service agreements. However, that is not always true for smaller RIA firms. We find that they often have taken their regular investment advisory agreement (such as the one they use for individual clients on the wealth management platform) and added language they hope address ERISA plans. That often leads to mistakes or omissions.

Having said that, we do see some issues with RIA agreements in terms of compliance with 408(b)(2).

- Surprisingly, we have seen a number of advisory agreements that do not specifically state that the RIA is a fiduciary under ERISA. That disclosure is now mandated by 408(b)(2). Sometimes that omission is due to oversight (that is, the RIA simply marked up its existing wealth management agreement), but other times it seems to be the result of a decision of the RIA firm to label itself as a "consultant." When we have evaluated the consulting services in those cases, though, we find that the firms are providing fiduciary

investment advisory services under ERISA. As a result, they will need to make the disclosure.

We often see that RIA agreements that are not well-drafted in the sense that they fail to properly limit the fiduciary status of the RIA. In other words, the agreements acknowledge fiduciary status generally, and do not limit it to the specific services that are defined as fiduciary services in the law. For risk management purposes, those descriptions should be modified. First, there should be a specific description of the fiduciary services being offered by the RIA to the client, and the agreement should clearly limit fiduciary status to those fiduciary services. The second is that the other services offered by the RIA firm should be labeled as "non-fiduciary." In other words, the RIA should identify the services for which it is, and for which it is not, an ERISA fiduciary.

- Some RIA firms receive additional payments—such as 12b-1 fees—but do not offset them against the advisory fee charged by the RIA. Under the new 408(b)(2) regime, those additional payments and the source of the payments will need to be disclosed. Furthermore, if they can in any way be attributed to the fiduciary activities of the RIA, they are likely to be prohibited transactions under ERISA section 406(b) . . . unless they are offset.
- Many RIA firms will rely on Form ADV Part 2 to incorporate disclosures into the advisory services agreement. In our experience, the ADVs seldom fully address ERISA concerns and, as a result, do not satisfy the more detailed requirements of the 408(b)(2) rules.

As with the other service providers in this Bulletin, this is not an exhaustive list of the issues facing RIAs.

Third Party Administrators (TPAs)

TPA agreements, like recordkeeper agreements, tend to have detailed—and more than adequate—descriptions of services. And, the descriptions of compensation are usually adequate for 408(b)(2) purposes . . . in the sense that they are adequately described and they are properly attributed to the particular services. Along those lines, it is our experience that TPA firms generally receive five forms of compensation, but that only one is presenting a problem in terms of 408(b)(2) compliance. Those forms of compensation are:

- A base fee for the administrative services.
- A per-participant fee for participant-directed plans.

  Note: Both of those fees are for the basic administrative and compliance services to the plan.
- A transaction fee, for example, a fee for the establishment and maintenance of a participant loan.
- An hourly rate for consulting. The rates usually vary depending on the experience and expertise of the employees, and that should be described in the service agreement.
- A "subsidy" paid from an insurance company or a mutual fund complex (where their investments are used in the plan). This is the area where we have found that the disclosures are often inadequate. First, there must be a disclosure about the participation in the program and the method of calculation of the compensation to be paid to the TPA. Second, there must be a disclosure about the specific services that are rendered in exchange for that compensation.

  Of course, that raises the issue of whether the compensation is in addition to the other compensation paid to the TPA or whether it is to offset the other compensation paid to the TPA.

Another issue for TPAs is the subsequent amendment of their fees. For example, if a TPA subsequently increases the hourly rates for their employees, then a "change notice" must be sent to the responsible plan fiduciary no later than 60 days after the TPA decides on the change.

Note that independent TPAs are only covered by the regulation if they receive indirect compensation and, even then, only for the plans for which they are paid indirect compensation.

Banks and Trust Companies

Compliance with the new disclosure requirements by banks and trust companies can be fairly complex because of the wide array of services they may offer. In our experience, banks and trust companies generally have robust and reasonably well-crafted agreements, though they still need to be updated for 408(b)(2) disclosure purposes.

The key problems we have seen are:

- Identification of ERISA Accounts. As with broker-dealers, some banks and trust companies have encountered difficulty in identifying the accounts to which 408(b)(2) disclosures need to be made. This is especially the case where a trust department may manage a portion of the funds in a pooled defined contribution plan or a sleeve of assets in a defined benefit pension plan. Individual directed accounts may also fall into this category.
- Description of services. Because the services offered by banks may range across plan consulting and compliance, recordkeeping, directed trustee, discretionary trustee and investment management services, making sure that the services are adequately described and properly categorized as fiduciary or non-fiduciary can be a challenge. This is in part due to the fact that different parts of the bank may provide different services, with different marketing arrangements, management teams and so on. So for the entities that provide such a broad base of services, the issue can be more one

of coordination to ensure compliance—rather than any real difficulty in describing the services.

- Trust services. When the bank or trust company serves as a trustee in addition to providing other services, our experience is that they have generally preferred to enter into separate trust agreements with the plan, using the forms they have historically used. The challenge in this case is to make sure that 408(b)(2) disclosures are made with reference to that agreement or that the other documentation in which the disclosures are made adequately reference the trust agreement.
- Compensation. For reasons similar to those related to the description of services, the breakout of compensation for each of the bank's services, especially indirect payments, can be difficult. This is particularly the case when the bank has affiliated brokers or investment advisory firms or has proprietary products that it offers to plans.

Conclusion

This is just a partial listing of the issues that we are finding and of the requirements in the 408(b)(2) regulation. In specific cases, other issues may be more important than those discussed in this bulletin. So, this is intended to be general education to the benefits community and should not be viewed as a checklist for compliance.

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