

First in a Series

The 408(b)(2) Regulation: An Overview

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On July 16, 2010, the Department of Labor's (DOL) interim final regulation under ERISA §408(b)(2) (the "final" regulation) was published in the Federal Register. Later that day, we emailed a Bulletin discussing the major changes between the proposed and final regulations ([http://www.reish.com/publications/pdf/DOLfinalfeedisc408\(b\)\(2\).pdf](http://www.reish.com/publications/pdf/DOLfinalfeedisc408(b)(2).pdf)).

This Bulletin describes the final regulation in more detail, with a few comments on the likely impact of certain provisions. Subsequent bulletins and articles will analyze the practical application of the regulation to registered investment advisers (RIAs), broker-dealers and their representatives, third party administrators (*i.e.*, compliance-only TPAs), and independent recordkeepers.

Background

First, as legal background, ERISA and the Code are structured in a convoluted manner in which services by providers are prohibited. More specifically, the Code labels service providers as disqualified persons, and ERISA calls them parties-in-interest. Both laws define the provision of services by those persons as prohibited transactions. (*See* ERISA §406(a)(1)(C) and Code §4975(c)(1)(C).) Obviously, that is not the end of the story or the system would not work.

Both laws create statutory exemptions when:

- the contract or "arrangement" is reasonable;
- the services are necessary for the plan; and
- no more than reasonable compensation is paid.

See ERISA §408(b)(2) and Code §4975(d)(2).

To further complicate matters, the DOL has been delegated the authority to write the regulations for both bodies of law.

Until now, there has been little in the way of guidance on what constitutes a "reasonable" contract or arrangement. . . only one short rule that permits reasonable termination charges, but prohibits unreasonable (or penalty) termination charges.

On July 16, that changed.

The new regulation is effective on July 16, 2011, for both new and existing arrangements.

Reasonable Contract or Arrangement

The regulation states: "No contract or arrangement for services between a 'covered plan' and a 'covered service provider,' nor any extension or renewal, is reasonable within the meaning of section 408(b)(2)" unless certain disclosures are made to the responsible plan fiduciary.

For the regulation to apply, a covered service provider must offer one or more covered services to a covered plan. (For ease of reference, after we have defined these terms, we will refer to them as service providers, services and plans.)

A "covered plan" is a "pension plan," except that the term "covered plan" does not include:

- SEP IRAs
- SIMPLE IRAs
- IRAs

Subject to those exceptions, the definition applies to all ERISA-governed retirement plans, including 403(b) arrangements. It appears that non-ERISA tax-qualified plans, like so-called one-person 401(k) plans, are not covered plans.

A "covered service provider" is a service provider that enters into an arrangement with a plan and reasonably expects to receive \$1,000 or more in compensation, direct or indirect, in connection with the services described in the regulation. While it is not entirely clear whether the \$1,000 limit applies to a one-year period or for the duration of the arrangement, it appears to be the latter. Thus, where a service provider has an "evergreen" contract (that is, an agreement that continues until either party terminates it), the \$1,000 threshold would almost always be expected to be exceeded. And, in our experience, most service provider contracts are evergreen.

Covered services include three categories of fiduciaries and two additional categories:

» Fiduciary services:

- Services provided directly to the plan as a fiduciary under ERISA §3(21). (We refer to this as an (A)(1) fiduciary.) Note that this includes service providers whose services

fall under any of the three prongs of the ERISA definition of fiduciary: managers, advisers and administrators.

- Services provided 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. (An (A)(2) fiduciary.) This would include, for example, managers of collective trusts and certain hedge funds and private equity partnerships.¹
 - Services provided directly to the plan as an investment adviser registered under either the Investment Advisers Act of 1940 or State law. (An (A)(3) fiduciary or RIA.) While RIAs are not automatically fiduciaries under ERISA, they are under the securities laws.
- » Recordkeeping services or brokerage services but only when these services are provided to:
- an individual account plan that permits participants or beneficiaries to direct the investment of their accounts; and
 - if one or more designated investment alternatives will be made available. (We refer to this as a (B) service.)

(A designated investment alternative is any investment option offered by a plan that has been selected by a fiduciary into which participants may direct the investment of assets held in their individual accounts...in other words, the investments generally considered to be the “core” lineup in a 401(k) plan. The DOL says, in contrast, that the term does not include brokerage windows, self-directed brokerage accounts and the like, under which a participant is able to select investments other than those specifically designated by the fiduciaries.)

- » The following services, but only if the service provider reasonably expects to receive “indirect compensation” (which is defined on the regulation and explained later in this Bulletin): accounting, auditing, actuarial, appraisal, banking, legal, valuation services, consulting (*i.e.*, consulting related to the development or implementation of investment policies or objectives, or the selection or monitoring of service providers or plan investments), custodial, insurance, investment advisory (for plan or participants), or recordkeeping, securities or other investment brokerage services, or third party administration.

Note that this category again includes recordkeeping and brokerage services, so that entities that provide those services but do not provide “(B) services” may still be “covered” so long as they receive indirect compensation. As a practical matter, most recordkeepers and brokerage firms receive indirect compensation so they will be “covered” service provider under this definition. (We refer to these as “(C) services.”)

Note also that the definition of investment advisory service (for plans or participants) is not limited to registered investment advisers. As a result, it includes any advisory services, *e.g.*, services provided by broker-dealers. In most of these cases, the broker-dealer will be receiving indirect compensation and thus providing “covered” services.

“Covered” service providers include, for the purposes of the regulation, their “affiliates” and “subcontractors” (both of which are defined terms in the regulation).

When a service provider satisfies one of these definitions, and the service is to a covered plan, it must make specified disclosures to the “responsible plan fiduciary” (which is defined in the regulation and discussed below).

Disclosures

Initial disclosure requirements: The service provider must disclose specified information to the “responsible plan fiduciary,” in writing. (Under the regulation, the responsible plan fiduciary is the plan official with authority to cause the plan to enter into, or to extend or renew, a contract with a covered service provider. For mid-sized and large plans, that will typically be the plan committee.)

The following information must be disclosed:

- » **Services:** A description of the services to be provided to the plan pursuant to the arrangement.

How much detail is required to describe the services? The regulation is vague on that point and the DOL’s explanation in the preamble is of little, if any, help:

“It is the view of the Department that the level of detail required to adequately describe the services to be provided pursuant to a contract or arrangement will vary depending on the needs of the responsible plan fiduciary.”

- » **Status:** If applicable, a statement that the service provider will provide, or reasonably expects to provide:
- services directly to the plan as an (A)(1) fiduciary or to an investment contract, product or entity that holds plan assets and in which the plan has a direct equity investment as an (A)(2) fiduciary, and/or
 - services directly to the plan as an investment adviser registered under either the Investment Advisers Act of 1940 or any State law.

So, if the service provider reasonably expects to provide ERISA fiduciary services, it must say so in the disclosures. In addition, if the services to a covered plan are as an RIA, the disclosures must say so. If both, then the disclosure must include both.

¹ This would also include non-publicly traded, non-mutual fund investments in which “benefit plan investors” hold 25% or more of the value of the entity. Benefit plan investors include employee benefit plans subject to Part 4 of Title I of ERISA or §4975 of the Code or an entity whose underlying assets are plan assets. There are exceptions for operating companies. The rules are set out in ERISA §3(42) and ERISA Regulation §2510.3-101.

» **Compensation:** The service provider must describe all of the compensation it expects to receive. For this purpose, the compensation will fall into one or more of the following four categories:

- Direct compensation
- Indirect compensation
- Compensation paid among related parties
- Compensation for termination of arrangement

Compensation is defined in the regulation to mean 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).

Direct compensation: A description of all direct compensation, either in the aggregate or by service, that the service provider reasonably expects to receive from a covered plan.

Indirect compensation: A description of all indirect compensation that the service provider reasonably expects to receive. The description must include:

- identification of the services for which the indirect compensation will be received; and
- identification of the payer of the indirect compensation.

This provision will impact broker-dealers, recordkeepers and bundled providers, who receive significant amounts of indirect compensation.

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.

» **Compensation paid among related parties:** A description of any compensation that will be paid to the service provider if it is:

- set on a transaction basis (*e.g.*, commissions, soft dollars, finder’s fees or other similar incentive compensation based on business placed or retained) or
- charged directly against the plan’s investments and reflected in the net value of the investments (*e.g.*, 12b-1 fees).

This description must include:

- identification of the services for which such compensation will be paid; and
- identification of the payers and recipients of such compensation (including the status of a payer or recipient as an affiliate or a subcontractor).

This provision will likely have the greatest impact on bundled providers who may disclose their revenues on a bundled, or aggregate, basis.

» **Termination compensation:** A description of any compensation that the service provider:

- reasonably expects to receive in connection with termination of the contract or arrangement; and
- how any prepaid amounts will be calculated and refunded upon such termination.

Most likely the greatest impact will be on insurance companies that apply surrender charges to their group annuity contracts.

A description or an estimate of compensation may be expressed as a monetary amount, formula, percentage of the covered plan’s assets, or a per capita charge for each participant or beneficiary or, if the compensation cannot reasonably be expressed in such terms, by any other reasonable method. Any description or estimate must contain sufficient information to permit evaluation of the reasonableness of the compensation.

Note that the proposed disclosures relating to conflicts of interest were not included in the final regulation. However, since many conflicts result from the payment of money or other items of monetary value, the compensation disclosures will reveal most of the likely conflicts of interest.

» **Recordkeeping Services:** There are additional disclosure requirements related to recordkeeping services provided to the plan. A covered recordkeeping service provider (whether they are providing (B) services or (C) services) must give a description of all direct and indirect compensation that the service provider reasonably expects to receive in connection with the recordkeeping services; and

- If the service provider reasonably expects recordkeeping services to be provided, in whole or in part, without explicit compensation for such recordkeeping services, or
- When compensation for recordkeeping services is offset or rebated based on other compensation received, . . .

A reasonable and good faith estimate of the cost to the plan of such recordkeeping services, including:

- an explanation of the methodology and assumptions used to prepare the estimate; and
- a detailed explanation of the recordkeeping services that will be provided to the plan.

Under this disclosure requirement, if a provider who is a recordkeeper receives other compensation (*e.g.*, revenue such as subtransfer agency fees) and offsets it against its stated fee or gives credits against its recordkeeping fees (*e.g.*, for the use of mutual funds managed by affiliated managers), the recordkeeper must disclose to the responsible plan fiduciary the reasonable costs of the recordkeeping services without the offsets or credits. Generally speaking, the reasonable cost is what the provider

would charge for those services if there was no revenue sharing and if proprietary funds were not used.

This change will have a significant impact on bundled providers, especially if they have internal credits for their proprietary funds.

- » Manner of Receipt: The disclosures must contain a description of the manner in which the compensation will be received, such as whether the plan will be billed or the compensation will be deducted directly from the covered plan's account(s) or investments.
- » Investment Disclosure – (A)(2) Fiduciary Services: In the case of an (A)(2) fiduciary service provider – one who manages a separate contract, product or entity that holds plan assets (which does not include mutual funds since they do not hold plan assets) – the following information for each investment in which the plan has a direct equity interest, and for which fiduciary services will be provided:
 - A description of any compensation that will be charged directly against the amount invested in connection with the acquisition, sale, transfer of, or withdrawal from the investment contract, product, or entity (*e.g.*, sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, account fees, and purchase fees);
 - A description of the annual operating expenses (*e.g.*, expense ratio) – but only if the return on the investment is not fixed; and
 - A description of any ongoing expenses in addition to annual operating expenses (*e.g.*, wrap fees, mortality and expense fees).

This requirement can be satisfied by giving the information to the recordkeeper, who in turn provides it to the plan.

This will be a significant change for some (A)(2) fiduciaries, *e.g.*, for collective trusts, partnerships, hedge funds, and so on.

- » Investment Disclosure – Recordkeeping and Brokerage Services: In the case of a 401(k) recordkeeping or brokerage service provider for a participant-directed plan with designated investment options (*i.e.*, (B) services), for each designated investment alternative for which recordkeeping services or brokerage services will be provided, the same information must be provided as for (A)(2) fiduciaries (above).

Format of Disclosure

Neither the proposal nor the interim final rule requires the service provider to make disclosures in any particular manner or format. As a result, the disclosures may be made through multiple documents, which could include prospectuses.

However, the preamble explains:

The Department is considering adding a requirement that service providers furnish a “summary” disclosure statement. For example, limited to one or two pages, that would include key information intended to provide an overview for the responsible plan fiduciary of the information required to be disclosed. The summary also would be required to include a roadmap for the plan fiduciary describing where to find the more detailed elements of the disclosures required by the regulation.

We understand that Congressman George Miller (Chair of the House Education and Labor Committee) has serious reservations about the effectiveness of the disclosures without this summary. As a result, we believe there is a significant chance that the interim final regulation will be amended to include the summary.

Timing of Initial Disclosure Requirements

A service provider must disclose the information to the responsible plan fiduciary reasonably in advance of the date the arrangement is entered into, and extended or renewed, with limited exceptions. (For example, if a change occurs as decisions are made, a later disclosure of the change may be made).

Unfortunately, the DOL declined to provide a safe harbor notice period, leaving both service providers and fiduciaries at risk.

While the timing is not clear, it would be a risky proposition to provide the notices so late that it was clear that the responsible plan fiduciary did not have a realistic opportunity to review the materials and seek advice.

Timing of Initial Disclosure Requirements: Changes

A service provider must disclose a change to the information as soon as practicable, but not later than 60 days from the date on which the service provider is informed of the changes. However, if the disclosure was precluded due to extraordinary circumstances beyond the service provider's control, the information must be disclosed as soon as practicable.

Reporting and Disclosure Information

Upon request of the responsible plan fiduciary or plan administrator, the service provider must furnish any other information relating to compensation received in connection with the arrangement, that is required for the plan to comply with the reporting and disclosure requirements of ERISA and the regulations, forms and schedules issued thereunder.

The service provider must disclose the information not later than 30 days following receipt of a written request from the responsible plan fiduciary or plan administrator unless such disclosure is precluded due to extraordinary circumstances beyond the service provider's control, in which case the information must be disclosed as soon as practicable.

Disclosure Errors

No arrangement will be unreasonable solely because the service provider, acting in good faith and with reasonable diligence, makes an error or omission in disclosing the information, . . . if the service provider discloses 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 an error or omission.

This provision was added to the final regulation in response to the expressed concerns of service providers, who feared that innocent mistakes, or even typographical errors, could result in a prohibited transaction.

Protection for Responsible Plan Fiduciaries

The regulation also contains a procedure for obtaining relief for plan sponsors, as responsible plan fiduciaries, who may have

inadvertently entered into prohibited arrangements because service providers have not given them the required information.

Burden of Proof

Since the general rule is that services are prohibited, 408(b)(2) is an exception, or exemption, to that rule. Where a service provider relies on such an exception, the burden of proof is on the service provider. In other words, service providers must prove that they satisfied these rules . . . the burden is not on the government or the plan to prove that the provider did not. As a result, service providers would be well-advised to interpret these rules in a conservative manner.

Conclusion

The regulation will have a significant impact on some practices of service providers. Subsequent bulletins and articles will discuss that impact on the key types of providers, such as RIAs, broker-dealers, third party administrators, and independent recordkeepers.

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