

Disclosure Regulation Not Approved

By Fred Reish and Bruce Ashton

This is a follow up to our bulletin of January 12 providing an update on the DOL's proposed regulation under ERISA section 408(b)(2) related to the disclosure of service provider compensation and conflicts of interest. Here's what has happened since then:

- The Office of Management and Budget (OMB) has not approved the 408(b)(2) regulation.
- We have heard that the DOL is withdrawing the 408(b)(2) regulation. (However, in discussions with DOL officials we have learned that the regulation has not been withdrawn at the time of this Bulletin and it is not certain that it will be withdrawn in the near future. In other words, it may depend on decisions made by President Obama's appointees.)
- The OMB has also not approved the regulation regarding disclosures to participants.
- The OMB has approved the proposed regulation and the related prohibited transaction class exemption regarding fiduciary advisers, that is, those who give advice to participants, and it was released on January 21, 2009. (We understand, however, that there is a move in Congress to effectively rescind this regulation, and there is a chance that the new Administration will withdraw it before it becomes effective. In that regard, on January 20, the new President issued an order delaying the effective date of newly issued regulations. We understand that the DOL believes the fiduciary adviser regulation is subject to that order and thus plans on delaying the effective date of the regulation for 60 days beyond its stated effective date of March 23, 2009.)
- At the same time, at the request of Congressman George Miller, Chair of the House Education and Labor Committee (which has jurisdiction over legislation in the House concerning ERISA), the Government Accountability Office (GAO) has undertaken a study of the requirements of Schedule C to the 2009 Form 5500 (related to after-the-fact disclosure of compensation to service providers in plans with 100 or more participants). Fred Reish has already been interviewed by the GAO for this study.

401(k) Summit Program

At the ASPPA 401(k) Summit in San Diego, Fred Reish and Bruce Ashton will be presenting a Pre-Conference Sponsor Workshop on the issues addressed in this bulletin. The program will be held on Sunday, March 22 at 9:00 a.m.

While this may seem to be a somewhat disjointed list, they are all interrelated, and some of the considerations behind these developments are, at the least, curious. Consider: The OMB has indicated that it believes the proposed 408(b)(2) disclosure regulation imposes too large a cost burden on service providers. Yet OMB approved the fiduciary adviser regulation which imposes similar disclosure requirements on those who provide advice to 401(k) participants. In contrast, Chairman Miller has expressed concern that the Schedule C disclosures – which require disclosures of service provider compensation that are substantially the same as those in the proposed 408(b)(2) regulation – do not go far enough; and the objective of the GAO study is to determine if the Schedule C disclosures are detailed enough.

The one thing we can be sure of is that service provider disclosure is not dead. Chairman Miller has already said he will introduce legislation that will mandate disclosure of service provider compensation. It is also likely that the DOL will reconsider the issue, though which will act first – Congress or the DOL – may depend on who is appointed as Assistant Secretary of Labor overseeing the interpretation and enforcement of ERISA. Regardless of what legislative or regulatory actions are taken, however, service providers are well-advised to fully disclose all of their compensation, both direct and indirect, going forward. Why? There are at least two reasons:

1. **Legal Risk Management.** Our concern is with “full” disclosure of service provider compensation. This covers both “direct” payments (from a plan sponsor or plan)

and “indirect” payments (which come from third parties, such as 12b-1 fees and other payments to broker-dealers or revenue sharing payments to recordkeepers and third party administrators). In this context, it is important to keep in mind that we are talking about *compensation* received by the service provider and not *cost* to the plan. Take the example of 12b-1 fees. Those fees are costs for mutual funds – and thus ultimately a *cost* to a plan (or participant accounts) as part of the mutual fund expense ratio. To the extent a broker-dealer receives the 12b-1 fees, it is receiving *compensation*. It is important for plan sponsors to evaluate both.

So why do we say that disclosure is an important risk management step? ERISA sections 406(a)(1)(C) and 408(b)(2), when read together, prohibit unreasonable arrangements between plans and service providers. Even without the proposed 408(b)(2) regulation, this is still the law; it doesn’t require a regulation to make it effective. Further, fiduciaries have a legal obligation to understand and evaluate both plan costs and service provider compensation. In the proposed 408(b)(2) regulation, the fiduciary adviser regulation and the Schedule C disclosure requirements, the DOL has expressed its opinion on what needs to be disclosed, especially with respect to direct and indirect compensation of service providers. Under these circumstances, it is conceivable that a court or other adjudicatory body – a FINRA arbitration panel, for example – could look to the DOL’s interpretation of what is required for a contract to be reasonable (though they would not be bound by the DOL’s views in the withdrawn regulation). Indeed, the complaints in most of the pending class action lawsuits regarding service provider compensation take this position, in one way or another.

What should be disclosed? We think the Instructions under Schedule C for “eligible indirect compensation” are a good place to start. If the amounts received by a service provider subject to the Schedule C requirement qualify as eligible indirect compensation and if advance written disclosure is made to the plan sponsor, the Schedule C reporting is simplified. The Instructions state that the following must be disclosed:

- (a) the existence of the indirect compensation;
- (b) the services provided for the indirect compensation or the purpose for payment of the indirect compensation;

- (c) the amount (or estimate) of the compensation or a description of the formula used to calculate or determine the compensation; and
- (d) the identity of the party or parties paying and receiving the compensation.

If a service provider makes the disclosures in advance, the amounts paid to the service provider do not have to be disclosed in the Schedule C; instead, the sponsor may check a box on the form indicating that it received the disclosures.

While this structure only applies to certain compensation disclosures on Schedule C to the Form 5500, we believe that it is a good starting point for the disclosure of compensation (that is, money or other things of value) received indirectly by service providers.

2. **Best Practice.** It also seems to us that the 401(k) industry is moving in the direction of full disclosure of costs and service provider compensation, both direct and indirect, and that plan fiduciaries will expect such disclosures in the future. So, from a competitive standpoint and to meet the expectations of existing and prospective clients, we believe it is good practice for service providers to make full disclosure of all money or other items received by the service provider that is in any way related to the plan. Further, we think that it is a best practice for service providers to meet with the responsible plan fiduciary each year to review the compensation received during the year, to discuss the services rendered during the year and to prioritize the goals and services for the ensuing year.

Yet another reason for making these disclosures is that we believe that, within 12 months, there will be a new regulation or law that requires, at the least, these types of disclosures. With that in mind, advisers would be well-served to disclose this information now... at point of sale, rather than being required to disclose that same information a year or two from now – and running the risk of difficult conversations with plan sponsors and fiduciaries.

This bulletin is a general discussion of recent developments. These developments will impact different types of service providers differently. In the next few weeks, we will be sending out another bulletin that discusses the primary effects on broker-dealers, RIAs, third party administrators and recordkeepers. ❖

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