

First in a Series

SEC and DOL Convergence: Are You Ready?

By Stephen Wilkes and Fred Reish

In addition to ERISA, our firm advises many clients on issues concerning federal and state securities laws. Employee benefits law and securities law have always run parallel on some issues, but we are now experiencing an unprecedented convergence of SEC and DOL regulation. These regulatory agencies have undertaken major initiatives with regard to fiduciary activity, plan investments, compensation, sales practices, and disclosure of services, compensation, and conflicts.¹ The complexities and interlocking relationship of both the regulations and regulators is increasing; it requires that service providers, especially those in the financial services industry, focus on the integration of these bodies of law.

To understand the magnitude of this convergence, consider the scope of DOL activity in the last few years with regard to plan investments. Final or proposed regulations, Interpretive Bulletins, Advisory Opinions, and PTE Class Exemption amendments have addressed Section 408(b)(2) disclosures, Form 5500 reporting, QPAM and cross trading exemptions from the prohibited transaction rules, participant investment advice, participant level disclosures, the definition of “plan assets” and “fiduciary,” safe harbor annuity selection, and proxy voting.² The SEC has issued significant final and proposed rules about plan investments, including total revision of Rule 12b-1; a new model for Form ADV Part 2 “brochure disclosure;” custody of assets; the advertising of Target Date Retirement Funds; and the rules governing content and distribution of prospectuses, to name only a few.

Finally, on top of it all, the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), enacted in July, will significantly impact the rules governing the sale and distribution of retirement plan investments. Dodd-Frank raises new questions under the securities laws (in addition to those under ERISA) such as: What are the registration implications of giving advice to varying clients? What is the fiduciary standard of conduct? When is an adviser a fiduciary? How are transaction

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Reish & Reicher has been included in the *U.S. News & World Report's* 2010 Best Law Firms listing and was given the highest ranking of “Tier 1” for its work in the Employee Benefits (ERISA) Practice. According to U.S. News & World Report, “Achieving a high ranking is a special distinction that signals a unique combination of excellence and breadth of expertise.” All first-tier firms, including Reish & Reicher, will be featured in the October issue of *U.S. News & World Report*.

Additionally, Fred Reish and Bruce Ashton were selected to be among the Best Lawyers in America for 2011. Both Fred and Bruce are part of a distinguished group of attorneys who have now been listed in Best Lawyers for ten years or longer. Their continuing recognition reflects their contribution to the benefits community.

Best Lawyers selects attorneys for that recognition based on an exhaustive and rigorous peer review process. In other words, inclusion on the list is the ultimate compliment for a lawyer, since it is based primarily on the opinion of other lawyers.

fees, distribution fees, sales fees, administrative fees, and consulting fees assessed, and reported, and paid? What are the standards for disclosures by an investment adviser or broker-dealer, or by a mutual fund in a prospectus?

We have reached the point when regulatory compliance and fiduciary practices and procedures require financial service providers to simultaneously answer to different regimes, namely, ERISA and the securities laws.

The purpose of this bulletin is to highlight, in general terms, several of the more immediate securities law changes to consider, so that our clients will be aware and ready to act in light of important issues impacting their business in the retirement plan industry. Related ERISA regulatory activities are the subject of separate bulletins and may be found on our website at http://www.reish.com/practice_areas/EmpBenefits/Bulletins/. More detailed

¹ Other federal regulatory agencies, such as the Office of Comptroller of Currency with regard to collective investment funds or trust department services, are also involved in some jurisdictional fashion that affects, directly or indirectly, the retirement plan industry. Virtually every state has a regulatory agency that supervises banking, trust services, securities, brokerage, insurance, etc, and thus impacts the retirement plan world.

² These fiduciary and investment issues require serious consideration and review by registered investment advisers, broker-dealers, custodian and record keeping platform providers, banks, trust companies, insurance companies, and both mutual funds and private or pooled fund vehicles.

bulletins will follow on these and other topics, with discussion of the practical considerations. But for now, the following are examples of securities issues that we are discussing with our clients.

I. Registration of Investment Advisers

There are significant implications under Dodd-Frank for registered investment advisers with between \$30 million and \$100 million of assets under management. The new threshold for SEC registration, effective July 21, 2011, is \$100 million in assets under management unless an exception applies.

- If you are an investment adviser currently registered with the SEC, but will not satisfy this new threshold by the effective date, you will need to (1) determine if another existing basis is available under The Investment Advisers Act (“Advisers Act”) upon which you may maintain SEC registration, (2) determine if an exception under Dodd-Frank to the new threshold is applicable which allows you to continue SEC registration, or (3) de-register with the SEC and re-register with the appropriate state.
- Advisory personnel of state-registered advisers may be subject to different registration standards with regard to the filing of Form U-4 than the personnel of SEC registered advisers.
- Additional implications under state-level registration of investment advisers must be considered, such as the potential for differences on the payment of referral fees or the need for investment adviser registration in multiple states.

II. Broker-Dealer Fiduciary Duty

Registered investment advisers are considered to be fiduciaries under the Advisers Act. Broker-dealers, on the other hand, are subject to a set of rules involving suitability, disclosure, and best execution.³

Dodd-Frank addresses this long standing difference by creating a likelihood that a broker-dealer firm will be subject to a fiduciary standard within the foreseeable future.⁴ Dodd-Frank provides several steps for SEC rule making authority in this area, including:

- The SEC is required to issue a report to Congress in January, 2011, regarding the effectiveness of current standards of care within the financial services industry for broker-dealers and investment advisers who provide personalized investment advice about securities to retail customers.
- Authorizes (but does not require) the SEC to adopt rules that would impose the same fiduciary standard on broker-dealers as that imposed on investment advisers when providing personalized investment advice about securities to retail customers.

III. Form ADV “Plain English”

The SEC has approved changes to Form ADV Part 2, and related rules under the Advisers Act. Registered investment advisers are required to deliver Part 2 of Form ADV—commonly referred to as the “brochure”—to clients and prospective clients.

- Part 2 of Form ADV must now be presented in narrative format using “plain English” to describe various aspects of an adviser’s business rather than a check the box format.
- For the first time, it must be filed electronically with the SEC, which allows public access to the form.
- A supplement relating to persons providing investment advice or contacting clients or prospective clients must be provided in certain instances.
- More detailed disclosure is required to address issues that are considered to be the most relevant to advisory clients.

Currently registered investment advisers whose fiscal years end on or after December 31, 2010 must include the new Form ADV Part 2 brochure with their next annual updating amendment. For example, an adviser with a December 31, 2010 fiscal year end must file the amendment no later than March 31, 2011. These advisers will have an additional 60 days to deliver the Form ADV Part 2 brochure and the new supplement to their clients.

IV. Rule 12b-1 Reform

Though comments on the proposal are due in November, and the effective date and the ultimate provisions of the final rule is unknown, the potential impact of the new Rule requires that advisers, broker-dealers, and other service providers who pay or receive 12b-1 fees must begin to understand how these changes could affect the operational or financial components of their business. The implications for disclosure requirements, various share class offerings, and revenue sharing, for example, are far reaching.

The proposed Rule 12b-2, which replaces current Rule 12b-1, along with other amendments to current rules, is designed to protect individual investors, according to the SEC. The proposed Rule 12b-2 would:

- Allow funds to deduct from fund assets a “marketing and service fee” of up to 0.25% annually to pay for distribution activities.
- Allow funds to deduct from fund assets an “ongoing sales charge,” in excess of the marketing and service fee, provided that the excess is treated as a sales charge subject to certain limits.

³ Of course, when an investment adviser or broker-dealer is providing investment advice or exercising investment discretion to an ERISA governed plan or participant, the ERISA fiduciary standards should be applicable.

⁴ DOL has announced its intention to propose an expanded definition of “fiduciary” under ERISA that may impact broker dealers as well.

- Require a cap on ongoing sales charges implemented by requiring shares to automatically convert to a class with no ongoing sales charges (other than marketing and service fees) once the cap has been reached.
- Allow for an alternative distribution system that would allow fund intermediaries, such as broker-dealers, to impose charges at negotiated rates in connection with the sales of fund shares.

The proposal could be troublesome to many retirement plans, especially smaller ones, that rely on these mutual fund fees to pay for services that are provided by a record keeper or as part of a bundled services platform. If the amount of fees necessary to provide services exceed the fee limits under the proposed rule, plans may be unable to invest in those funds. Further, the proposal requires mutual funds (or some other party) to track the cumulative amount of sales charges that an investor pays for shares. The cost to develop financial reporting for this level of recordkeeping could be a major burden for retirement plan administrators.

In addition, many commentators in the securities and 401(k) industries are concerned that the proposal will not provide adequate ongoing compensation to broker-dealers who serve small plans.

V. Conclusion and Next Steps

We have been working with registered investment advisers, broker-dealers, and other plan providers to begin to assess the impact of these changes, and how to best comply in recognition of both securities law and ERISA regulatory activity.

Registered investment advisers need to consider their registration status, and the implications of maintaining federal registration or re-registering at the state level, as the case may be.⁵ Form ADV Part 2 changes will require action not only with regard to narrative content, but the timing and manner of distributing the “brochure” and the new “supplement.” These changes should be written in a manner consistent with, and supportive of, the new disclosure requirements under the DOL’s 408(b)(2) regulation.

Broker-dealers will need to address the potential implication of a “fiduciary standard” in many ways, the most important being how

to demonstrate compliant processes and procedures (at least with regard to retail clients) for the delivery of recommendations or advice. How will the broker-dealer apply “best interests?” What type of information must it obtain from clients? How does the investment process demonstrate reasonable care, skill and prudence with regard to managing and advising client investments? These and many more issues will require substantial effort, along with the need to undertake major compliance training initiatives within the firm for the advisers in the field.

All financial service providers will be faced with significant requirements (although the timing of potentially hundreds of new rules is not yet certain) for broader and deeper disclosures of information ranging from fees and conflicts to sales practices and investment performance.

Plan fiduciaries will need to understand the new mutual fund fee regime under Rule 12b-2, as will the registered investment advisers, broker-dealers, and other financial intermediaries who must disclose such information to the plan and/or advise plan fiduciaries about the reasonableness of such fees, or evaluate the fees for compliance with SEC and FINRA rules. Recipients of 12b-1 fees currently will need to consider how this form of compensation will impact them under the new rules. Although the SEC believes that 401(k) plans currently hold 80% or more of their assets in non-12b-1 paying funds, plans and their platform providers will need to develop systems of tracking and calculating potential excess 12b-2 fees for various classes of fund shares. This is challenging because many question whether and how R class shares, for example, will realistically be able to comply with the limits on the ongoing sales charge. The ability of many smaller-sized plan administrators and record keepers to acquire or upgrade technology capable of tracking fee limitations and facilitating share class conversions may materially affect their operations. What alternatives are available to TPA and recordkeeping firms given the impact of the proposed 12b-2? Will certain fund share classes be effectively unavailable on their platforms?

We will be monitoring these developments closely, especially as they relate to the delivery of financial services to the retirement plan industry, and be following up with more detailed bulletins.

⁵ The potential to “grandfather” existing SEC registered investment advisers is possible though not mentioned anywhere in Dodd-Frank.

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