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ERISA COMPLIANCE: AN OVERVIEW OF DOL 408(b)(2) DISCLOSURE REGULATION

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I. Introduction

On February 2, 2012, the Department of Labor ("DOL") issued final regulations under section 408(b)(2) of the Employee Retirement Income Security Act of 1974 ("ERISA"), which in general, requires certain plan service providers to disclose to plan fiduciaries certain information regarding their compensation. *See* 29 C.F.R. § 2550.408b-2.

II. Summary of Implications for Investment Advisers

Investment advisers that provide services as a fiduciary or an adviser registered under the Advisers Act or State law to ERISA-governed pension plans must make certain disclosures regarding their services and compensation prior to entering into, extending, or renewing an advisory arrangement with the plan. This disclosure must be updated if any information in the disclosure changes. While existing documents like the Form ADV and investment management contracts contain much of the information that must be disclosed under the DOL's rule, an adviser may need to supplement existing disclosures to ensure they fully comply with DOL's rule.

III. Background

A. ERISA

(1) ERISA section 406 contains a broad prohibition on any "party in interest," including investment advisers, fiduciaries and other service providers, entering into a transaction with a plan. Therefore, absent an exception, an investment adviser cannot get paid for providing advisory services to an ERISA plan.

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(2) ERISA section 408(b)(2) provides an exception for "reasonable arrangements" for necessary services. Under ERISA § 408(b)(2), no more than "reasonable compensation" may be paid.

(3) The 408(b)(2) regulation provides that a service arrangement is not reasonable unless specific disclosures are made to the hiring fiduciary.

B. History of the 408(b)(2) Regulation

(1) Part of "three-pronged" fee disclosure initiative from DOL

(a) Updates to Form 5500 Schedule C

(b) Disclosure to Participants in Defined Contribution Plans

(c) The 408(b)(2) Regulation

(2) Development of 408(b)(2) Regulation

(a) December 2007 – DOL issues proposed regulations

(b) March 2008 – Hearing held on proposed regulations

(c) July 2010 – DOL publishes "interim" final rule

(d) February 2012 – DOL publishes final rule

IV. Overview of Final Rules

A. Changes from Interim Final Regulations

(1) The final rule contains a number of technical and other changes in response to comments received on the interim final rule. Some of the changes include:

(a) An exclusion for certain Internal Revenue Code section 403(b) annuity contracts and custodial accounts;

(b) Expansion of the information to be disclosed concerning a covered service provider's receipt of indirect compensation to include a description of the arrangement between a payer and the covered service provider pursuant to which indirect compensation will be paid;

(c) Conformance of investment-related disclosures for covered plans' designated investment alternatives to the requirements of DOL's participant-level disclosure regulation; and

(d) A separate provision for the disclosure of changes to investment-related information, which must be updated at least annually.

B. The Final Regulations - In General

(1) The final regulations require "covered service providers" to provide responsible fiduciaries with information they need to:

(a) Assess reasonableness of total compensation, both direct and indirect, received by the covered service provider, its affiliates, and/or subcontractors;

(b) Identify potential conflicts of interest; and

(c) Satisfy reporting and disclosure requirements under Title I of ERISA.

C. Covered Plans and Clients

(1) Rule applies to all ERISA-governed retirement plans

(a) Defined benefit pension plans

(b) Defined contribution/401(k) plans

(2) Plans that are not covered

(a) Welfare plans (like VEBAs and retiree health trusts)

(b) IRAs (including SEPs and SIMPLEs)

(c) Governmental plans

(d) Church plans

(e) "Keogh" plans covering only the business owner (and spouse)

(f) Nonqualified executive compensation plans

(g) Non-ERISA 403(b) contracts and certain pre-2009 frozen 403(b) contracts

D. Covered Service Providers

(1) A "covered service provider" is a service provider that enters into a contract or arrangement with a covered plan and reasonably expects $1,000 or more in compensation, direct or indirect, to be received in connection with providing one or more of the services covered under the final regulation. The services are broken down into three categories in the final regulation.

(2) Category 1: Fiduciary/Registered investment adviser services

(a) This category is further split into three categories and includes

(i) Services provided directly to the plan as an ERISA fiduciary;

(ii) Services as a fiduciary to a separate account, collective trust, or other investment contract or product (a) that holds "plan assets" and (b) in which the plan has a "direct equity investment"; and

(iii) Services provided directly to the plan as an investment adviser registered under the Advisers Act or State law.

(3) Category 2: Recordkeeping and brokerage for defined contribution plans that allow participant direction

(a) Applies if you make available "platform" of investments in connection with recordkeeping or brokerage services

(b) Recordkeeping is broadly defined to include:

(i) Services related to plan administration;

(ii) Monitoring of plan and participant accounts and transactions;

(iii) Maintaining records of participant accounts;

(iv) Sending participant statements; and

(v) Processing loans, distributions and withdrawals.

(c) This category has special disclosure obligations (*See* Part IV.E(4), below).

(4) Category 3: Other service providers but only if they expect to receive indirect compensation

(a) The services set forth in this category have not changed from the interim final rule and include:

(i) Accounting;
(ii) Auditing;
(iii) Actuarial;
(iv) Appraisal;
(v) Banking;
(vi) 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);
(vii) Custodial;
(viii) Insurance;
(ix) Investment advisory (for plan or participants);
(x) Legal;
(xi) Recordkeeping;
(xii) Securities or other investment brokerage;
(xiii) Third party administration; and
(xiv) Valuation services provided to the covered plan.

(b) Persons and entities providing these services are not considered to be covered service providers unless they expect to receive "indirect compensation" in connection with the contract.

(5) Exclusion for subcontractors and services to investments and products

(a) The regulation provides that a person or entity is not a covered service provider solely by providing services as an affiliate or contractor of a covered service provider.

(b) The regulation provides that a person or entity is not a covered service provider solely by providing services to an investment contract, product, or entity in which a plan invests, except in the case of an investment product that holds "plan assets" and in which the plan has a direct equity investment.

(i) For example, the adviser of a mutual fund that a plan purchases is not considered a "covered service provider" solely on that basis.

(ii) On the other hand, the investment manager of a collective investment trust holding "plan assets" would be considered a "covered service provider."

E. Required Disclosures

(1) Description of Services. A covered service provider must describe the services to be provided to the covered plan pursuant to the contract or arrangement (but not including certain non-fiduciary services to an investment product, contract, or entity in which the covered plan invests).

(2) Status of Covered Service Providers, Affiliates, and Subcontractors. The final regulations require a statement that the covered service provider, an affiliate, or subcontractor will provide, or reasonably expects to provide, services pursuant to the contract or arrangement directly to the covered plan (or to an investment vehicle that holds plan assets in which the covered plan has a direct equity investment) as a fiduciary (under ERISA). A statement is also required if any of the parties reasonably expects to provide services under the contract to a covered plan as an investment adviser registered under either the Advisers Act or any State law. If the service provider expects to serve both roles, the statement must reflect that.

(3) Disclosure of Compensation. The final regulations require a covered service provider to disclose comprehensive information about the compensation that will be received in connection with the services provided pursuant to a contract.

(a) Direct Compensation. Description of all direct compensation, either in the aggregate or by the service that the covered service provider, an affiliate, or a subcontractor reasonably expects to receive in connection with the services provided. "Direct" compensation is compensation paid directly from the covered plan (this would include amounts deducted from participant accounts).

(b) Indirect Compensation. Description of all indirect compensation, either in the aggregate or by the service that the covered service provider, an affiliate, or a subcontractor reasonably expects to receive in connection with the services provided. "Indirect" compensation is compensation received from any source other than the covered plan, the plan sponsor, the covered service provider, or an affiliate.

(c) Incentive compensation. Description of any compensation that will be paid among the covered service provider, an affiliate, or

subcontractor 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 is charged directly against the covered plan's investment and reflected in the net value of the investment (*e.g.*, 12b-1 fees).

(d) Termination charges. Description of any compensation reasonably expected to be received in connection with the termination of the contract and how any prepaid amounts will be calculated and refunded upon such termination.

(4) Disclosures Regarding Recordkeeping Services. Final regulations require disclosure concerning the cost to the covered plan of recordkeeping services, to the extent such services will be provided to the plan.

(a) A description of all direct and indirect compensation reasonably expected to be received in connection with such recordkeeping services.

(b) In cases where the covered service provider reasonably expects recordkeeping services to be provided without explicit compensation for such services or when the compensation for recordkeeping is offset or rebated based on other compensation received by the covered service, provider

(i) A reasonable good faith estimate of the cost to the covered plan of such recordkeeping services, including:

(A) An explanation of the methodology and assumptions used to prepare the explanation, and

(B) A detailed explanation of the services that will be provided to the covered plan.

(5) Investment Disclosure – Fiduciary Services

(a) Providers of fiduciary services to an investment contract, product, or entity that holds plan assets in which the covered plan has a direct equity investment.

(b) The disclosures must be made for each contract, product, or entity for which fiduciary services will be provided pursuant to the contract with the covered plan unless the information is disclosed to the responsible plan fiduciary by a covered service provider providing recordkeeping or brokerage services.

(c) Required Disclosures

(i) Description of any compensation that will be charged directly against an investment such as commissions, sales loads, sales charges, deferred sales charges, exchange fees, and purchase fees, and that is not included in the annual operating expenses of the investment contract, product or entity.

(ii) Description of the annual operating expenses (*e.g.*, expense ratio) if the return is not fixed and any ongoing expenses in addition to annual operating expenses (*e.g.*, wrap fees, mortality and expense fees), or for an investment contract, product or entity that is a designated investment alternative, the total annual operating expenses expressed as a percentage (in accordance with participant-level fee disclosure regulation).

(iii) For contracts, investments, or entities that are designated investment alternatives, any other information or data about the designated investment alternative that is within the control of, or reasonably available to the covered service provider and that is required for the covered plan administrator to comply with the participant-level disclosure regulation.

(6) Investment Disclosures – Recordkeeping and Brokerage Service. Same disclosures as for fiduciary services (described above) for each designated investment alternative for which the service provider is providing recordkeeping and brokerage services.

(7) Compensation can be disclosed in dollars, formulas, or other reasonable method. Estimates can be used with explanation of assumptions.

(8) Existing disclosures (like Form ADV) can be used if they contain all the information required by the rule. In our experience, an investment advisory agreement coupled with the Form ADV will contain much of the information required by the rule, but not necessarily all. Accordingly, many investment advisers have found it worthwhile to create a separate 408(b)(2) disclosure that summarizes where the relevant information can be found and supplements with any additional detail.

(9) Disclosure goes to the "responsible plan fiduciary" – fiduciary with authority to enter into the arrangement.

F. Timing of Disclosures

(1) The final regulation is effective for both existing and new contracts and arrangements between covered plans as of July 1, 2012. The effective date was extended in order to allow covered service providers more time to respond to the specific changes made to the interim final rule.

(2) Interaction with participant-level disclosure requirements

(a) The transitional rule for the participant-level disclosure regulation was in July 2011 so that the first disclosures would follow the effective date of the 408(b)(2) regulations.

(b) For calendar year plans, the initial annual disclosure of "plan-level" and "investment-level" information (including associated fees and expenses was required to be furnished by August 30, 2012 (*i.e.*, 60 days after the 408(b)(2) regulation's effective date).

(c) The first quarterly statement was required to be furnished no later than November 14, 2012 (*i.e.*, 45 days after the end of the third quarter (July through September) during which initial disclosures were first required).

(3) For new contracts or arrangements disclosure must be made reasonably in advance of entering into a contract or arrangement plus in advance of contract renewal or extension.

(4) If any information changes, new disclosure is required within 60 days from being informed of the change.

(5) Investment related disclosure error can be fixed, but only within 30 days of becoming aware of the error.

G. Consequences of Failing to Comply

(1) Prohibited Transaction Results under IRC section 4975

(a) 15% excise tax due to IRS (increasing to 100% if discovered on audit). Due every year until issue corrected.

(2) The "Tattletale Rule"

(a) The final regulations include a class exemption from the prohibited transaction provisions of ERISA for responsible plan fiduciaries that enter into service contracts without knowing that the covered

service provider has failed to comply with its disclosure obligations.

(b) Plan fiduciary must request disclosure, and if not provided in 90 days, must report adviser to DOL. Fiduciaries can disclose to DOL online at www.dol.gov/ebsa/regs/feedisclosurefailurenotice.html.

(c) Unless the covered service provider remedies the disclosure error, the fiduciary must decide whether to terminate the service contract. If the failed disclosure relates to future services (as opposed to compensation for prior services) the fiduciary must terminate the arrangement.