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ERISA Compliance for Investment Advisers: A Q&A Guide To DOL's 408(b)(2) Disclosure Regulation

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On February 2, 2012, the Department of Labor (DOL) issued a final regulation under Section 408(b)(2) of the Employee Retirement Income Security Act of 1974 (ERISA), which, in general, requires certain plan service providers – including many investment advisers to plans – to disclose to plan fiduciaries information regarding their compensation.[1] Below is a series of questions and answers aimed to provide background on the final regulation as well as explain its impact on investment advisers.

1. We've been told we have to provide a "408(b)(2)" disclosure to our ERISA clients for whom we provide advisory services. Why do we have to do that? Why is it called a "408(b)(2)" disclosure?

ERISA Section 406 contains a broad prohibition on any "party in interest," such as investment advisers, fiduciaries and other service providers, entering into a transaction with a plan, including providing services to a plan. Therefore, absent an exception, an investment adviser cannot get paid for providing advisory services to an ERISA plan. ERISA Section 408(b)(2) – sometimes called the "service provider" exemption – provides the necessary relief. ERISA Section 408(b)(2), however, contains three conditions. First, the services provided must be "necessary" to the plan. Second, the service arrangement must be "reasonable." Third, no more than "reasonable compensation" may be paid to the service provider.

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For many years, DOL had a regulation implementing Section 408(b)(2) that simply required that any service arrangement not contain any termination penalty that unnecessarily locked a plan into an arrangement that had become disadvantageous. In February 2012, DOL finalized a regulation that added disclosure conditions to the relief of Section 408(b)(2). In essence, the revised 408(b)(2) regulation provides that a service arrangement is not reasonable unless specific disclosures, described in more detail below, are made to the hiring fiduciary, called the "responsible plan fiduciary." These new requirements are called the "408(b)(2)" disclosure.

2. I've been hearing about fee disclosure for ERISA plans for years. Has this been in the works for a while?

The need to enhance disclosure, particularly regarding fees, has been a topic of conversation at DOL and within the retirement plan community for almost a decade. The development of the 408(b)(2) regulation was part of a "three-pronged" fee disclosure initiative from DOL. The initiative included (1) updates to the Schedule C of Form 5500; (2) disclosure to participants in defined contribution plans; and (3) the 408(b)(2) regulation itself. In December 2007, DOL issued a proposed 408(b)(2) regulation and held a public hearing on the proposal in March 2008.[2] In July 2010, DOL published an "interim" final rule.[3] In February 2012, the final rule was published.[4]

3. How does the final regulation differ from the interim final regulation?

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:

- An exclusion for certain grandfathered Internal Revenue Code Section 403(b) annuity contracts and custodial accounts;[5]
- 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;[6]
- Conformance of investment-related disclosures for covered plans' designated investment alternatives to the requirements of DOL's participant-level disclosure regulation;[7] and
- A separate provision for the disclosure of changes to investment-related information, which must be updated at least annually.[8]

4. What does the final regulation require?

In broad terms, the final regulation requires "covered service providers"—more on that in later questions—to provide responsible plan fiduciaries with information they need to:

- Assess reasonableness of total compensation, both direct and indirect, received by the covered service provider, its affiliates, and/or subcontractors;
- Identify potential conflicts of interest; and
- Satisfy reporting and disclosure requirements under Title I of ERISA.

5. I'm managing the assets of an individual retirement account (IRA) or "X" type of plan. Do I have to provide the disclosure?

The regulation applies to all ERISA-governed retirement plans, which include most defined benefit pension plans and defined contribution/401(k) plans. As a general matter, an investment adviser should know whether the assets it is managing or advising represent assets of an ERISA plan. Space—and your patience—does not permit a full description of ERISA coverage, but a few types of plans are not covered by ERISA's fiduciary rules, including state and local government plans, church plans, and certain nonqualified executive compensation plans. In addition, the regulation exempts ERISA-governed welfare plans – thus the regulation does not apply to a voluntary employee beneficiary association (VEBA) or similar funded health and welfare trust.

Although IRAs are not generally subject to ERISA, they are subject to parallel prohibited transaction rules in the Internal Revenue Code. But the regulation exempts IRAs, including simplified employee pension (SEP) IRAs and savings incentive match plan for employees (SIMPLE) IRAs.[9]

6. What types of service providers are covered under the final regulation?

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.[10]

The first category is for fiduciary/registered investment adviser services. This category is further split into three subcategories: (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 Investment Advisers Act of 1940 (Advisers Act) or state law.

The second category pertains to recordkeeping and brokerage for defined contribution plans that allow participant direction. This category applies if you make available a "platform" of investments in connection with recordkeeping or brokerage services. 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.

The third category relates to other service providers, but only if they expect to receive indirect compensation. Services set forth in this category include most of the services of consequence provided to retirement plans, including accounting, auditing, actuarial, banking, consulting, insurance, investment advisory (for plan or participants), securities and other investment brokerage, legal, recordkeeping, and valuation. 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.

The regulation provides that a person or entity is not a covered service provider solely by providing services as an affiliate or subcontractor of a covered service provider. Further, 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.

7. How does this long definition of "covered service provider" apply to investment managers and advisers?

Many investment advisers and managers will fall under the first category of covered service provider because they provide services *directly to the plan* as an ERISA fiduciary or as an investment adviser registered under the Advisers Act or state law.

If the adviser is not advising the plan directly, but rather is advising or managing a pool of assets in which a plan invests, the analysis is more complex and turns on whether the pool of assets hold ERISA "plan assets." Thus, the adviser of a mutual fund that a plan purchases is not considered a "covered service provider" solely because the adviser is providing services to the mutual fund.[11] On the other hand, the investment manager of a collective investment trust holding "plan assets" would be considered a "covered service provider."

8. I have been engaged by an individual to provide investment advice on all of her accounts, including a 401(k) plan account. I have not been hired by the plan directly. Am I a covered service provider?

It appears the answer is "no" under the regulation, but tread carefully. An adviser can be a fiduciary with respect to an ERISA plan even if the plan does not hire the adviser directly, if the individual is providing investment advice to a participant in a plan with respect to plan assets. Nevertheless, the first and third categories of covered service providers both appear to require providing services to the plan. The first category applies to services provided "directly" to the plan. The third category clearly covers advice to participants (if indirect compensation will be received), but is limited to services "provided to the covered plan."

9. We provide investment advisory services to a plan, but all of our compensation comes directly from the employer that sponsors the plan. Are we a covered service provider?

No. In order to be a covered service provider, you must reasonably expect to receive $1,000 or more in "direct" or "indirect" compensation. "Direct" compensation is defined as compensation received directly from the plan. "Indirect" compensation is defined as compensation received from any source other than the covered plan, the plan sponsor, the covered service provider, or an affiliate.

Two cautions to keep in mind. First, the DOL has said that simply because a service arrangement is not subject to the 408(b)(2) disclosures does not mean that a plan fiduciary that engages the service provider does not need information about the service provider's compensation. ERISA requires contracts or arrangements to be "reasonable" in order to satisfy the ERISA section 408(b)(2) statutory exemption. ERISA also obligates plan fiduciaries to obtain and carefully consider information necessary to assess the services to be provided to the plan, the reasonableness of the fees and expenses being paid for such services, and potential conflicts of interest that might affect the quality of the provided services.[12]

Second, many plans allow the plan sponsor to pay a fee that may be charged to the plan, and later seek reimbursement. An adviser may not know whether or not this will occur, and the regulation does not address whether this would be considered "direct" compensation.

10. What disclosures are required under the final regulation?

- **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).[13]
- **Status of Covered Service Providers, Affiliates, and Subcontractors.** The final regulation requires a statement as to whether 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).[14] A statement is also required if any of the parties reasonably expect 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.
- **Disclosure of Compensation.** The final regulation requires 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.[15] This includes disclosure of all direct, indirect, and "incentive" compensation reasonably expected to be received in connection with services provided to the plan as well as termination charges reasonably expected to be received in connection with the termination of the contract. Each is discussed in more detail below.
  - *Direct compensation*. The regulation requires a 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).
  - *Indirect compensation*. The regulation requires a 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.
  - *Incentive compensation*. The regulation requires a 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 (for example, 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 (for example, 12b-1 fees).
    - *Termination charges*. The regulation requires a 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.
- **Disclosures Regarding Recordkeeping Services.** The final regulation requires disclosure concerning the cost to the covered plan of recordkeeping services, to the extent such services will be provided to the plan.[16] This includes a description of all direct and indirect compensation reasonably expected to be received in connection with such recordkeeping services. 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, the plan must receive 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. This disclosure is sometimes referred to as a requirement to "unbundle" recordkeeping.

- **Investment Disclosure – Fiduciary Services to Pooled Investment Fund.** The final regulation requires disclosure of 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.[17] 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. Required disclosures include:
    - a 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;
    - a description of the annual operating expenses (for example, expense ratio) if the return is not fixed and any ongoing expenses in addition to annual operating expenses (for example, 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); and
    - 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.
- **Investment Disclosures—Recordkeeping and Brokerage Service.** These disclosures are the same as for fiduciary services (described above) for each designated investment alternative for which the service provider is providing recordkeeping and brokerage services.[18]

Compensation can be disclosed in dollars, formulas, or other reasonable method and estimates can be used with explanation of assumptions.[19] The disclosure goes to the "responsible plan fiduciary"—the fiduciary with authority to enter into the arrangement.

11. We always provide our clients with a Form ADV, which describes our fees, and the client also signs an investment management agreement. Does that comply with the rule?

This is the most frequently asked question we have received from investment advisers. The regulation allows existing disclosures to be used if they contain all the information required by the rule, and does not require that

the disclosures come in a particular form or format. In our experience, an investment management agreement coupled with the Form ADV will contain much of the information required by the rule, but not necessarily all. For example, many investment advisers need to supplement the disclosures regarding soft dollar compensation.

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 it with any additional detail. This is not a requirement, but advisers with a significant ERISA plan business find it helpful to ensure compliance.

DOL has a project on its regulatory agenda that could require that all plans receive a guide, index, or "road map" that points responsible plan fiduciaries to where the relevant information can be found.[20] The concern is that if relevant information is contained and hidden in multiple lengthy documents, a responsible plan fiduciary needs help finding that information. No formal proposal has been released by DOL at this time.

Another common issue that investment advisers encounter is that existing disclosures may not describe fees with enough specificity to comply with the regulation. For example, we are often asked to review disclosures that describe an item of indirect compensation as a range. Ranges are often used in Form ADV and similar disclosures. (For example, "We may receive between X and Y basis points from Z.") The regulation states that a description of compensation or cost 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 or cost cannot reasonably be expressed in such terms, by any other reasonable method. In the preamble to the final regulation, DOL states that ranges can used, but they must be "reasonable" under the circumstances surrounding the service and compensation arrangement and should communicate meaningful and understandable compensation information to responsible plan fiduciaries whenever possible. DOL cautioned that more specific, rather than less specific, compensation information is preferred whenever it can be furnished without undue burden.[21] Informal statements of senior DOL officials have indicated this is an area that DOL will look at closely, and could be an area for further guidance in the future.

12. When do the disclosures need to be made?

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. If any information changes, new disclosure is required within 60 days from being informed of the change.[22] A disclosure error can be fixed, but only within 30 days of becoming aware of the error.[23]

The final regulation is effective for both existing and new contracts and arrangements between covered plans as of July 1, 2012.[24] 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.

13. I thought this was an annual disclosure requirement. Is it not?

Unless the information in the disclosure changes, no annual disclosure is required. (Contrast this with the disclosure that goes to participants, which is an annual disclosure requirement.) In practice, many advisers may wish to provide the disclosure annually.

The rules do require, however, disclosures that may be needed more frequently. First, as stated earlier, advisers providing services to an investment product in which a plan invests and that holds "plan assets" must provide certain information that the plan needs to complete the participant disclosure. Generally, this would mean passing along an updated expense ratio and similar information, and the regulation requires that this information be updated at least annually.

In addition, the regulation includes a requirement that a covered service provider furnish any information relating to compensation that is required for the plan to comply with its reporting and disclosure obligations under Title I of ERISA, and must do so reasonably in advance of the date the plan administrator states it must comply with the applicable requirement (absent extraordinary circumstances).[25] Most importantly, this

includes information the plan needs to complete its Form 5500, including Schedule C, which generally occurs annually.

14. What happens if I do not comply with the regulation?

If a covered service provider fails to provide the information required by the regulation, the contract or arrangement between the plan and the service provider is prohibited by ERISA, and the responsible plan fiduciary will have engaged in a prohibited transaction. There is a 15 percent excise tax due to the Internal Revenue Service (increasing to 100 percent if discovered on audit) if a prohibited transaction has occurred. The excise tax is due every year until the transaction is corrected.

The final regulation includes 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.[26] A plan fiduciary must request disclosure, and if disclosure is not provided in 90 days, he or she must report the covered service provider to DOL. Fiduciaries can disclose to DOL online at *www.dol.gov/ebsa/regs/feedisclosurefailurenotice.html*. 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.

15. I have just learned from my compliance department that we failed to make a 408(b)(2) disclosure to a client when the regulation went into effect last July. What should we do?

As noted in the previous question, the penalties for prohibited transactions are severe, so it may be worthwhile to seek the guidance of competent ERISA counsel. The regulation states that a contract or arrangement does not fail to be reasonable solely because a covered service provider, acting in good faith and with reasonable diligence, makes an error or omission in meeting the disclosure requirements, provided the correct information is disclosed as soon as practicable, but not later than 30 days from the date on which the covered service provider knows of the error or omission. This provision could be read to allow for correction of the complete failure to provide a disclosure, if the error was made despite the provider acting in good faith and with reasonable diligence. Obtaining relief for inadvertent errors, which are bound to occur, was a key comment from the regulated community. Even if retroactive relief is not available, it may be worthwhile making the disclosure now to avoid a continuing prohibited transaction with respect to compensation paid in the future.

16. Can we expect a set of FAQs from DOL that are official?

In May 2012, DOL issued a "Field Assistance Bulletin," FAB 2012-02, that provided guidance, in the form of questions and answers, regarding the participant disclosure regulation.[27] Because there is significant interplay between that regulation and the 408(b)(2) regulation, some of those Q&As served as guidance concerning specific requirements of the 408(b)(2) regulation. By and large, however, the Q&As did not address this regulation.

DOL officials at one point indicated informally an interest in collecting questions for a similar set of Q&As for the 408(b)(2) regulation. DOL officials met with trade associations and other interested parties who generally told them that "Q&A" guidance would not be helpful at this time. Largely this was out of concern that the first round of 408(b)(2) disclosures in July 2012 had been made based on a reasonable interpretation of the regulation, and systems programming had been implemented based on that interpretation. Many were concerned that Q&As would be counterproductive. Some DOL officials have said publicly that no Q&As are planned at this time. DOL officials have indicated that they are monitoring compliance with 408(b)(2) and continuing to collect information.[28]

Notes

1. *See* 29 C.F.R. § 2550.408b-2.
2. 72 Fed. Reg. 70,988 (Dec. 13, 2007).
3. 75 Fed. Reg. 41,600 (July 16, 2010).
4. 77 Fed. Reg. 5632 (Feb. 3, 2012).
5. 29 C.F.R. § 2550.408b-2(c)(1)(2); 77 Fed. Reg. 5634 (Feb. 3, 2012).

6. 29 C.F.R. § 2550.408b-2(c)(1)(iv)(C)(2); 77 Fed. Reg. 5636-37 (Feb. 3, 2012).

7. 29 C.F.R. § 2550.408b-2(c)(1)(iv)(F); 77 Fed. Reg. 5638-41 (Feb. 3, 2012).

8. 29 C.F.R. § 2550.408b-2(c)(1)(v); 77 Fed. Reg. 5643-44 (Feb. 3, 2012).

9. 29 C.F.R. § 2550.408b-2(c)(1)(ii); 77 Fed. Reg. 5634 (Feb. 3, 2012).

10. 29 C.F.R. § 2550.408b-2(c)(1)(iii)(A)-(C); 77 Fed. Reg. 5634-35 (Feb. 3, 2012).

11. ERISA §§ 3(21)(B) and 401(b)(1).

12. 75 Fed. Reg. 41,600, 41,606.

13. 29 C.F.R. § 2550.408b-2(c)(1)(iii)(A)-(C); 77 Fed. Reg. 5634-35 (Feb. 3, 2012).

14. 29 C.F.R. § 2550.408b-2(c)(1)(iii)(C); 77 Fed. Reg. 5635 (Feb. 3, 2012).

15. 29 C.F.R. § 2550.408b-2(c)(1)(iv)(C); 77 Fed. Reg. 5636 (Feb. 3, 2012).

16. 29 C.F.R. § 2550.408b-2(c)(1)(iv)(D); 77 Fed. Reg. 5638 (Feb. 3, 2012).

17. 29 C.F.R. § 2550.408b-2(c)(1)(iv)(E); 77 Fed. Reg. 5638-39 (Feb. 3, 2012).

18. 29 C.F.R. § 2550.408b-2(c)(1)(iv)(F); 77 Fed. Reg. 5640-41 (Feb. 3, 2012).

19. 29 C.F.R. § 2550.408b-2(c)(1)(viii)(B)(3); 77 Fed. Reg. 5645 (Feb. 3, 2012).

20. Available at *http://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201210&RIN=1210-AB53*.

21. 77 Fed. Reg. 5645 (Feb. 3, 2012).

22. *Id.*

23. 29 C.F.R. § 2550.408b-2(c)(1)(vi).

24. 29 C.F.R. § 2550.408b-2(c)(1)(xii); 77 Fed. Reg. 5649 (Feb. 3, 2012).

25. 29 C.F.R. § 2550.408b-2 (c)(1)(vi)(A).

26. 29 C.F.R. § 2550.408b-2(c)(1)(ix); 77 Fed. Reg. 5646-49 (Feb. 3, 2012).

27. FAB 2012-02 (May 7, 2012) available at *http://www.dol.gov/ebsa/pdf/fab2012-2.pdf*. FAB 2012-02 was revised on July 30, 2012, and superseded by FAB 2012-02R (available at *http://www.dol.gov/ebsa/pdf/fab2012-2R.pdf*).

28. *See* Kristen Ricaurte Knebel, "EBSA Outlook OK in Face of Sequestration, Agency Still Assessing Disclosures, Borzi Says," BNA, February 25, 2013.

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