



ERISA COMPLIANCE GUIDE: TIPS AND TRAPS FROM THE TRENCHES

West Coast
613 Ocean Drive
Manhattan Beach
CA 90266
T: 310 210 1679

East Coast
60 Thomas Park S.
Boston
MA 02127
T: 617 834 0900

pension-resources.com

By: Jason C. Roberts, Esq.

AUGUST 30, 2011

Sweeping reforms introduced by the Department of Labor (DOL) over the past five years will become effective in 2012 and are expected to present numerous and unique challenges for broker-dealers and advisers. Beginning with the passage of the Pension Protection Act of 2006, which among other things introduced the participant advice exemptions and the concept of qualified default investment alternatives (QDIAs), the DOL has proposed and finalized regulations that require broker-dealers to adhere to certain procedural safeguards and provide frequent and specific information concerning “covered” services offered to ERISA clients. For example, by April 2012, broker-dealers and RIAs must deliver written disclosures to plan sponsors that set forth the services to be provided and all direct and indirect compensation received in connection therewith (including that paid to affiliates, subcontractors, etc.). Affected firms must disclose whether or not they intend to provide any fiduciary services under ERISA, and the DOL recently proposed a regulation that seeks to significantly expand the types of activities that would give rise to fiduciary status.

Over the years, there has been a shift in the way firms are responding to regulatory reform. Broker-dealers that took a proactive approach to assessing the impact of the new requirements tended to view ERISA compliance from a legal perspective and have been forced to rethink their ERISA strategies in light of additional and changing DOL guidance and proposed regulations. These firms typically assembled an ERISA task force and sought the assistance of outside counsel to develop new agreements and/or disclosures and attempted to integrate the agreed-upon services into existing policies and procedures.

While this traditional approach may have helped prepare firms to support ERISA business on a going forward basis, many broker-dealers experienced difficulties in allocating internal resources to successfully implement the programs and/or struggled in their efforts to “retrofit” or migrate existing business. New guidance and regulations have added to these challenges, and firms are beginning to embrace a more holistic approach to ERISA compliance – placing an emphasis on aligning objectives to current resources and/or solutions offered by third-parties. Successful and sustainable programs must take into account all aspects of due diligence, operations, sales, compliance and supervision; amending existing agreements and disclosures alone may no longer suffice.

The remainder of this article provides a “roadmap” for broker-dealers to consider when developing and deploying an ERISA compliance program and emphasizes the need to address the effects of the firm’s proffered strategy as it relates to implementation across all affected areas of the firm. Only after determining the resources, data, policies and procedures required to support each discrete offering, can a broker-dealer successfully implement a compliant and sustainable suite of ERISA-covered services. In other words, given the added complexity of meeting the requirements that are now in play, preparing new agreements and disclosures should be the final step of the project – serving as a wrapper to the protocols and workflow the firm has determined that it can accommodate during the initial phases as articulated below.

Phase I: Develop ERISA Compliance Task Force, Educate on Requirements, Determine Stakeholders and Develop Project Plan:

As discussed, the new requirements will require firm-wide attention, and it is imperative that all affected departments are informed of the issues to be addressed and how any proposed strategy may affect their existing responsibilities, capacity and resources. It is recommended that at least one person from the following areas participates in the firm's ERISA Task Force: executive; legal; compliance; due diligence; operations; supervision; and adviser sales support and education. While broker-dealers typically employ robust securities compliance and legal resources, most do not have the requisite support in terms of in-house ERISA-specific expertise. The Task Force should seek to procure guidance and education on ERISA/DOL requirements, which are specific to broker-dealers, and ensure that each of the areas represented on the Task Force is apprised regarding any potential changes to their staffing needs or required resources. Once the Task Force members understand how the requirements will affect their duties, affected stakeholders may be properly identified and an actionable Project Plan established.

Phase II: Identify Accounts, Collect Data and Determine Gaps in Existing Protocols:

The Project Plan should identify the person(s) responsible for classifying all accounts that may be subject to the new requirements. Under ERISA 408(b)(2), for example, broker-dealers must identify all clients that are receiving "covered" services. This exercise presents tremendous challenges in and of itself, as most broker-dealers have reported difficulties in determining which accounts are subject to ERISA.

After identifying all "covered" services and accounts, firms may begin establishing a centralized point for data collection, including the deployment of technological resources to facilitate the coordination of data gathering from third parties, and develop procedures to provide this data to clients on an ongoing basis. The firm may collect additional information concerning affected services and compensation through a survey its advisers. The designated person(s) should report and remediate any gaps in the identification or data collection processes to the Task Force and procedures should be developed to capture the necessary information going forward.

Phase III: Define Nature and Scope of Desired Programs:

This step is perhaps the most challenging for broker-dealers, as it requires an alignment of goals to current resources (e.g., staffing, in-house ERISA expertise, ability to leverage technology, etc.) to determine whether or not the firm can adequately support approved or desired services. The issues presented by the new requirements, however, can serve as an opportunity to critically evaluate the risks and profitability associated with such offerings. Firms can help to ensure viability

of, and demand for, specific services by establishing focus groups with advisers representing varying levels of sophistication and experience in servicing qualified plans and plan participants.

As a foundational matter, the Task Force will need to determine whether and under what circumstances the broker-dealer will permit advisers to provide ERISA fiduciary services (most often associated with fee-based advisory programs). ERISA imposes a “prudent expert” standard of care on fiduciaries and prohibits fiduciaries from engaging in certain transactions regardless of intent or outcome. For example, it is a prohibited transaction to provide investment advice to a plan or a participant where the adviser is able to affect his/her compensation or that received by an affiliate (e.g., variable 12b-1 fees, revenue sharing, proprietary products, etc.). A firm’s ability to support ERISA fiduciary programs is typically a function of the sophistication of its retirement plan advisers and home office resources. Broker-dealers that elect to take a more conservative position on ERISA fiduciary services or fail to deploy adequate resources to support advisers in this regard may find it difficult to retain top-producing retirement plan specialists.

The Task Force should also carefully consider the appropriateness and competitiveness of allowing advisers to provide specific non-fiduciary support (e.g., investment education, plan committee support, vendor benchmarking, etc.). As fiduciary investment advisers continue to come down market, registered representatives may find themselves at a competitive disadvantage if the broker-dealer does not permit or facilitate a robust offering of non-fiduciary support to plan sponsors.

Once a preliminary set of services are identified, the Task Force can map the flow of documents and information required for each offering. The Task Force should test its existing procedures (i.e., due diligence, compliance, supervision, etc.) and identify changes or additions necessary to support the desired services. For example, the Task Force might consider whether or not it can develop procedures to ensure that compensation received in connection with fiduciary services is level or consider leveraging the capabilities of third parties to mitigate fiduciary risks. In some cases, it may make more sense to “outsource” a fiduciary function to an unrelated, third party (e.g., investment advice or management services offered through the plan’s recordkeeper).

The Task Force should also consider which and under what circumstance plan advisers will be permitted to use tools and resources offered by third parties (e.g., investment monitoring software, investment policy statements, benchmarking programs, education and enrollment materials, etc.). The methodology and output of any deliverables should be evaluated from an ERISA perspective, and specific due diligence procedures should be developed around the selection and monitoring of third-party tools and resources.

Phase IV: Assess the Continued Viability of Existing Programs and Develop Procedures to Migrate Clients to Compliant Arrangements:

Many providers have expanded and enhanced their products to accommodate the needs of broker-dealers. For example, more and more recordkeepers are developing alternative platforms that pay level compensation to the broker-dealer and/or offer access to “remote” advice or investment management programs. These products can mitigate a number of the most common prohibited transactions for broker-dealers by shifting fiduciary risk to third parties or removing prohibited conflicts of interest between the adviser and the client. The Task Force should arrange for ERISA-centric due diligence to be conducted on the availability of these programs and carefully review any agreements executed in connection therewith.

The Task Force should also review the potential impact of new and proposed requirements on its existing arrangements with third parties (e.g., solicitor programs, tri-party service agreements, etc.) to ensure that the responsibilities imparted to the adviser and the broker-dealer are reasonable and are likely to remain compliant. The DOL’s recent proposal to expand the definition of fiduciary under ERISA, for example, seeks to make advice or recommendations concerning the management of securities or other property a fiduciary act. If the adviser or the firm receives more compensation in connection with the recommendation of one manager over another, a prohibited transaction may occur if the adviser is deemed to be providing fiduciary services under the new definition. Similarly, while existing agreements may delegate certain functions to third parties (e.g., model portfolios, managed accounts, participant advice, etc.), many of these arrangements may nevertheless require the adviser to provide services that may give rise to fiduciary status (e.g., advice concerning the selection and monitoring of the plan’s designated investment alternatives). Consequently, there may be cases where the broker-dealer remains liable as an ERISA fiduciary in connection with providing a subset of services to the plan. In addition to reviewing existing arrangements, the Task Force should develop procedures to review future agreements to ensure the services are provided in a manner consistent with its chosen ERISA compliance structure.

Phase V: Develop Service Agreements and/or Disclosure Documents and Map to Procedures:

Once the foregoing analysis is completed, and the Task Force has determined the nature and extent of its ERISA-covered services, new agreements and/or written disclosures should be developed to comply with the specific requirements of the 408(b)(2) regulation. The final regulation does not require written service agreements, so broker-dealers may opt to provide the required information in through disclosures alone. We are encouraging broker-dealers to develop written agreements to contain the disclosures and memorialize the services to be provided – and perhaps more importantly – to disclaim responsibility for services they do

not intend to provide. Having a written agreement also helps to ensure that disclosure has been made to the appropriate person (the responsible plan fiduciary), and the broker-dealer can use the agreement to collect information about the plan that may help to monitor the services being provided.

On the fee-based advisory programs, written agreements and disclosures in the Form ADV Part II are required under the Investment Advisers Act of 1940. That said, given the complexity and the manner in which the ERISA disclosures must be made, firms should develop ERISA-specific investment advisory agreements and supplement the Schedule F to the Form ADV Part II to reflect the covered services.

Building upon the above-referenced analysis of the procedures and resources required to support the agreed-upon services (Phases III and IV), program-specific due diligence, compliance and supervisory procedures will need to be codified. At this point in the process, however, the Task Force should be familiar with the third-party tools, resources and service arrangements that may be offered in connection with the services as well as the flow of documents and information between the firm and its clients and the firm and its advisers. By proceeding in this manner, the Task Force can streamline the implementation of the desired program(s), as it will have already determined activities that are capable of being adequately supported, and if the firm has elected to utilize the services of third parties (e.g., off-the-shelf technology solutions, outsourced sales support, etc.), the applicable procedures can be drafted to reflect the input and output of required information. Waiting until the services have been confirmed saves considerable time in the development of procedures because the procedures need to be specific to those services as well as the accounts that were previously identified as covered (Phase II). The Task Force should consider what, if any, programs offered by third parties it may wish to require for its plan advisers and incorporate those requirements into the adviser training (Phase VI) as well as applicable compliance and supervisory procedures.

Phase VI: Develop and Deliver Home Office and Adviser Training:

As a final step in preparing for the new requirements and implementing the chosen strategy, home office training, in addition to program-specific adviser training should be conducted. Effective supervisory review, for example, will be a function of the understanding and expertise of those charged with supervision. Given the complexity of ERISA compliance and the fact that most firms have not provided training on these issues, it is necessary that home office personnel understand the new requirements and the structure and processes developed by the Task Force to implement and maintain the approved services.

Adviser training should similarly incorporate the firm's program-specific requirements, and many firms are seeking to bifurcate their advisers into varying degrees of expertise in servicing qualified plans and ERISA clients. If the firm

determines that certain advisers will be able to offer more or different services than others with less experience, the training should be developed in modular fashion so that the materials and information can be targeted to the approved services. If the firm elects to qualify its advisers through third-party programs or designations, it should nevertheless provide ongoing firm-specific training on the policies and procedures required to conduct ERISA-covered business. Given the complexity of the current regulatory environment an increasingly competitive marketplace, broker-dealers may also want to consider developing and maintaining retirement plan “sales guides” that incorporate ERISA compliance protocols with specific retirement plan sales strategies.

Once the firm has completed the foregoing, it should seek to procure ongoing education to ensure compliance with new regulations and evolving DOL guidance. Again, compliance strategies will vary from firm-to-firm, and the above-referenced Phases are meant to serve as a guide to consider when responding to the challenges presented by pending requirements. Some firms may have more or fewer issues to consider based upon their affiliates, internal resources, adviser demographics, etc. For more information about this guide, please contact Jason C. Roberts, founder and CEO of the Pension Resource Institute, LLC, at jroberts@pension-resources.com.