

ERISA 408(b)(2) Compliance Roadmap: A 10-Step Approach to Plan-Level Fee Disclosures for Broker-Dealers and Investment Advisers

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A new regulation requires service providers to employee benefit plans to disclose information to plan fiduciaries describing the services they perform and the compensation received for those services. Most services provided by broker-dealers and investment advisers are covered by the new rules, even where the compensation is received indirectly from investment providers and/or managers.

Scheduled to take effect April 1, 2012,¹ the new disclosure rules are intended to help plan fiduciaries assess whether:

1. the contract or arrangement is necessary for the operation of the plan;
2. the compensation received for the services is reasonable; and
3. any conflicts of interest exist that might make the contract or arrangement unreasonable.

It is a prohibited transaction under ERISA for plan fiduciaries to enter into arrangements that are unnecessary or unreasonable, and the sufficiency of the service providers’ disclosures is measured by whether the plan fiduciaries have sufficient information to meet the plan’s reporting requirements (e.g., Form 5500, Schedule C, 404(a) (5) participant-level disclosures, etc.) Consequently, where a service provider fails to deliver the information accurately or timely, the new rules provide a mechanism for plan fiduciaries to report the deficiency; and the burden shifts to the service provider to demonstrate compliance with the rules and avoid engaging in a prohibited transaction.

This ERISA Compliance Roadmap is meant to provide a foundation from which broker-dealers and RIAs can assess the impact of the new rules on their business lines and implement the necessary

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steps to meet their disclosure requirements under ERISA 408(b)(2). Affected firms should begin by addressing the following steps:

1. Determine which accounts are “covered” plans under the new regulations;
2. Determine whether the services provided are “covered” by the new regulations;
3. Evaluate the impact of covered services on fiduciary status;
4. Analyze all arrangements for compensation received in connection with covered services for prohibited transactions;
5. Determine if prohibited transactions are implicated and whether exemptions are available;
6. Amend the firm’s policies and procedures to comply with ERISA or meet the requirements for relief provided by a prohibited transaction exemption;
7. Develop disclosures describing the covered services that align with the firm’s desired posture regarding the foregoing, including an acknowledgement of fiduciary status under ERISA and/or the Investment Advisers Act if/where required;
8. Determine how to obtain the compensation-related information required to be disclosed;
9. Develop procedures to ensure effective delivery of the disclosures and required updates when there is a change in covered services or compensation; and
10. Educate home office and field personnel on the new requirements and any changes to the firm’s policies and procedures.

This Roadmap addresses Steps 1–3. Affected firms should engage consultants or legal counsel with the necessary expertise to evaluate Steps 4–10 based upon the results of the following considerations.

When looking to third-parties for support, it is imperative that firms seek guidance from professionals who have experience with both securities- and ERISA-related matters, as many of the decisions required to be made will impact all aspects of the firm, including compliance, due diligence, sales and supervision. Lastly, it may not be advisable to take a compliance-only approach to the new rules; the competitive nature of the services must be considered to ensure a comprehensive

strategy is adopted that is sustainable and profitable in the new retirement plan marketplace.

1. Determine which accounts are “covered” plans under the new regulations

A “covered plan” is an employee benefit plan as defined by ERISA, including defined benefit or pension plans and defined contribution plans such as 401(k) and profit sharing plans. SEPs, SIMPLEs and IRAs are not “covered” by the new regulations. ERISA-covered 403(b) plans are also subject to the new disclosure rules, but public education employer 403(b) arrangements and the plans of tax exempt entities that are not subject to ERISA are not covered.

Affected firms should conduct an audit of their covered plans to ensure they will have adequate information to make the required disclosures. For held away business, the firm should begin communicating with custodians, record keepers and other third-party retirement plan providers to identify the accounts and nature of compensation received by the firm. Specifically, the firm should request the following basic information: (i) the type of plan (e.g., 401(k) bundled/unbundled, group variable annuity or mutual fund platform, etc.); (ii) the name(s) and contact information for plan fiduciaries; (iii) the investments held by the plan; (iv) the nature of the compensation received (e.g., 12b-1, commissions, Assets Under Management, etc.) and whether it varies based upon the investments designated by the plan; and (v) if so, how that information will be received by the firm when required to be reported to plan fiduciaries.

Most firms will have better access to information for covered accounts held long; however, there may be a number of additional considerations with respect to compensation. For example, broker-dealers may receive revenue sharing payments, networking fees, reimbursements and/or compensation on money market or bank sweeps, mark-ups, etc. in connection with brokerage services provided through a clearing firm or direct with mutual funds.

To ensure all of the firm’s covered plans are properly identified, appropriate field personnel should be surveyed so the firm can cross-reference the

information with that obtained through third-parties.

Keeping in mind that the regulations require firms to disclose any and all compensation, direct and indirect, received by the firm, its affiliates and/or sub-contractors, in connection with the services provided, it is imperative that the firm evaluate such compensation to ensure there are no violations of ERISA's fiduciary duties and no prohibited transactions. Table 1 is intended to provide a framework for categorizing covered plans and compensation.

Table 1

Type of Arrangement	Location of Plan Assets/ Records	Plan Accounts			
		Acct. #	Plan Type	Plan Investments	Nature and Source of Comp.
Brokerage	Firm-Level				
Outside Recordkeeping Platforms					
1. Mutual Funds	(Name)				
2. Group Annuities	(Name)				
3. Bank (CIT)	(Name)				
4. RK Only	(Name)				
Directly Held Mutual Funds	(Name)				
Directly Held Annuities	(Name)				
Others (e.g., TPAM)	(Name)				

2. Determine whether the services provided are "covered" by the new regulations

The regulation applies to covered service providers that reasonably expect to receive \$1,000 or more in direct or indirect compensation and provide the following services:

1. Services directly to a covered plan as a fiduciary under ERISA or the Investment Advisers Act of 1940;
2. Services as a fiduciary for investment vehicles that hold plan assets;
3. Services to a covered plan as an RIA;
4. Recordkeeping or brokerage services to participant-directed plans that offer one or more "designated investment alternatives;" and
5. Other services, such as accounting, actuarial, legal and other professional services, consulting, banking, insurance, securities or other investment brokerage, recordkeeping and third party administration services, among others, if the service provider receives indirect compensation (including compensation paid by anyone other than the plan sponsor, the plan itself or any affiliate of the service provider).

The first three categories are definitional, and the firm evaluates its status to determine whether the services are covered for each plan identified in Step

1. For example, services provided by RIAs may be covered under numbers 1 and/or 3, as most RIAs provide investment advice to plan fiduciaries and/or participants. Number 2 may apply if the RIA sponsors or sub-advises a collective investment trust, for example.

For category number 4 (recordkeeping or brokerage services for direct compensation), the firm must answer the following questions to determine whether the services are covered:

1. Does the firm (and its affiliates) expect to receive more than \$1,000 in connection with the services over the lifetime of the arrangement?
2. Is the plan an individual account plan that permits participants or beneficiaries to direct the investment of their accounts?
3. If so, is one or more designated investment alternative made available in connection with the brokerage or recordkeeping services?

Direct compensation includes anything of monetary value (other than non-monetary compensation valued \$250 or less) that the firm, an affiliate or a subcontractor expects to receive from the plan. Direct compensation, however, does not include payments from the plan sponsor that are not out of plan assets. If all of the above questions are answered in the affirmative, the firm must disclose the following: (i) how direct compensation is determined (e.g., as an amount, formula, per capita charge or percentage of plan assets); and (ii) the manner of receipt (i.e., whether the compensa-

tion will be billed to the plan or deducted directly from participant accounts).

With respect to category number 5 (consulting and/or brokerage for indirect compensation, etc.), potentially affected firms must answer the following questions:

1. Does the firm (and its affiliates) expect to receive more than \$1,000 in connection with the services over the lifetime of the arrangement?
2. Does the firm provide consulting services (i.e., providing assistance to develop investment policy statements or to select or monitor service providers or investment managers), brokerage, accounting, auditing, actuarial or other services?
3. Does the firm (or its affiliates) receive indirect compensation in connection with the services?

Indirect compensation is compensation received for the service from any source other than the covered plan or the plan sponsor. If each of the above answers is “yes,” the firm must provide the required disclosures by: (i) identifying the services for which the indirect compensation is received; (ii) the payer(s) of indirect compensation; (iii) describing how the indirect compensation is determined (e.g., as an amount, formula, per capita charge

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or percentage of plan assets); and (iv) the manner of receipt (i.e., whether the compensation will be billed directly or deducted from the covered plan’s account or investments).

3. Evaluate the impact of covered services on fiduciary status

In addition to disclosing the services to be provided to covered plans, and all direct and indirect

compensation received in connection therewith, affected firms must include an acknowledgment of fiduciary status where the services are reasonably expected to give rise to such status under ERISA and/or the Advisers Act. While the latter is beyond the scope of this Roadmap, Section 3(21) of ERISA defines a “fiduciary” as one who:

1. has any discretionary authority or control in the administration of the plan;
2. exercises any authority or control with respect to the management or disposition of plan assets; or
3. renders investment advice to a plan for a fee or other compensation, direct or indirect.

Because the definition focuses on the activities of the individual, a person’s title or position is immaterial if he or she meets one or more of the three tests. Employees who administer the plan on behalf of the plan sponsor (i.e., plan committee members) derive their fiduciary status from making decisions affecting the plan (e.g., selection of service providers) and/or plan assets (e.g., designating or replacing investment options).

ERISA requires plan fiduciaries to manage their plan’s investments in accordance with the “prudent man rule.”² They must understand and apply generally accepted investment theories, such as modern portfolio theory. If they do not have the necessary expertise, they are required to engage investment professionals.³ Consequently, most plan sponsors look to financial advisers for support in selecting and monitoring investments.

If the advice provided is determined to be fiduciary “investment advice” under ERISA, the adviser (and his/her supervising firm) will be subject to strict prohibitions regarding conflicts of interest and may be held personally liable for losses stemming from a breach of a fiduciary duty.⁴ For example, Sections 403(c)(1) and 404(a) of ERISA require, among other things, that the assets of a plan be held for the exclusive purpose of providing benefits to participants and beneficiaries of the plan and defraying reasonable administrative expenses of administering the plan, and that a fiduciary with respect to the plan carry out his duties for the exclusive purpose of providing benefits to participants and beneficiaries. Section 406(b) applies to fiduciaries and prohibits, among

other things, using the authority that makes one a fiduciary to affect the compensation received by the fiduciary (or an affiliate) or acting on behalf of a party whose interests are adverse to the plan. If the advice is administrative or educational in nature, the financial adviser will not be subject to ERISA's fiduciary duties or the above-referenced prohibited transactions.

Regulations issued by the Department at 29 CFR 2510.3-21(c), define the circumstances under which a person will be deemed to be rendering "investment advice" within the meaning of section 3(21) of ERISA.

A person shall be deemed to be rendering investment advice under ERISA if:

1. Such person renders advice to the plan as to the value of securities or other property, or makes recommendation as to the advisability of investing in, purchasing, or selling securities or other property; and

Such person either directly or indirectly (e.g., through or together with any affiliate) renders such advice:

2. on a regular basis to the plan;
3. pursuant to a mutual agreement, arrangement or understanding, written or otherwise, between such person and the plan or a fiduciary with respect to the plan;
4. that such services will serve as a primary basis for investment decisions with respect to plan assets; and
5. such person will render individualized investment advice to the plan based on the particular needs of the plan regarding such matters as, among other things, investment policies or strategy, overall portfolio composition, or diversification of plan investments.⁵

ERISA does not distinguish the application of fiduciary status at the plan- or participant-level. Consequently, financial advisers may become ERISA fiduciaries if they provide investment advice to the plan sponsor (or committee) or to plan participants and beneficiaries. ERISA does, however, provide a distinction between what constitutes investment education to plan participants.

In 1996, the DOL issued an Interpretive Bulletin (96-1) relating to "participant education." Under this interpretation, a person will *not* be deemed to be providing "investment advice" with respect to investment education materials in the following categories:

1. Information about the plan, including the investment options available under the plan and the objectives of the various options;
2. information about investing generally, including information about different types of investments;
3. information about different investment allocation strategies, including information about historical returns; and
4. interactive materials designed to help participants identify appropriate investment strategies.

As discussed, ERISA imposes a number of stringent duties on those who act as fiduciaries, including a duty of undivided loyalty, a duty to act for the exclusive purposes of providing plan benefits and defraying reasonable expenses of administering the plan, and a stringent duty of care grounded in the prudent man standard from trust law. Congress supplemented these general duties by categorically barring, subject to exemption, certain "prohibited" transactions.

It is a prohibited transaction under ERISA for plan fiduciaries to enter into arrangements that are unnecessary or unreasonable, and the sufficiency of the service providers' disclosures is measured by whether the plan fiduciaries have sufficient information to meet the plan's reporting requirements....

If the firm does not have sufficient policies and procedures to ensure compliance with these requirements, it should be careful to limit the disclosed services to those which do not implicate fiduciary status. Because the test is functional, however, supervising firms should take steps to educate their

advisers regarding the provision of investment education so they do not become fiduciaries by rendering investment advice.

Upon completion of the foregoing analysis, firms should proceed by analyzing compensation arrangements for prohibited transactions and exemptive relief (if available) and developing compliant disclosures and corresponding policies and procedures. Prior to educating home office and field personnel, any new processes should be tested to ensure that any changes to

the disclosed information can be accurately and timely communicated to covered plans. Engaging outside expertise can streamline this analysis and provide a foundation from which to evaluate firm-specific considerations and make well-informed decisions. Given the breadth of the regulation and severity of penalties for violations of ERISA, affected firms should take action now in order to properly develop, test and deploy a competitive and compliant approach to the new plan-level fee disclosures.

ENDNOTES

¹ At the time of publication, the 408(b)(2) regulation is considered "interim final." The DOL has indicated that any changes in the final regulation will be limited to the format (and perhaps timing) of the disclosures, as it considered additional comments and testimony regarding whether to include a summary disclosure form or "roadmap" to be delivered along with the required disclosures; the nature and scope of the disclosures are expected to be substantively similar to the requirements contained in the interim final rule.

² ERISA 404(a)(1)(B).

³ DOL Reg. § 2509.95-1(c)(6).

⁴ Section 405(a) of ERISA provides that a fiduciary of a plan may be liable for a breach

of fiduciary responsibility committed by another fiduciary of the plan: (1) if s/he knowingly participates in, or undertakes to conceal, a fiduciary breach of another; (2) if, by failing to comply with 404(a)(1), s/he has enabled such other fiduciary to commit a breach; or (3) if s/he has knowledge of the breach by such other fiduciary and fails to remediate.

⁵ On October 22, 2010, the DOL published a notice of Proposed Amendment to Regulation under ERISA Section 3(21)(A)(ii). Specifically, the proposed regulation if adopted, would have amended the regulation at 29 CFR 2510.3-21(c) defining what it means to render "investment advice" as fiduciary under ERISA. While the proposal was withdrawn in September 2011, the DOL

is expected to introduce a revised proposal in early 2012.

The proposed definition would eliminate some of the requirements of the multi-part test referenced above and set forth additional activities such as advice or recommendations relating to the selection of investment managers. Under the proposed regulation, for example, there is no requirement that the advice or recommendations be rendered on a "regular basis" or that there be an understanding that it will be the "primary basis" for investment decisions; if there is an understanding or agreement that the advice "may be considered" in connection with a plan investment decision, such advice would give rise to fiduciary status under the proposed definition.

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