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DEPARTMENT OF LABOR IMPOSES SIGNIFICANT DISCLOSURE OBLIGATIONS ON BROKER-DEALERS AND INVESTMENT ADVISERS

The Department of Labor ("DOL") recently issued interim final regulations under Section 408(b)(2) (the "Rule") of the Employee Retirement Income Security Act of 1974 ("ERISA"). This amendment is generally considered to be a fee disclosure regulation which will require fiduciaries and certain service providers to employee pension plans to disclose additional information, including the reasonableness of the service providers' compensation and potential conflicts of interest that may affect the service providers' performance. It is anticipated that this information will further enable fiduciaries to fulfill their duty to make informed decisions about the reasonableness of fees as required under ERISA 404(a)(1).

Background

Section 401(a) of ERISA requires plan fiduciaries to act prudently and solely in the interest of the plan's participants and beneficiaries when selecting and monitoring service providers and plan investments. To this end, plan fiduciaries must ensure that arrangements with their service providers are "reasonable" and that only "reasonable" compensation is paid for services. Fundamental to the ability to determine such reasonableness, is the availability of information sufficient to allow the plan fiduciary to make informed decisions about the services, the costs, and the service provider.

Simultaneously, as a result of changes in the tools and methods utilized to provide plan services, the costs of administrative services have been reduced for plans and their participants. However, these same changes to the process result in a blurring of how, and at what cost, service providers are compensated for the specific plan services being rendered (e.g. through revenue sharing and other arrangements).

The apparent purpose of this regulation is to require plan service providers to provide sufficient disclosure to the plan sponsor and fiduciary in order to enable them to fulfill their obligations in determining both the reasonableness of what is being paid and the potential conflicts of interest that may affect the performance of those services.

Current Definition of Fiduciary

ERISA's current definition of fiduciary status is functional, which means that even if an adviser does not acknowledge that it is acting as a fiduciary, if the adviser performs fiduciary tasks, it will be subject to fiduciary standards and prohibited transaction rules. ERISA provides three ways in which one can be deemed to be a fiduciary:

- Exercising any discretionary authority or discretionary control regarding the management of such plan or exercising any authority or control respecting management or disposition of its assets, or
- Rendering investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or having any authority or responsibility to do so, or
- Having any discretionary authority or discretionary responsibility in the administration of such plan.

Covered Plans
All ERISA governed retirement plans, other than simple IRAs and SEP IRAs (since they are not ERISA plans.) are "covered plans." This means that 401(k) plans, ERISA covered 403(b) plans, defined benefit pension plans, and non-participant directed profit sharing plans, among others, are all subject to this regulation.

Covered Service Providers
"Covered service providers" are defined as those persons or companies that reasonably expect to receive $1,000 or more in direct or indirect compensation and provide "covered services." There are three categories of services that have the greatest impact on investment advisers and broker-dealers:

- Services provided directly to a plan as a fiduciary under ERISA §3(21), which would generally include an investment adviser providing advisory services to a plan or participants in a plan;
- Services provided directly to a plan as an investment adviser registered under the Investment Advisers Act of 1940 ("Act") or state law, which would include IRAs providing services that might not constitute fiduciary services;
- Consulting and investment advisory services if the service provider reasonably expects to receive "indirect compensation". Generally, "consulting" services are those services that relate to the development or implementation of investment policies or objectives or the selection or monitoring of service providers or plan investments. These services may be rendered in a manner that results in them being non-fiduciary services, which presumably is why the DOL included this category of "covered service."

Covered Service Provider Disclosure
The rule requires covered service providers to disclose in writing the following information to the plan fiduciary, reasonably in advance of the date the contract or arrangement is entered into, and or is extended or renewed:

- **Services.** A description of the services to be provided pursuant to the contract or arrangement.
- **Status.** If applicable, a statement that the provider, an affiliate, or a subcontractor will provide, or reasonably expects to provide, services as a fiduciary and/or an investment adviser registered under the Act or any state law.

- **Compensation.** A description of all direct and indirect (i.e., commissions, 12b-1 fees for designated investment alternatives, etc.) compensation received by the service provider, an affiliate, or a subcontractor in connection with the services. Direct compensation means anything of monetary value, such as money, gifts, awards and trips, but excluding non-monetary items valued at $250 or less, received during the term of the contract or arrangement, that is received directly from a plan. Indirect compensation is "compensation" that is received from any source other than the plan, the plan sponsor, the covered service provider, an affiliate of the service provider or a subcontractor of the service provider. The disclosure of indirect compensation must identify the services for which such compensation will be paid and the payers and recipients of such compensation, including the status of a payer or recipient as an affiliate or a subcontractor.
- **Compensation for Termination.** A description of any compensation that the service provider, an affiliate, or a subcontractor reasonably expects to receive in connection with termination of the contract or arrangement, and how any prepaid amounts will be calculated.

Other Disclosure Issues
A service provider must disclose any change to the required information as soon as practicable but in any case no later than 60 days from the date on which the service provider acquires knowledge of the change. However, there is a provision that allows for additional time in extraordinary circumstances.

Reporting and Disclosure Information
The regulation requires a service provider to disclose, upon written request, any other information relating to compensation received in connection with the arrangement, if it is required for the plan to comply with the reporting and disclosure requirements of ERISA and the regulations, forms and schedules issued thereunder. The information must be provided not later than 30 days after receipt of a written request from the responsible plan fiduciary or plan administrator unless the disclosure is precluded due to extraordinary circumstances beyond the service provider's control.

Impact on Investment Advisers
Most investment advisers, with ERISA specific agreements, probably provide adequate disclosure of the direct compensation they receive currently. In many cases, those who receive indirect compensation already disclose that fact, and the fact that they offset such compensation against the fees they charge (since it would be a prohibited transaction under ERISA §406(b)(3) if they do not offset indirect payments related to recommended investments where they are providing fiduciary investment advice).

However, even these investment advisers will be affected by the modification to the Rule, as investment adviser disclosures will need to be modified due to the requirement to disclose the amount or formula and the payer of indirect compensation. This is because In cases where an investment adviser currently makes generic disclosures of indirect compensation, without disclosing the amount of, or formula for, the compensation, and the entity from which the compensation will be paid, will now have to prepare and deliver a more detailed disclosure. This type of compensation is not unusual for investment advisers that are dually licensed as a broker-dealer and receive 12b-1 fees.

Even those investment advisers that don't exercise discretionary authority or control over the management or administration of a plan or plan assets will be impacted by the rule. Based upon the services that a plan receives, and the services a plan believes it is receiving, an investment adviser may be deemed a covered service provider and subject to the rule. Thus, an investment adviser who provides instructions directly to the plan's custodian and or record keeper with respect to the rebalancing of assets in the account, may be deemed to be exercising discretion over those assets, even if the plan fiduciary and or the participant makes the final determination on how the assets are to be invested.

Additionally, the disclosure requirements apply to all covered services and to all compensation received by an investment adviser and or an affiliate, both direct and indirect. As a result, investment advisers will need to either cover all of the services in a single contract or enter into separate contracts, with separate disclosures, for each such service.

The final requirement, regarding termination payments and prepaid amounts, will have varying impacts. Investment advisers do not generally impose a termination charge and most are paid in arrears for their services. However, investment advisers that are paid in advance will need to include a description of the proration and refund of the advance payment if the contract is terminated before the entire advance payment is earned.

Impact on Broker-Dealers

The final regulation is also expected to also have a significant impact on broker-dealers, given that registered representatives, as well as their firms, receive ongoing, indirect compensation from investment providers in the form of 12(b)(1) fees. Thus broker-dealers whose registered representatives are determined to be providing investment advice will be at risk for potential prohibited transactions when that compensation is disclosed in writing. Since participation in a prohibited transaction can result in serious regulatory and criminal sanctions, it is critical that broker-dealers review their relationships with their plans and implement appropriate safeguards to monitor and supervise this activity at the plan and participant level.

Additionally, investment advisers are currently required by Form ADV Part II to disclose conflicts of interest, so disclosure is not a new issue for them. However, broker-dealers have no disclosure document that is comparable, so they will have to create one. And with the numerous conflicts of interest related to compensation, there may be more potential conflicts of interest that are required to be disclosed.

Action Items

Based on the client base and services provided, both investment advisers and broker dealers will be impacted by the recent changes in ERISA, which generally become effective on July 16, 2011. Since the requirements of the Rule will apply to all contracts or arrangements between covered plans and covered service providers on the effective date, whether or not entered into prior to the effective date, any information required to be provided pursuant to the regulations with respect to contracts or arrangements entered into prior to July 16, 2011 must be furnished no later than July 16, 2011.

As such, investment advisers, broker-dealers, as well as affiliates and other direct or indirect providers of financial services to plans or entities in which they invest should:

- Take inventory all of their covered plan clients;
- Determine what services are provided to those covered plans;

- Determine the status of such services (i.e., fiduciary or non-fiduciary);
- Determine the direct and indirect compensation related to those covered plans and the plan services provided;
- Meet with ERISA counsel to determine whether such services are in fact impacted by the regulations;
- Consider whether current contracts or arrangements, or those anticipated to be entered into before July 16, 2011, are or will be subject to the regulations;
- Prepare relevant disclosure documentation related to such services;
- Modify their policies and procedures accordingly; and
- Train and educate their staff with respect to the impact required modifications made to address the new client relationships and disclosures.

We hope that this information has been helpful to you. Should you have any additional questions or concerns, please feel free to contact Daniel E. LeGaye or Michael Schaps by e-mail at www.legayelaw.com or phone, at 281-367-2454, or consult with your legal counsel or third party consultant.