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New ERISA 408(b)(2) Regulations

Mastering Detailed Requirements for Service Provider Fee Disclosures

WEDNESDAY, JANUARY 26, 2011

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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New ERISA 408(b)(2) Regulations Webinar

Jan. 26, 2011

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Today's Program

Sarah Lowe, Kilpatrick Townsend

408(B)(2) BACKGROUND

Background: Rationale For 408(b)(2)

- ERISA Sect. 406(a)(1)(c) prohibits the "furnishing of goods, services or facilities between a plan and a party in interest."

- However, even at its inception, ERISA provided a statutory exemption to this prohibition if:
  - The service arrangement is reasonable,
  - The services are necessary for the establishment and operation of the plan, and
  - No more than reasonable compensation is paid for the services.

- Congress recognized plans would be better served by allowing parties in interest to provide services and goods to plans, provided that certain safeguards were in place.

Rationale For 408(b)(2), Cont.

- Until now, there has been little guidance on what constitutes a "reasonable" contract or arrangement.

- In 1977, the Department of Labor (DOL) issued a regulation that provided a reasonable contract be terminable upon reasonably short notice without penalty.
  - Reasonable termination charges for loss to the service provider are not considered a penalty.

- Burden has been on the plan fiduciary to determine that the arrangement falls within the exemption.

The Perfect Storm

- Shift from defined benefit plans to defined contribution plans
  - Risk shifted from corporate sectors to individuals
  - Retirement income dependant on investment performance
  - Small changes in 401(k) fund fees can have huge effect on nest egg over time.
- Participants were responsible for investing 401(k) appropriately.
- Plan fiduciaries (often sponsors) were responsible for designing maximum retirement savings.
- Hidden fees made it difficult to determine how and what service providers were compensated and to identify conflict of interests that might affect their performance.
  - Revenue-sharing
  - "No cost" recordkeeping services

The Perfect Storm (Cont.)

- Rise in fee litigation
  - Against plan fiduciaries
  - By plan fiduciaries against service providers
- Increased scrutiny by government regulators
  - Department of Labor
  - Securities and Exchange Commission
  - Memorandum of understanding (2008) between DOL and SEC to share information on retirement and investments in what they said was a bid to protect the $5.8 trillion in retirement assets of American workers, retirees and their families held in employee benefit plan' “no cost” recordkeeping services.
- Increased attention from Congress

KILPATRICK TOWNSEND

The DOL Initiative:
A Three-Part Initiative To Increase Transparency Of Fees And Expose Conflicts Of Interest

- Form 5500, Schedule C
  - In 2007, the DOL finalized changes, effective for 2009 plan year
  - Requires increased reporting of fees paid directly or indirectly by large plans
- ERISA Sect. 408(b)(2)
  - In 2007, the DOL proposed new regulations under ERISA Sect. 408(b)(2)
  - In July 2010, the interim final regulations under 408(b)(2) were issued, effective July 16,2011.
- Participant-disclosure regulations issued in 2010
  - Mandate fee disclosures for participant-directed plans
  - Applicable for plan years beginning after Nov. 1, 2011
  - Some fee disclosures are required to receive protection under ERISA section 404(c), but compliance is optional.

Marianne Yudes, Morgan Lewis
Sarah Lowe, Kilpatrick Stockton

INTERIM FINAL REGULATIONS

Agenda For This Section

- When are the new rules effective?
- Which plans are covered?
- Standards for covered service providers
- Which services must be disclosed, and when?
- Standards for direct and indirect provider compensation
- Bundled service arrangements
- Recordkeeping services
- Potential non-compliance penalties
- Other significant terms

Effective Date

- Certain service providers to employee benefit plans will be required to disclose detailed information to independent plan fiduciaries regarding services, and the direct and indirect compensation they receive in connection with those services.
- Effective July 16, 2011 (comment period closed 8/30/10)
  - Applies to all covered service contracts or arrangements as of this date
  - For pre-existing contracts or arrangements, the disclosures must be furnished no later than this date.
- DOL has indicated that it will not issue new guidance until it issues the final rule expected in April 2011 (maybe); department has said it will be "sensitive" to need for time to adjust to any changes in the final rule before the effective date.

Covered Plans

- Requirements apply *only* to ERISA-governed pension plans (DB and DC), with a separate subsection reserved to deal with welfare plans in future guidance.

- Does not apply to IRAs, IRA annuities, SEPs or SIMPLEs

Covered Service Providers

- Only applies to certain "covered" service providers, defined as service providers that enter into a contract or arrangement with a covered plan to provide any of the following:
  - Services as an ERISA fiduciary: Including as a fiduciary to an investment contract, product or entity that holds plan assets in which the covered plan has a direct equity investment (a plan asset fiduciary); or as a registered investment adviser (whether under federal or state law)
  - Recordkeeping or brokerage services: To a covered plan that is an individual account plan and that permits participant investment direction, where "designated investment alternatives" will be made available in connection with recordkeeping or brokerage services
  - Other services: Such as accounting, auditing, investment advisory, recordkeeping, brokerage and consulting for which the covered service provider, an affiliate of the service provider or a subcontractor reasonably expects to receive either "indirect" compensation or "compensation received among related parties"

Covered Service Providers (Cont.)

- The concept of a covered service provider captures only the party directly responsible to the covered plan for the provision of the services, even when some or all of the services may be performed by an affiliate or subcontractor of that party.
- To be “covered,” the service provider must reasonably expect to receive $1,000 or more in compensation, direct or indirect, in connection with providing one or more of the covered types of services (but, it is unclear whether it’s measured per year or over life of contract).
- “Compensation” is anything of monetary value, such as money, gifts, awards and trips. However, this term does not include nonmonetary compensation valued at $250 or less, in the aggregate, during the term of the contract or arrangement.
- Parties reported as service providers for Form 5500 Schedule C purposes will not necessarily be the same as those covered by the new disclosure rules.

Initial Disclosure Requirements

- A series of disclosures must be provided by the covered service provider to a "responsible plan fiduciary," who is a plan fiduciary with the authority to cause the covered plan to enter into, or extend or renew, the contract or arrangement for the services.

- The required disclosures include certain information regarding the services to be provided and a description of the expected compensation.

- Additional information is required for plan asset fiduciaries, bundled service arrangements, recordkeeping services and brokerage services that are provided in connection with participant-directed plans.

Services

- Description of the services in sufficient detail to enable the fiduciary to assess the reasonableness of compensation
- If applicable, must also include a statement that the covered service provider (or its affiliate or subcontractor) will provide, or reasonably expects to provide, services either:
  - Directly to the covered plan as a fiduciary,
  - As a plan asset fiduciary, and/or
  - Directly to the covered plan as a registered investment adviser

Compensation

- Must describe the covered service provider's "direct" compensation and its "indirect" compensation
- Should include the amount the covered service provider reasonably expects to receive, either in the aggregate or by service, in connection with such services
- May be expressed as a monetary amount, formula, percentage of the covered plan's assets, or per capita charge for each participant or beneficiary
- If the compensation cannot reasonably be expressed in such terms, it may be described by any other reasonable method.

Basic Contents

- The disclosure must:
  - Contain sufficient information to permit evaluation of the reasonableness of the compensation
  - Describe the manner in which the compensation will be received, and
  - Include a description of any compensation that the covered service provider reasonably expects to receive in connection with the termination of the contract or arrangement, and how any prepaid amounts will be calculated and refunded upon termination

Additional Information

- The plan asset fiduciary must include additional information for each affected plan asset vehicle in which the covered plan has a direct equity investment (unless covered by the special rule), consisting of descriptions of:
  - Any compensation that will be charged directly against the amount invested in connection with the acquisition, sale, transfer of, or withdrawal from the plan asset vehicle;
  - The annual operating expenses if the return is not fixed; and
  - Any ongoing expenses in addition to annual operating expenses

Bundled Services Arrangements

- Special rule for "compensation paid among related parties"
- The types of compensation that must be disclosed under this rule are those that are either:
  - Set on a transaction basis, or
  - Charged directly against the covered plan's investment and reflected in the net value of the investment
- Otherwise, compensation paid among related parties within a bundled service arrangement need not be disclosed.

Recordkeeping Services

- Recordkeeping fees (or their equivalent costs) must be separately disclosed without regard to whether the compensation is also covered by the other disclosure rules.
- Includes services related to plan administration and monitoring of plan and participant transactions, and maintenance of covered plan and participant accounts, records and statements
- Must include:
  - A reasonable, good-faith estimate of the stand-alone cost of the recordkeeping services
  - Methodology and assumptions used to prepare the estimate, and
  - A detailed explanation of recordkeeping services to be provided

Participant-Directed Plans: Platform

- If a covered service provider furnishes recordkeeping or brokerage services to participant-directed individual account plans, the following additional information must be provided:
  - Any compensation that will be charged directly against the amount invested in connection with the acquisition, sale, transfer of, or withdrawal from the designated investment alternative
  - The alternative's annual operating expenses, if the return is not fixed
  - Any ongoing expenses in addition to annual operating expenses

Disclosure Materials

- This disclosure requirement can be met by using the current disclosure materials of the issuer of the designated investment alternative that include the necessary information, provided that:
  - The issuer is not an affiliate of the covered service provider
  - The disclosure materials are regulated by a state or federal agency
  - The covered service provider has no knowledge of the materials being incomplete or inaccurate

Timing/Initial

- The initial disclosures must be provided “reasonably in advance” of the date the particular services contract or arrangement is entered into, extended or renewed.
  - An exception allows 30 days to provide the disclosure when an entity that was not treated as holding plan assets becomes a plan asset entity.
  - Another exception permits information relating to a designated investment alternative to be provided as soon as practicable, but not later than the date the investment alternative has been designated as such by the responsible plan fiduciary.

Timing/Changes

- Changes to the required information must be disclosed as soon as practicable, but not later than 60 days from the date on which the covered service provider is *informed* of the change.
- In the event disclosure is precluded due to extraordinary circumstances beyond the covered service provider's control, the information must be disclosed as soon as practicable.

Timing/Upon Request

- Upon request, covered service provider must furnish any other information relating to the compensation received in connection with the contract or arrangement that is required for the covered plan to comply with the reporting and disclosure requirements of ERISA.
- Requested information must be disclosed not later than 30 days following receipt of such a request in writing, unless precluded due to extraordinary circumstances beyond the covered service provider’s control, in which case it must be given as soon as practicable.

Service Provider Relief/Disclosure Errors

- No contract or arrangement will fail to be reasonable solely because the covered service provider, acting in good faith and with reasonable diligence, makes an error or omission in disclosing the required information.
- The provider must disclose the correct information to the responsible plan fiduciary as soon as practicable, but not later than 30 days from the date on which the provider knew of the error or omission.

Plan Administrator Relief/Class Exemption

- The class exemption can protect a responsible plan fiduciary from violating the prohibited transaction rules in the event of a failure by a covered service provider to provide required disclosures, subject to the following conditions:
  - The responsible plan fiduciary did not know that the covered service provider failed or would fail to make the required disclosures, and reasonably believed that the covered service provider disclosed the required information.
  - Upon discovering the failure, the responsible plan fiduciary requests in writing that the covered service provider furnish the information.
  - If the covered service provider fails to comply with the written request, the responsible plan fiduciary notifies DOL of such failure, not later than 30 days following earlier of (a) the covered service provider's refusal to furnish the requested information, or (b) 90 days after the written request is made.
    - DOL sample http://www.dol.gov/ebsa/DelinquentServiceProviderDisclosureNotice.doc
  - The fiduciary makes a determination as to whether to terminate or continue the contract with the service provider

Failure To Comply

- Failure to comply with 408(b)(2) requirements could result in a prohibited transaction, resulting in:
  - For service provider: Disgorgement of fees, excise taxes
  - For plan fiduciary: Engaging service providers without an available exemption would be a breach of fiduciary duty, with potential liability for losses to the plan (if any) and illicit profits (if any), and possible equitable relief.
  - For fiduciary: May not be a significant issue unless either (a) the service provider's fees are excessive or otherwise unreasonable, so that the plan assets were wasted; or (b) there is a 406(b) self-dealing issue for the fiduciary

Final Notes

- The interim final regulation provides that it is not to be construed as superseding any state law (e.g., state contract or consumer protection law) that governs service provider disclosures, except to the extent it prevents application of a requirement of the regulation.
- The effective date is July 16, 2011 for all contracts, meaning even existing arrangements must comply.
- Coordination with Form 5500 Schedule C
  - Considerable overlap, but not fully congruent, as acknowledged by DOL
  - DOL staff potentially considering revisions to Schedule C to better conform to 408(b)(2)

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Marianne Yudes, Morgan Lewis

PREPARING FOR YOUR NEXT SCHEDULE C

Agenda For This Section

- Overview
- Experiences in reporting
- Coordination with 408(b)(2) regulations
  - Similarities
  - Differences
- Preparing for 2010

Overview

- Applies to large ERISA Plans (generally, plans with 100 or more participants)
- Direct and indirect compensation are reportable
- All service providers who receive $5,000 or more in compensation with respect to the plan are covered
- May include "indirect" service providers, such as an adviser to a mutual fund in which the plan invests
- 408(b)(2) adds "teeth": A reporting obligation by service providers
- Service providers that do not provide the requested information are to be identified to the DOL.
- Good faith effort/transition relief only applied in 2009.

Experiences In Reporting

- Direct compensation paid by the plan
- Full or estimated indirect compensation
- Fees or expense reimbursements charged to “investment funds”
- Gifts and entertainment

Coordination With 408(b)(2)

- Considerable overlap, but not fully congruent, as acknowledged by DOL
- Under 408(b)(2), upon request of the responsible plan fiduciary or plan administrator, the *covered service provider* must furnish any other information relating to the compensation received in connection with the contract or arrangement that is required for the covered plan to comply with the reporting and disclosure requirements of ERISA.
  - Thereby tying these rules to the Form 5500 Schedule C disclosure requirements
- The types of plans, and parties reported as service providers for Form 5500 Schedule C purposes, will not necessarily be the same as those covered by the new 408(b)(2) disclosure rules.

Similarities: 408(b)(2) And Schedule C

- Similar (but not identical)
  definitions of direct and indirect compensation
- Requirement that plan fiduciaries report non-responsive service providers to DOL
- "Indirect compensation" includes non-monetary compensation (e.g., meals, entertainment, and gifts)
- Contain a *de minimis* exception for gifts and entertainment
  - Expected to exceed a total of
    $250 from single source during the term of the arrangement under 408(b)(2)
  - Expected to exceed a total of
    $100 from a single source annually for Schedule C

Differences: 408(b)(2) And Schedule C

- Will not necessarily apply to the same plans
  - Small pension plans are not required to complete Schedule C but are "covered plans" under 408(b)(2).
  - Large welfare plans that may be required to complete Schedule C are currently excluded from 408(b)(2).
- Schedule C definition of "service providers" is generally broader than will be required for "covered service providers" under 408(b)(2) (e.g., a subcontractor to a plan provider with no direct relationship to the plan is a service provider for purposes of Schedule C, but not 408(b)(2)).
- The compensation thresholds are different,
  - $1,000 in total under 408(b)(2)
  - $5,000 per year for Schedule C

Preparing For 2010

- Identify your covered plans
- Identify and contact your plan ”service providers”
  - Have there been any changes in plan providers?
- Gather gifts and entertainment information
- File Form 5558 before the normal due date, as needed
- Sign and retain the “official copy” of the completed Form 5500 along with the originals of any signed schedule or attachments (and extension request, if applicable), for your records (and to provide on request to participants and beneficiaries under ERISA's disclosure rules)
- Evaluate and and modify (as needed) your systems and procedures to prepare for 2011

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Susan Serota, Pillsbury Winthrop Shaw Pittman

PREPARING FOR FEE-DISCLOSURE RULES: PLAN SPONSORS AND FIDUCIARIES

Plan Fiduciaries: Next Steps

While plan fiduciaries are not responsible for preparing and providing the applicable disclosures, they must adequately review and process the disclosures, as necessary, to satisfy their fiduciary obligations.

Appropriate review and recordkeeping of the review process will assist fiduciaries in applying the available fiduciary exemption from liability for inadequate disclosures (discussed below).

Plan fiduciaries should develop processes and procedures to adequately review new fee disclosures by covered service providers now, in order to ensure the requirements are met in advance of the July 16, 2011 compliance deadline.

Fiduciaries: General Duties

I. Determine the allocation of fiduciary responsibilties
II. Establish a prudent process for selecting service providers and investment alternatives under the plan
    A. Assess reasonableness of plan fees and expenses
    B. Select reasonable and adequately diversified investments
III. Continuous monitoring
    A. Investment choices and service providers
    B. Fees and expenses
IV. Document the decision-making process (for a fiduciary, the process used can be just as important as the final decision)

Fiduciaries: Preparation Checklist

I. Fiduciary awareness - Identification, training and expectations

II. Review current protocol for documenting fiduciary decisions regarding service providers and investment options (as well as other fiduciary decisions)

   A. Review current investment selections and service provider arrangements to prepare for new disclosures

   B. Is there a written investment policy for fiduciaries to use as a guide?

III. Gather available data on current investment costs (DOL plan fee disclosure form)

Fiduciaries: Initial Steps

I. Fiduciaries should take steps to anticipate service provider fee disclosures
   A. Educate investment committee or other fiduciaries about the new regulations and the prohibited transaction exemption; ensure all parties understand their duties and responsibilities
   B. Review available information on current providers and fees paid for services
   C. Establish timeline and process for the appropriate fiduciaries to (1) review and assess fee disclosures to make determinations on the reasonableness of the arrangements, and (2) review ongoing disclosures
   D. Centralized system to document the disclosures, follow-up issues and fiduciary decisions

II. Plan ahead for dealing with inadequate disclosures and educate plan fiduciaries on what steps must be taken for the fiduciary exemption to apply

Compliance With 408(b)(2)

I. Identify all covered service providers (fiduciary should know which agreements and service provider relationships are subject to the disclosure rules)

II. Develop procedures to solicit and review required disclosures (including updated and ongoing disclosures)

III. Review RFP to determine what disclosures should be provided

    A. Consider requiring a contract representation from the service provider stating that all required information will be provided

IV. Identify when additional disclosure may be necessary or required

V. Specify disclosure requirements within service agreements

Inadequate Disclosures

I. Regulations provide ways for service providers and plan fiduciaries to remedy disclosure errors or inadequate disclosures under the regulations.

II. An error or omission of the required fee disclosures will not be a violation of the regulations if:
   A. The covered service provider acted in good faith and with reasonable diligence
   B. The service provider corrects the error within 30 days of discovery

Inadequate Disclosures (Cont.)

I. Exemption for plan fiduciary
   A. Protects the plan fiduciary from liability even if the requirements under the fee disclosure regulations are not satisfied
      1. Plan fiduciary cannot have actual knowledge or reason to know of the inadequate disclosure.
   B. Plan fiduciary must take certain steps once it has reason to know of the failure.
      1. In writing, request the applicable disclosures
      2. Notify the DOL of the failure if the service provider does not adequately respond to the request
      3. Reasses the applicable arrangement and determine whether to continue or terminate such arrangement

C. Todd Lacey, The (k)Larity Group

PREPARATORY STEPS FOR PLAN SPONSORS

An On-Point Quote

"Financial services firms offer to handle the investment decisions, trading, and administrative tasks associated with the portfolio of assets within the plan—often at zero disclosed cost. Although almost everyone understands at a visceral level that the industry is receiving undisclosed compensation, the methods used to extract those fees are complex and difficult for the busy executives of plan sponsors to follow. The profitability of the 401(k) industry depends upon the magnitude of the fees it can extract from plan assets and plan sponsors—not on how well it protects and enhances the retirement income security of plan participants." *

* *Uncovering and Understanding Hidden Fees in Qualified Retirement Plans* Mathew D. Hutcheson Fall 2007

Introduction To 408(b)(2)

- Sect. 408(b)(2) is not new. It has been a part of ERISA since its inception.
- Related to ERISA Sect. 406(a), which actually prohibits service providers from providing services for compensation because they are a "party in interest"
- The purpose of Sect. 408(b)(2) was to create a conditional exemption that allows service providers to receive compensation for services provided to the plan.
- The original three conditions required by 408(b)(2) are:
  - Services must be necessary.
  - Contract/arrangement must be reasonable.
  - Compensation must be reasonable.
- The recently released amendment to 408(b)(2), 408b-2, adds additional requirements to the second condition stating contracts must be reasonable.
- The interim 408b-2 regulation was released on July 15, 2010 and must be complied with by July 16, 2011.

Basic Requirements Of The New Regulation

- A "written disclosure" (not contract) must be provided listing all services provided, indirect and direct compensation received, fiduciary status and any conflicts of interest.
- The disclosure does not need to cover EVERY service a provider will offer, most likely leading to a somewhat vague listing of services.
- Direct and "indirect" compensation for individual services must be disclosed, unless cost of service is less than $250 or total annual compensation is $1000 or less.
- All payment sources, amounts and recipients must be disclosed; then, resulting conflicts of interest become evident.
- Compensation received by "bundled" providers must be broken down by individual service.
- Anyone who reasonably expects to serve in a fiduciary capacity (functional or named) must clearly say so.

What You Should Do To Prepare

- Create a checklist of the new requirements and have each of your service provider(s) complete it
- Don't be afraid to go above and beyond the basic requirements.
- Mandate responses well before the July 16, 2011 deadline
- Require your broker/advisor (B/A) to provide you with a formal, written contract that addresses the following:
  - Do you consider yourself a fiduciary on our plan according to the Investment Advisers Act of 1940?
  - If so, for what specific services are you acting in a fiduciary capacity?
  - If not, clearly outline how and why
  - Direct and indirect compensation received from ALL sources
  - List of specific services being provided
  - Length of contract and means of termination
- Checklist and/or request for information should be completed on an annual basis.
- Replace service provider(s) and/or B/As that are not in compliance, to avoid committing a PT.

C. Todd Lacey, The (k)Larity Group

IMPACT ON BROKER-ADVISOR SECTOR

Massive Impact On Broker/Advisor (B/A) Community
(And, By Extension, Massive Impact On You)

- All B/As will have to clearly disclose whether they are acting in a fiduciary capacity.
- It could be argued that nearly ALL B/As are functional fiduciaries.
- If a B/A does not acknowledge fiduciary status but acts as a fiduciary, this is not a "reasonable contract or arrangement" and is clear violation of the 408b-2 regulation.
- A B/A that does not comply with the new regulation has committed a prohibited transaction (PT) under IRC Sect. 4975 PT.
- If your plan works with a B/A that has committed a PT, you as a plan sponsor are ALSO GUILTY OF COMMITTING AN ERISA PT.
- Committing a PT can potentially subject the plan to excise tax and massive corrections.
- This new regulation may eliminate the "golf buddy" B/A arrangement.
- If you are in this arrangement or are unsure, ACT NOW!!!