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First in a Series

The DOL's Proposed 408(b)(2) Regulation: Impact of the Mandated Disclosures on Registered Investment Advisers (RIAs)

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This is the first in a series of bulletins about the Department of Labor's (DOL) new proposed 408(b)(2) regulation mandating disclosures of compensation and conflicts of interest by plan service providers. The proposal defines the ERISA requirement that contracts and arrangements with service providers must be "reasonable." The effect will be to require that almost all providers of services to retirement and welfare plans have a written agreement and disclose all of their direct and indirect compensation.

This bulletin focuses on the likely impact of the proposed regulation on independent registered investment advisers (RIAs). (By "independent," we mean an RIA that is not affiliated with a broker-dealer, mutual fund management complex, recordkeeper or the like.) For purposes of this bulletin, we discuss RIAs who provide advice services, as opposed to investment management services; but this covers both advice to plan fiduciaries and advice to participants. In a future bulletin, we will discuss the application of the proposed regulation to broker-dealers and their registered representatives.

BACKGROUND

In the past, the burden was almost entirely on the primary plan fiduciaries to investigate and understand the arrangement between a plan and a service provider and to determine if it was reasonable. Under a regulation proposed by the DOL in December, arrangements for most plan services will be prohibited unless the service provider has a written arrangement with the responsible plan fiduciaries and makes extensive disclosures about its direct and indirect revenues and about any potential conflicts of interest. Thus, the burden is shifted to the service provider to give information to the fiduciaries that is sufficient for them to determine whether the arrangement, including compensation, is reasonable and whether the conflicts are acceptable. Further, the information must be delivered sufficiently in advance of entering into the arrangement to give the responsible plan fiduciary time to review the information before entering into the transaction. Failure to fulfill the written agreement and disclosure obligations will cause the service provider's engagement to be a prohibited transaction, which means, at the least, that the service provider will presumably have to pay back any compensation it received and that excise taxes may be imposed on the service provider.

This bulletin is further limited to the likely application of these rules to 401(k) plans. However, as a practical matter, Internal Revenue Code § 403(b) plans will be impacted in much the same way.

Seminar on Proposed Regulation on Disclosure of Fees and Revenue Sharing

Next Sunday, February 10th, at the 401k Summit in Orlando, Florida, Fred Reish, Bruce Ashton and Debra Davis will be conducting a seminar on the new 408(b)(2) regulation. The seminar will focus on the requirements under the proposed regulation for RIAs and financial advisers to disclose their revenues, both direct and indirect, prior to entering into a contract or arrangement with a plan.

The impact of the proposed regulation, when finalized, will be substantial. It will require every investment adviser and financial adviser to have a written contract with client plans that explains the services rendered, the revenues received, and any potential conflicts of interest. We believe that the consequence will be an enhanced focus on fees which will require a more detailed and thorough explanation of the value received for those fees, that is, of the services provided to the plan and the participants by RIAs and financial advisers.

The session will begin at 9:00 a.m. and will go for 50 minutes. It will be held in Grand Ballroom #9 in the Orlando World Center Marriott.

OVERVIEW

Applicability

If adopted as proposed, the regulation will apply to any service provider who:

1. is a fiduciary under ERISA or the Investment Advisers Act of 1940 (the "'40 Act");

2. provides banking, consulting, custodial, insurance, investment advisory, investment management, recordkeeping, securities, other investment brokerage, or third party administration services; or

3. receives indirect compensation **and** provides accounting, actuarial, appraisal, auditing, legal, or valuation services.

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Impact on RIAs: RIAs are subject to the proposed regulation under at least two of these categories: they provide investment advisory services and are fiduciaries under the '40 Act. In addition, they may or may not be fiduciaries under ERISA (depending on whether their advice satisfies ERISA's definition of investment advice), but even if they are not, they would still be covered service providers under both the first and second categories.

Further, RIAs may provide consulting services to 401(k) plans on a number of issues, such as plan design and other plan and investment services.

SPECIFIC REQUIREMENTS

1. Contract Must Be in Writing

The proposed regulation requires (1) that there be a contract or arrangement between the plan and the service provider and (2) that the contract or arrangement be in writing. However, the "contract or arrangement" would not have to be signed by either a fiduciary of a plan or the service provider. In most cases, though, it would be advisable to have a signed agreement. (For ease of reference, for the rest of this bulletin we use the term "contract" instead of the proposed regulation's use of "contract or arrangement.") While it is not clear from the proposal, we anticipate that the final regulation will be effective January 1, 2009.

General Comments: The proposed regulation requires all covered service providers to have a written contract with the responsible plan fiduciaries. It seems clear that, for new engagements after the effective date of the final regulation, a written contract will be required. While it is not clear from the proposal, we assume that, where there are existing oral arrangements, they will need to be documented as written contracts as of the effective date. And, although not discussed in the proposal, we further assume that, for existing written arrangements, the final regulation will either "grandfather" them or provide for a transition period before requiring a compliant written contract.

Impact on RIAs: In our experience, most independent RIAs have written contracts. However, the contracts will need to be modified to meet the requirements of the final regulation, when effective. Assuming that the regulation will be effective on January 1, 2009, that means that RIAs will need to revise their agreements before the end of this year. As a practical matter, our advice is to start work on the agreements now, because we believe that knowledgeable attorneys will be overwhelmed with work in the last part of the year with agreements for RIAs, broker-dealers, recordkeepers, third party administrators and other service providers.

2. Services and Compensation

The proposed regulation requires that various disclosures be made in writing before the contract is entered into and before a contract is extended or renewed. The disclosures must be made to the "best of the service provider's knowledge" and they must be provided to the fiduciary with the authority to cause the plan to enter into, extend or renew the contract (referred to by the DOL as the "responsible plan fiduciary"). Additionally, the contract must affirmatively require the service provider to make these disclosures. There are four types of disclosures that must be made, which we discuss separately.

a. All services to be provided to the plan under the contract.

General Comments: The proposed regulation does not specify how the services are to be described. However, in both the preamble (where the DOL explains much of the thinking behind the proposed rules) and the proposed regulation, the DOL generally uses the term "services" broadly. Thus, we believe it would be satisfactory for a service provider to use a broad definition, though this is something that the DOL should clarify in the final regulation. Also, the DOL indicates in the preamble that the written contract may incorporate other materials by reference, if they are adequately described and explained.

Impact on RIAs: Based on our experience, independent RIAs that already have an ERISA-specific service agreement usually spell out their services in more detail than is apparently required by the proposed regulation. Therefore, except for those RIAs that do not have ERISA-specific agreements, this requirement should require little, if any, change.

Some RIAs may seek to comply with portions of the disclosure obligation by providing Part II of their Forms ADV and incorporating the Forms by reference. However, the DOL states in the preamble that it "expects that the service provider will clearly describe these additional materials and explain to the responsible plan fiduciary the information they contain." We understand from informal discussions with the DOL that such an explanation is required as a condition to using separate documents as a "part" of the contract. Thus, RIAs that incorporate information from their ADV or other documents by reference will need to explain the information that is being incorporated by reference. In other words, it is not enough to simply deliver the ADV Part II without further explanation.

b. For each service, the direct and indirect compensation to be received by the service provider and its affiliates.

General Comments: There is a question about how much "each service" needs to be broken down, *i.e.*, how broad the descriptions can be. However, as a practical matter, that may be answered by aggregating the services covered by the primary fee, and then separately describing each service for which additional fees are charged, or revenues are received.

The definition of compensation includes both money and "any other thing of monetary value (for example, gifts, awards and trips)" and covers amounts received directly from the plan or plan sponsor and amounts received indirectly (*i.e.*, from a source other than the plan or the plan sponsor). With respect to the non-monetary items, the proposal does not specify how to disclose the value or cost. However, as a general premise, service providers must disclose whether compensation is a fixed amount, a formula based on plan assets, a per participant charge or all of the above. The proposed regulation does not offer other alternatives for how the disclosure might be made, such as an hourly charge or transaction-based fee. Nevertheless, the information about the calculation of fees must be specific enough that the responsible plan fiduciaries can determine whether the fees are reasonable. Finally, the definition covers amounts received by the service provider or any affiliates of the service provider.

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Impact on RIAs: In our experience, most RIAs with ERISA-specific agreements already provide adequate disclosure of the compensation they receive. And, in most cases, those who receive indirect compensation disclose that fact and that they offset such compensation against the fees they charge. (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. That prohibition is not covered by the proposed exemption.)

In cases where an RIA has, in the past, made generic disclosure of indirect compensation, but without disclosing the amount of, or formula for, the compensation, more detailed disclosures will be required. In our experience, this type of compensation is not usual for RIAs, but does occur occasionally (*e.g.*, an RIA who is also licensed as a registered representative or broker-dealer may receive 12b-1 fees).

The disclosure requirements apply to all covered services and to all compensation received by an RIA and/or an affiliate, both direct and indirect. As a result, RIAs will need to either cover all of the services in a single contract or to enter into separate contracts for each such service (perhaps on a project basis). For example, some independent RIAs assist with provider searches, which are separate services and are, in most cases, compensated separately. Further, RIAs that have a separate charge for managing a model asset allocation portfolio (often consisting of the plan's core investments) need to separately describe and disclose that compensation, either in their primary contract for investment advice or in a separate contract. (As a word of caution, that arrangement may present other, non-exempted, prohibited transaction issues.)

c. **The method for calculating and repaying any prepaid compensation if the contract terminates.**

Impact on RIAs: If an RIA is paid in advance (which is unusual in our experience), its contract would need to state that it will disclose how the prepaid fees will be handled if the contract ends before the prepaid amounts are fully earned. The disclosure may be made in the agreement, an attachment or a separate document. As a practical matter, in instances where the fees are paid in advance, we usually see a description of the mechanism for calculating and returning any unearned fees in the contract.

d. **The manner of receipt of the compensation.**

General Comments: The proposed regulation requires that a service provider disclose whether it will bill the plan, deduct fees from plan accounts or reflect a charge against the plan investments.

Impact on RIAs: In our experience, most RIAs already make this type of disclosure. In fact, most RIAs are paid either directly by the plan sponsor or directly from the trust (*i.e.*, out of plan assets), either upon presentation of a statement or automatically (*e.g.*, approved quarterly payments). However, if an RIA is receiving disclosed indirect payments, further explanations may be needed.

3. Fiduciary Status

The proposed regulation would require a service provider to disclose whether it or an affiliate will provide any services to the plan as a fiduciary as defined under either ERISA § 3(21) or the '40 Act. The preamble indicates that this disclosure requirement applies to both acknowledged and functional fiduciaries.

General Comments: A person providing investment advice for a fee is a fiduciary under ERISA if he advises regarding the purchase, sale or holding of investments and if the advice is individualized, based on the particular needs of the plan or the participants. Under this provision, such an adviser would be required to acknowledge – in writing – that he is an ERISA fiduciary. The failure to do so would cause the arrangement to be a prohibited transaction. That is problematic for service providers who do not ordinarily acknowledge that they are fiduciaries, but may later found to be functional fiduciaries, such as some brokers.

Impact on RIAs: Independent RIAs will need to disclose their fiduciary status to the responsible plan fiduciary. Since they are fiduciaries under the '40 Act, if they provide virtually any investment recommendations, and regardless of whether they are providing investment advice of the type that makes them a fiduciary under ERISA, at least their '40 Act status must be reported. As a practical matter, though, in most cases RIAs will be fiduciaries for both reasons and must disclose accordingly.

However, RIAs will need to be careful in how the disclosures are made in order to properly distinguish between their fiduciary and non-fiduciary roles and to properly limit the extent to which they serve in a fiduciary capacity. For example, an RIA would typically not be a fiduciary for participant investment education, provider searches, and consulting on plan design (*e.g.*, automatic enrollment). Thus, as a practical matter, the RIA agreement should distinguish between which are fiduciary services and which are not. This will require some redrafting of RIA agreements. As an interesting side note, a likely interpretation of the listed services is that consulting is a "covered" non-fiduciary service, while the provider search and the employee education are non-covered, non-fiduciary services. Practically speaking, though, it seems to us that most provider searches also include some consulting, which would make them covered services.

4. Financial or Other Interest

Service providers will need to disclose whether they or an affiliate will have any financial or other interest in any transaction to be entered into by the plan in connection with covered services. If they will have such an interest, they would need to provide a description of the transaction and their participation or interest in it. The example given by the DOL in the preamble is a service provider assisting in the sale of property in which an affiliate of the service provider has an interest.

General Comments: This requirement appears to be very broad. For example, if a service provider receives almost any form of third party payment related to the plan or its assets, that would seem to fall under this item and would need to be disclosed. An example would be a situation where a service provider receives payments or reimbursement of expenses from another provider to the plan in connection with services rendered to the provider.

Impact on RIAs: In our experience, independent RIAs usually do not have relationships that would require disclosure under this requirement, at least of a type similar to the example in the preamble. Further, they do not, by definition (*i.e.*, "independent"), have affiliates that would create such a conflict or potential conflict of interest.

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However, some RIAs are affiliated with third party administration firms or recordkeepers that may receive compensation from other service providers, such as subsidies or other payments from a plan provider or an investment (*e.g.*, a mutual fund or its manager). Even though that compensation is disclosed in the administration firm's (TPA) agreement with the plan, the RIA would need to disclose the existence of an "interest" under this item. Presumably, the RIA could refer to the affiliate's contract for details, so long as the RIA describes those TPA agreements and explains to the responsible plan fiduciary the information that they contain.

Also, it is possible that this requirement would apply to a situation in which an RIA, who is providing investment advice, would receive additional compensation from a plan by virtue of an investment recommendation to a participant, *e.g.*, a wrap fee on an asset allocation model managed by the RIA.

5. Other Relationships or Arrangements

The proposed regulation requires a service provider to disclose whether it or an affiliate has any material financial, referral or other relationship or arrangement with a money manager, broker or other service provider to the plan that creates or may create a conflict of interest in performing services for the plan. The preamble explains that the service provider is required to disclose any "material financial, referral or other relationship" with third parties and states that, "If the relationship between the service provider and this third party is one that a reasonable plan fiduciary would consider to be significant in its evaluation of whether an actual or potential conflict of interest exists, then the service provider must disclose the relationship."

General Comments: This requirement may be a trap for the unwary. For example, a service provider might view its relationship with another party as consistent with the interests of the plan and not as a potential conflict. In practice, a service provider's involvement with another service provider could be considered an interest in a transaction involving the plan (discussed in #4 above) as well as a relationship that needs to be described under this condition. However, this condition only applies to "material" relationships or arrangements, while item #4 applies to any interest in any transaction to be entered into by the plan in connection with covered services.

Impact on RIAs: For the purpose of this discussion, we are assuming that a referral relationship is one where an RIA compensates a third party (with money or items that have monetary value) for referrals, *e.g.*, a finder's or solicitor's fee. However, we acknowledge that a plausible interpretation would include a "cross-referral" relationship where two service providers refer material amounts of business to each other, even if it is not *quid pro quo*. Certainly, the first referral relationship must be disclosed; perhaps the second does also. (Since this proposed regulation will be an exemption, or exception, to a prohibited transaction, the burden will be on the service provider to prove that it complied. As a result, service providers have no practical choice but to disclose everything that might be required.)

We have also seen instances in which an RIA receives payments related to a change in service providers. An example would be the change to a new recordkeeper or custodian. Where that possibility was known at the time of entering into the arrangement, the service provider would be required to make initial disclosures. However, where the service provider was not aware of the possibility, it appears that this situation could be dealt with under a provision in the proposed regulation under which a service provider is required to disclose material changes within 30 days after the service provider becomes aware of the change. (See #8 below.) Thus, when the RIA became aware of the availability of such a payment, it would be required to make the disclosure within 30 days. (As a word of caution, those payments may invoke other prohibited transaction rules.)

6. Ability to Affect Own Compensation

Under the proposed regulation, a service provider would need to disclose whether it or an affiliate would be able to affect its compensation without the prior approval of an independent plan fiduciary. The DOL provides as examples "incentive, performance-based, float, or other contingent compensation." If the service provider can affect its compensation without prior approval, it would need to describe that fact and the nature and amount of the compensation.

General Comments: At first blush, this may seem to have little, if any, application to 401(k) plans. However, it does because compensation can be unilaterally changed by providers in a number of ways, depending on the service being rendered.

Impact on RIAs: In our experience, RIA service agreements often indicate that an RIA may change the amount it bills for its services from time to time, usually by giving written notice of a change in fees to the client. Unless the RIA obtains approval of the change in fees before the change goes into effect (or adds an "Aetna-style" negative approval process to its agreement), this condition would likely be violated. (The failure to obtain prior approval for an increase in fees also implicates other prohibited transaction rules for which there is not an exemption.)

By "Aetna-style" negative approval process, we are referring to the arrangement approved by the DOL in Advisory Opinion 97-16A in which a service provider (1) gave advance notice of a change – in that case, a change in investments offered on a provider's platform, (2) gave the plan fiduciaries 60 days in which to object to the change, (3) provided in the agreement that, if the fiduciaries did not object, they were deemed to have approved the change, and (4) provided that, if the fiduciaries did object, they could change providers without penalty and would have an additional reasonable time period to do so.

7. Policies to Address Conflicts of Interest

The proposed regulation requires the disclosure of whether the service provider or an affiliate has any policies or procedures that address or prevent actual or potential conflicts of interest. If a service provider has such policies or procedures, it must explain them to the responsible plan fiduciary and describe how they address conflicts of interest or prevent an adverse effect on the provision of services. However, service providers are not required to develop any such policies or procedures if they do not already have them.

General Comments: This requirement will impact some service providers, but not others. Service providers are advised to review their corporate ethics and conflicts of interest policies in order to comply with this requirement.

Impact on RIAs: In our experience, RIA firms have written conflict of interest policies. Typically, some or all of those policies are disclosed in the ADV Part II. Presumably, an RIA that has such a written policy could comply with this requirement by providing a copy of the policy or of the ADV Part II to the client,

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although a separate explanation of the referenced provisions would be required in order to incorporate those documents by reference into the contract.

There is another "policy" that would also appear to fall within this requirement. Some dual-licensed RIAs avoid conflicts of interest (and 406(b) prohibited transactions) by offsetting indirect payments against their advisory fees. These policies or procedures would need to be disclosed. However, this would already be disclosed in connection with the compensation disclosure, so it would not need to be further disclosed to satisfy this requirement.

8. Material Changes

The terms of the contract must require that the service provider disclose any material change (to the information required to be disclosed) to the responsible plan fiduciary not later than 30 days from the date on which the service provider acquires knowledge of the material change.

General Comments: The short time period for notifying clients of a material change could be problematic. While the proposed regulation does not explicitly say so, we believe it goes without saying that a service provider would only need to disclose material changes related to its contract or to information that it previously provided to comply with its obligations. That is, we do not believe the proposal intends to create an obligation to oversee the disclosures of other service providers.

Impact on RIAs: This should have little impact on independent RIAs since they are already required to amend their Form ADV and provide it to clients under the '40 Act in the event of a material change. However, RIAs will need to explain the change and provide the ADV within 30 days to avoid converting the arrangement into a prohibited transaction.

That said, there may be material changes that are not required to be described in an updated ADV. Those would require separate, timely disclosures.

9. Reporting Assistance

The proposed regulation requires a service provider to disclose "all information related to the contract and any compensation received thereunder" if it is requested by the responsible plan fiduciary or plan administrator in order to comply with ERISA's reporting and disclosure requirements. This would arise most frequently in the context of reporting information on Schedule C to the Form 5500 for large plans (*i.e.*, plans with 100 or more participants).

General Comments: Service providers need to be aware of their obligation to provide this information. The failure to do so could convert their "reasonable" contract into a prohibited transaction. Further, the responsibility may be increased in the future when the DOL issues a new regulation concerning the information that must be given to participants. It appears that such information would fall within the definition of "disclosure."

Impact on RIAs: This condition should not pose a problem for independent RIAs, unless, possibly, they receive indirect compensation. If they do receive indirect compensation related to plans that file a Schedule C (generally, plans with 100 or more participants), beginning in 2009 RIAs will be required to provide specified information to plan fiduciaries upon request.

10. Actual Disclosure

The proposed regulation requires that, in order for the exemption to apply: (i) the service provider have a written contract that requires it to make the disclosures in this bulletin; and (ii) that it actually make these disclosures.

General Comments: This item should not present issues separate from those discussed elsewhere in this bulletin.

Impact on RIAs: RIAs will want to make sure they have procedures in place to ensure that the necessary disclosures are made. Although most of the disclosures are made before the contract is entered into, renewed or extended, some of the disclosures will be made during the course of the contract, such as material changes and information requested for reporting and disclosure purposes.

Effective Date

The proposal states that the effective date will be 90 days after the final regulation is published in the Federal Register. However, we understand that the DOL is considering an effective date of January 1, 2009, which would coincide with the effective date for changes to reporting service provider compensation on Schedule C to the Form 5500. We believe that at least that much time is needed for the 401(k) industry to make the changes required by the proposed regulation.

Conclusion

For service providers that do not already have written contracts with their plan clients, the proposed regulation will require significant changes in both how they document their business and how they disclose compensation and conflicts of interest. Even for those with contracts, the proposed regulation will require material amendments. However, in our experience, for most independent RIAs, a relatively small number of changes will be needed to satisfy these new prohibited transaction requirements. ❖

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