

## Second in a Series

# The DOL's Proposed 408(b)(2) Regulation: Impact on Broker-Dealers and Registered Representatives

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This is the second in a series of bulletins about the Department of Labor's (DOL) proposed 408(b)(2) regulation mandating disclosures of "comprehensive, straight forward and helpful information concerning [a] service provider's compensation and possible conflicts of interest." Our first bulletin [[www.reish.com/publications/pdf/proposed408ria.pdf](http://www.reish.com/publications/pdf/proposed408ria.pdf)] discussed the likely impact of the proposed regulation on independent registered investment advisers (RIAs). Here, we discuss the impact on broker-dealers and their registered representatives and their relationship with plans. (However, we do not discuss the application of the proposed regulation to investment advice or services to participants, e.g., serving as a fiduciary adviser under the Pension Protection Act.) By broker-dealer (or B-D) we mean a firm that provides brokerage services to a plan and is not acting as an RIA; we use the term financial adviser (or FA) to refer to the individual registered representative of the B-D who actually services a plan, whether employed by, or acting as an agent of, the broker-dealer. Except as otherwise specified, we limit the discussion to B-Ds that are not affiliated with an investment provider, e.g., a mutual fund complex.

This bulletin focuses on 401(k) plans, though all types of ERISA pension and welfare benefit plans, including ERISA covered private sector 403(b) plans, will be impacted in much the same way.

The proposed regulation defines the requirement in ERISA section 408(b)(2) that contracts and arrangements with service providers must be "reasonable" in order to avoid being prohibited transactions. The effect will be to require that almost all service providers have written agreements and disclose, before the arrangement is entered into, all of their direct and indirect compensation and any potential conflicts of interest. (For information on the background to the proposed regulation, see our first bulletin dated February 4, 2008, at the link above.)

Understanding the requirements of the proposed regulation is critical. Unlike a claim of breach of fiduciary duty, where there can be legitimate disagreements about whether someone was prudent in carrying out his or her duties, a prohibited transaction is just that, prohibited. You can't do it, regardless of intent, good faith, reasonable efforts to comply and the like. Thus, failure to fulfill the written agreement and disclosure obligations will cause the service provider's engagement to be a prohibited transaction, which means that, by law, the service provider will have to restore to the plan the "amount involved"—which apparently would be the compensation the broker-dealer received—and that an excise tax may be imposed under the Internal Revenue Code. (While it is possible that the

## Ashton to Testify at DOL Hearing

The DOL has scheduled a hearing for March 20th to receive oral comments and ask questions of interested parties about the proposed 408(b)(2) regulation on the disclosure of fees by service providers. Bruce Ashton will be presenting testimony at the hearing on behalf of the American Society of Pension Professionals & Actuaries (ASPPA) and the Council of Independent 401(k) Recordkeepers (CIKR). We will provide a link to his prepared comments when they are posted on the ASPPA website.

DOL may modify the proposed regulation to add a "substantial compliance" or overall "materiality" standard that would change what seems to be a harsh penalty, under the existing proposal, this result would appear to be required.)

## Overview

**Comment:** We believe that, of all the service providers covered by the proposed regulation, the new rules will have the most significant impact on broker-dealers and financial advisers and will require changes in their business practices. Why? Because in our experience they are the furthest away from compliance with the regulation's proposed requirements:

- They generally do not have ERISA-specific agreements already in place (as many RIAs do) that can be modified to achieve compliance.
- They must state in the contract or arrangement if the B-D and the FA are acting as ERISA fiduciaries (which would include anyone acting as a functional fiduciary, which is not always clear).
- Their compensation is indirect (i.e., primarily 12b-1 fees) and varies based on the investments selected.

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- They have significant interests and relationships that may be considered conflicts of interest for disclosure purposes.
- Many do not have procedures in place to describe and explain, prior to the point of sale, all compensation to be paid to the B-D, both direct and indirect.

We discuss the application of each of these requirements in greater detail below.

A practical challenge for broker-dealers will be identifying all plan accounts in order to be able to comply with the 408(b)(2) requirements. One firm with which we work has identified the following types of situations in which an FA (and thus the B-D) would be providing covered services to a plan:

- The B-D allows the FA to provide investment advice under an RIA license, so that the B-D is an acknowledged fiduciary under ERISA;
- The FA, acting as a registered representative, works primarily with retirement plans;
- The FA occasionally sells a plan;
- The FA opens a brokerage account for a plan; or
- The FA opens an individual brokerage account for a participant.

We were told that the first two situations are easier to identify, track and establish procedures for ensuring compliance. The last three will doubtless be more difficult, and broker-dealers will need to establish procedures to identify these situations in advance and establish administrative rules for making sure that the arrangement does not become a prohibited transaction.

## 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 or other investment brokerage, or third party administration services; or
3. receives indirect compensation and provides accounting, actuarial, appraisal, auditing, legal, or valuation services.

**Impact on Broker-Dealers:** Broker-dealers and financial advisers are subject to the proposed regulation under the second category and, depending on the circumstances, possibly the first. They provide investment brokerage services and some FAs may also provide consulting services to the plans they serve, including, for example, plan design and other plan services. In addition, they may provide investment advisory services.

Under the first category, some B-Ds and financial advisers may be ERISA fiduciaries if they provide advice regarding the selection and/or monitoring of investments that satisfies ERISA’s definition of investment advice. This is significant because of the requirement, discussed later, that the covered service provider disclose whether it

is acting as a fiduciary to the plan.

Whatever the category, it is clear that the regulation will apply to B-Ds and FAs and that they will need to comply with its requirements.

## 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 is 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.”)

**General Comments:** All covered service providers will need a written contract with the responsible plan fiduciaries. While it is not clear from the proposal, we anticipate that the final regulation will be effective January 1, 2009, and that, therefore, any new arrangements beginning on or after that date will need to be in writing. This is relatively straightforward for new engagements after the effective date of the final regulation. But what about existing arrangements? We assume that the final regulation will contain a transition period before requiring a compliant written contract; however, this transition rule is not included in the proposed regulation.

**Impact on Broker-Dealers:** In our experience, most broker-dealers do not have detailed written contracts for 401(k) plans—other than brokerage account agreements. Thus, firms will need to prepare agreements that meet the requirements of the regulation. Almost certainly the B-Ds will develop the contracts, rather than leaving it to the FAs to do so—both to ensure overall compliance and consistency and to manage their potential exposure to liability.

Also, viewed from an ERISA perspective, a B-D will need to provide services to the plan to justify the initial and ongoing compensation that it is receiving (primarily in the form of 12b-1 fees). Those services will likely consist of supervision and training of the FA, evaluating providers and entering into selling agreements with them, providing retirement sales support services, and so on.

Because of the need to develop disclosure procedures, to identify potential conflicts and to train the FAs and support personnel, we suggest that firms begin the process of drafting such agreements now and then make modifications once the regulation is finalized (probably this summer). Otherwise, it may be very difficult for broker-dealers to be in a position to comply on the effective date.

A significant practical issue for most B-D firms will be how to police the process of obtaining written agreements. Where an FA focuses all, or most, of his or her practice on plans, the process may be relatively simple. But what about FAs who sell one or two plans a year? Or, FAs who open individual brokerage accounts for plans or for participant accounts? Making sure that these arrangements

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are properly documented and that the proper disclosures are made in advance will be a challenge for some—perhaps many—firms. As a result, we recommend that B-Ds begin the process of evaluating the types of ERISA and tax qualified plan accounts they serve and the procedures needed to identify those relationships in order to ensure that proper documentation and disclosures will be made.

## 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 must be provided to the fiduciary with the authority to cause the plan to enter into, extend or renew the contract on behalf of a plan (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:

### 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 its thinking) and the proposed regulation, the DOL generally uses the term “services” broadly. Further, the disclosure is not limited to the covered service. The DOL indicated in the preamble that, if a service provider is covered for some of its services, all of its services are subject to the proposed regulation. The DOL indicates in the preamble that the written contract may incorporate other materials by reference, but only if they are adequately described and explained. As a result, it would be possible to describe some or all of the services in a separate document and then incorporate that document by reference. However, the separate document would need to be provided to the responsible plan fiduciary prior to entering into the contract. Further, the contract would need to describe that separate document and explain the relevant information that is in the document.

**Impact on Broker-Dealers:** Broker-dealers will need to develop practices and procedures for satisfying this requirement. First, disclosures must be made before the contract is entered into, that is, before the client makes a “buy” decision. But when does this occur? Consider a common example: An FA makes a sales call on a small company to encourage an employer to hire him to help set up a new 401(k) plan. As a part of the initial presentation, the FA presents a proposed line-up of mutual funds, together with a recommended recordkeeper. The FA contemplates that, if the employer accepts the proposal, the FA will be compensated through 12b-1 fees. The employer likes the proposal and accepts it on the spot. When was the contract or arrangement entered into?

One answer might be that there was not an “arrangement” until after the employer accepted—and that a contract would follow after that. However, that conclusion is inconsistent with the proposed regulation, since it requires disclosures about compensation and conflicts of interest to be made prior to the employer agreeing to the “deal.” As a result, we believe that the FA will need to provide a contract and the associated disclosures as a part of the proposal package.

Second, the contract will need to describe the services being provided—that is, brokerage, consulting, participant services (like investment education and enrollment), etc., in exchange for the compensation. (However, as pointed out elsewhere in this bulletin,

the proposed regulation is not helpful in determining the level of detail needed for describing those services.)

For a number of reasons, thought should be given to how the services are described. In addition to the requirements in the proposed regulation, there are considerations of perception and of the “reasonableness” of the compensation. For example, if the contract describes only “brokerage services,” it may sound transactional, creating issues about the justification, under ERISA, of on-going compensation to the firm and the FA.

Third, the regulation permits incorporation of other documents for purposes of making the disclosure. Presumably, this could permit the broker-dealer to use prospectuses to help comply with the disclosure requirements for compensation. However, there are two practical limitations to consider. First, the DOL states in the preamble to the proposed regulation that it “expects that the service provider will clearly describe these additional materials and explain to the responsible plan fiduciary the information they contain.” This means, based on both a fair reading of the preamble’s language and informal conversations with DOL representatives, that it is not enough to simply deliver prospectuses without further explanation. Thus, B-Ds and FAs that wish to incorporate information from prospectuses will need to explain the information that is being incorporated by reference.

The second limitation regarding incorporation by reference is a practical one: are clients or prospects going to find it acceptable to be handed a stack of 20 or more prospectuses and told that they contain important disclosures that the fiduciaries should review? Or, alternatively, will it be more effective, and more successful for FAs to provide summary information about the revenues that they and their B-Ds receive from the mutual funds?

### 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. Regardless of the approach, though, it is critical that covered service providers adequately describe their services (1) because the failure to do so will cause the arrangement to be a prohibited transaction—and the burden of providing compliance is on the service provider, and (2) the descriptions may be used by the DOL and/or plaintiffs’ attorneys who later challenge the reasonableness of the service provider’s compensation.

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, a percentage 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 (although those may be included in a broad

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definition of “formula”). 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 disclosure must include amounts received by the service provider or any affiliates of the service provider.

**Impact on Broker-Dealers:** In most cases (e.g., mutual funds), the compensation of broker-dealers and financial advisers is indirect and generally varies from fund to fund. In addition, B-D firms may have relationships with fund families that pay them bonuses or other contingent compensation.

We have recently heard that some mutual fund families are approaching broker-dealers about eliminating the payment of contingent or “profit-sharing” amounts (usually based on the total volume of business placed with the mutual fund family by the broker-dealer). In its place, the mutual fund families are proposing the payment of a fixed annual amount to support FA education, conferences, etc. If those payments are not connected, formally or informally, with the volume of business placed with the mutual fund family (i.e., eliminates the connection with the sale to a plan), the payments would not need to be disclosed as compensation. However, they would still need to be reported as conflicts of interest—if they are material (which is likely). See the discussion of conflicts later in this bulletin.

The definition of compensation also includes non-monetary items. The proposed regulation gives examples of gifts, trips or awards received or to be received by the service provider in connection with services to be provided under the contract. All of this will need to be disclosed, in advance.

The new Schedule C disclosure requirements that go into effect for 2009 plan years (for plans with more than 100 participants) will require similar disclosure of compensation, including non-monetary items. Schedule C says that small gifts do not need to be disclosed, but there is no similar exception under the proposed regulation. However, recognize that the non-monetary items only need to be disclosed in advance if they are to be received “in connection with services to be provided under the contract.” Thus, for example, if an FA goes to a conference and is taken out to dinner by an investment provider, arguably the dinner is not received by the FA in connection with services to be provided under a contract with a plan and therefore does not have to be disclosed.

It will not be possible to use a generic form of disclosure without including the specific formula or other basis on which the amount of the indirect compensation is determined. To deal with the variability of compensation, it may be necessary for the firm to develop a chart on a fund-by-fund or provider-by-provider basis.

This disclosure requirement also applies to compensation received by affiliates. (There is a partial exception for bundled providers. We will discuss the bundled services issues in a subsequent bulletin).

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

**Impact on Broker-Dealers:** We do not anticipate that this requirement will have a significant impact on broker-dealers since they are generally not paid in advance. However, this provision may effect how the B-D and FA services are described. For example, if they receive a finder’s fee or other commission-like payment on the front end, but then describe their services as ongoing (e.g., assistance with ongoing monitoring of investments, participant

education, etc.), the payment may appear to be a prepayment for those services.

#### **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 Broker-Dealers:** For broker-dealers, this disclosure should not present a significant issue inasmuch as their compensation is indirect, meaning that it is received from a third party (a fund, fund manager or plan provider). Nonetheless, the sources of the payments and the fact that they are paid from the participants’ investments will need to be disclosed. Note that some reportable payments, such as finder’s fees and B-D bonus, or profit-sharing, amounts, do not explicitly reduce the value of participants’ investments.

### **3. Conflicts of Interest: 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, that is, a person who meets the definition of a fiduciary under ERISA because of his activities (a “functional” fiduciary) rather than because he is selected or appointed as a fiduciary (an “acknowledged” fiduciary).

**General Comments:** A person providing investment advice for compensation is a fiduciary under ERISA if he provides advice 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 (as defined in ERISA §3(21)(A)(ii)). Under this requirement (and subject to the “best of the service provider’s knowledge” provision), that “person” would be required to acknowledge—in writing—that he (or it) is an ERISA fiduciary, even if the contract does not spell out that the service provider is rendering investment advice. 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 who later may be found to be functional fiduciaries.

**Impact on Broker-Dealers:** This disclosure will be one of the most problematic for broker-dealers. In our experience, many B-D firms have been unwilling to allow their FAs to provide ERISA-defined investment advice and thus to function as investment adviser fiduciaries. However, once the regulation becomes final, we anticipate that there will be considerable pressure, both legal and practical, to permit FAs to provide fiduciary investment advice. This is because, among other reasons, in order to avoid violating the 406(b) prohibited transaction rules, the broker-dealer will need to declare if it is providing fiduciary investment advice—through the FA. (The proposed regulation may be read to require only that a fiduciary state that it is functioning as such and, thus, not to require an affirmative statement that it is *not* a fiduciary. However, silence on that issue will be the equivalent of a statement that the broker-dealer and the FA are not acting as fiduciaries. Because of that, if they are acting as fiduciaries and the contract does not say so, the arrangement will be a prohibited transaction with the attendant

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remedies and penalties will apply.) As a result, broker-dealers are well-advised to develop an updated position on the advice issue, to document the arrangement properly, and to train and monitor their FAs accordingly.

Obviously, this issue goes beyond the words in the contract. Broker-dealers will have to examine their business models for dealing with retirement plan business and determine whether:

- they want to impose stricter restrictions on their FAs to avoid fiduciary status—which could limit their ability to service their clients (nonfiduciary services);
- they want to adopt an intermediate position, such as by arranging for third party advisory services (for example, using investment managers or advisers or a program based on the Sun America Advisory Opinion) (independent fiduciary services); or
- they want to acknowledge fiduciary status and accept the legal and regulatory challenges that status presents, including leveled compensation to both the B-D and the FA, and any other affiliated entity (fiduciary advice services).

For B-Ds or FAs that are affiliated with mutual fund families, this requirement may also mean that they will need to include disclosure that the investment adviser to the funds they recommend are fiduciaries under the '40 Act. There is considerable controversy over whether and how the proposed regulation applies to mutual fund managers, but on the assumption that the DOL requires that disclosures with respect to affiliated mutual fund managers need to be made, the broker-dealer's contract will need to contain this disclosure.

Broker-dealers that accept fiduciary status will need to craft their agreements carefully to distinguish between their fiduciary and non-fiduciary roles and to properly limit the extent to which they serve in a fiduciary capacity. For example, a B-D and the FA would typically not be fiduciaries for participant investment education and consulting with the plan sponsor on plan design or operational issues. This distinction between services is not required by the proposed regulation, but we believe it is critical from a risk management perspective.

#### 4. Conflicts of Interest: 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 assistance 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. If a service provider engages in any transaction or co-invests with a plan, it would seem to fall under this item and would need to be disclosed.

**Impact on Broker-Dealers:** This may impact broker-dealers in unexpected ways. For example, if a broker-dealer sells any investments out of inventory to a plan, the fact that the B-D or an affiliate owned (or was under some financial commitment related to) those investments would need to be disclosed. Similar issues exist for public offerings of securities where the B-D has a firm commitment to sell its allocated interest.

The Form ADV for registered investment advisers requires a number of disclosures that are similar to those contemplated by the proposed regulation. Broker-dealers should consider using similar disclosures for themselves and their financial advisers for this purpose.

#### 5. Conflicts of Interest: 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.

However, the disclosure requirement only applies to "material" relationships or arrangements, while item #4 above applies to any interest in any transaction to be entered into by the plan. (As a practical matter, this requirement and the preceding one appear to overlap in some cases. We assume that will be clarified in the final regulation or its preamble.)

The question has come up about whether the disclosure must specifically state whether the transactions or relationships are conflicts of interest. We do not believe this is required. However, the description must be clear enough that it would be relatively easy for a reasonable plan fiduciary to identify and evaluate the nature and extent of the potential conflict.

**Impact on Broker-Dealers:** If the firm is affiliated with a mutual fund management company, there will need to be disclosures under this requirement because the mutual fund manager will receive compensation from a fund in which the plan may invest, which will in turn compensate the B-D. In general, B-Ds will need to give careful consideration to disclosure in any case where the broker-dealer is affiliated with another service provider to a plan and the B-D may receive direct or indirect compensation as a result of that relationship.

Also, this requirement will mandate disclosure of any contingent or bonus compensation (sometimes called profit sharing, performance or just "additional" compensation) that the B-D may earn as a result of its overall relationship with a mutual fund family, regardless of whether it is affiliated. In some cases, this will have been disclosed in connection with the compensation being received by the broker-dealer, such that no additional disclosure is required under this category. However, if the disclosure is not required under the compensation disclosures, it will need to be made under the conflict of interest disclosures.

The meaning of a referral relationship is somewhat unclear. One interpretation is that it refers to a situation in which one party compensates a third party (with money or items that have monetary value) for referrals, e.g., a finder's fee. Another would include a "cross-referral" relationship where two service providers

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refer significant 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 the 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 may have no practical choice but to disclose everything that might be required.)

Again, the Form ADV may be a good model for at least some of these disclosures.

#### 6. Conflicts of Interest: 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.

**Impact on Broker-Dealers:** At first blush, this item would seem to have little impact on broker-dealers since their commissions or 12b-1 payments are fixed by the prospectus. But there are a number of ways in which this item could require disclosure—and keep in mind that this is advance disclosure and relates to whether the B-D has the *ability* to affect its own compensation, not whether it actually does so. Some examples are:

- The FA recommends replacing one fund with another that has a higher 12b-1 payment;
- The FA recommends using a share class for plan investments with higher 12b-1 payments than another share class;
- The FA has the ability to determine the amount of its commission—sometimes referred to as “dial-a-commission”; and
- The FA assists participants with individual brokerage accounts where the commissions or 12b-1 payments they receive will vary based on the number of investment changes and/or from investment to investment. (A similar issue exists in non-participant directed plans, where the FA advises a trustee on the investment of plan assets through a brokerage account.)

It is unclear from the proposed regulation how detailed the disclosure of any of these potential conflicts would have to be, that is, whether a simple disclosure that the compensation of the broker-dealer will vary depending on what funds the plan offers or the participants select for their accounts is sufficient or whether something more specific is required.

#### 7. Conflicts of Interest: Policies to Address Conflicts of Interest

The proposed regulation requires disclosure of whether a service provider or an affiliate has any policies or procedures that address actual or potential conflicts of interest. If a service provider has such policies or procedures, the contract or related materials must explain them to the responsible plan fiduciaries and describe how they address conflicts of interest or prevent an adverse effect on the plan. For example, a procedure for offsetting revenue sharing or other indirect payments would need to be disclosed. 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. It will depend primarily on whether the members of a particular industry commonly have such policies. Service providers are advised to review their corporate ethics and conflicts of interest policies in order to comply with this requirement.

**Impact on Broker-Dealers:** Many broker-dealer firms have written conflict of interest policies, though they may not relate specifically to plan business. If so, a description of the relevant portions of such policies (*i.e.*, those that would apply to plans) must be provided in advance to the responsible plan fiduciary.

#### 8. Material Changes

The terms of the contract must require that the service provider disclose any material change 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. In comments we have made to the DOL on the proposed regulations, we recommended that the time frame be extended to longer than 30 days.

“Material” in this context refers to items that a reasonable plan fiduciary would view as “significantly altering the ‘total mix’ of information made available to the fiduciary, or as significantly affecting [the] fiduciary’s decision to hire or retain the service provider,” not items that are material to the business of the service provider. While the proposed regulation does not explicitly say so, we believe 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 Broker-Dealers:** We do not anticipate that this requirement will generally impact broker-dealers more than other service providers. Clearly, however, the 30-day provision could, as a practical matter, be more problematic to B-Ds than to most covered service providers. A broker-dealer firm may do significant amounts of business with investment providers and recordkeepers and their relationships may evolve over time. To the extent a B-D enters into a new alliance or preferential arrangement with another provider, the firm will need to examine whether this is material enough to require additional disclosure. (Obviously, if in doubt, the right answer is to disclose.)

Also, a broker-dealer may have hundreds or thousands of plan clients that are handled through multiple offices. Some of those “clients” may be no more than a brokerage account for a single plan or a brokerage account for a single participant in a plan. Ensuring that the disclosures of changes are made to every plan within the 30-day period requires recordkeeping that many B-Ds are not now doing. This highlights the importance of keeping track of every ERISA account handled by the firm.

#### 9. Reporting Assistance

The proposed regulation requires a service provider to disclose “all information related to the contract and any compensation received

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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.*, as a general rule, 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.

**Impact on Broker-Dealers:** As a practical matter, this condition will require broker-dealers to set up procedures for ensuring that they are providing plans with the information needed for Schedule C reporting. That is because, while the rule only requires that covered service providers supply the information on request, we believe that most providers, including B-Ds, will want to service their plan clients by giving them the information, rather than waiting until a formal request is made. (But, of course, B-Ds will still need to have procedures in place to ensure the delivery of the information when requested.)

While technically only required for plans that must file Schedule C, the B-D may not know whether a plan is a Schedule C filer or not, and rather than take a chance, from a risk management perspective B-Ds will need to keep records to enable them to give the information to all plan clients.

#### 10. Actual Disclosure

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

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

**Impact on Broker-Dealers:** Broker-dealers will need to establish procedures to ensure that the necessary disclosures are made for all types of clients and accounts that involve plans. Earlier in this bulletin, we described five possible situations in which FAs may become involved where 408(b)(2) compliance will be required. There may, of course, be others that we have not identified. The point is that B-Ds will need to set up procedures for identifying and tracking these clients, regardless of size and regardless of the primary business of the FA who brings in the client.

#### Effective Date

See our February 4, 2008 bulletin for a discussion of the effective date issue. Suffice it to say that the broker-dealers should begin working on compliance now, since it appears that the final regulation will be upon us no later than the end of this year.

#### Conclusion

For broker-dealers that do business in the 401(k) marketplace, the proposed regulation will require significant changes. The requirement of written contracts and extensive disclosure of compensation and conflicts of interest may be the least of it; many may decide to change their business model, possibly accepting fiduciary status for the first time, as a result of the new regulation. ❖

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