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Impact of ERISA 408(b)(2) Fee Disclosures on Investment Advisers

May 19, 2011
Lisa B. Zimmer

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Agenda


- w Provider disclosure regulations
- w Proposed DOL regulation expanding definition of ERISA fiduciary
- w Compliance steps for RIAs

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Provider disclosures

Legal Framework

- w Second part of DOL three-pronged approach on plan fee disclosures
 - > Form 5500 Schedule C reporting – disclosure to government
 - > Provider disclosures under ERISA Section 408(b)(2) - point of sale disclosure to plan sponsors
 - > Participant disclosures under ERISA Section 404(a) – disclosure to participants
- w Provider disclosure regulations now in interim final form
 - > DOL considering adding summary disclosure statement requirement
 - > Expected to be finalized soon


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Provider disclosures

Compliance Deadline


- w Delayed from July 16, 2011, to January 1, 2012
 - > Matches up with participant disclosure timing for calendar year plans
 - > Will be based on the requirements in the final regulations
- w Applies to:
 - > New service agreements entered into on or after effective date
 - > Pre-existing service agreements must be brought into compliance by effective date

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Provider disclosures

Goal of regulation


- > To ensure that plan fiduciaries have the information they need to:
 - Assess reasonableness of fees
 - Identify potential conflicts of interest
 - Satisfy ERISA reporting and disclosure requirements

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Provider disclosures

Background

- w ERISA's prohibited transaction rules restrict use of plan assets
 - > Furnishing of services between a plan and a "party in interest" (such as a service provider) is prohibited
- w ERISA Section 408(b)(2) contains exemption to allow use of plan assets for plan services, but only if contracts and fees are reasonable
- w Regulations say arrangement is reasonable if:
 - > Disclosure requirements are met
 - > Arrangement allows for termination without penalty on short notice
- w Only covers fees paid with plan assets – not fees paid by employer

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Provider disclosures

Scope of regulations

- w Apply to service arrangements between:
 - > Covered plans
 - > Covered service providers (CSP)

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Provider disclosures

Covered Plans

- w Defined benefit plans
- w Defined contribution plans (including ERISA-covered 403(b) plans)
- w Plans excluded from rule:
 - > SIMPLE IRAs
 - > SEPs
 - > IRAs
 - > Top-hat plans
 - > Plans not subject to ERISA
 - Non-ERISA 403(b) plans, 457 plans and government plans
- w DOL intends to issue future guidance for welfare plans

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Provider disclosures

Covered service providers (CSP)

- w Not necessarily same as Form 5500 Schedule C providers
 - > Small pension plans (<101 participants) exempt from Schedule C, but are covered plans under provider disclosure regulations
 - > Different minimum compensation thresholds (\$1,000 vs \$500)
 - > Schedule C has broader definition of service provider (i.e., includes subcontractor)

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Provider disclosures

Covered service providers (CSP) (cont'd)

w Definition

- > Enters into contract/arrangement to provide retirement plan services
- > Aggregate compensation from services expected to be at least \$1,000 over term of arrangement
 - Direct or indirect (i.e., revenue sharing)
 - Even if received by an affiliate or subcontractor
 - Even if services performed by an affiliate or subcontractor

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Provider disclosures

Covered service providers (CSP) (cont'd)

- > ERISA fiduciary providing services directly to plan or plan asset investment vehicle (e.g., collective trust, pooled separate account)
- > Investment advisor registered under Investment Advisors Act of 1940 or state law
- > Record-keeper or broker who makes designated investment alternatives available to a participant-directed DC plan (e.g., a platform provider)
- > Provider that receives indirect compensation
 - i.e., compensation from other than plan assets or plan sponsor (e.g., third parties)
 - For the following services: accounting, auditing, actuarial, banking, consulting, custodial, insurance, investment advisory (for plan or participants), legal, recordkeeping, securities brokerage, third party administration, or valuation

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Provider disclosures

Parties who are not CSPs

w CSP captures only party directly responsible to covered plan for services under contract or arrangement (i.e., primary contract holder)

w CSP does not include:

- > An affiliate or subcontractor providing one or more of the services to be provided under the contract or arrangement (but does not mean their compensation is not disclosed)
- > An entity providing services to an investment contract, product or entity in which the covered plan invests (other than services as a fiduciary)

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Provider disclosures

Initial disclosure requirements

- > In writing
 - Not required as part of contract
 - No particular format required (DOL considering summary disclosure requirement)
 - Can be multiple documents from separate sources
 - Electronic delivery permitted
- > CSP must disclose information on behalf of its affiliates and subcontractors, if applicable
- > Reasonably in advance of entering into, extending or renewing service contract or arrangement
 - For existing arrangements – January 1, 2012

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Provider disclosures

Disclosure Items

- w Services
- w Status
- w Compensation
- w Investment information

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Provider disclosures

Disclosure items (cont'd)

- w Services
 - > Description of services to be provided
 - > Level of detail will vary depending on needs of responsible plan fiduciary (RPF)
 - > RPF must decide whether information about services sufficient to allow determination of reasonableness of fees
 - > If RPF determines information provided insufficient:
 - RPF must request additional information; AND
 - CSP must provide

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Provider disclosures

Disclosure items (cont'd)

w Status

- > If applicable, a statement that CSP, an affiliate or a subcontractor, will provide, or *reasonably expects to provide* services directly to the plan (or to an investment vehicle) as a:
 - Fiduciary, or
 - RIA
- > If both, need to disclose both
- > Fiduciary status function test
 - May become fiduciary whether contract says so or not
 - Disclaimers do not supersede actual function


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Provider disclosures

Disclosure items (cont'd)

w Compensation

- > Means anything of monetary value, excluding non-monetary compensation valued at \$250 or less, in the aggregate, during term of contract
- > Compensation may be disclosed as monetary amount, formula, percentage of plan assets or per capita charge for each P/B, or other reasonable methods if cannot reasonably be expressed in such terms
 - Must contain sufficient information to allow RPF to evaluate reasonableness of compensation
- > Must describe manner of receipt: (1) billed directly; (2) charged against plan accounts, or (3) charged against plan investments
- > Expenses paid by plan sponsor are NOT compensation under rule


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Provider disclosures

Disclosure items (cont'd)

w Compensation (cont'd)

- > Must disclose:
 - Direct compensation
 - Indirect compensation
 - Compensation paid among related parties
 - Compensation for termination of contract
 - Compensation paid for recordkeeping services

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Provider disclosures

Disclosure items (cont'd)

w Compensation (cont'd)

- > Direct compensation
 - Definition: compensation received directly from plan
 - Must disclose direct compensation *reasonably expected*, including amounts paid to an affiliate or subcontractor
 - As total or itemized list by services

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Provider disclosures

Disclosure items (cont'd)

w Compensation (cont'd)

- > Indirect compensation
 - Definition: compensation received from any third party source (other than plan, plan sponsor, CSP and its affiliates or subcontractors)
 - Identify services provided and payer

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Provider disclosures

Disclosure items (cont'd)

w Compensation (cont'd)

- > Paid among related parties
 - If set on transaction basis (e.g., commissions, soft dollars, finder's fees) OR charged directly against plan's investments (e.g., 12b-1 fees)
 - Identify: (1) services provided; (2) payers and recipients; and (3) status of each payer/recipient as an affiliate or subcontractor
 - Must be disclosed even if already disclosed as direct/indirect compensation or in investment disclosure
 - Does not apply to compensation received as employee
 - RPF responsible for determining any conflicts of interest among related parties

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Provider disclosures

Disclosure items (cont'd)

w Compensation (cont'd)

> Contract termination

- Compensation reasonably expect to receive in connection with termination of contract (CSP, affiliates and subcontractors)
- How any prepaid amounts will be calculated and refunded upon such termination

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Provider disclosures

Disclosure items (cont'd)

w Compensation (cont'd)

> Recordkeeping services

- Direct and indirect compensation
- If services provided, in whole or part, without explicit charge or subject to an offset or rebate based on other compensation, must provide reasonable good faith estimate of cost
 - Must explain methodology and assumptions
 - Must describe recordkeeping services provided
 - Estimate must consider rates would charge if unbundled or prevailing market rates charged for similar services to similar plan
 - Cannot merely disclose a de minimus amount of compensation when such amount has no relationship to cost of services

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Provider disclosures

Disclosure items (cont'd)

w Investment information

> Who must provide?

- ERISA fiduciary to a plan asset investment vehicle, OR
- Recordkeeper/broker that makes available designated investment alternatives (i.e., platform)
 - Designated investment alternative does not include brokerage windows or self-directed brokerage accounts

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Provider disclosures

Disclosure items (cont'd)

w Investment information (cont'd)

> What investment information is required?

- For each designated investment alternative:
 - Charges against amount invested in connection with purchase, sale, etc. (e.g., sales loads, redemption fees, etc.)
 - Annual operating expenses (e.g., expense ratio) if return not fixed
 - Additional ongoing expenses (e.g., wrap fees, mortality and expense fees)
- May rely on current, regulated disclosures materials of issuer of designated investment alternative if:
 - Not related to issuer
 - Materials regulated by state or federal agency
 - CSP has no knowledge or omission/inaccuracy

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Provider disclosures

Timing of disclosures

w Initial - reasonably in advance of entering into, extending or renewing service contract

> Exceptions:

- Existing contracts – January 1, 2012
- Investment later becomes plan asset vehicle – 30 days
- Investment alternative added later – not later than date investment alternative designated by RPF

w Changes during term of service contract – 60 days from date CSP notified of such change

w Discovery of mistake – 30 days

w Upon request – 30 days

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Provider disclosures

Consequences of failure to comply

w An ERISA/Code prohibited transaction (PT) will occur

> 15% PT excise tax payable by CSP or RPF

- Class exemption for “innocent” plan fiduciary
- No exemption for CSP
- Tax is self-assessing and not subject to discretion of IRS

> Must reimburse plan for all compensation received plus interest

w Form 5500 reporting still required, event if RPF qualifies for exemption

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Provider disclosures

Consequences of failure to comply (cont'd)

- w RPF qualifies for class exemption (not liable for excise tax) if:
 - > RPF reasonably believed CSP disclosed all required information and did not know of CSP's failure
 - > RPF notifies CSP of any failure in writing and allows 90 days to cure
 - > No cure, the RPF
 - Notifies the DOL within 30 days
 - Decides whether to terminate/continue arrangement
 - Nature of failure
 - Availability, qualifications, cost of replacement
 - CSP's response to notice of failure

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Definition of fiduciary

Fiduciary status for investment advice

- w DOL issued proposed regulation that would, if adopted:
 - > Expand definition of fiduciary investment advice
 - ERISA; and
 - Code (i.e., IRAs)
 - > Cause current practices of consultants, advisors, appraisers and others to be considered fiduciary investment advice

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Definition of fiduciary

DOL's stated reasons for change

- w Current rule
 - > 35 years old
 - > Does not reflect:
 - Shift to defined contribution plans
 - Changes in financial market place
 - > Significantly narrows plain language of ERISA

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Definition of fiduciary

Current 5-part test

1. Render advice as to value of securities or other property or make recommendations as to the advisability of investing in, purchasing or selling securities or other property
2. On a regular basis
3. Pursuant to mutual agreement, arrangement or understanding, with the plan or a plan fiduciary, that
4. The advice will serve as a primary basis for investment decisions with respect to plan assets, and that
5. The advice will be individualized based on the particular needs of the plan

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Definition of fiduciary

Proposed new definition

w 2 part test, with several criteria under each part – if satisfy one criteria in each part, would be considered a fiduciary

w First step (only need to meet one):

- > Provide advice (or appraisal or fairness opinion) about the value of securities or other property; or
- > Make recommendations about advisability or investing in, purchasing, holding, or selling securities or other property; or
- > Provide advice or make recommendations about the management of securities or other property

And

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Definition of fiduciary

Proposed new definition (cont'd)

w Second step: person, either directly or indirectly (e.g., through an affiliate) (only need to meet one):

- > Represents or acknowledges fiduciary status for advice or recommendations; or
- > Is a fiduciary by reason of having discretionary authority in management of plan assets or in plan administration; or
- > Is an investment advisor under Investment Advisors Act of 1940; or
- > Provides advice or makes recommendations
 - Pursuant to agreement, arrangement or understanding, written or otherwise; and
 - Advice may be considered in investment or management decisions; and
 - Will be individualized to the needs of the plan, plan fiduciary, or a participant or beneficiary

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Definition of fiduciary

Exclusions from fiduciary status

- w For individual account plans:
 - > Persons providing investment education in accordance with DOL Interpretive Bulletin 96-1
 - > Marketing or making available investment platform if:
 - Offered w/o regard to individualized needs;
 - Written disclosure stating not providing impartial investment advice;
 - If, in connection with offering platform, give general information and data to assist in selecting/monitoring investments, and give written disclosure stating not providing impartial investment advice
- w Persons providing advice or recommendations as the seller or purchaser of security and:
 - > Interests adverse
 - > Not providing impartial advice

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Definition of fiduciary

Implications

- w If become an ERISA fiduciary, must comply with ERISA's fiduciary standards
 - > Duty of loyalty
 - > Prudent man standard
 - > ERISA/Code prohibited transaction rules
 - Self-dealing
 - Cannot give advice that results in additional compensation or any other thing of value
 - Solution – level fee
 - > 408(b)(2) compliance

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Compliance steps

- w Remember: RPF **must ask** and CSP **must tell**
- w Identify affected accounts
- w Determine where and how to obtain disclosure data
 - > Begin contacting your third-party providers now
- w Determine identity of the RPF to ensure delivery to appropriate person
 - > Ask – most direct approach
 - > Document due diligence process
 - > Have person sign form affirmatively acknowledging fiduciary role

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Compliance steps

- w Develop approach for meeting compliance deadline
 - > Existing clients
 - Written disclosure notice; or
 - Enter into new service agreement
 - > New clients – include in service agreement
- w Develop ERISA-specific service agreement
 - > Services
 - Spell out services in detail (what will and will not provide)
 - Can cover all services in single contract or enter into separate contracts (with separate disclosures) for each service (e.g., separate charge for managing model asset allocation portfolio)
 - Can refer to Part 2 of Form ADV, but need to be clear where to look

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Compliance steps

- w Develop ERISA-specific service agreement (cont'd)
 - > Status
 - Describe scope and extent of fiduciary and non-fiduciary services and clarify that fiduciary standard only applies to fiduciary services
 - Standard varies (i.e., prudent man standard for fiduciary services)
 - May be able to limit potential liability for errors in performing non-fiduciary services
 - Fiduciary services include: IPS development and/or review, investment selection/monitoring, recommendations for model portfolio allocations and rebalancing, and participant investment advice
 - Non-fiduciary services include: plan design consultation, vendor search and fee benchmarking services; plan committee education, compliance assistance, participant investment education and enrollment support

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Compliance steps


- w Develop ERISA-specific service agreement (cont'd)
 - > Status (cont'd)
 - If reasonably expect to qualify as a fiduciary, make sure to disclose
 - If do not make declaration, then a prohibited transaction results
 - If no expectation initially, but later provide fiduciary services, have 60 days to provide disclosure

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Compliance steps


- w Establish procedures for communicating any changes to disclosures
 - > Amended Form ADV may be able to satisfy
 - > Just need to make timely under disclosure rules (60 days)
- w Implement firm-specific training for affected advisers and supervisors
- w Reconcile services provided with errors and omissions coverage

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Questions & Answers

Thank you!

Lisa B. Zimmer
Warner Norcross & Judd LLP
2000 Town Center
Suite 2700
Southfield, MI 48075-1318
248.784.5191
lzimmer@wnj.com

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