Overview

• Introduction
• What is a “408(b)(2)” disclosure?
• Which types of plans must receive this disclosure?
• Which service providers must provide the disclosure?
• What should be in the disclosure?
• When should the disclosure be provided? What if something changes?
• How should a plan fiduciary react to the disclosure?
Introduction

- The Problem
  - Impact of fees on retirement savings
  - Ensuring plan sponsor oversight
  - Complexity of compensation
  - Insufficient access to information
- The Response
  - Schedule C Form 5500
  - Participant-level Disclosure Regulation (2550.404a-5)
  - Service Provider – Plan Sponsor Disclosure Regulation (2550.408b-2)
Introduction

• The Parties
  ▪ Plan Sponsor duties 404(a) / 408(b)(2)
  ▪ Service Provider duties 408(b)(2)

• The Risks
  ▪ Excise taxes
  ▪ Reputational
  ▪ Investigations / litigation
History of the 408(b)(2) Regulation

- Proposed December 2007 (Council files comment letter)
- Hearing held March 2008 (Council testifies)
- DOL published “interim” final rule July 2010 (Council files comment letter)
- Final rule published February 2012
Why is this called a “408(b)(2) disclosure”?

- ERISA section 406 contains a broad prohibition on any “party in interest,” including investment advisers, fiduciaries and other service providers, entering into a transaction with a plan.
  - Absent an exception, you can’t get paid for providing advisory services to an ERISA plan!
- ERISA section 408(b)(2) provides an exception for “reasonable arrangements” for necessary services; no more than “reasonable compensation” may be paid.
- The “408(b)(2)” regulation says that a service arrangement is not “reasonable” unless specific disclosures are made to the hiring fiduciary.
Covered Plans and Clients

• Rule applies to all ERISA-governed retirement plans
  ▪ Defined benefit pension plans
  ▪ Defined contribution/401(k) plans

• Which plans are not covered?
  ▪ Welfare plans (subject of separate rulemaking)
  ▪ IRAs (including SEPs and SIMPLEs)
  ▪ Governmental plans
  ▪ Church plans
  ▪ “Keogh” plans covering only the business owner (and spouse)
  ▪ Nonqualified executive compensation plans
  ▪ Non-ERISA 403(b) contracts and certain pre-2009 frozen 403(b) contracts
Covered Service Providers

• Covered Category 1: Fiduciary/RIA services
  a) Services provided directly to the plan as an ERISA fiduciary
  b) Services as a fiduciary to a separate account, collective trust, or other investment contract or product that (a) holds “plan assets” and (b) in which the plan has a “direct equity investment.”
  c) Services provided directly to the plan as an investment adviser registered under Advisers Act or state law.

• Unless (b) applies, services provided to an investment contract or arrangement in which a plan invests (including an investment that holds plan assets) are excluded.
Covered Service Providers

• Covered Category 2: Recordkeeping and brokerage for defined contribution plans that allow participant direction
  ▪ Applies if you make available “platform” of investments in connection with recordkeeping or brokerage services
  ▪ Recordkeeping broadly defined, including
    • Services related to plan administration
    • Monitoring of plan and participant accounts and transactions
    • Maintaining records of participant accounts
    • Sending participant statements
    • Processing loans, distributions, and withdrawals
  ▪ This category has special disclosure obligations
Covered Service Providers

- Covered Category 3: Other service providers but only if they expect to receive indirect compensation:

  - Accounting
  - Auditing
  - Appraisal / Valuation
  - Banking
  - Consulting (non-fiduciary)
  - Custodial
  - Insurance
  - Investment advisory to plan
  - Investment advisory to participants
  - Legal
  - Recordkeeping / TPA
  - Brokerage

- Remember: Services provided to an investment contract or arrangement in which a plan invests, except “plan asset” vehicles in which the plan has a direct investment are excluded.
Applying the Rules

• Affiliates and subcontractors of a covered service provider do not need to separately disclose

• Parties in a “bundled” arrangement can agree amongst themselves who will be the covered service provider.

• Disclosure goes to the “responsible plan fiduciary”—fiduciary with authority to enter into the arrangement
Required Disclosure

• Status as a fiduciary or registered investment adviser
• Direct compensation expected to be earned (i.e. paid from the plan or participant accounts)
• Indirect compensation expected to be received from a source other than the plan, plan sponsor, affiliate or subcontractor
  ▪ NEW: A description of the arrangement
• Incentive compensation to be paid among affiliates and subcontractors (e.g., commissions, soft dollars, 12b-1)
• Charges for termination of contract
• Reasonable estimate of recordkeeping costs
• Manner of receipt of compensation
Required Disclosure

• Indirect Compensation – Special Focus
  ▪ For recordkeepers and brokers: describing payments from investments on platform (12b-1, sub-TA, revenue sharing)
  ▪ “Soft dollar” research
  ▪ Gifts and entertainment
  ▪ Conference exhibitors and sponsors

• Direct Compensation – Payments from Plan Sponsor
  ▪ Focus on payments usually paid by plan sponsor but could be paid by plan
Required Disclosure

Plan Investments

- Fiduciary managers of plan asset investments and recordkeepers/brokers offering an investment platform must provide additional investment information
- Description of compensation to be charged directly against the investment (commission, sales charges, redemption fees)
- Annual expense ratio
- NEW: For participant directed plans, any information in the control of, or reasonably available to, service provider that plan needs to complete participant disclosure.

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Required Disclosure

• Compensation can be disclosed in dollars, formulas, or other reasonable method. Estimates can be used with explanation of the assumptions.
• No disclosure required unless $1,000 or more in compensation expected
• DOL considering adding “summary” or “guide”.
Timing

• Initial disclosures for existing relationships due July 1, 2012.
  ▪ Moved back participant disclosure deadline to August 30
  ▪ First quarterly statement to participants reflecting participant disclosure rules due November 14.

• For new contracts or arrangements, reasonably in advance of entering into contract or arrangement PLUS in advance of contract renewal or extension

• If any information changes, new disclosure required within 60 days from being informed of the change

• Investment related disclosures (i.e. expense ratios) need only be updated annually

• Errors in disclosure can be fixed by service provider, but only within 30 days of becoming aware of the error.
Applying the Rules to DB Plans

• Primary covered service provider will be investment manager
  ▪ Primary fee disclosure will be investment management fee, plus any indirect compensation (soft dollars, gifts and entertainment)
  ▪ Form ADV plus investment management agreement may contain most information
  ▪ Depending on arrangement, subadviser likely considered subcontractor

• Other common service providers like brokers, non-fiduciary consultants, actuaries, attorneys subject to the rule only if receiving indirect compensation
Consequences of Failure to Comply

• Prohibited Transaction Results
  ▪ Service provider incurs 15% excise tax due to IRS (increasing to 100% if discovered on audit). Due every year until issue corrected.

• Class Exemption for Responsible Plan Fiduciaries
  ▪ Plan fiduciary must request disclosure, and if not provided in 90 days, must report adviser to DOL.
  ▪ Then must terminate future services.
  ▪ Most questions and errors can probably be easily addressed through a dialogue with service provider.
Reviewing the Disclosure

- Basic fiduciary responsibility has not been changed by this regulation.
  - Act prudently in hiring and monitoring service providers
  - Ensure plan assets are used for exclusive purpose of paying benefits and defraying “reasonable” expenses
  - Ensure services are necessary and that no more than reasonable compensation is paid to service provider
- Review 408(b)(2) disclosure and make sure you understand it.
  - Don’t be afraid to ask questions
- Periodic and documented review of service provider performance and fees.
Questions?