

Impact of the 408(b)(2) Regulation on ERISA 403(b) Plans

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On July 16, 2010, the US Department of Labor (DOL) issued its "interim final" regulation requiring advance disclosure of the services to be provided and the compensation to be received by "covered service providers" to "covered plans." The regulation was issued under ERISA section 408(b)(2), which provides an exemption from the prohibited transaction rules of ERISA. That section says that service arrangements between plans and service providers must be "reasonable" and that no more than reasonable compensation can be paid to the service provider. The new regulation interprets the "reasonableness" requirement, imposing an obligation on service providers to give written disclosures to plan fiduciaries before they enter into, renew or extend contracts or arrangements to provide their services.

In the 403(b) marketplace, this regulation will likely present serious challenges for some service providers. For those that regularly deal with the employer, the impact will be less severe, though it will require the establishment of new practices and procedures to ensure compliance. However, where the service provider deals in individual annuity and custodial contracts – which may still be the norm – the impact on producers and possibly providers will be significant, since they may need to establish a new way of doing business with a party, the employer, with which they've had little dealings in the past. And they may need to educate the employer on why they are now providing it with information that it may not expect to receive and, frankly, may not want or know how to handle. The challenge is even more significant given the fact that the compliance effective date is less than a year away (July 16, 2011) and requires disclosures to all existing clients as well as new ones obtained on or after that date.

What Plans are Affected? The regulation applies to "covered plans" (*i.e.*, all ERISA-governed retirement plans other than SEP IRAs and SIMPLE IRAs). This means that ERISA-covered 403(b) plans are subject to the new disclosure rules, and the fiduciaries of such plans will have an obligation to review the information provided to them. Public education employer 403(b) arrangements and the plans of tax exempt entities that are not subject to ERISA are not covered by the rule.

Comment: While only the service providers to ERISA 403(b) plans will be *required* to comply with the new requirements, other service providers may elect to comply on a voluntary basis. (We are not recommending this approach so much as pointing out reasons why a service provider *might* decide to follow the regulation

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for all its business.) Why? Some service providers that serve multiple markets – such as product providers, recordkeepers, RIAs and other consultants who work in the public education market as well as the ERISA 403(b) plans of non-governmental 501(c)(3)s – may find it is more cost-effective to have one disclosure approach rather than tracking when the disclosures are required and when they are not. Further, the disclosures required by the new regulation might become the “standard” used by plan sponsors in evaluating their service providers, regardless of whether they are covered by the regulation. Finally, especially in the case of public education plans, the laws of some states *may* impose standards that are virtually identical to ERISA. In those cases, it is possible that a state court might look to ERISA and the regulations under ERISA to determine compliance with the state law. [We’re not implying that all states have such requirements; indeed, in many states, there are no rules applicable to 403(b) arrangements that are comparable to ERISA. And even in those states with comparable laws, the courts may determine that the requirements of the ERISA regulation are not applicable in their state.]

What Services are Covered? The regulation applies to “covered service providers” that reasonably expect to receive \$1,000 or more in direct or indirect compensation and provide “covered services.” There are five categories:

- Services directly to a covered plan as a fiduciary or investment adviser under ERISA.
- Services as a fiduciary for investment vehicles that hold plan assets.
- Services to a covered plan as an RIA under the Investment Advisers Act of 1940.
- Recordkeeping or brokerage services to participant-directed plans that offer one or more “designated investment alternatives” (*i.e.*, investments selected by a fiduciary to be offered under the plan).
- Other services, such as accounting, actuarial, legal and other professional services, consulting, banking, insurance, securities or other investment brokerage, recordkeeping and third party administration services, among others, if the service provider receives indirect compensation (that is, compensation paid by anyone other than the plan sponsor, the plan itself or any affiliate of the service provider). We refer to this as the “catchall” provision.

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How Does this Apply to 403(b) Plans? Let's look at various types of providers:

- Clearly, financial advisers that give fiduciary investment advice to a plan or participants (*e.g.*, for the selection of the investments offered by the plan or to be purchased by the participant) are covered, under the first category and possibly the third.
- An independent producer would be a covered service provider (because he or she is providing brokerage services). This is true if the plan sponsor has selected the specific investments in which the participants may invest but also even if not. Why? Because the producer will generally be receiving indirect compensation and would be covered under the "catchall" provision.
- An administrator or consultant would be covered only to the extent it is paid indirectly, such as through an investment provider. While this may occur in some cases, it may not be the general rule. Thus, service providers that are paid directly by the plan would not need to comply with the new regulation, even if they serve ERISA 403(b) plans.
- Finally, an investment provider that also offers recordkeeping services would need to comply in either of two cases: where the plan fiduciaries select the investment options *or* where they receive indirect compensation (*e.g.*, from a mutual fund) and fall under the "catchall" category.

What Does the New Regulation Require?

1. A covered service provider must disclose specified information to the "responsible plan fiduciary" (a defined term) in writing before the arrangement is entered into. This may be done through a notice or in a written contract (though a written contract is not required). As a practical matter, a number of service providers may already use a written contract – such as recordkeepers and those providing administrative services or consulting – and from a risk management perspective, it may be a good idea to use a service agreement to spell out the services and any limitations on the services. The regulation will have the biggest impact on independent producers, since few of them currently provide any form of written disclosure of services or compensation.

2. The disclosures required by the regulation must be made *before* the plan fiduciary agrees to hire the service provider and must be made sufficiently in advance to enable the responsible plan fiduciary to assess the information it receives (though there is no specific time period required by the regulation). This requirement could prove problematic, since it may well change the dynamic of the sales process.

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3. Covered service providers must comply with the disclosure requirements for *all* covered plans by July 16, 2011. There are no “grandfathered” clients to whom the disclosures will not need to be made, and covered service providers will need to give the disclosures to all of their existing clients before that time, in addition to establishing procedures for complying in the future for new clients. The impact of this requirement is that service providers may need to adopt separate approaches for existing and new clients, especially if they use a service agreement.

4. The service provider must describe the services it will provide. The regulation does not mandate the degree of specificity but says that the level of detail will depend on the needs of the responsible plan fiduciary. As noted above, we suggest a more detailed description of services to avoid confusion and to make it clear what the service provider will *not* be doing. [The DOL has requested comments on whether it should require service providers to give a short (one or two-page) summary disclosure, and it is quite possible the DOL will adopt this amendment to the regulation.]

5. The covered service provider must describe the direct and indirect compensation it will receive (including amounts to be received by affiliates and subcontractors). *Compensation* means anything of monetary value, such as money, gifts, awards and trips, but excluding non-monetary items of \$250 or less received during the term of the arrangement. *Direct compensation* is any amount received from a plan. *Indirect compensation* is any amount received from a source other than the plan, the plan sponsor, the covered service provider, an affiliate of the service provider or a subcontractor of the service provider. Note that compensation paid by the plan sponsor is neither direct nor indirect and thus is not technically required to be disclosed.

For indirect compensation, the regulation also requires identification of (i) the services for which it will be received and (ii) the payer of the indirect compensation. A general (or generic) description will not suffice because it must be specific to the plan for which services are to be provided. This requirement will affect recordkeepers that receive revenue sharing from mutual funds on their platform and producers, whose compensation may be entirely indirect.

Two other requirements: service providers must disclose whether compensation is a monetary amount, formula, percentage of the covered plan's assets, or a per capita charge for each participant (or using any other reasonable method if one of these won't work). And for all types of compensation, there must be

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disclosure of how it will be paid (*e.g.*, whether the service provider will bill the plan, deduct fees from plan accounts or reflect a charge against the plan investments).

Finally, there is a requirement to disclose any compensation the service provider reasonably expects to receive in connection with termination of the contract (*e.g.*, a surrender charge) and how prepaid amounts will be calculated and refunded upon termination of the contract, which would apply if the service provider charges for its services in advance and the arrangement is terminated before all services have been provided. This requirement will clearly impact providers that impose a surrender charge on their products.

6. There are a number of additional disclosures applicable to recordkeepers and brokers. First, with respect to designated investment options, they will need to disclose amounts charged directly against the investment for the acquisition, sale, transfer of or withdrawal from the investment (*e.g.*, sales loads or charges, redemption fees, surrender charges, exchanges fees, etc.); the annual operating expenses for non-fixed return products; and ongoing expenses in addition to annual operating expenses (such as wrap fees, mortality and expense charges and the like). Second, to the extent a recordkeeper does not have an explicit charge for its services, it will need to disclose an estimated amount based either on internal allocations or industry standards.

7. The regulation requires a service provider to disclose whether it, or an affiliate or subcontractor, will provide any services to the plan as a fiduciary as defined under either ERISA § 3(21)(A) or as an investment adviser registered under the '40 Act (or state law). If both, then both must be disclosed. Given the ERISA definition of a fiduciary – which includes anyone who provides investment advice for compensation – this requirement will cause producers and others, who may not have previously acknowledged this status, to do some soul searching to ensure that their service arrangements are reasonable.

8. A service provider must disclose any change to the required information no later than 60 days from the date it becomes aware of the change. Note that there is no “materiality” standard applied to the change. This will probably impact providers/recordkeepers and producers the most significantly, given their obligation to disclose information regarding designated investments.

9. Service providers must disclose, upon written request, any other information relating to compensation received in connection with the arrangement, if it is required for the plan to comply with the reporting and disclosure requirements of ERISA (*e.g.*, to complete the Form 5500). The information must be provided no later than 30 days after the request or as soon as practicable if this can't be done due to

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extraordinary circumstances beyond the service provider's control.

10. Finally, the regulation specifies that no arrangement will be considered unreasonable (*i.e.*, a prohibited transaction) solely because the service provider makes an error or omission in disclosing the information, so long as: (a) it was acting in good faith and with reasonable diligence; and (b) it discloses the correct information no later than 30 days from the date the service provider knows it made the error or omission. This will protect service providers from innocent mistakes that otherwise could have caused their contract to constitute a prohibited transaction.

CONCLUSION

The regulation is designed to help fiduciaries fulfill their obligation to ensure that no more than reasonable compensation is paid to service providers. For 403(b) service providers that do not regularly deal with ERISA plans, the regulation may require a significant degree of change in how they do business. And even for those that have a regular ERISA clientele, it will have an impact, especially for producers who have not previously established a practice of describing their services and compensation in writing.

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