Legal Risk Management Tip
June 2012

ERISA 408(b)(2) DISCLOSURES: ARE YOU READY?

BACKGROUND

In 2007, the Department of Labor ("DOL") released proposed regulations to help workers and retirement plan sponsors of ERISA-covered plans to understand the cost of services the plan receives. The goal was to improve the transparency of the fees that are charged to the plan and highlight the conflicts of interest that may arise due to certain arrangements between the covered service[1] provider and a third party[2]. Today the DOL is achieving these goals by requiring covered service providers to disclose certain facts to plan sponsors with respect to their compensation. An interim final regulation was proposed in July 2010 and was finalized on February 3, 2012. The deadline for a covered service provider to make their initial disclosures to the plan sponsor is **July 1, 2012**.

The covered plans subject to the disclosure requirements include employee pension plans, 401(k) plans and traditional defined benefit pensions. However, IRAs, SIMPLE retirement accounts, Simplified Employee Pensions and certain 403(b) arrangements are excluded from the regulation and its disclosure requirements.[3]

The spirit of the disclosure requirements under the regulation is to assist the plan participants in understanding the hidden fees and conflicts of interest that are present in their investments. While plan participants are more than likely aware of the direct costs to the plan, they may not be as knowledgeable about the "indirect compensation" a covered service provider may receive. "Compensation" as defined in the regulation is anything of monetary value (for example money, gifts, awards and trips) but does not include non-monetary compensation valued at $250 or less (in the aggregate) during the term of the contract or arrangement. Several commentators to the interim rule argued that the $250 threshold for non-monetary compensation should be revised and measured on a calendar or plan-year basis, but the DOL declined to accept this suggestion.

COMPENSATION DISCLOSURES

As it stands, the definition of compensation seems to include research seminars and subsidies for such seminars including meals and travel. As the regulation is currently written it appears that any non-monetary compensation a covered service provider receives will be aggregated for the

---

[1] A "covered service provider" is a service provider that enters into a contract or arrangement with the covered plan and reasonably expects $1,000 or more in compensation, direct or indirect, to be received in connection with providing one or more services (29 CFR 2550.408b-2 (c)(1)(iii))

[2] An example of a third party is a financial institution that subsidizes the cost of attendance at a conference that a covered service provider offered for its clients. *Id.*

[3] 29 CFR 2550.408b-2 (c)(1)(ii)

entire relationship and must be disclosed if the sum exceeds $250. However, there continues to be debate among industry professionals as to what actually needs to be disclosed as indirect compensation and how much detail is required. While some argue for more specific and customized disclosures, others maintain that the customizations should be not be so specific that they must be revised annually. Whatever the covered service provider decides, the analysis of the sufficiency of the disclosures should be based on a practical interpretation as to whether a plan sponsor can truly understand the various forms of compensation a covered service provider may receive.

PROHIBITED TRANSACTION CONSIDERATIONS

ERISA generally prohibits the furnishing of services between a plan and party in interest and the transfer of any plan assets unless an exemption applies. A party in interest is an individual who provides services to a plan. For example, a registered investment adviser ("RIA") providing services to an ERISA plan is a party in interest. Thus, without an exemption the plan cannot employ the RIA or use plan assets to pay their fees. In addition, a prohibited transaction may be subject to an excise tax and rescission.

Prior to the new regulation, the exemption under 408(b)(2) was not difficult to satisfy. It provided a general safe harbor that states that contracts with a party in interest for "services necessary for the establishment of the plan" are permitted so long as no more than "reasonable compensation" is paid. The new regulation has defined what disclosures are required to allow a plan fiduciary to determine whether the compensation is "reasonable." Failure to provide those disclosures by the deadline of July 1, 2012 will not satisfy the requirements of the exemption and therefore will subject the arrangement to be classified as a prohibited transaction, unless an alternative exemption can be relied on.

THE WRITTEN DISCLOSURE STATEMENT

A covered service provider must furnish a written statement to the plan fiduciary of the direct and indirect compensation. Direct compensation is any compensation that is received from the plan or where the plan reimburses the plan sponsor. Indirect compensation is any compensation received from a source other than the plan, plan sponsor, the covered service provider, an affiliate or a subcontractor of the covered service provider. A recipient of indirect compensation must also provide a description of the arrangement with the payer sufficient to allow a plan sponsor to determine if the compensation is reasonable.

While direct compensation disclosures attempt to highlight the cost of the services to the plan, the indirect compensation disclosures are intended to highlight the conflicts of interest of the covered service provider. Compensation may be expressed in any method that would be reasonable to allow the plan fiduciary to evaluate the reasonableness of the compensation. That may be in a dollar amount, formula, tiered schedule based on Assets Under Management etc.

FORM, TIMING & CURING DISCLOSURE FAILURES

All the disclosures are not required to be in a single document. However, the DOL has suggested providing a summary of where a plan fiduciary can find all the required disclosures to determine whether the compensation received is reasonable and therefore qualifies as an exemption to ERISAs prohibited transaction rules. The DOL provided a sample guide of the summary and has hinted that in the future they may require a sample guide as well.

Notably, disclosures must be made “reasonably in advance” on entering into, renewing or extending the contract for services. The effective date for providing the disclosures “reasonably in advance” will be July 1, 2012. If a covered service provider acts in good faith then they will not lose their exemption if an error or omission is found. However, the covered service provider must disclose the error or omission within 30 days of knowing of the failure. As long as covered service providers act in good faith and diligently take corrective steps when they discover an error or omission or upon request by the plan fiduciary, the exemption provided under 408(b)(2) will continue to allow for necessary services to the plan.

Finally, if a plan fiduciary discovers an error or omission the fiduciary must request in writing that the covered service provider correct disclosure information. When a covered service provider receives such a request from a plan fiduciary they have 90 days to supply the necessary disclosures or the plan fiduciary will be required to notify the DOL.

Author: Andrew Deddeh, Esq., Associate Attorney; Editor: Michelle L. Jacko, Esq., Managing Partner, JLG. JLG works extensively with investment advisers, broker-dealers, investment companies, hedge funds, private equity firms, banks and financial professionals on securities and corporate law regulatory matters.

This article is for information purposes and does not contain or convey legal advice. The information herein should not be relied upon in regard to any particular facts or circumstances without first consulting with a lawyer.