

ERISA Alert

New Regulations Under ERISA Section 408(b)(2) Require Additional Disclosure of Service Provider Compensation

August 13, 2010

On July 16, 2010, the United States Department of Labor (DOL) published interim final regulations¹ under Section 408(b)(2) of the Employee Retirement Income Security Act of 1974, as amended (ERISA). If you act as an investment manager for a separate account holding the assets of an employee benefit plan subject to ERISA (a “Plan”) or for a Plan asset fund, you may be subject to a new disclosure obligation. Following are questions intended to help explain the impact of these regulations—

1. Why should we care about Section 408(b)(2)?

Generally, unless an investment manager is retained on behalf of a Plan by a “qualified professional asset manager” (QPAM), the payment of fees to the manager would be a prohibited party-in-interest transaction under ERISA unless the requirements of Section 408(b)(2) are met. Frequently, these managers are not retained by QPAMs.

Currently, the regulations under Section 408(b)(2) provide only that a contract or arrangement involving a Plan will not be considered “reasonable” (and, therefore, not satisfy the requirements of Section 408(b)(2)) unless it permits the Plan to terminate the contract or arrangement without penalty on reasonably short notice. The new regulations add a requirement that, in order for a contract or arrangement to be considered “reasonable,” a “covered service provider” providing services to a “covered Plan” must disclose specified information to the Plan.

2. Do we have to comply with Section 408(b)(2)?

An investment manager providing services to a Plan or Plan asset entity will generally have to comply with Section 408(b)(2) if it answers “yes” to questions A, B and C below.

A. Are we a “covered service provider”?

A service provider will only be subject to 408(b)(2) if it provides the types of services covered by the regulations. These include acting as a fiduciary (e.g., an investment manager) or a registered investment advisor, in each case for which the service provider expects to receive at least \$1,000. If an entity is, or will be, providing any of these services, it should then determine if it is, or will be, providing such services to a covered Plan.

B. Do we provide services to a “covered Plan”?

As a general matter, any private U.S. pension or retirement Plan should be considered a covered Plan for purposes of the regulations unless determined otherwise. A covered Plan also includes any investment contract, product or entity holding Plan assets (e.g., an over 25 percent hedge fund).

¹ 75 Fed. Reg. 41600 (July 16, 2010)



C. Is Section 408(b)(2) necessary for the services we provide?

As noted above, Section 408(b)(2) will be necessary for the payments of fees to an investment manager from a Plan or Plan asset entity unless another exemption is available. One such exemption is Prohibited Transaction Class Exemption 84-14 (the “QPAM Exemption”). To determine if the QPAM Exemption or some other exemption is available, representations to this effect should be obtained from the person retaining the manager or directing the investment into a Plan asset fund.

3. If we are subject to these new requirements, what do we have to disclose?

The regulations require service providers to disclose the following in writing to the Plan—

- a description of the services to be provided
- if applicable, a statement that the service provider is providing services directly to the covered Plan as a fiduciary or as an investment adviser
- a description of all direct and indirect compensation reasonably expected to be received by the service provider, an affiliate or a subcontractor in connection with the provision of services to the covered Plan (including commissions, soft dollars, finder’s fees, 12b-1 fees and similar compensation based on business placed or retained), including, in the case of indirect compensation, the identity of the payor of the compensation
- a description of any compensation reasonably expected to be received by the service provider in connection with termination of the contract or arrangement, including how any prepaid amounts will be calculated and refunded upon such a termination
- if recordkeeping services are to be performed, a description of all direct and indirect compensation expected to be received in connection with such services and reasonable estimates of the costs of such services in instances where no explicit compensation is paid therefore (such as, for example, when the recordkeeping services are provided in connection with bundled service arrangements)
- a description of the manner in which compensation will be received, such as whether the covered Plan will be billed or the compensation deducted directly from the Plan’s accounts or investments.

In the event that services are provided as a fiduciary to an investment contract, product or entity that holds Plan assets and in which the covered Plan has a direct equity investment, and such information is not disclosed to the Plan by a service provider providing recordkeeping services or brokerage services provided to the covered Plan, the fiduciary must also provide—

- a description of any compensation that will be charged directly against the amount invested in connection with the acquisition, sale or transfer of, or withdrawal from, the investment contract, product or entity (e.g., sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, account fees and purchase fees)
- a description of the annual operating expenses (e.g., expense ratio) if the return is not fixed
- a description of any ongoing expenses in addition to annual operating expenses (e.g., wrap fees, mortality and expense fees).

4. When must the required information be disclosed?

The disclosure must be made reasonably in advance of the date the contract or arrangement is entered into, extended or renewed. In the event of changes, the change must be disclosed as soon as practicable, but not later than 60 days after the date on which the covered service provider is informed of such change, unless such disclosure is precluded due to extraordinary circumstances beyond the covered service provider’s control, in which case the information must be disclosed as soon as practicable. In the event that an investment contract, product or entity not holding Plan assets is subsequently determined to hold Plan assets, the required information must be disclosed as soon as practicable, but not later than 30 days after the date on which the covered service provider knows that such contract, product or entity holds Plan assets.

In addition, upon request by a covered Plan, the covered service provider must furnish any other information relating to services rendered to the covered Plan that is required for the covered Plan to comply with the reporting and disclosure requirements of Title I of ERISA (e.g., the annual Form 5500).

5. How must the required information be provided?

The service provider must ensure that the necessary disclosures are provided in writing to the Plan fiduciary having the authority to cause the Plan to enter into, extend or renew the contract or arrangement pursuant to which the services are provided.

6. When do the regulations become effective?

The regulations generally become effective on July 16, 2011. The regulations provide that their requirements will apply to all contracts or arrangements between covered Plans and covered service providers on the effective date, whether or not entered into prior to the effective date. Any information required to be provided pursuant to the regulations in respect of contracts or arrangements entered into prior to the effective date must be furnished no later than the effective date.

7. What should we do now?

Investment managers and advisors, as well as other direct or indirect providers of financial services to Plans or entities in which they invest should consider whether their current contracts or arrangements, or those anticipated to be entered into before July 16, 2011, are or will be subject to the regulations. For those contracts or arrangements expected to be entered into prior to the effective date, it may be advisable to provide any required disclosure at the time the contract or arrangement is entered into, rather than waiting until the effective date.

CONTACT INFORMATION

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