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ERISA for Money Managers: A Practical Workshop

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HOT ISSUES FOR INVESTMENT
ADVISERS WITH ERISA CLIENTS

New York, New York
April 17, 2008



Changes to Schedule C

New Plan Reporting Rules Effective in 2009 Require Increased Disclosure of Direct and Indirect Compensation Paid to Service Providers

- On November 16, the Department of Labor issued a revised Annual Return/Report of Employee Benefit Plan form (Form 5500).
- Plans will have to file the new Form 5500 beginning with reports for their 2009 plan years (generally filed in 2010).
- ***The revised Form 5500 will require plans to report to the DOL virtually all “direct and indirect compensation” received by the plans’ service providers who receive more than \$5,000 and, therefore, will greatly increase the burden on all plan service providers to collect and report the compensation information required by plans.***
- Prior to these changes, plans were required to report only direct compensation provided to their service providers, and brokerage commissions were reportable only if the broker had discretion.
- Since the reporting rules become effective for plans in 2009, plan fiduciaries and service providers will need to address their ability to comply with them during 2008.

Changes to Schedule C

What is Direct and Indirect Compensation?

- “Direct and indirect compensation” -- money or other thing of value (including gifts, entertainment, awards, trips, *etc.*) that a person receives directly or indirectly in connection with services rendered to the plan or their position with the plan during the plan year, including:
 - Asset based fees and fees deducted from investment returns.
 - *Custody fees.*
 - *Overdraft fees.*
 - *Sweep fees.*
 - *Securities lending fees.*
 - *Investment management fees.*
 - Finder’s fees.
 - Float.
 - Brokerage commissions.
 - Soft dollars.
 - All transaction-based fees received in connection with transactions or services involving the plan, whether or not they are capitalized as investment costs.
- Fees paid by the plan sponsor are excluded unless reimbursed by the plan.

Changes to Schedule C Reporting Appears to Look Through Non-Plan Asset Vehicles

- In a major change, the reporting rules appear to require fee reporting for persons who provide services to ***non-plan asset vehicles*** (such as a mutual funds and hedge funds with under 25% benefit plan investors) in which a plan invests.
- Reporting specifically is required for fees and expense reimbursement received from mutual funds, bank commingled trusts, insurance company pooled separate accounts, and other separately managed accounts and pooled investment funds in which the plan invests that are charged against the fund or account and reflected in the value of the plan's investment (e.g., management fees paid by a mutual fund to its investment adviser, sub-transfer agency fees, shareholder servicing fees, account maintenance fees, and 12b-1 distribution fees).
- The 5500 rules differ from disclosure rules under the Investment Company Act that apply to mutual funds (e.g., under the ERISA rules, but not under the Investment Company Act, a mutual fund might need to name each broker it uses and provide an estimate of the amount of brokerage commissions paid to each one).

Changes to Schedule C

Alternative Reporting for Compensation Paid by Investment Funds

- Plans are permitted (but not required) to report far less information for “eligible indirect compensation” paid to service providers by commingled investment vehicles (but apparently not separate accounts).
- “Eligible indirect compensation” defined as distribution fees, investment management fees, recordkeeping or shareholder service fees, finders fees, float revenue, brokerage commissions and other transaction-based fees and soft dollars paid to service providers from commingled investment funds in which a plan invests.
- Plan must receive (in one or more documents, including prospectuses, statements of additional information (“SAIs”), *etc.*):
 - Disclosure that service providers receive eligible indirect compensation.
 - A description of the services provided or the purpose of the payment of eligible indirect compensation.
 - The actual amount, or an estimate of or a formula for determining the amount, of the eligible indirect compensation paid during the year.
 - The name of the entity paying the compensation and receiving the compensation.
- Under alternative reporting, a plan can report (i) that eligible indirect compensation was paid, (ii) that plan received the appropriate disclosures and (iii) the identity of the party providing the disclosures.

Changes to Schedule C: Bundled Service Arrangements

- For bundled service arrangements (e.g., wrap programs) where a plan pays a single fee for a “bundle” of services:
 - Direct payments by the plan can be reported as being paid to the bundled service provider and do not have to be allocated among affiliates and subcontractors unless charged on a per-transaction basis.
 - ***Plans will have to “un-bundle” and separately report fees charged on a per-transaction basis and fees charged against the plan’s investment,*** including commissions, soft dollars and other non-monetary compensation, securities lending fees and float.

Changes to Schedule C

Gifts and Entertainment are Treated as Reportable Compensation . . .

- Gifts and entertainment are considered indirect compensation for plan reporting purposes and are reportable unless:
 - the gift or entertainment is valued at less than \$50; and
 - the aggregate amount of gifts or entertainment provided in a year is less than \$100.
- Gifts under \$10 do not have to be counted toward the \$100 limit.
- These rules differ both from NASD rules and DOL's LM-10 rules for reporting gifts and entertainment provided to union officials.
- Gifts received by one person from multiple employees of one entity treated as single gift for the \$100 threshold; gifts received by multiple employees of one entity from one person treated as separate the \$50 and \$100 thresholds.
- DOL has suggested informally that reportable gifts and entertainment might even include educational conferences that benefit the plan.

Changes to Schedule C ... and the DOL Strongly Cautions (Again) that *All Gifts and Entertainment May Give Rise Penalties*

- Form 5500 instructions state:

“CAUTION: These thresholds are for purposes of Schedule C reporting only. Filers are ***strongly cautioned that gifts and gratuities of any amount paid to or received by plan fiduciaries may violate ERISA*** and give rise to civil liabilities and criminal penalties.” (Emphasis added.)
- Similar to Comments by EBSA Director of Enforcement Virginia Smith in March 2007:

“[plan fiduciaries] need to be very, very careful under ERISA about accepting any gifts or gratuities from a service provider, even items of modest value.” “All these people are ending up in jail.”
- Civil liabilities - ERISA §406(b)(3) – prohibited transaction for fiduciary to receive “any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan” (penalties include payment of amount received to plan and excise tax of 15% per year).
- Criminal Penalties - 18 USC § 1954 – giving anything of value to an ERISA fiduciary because of or with an intent to influence plan decision (and fiduciary’s receipt of any thing of value because of or with an intent to be influenced) punishable by fine and/or imprisonment up to 3 years.
- DOL may issue more useful guidance soon.

Changes to Schedule C Plans Required to Disclose Service Providers that Do Not Provide Required Information

- Plans will be required to disclose on Form 5500 the names of any service providers that do not provide all required compensation information.
- It should be possible to agree with a plan on a method of allocating reporting responsibility to those parties who are in the best position to collect the relevant information.
- Under the DOL's proposed services exemption regulation (discussed below), failure to provide requested information could result in a "prohibited transaction" requiring rescission of fees and potentially excise taxes.

Proposed “Services Exemption” Regulations Add Written Contract and Disclosure Requirements

- On December 13, the DOL issued proposed regulations under Section 408(b)(2) of ERISA, the statutory exemption that permits a plan to pay reasonable compensation for services necessary to the operation of a plan.
- Other exemptions are available for services (e.g., 75-1 Part I (securities brokerage), PTE 84-14 (transactions directed by QPAM), PTE 96-23 (transactions directed by INHAM), *etc.*) that may involve less onerous conditions.
- The comment period closed on February 11, 2008.
- Over 100 comments received
- DOL held two days of hearings March 31 and April 1.
- The proposed regulations become effective 90 days after the final regulations are published in the Federal Register.

Proposed “Services Exemption” Regulations All Service Arrangements Must be in Writing

- The proposed regulations provide that no contract or arrangement for services will be considered “reasonable” unless it is “in writing,” and requires the service provider to make specific disclosures to the plan.
- ***Service providers that want to comply with Section 408(b)(2) will have to make sure all of their relationships with ERISA plans are properly documented by the effective date of the final regulations.***

Under the Proposed “Services Exemption” Regulations , All Contracts With Plans *Must* include . . .

- A description of all services to be provided to the plan.
- The direct and indirect compensation and fees to be received by the service provider and its affiliates, and the manner of receipt of the compensation.
- The manner in which the plan will be charged (e.g., plan billed directly, account value reduced automatically, reflect charge in plan investment, etc.).
- Whether the service provider or an affiliate will provide services as a fiduciary under ERISA **or the Investment Advisers Act of 1940**.
- A statement of whether the service provider or any of its affiliates expects to have a financial or other interest in any transaction to be entered into by the plan, a description of any such transaction and the service provider’s participation.
- A statement of whether the service provider or its affiliates have any material financial, referral or other relationship or arrangement with a money manager, broker, other client, other plan service provider, etc., that creates or may create a conflict of interest and a description of any such arrangement.
- A statement of whether the service provider can affect its own compensation or fees from any source without the prior approval of the plan and a description of the nature of such compensation.
- A statement of whether the service provider or an affiliate has conflict resolution policies and procedures and an explanation of those policies and procedures and how they will address potential conflicts or prevent an adverse effect on the provision of services.
- An agreement to provide any information the plan requests to meet its ERISA reporting obligations.

Proposed “Services Exemption” Regulations

Time and Form of Disclosure

- ***Disclosures do not need to be in a single document as long as they are provided to the plan prior to entering into the contract.***
- Disclosures may be in electronic format.
- Disclosures may be incorporated by reference from other documents, such as prospectuses or Forms ADV.
- There is no prescribed time prior to entering into a contract by which service providers must provide the required disclosures.
 - Information must be provided “sufficiently in advance of entering into the contract or arrangement to allow the fiduciary to prudently consider the information.”
- The contract must require the service provider to update the required disclosures within 30 days after becoming aware of any material change.

Proposed “Services Exemption” Regulations Possible Application to Non-Plan Asset Investments

- Service providers to non-plan asset vehicles (as opposed to plans) are not “parties in interest” subject to ERISA. Nevertheless some have suggested DOL intends the regulations to apply to arrangements with service providers of non-plan asset investment vehicles in which any plans invest.

The Proposed “Services Exemption” Regulations Do Not Amend Regulations Under Section 4975

- Section 4975(d)(2) of the Internal Revenue Code of 1986 (the “Code”) is a corresponding “services exemption” under the Code. Current regulations under Section 4975(d)(2) are identical to current regulations under Section 408(b)(2), and provide rules relating to the excise taxes imposed under the Code.
- The proposed Section 408(b)(2) regulations do not amend the Section 4975(d)(2) regulations. As a result, failing to comply with the Section 408(b)(2) regulations should not result in excise taxes (note that the preamble to the proposed regulations suggests failure to comply with the regulations might result in excise taxes).
- IRAs and Keoghs, which are subject to Section 4975 but not ERISA, are not covered by the proposed regulations.

Some Differences from the New 5500 Reporting Rules to Consider

- Unlike the 5500 reporting rules, the proposed Section 408(b)(2) regulations do not include a *de minimis* reporting threshold for gifts and entertainment.
- While the 5500 reporting rules specifically exclude payments from a plan sponsor from the definition of compensation, the definition of compensation under the proposed Section 408(b)(2) regulations includes payments from a plan sponsor.

LM-10 (Disclosure of Gifts and Payments to Labor Unions) Why Do We Care?

- The broad definition of “Employer”
- Include payments made to Trustees of Taft-Hartley plans.
- President and treasurer must sign completed LM-10 reports (exception for initial report)
 - **Criminal and monetary penalties apply**
- Information contained on LM-10 reports implicates other statutes with potential penalties
- Disclosures are available to the public and compared with LM-30 union reports

LM-10 Broad Employer Reporting Obligations

- Definition of Covered “Employer” Interpreted Broadly
 - Any entity that has an employee
- Broad Range of Payments Potentially Covered
 - Meals (*e.g.*, lunches and dinners)
 - Travel expenses and/or reimbursements
 - Gifts
 - Tickets to sporting or other entertainment events
 - Products or services (including food and other consumer goods)
 - Social events/parties (*e.g.*, contract-signing parties)
 - Fees paid to attend union-sponsored events
 - Payments to Charities (other than direct payments to IRC 501(c)(3)s)

LM-10

\$250 *De Minimis* Exception

- Elements of Exception:
 - (1) *Total value of payments provided to any one union, union officer, union agent, or union employee is \$250 or less in any fiscal year; and*
 - (2) *Payment is unrelated to the recipient's status in a labor organization.*
- All Payments Reportable if \$250 Threshold Exceeded. Need to track all payments. Recent relief under LM-30 for amounts under \$20.

LM-10

Calculating Value the of Meals and Other Reportable Events

- No Single “Right” Way
- Estimating the Payment or Benefit Provided to Each Individual
- Per Person Cost for a Meal or Event

LM-10 Implications of Other Statutes

- 18 U.S.C. § 1954
- Prohibited Transaction Provisions under ERISA and the Code

LM-10 General Compliance Considerations

- Separate Versus Consolidated Reports for Subsidiaries or Related Companies
- Collection Methods
 - Scope of Information Collected
 - Privilege Considerations
- Records Must be Maintained for 5 Years
- Potential for DOL Audit

LM 10
Reporting Compliance -
Developing Policies and Procedures

- Consider Modifying Payment Practices
 - Balancing Legal Risk and Labor-Management Relations/
Customer-Client Relations
 - Analyzing the Choices:
 - *Prohibiting all covered payments and gratuities*
 - *Allowing payments up to \$250*
 - *Permitting all payments and gratuities*
 - Implementing Tighter Controls/Authorization Requirements
- Developing Recordkeeping Procedures
- Considering Privilege Issues

Proxy Voting and Shareholder Activism

- Who cares?
 - Department of Labor
- Who votes?
 - Allocation of voting responsibility among plan fiduciaries
 - *Adopting proxy voting policies and procedures*
 - Plan participants

Proxy Voting and Shareholder Activism

- Special issues
 - Employer stock
 - Proprietary mutual funds under PTE 77-4 (or PTE 77-3)
 - Other conflicts of interest
 - Shareholder/political activism

Soft Dollars under ERISA

- Technical Release 86-1
 - Soft dollar arrangements that are outside of Section 28(e)
 - *Raise disclosure obligations (Part 2 of Form ADV) under Advisers Act*
 - *Raise fiduciary and prohibited transaction issues under ERISA*
 - “Good” directed brokerage – outside Section 28(e), but permissible if structured properly
 - *Amount paid for brokerage or other goods and services is reasonable*
 - *Use of broker is consistent with best execution*
 - *Any rebates or other goods or services provided to the plan must be used for the exclusive benefit of the plan and its beneficiaries*
- Use of research and brokerage services to service all client accounts vs. Schedule C obligation to “un-bundle” compensation and attribute it to specific plans

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Participant Questions

