ERISA SECTION 408(b)(2) FEE DISCLOSURES: IMPACT ON BROKER-DEALERS

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by: Marcia S. Wagner, Esq.
The Wagner Law Group
A Professional Corporation
99 Summer Street, 13th Floor
Boston, MA 02110
Tel: (617) 357-5200
Fax: (617) 357-5250
www.erisa-lawyers.com

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I. OVERVIEW OF PROPOSED 408(b)(2) REGULATIONS

A. Background

Let me begin with a few definitions to facilitate the discussions. I sure most of you are familiar with them but they are worth repeating for those unfamiliar with them:

Broker-dealer:	The organization registered with SEC and FINRA, not the individual professional working for the broker-dealer.
Registered Representative:	The investment professional representing the broker-dealer and registered with the broker-dealer.
RIA	The organization or investment professional registered with the SEC as an investment adviser.
IAR	IAR stands for investment adviser representative. This is the investment professional representing the RIA.
Financial adviser	This is a deliberately ambiguous term that could refer to an investment professional serving as either registered representative for a broker-dealer or as an IAR for an RIA. Also, the term could also refer to an investment professional separately registered with SEC as an RIA.

1. Statute.

ERISA §408(b)(2) provides relief from ERISA's prohibited transaction rules for service between a plan and a party in interest (e.g., broker-dealer) if the contract or arrangement:

- is reasonable,
- the services are necessary for the establishment or operation of the plan, and
- no more than reasonable compensation is paid for the services.

2. Current Regulations.

In addition to the above requirements in ERISA, the current regulations impose only one other significant additional requirement. The plan must be able to terminate the service contract or arrangement without penalty on reasonably short notice.[1]

Neither ERISA nor the current regulations impose a significant administrative burden on service providers nor expose them to significant risk of legal liability.

3. Proposed Regulations.

The U.S. Department of Labor ("DOL") has proposed[2] amending its regulations to require service providers to disclose in writing their fees and conflict of interests. If adopted as

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

[2] 72 Fed. Reg. 70988 (Dec. 13, 2007). If DOL adopts the 408(b)(2) regulations as proposed, the final regulations would take effect 90 days after publication in the Federal Register.

proposed, the new regulations will impose significant administrative burden on service providers and expose them to significant risk of legal liability for failure to disclose their fees and conflicts of interest. Indeed, the new fee and conflict of interest disclosure regulations will accelerate the trend for financial advisers to do business as IARs (investment adviser representatives) for a RIA (registered investment adviser) receiving asset-based fees instead of as a registered representative for broker-dealer receiving commissions.

DOL's proposed fee and conflict of interest disclosure rules for service providers are the second of three fee-related regulations. The first set applies to a plan's disclosures of fees that it pays on Form 5500, Schedule C. DOL has already issued final regulations on the revised Schedule C,[3] but they will not apply until the 2009 plan year. DOL has not yet proposed the third set of regulations that will apply to the disclosures by the plan to its plan participants.

4. __Rationale for Proposed Regulations__.

The three sets of fee-related disclosure regulations are the current installment in the 401(k) fee saga that began more than ten years ago. In 1997, several consumer magazines published provocatively entitled articles, such as "Protect Yourself against the Great Retirement Rip-off"[4] and "Your 401(k)'s Dirty Little Secret."[5] These articles apparently prompted DOL to launch its 401(k) plan fee initiative. In November 1997, DOL held a hearing on 401(k) fees.[6]

In June 1998, DOL published a 19-page booklet, "A Look At 401(k) Plan Fees," for plan participants[7] and a 72-page report, "Study of 401(k) Fees and Expenses," for plan sponsors.[8] The study appears to have been an attempt to educate plan sponsors about their fiduciary responsibilities regarding fees and expenses for service providers. The booklet appears to have been an attempt to persuade plan participants to put pressure on plan sponsors to pay attention to the fees and expenses that plan participants were paying for investment management and plan administration.

DOL's 10-year educational effort to persuade plan sponsors and plan participants to ask the right questions about 401(k) fees has apparently failed. In light of that failure, DOL is proposing to require service providers to disclose the answers to questions that DOL believes plan sponsors should have been asking.

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[3] 72 Fed. Reg. 64710 (Nov. 16, 2007).

[4] April 1997 *Money Magazine*

[5] September 1997 *Bloomberg Personal*

[6] The hearing notice is posted at http://www.dol.gov/ebsa/regs/fedreg/notices/97_27431.htm.

[7] A Look at 401(k) Plan Fees" is posted at http://www.dol.gov/ebsa/publications/401k_employee.html.

[8] The Study of 401(k) Fees and Expenses is posted at: http://www.dol.gov/ebsa/pdf/401kRept.pdf.

B. Content of Proposed Regulations

1. Service Providers Affected.

a. Primarily Fiduciaries and Administration and Investment Service Providers

The proposed rules are limited to service providers who:

1. are fiduciaries under ERISA or under the Investment Advisors Act of 1940;
2. provide securities brokerage, investment advice (to the plan or plan participants), investment management, custodial, recordkeeping, consulting, or third party administration services, regardless of whether they receive the compensation directly from the plan or plan sponsor, or indirectly from third parties, or
3. provide accounting, actuarial, appraisal, auditing, legal or valuation services but only if they receive any compensation indirectly from third parties.

In other words, fiduciaries (e.g., investment advice fiduciaries) and service providers involved with plan administration or investments are subject to the new disclosure rules, even if they do not receive any indirect compensation. However, accounting, actuarial, legal, and similar professional service providers are subject to the new disclosure rules only if they receive indirect compensation. According to DOL, the distinction is based on its belief that the service providers subject to the enhanced disclosure requirements are most likely to have conflicts of interest.

b. Health and Welfare as well as Retirement

Although the focus of the proposed 408(b)(2) regulations is 401(k) fees, the proposal applies to services provided to health or other welfare plans as well as 401(k) and other retirement plans.

c. Service Provider's Subcontractors Not Subject to Regulations

The proposed rules would apply only to services to employee benefit plans, not services to plan participants provided by subcontractors of the service provider. For example, if a plan contracts with an HMO to provide medical service to plan participants, the proposed 408(b)(2) regulations would not apply to the service contract between the HMO and the doctors in its network regarding the doctors' services to plan participants. Of course, the proposed regulations

would apply to the service contract between the plan and the HMO. The HMO is example is taken from the preamble to the regulations.[9]

*2. **Fee Disclosures**.*

a. General Rule

An affected service provider must disclose to the plan sponsor or similar plan fiduciary in writing, to the best of its knowledge, all services to be provided to the plan and, with respect to each such service:

- the fees[10] to be received by the service provider (expressed as a specific monetary amount or formula, percentage of the plan's assets, or per capita charge),
- whether the service provider will bill the plan, deduct fees directly from plan accounts, or reduce the plan's investment earnings to pay the fees, and
- how any prepaid fees will be calculated and refunded when a contract terminates.

b. Bundled Services

If a service provider offers a bundle of services to the plan that is priced as a package, rather than on a service-by-service basis, then only the service provider offering the bundle of services must provide the required disclosures. In addition, the bundled service provider is not required to disclose the fee allocation among the services, unless fees are separately charged against a plan's investment (e.g., management fees paid to mutual fund advisors) or on a transaction basis (e.g., brokerage commissions).

*3. **Conflicts of Interest Disclosures**.*

An affected service provider must also disclose to the plan sponsor or similar plan fiduciary in writing, to the best of its knowledge, information about different types of relationships or interests that raise conflicts of interests for the service provider in performing plan services. For example, service providers must disclose whether they:

- will provide any services to the plan as a fiduciary either within the meaning of ERISA §3(21) or under the Investment Advisers Act of 1940;

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[9] 72 Fed. Reg. 70988, 70989 (Dec. 13, 2007).

[10] "Fees" include money or any other thing of monetary value (e.g., gifts, awards, and trips) to be received by the service provider (or its affiliate) directly from the plan or plan sponsor, or indirectly from third parties (i.e., from any party other than the plan or the plan sponsor), in connection with the services to be provided pursuant to a contract or arrangement with the plan or because of the service provider's position with the plan.

- have any material financial, referral, or other relationship or arrangement with other parties (e.g., a money manager, broker) that creates or may create a conflict of interest, and if so, a description of such relationship or arrangement;
- will be able to affect its own compensation or fees, from whatever source, without the prior approval of the plan sponsor or similar plan fiduciary;
- expect to participate in, or otherwise acquire a financial or other interest in, any transaction to be entered into by the plan pursuant to the contract and, if so, a description of the transaction and the service provider's participation or interest therein; and
- have any policies or procedures that address actual or potential conflicts of interest or that are designed to prevent either compensation or fees or the relationships or arrangements from adversely affecting the provision of services, and if so, an explanation of these policies or procedures.

4. ***Timing and Format of Disclosures.***

There is no specified timeframe to disclose the information other than prior to entering into the contract. All of the required disclosures need not be contained in the same document and may be provided in electronic format. The service contract must include a representation by the service provider that, before the contract was entered into, all the required conflicts of interest information was provided to the responsible plan fiduciary. During the term of the contract, any "material" change to the previously furnished information must be disclosed within 30 days of the service provider's knowledge of the change.

C. Curing Disclosure Failures: Prohibited Transaction Exemption

1. ***Relief for Plan Sponsor, Not Service Provider.***

A service provider's failure to comply with the disclosure obligations under the proposed 408(b)(2) regulations would result in a prohibited transaction. Because the prohibited transaction could adversely affect the plan sponsor or similar plan fiduciary, DOL has also proposed a class exemption[11] that would provide relieve for them. Conspicuous by its absence is any relief to the service provider that fails to comply with the proposed 408(b)(2) regulations.

a. Corrective Action

[11] 72 Fed. Reg. 70893 (December 13, 2007). The class exemption would be effective 90 days after its publication in the Federal Register.

The relief would be provided if the plan sponsor or similar plan fiduciary enters into a service contract without knowing that the service provider failed to comply with its disclosure obligations under the proposed 408(b)(2) regulations. To qualify for relief, plan sponsor or similar fiduciary:

- must have entered the service contract reasonably believing that the disclosure requirements had been met;
- take corrective steps with the service provider after discovering the disclosure problem by requesting in writing the disclosure information; and
- notify the DOL of uncooperative service providers not later than 30 days following the earlier of:
  - the service provider's refusal to furnish the requested information; or
  - the date which is 90 days after the date the written request is made.

b. Whistleblowing Notice to DOL

The notice to the DOL must contain the following information:

- plan's name and number;
- plan sponsor's name, address, and EIN;
- plan fiduciary's name, address, and telephone number;
- service provider's name, address, phone number, and if known, EIN;
- description of the services provided to the plan;
- description of the information that the service provider failed to furnish;
- date on which such information was requested in writing from the service provider; and
- a statement as to whether the service provider continues to provide services to the plan.

***2. Decide whether or not to terminate the service contract*.**

The plan sponsor or similar fiduciary must also determine whether to terminate or continue the service contract by evaluating the nature of the particular disclosure failure and determining the extent of the actions necessary under the facts and circumstances. Factors to consider, among others, are:

- the responsiveness of the service provider in furnishing the missing information, and
- the availability, qualifications, and costs of potential replacement service providers.

D. Immediate Impact and Issues

Currently, service providers need not disclose specific types of information to plan sponsors or similar fiduciaries. DOL is proposing to require service providers to disclose extensive amounts of information, including the identity of third parties from whom it receives fees as a result of providing services to the plan.

The fee and conflict of interest disclosures will present significant internal tracking and communication challenges for large/complex companies. In addition, the ongoing 30-day disclosure deadline for material changes will also result in similar challenges.

It is unclear whether the proposal will apply to contracts in place when the regulation becomes effective. If final regulations apply to service contracts in place, the deadline for compliance will be short (i.e., 90 days after final regulations are published). Service providers should begin preparing now to meet the new disclosure requirements.

II. BEST PRACTICES EVOLVING FROM 401(k) FEE LITIGATION

As noted earlier, the proposed 408(b)(2) regulations can be viewed as confirmation that DOL has failed to persuade plan sponsors through education to fulfill their fiduciary duties in negotiating service provider fees, particularly 401(k) fees, on behalf of plan participants. Taking their cue from DOL, law firms representing plan participants in class actions have alleged that some of the nation's largest employers[12] have failed to negotiate reasonable 401(k) fees. In light of these class actions, more employers are beginning to adopt best practices in monitoring and negotiating service provider fees. Broker-dealers and financial advisors need to be aware of these best practices as well as the 408(b) regulations.

A. Identifying Fees

Plan sponsors will be making a more concerted effort to learn how much the plan and participants are actually paying in fees and expenses. Although the proposed 408(b)(2) regulations allow disclosure by formula, many plan sponsors will attempt to determine the actual dollar, even if it is an estimate.

B. Comparing Investment Management Fees or Expense Ratios against Benchmarks

[12] The large employers include the following: (1) Boeing Co., (2) Caterpillar, Inc., (3) General Dynamics Corp., (4) Kraft Foods Global, Inc., (5) Lockheed Martin Corp., (6) International Paper Company, in the S.D. Ill.; (7) Exelon Corp. in the N.D. Ill.; (8) Bechtel Corp. in the N.D. Cal.; (9) United Technologies Corp. in the D. Conn., (10) Deere & Co., in the W.D. Wis.; (11) Unisys Corp. in the C.D. Cal.; and (12) ABB, Inc. in the W.D. Mo.

Plan sponsors will attempt to avoid paying above-average investment management fees or expense ratios unless the investment manager or mutual fund can demonstrate it is delivering above-average investment performance for the plan participants.

C. Continuous Monitoring

Continuous monitoring will become a best practice standard. In addition to a broad range of qualitative and quantitative questions about the investment managers or mutual fund, plan sponsors will be asking whether the fees are reasonable with respect to investment performance and related services plan participants are receiving.

D. Documenting Reviews of Investment Vehicles and Fees

Plan sponsors will be documenting their reviews of investment vehicles, including negotiations related to service provider fees paid directly by the plan or plan sponsor or indirectly by the plan participants through a reduction in investment earnings. The documentation should demonstrate a thoughtful process addressing key questions or discussions, and decisions made.

E. Hiring Independent Third Party Investment Experts

More plan sponsors will employ independent third parties (e.g., consultants) to assist with reviewing the investment performance and fees of investment managers and related service providers. While these vendors typically provide reports and recommendations for analysis by the plan sponsor, there is an inherent conflict of interest when vendors report on proprietary funds or even nonproprietary funds where long-term business relationships and revenue agreements may influence the reports and recommendations.

F. Conducting Fiduciary Audit

When appropriate, more plan sponsors will be hiring an independent third party to conduct a fiduciary audit of the plan's outsider fiduciaries, particularly when vendors fail to adequately disclose fees or fees do not seem reasonable.

III. FINANCIAL ADVISER BUSINESS MODEL

Earlier this year, SEC released the text of the RAND study[13] that it had commissioned to address two questions:

- What are the current business practices of broker-dealers and RIAs (registered investment advisers)?
- Do investors understand the differences between a registered representative and an IAR (investment adviser representative)?

With respect to the first question the RAND study found that:

- A relatively few dually-registered broker-dealers and investment advisers play a disproportionately large role in the market.
- The number of dual registrants has remained stable from 2001 through 2006. During the same time period, however,
  - the percentage of broker-dealer firms registering as investment advisers increased, but
  - the percentage of investment advisers registering as broker-dealers declined.
- Similarly, the number of firms registering with the SEC as investment advisers has increased substantially, but the number of registered broker-dealers has declined.

With respect to the second question, the RAND study found that investors:

- had difficulty distinguishing between registered representatives and IARs, and
- struggled to understand the differences between a registered representative's suitability obligations and an IAR's fiduciary duties, even after they were provided a plain-English explanation during RAND focus groups.

In line with the trends found in the RAND study, we think more financial advisers will prefer doing business as IARs (investment adviser representatives) rather than registered representatives in light of the Financial Planning Association court decision discussed immediately below and the proposed 408(b)(2) regulations. Before explaining our thoughts, let's quickly review these two developments from a financial adviser's point of view.

[13] SEC Press Release 2008-1 (1/3/08) posted at http://www.sec.gov/news/press/2008/2008-1.htm. The RAND study, "Investor and Industry Perspectives on Investment Advisers and Broker-Dealers," is available through a link in the posted press release.

A. Financial Planning Association ("FPA") v. SEC

In FPA decision,[14] the appeals court for the District of Columbia invalidated the SEC investment adviser exemption for broker-dealers receiving asset-based fees instead of traditional commission. In light of that decision, clients needed to make a decision whether (a) to convert brokerage accounts with asset-based fees into traditional brokerage accounts generating commissions or (b) to convert the brokerage accounts into investment advisory accounts with asset-based fees.

We understand that many clients chose investment advisory accounts with asset-based fees. As a result, broker-dealers sponsoring those advisory accounts must comply with the Investment Advisers Act of 1940. Thus, the broker-dealer had to register as investment advisers, if they were not already dually registered as investment advisers and broker-dealers. As investment adviser, they would also have to act as fiduciaries with respect to those clients, disclose all potential material conflicts of interest, and otherwise fully comply with the Investment Advisers Act.

Given client demand for advisory accounts with asset-based fees over brokerage accounts with commissions, the FPA decision will accelerate the trend for financial advisers to operate as IARs rather than registered representatives. Before evaluating the implications of that trend, let's take another look at the proposed 408(b) regulations from a financial adviser's point of view.

B. Proposed 408(b)(2) Regulations

The proposed 408(b)(2) regulations treat both IARs (i.e., fiduciaries) and registered representatives not providing investment advice (i.e., non-fiduciaries) equally in terms of their obligations to disclose their compensation and potential conflicts of interest in providing services to the plan. Thus, registered representatives do not have a non-disclosure advantage over IARs with respect to conflicts of interest or compensation.

C. ERISA Investment Advice Fiduciary Status

Without a doubt, financial advisers operating as RIAs (registered investment advisers) or IAR's (investment adviser representatives) are investment advice fiduciaries under ERISA. Thus, they must comply with fiduciary responsibility rules under ERISA as well as the Investment Advisers Act of 1940.

In considering whether to do business as a registered representative, one of the threshold questions is whether a registered representative can serve an ERISA plan without becoming an investment advice fiduciary under ERISA. For registered representatives providing investment

[14] Financial Planning Association v. SEC, 482 F.3d 481 (D.C. Cir. 2007).

education, not investment advice, the answer is theoretically yes.[15] As a practical matter, however, many ERISA plans will not retain a financial adviser unwilling to provide investment recommendations. On the other hand, providing investment recommendations to an ERISA plan frequently increases the chances that the registered representative will become an investment advice fiduciary and might not know when the change in status occurred.

1. Investment Education, Not Investment Advice.

DOL has provided safe harbors describing investment education that would not be considered investment advice under ERISA presumably because it is not individualized to the needs of the investor (i.e., plan participant). The safe harbors include:

1. Explanations of the advantages of participating in a retirement plan.
2. General financial information and investment concepts, such as risk return, diversification, dollar cost averaging, compound returns, and tax deferred investments.
3. Charts, graphs, and case studies illustrating model investment allocations for hypothetical individuals with different time horizons and risk profiles.
4. Questionnaires, worksheets, software, or similar interactive tools that allow a participant to estimate future retirement income needs and assess the impact of different investment allocations on retirement income.

This type of investment education could also be provided to a plan sponsor regarding an ERISA plan without it becoming investment advice because it is not individualized to the needs of the plan. While the DOL safe harbors do not apply to the Financial Industry Regulatory Authority ("FINRA"), it would be surprising if FINRA applied its suitability requirements to DOL's investment education.[16]

2. Infrequent "Suitable Recommendations".

A registered representative can provide incidental investment advice as part of a package of services, including execution and custody, without becoming an investment adviser under the Investment Advisers Act of 1940 and without becoming an investment advice fiduciary under ERISA. However, the registered representative's incidental investment advice must comply with suitability obligations. Providing suitable investment advice to their ERISA plans without becoming investment advice fiduciaries is and will continue to be a difficult challenge. To understand the difficulty, let's briefly compare the definition of investment advice under the

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[15] The investment advice fiduciary regulations acknowledge that a broker is not an investment advice fiduciary solely because the broker executes securities transactions pursuant to the instructions of a plan fiduciary. See 29 CFR 2510.3-21(d).

[16] A broker-dealer that provides generalized, non-specific investment advice to a customer (e.g., "invest a portion of your account in equities") would not be acting in advisory capacity, according to Securities Industries Association, SEC Staff No-Action Letter (December 16, 2005), available at 2005 WL 3526529.

ERISA regulations[17] and the definition of suitable investment advice under NASD Rules of Conduct[18] now enforced by FINRA.[19]

> *ERISA Investment Advice:*
> on a regular basis to the plan pursuant to a mutual agreement, arrangement or understanding, written or otherwise, . . . that such [advice] will serve as a primary basis for investment decisions with respect to plan assets, and that such person will render individualized investment advice to the plan based on the particular needs of the plan regarding such matters as . . . overall portfolio composition . . . .
>
> *Broker-Dealer Suitable Recommendations:*
> a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

The common element of both definitions is that the financial adviser recommends investments that are suitable (i.e., individualized) based on the needs of the investor. Thus, a registered representative making suitable recommendations to an ERISA plan would be providing individualized investment advice based on the need of the ERISA plan.

The principal difference between an investment advice fiduciary under ERISA and a registered representative complying with the suitability requirement is when or how often they must make recommendations. An investment advice fiduciary under ERISA has an ongoing obligation to advise the ERISA plan regarding its investments. In contrast, the registered representative need only provide suitable recommendations when asked by the ERISA plan but has no ongoing duty to advise the ERISA plan.[20]

The tricky question is how often can an ERISA plan ask a registered representative for suitable recommendations before this investment advice becomes “regular” and serves as “a primary basis” for the plans investment decisions based on the common understanding of the registered representative and ERISA plan. Whatever the frequency that causes this to happen, the registered representative will become an investment advice fiduciary under ERISA. Consider the recent example of the Edward Jones broker who was found to be an investment advice fiduciary under ERISA because:

- the broker and his client (i.e., the plan trustee and president of the plan sponsor) met regularly over the course of a number of years to review the plan’s investments;
- the broker was the trustee’s only source of investment advice; and

[17] 29 C.F.R. 2510.3-21(c).
[18] National Association of Securities Dealers (NASD) Conduct Rule 2310(a).
[19] Effective July 30, 2007, the Financial Industry Regulatory Authority (FINRA) succeeded NASD. Rule 2310 continues to be designated as a NASD Conduct Rule at http://finra.complinet.com/finra/display/display.html?rbid=1189&element_id=1159000466
[20] Kwiatkowski v. Bears, Stearns & Co., Inc., 306 F.3d 1293 (2nd Cir. 2002).

- the trustee never failed to accept his recommendations.[21]

To summarize, the FPA decision will encourage more financial advisers to do business as RIAs to accommodate clients that want advisory accounts with asset-based fees rather than brokerage accounts generating transaction-based commissions. The fee and conflicts of interest disclosure will apply with equal force regardless of whether financial advisers operate as RIAs or registered representatives. Finally, financial advisers operating as RIAs do so with certainty that their conduct must comply with fiduciary responsibility rules under the Investment Advisers Act of 1940 and ERISA. On the other hand, financial advisers operating as registered representatives need to work either with the handicap of providing only investment education or with the uncertainty that making suitable investment recommendations to the ERISA plan may accidentally cause them to be investment advice fiduciaries.

So far, a reasonable case has been made for financial advisers to conduct business as RIAs rather than registered representatives. However, let's now consider the disadvantages of RIAs serving as investment advice fiduciaries for ERISA plans.

D. Conflicts of Interest

1. Investment Advisers Act of 1940 v. ERISA.

Although the fiduciary duties are similar under the Investment Advisers Act of 1940 and ERISA, one critical difference is especially noteworthy. The Advisers Act allows an RIA to provide conflicted advice so long as the RIA discloses the conflict of interest to the client. However, disclosure is the cure for conflicts of interest under ERISA only if a prohibited transaction exemption authorizes the disclosure. Otherwise, ERISA's prohibited transaction rules bar an RIA from providing conflicted advice to an ERISA plan.

To some extent the proposed 408(b)(2) regulations are misleading. The regulations require service providers, including fiduciary service providers, to disclose their fees and conflicts of interest. Thus, the regulations suggest a fiduciary could cure a conflict of interest through disclosure. However, the regulations provide relief only from the party-in-interest transactions in ERISA section 406(a), and not the conflict of interest rules under ERISA section 406(b). Thus, a fiduciary disclosing conflicts of interest under the proposed 408(b) regulations will not get any relief from ERISA's conflict of interest rules. Essentially, the proposed 408(b) regulations are designed to force non-fiduciary service providers to disclose their conflict of interests, even though they are not subject to the conflicts of interest rules that apply to fiduciaries.

2. Fixed v. Variable Fees.

[21] Ellis v. Rycenga Homes, Inc., 484 F.Supp.2d 694 (W.D. Mich. 2007).

Before the Pension Protection Act of 2006 ("PPA"), DOL had issued several advisory opinions explaining that financial advisers would not have a conflict of interest based on their compensation if it were a fixed fee (i.e., a flat dollar amount or percentage of assets under management) that did not vary based on the investments selected under the plan. In early 2007, DOL issued a field advice bulletin[22] confirming that plan sponsors and investment advisers can still rely on those fixed fee advisory opinions.

The fixed fee approach is also a central requirement of the PPA statutory exemption for providing investment advice to plan participants. In its field advice bulletin, DOL clarified that the fixed fee requirement does not extend to an affiliate of an investment advice fiduciary, unless the affiliate is also providing investment advice to the plan. In other words, the statutory investment advice exemption would apply if an IAR received fixed compensation (i.e., asset-based fee), even though the affiliated RIA that makes the investment platform available to IAR would be receiving variable fees from the mutual funds or other investment providers offered on the platform. The issue that still requires confirmation is whether this clarification applies to the pre-PPA fixed fee advisory opinions.

3. ***Choice of Investment Platform***.

Another unresolved issue is whether IAR can rely on the fixed fee advisory opinions when the IAR is associated with multiple RIAs that have different asset-based fees. In this situation, the IAR effectively has variable compensation depending upon which investment platform he or she advises the ERISA plan to use. Although unlikely, it is possible that DOL might conclude that the IAR has no conflict of interest if more significant factors other than the variable compensation are influencing the IAR's recommendation to use one platform over another. This potential conflict of interest is a good reason for RIAs to require its IARs to work exclusively on its platform.

E. Co-Fiduciary Responsibilities

In addition the conflict of interest rules, an IAR serving as an investment advice fiduciary to an ERISA plan or its participants needs to be concerned about ERISA's co-fiduciary responsibility rules. Under those rules, an investment advice fiduciary will be liable for a breach of fiduciary responsibility by the plan sponsor or similar fiduciary (e.g., the plan sponsor's benefit) if the investment advice fiduciary:

- participates knowingly in or knowingly undertakes to conceal, an act or omission of the plan sponsor, knowing that such act or omission is a breach,
- has knowledge of a breach of fiduciary duty by the plan sponsor, unless he or she makes reasonable efforts to remedy the breach, or
- has enabled the plan sponsor to commit a breach by failing to fulfill his or her duties as an investment advice fiduciary.

[22] Field Advice Bulletin 2007-1 (2/2/07).

The first two theories of co-fiduciary responsibility do not present much exposure to the co-fiduciary because they require knowing participation or knowing failure to correct. Presumably, if the investment advice fiduciary does not know about the plan sponsor's breach of fiduciary duty, the investment advice fiduciary cannot be held liable.

The third theory is more problematic because it says the investment advice fiduciary is liable if he or she has enabled the plan sponsor to commit a breach by failing to fulfill his or her duties as an investment advice fiduciary. Some commentators erroneously believe that this co-fiduciary liability rule means an investment advice fiduciary must assume the role of fiduciary compliance officers with a duty to prevent plan sponsors from breaching their fiduciary duty. We believe the correct interpretation is that an investment advice fiduciary would be liable as a co-fiduciary for the plan sponsor's breach of fiduciary duty only if the investment advice fiduciary acted imprudently and only if that imprudence enabled the plan sponsor to breach its fiduciary duty. Importantly, this interpretation enables an investment advice fiduciary to circumscribe the scope of its fiduciary duty and, thus, its co-fiduciary duty by contract with the plan sponsor.

Co-fiduciary liability is not an academic issue but a practical one with profound practical implications for the investment advice fiduciary working with an unscrupulous plan sponsor. In the Edward Jones case discussed earlier, the reason the plan participants wanted to establish that the broker was an investment advice fiduciary was to impose co-fiduciary liability on Edward Jones. After the plan trustee and president of the plan sponsor made prohibited loans to the plan sponsor, it went into bankruptcy. Edward Jones was the only remaining deep pocket. The broker did not participate in the prohibited loan transactions. However, the plan sponsor made the loans by writing checks on the plan's brokerage account maintained by Edward Jones. If the case goes to trial, one of the issues will be whether the broker negligently allowed the prohibited loans to take place.

F. Limited Class Exemption for Registered Representatives

For registered representatives that become investment advice fiduciaries, ERISA's conflict of interest rules are a formidable obstacle. As noted above, disclosure does not cure conflicts of interest under ERISA unless a prohibited transaction exemption authorizes the disclosure. Otherwise, ERISA's prohibited transaction rules would prevent a broker from receiving commissions in connection with a recommended securities transaction. So far, only two class exemptions are available to securities brokers:

- Prohibited Transaction Exemption ("PTE") 84-24,[23] and
- PTE 86-128.[24]

[23] 71 Fed. Reg. 5887 (2/3/2006) at http://www.dol.gov/ebsa/regs/fedreg/notices/2006001504.htm

[24] 67 Fed. Reg. 64137 (10/17/2002) http://www.dol.gov/ebsa/regs/fedreg/notices/2002026424.htm.

1. ***PTE 84-24: Commissions on Sale of Mutual Funds by Principal Underwriters*.**

PTE 84-24 is designed to allow brokers serving as the principal underwriter for a mutual fund to receive commissions on the sale of mutual fund shares. This exemption requires the broker to disclose the commissions to the plan sponsor or other independent plan before the sale is executed. However, it is important to note that this exemption is not available to brokers who are not serving as the principal underwriter for the mutual fund.

2. ***PTE 86-128: Commissions on Sale of Individual Securities*.**

PTE 86-128 is designed to accommodate brokers receiving commissions for executing individual securities transactions, although it theoretically applies also to brokers receiving commissions for selling mutual fund shares not covered by PTE 84-24. PTE 86-128 applies only if:

- the plan sponsor or similar independent fiduciary provides written authorization for the brokerage arrangement;
- the broker discloses its placement practices and any other reasonably available information that the independent fiduciary requests;
- the securities transactions are not excessive in either amount or frequency; and
- the broker provides:
  - confirmation slips for each transaction with the commission paid by the plan and the amount retained by the broker (or, alternatively, quarterly reports compiling the information from the confirmation slips);
  - annual reports compiling the information from confirmation slips or quarterly reports.

The bottom line is that there is no class exemption designed to accommodate most brokers receiving commissions for selling mutual fund shares. <u>This means that the DOL could argue that registered representatives who are investment advice fiduciaries under ERISA are violating ERISA's prohibited transactions rules by receiving commissions in connection with their mutual fund recommendations.</u>

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