Integrating ERISA Compliance
Into the Securities Compliance Program

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Financial service companies which do business, even casually, with retirement plans are now faced with increasing compliance challenges of the sort which they have never experienced in the past. The ability to pay or keep either direct or indirect compensation generated by dealings with these plans is contingent upon meeting certain "prohibited transaction" rules; and the design of compensation arrangements is coming under stricter scrutiny by the DOL.

With the DOL and the SEC implementing their Memorandum of Understanding related to cooperative enforcement of these types of rules where there is concurrent jurisdiction of both agencies, there is increasing pressure on the securities compliance professional to integrate elements of ERISA compliance into their securities compliance programs. The DOL has also a "Consultants and Advisors Program" (CAP) under which it is actively investigating fees paid to consultants and advisors to retirement plans.

I. Do You Do ERISA Business?

Not all employee benefit plans are governed by ERISA. So, the threshold issue for the compliance professional is to identify which plans in their blocks of business are subject to ERISA's rules. Generally, the following discusses which plans that are covered:

Type of Client	Subject to Title I of ERISA?
U.S. retirement plan, including defined benefit and defined contribution plans (e.g., 401(k), 403(b) [1], cash balance, ESOP and profit sharing plans) for private employers	Yes
Taft-Hartley plans (e.g., pension, medical and disability plans for union employees)	Yes
Employer funded medical plans	Yes
Hedge funds and private equity funds[2]	Yes
Retirement and medical plans for U.S. federal, state or local government employees[3]	No
Individual retirement accounts [4]	No
Non-U.S. retirement and medical plans [5]	No
Registered investment companies[6]	Yes

[1] Some private 403(b) plans will not be subject to ERISA if very specific rules are met
[2] If interests sold to ERISA plans
[3] May be subject to state or local laws similar to the ERISA
[4] Subject to Section 4975 of the Internal Revenue Code, which is similar to ERISA and prohibits certain transactions
[5] May be subject to non-U.S. laws similar to ERISA
[6] The assets of the fund are not governed by ERISA, but the sales of the shares; payment of 12b-1 and sub TA fees related to the fund; and the management of plan assets by managers of the funds are all governed by ERISA.

II. Impact of ERISA on Financial Service Companies.

ERISA provides an extensive set of rules which governs the establishment and operation of employee benefit plans, and includes elements of both labor law and the tax code. The IRS and the U.S. Department of Labor have concurrent jurisdiction over ERISA's administration, but the DOL is the chief concern of companies which provide products and services in support of these plans.

The key elements affecting the provider of products or services to plans involve the payment and receipt of compensation under the "prohibited transaction" rules; reporting and disclosure requirements; and liability arising from fiduciary status.

a. Prohibited transactions

ERISA's conflict of interest rules are found in ERISA Section 406, and Code Section 4975. These rules effectively prevent any compensation related to ERISA plans, either direct or indirect, to be paid or received unless it is specifically permitted by statute, regulation, or by administrative ruling. This means a financial service company's revenue related to ERISA plans must meet specific criteria. Be aware that there are a number of rulings called "Prohibited Transaction Exemptions" that have been issued by the DOL which will permit certain transactions (including certain compensation arrangements) as long as certain conditions are met.

Basic rules relating to the compensation:

i. Fee disclosure/Reasonable compensation.

No compensation may be paid in relation to the plan unless it is "reasonable." ERISA requires that no compensation will ever be considered "reasonable" unless it is disclosed in accordance with the regulations under Section 29 CFR 2550.408b-2.

- Effective July 1, 2012, service providers to retirement plans must disclose the direct and "indirect" compensation they receive related to the services they provide in a very specific way.

- Failure of the service provider, including broker dealers, investment advisors, *and their affiliates* to appropriately and timely disclose indirect compensation (including commissions, 12b-1 fees, soft dollar, bonus and award programs, and other revenue based upon the transaction) will result in a "prohibited transaction" under ERISA.

- If compensation is paid or received violates the disclosure rules, it must be "corrected," which means returned, in most cases, and excise taxes paid on the amount involved in the transaction. This is, for any financial service companies, a substantial business risk.

-Compliance officers are involved directly impacted as the matters that they supervise are subject to 408(b)-2: sales activities, compensation arrangements, OBAs, advisory and broker dealer relationships with clients, disclosure of services, and others.

ii. Levelized compensation

A fiduciary, as defined by ERISA, cannot exercise its authority in a manner which can influence its own compensation. This differs from the SEC rules, where potential conflicts of interest can be cured by disclosure. Under ERISA, disclosure (generally) does not correct a prohibited transaction. The most significant impact is that an RIA cannot receive sales commissions on the sale of a product which varies dependant upon the advice given.

The DOL has proposed a regulation which will significantly broaden the definition of what constitutes a fiduciary act, under 29 CFR 2510.3-21, which will include certain activities which may generally, today, be considered sales activities. Changing that definition changes the way in which registered reps and insurance agents can be compensated, and subjects more compensation to the prohibited transaction rules.

-The ERISA rules governing fiduciaries are, and will continue to be different than the '40 Advisors Act rules governing fiduciaries. Advisors and their affiliated organizations will need to follow both sets of rules with regard to those advising/selling to plans.

-It effectively eliminates the incidental rule: a one time offer of advice, even if "incidental" to the ale, will cause the b/d to become a fiduciary. This would be a change from the current ERISA rule which requires the advice to be regular and mutually be considered the basis of investing.

iii. ***Plan level*** advice fiduciary advice

Frost Bank, DOL Advisory Opinion 97-15A, and Sun America, DOL Advisory Opinion 2001-09A together stand for the proposition that an investment fiduciary may provide advice to the plan which results in variable compensation being paid by the investment

managers under the plan, as long as the plan--not the investment advisor--receives the benefit of that variable compensation. Further, an investment advisor may receive funds generated by the plan's investments as long as such discretion does not result in the payment of variable compensation to the advisor.

The compliance structure, below, contemplates a system where the advice to a plan fiduciary with regard to the plan's investments will not result in variable comp which is payable to the advisor or an affiliate of the advisor, or to the extent it is, such variable comp is paid for the benefit of the plan.

iv. ***Participant level*** fiduciary advice

The Pension Protection Act created class of "fiduciary advisors" which would be permitted to provide investment advice to plan participants which generated variable compensation to an affiliate of the investment advisor, though payments to the investment advisor themselves must be level. In order to qualify for this special treatment, the fiduciary advisor must:

-provide for an independent auditor

-disclose certain items: (1) the role of any party that has a material affiliation or contractual relationship with the advisor; (2) the past performance and historical rate of returns of the investment options available under the plan; (3) all the fees and other compensation related to the advice that the fiduciary advisor or any affiliate is to receive (including compensation provided by any third party) in connection with the provision of the advice; (4) any material affiliation or contractual relationship of the fiduciary advisor to the investment company's offer under the plan; (5) the types of services provided by the fiduciary advisor; (6) that the advisor is acting as a fiduciary of the plan in connection with the provision of the advisor; (7) that a recipient of the advice may separately arrange for the provision of advice by another advisor; and (8) that at all times during the provision of the advisor's services the advisor would provide and maintain certain records with regard to the relationship;

-the records must be maintained for six years.

-These disclosures must be made to each participant to whom the fiduciary advisor provides investment advice. Failure to provide such information properly would result in the payment of any fees to the fiduciary advisory as being prohibited. Because of the resources and expenses involved in maintaining and properly distributing such information, acting as a fiduciary advisor will not be adopted.

v. Plan assets

The compensation and fiduciary rules only apply to "plan assets," which is a specific term. The assets in a registered investment company or registered separate account in an annuity contract are not considered plan assets to which these rules apply (though the mutual fund shares and the annuity contract itself will be considered plans assets if owned by a plan); and the typical private venture, hedge fund and non-registered separate account in an annuity contract will be considered plan assets.

vi. IRAs

Though most IRAs are not governed by ERISA, they are governed by the tax code's version of the prohibited transaction rules under code section 4975. A review of those rules should be built into a compliance program.

b. Participant disclosures. There are a number of issues which, though not regularly impacting the compliance professionals own work, will create a demand for that professional's knowledge and experience. This includes the new participation fee disclosures rules. The following list of disclosures which now must by made to 401(k) plan participants as a fiduciary responsibility of plan sponsors under ERISA. Much is based on information needed under mutual fund prospectuses. Plan sponsors are entitled to rely upon information provided to them by service providers on complying with this rule.

- Effective, generally, September 1,2012, all sponsors of individual account plans like 401(k) and 403(b) will be required to provide written disclosures of investment and administrative costs related to participant accounts. This information will be required to be given prior to a participant enrolling in the plan, and certain information must be provided quarterly as well.

- This is an employer obligation, not a vendor obligation, but investment vendors will be expected to assist employers in providing the data.

-The data for each investment in the plan will be required to be disclosed in a uniform comparative chart.

-Identifying information. Such information shall include:

--The name of the designated investment alternative;

--An Internet Web site address that is sufficiently specific to lead participants and beneficiaries to supplemental information regarding the designated investment alternative, including the name of the investment's issuer or provider, the investment's principal strategies and attendant risks, the assets comprising the investment's portfolio, the investment's portfolio turnover, the investment's performance and related fees and expenses;

--The type or category of the investment (e.g., money market fund, balanced (stocks and bonds) fund, large- cap fund); and,

--The type of management utilized by the investment (e.g., actively managed, passively managed);

- Performance data.
  --For designated investment alternatives with respect to which the return is not fixed, the average annual total return (percentage) of the investment for the following periods, if available: 1-year, 5-year, and 10-year, measured as of the end of the applicable calendar year; and a statement indicating that an investment's past performance is not necessarily an indication of how the investment will perform in the future.
  --In the case of designated investment alternatives with respect to which the return is fixed for the term of the investment, both the fixed rate of return and the term of the investment

- Benchmarks.
  --For designated investment alternatives with respect to which the return is not fixed, the name and returns of an appropriate broad-based securities market index over the 1-year, 5-year, and 10-year periods comparable to benchmarks not administered by an affiliate of the investment provider, its investment adviser, or a principal underwriter, unless the index is widely recognized and used.
  -- Fee and expense information for designated investment alternatives with respect to which the return is not fixed:
  --the amount and a description of each shareholder-type fee (i.e., fees charged directly against a participant's or beneficiary's investment), such as sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, account fees, purchase fees, and mortality and expense fees;
  --The total annual operating expenses of the investment expressed as a percentage (e.g., expense ratio); and
  -- A statement indicating that fees and expenses are only one of several factors that participants and beneficiaries should consider when making investment decisions.
  --In the case of designated investment alternatives with respect to which the return is fixed for the term of the investment, the amount and a description of any shareholder-type fees that may be applicable to a purchase, transfer or withdrawal of the investment in whole or in part.
  --Plans will be required to give participants the underlying prospectuses upon request.

III. Compliance Procedures

The compliance professional can effectively build critical pieces of ERISA rules into their securities compliance programs when dealing with retirement plan business. Some guidelines:

a. Build on existing control structure to minimize costs, duplication and confusion.

b. Establish the basic practice rules for providing advice and receiving compensation from ERISA plans.

a. Establish which markets are to be served (for example, any limit on plan types, defined benefit plans) or limits on employer types, such as government plans.

b. Consider establishing minimum expertise requirements, certification requirements and training requirements.

IV. Audit Procedures

Establish written policies and procedures and key elements related to the business of giving fiduciary advice, including the following:

a. IA Issues

Confirm that paperwork on file reflects the fees being collected

Confirm existence of ERISA fiduciary bonding and errors and omissions coverage for services providing to qualified plans

Log/track all qualified plans, including union plans.

Train FAs on what services they can and can't provide for plan sponsors

Determine how firm will supervise the services FAs provides.

Review agreements. Are they adequate as is for qualified plan clients? If not, consider addendum to agreements.

For third party TAMPs that firm offers, review TAMP selling agreement, disclosure brochures, and client agreements through an ERISA lens if the TAMP could be offered to a qualified plan client.

Review rules for gift and entertainment policies, political contributions policies, and seminar and non-cash compensation policies.

Review marketing support received from third parties.

Does the firm have house accounts that are qualified plans? Can you provide the agreed for services or should the firm terminate the relationships?

For independent financial advisers, do their firms have retirement plans where they are the financial adviser and fiduciary?

For recommended TPAs and recordkeepers, what due diligence is conducted?

408(b)(2) fee disclosure; determine role in 404a-5 disclosures.

Decide how basic or complex you want to go.

Basic version will refer client to other documents (roadmap). Confirm that the documents referred to actually have the anticipated information.

The more basic, the more likely employers will request additional information

Decide if brokerage and advisory accounts will get same or different disclosures

File with FINRA brokerage fee disclosures

Determine how firm will know if fees change for

Program level fee change

Individual plan level fee changes

Template from EBSA

b. BD Issues

Fee Disclosure should be tailored to the specific service being provided

Create an inventory of all service providers

Obtain and review disclosures

Disclosure of fees on a "ranged basis" in 10BPS increments

Document the review of disclosures and actions taken as a result

Remember to disclaim responsibility for services you do not intend to provide

Strive to provide simple and clear disclosures to investors regarding the scope and the terms of the relationship

Records Retention requirements

Ensure all required information is being maintained for 6 years pursuant to ERISA §107

Maintenance of account paperwork and agreements

Marketing and sales literature

Review and approval

See FINRA NTM 12-02 (Firms not required to file 404a-5 disclosures with FINRA)

Self directed accounts - §404(c)

Utilize a checklist of all the requirements to evidence compliance

Conduct ongoing review to ensure that all requirements are continually being met

Training

Ensure that Advisors understand the requirements when catering to ERISA clients

Require reporting of all gifts and entertainment to ERISA clients

Ensure accounts are coded as ERISA accounts at the firm (or clearing firm)

Evaluating expense ratios/fees

Fiduciary review should take into account all fees and expenses.

Be sure to review indirect fees (e.g., soft dollars, sub-transfer agency fees, 12b-1 fees, sales charges, revenue sharing and float).

Develop policies and procedures to:

Cover account opening and coding

Execution of agreements

Delivery of disclosures (prior to account and when renewed/changed)

Training of personnel

Discuss “Self Directed Account” requirements

Review of agreements and disclosures and any potential remediation

Review of fees (direct and indirect)

Reporting of gifts and business entertainment

Review of service providers and ongoing due diligence

NOTE: It is generally advisable to create your procedures after the ERISA platform has been established in order to ensure that all portions of the procedures reflect the reviews/processes actually taking place. However, the policies should be developed promptly after the platform is launched to avoid gaps.

c. Risk management, bonding and fiduciary coverage. Undergo periodic risks of adopted practices; review firms coverage for any potential gaps in coverage related to provision of advice to plans.

V. Scope of CAP Investigations

a. Documents listing benefit plan clients and information about the client, such as service dates and identification of other providers
b. Agreements between the service provider and plan clients
c. Documents that describe services provided to benefit plan clients
d. Documents relating to arrangements providing plan clients with advice regarding securities valuation and investing in securities to be used as the basis for investment decisions
e. Information regarding individuals who gave advice regarding the valuation of securities, made recommendations regarding selecting investments or exercised discretionary control over selecting investments.