Compliance Corner

— By: David C. Kaleda*

Disclosure of Compensation by RIAs to ERISA Plans: Are You Ready?

The manner in which registered investment advisers ("RIAs") report their compensation to representatives of defined contribution and defined benefit plans subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), is impacted by two recent initiatives by the Department of Labor ("DOL"). These initiatives are designed to improve such representatives' understanding of the compensation paid by such plans ("Plans") to their service providers including RIAs. Failure to report compensation in the appropriate manner can result in the RIA being reported to the DOL for noncompliance or, effective January 1, 2012, being exposed to excise taxes under the Internal Revenue Code of 1986, as amended (the "Code").

The DOL's two fee disclosure initiatives include the following:

1. Compensation Actually Paid—Form 5500 Schedule C: Effective January 1, 2009, the amount of information about compensation paid by Plans to RIAs required to be reported on Schedule C of the Form 5500 increased significantly. In 2011, plan representatives must begin to report to the DOL RIAs who do not provide the information upon request.

2. Compensation Expected to be Paid—Prohibited Transaction Exemption for Reasonable Compensation: Effective January 1, 2012, most RIAs must provide more information about the compensation expected to be paid to RIAs in order to prevent the payment of compensation from resulting in a prohibited transaction under Section 406(a) of ERISA and Section 4975 of the Code. If the service provider does not disclose the information upon request, the liability for any excise taxes can be shifted to the RIA.

This article is intended to help RIAs better understand the differences between the two disclosure regimes with respect to how compensation is defined and reported so that they may develop their compliance procedures accordingly.

Reporting Compensation Actually Paid—Form 5500 Schedule C

On Schedule C of Form 5500, Plans with one hundred or more participants are required to annually report both direct and indirect compensation (including monetary and non-monetary compensation) paid to fiduciary and non-fiduciary service providers, including RIAs, if the compensation paid to the service provider is $5,000 or more. The information required to be reported is dependent on the type of compensation received.

Direct Versus Indirect Compensation

"Direct compensation" is a payment made directly by the Plan to the RIA for services rendered to the Plan or because of the RIA's position with the Plan. In other words, amounts paid from the assets of the Plan's trust or custodial account is classified as "direct compensation." Examples may include direct payments by the Plan out of a participant's account as well as charges to Plan forfeiture accounts and fee recapture accounts.

"Indirect compensation," on the other hand, is a payment to the RIA for services rendered to the Plan or because of RIA's position with the Plan received from sources other than directly from the Plan's trust (or from the Plan's sponsor) is reportable on Schedule C. Notably, "indirect compensation" is a very broad definition that includes a lot of amounts that might not be readily viewed by RIAs as "compensation." Examples of indirect compensation include, but are not limited to, (i) fees and expense reimbursement payments received by a person or entity, charged against the fund, and reflected in the values of the plan's investment (*e.g.* 12b-1 fees, shareholder servicing fees, sub-transfer agency fees, *etc.*) and (ii) soft dollars.

Definition of Eligible Indirect Compensation

A special alternative reporting rule may apply to "eligible indirect compensation," which includes the following types of indirect compensation:

- fees or expense reimbursement payments charged to investment funds and reflected in the value of the investment or return on investment;
- finder's fees;
- "soft dollar" revenue;
- float revenue; and
- brokerage commissions or other transaction-based fees for transactions or services.

As such, "eligible indirect compensation" is a sub-category of

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reportable indirect compensation. The definition of "fund" for this purpose as well as for purposes of identifying indirect compensation in general is discussed below.

Definition of "Fund"

A key element of determining whether compensation paid to a RIA is indirect compensation (and possibly eligible indirect compensation) is the meaning of the word "fund." A "fund" includes both an investment vehicle the assets of which are "plan assets" under the DOL regulations and those that are not plan assets under such regulations. Examples of funds the assets of which are "plan assets" include collective trusts and funds in which benefit plan investment is "significant" because twenty-five percent or more of the fund's assets are attributable to ERISA-governed plans or "plans" as defined under Section 4975 of the Code such as IRAs. Funds the assets of which do not include "plan assets" include mutual funds and funds in which benefit plan investment is not significant (i.e., below the aforementioned twenty-five percent limit). A "fund" also includes a "separately managed account." Therefore, compensation paid from such vehicles to RIAs who provide management, advisory, or other services to such vehicles is reportable indirect compensation. However, in the case of an operating company (*e.g.,* VCOC, REOC, *etc.*), the management fee paid to a RIA by the operating company is not reportable indirect compensation; although compensation paid for the sale of units in the fund is reportable.

Reporting of Compensation that is Only Eligible Indirect Compensation

There is a simplified, alternative reporting option available if the only compensation a RIA receives is "eligible indirect compensation." This option can be very effective in reducing a RIA's burden in meeting its Schedule C disclosure obligation. In many cases, delivery of a prospectus, offering memorandum, advisory agreement, Form ADV, or similar documentation during the normal course of business will be adequate, though adjustments to the language in such documentation may be necessary.

In many cases, the RIA can take the position that it manages the asset of the Plan through a "fund" such as a "separately managed account." For example, if the only compensation paid to the RIA is the management fee or performance fee reflected in the value of the account and also consists of "soft dollars," all of the compensation should be "eligible indirect compensation." Thus, the RIA can take advantage of the alternative reporting option. In order to reduce its compliance burden, the RIA should consider whether documents such as the offering memorandum or advisory agreement adequately disclose the indirect compensation received. For example, the soft dollar arrangement should be presented via a formula that will meet the Schedule C alternate reporting requirements. In addition, the documents should indicate the existence of the indirect compensation, the formula for determining any other eligible indirect compensation (in addition to the soft dollars), and the parties paying and receiving any indirect compensation. Many advisers take the position that the disclosure in the Form ADV, Part 2 is adequate under these circumstances particularly in light of the heightened disclosure now required by the SEC.

Reporting Compensation Other than Eligible Indirect Compensation

If the alternative reporting option for "eligible indirect compensation" (discussed above) is not available because a RIA receives compensation other than eligible indirect compensation, detailed information about the compensation paid must be reported. The exact dollar amount of direct compensation should be reported. However, indirect compensation can be reported as an exact dollar amount, as a formula, or a combination. Furthermore, if the RIA is a key service provider by reason of its providing asset management or advisory services to the Plan, it will be required to provide more detailed compensation-related information if the compensation is $1,000 or more. Such information includes the services performed for the indirect compensation, a description of the indirect compensation, and the amount or the formula used to determine the amount of or eligibility for the indirect compensation.

A common area that results in some confusion is the reporting of "soft dollars." In the event of such an arrangement, the RIA must devise a reasonable method for allowing the Plan to calculate the value of the research or other services it receives through the soft dollar arrangement and deliver this information to the Plan. In addition, if the RIA is a key service provider, the formula and the source of the soft dollar "compensation" (*e.g.,* the broker) must be included on the Schedule C. Importantly, "soft dollar" disclosure that conforms with the securities laws will likely not meet the Schedule C requirements, assuming the alternative reporting option for eligible indirect compensation is not available, because such disclosure is not presented in a formulaic way that allows the Plan to estimate the compensation received by the RIA and for other reasons.

Special Rules for Bundled Arrangements

In the event a Plan hires a RIA to provide a broad array of services on behalf of the Plan (*e.g.*, recordkeeping, trustee, advisory, *etc.*) and the RIA provides such services through one or more affiliates, special reporting rules apply. Often, the DOL refers to payments to be divided among such parties as "revenue sharing."

As a general rule, revenue sharing

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payments paid to a RIA need not be reported on an "unbundled" basis. However, any compensation received by a RIA that is charged against a plan's investment (*e.g.,* investment management or advisory fees) should be reported separately. In addition, a RIA that is a key service provider (discussed above) must report transaction-based fees, finder's fees, float revenue, soft dollar and other non-monetary compensation separately on Schedule C. Notwithstanding, the alternate reporting option may still be available.

Reporting Compensation Expected to be Paid – Prohibited Transaction Exemption for Reasonable Compensation

Beginning on January 1, 2012, the DOL's interim final regulation ("IFR" or "regulation") issued under Section 408(b)(2) of ERISA becomes effective with respect to all contracts or agreements to provide advisory and management services to a Plan (even agreements already in existence on such date). We note that the DOL recently extended this compliance deadline, which in the IFR was originally set at July 16, 2011. It remains to be seen whether the DOL will issue final regulations prior to that date or, in absence of final regulations, the DOL will clarify certain issues with respect to the IFR. For example, the IFR does not address the appropriate manner and form in which the required disclosures can be communicated. Therefore, it is not clear whether the disclosure of "soft dollars" and other compensation information through the Form ADV is acceptable or whether the DOL's intent was to otherwise align the 408(b)(2) disclosures with the Schedule C disclosures.

The purpose of this disclosure regime is different than that of the Schedule C because it is designed to allow responsible plan fiduciaries ("Fiduciaries") to better evaluate the compensation to be paid before the agreement is entered or renewed. The below is a simplified summary of the regulation provided to give RIAs a basic understanding of the regulation as it compares to Schedule C reporting.

Application of Regulation to RIAs

Effectively, any RIA that directly provides advisory services or asset management services to a Plan, whether or not it is an ERISA fiduciary, must disclose certain information required under the regulation to the Fiduciaries. Furthermore, if the RIA is a fiduciary with respect to the Plan by reason of such Plan's ownership of an equity interest in a "plan asset" fund, the regulation will also apply. In fact, the RIA must affirmatively disclose to the Fiduciaries whether it is acting as a fiduciary under ERISA or providing non-fiduciary services as an adviser registered under state or federal law. Notably, proposed regulations issued by the DOL in 2010 if finalized in their current form will result in most RIAs being a fiduciary under ERISA.

Direct & Indirect Compensation

Much like the Schedule C requirements, the focus of the regulation is adequate disclosure of compensation. However, more specificity is required with respect to what compensation will be paid, to what party, and for what services. Compensation can be stated in terms of a dollar amount or, if reasonable under the circumstances, a formula.

"Direct compensation" is compensation expected to be received by the RIA (or its affiliate or subcontractor) directly from the Plan. Examples of direct compensation likely include management fees directly paid from plan assets as well as transaction-based fees and similar amounts.

On the other hand, "indirect compensation" is compensation expected to be received by the RIA (or its affiliate or subcontractor) from any source other than the Plan, an affiliate of the RIA, or certain subcontractors of the RIA. "Indirect compensation" covers a broad array of payments that are paid by investment funds, but then directed (usually by a plan fiduciary) to plan service providers, their affiliates, or their subcontractors. Such types of payments typically arise in the context of mutual funds, which in many cases pay 12b-1 fees, sub-transfer agent fees, and shareholder servicing fees. A plan fiduciary, usually the employer plan sponsor or employer trustee, will direct the fund or its affiliate to pay such amounts to certain service providers, their affiliates, or their subcontractors. In addition, payments made by a fund's adviser, distributor, or other party in connection with the fund investment (*e.g.,* marketing support payments) are likely indirect compensation. "Soft dollars" are also an example of indirect compensation. RIAs, their affiliates, or their subcontractors may receive one or more of such payments and thus must disclose the compensation in accordance with the IFR.

Unlike the Schedule C, the regulation focuses on the compensation paid to the RIA as well as compensation paid to the RIA's affiliates and subcontractors. Furthermore, the regulation requires a degree of specificity with respect to what compensation will be paid to the RIA, its affiliates, and subcontractors and for what services. In other words, the regulation effectively requires the "unbundling" of revenue sharing arrangements. As explained above, compensation paid under "bundled" service arrangements often does not need to be unbundled for Schedule C purposes.

"Plan Asset" Funds

In the event the RIA is a fiduciary as defined under ERISA with respect to a fund or similar entity that includes ERISA plan assets, the RIA must disclose additional information to a Plan investor including: (i) any compensation that will be charged directly against the amount invested in connection with the acquisition,

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The SEC seeks comment on whether it should expand the coverage of the Rule to include investment advisers of pooled investment funds, and the advisers' directors, officers, general partners, and managing members.

Reasonable Care Exception for Issuers after Factual Inquiry. The SEC noted that there is no central repository that aggregates information from all the federal and state courts and regulatory authorities that would be relevant in determining whether a covered person has a disqualifying event in his or her past. Therefore, the SEC proposed to include a "reasonable care" exception to permit issuers to continue to rely on the Rule 506 safe harbor, despite the existence of a disqualifying event, if the issuer can show that it did not know and, in the exercise of reasonable care, could not have known of the disqualification.

SEC Waiver. The SEC proposed to include a waiver of the disqualification provisions in the amendments to Rule 506 upon a showing of good cause, as determined by the SEC, and without prejudice to any other action by the SEC.

Transition Dates. The SEC proposed that the disqualification provisions would apply to all sales made under Rule 506 after the effective date of the new provisions, but would not affect any transaction that was completed before the effective date. Offerings made after the effective date of the new rules would be subject to disqualification for all disqualifying events that had occurred within the relevant look-back period, regardless of whether the events occurred before the enactment of the Dodd-Frank Act, or the proposal or effective date of the amendments to Rule 506.

Steps Issuers Need to Take. The SEC noted that issuers will be required to take a number of actions before they could confirm that they were not disqualified from relying on Rule 506, including, for example: (i) undertaking an inquiry of covered persons; (ii) modifying existing due diligence questionnaires; (iii) taking steps to remove any existing disqualifications; and (iv) seeking waivers of disqualification from the SEC, if necessary.

The SEC's proposing release is available at: http://www.sec.gov/rules/proposed/2011/33-9211.pdf.

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sale, transfer of, or withdrawal of the interest (*e.g.,* sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, account fees, and purchase fees), (ii) annual operating expenses (*e.g.,* expense ratio), and (iii) any ongoing expenses other than the annual operating expenses (*e.g.,* wrap fees, mortality and expense fees). Therefore, unlike for Schedule C purposes, more specificity must be provided regarding the break-down of compensation paid through "plan asset" fund investments. As discussed above, a fund is most often a "plan asset" fund when the fund is a collective trust or when benefit plan investment in the Fund is "significant."

Conclusion

Both the Schedule C reporting requirements currently in effect and the regulation under Section 408(b)(2) of ERISA effective January 1, 2012, represent a significant shift in DOL compensation disclosure policy. RIAs are now required and will be required to disclose a lot more information about the compensation they receive or will receive. Furthermore, the liability for failing to provide the required disclosure can easily be shifted to RIAs who will not or cannot comply.

Fortunately, in many cases, RIAs should be able to adopt procedures through which they meet both the Schedule C reporting and 408(b)(2) regulatory requirements through providing documentation standard to the investment process such as offering memoranda and advisory agreements. However, some changes to the language in such documents (*e.g.,* the description of soft dollar arrangements) may be necessary. In addition, providing a "road map" document explaining where required information can be found could help RIAs respond to investor inquiries. Finally, creation of a standard response to Schedule C inquiries may also be helpful. As such, prior to the end of 2011, RIAs would do well to work on amending their documentation and revising their compliance procedures so they are in a position to comply with both regimes in a complete and efficient manner. Notably, the RIA may be able to point its ERISA plan clients to their investment advisory agreement and to the RIA's Form ADV Part 2 to meet its disclosure obligations. Further clarification on this point may be forthcoming in the final rule under 408(b)(2).

** David C. Kaleda is a partner in Alston & Bird's Employee Benefits & Executive Compensation Group in Washington, D.C. He may be reached at (202) 239-3329 or david.kaleda@alston.com. This article is for general informational purposes only and should not be relied upon for legal advice on any specific matter.* ■

David C. Kaleda