ERISA Compliance
for the Securities Compliance Professional
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Robert J. Toth, Jr.
Law Office of Robert J. Toth, Jr., LLC

Chris Guanciale
PlanMember Services Corporation

I. The SEC, the Compliance Professional and Retirement Plans

A. Retirements constitute a significant part of the market, generating SEC attention.

According to the Investment Company Institute, the trade association for the mutual fund industry, U.S. retirement plans held $16.6 trillion as of the end of the third quarter 2010, with $4.2 trillion in individual account plans like 401(k) plans. According to the World Federation of Exchanges, the total capital U.S. equity markets was valued at $18.98 trillion as of January 2010, and $46.63 trillion worldwide.

This means retirement plans have the value of nearly 88% of the total U.S. equity market, and the value of 36% of worldwide equity markets. This is too big for the SEC to ignore.

B. Security law structure limits SEC's involvement

1. Interests in retirement plans into which employees make voluntary deferrals are securities subject to registration.

2. Section 3(a)(2) of the 33 Act exempts retirement plans under 401(a) of the Internal Code, and governmental plans, from registration. It does no, however, exempt 403(b) plans

3. SEC issued Release 33-6188 on February 1, 1980 and 33-6281 on January 15, 1981. These outline the general approach to retirement plans, including granting the 3(a)(2) relief afforded to plans to the investments purchased by those plans. It exempts from registration "as a matter

4. Generally, only plans which offer employer stock as an investment option under which employees can invest using their deferrals need to be registered, using a Form S-8

C. SEC has been asserting its remaining authority in order to reach these assets in order to protect plan participants

1. Though there is exemption from registrations, many retirement plans (particularly 401(k) plans) are securities which can still be still subject to the anti-fraud provisions of securities laws, such as Rule 10b-5 of the 34 Act, 17CFR 240.10b-5. Using this authority, the SEC began sweeps of retirement advisors and consultants which did not properly disclose their fees and conflicts.

2. In 2003, SEC proposed that mutual funds being held by 401(k) participants be required to provide their prospectuses directly to these plan participants.

3. SEC issued Rule 22c2, 17CFR 270.22c-2, to address excess trading. It included retirement plans, and labeled 401(k) plan participants as "shareholders" for purposes of tracking excess trading.

4. July 29, 2008, SEC and the DOL entered into a Memorandum of Understanding by which they agreed to coordinated enforcement activity related to retirement plans.

5. On June 18, 2009, SEC and DOL held joint hearings on use of Target Date Funds in certain retirement plans, jointly issuing guidance on May 6, 2010.

6. On August 4, 2010, the SEC proposed 12b-1 rule changes (see 75 FR 47064), which labeled 401(k) participants for purposes of tracking compliance with the changes, August 4, 2010.

II. The DOL's new rules impacting the Compliance Professional

The DOL has been active in the past several years in enhancing the reporting, disclosure and prohibited transaction scheme under retirement plans to increase the transparency of costs and fees (particularly related to investments under those plans. The DOL asserts that the lack of transparency has caused plans to collectively pay more than $3 billion in excess fees per yea. It has consulted with the SEC on many of these efforts, and parts of the new rely on SEC effots.part, on rules established by the SEC.

A. <u>Direct Impact.</u> A number of the DOL rules will directly impact the daily work of the securities compliance professional. These rules include the

new service fee disclosure; the proposed target date funds proposals; and the proposed fiduciary rules.

1. Service fee disclosure, 29 CFR 2550.408b-2.
   a. Effective January 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.

   b. 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.

   c. "Prohibited transactions" under ERISA are ERISA's conflict of interest rules. If compensation is paid which violates the PT 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.

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

2. Proposed Target Date Funds rules, 29 CFR 2550.404c-5 (and Rule 482 under the Securities Act of 1933 and rule 34b-1 under the Investment Company Act of 1940).

   a. Retirement plans which offer Target Date Funds for their "Qualified Default Investment Alternatives" under automatic contribution 401(k) and 403(b) programs must would need to make certain disclosures regarding the makeup, objectives and limitations of Target Date Funds required by plans.

   b. The SEC rules regarding advertising and marketing are correlated with the DOL rules, and can be used t fulfill the obligations under both.

   c. Failure to comply under ERISA results fiduciaries losing "404(c)" protection, which protects fiduciaries from losses from participant investment choices.

3. Proposed Definition of Fiduciary 29 CFR 2510.3-21.

a. The DOL has proposed amending its definition of “fiduciary” to expand it to 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.

b. 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.

c. 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.

B. Compliance professionals as a resource. 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 participation fee disclosures and the efforts at annuitization form defined contribution plans.

1. Participant fee disclosure rules, 29 CFR 2550.404a–5. We provide the following list of disclosures which now must b made to 401(k) plan participants as a fiduciary responsibility under ERISA. Much is based on information needed under mutual fund prospectuses.

a. Effective January 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.

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

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

d. Identifying information. Such information shall include:
    i. The name of the designated investment alternative;

ii. 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;
iii. The type or category of the investment (e.g., money market fund, balanced (stocks and bonds) fund, large- cap fund); and,
iv. The type of management utilized by the investment (e.g., actively managed, passively managed);

e. Performance data.
   i. 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.
   ii. 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

f. 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.

g. Fee and expense information for designated investment alternatives with respect to which the return is not fixed:
   i. 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;
   ii. The total annual operating expenses of the investment expressed as a percentage (e.g., expense ratio); and

iii. A statement indicating that fees and expenses are only one of several factors that participants and beneficiaries should consider when making investment decisions.

h. 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.

i. Plans will be required to give participants the underlying prospectuses upon request.

C. Annuitization

The DOL and IRS are both engaged in active efforts to encourage the provision of guaranteed lifetime income from defined contribution plans like 401(k) plans. There are two ways in which t provide this income: from annuities held by the plan itself, or by annuities purchased by the plan for distribution to retiring plan participants.

The purchase of these contracts is considered a fiduciary act under ERISA, and fiduciaries will be held to a fiduciary standard when choosing the annuities to be purchased. Though the DOL has published general fiduciary guidelines for this activity, it is obscure.

The suitability standards used in the retail sale of annuities generally do not apply to these purchases. However, such standards may provide guidance in the establishment of fiduciary standards.