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New DOL 408(b)(2) Rules Require Disclosures By Investment Managers To Their ERISA Plan Clients

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And To Any Funds They Manage Which Are Subject To ERISA: Deadline is July 1, 2012

New regulations issued by the Department of Labor under ERISA Section 408(b)(2) require certain disclosures by investment managers to their ERISA clients of the fees and other compensation paid to the investment manager for services provided to such clients. These rules apply to investment managers with discretionary authority over pooled investment vehicles (funds) deemed to hold ERISA plan assets (generally because ERISA investors and IRAs collectively own 25% or more of a class of interests of the fund), as well as to those who manage ERISA plan investments directly through managed (separate) accounts. The deadline for compliance is July 1, 2012, for existing management relationships; for new management relationships the required disclosure must be made "reasonably in advance" of entering into the new management relationship.

ERISA 408(b)(2) provides an exemption to the prohibited transaction rule against payment of fees to a service provider, such as an investment manager. The exemption requires that the arrangement pursuant to which the fees are paid be "reasonable;" under the new 408(b)(2) rules, no arrangement will be considered "reasonable" unless certain disclosure is provided in writing.

The information required to be disclosed by investment managers to ERISA clients generally includes: (i) a description of the services to be provided; (ii) a statement of fiduciary and/or registered investment advisor status, as applicable; (iii) a description of the "direct" and "indirect" compensation (as discussed below) that the manager, and any affiliate or subcontractor of the manager, will receive; (iv) a description of any compensation to be received in connection with termination of the contract; and (v) the manner of payment of any compensation.

Direct compensation includes any compensation received directly from ERISA clients, whether paid directly as a fee or charged against investment returns. Indirect compensation means compensation received from any source other than the investor, including for example "soft dollars." Under the new rules, disclosure of indirect compensation must include both identification of the payer of the compensation and a description of the arrangement pursuant to which the indirect compensation is to be paid.

Most fund documents and managed account contracts likely already include much of the disclosure required by the new rules (but should be reviewed to confirm that), with the possible exception of the required disclosure of indirect compensation. This is likely to be the most problematic requirement for investment managers, especially those who expect to receive "soft dollars," for which the required information may not be known in advance. The DOL has stated that indirect compensation may be described in general terms "provided that the description contains information that is sufficient to permit a responsible plan fiduciary to evaluate the reasonableness of such compensation in advance of the service arrangement," and clarified that under this standard, it would not be necessary to identify a specific payer if that information were not known in advance. Also, under the new rules a description of compensation may include a "reasonable and good faith estimate" if more precise information is not available, provided that the method of preparing the estimate is explained.

At present there is no required form of disclosure (other than that it must be in writing), but DOL has indicated that it may issue further guidance requiring at least a short summary (much like a table of contents) describing where to find more detailed information in client documents.

The above is only a brief overview of the new 408(b)(2) disclosure rules. Investment managers who manage ERISA separate accounts, or funds subject to ERISA, should consult with their attorneys to be sure that they are in full compliance with the new disclosure rules in order to avoid inadvertently engaging in an ERISA prohibited transaction.

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