CORE COMPLIANCE & LEGAL SERVICES, INC.
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PRACTICAL TIPS FOR YOUR ADVISORY CONTRACTS PART 2 – WHAT YOU SHOULD CONSIDER IN 2012

Last month CCLS delivered Part 1 of this article and delved into Essential Contractual Provisions for Registered Investment Adviser Agreements. This month we will continue and provide practical tips related to:

1. How the *Final Rule* on 408(b)(2) Prohibited Transactions and required disclosures for "Covered Service Providers" may affect your advisory contracts[1]; and
2. Standard contractual clauses to consider (including notice provisions and electronic delivery of documents).

ERISA DISCLOSURES

Fundamental to the Employee Retirement Income Security Act of 1974 ("ERISA") is the need to establish safeguards for dealing with ERISA-qualified retirement accounts. This requires, among other things, Responsible Plan Fiduciaries ("RPFs," who include the Plan Sponsor and named fiduciaries in the plan documents), to act prudently and solely in the interest of the plan's participants and beneficiaries[2] and avoid prohibited transactions under Section 406. Section 408(b)(2) provides an exemption to Section 406 by requiring RPF's to only select "covered" service providers, such as investment advisers, whose service arrangements are considered "reasonable".[3] Non-compliance effectively means that in this case the advisory service arrangement can be a prohibited transaction and potentially subject to related sanctions and penalties.

Under Section 408(b)(2), certain written disclosures must be delivered to the RPF prior to entering into the service arrangement, such that the RPF has enough time to make a reasonable, informed and prudent decision when selecting a service provider.[4] These disclosures include:

1. A Description of the Advisers Services;
2. Acknowledgment of Exact Fiduciary Status;
3. Information regarding all forms of **"direct" and "indirect"** compensation received; and
4. Timing of Disclosures.

Description of Services: Disclosures should clearly and *specifically* list all services you provide, distinguish those services that are subject to ERISA and your acknowledged fiduciary duties, and decipher which services are outside this list. This approach will help to clearly establish your advisory role for ERISA clients and help to manage clients' expectations.

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[1] *See generally* "Final Regulation Relating to Service Provider Disclosures Under Section 408(b)(2)," *available at* http://www.dol.gov/ebsa/newsroom/fs408b2finalreg.html.
[2] Id.
[3] Id.
[4] Id.

Acknowledgment of Exact Fiduciary Status: Your ERISA advisory contracts will need to disclose your status as a "fiduciary" to the ERISA plan. Dependent upon the type of services provided, in some cases an adviser may elect to label itself as a "consultant," which could avoid applicability of section 408(b)(2). However, disclosure of being a fiduciary could be triggered based on those services provided under the service agreement.
Most advisers typically are classified as an ERISA fiduciary under Section 3(21)(A) (relating to investment adviser fiduciaries) and Section 3(38) (for investment manager fiduciaries) , both of which are dependent upon the adviser's level of discretionary authority and involvement in the ERISA account.[5]

Compensation: This area may require the most attention of advisers. In accordance with new 408(b)(2) requirements, the adviser must list all "direct" and "indirect" compensation received by the RIA, its affiliates, and subcontractors. Direct compensation is that compensation which is received for services pursuant to the terms of the advisory contract. This information must be clear and easily understandable so that an RPF can judge the reasonableness of the compensation in light of the services provided. On the other hand, indirect compensation reflects that compensation received related to the ERISA account, and includes soft dollar arrangements, corporate sponsorships, gifts (event tickets, wine bottles, gift baskets, dinners, etc.), trips to marketing/networking events, 12b-1 fees, third-party finder/manager fees, solicitor fees, and more.

Such disclosures involving the description of the adviser's services, the arrangement between the adviser and the indirect servicer and identity of the indirect servicer could be lengthy and practically, may not be best made in a new ERISA investment advisory agreement. Consequently, for some advisers, a separate ERISA disclosure document and enhanced disclosures within Form ADV Part 2A, may be a better means to provide these necessary disclosures.

The DOL has provided a sample ERISA disclosure guide to assist with 408(b)(2) disclosures which may be found at http://webapps.dol.gov/federalregister/PdfDisplay.aspx?DocId=25781.[6]
Notably, initial disclosures to clients must be made by July 1, 2012 to both **new** and **existing** clients. After the initial disclosure, an RIA *must* make annual disclosures to their clients for changes in policy. If there is new compensation earned by the adviser, it must be disclosed to the client within 60 days of receipt.

STANDARD CONTRACTUAL CLAUSES

Boilerplate is legal terminology for commonly included language in an agreement that is standard among agreements of a similar nature.[7] Here are some of the most common contractual provisions for you to consider in light of today's business advisory models.

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[5] Rule Section 3(21)(A) Employee Retirement Income Security Act of 1974, as amended, *available at* http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&tpl=/ecfrbrowse/Title29/29cfr2510_main_02.tpl (Last Visited on January 13, 2012); 29 CFR 2510.3–21(c); Department of Labor Advisory Opinion No. 2011-08A (June 21. 2011) *available at* http://www.dol.gov/ebsa/regs/aos/ao2011-08a.html (Last Visited on January 13, 2012); 29 CFR Part 2550.
[6] 77 FR 5632, 5659.
[7] *Black's Law Dictionary*, 6th Ed. (St. Paul: West Publishing Co., 1990) at 175.

Notices.
A Notice clause identifies the contact information of record for all parties. In addition to the parties' names, mailing addresses, telephone and facsimile numbers, advisers may want to include an email address as well, particularly if they desire electronic communication notifications. If so, be sure to include language reflecting that the client acknowledges it has the capability to view and send electronic communication, when electronic communication is deemed delivered, and the client consents to such delivery method.

Entire Agreement.
An Entire Agreement clause basically states that the agreement is final, supersedes any previous agreements or understandings, and neither party is allowed to use extraneous communications, documents, or evidence to prove what is and what is not intended by the parties. This provision may allow a court, mediator, or arbitrator to rely upon only the four corners of the adviser's agreement to resolve a dispute.

Non-Exclusive Relationship.
If applicable, acknowledge that you have other clients and the investment advice you provide to your other clients or the securities you (and/or your employees) hold may differ from that given or those recommended to a particular client.

Confidentiality.
A confidentiality clause serves an important purpose for enforcing an obligation for both parties to agree not to disclose certain information provided by the other to any third party except as required by law or for advisory servicing purposes.

CONCLUSION

Advisory contracts, while not required, serve an important purpose: to capture essential descriptions of what the adviser is providing to its clients, and disclosures relating to the associated fees and services for the advisory engagement. If your contracts have not been reviewed or revised recently, you may wish to use the January and February CCLS Risk Management Updates as a checklist to ensure that essential provisions are updated. For more information or to learn about how CCLS may be of assistance, please do not hesitate to contact us at (619) 278-0020. Be sure to also visit our weekly blogs at www.corecls.com/newsstand for additional information.

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