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The Importance of 408(b)(2) Disclosures to Nonprofits

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I'm impressed that you have read this far – particularly if you know that 408(b)(2) disclosures do not apply to nonprofits. So you are probably asking yourself one of two questions: What is 408(b)(2)? Or if it doesn't apply to nonprofits, how can it be important?

408(b)(2) is an Employee Retirement Income Security Act (ERISA) regulation that, in summary, requires retirement plan service providers (fiduciary consultants, investment advisors, investment consultants, custodians, etc.) to disclose in writing on an annual basis the following three things:

1. What is the service provider's fiduciary status (are they a fiduciary or not)?

2. What is the scope of services being provided by the service provider?

3. What is the total compensation (both direct and indirect)[1] that the service provider received for their services related to the plan in the past year? This should include compensation received by the provider and any compensation received by any related party of the provider such as the parent company or any affiliate.

While 408(b)(2) is an ERISA regulation written for retirement plans, I believe it provides a critically important model that should also be used by nonprofits. What 408(b)(2) requests on an annual basis from every service provider is the exact information that nonprofits should be requesting and receiving from their service providers and information that is essential for a nonprofit implementing fiduciary best practices.

Nonprofits have a duty to minimize costs under the Uniform Prudent Management of Institutional Funds Act (UPMIFA). Section 3(c)(1) of UPMIFA is the provision that directs nonprofits to incur only reasonable costs in managing and investing an institutional fund. The annual receipt of "408(b)(2) like" disclosures by a nonprofit from its service providers is an excellent step in fulfilling that duty.

The Global Fiduciary Standard of Excellence,[2] developed by the Center for Fiduciary Studies, consists of twenty-one fiduciary best Practices.[3] These twenty-one Practices are further supported by over one hundred Criteria,[4] which represent the details of the Global Fiduciary Standard of Excellence. Each Practice is supported by legal substantiation based on statutes, case law, regulations and regulatory guidance.

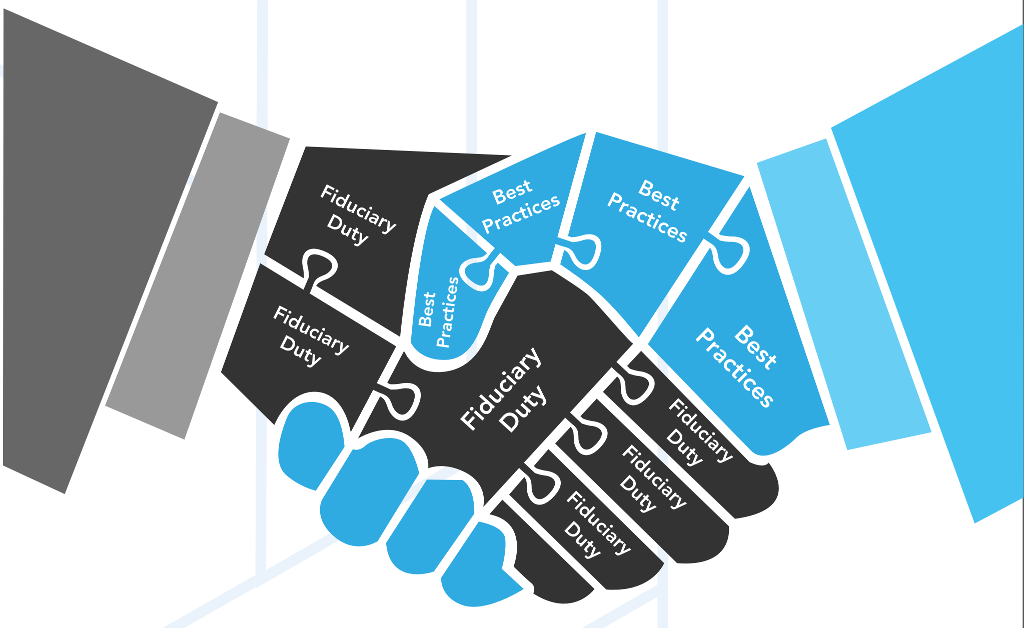
> *"408(b)(2) disclosures provide a critically important model that should also be used by nonprofits."*

"What is the service provider's fiduciary status?"

Let's take a look at how 408(b)(2) disclosures (the three questions listed above) are supported by fiduciary best Practices. The first question, "What is the service provider's fiduciary status?" is supported by fiduciary best Practice 1.3, which states, "The roles and responsibilities of all involved parties (fiduciaries and non-fiduciaries) are defined and documented," and Criteria 1.3.2, which states, "The Investment Steward[5] requires each service provider to make full written disclosure of the services to be provided and the compensation arrangements, affiliations, and fiduciary status of the service provider."

A nonprofit investment steward should know whether a service provider is a fiduciary and if so, in what capacity. This allows the nonprofit's staff, board and investment committee to know what fiduciary responsibilities and liabilities fall to them and which, if any, of those responsibilities and liabilities are being shared with the service provider.

> *"...and which, if any, of those responsibilities and liabilities are being shared with the service provider."*



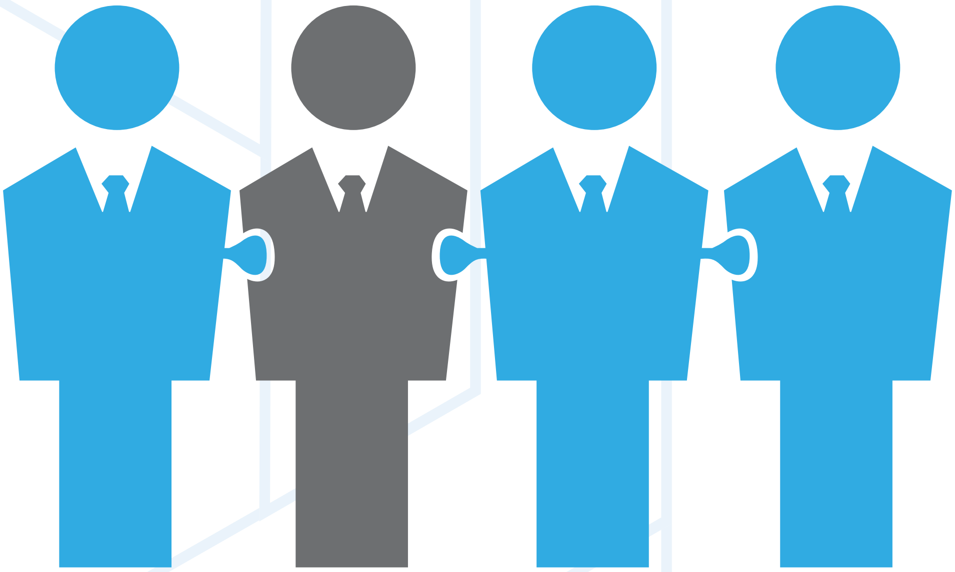
"What is the scope of services being provided by the service provider?"

The second question, "What is the scope of services being provided by the service provider?" is supported by Criteria 1.5.1, which states, "The roles and responsibilities of all involved parties are documented in the investment policy statement."

It takes a team to effectively manage the investments of a nonprofit. This team may include the nonprofit's staff and/or board, investment committee, custodian, fiduciary consultant, investment manager(s), investment advisor and investment consultant. All of the various parties involved in the investment process must work in coordination with one another and have a clear understanding of their own functions and duties.

In a nonprofit's investment policy statement (IPS), each service provider should have their specific duties and requirements documented. This best practice is supported by Criteria 2.6.2, which states, "The investment policy statement defines the duties and responsibilities of all parties involved." Documentation ensures continuity of the investment strategy when there is a change made to the team, prevents misunderstandings between the team and prevents omission of critical fiduciary functions.

> *"Documentation....prevents omission of critical fiduciary functions."*



> "What is the total compensation (both direct and indirect) that the service provider received in the past year?"

The third question, "What is the total compensation (both direct and indirect) that the service provider received in the past year?" is supported by Practice 4.4, which states, "Periodic reviews are conducted to ensure that investment-related fees, compensation, and expenses are fair and reasonable for the services provided."

A key fiduciary duty is to pay only reasonable expenses. Without knowing exactly how much service providers are compensated, it is impossible to know if their compensation is reasonable. Once all compensation is known, the nonprofit is then able to benchmark fees to determine reasonableness. If the nonprofit lacks the capacity to benchmark fees in-house, they should outsource this fiduciary best practice to a fiduciary consultant.

The difficulty in accounting for all fees and expenses is illustrated by numerous Fiduciary Assessments[6] conducted by Hardy Reed. In one case, a Fiduciary Assessment for a foundation that found a service provider served in the role of custodian and investment manager. As the investment manager, they were paid a reasonable fee based on a fixed percentage of assets under management. However, the service provider was also paid an extra 25 basis points for assets held in money market funds in addition to the custodial fee and management fee. This was stated in the contract, but the foundation investment committee was not aware of this compensation structure; nor did they know what the foundation was paying this service provider in indirect compensation. This was an obvious conflict of interest that was not being addressed. Had the foundation received the "408(b)(2) like" disclosures from their service providers, it would have helped the foundation's stewards detect these fiduciary deficiencies.

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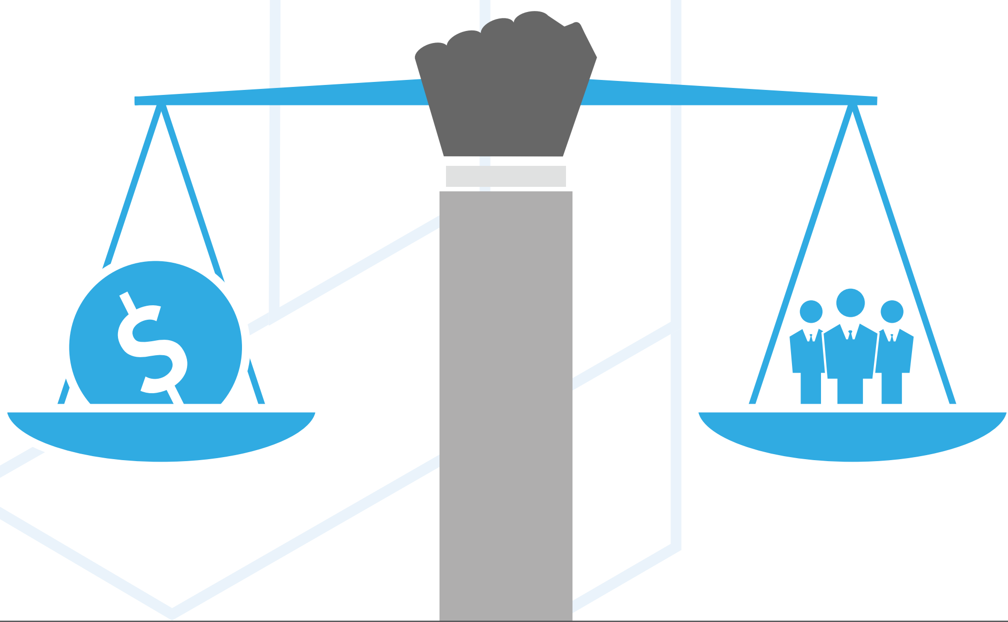

As we move into the new year, now is the perfect time for nonprofits to request "408(b)(2) like" disclosures from their service providers. All service providers should be able to provide this information to the nonprofit in writing within thirty to forty-five days after year-end. A Sample Annual Disclosures Letter for Foundations is attached at the end of this article. You can learn more about the Global Fiduciary Standard of Excellence at Hardy Reed Fiduciary Consulting Services or Center for Fiduciary Studies

This article was written by Ken Mathis. Ken served as chairman of the CEFEX Foundation Committee and holds the Accredited Investment Fiduciary Analyst® (AIFA®)[8] and Professional Plan Consultant® (PPC®) designations. In addition, he is approved as a CEFEX Analyst[9] by the Centre for Fiduciary Excellence.[9] Ken serves as the Chief Operating Officer for Hardy Reed, LLC. He can be reached at kmathis@hardyreed.com or 662-823-4722.

Glossary

Glossary of Terms was taken from the Prudent Practices for Investment Stewards. Copyright © 2006-2013 by fi360, Inc.

(1) Indirect compensation generally is compensation received from any source other than the nonprofit by the Covered Service Provider, an affiliate, or subcontractor. Covered Service Providers who disclose indirect compensation also must describe the arrangement between the payer and Covered Service Provider pursuant to which indirect compensation is paid. Covered Service Providers must identify the sources for indirect compensation, plus services to which such compensation relates. Compensation disclosures by Covered Service Providers must include allocations of compensation made among related parties (i.e., among a Covered Service Provider's affiliates or subcontractors) when such allocations occur as a result of charges made against a plan's investment or are set on a transaction basis.

(2)

Fiduciary excellence – A function of how well Investment Stewards, Investment Advisors, and Investment Managers follow defined fiduciary Practices and Criteria.

(3) Practice – The details of a prudent process that provide the foundation and framework for a disciplined investment process.

(4) Criteria – Define the scope and details of a Practice and provide a standard by which a Practice can be evaluated.

(5) Investment Steward – A person who has the legal responsibility for managing investment decisions on behalf of others, including plan sponsors, trustees, and investment committee members.

(6) Assessment – The process of determining whether a fiduciary conforms with defined Practices and Criteria.

(7) Accredited Investment Fiduciary Analyst® (AIFA®) – Professional designation for those who wish to conduct ISO-like assessments of a global fiduciary standard of excellence.

(8) CEFEX Analyst – A person approved by CEFEX to conduct an assessment of a firm's fiduciary practices for CEFEX Certification.

(9) CEFEX™, Centre for Fiduciary Excellence – An independent global assessment and certification organization. CEFEX works closely with investment fiduciaries and industry experts to provide comprehensive assessment programs to improve risk management for institutional and retail investors. CEFEX certification helps determine trustworthiness of investment fiduciaries.

Sample Annual Disclosures Letter for Foundations

Date

Dear Service Provider:

Important fiduciary duties of nonprofits include paying only reasonable fees for the services being provided and a written acknowledgment of their fiduciary status by service providers. Therefore, we are requiring each of our service providers to deliver the following information in writing to us no later than February 15, 20XX:

1. Please detail the services you are providing to our nonprofit. Are these services outlined in our agreement/contract with you? Please list any services listed in our agreement/contract with your organization that you are not providing to our nonprofit.

2. Please describe all direct and indirect compensation, any compensation that will be paid among related parties, and compensation for termination of the contract or arrangement.

3. Please specify whether your organization is a fiduciary to our nonprofit. If your organization is a fiduciary, please detail the scope of your fiduciary duties.

Thank you in advance for your assistance. If you have any questions, please let us know as soon as possible.

Best regards,

Nonprofit Staff/Board Member/Investment Committee Member