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DOL Issues Final Participant Disclosure Regulations for Defined Contribution Plans

The Department of Labor (DOL) has released final regulations intended to ensure that participants in self-directed individual account plans such as 401(k) plans have sufficient information to manage their accounts. The regulations will be applicable for plan years beginning on or after November 1, 2011 (e.g., January 1, 2012 for calendar year plans).

Background

The Employee Retirement Income Security Act (ERISA) requires a fiduciary to act prudently and solely in the interest of a plan's participants and beneficiaries when investing plan assets. The DOL believes that fiduciaries of plans that allow participants and beneficiaries to direct their accounts' investments have a fiduciary duty to provide the participants and beneficiaries with sufficient information, including information on expenses and on the available investment alternatives, to allow the participants and beneficiaries to make informed decisions. The DOL issued proposed regulations on plan disclosure to participants and beneficiaries on July 23, 2008 (see our August 21, 2008 *For Your Information*).

These final regulations on plan disclosure to participants and beneficiaries are the third in the series of DOL regulations focused on increasing the transparency of plan-related fees and expenses. In November 2007, DOL issued final regulations on Schedule C of the Form 5500 annual report for employee benefit plans (see our December 19, 2007 *For Your Information*), which provided information on expenses incurred in the Form 5500 plan year. In July 2010, the DOL issued final interim regulations addressing the exemption from the prohibited transactions rules for making reasonable arrangements with a party in interest. The regulations require that plan fiduciaries receive disclosures of fees, compensation and conflicts of interest from service providers prior to entering into a service agreement (see our September 2, 2010 *For Your Information*).

The Final Regulations on Participant Disclosures

The final regulations generally follow the approach of the proposed regulations. The DOL has made changes to clarify fiduciary responsibility, who must receive information, and when information must be provided. The DOL has also adjusted the information that the plan must provide with respect to non-mutual fund investments to deal with the differences in structure between mutual funds and other types of investments.

What Plans Are Subject to the Final Regulations?

The regulations apply to individual account plans that provide for investment self direction by participants and beneficiaries. The regulations do not apply to IRA-based plans (SEP arrangements and SIMPLE IRAs), non-ERISA 403(b) plans, and individual account plans that do not provide for participant investment direction. Disclosure requirements for welfare plans are the subject of a separate, pending, DOL regulatory project.

When Do Plans Have to Comply with the Final Regulations?

The regulations are effective on December 20, 2010 but plans do not have to comply with the regulations until the first plan year beginning on or after November 1, 2011 (until January 1, 2012 for calendar year plans). The final regulations also permit a plan to delay providing the initial disclosure (see below) until 60 days after the applicability date (until March 1, 2012 for calendar year plans).

Who Must Provide the Information and What Protections Do They Have?

The final regulations make clear that the fiduciary responsible for providing the required information is the plan administrator as defined under ERISA (normally the administrative committee under the plan). In many instances, the plan administrator is providing participants and beneficiaries with information provided originally by a service provider or the issuer of a designated investment alternative. The final regulations provide that the plan administrator may rely on this information as long as the administrator does so reasonably and in good faith.

Who Must Receive the Information?

For purposes of these regulations, the DOL defines "participants" to include all employees eligible for the plan, not just those who elect to participate. In the case of beneficiaries, plan administrators must provide disclosures only to those with the right under the plan's terms to direct an investment because of, for example, the death of the participant or a qualified domestic relations order. All of the required disclosures must be written in a manner that can be understood by the average plan participant.

> ***BUCK COMMENT.*** *Because the final regulations require disclosures about the plan to be provided to all eligible employees and not just to participants and beneficiaries, and plan administrators do not typically distribute other required disclosures to eligible non-participants, plans may face increased administrative burdens and compliance costs.*

When and How Must the Plan Provide Information?

Initial Disclosure. The plan administrator must disclose information on expenses and on the available investment alternatives (described below) on or before the date the participant or beneficiary first becomes

eligible to direct his or her investments under the plan. However, as discussed earlier, in the first year the regulations are applicable, plans are not required to make the initial disclosure until 60 days after the new regulations are applicable to the plan. The final regulations permit plan administrators to use the most recent annual notice as the initial disclosure for new participants as long as any updates are attached.

Annual Notice. After the initial disclosure, the plan administrator must provide annually the required plan-related and investment-related disclosures (see below). Where applicable, the plan administrator may provide the initial disclosure and annual notice with the distribution of individual benefit statements or include the information in the summary plan description, as long as the information is distributed at the times required.

Updates. The plan administrator must provide a notice of any changes to general operational and identification information, administrative expenses, or individual expenses at least 30, and not more than 90, days before the effective date of the change, except when such notice is not possible (e.g., when a plan drops an inappropriate investment). In that case, the plan must furnish a notice as soon as practicable. Under the proposed regulations, the DOL only required updates for "material" changes. However, the final regulations drop the "material" limitation because the DOL has concluded that all changes are "material."

> ***BUCK COMMENT.*** *The requirement that plan administrators provide advance notice of all changes, and not just those deemed "material," has the potential to overwhelm participants and cause them to ignore critical information when provided.*

Quarterly Notices. On a quarterly basis, the plan administrator must provide each plan participant or beneficiary a statement of the actual dollar amount charged to his or her account for administrative services during the preceding quarter, along with a general description of the services provided. This requirement applies to both administrative expenses and individual expenses (both defined below). The administrator need not break out fees on a service-by-service basis; disclosing fees in the aggregate is sufficient. Where applicable, the plan administrator may include the information as part of the quarterly benefit statement already being provided to participants and beneficiaries. The administrator need not include in the quarterly information any fee or charge disclosed earlier to the participant or beneficiary (e.g., if a participant received written confirmation of a securities sale or purchase at the time of the sale or purchase).

> ***BUCK COMMENT.*** *The requirement to disclose expenses not otherwise included in a fund's annual operating expenses will significantly impact unitized investments such as employer stock funds that indirectly charge expenses by reducing investment returns instead of directly charging participant accounts. Many of these unitized investments have never individually disclosed expenses to participants or even calculated expenses on an individual basis.*

The regulations permit the administrator to make the disclosures electronically, as long as the disclosure is consistent with the DOL's electronic disclosure requirements. The DOL indicates that it is going to issue further

regulations on electronic delivery and they are likely to be in place before the requirements of this regulation are applicable.

What Plan-Related Disclosures Must a Plan Provide?

The regulations break plan-related disclosures into three categories: general operational and identification information, administrative expenses, and individual expenses.

General Operational and Identification Information. In addition to plan identification information, this category covers broad information such as how participants may give investment instructions, any limitations on instructions, the process for exercising voting and tender rights, lists of investment options and designated investment brokers, and a description of any self-directed brokerage accounts available under the plan.

Administrative Expenses. This category includes an explanation of any possible fees for general plan administrative services (e.g., legal, accounting, recordkeeping) that will not be included in the total annual operating expenses of the plan's investment options. The plan administrator must also include a description of how these fees will be allocated to each individual account (e.g., pro rata, per capita). Special rules for certain investment options such as investment in the employer's securities are discussed below.

The plan administrator of a plan that (in whole or in part) uses revenue sharing from the plan's investments to finance administrative expenses must provide participants with a statement that, in addition to the expenses reported on the statement, some of the plan's administrative expenses for the preceding quarter were paid from the annual operating expenses of one or more of the plan's designated investment alternatives (e.g., through revenue sharing arrangements, Rule 12b-1 fees, sub-transfer agent fees). However, the administrator does not need to disclose the specific fee sharing amounts for each investment.

Individual Expenses. Plan administrators must provide participants and beneficiaries an explanation of the fees and expenses that the plan may charge directly against their accounts for individual services (e.g., fees related to plan loans, QDROs, investment advice services, investing through a brokerage window, front or back-end loads or sales charges). These direct charges also could include fees from certain unregistered investments, such as bank collective investment funds, that do not fully incorporate all fees in their annual operating expenses.

What Investment-Related Disclosures Must a Plan Provide?

General. For each investment option in the plan (other than a self-directed brokerage account or other similar individual-investment arrangement), the plan administrator must disclose to each participant and beneficiary certain information including the name of the investment, asset category (e.g., money market fund, balanced, large-cap stock fund, employer stock fund, employer securities) and the website where the participant or beneficiary may obtain supplemental information on the investment option.

Performance Data and Benchmarks. If an investment alternative does not guarantee a fixed return, the plan administrator must disclose the average annual total return on investment for the preceding one-year, five-year, and ten-year periods (or the life of the investment if shorter) and provide a statement that past performance in not necessarily an indication of how the investment will perform in the future. The plan administrator must also provide broad-based investment benchmarks (e.g., S&P 500 Index, Russell 2000 Index, etc.) for the same one-year, five-year, and ten-year time periods (or the life of the alternative if shorter). The benchmark may not be administered by an affiliate of the investment issuer, its investment adviser, or a principal underwriter, unless it is a widely-recognized index. Every investment alternative must be compared to a single, broad-based investment benchmark. However, the plan administrator may also provide a custom benchmark blended with the returns of more than one appropriate broad-based index, provided the blended returns proportionally reflect the actual equity and fixed-income holdings of the designated investment.

> ***BUCK COMMENT.*** *As many investments are managed to a custom benchmark made up of multiple indicators (e.g. some international funds combine large and emerging market indices for their benchmark), the requirement to present a single broad-based index to benchmark returns may present a misleading comparison of a fund's performance.*

If the return on an investment alternative is fixed or stated for the term of the investment, the plan administrator must provide information on the fixed or stated annual rate of return and the term of the investment. If the issuer reserves the rate to adjust the fixed or stated rate of return during the term of the investment, the plan administrator must provide the current rate of return, the minimum rate guaranteed under the contract, if any, and a statement advising the participants and beneficiaries that the issuer may adjust the rate or return prospectively and how to obtain the most recent rate of return.

Fee and Expense Information. The plan administrator must include shareholder fees related to the purchase, sale and holding of the investment alternative (e.g., sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, mortality and expense fees) to the extent the fee is not included in the operating expenses of a designated investment vehicle. The administrator must also provide a description of any applicable plan restriction or limitation on the purchase, transfer, or withdrawal of the investment. To the extent there is an overlap with individual expense disclosures (e.g., a front-end sales load), the final regulations require the fee to be disclosed in both places.

In addition, the administrator must disclose the total annual operating expenses of the investment expressed as a percentage (i.e., expense ratio) and as a dollar amount per $1,000 investment. Variable rate investments, other than a registered mutual fund or a variable annuity contract, must include in the expense ratio amounts charged to the plan but not included in the annual operating expenses.

Statements. The notice must include several statements. These are: (a) fees and expenses are only one factor, among many, to consider when investing; (b) the cumulative effect of fees and expenses can substantially reduce the growth of a participant's or beneficiary's retirement account; (c) participants and beneficiaries can visit

the DOL's website for a demonstration of the long-term effect of fees and expenses; and (d) more current investment-related information may be available at the investment vehicle's listed website. The notice must include the name and contact information of the fiduciary that will provide participants and beneficiaries with material (e.g., the fund prospectus, annual financial reports, and the current share price or unit value) upon request.

Model Comparative Chart. The final regulations require the plan administrator to provide the information in the form of a comparative chart. The DOL has provided a model comparative chart that may be used to satisfy the regulations' new comparative format requirements. The chart must include information on how to obtain, free of charge, copies of the information on the investment vehicle's website.

> ***BUCK COMMENT.*** *The model comparative chart is the key to the DOL's thinking in the regulations. The DOL wanted to make information on different investment alternatives comparable to the extent possible.*

In the case of a 403(b) plan subject to these requirements, the plan administrator must consolidate the information from separate annuity providers into a single disclosure (though each provider's investments may be listed on separate documents so long as the information from all the providers is sent together).

Website for Each Investment Alternative. The plan administrator must provide information to the participant and beneficiary as to the websites for each of the designated investment alternatives under the plan. The issuer of the investment alternative must establish a website where a participant can obtain the fund's investment objective, a general description of the types of assets held, portfolio turnover percentage, performance data updated on at least a quarterly basis (or more frequently if required by other applicable law), and the fee and expense information required under this regulation. There are special website rules for fixed return investments, and there is no website requirement for funds invested primarily in employer securities (subject to the rules below). A plan administrator has the responsibility to assure that there is a website where participants can get information but can rely on the investment issuer to provide the website.

Special Rules for Certain Investment Alternatives. The final regulations add certain exemptions and special rules governing disclosures for employer stock funds, annuity options, and fixed return investments under a plan. They also include special rules for investment vehicles provided by banks.

Fixed return investments. The final regulations define a "fixed return investment" as any alternative that provides a fixed or stated rate of return to the participant for a stated duration, and with respect to which investment risks are borne by an entity other than the participant (e.g. an insurance company). While stable value funds generally aim to preserve principal, they are not free of investment risk to the investor. Accordingly, these investments are subject to the variable return provisions of the regulation, even though they routinely hold fixed-return investments.

In the case of a fixed return investment, the administrator must disclose the current rate of return, the term of the investment, and any minimum rate guarantee. The administrator must also advise participants and beneficiaries

that the issuer may adjust the rate of return prospectively and how they can obtain the most recent rate of return information. No performance or benchmark data are required. Among the other differences, the administrator does not need to disclose an annual expense ratio or cost per $1,000 nor provide portfolio turnover data.

Employer Securities. If a fund invests primarily in qualifying employer securities, the plan administrator need not disclose principal holdings and risks nor provide turnover information. However, the notice must include a statement on the importance of a well-balanced and diversified portfolio. In the preamble to the regulations, the DOL provides sample language for this disclosure. The final regulations contain special rules as to how funds in which employees are allocated shares (as opposed to a unitized stock fund) should report returns. These allocated-share funds are also exempt from the requirement to provide an annual expense ratio/cost per $1000. Unitized funds must comply with the requirements applicable to variable return funds rather than those applicable to employer securities.

Annuity Options in Variable Annuity Contracts. An annuity option is a contract, fund or product that permits participants or beneficiaries to allocate contributions toward the current purchase of a stream of retirement income payments guaranteed by an insurance company. The final regulations contain special rules for annuity options within variable annuity contracts. The disclosures are to provide information on both the portfolio operating companies within the variable annuity contract and the variable annuity itself. The disclosures are aimed at alerting the participant or beneficiary to the option's objectives or goals, the price of the guaranteed income payments, any withdrawal or transfer limitations or fees, and any surrender charges, market value adjustments, and administrative fees. The disclosure must include a statement that any guarantees of an insurance company are subject to its long-term financial strength and claims paying ability and the address of a website with certain specified disclosures.

Bank Collective Trusts. The final regulations have special rules with respect to disclosing total and average operating expenses for variable rate investments that are not registered mutual funds (e.g. bank collective investment trusts). In the case of the one-year, five-year, and ten-year disclosures of fund performance data, the regulations permit the plan administrator to use reasonable estimates of annual expenses in calculating returns as long as this is disclosed to participants.

> ***BUCK COMMENT.*** *Despite the transition rule, calculating returns for bank collective funds under these requirements is likely to be problematic given that, unlike mutual funds, fees are not charged in a consistent manner and it may be difficult to capture the actual expenses charged.*

Glossary. The plan administrator must provide access to a general glossary of terms to assist participants and beneficiaries in understanding the designated investment alternatives, either through a website or some other vehicle not specified. The DOL has asked for comments on what terms should be included in a general investment glossary and what glossaries already exist that could be used to advise relatively unsophisticated investors, but the agency has not at this time provided a model glossary.

Final Regulation on ERISA Section 404(c)

The regulations make providing information a fiduciary requirement for plan administrators individual account plans with participant direction of investments (other than IRA-based plans). Prior to these regulations, ERISA provided similar rules only for plans that chose to be covered by the special rules of ERISA for participant-directed plans. These plans are known as "Section 404(c)" plans. The final regulations amend the Section 404(c) regulations to make them consistent (by cross-reference) with the general requirements provided for all plans. As a result, the disclosure requirements under 404(a) and 404(c) are essentially the same except that a plan seeking 404(c) protection has to (1) explain that it seeks to be a 404(c) plan and that 404(c) relieves plan fiduciaries of certain liability and (2) provide a description of the procedures established to provide for the confidentiality of information relating to the purchase, holding, and sale of employer securities. Though not directly dealing with disclosure to participants, the regulations stress that any relief available under Section 404(c) does not extend to a fiduciary's duty to prudently select and monitor investment managers and funds under the plan.

> ***BUCK COMMENT.*** *Under the final regulations, sponsors are now subject to fiduciary liability for failing to satisfy the requirements of Section 404(a) (which essentially but not totally mirror the Section 404(c) requirements). The DOL also notes that Section 404(c) does not relieve the fiduciary from liability for the selection of investment alternatives. Sponsors should consult with their attorneys as to these matters and whether following Section 404(c) provides any additional fiduciary protection.*

Future Guidance

The DOL states that it will be seeking comments in the near future on the electronic distribution of plan information as well as special rules for disclosures by target date funds. The DOL intends to make any changes to the regulations relating to these matters in advance of the November 1, 2011 applicability date.

> ***BUCK COMMENT.*** *The DOL issued proposed regulations on target date funds on November 29, 2010. They will be the subject of a separate* For Your Information*.*

Conclusion

Although recordkeepers, investment companies and other plan vendors will be able to provide many of the required disclosures, plan administrators must be prepared to add any other required disclosures and to coordinate with other service providers to obtain the required information.

Buck's consultants would be pleased to assist you in preparing to meet the new and expanded disclosure requirements for participant-directed individual account plans.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.