For your information

Volume 35 | Issue 32 | June 5, 2012

DOL Releases Long-Awaited FAQs on Participant-Directed Account Fee Disclosures under ERISA Sections 404(a) and 404(c)

The DOL recently issued a press release and FAQs that provide plan administrators of participant-directed individual account plans a clearer picture of what is required under the new fee and investment expense disclosure regulations. In addition to answering some questions, the FAQs raised some new questions as well. Notwithstanding the hopes of some practitioners, the deadline for compliance was not extended. And, unfortunately, the DOL's description of good faith compliance relief was less robust than anticipated.

Background

On October 20, 2010, the Department of Labor (DOL) published a final regulation under the Employee Retirement Income Security Act (ERISA) requiring specific disclosures to be made by defined contribution plans that allow participants (used in this For Your Information to include participants, eligible employees, beneficiaries, and alternate payees) to direct the investment of their plan accounts. The disclosures cover plan and investment information, including detail about fees and expenses. The regulation aims to ensure that these individuals receive information in a format that enables them to meaningfully compare their plan's investment options. (See our November 30, 2010 For Your Information.)

FAB 2012-02

The DOL's Field Assistance Bulletin (FAB) 2012-02 responds to frequently asked questions (FAQs) about the regulation and is intended to assist covered service providers and plan administrators with implementation.

The FAB covers a number of general topics, with particular emphasis on disclosure of plan- and investment-related information, forms of disclosure, and clarity about definitions of certain terms. It also provides guidance on the calculation of Total Annual Operating Expense (TAOE). Although the FAB answers many questions, it also raises some new ones, particularly for the handling of brokerage windows.

No Extension of Disclosure Deadline, But "Good Faith" Counts

Despite industry requests for additional time to comply, FAB 2012-02 does not offer deadline relief. Initial annual disclosures for calendar year plans must be furnished to participants no later than August 30, 2012. The initial quarterly disclosures of fees and expenses actually deducted are due by November 14, 2012 for calendar year plans. Compliance deadlines may differ for plans with off-calendar plan years.

Although the DOL is not extending these compliance deadlines, it will take good faith efforts to comply and plans for future disclosure compliance into account when determining the need for enforcement action. The DOL recognizes that, at this time, it may be difficult or costly for plan administrators and service providers to make further system adjustments in advance of the deadlines, but "in light of the significance of these required disclosures and the already extended delay in the implementation of the regulations, the Department does not believe further broad-based extensions are appropriate."

INSIGHT

Although the language about good faith compliance is helpful, it only addresses DOL enforcement efforts and does not provide any protection against participant litigation.

Plan-Related Information

General and Administrative Fees and Expenses. When fees are taken directly from participant accounts, a high degree of specificity is required in the explanation of those fees. The FAB explains that the appropriateness of the annual disclosure will vary based on the facts and how much is known at the time of the disclosure. It provides examples for circumstances in which:

- Fees are known at time of disclosure
- Fees are not known with certainty, but can be predicted
- Fees are offset by revenue sharing

INSIGHT

A clear distinction is made between the detail required in the annual and quarterly disclosures when fees and expenses are incorporated in the TAOE of a designated investment alternative (DIA) and the detail required when fees and expenses are taken directly from participant accounts. Fees included in the TAOE need not be itemized or identified annually or quarterly; rather, the quarterly disclosure must include language that "some of the plan's

administrative expenses for the preceding calendar quarter were paid from the total annual operating expenses of one or more of the plan's designated investment alternatives." Only when fees are taken directly from participant accounts must a detailed breakdown of the fees charged be provided. Curiously, the DOL felt it necessary to make clear that fees can only be represented as being part of the TAOE of the DIA if they are actually funded in that manner.

The FAQ clarified several other important points about the structure and content of information in the Annual Disclosure:

- There are two components of the Annual Disclosure: plan-related information and investment-related information. The FAB confirms that information required in each component need not be repeated provided that the information is issued in a single document.
- If a plan offers both participant-directed and trustee-directed investments, the plan is subject to the disclosure requirements, but it is only necessary to provide the required elements for the participant-directed investments.
- To the extent that the plan provides that administrative expenses are to be paid from plan forfeitures or from the general assets of the sponsor, it is not necessary to provide an explanation of the fees or expenses, because their payment does not affect participant account balances or investment returns.
- If revenue sharing is used to fund some or all of the plan's expenses, it is not necessary to detail the expenses being paid or the DIAs from which the payments are made.
- The quarterly disclosure must include the required revenue-sharing language, even if no fees are being taken directly from participant accounts. In addition, if the expenses paid from revenue sharing are paid less frequently than quarterly, it is acceptable to include the required revenue-sharing language on every quarterly disclosure.

Brokerage Windows. The FAB addresses two key issues about the use of brokerage windows within defined contribution plans. One relates to the disclosure of the full range of fees that can apply in connection with investing through a brokerage account. The other, which will be addressed later in this For Your Information, is a thornier issue related to the boundaries between the required disclosure of the sponsor's selected investments offered in defined contribution plans and the potential obligation to provide disclosure for certain other investments through brokerage windows/investment platforms.

The FAB states that, at a minimum, the plan administrator must provide sufficient information so that the participant understands how the brokerage window works. It also confirms that all participants must receive detailed fee information about the brokerage window, not only those who choose to invest through the window.

Facts and circumstances determine the level of detail about brokerage window fees and expenses that must be disclosed annually and quarterly. Although the regulations provided guidelines for disclosing fee details associated with brokerage windows, such as those for account opening and maintenance, the FAB expanded on the level of detail required in connection with the purchase and sale of individual securities.

Although the DOL requires that those fee details be disclosed to the participant, it recognizes that the fee structure may be complex, and can differ by investment. The FAB notes a concern that "…plan administrators might inundate participants and beneficiaries with information about the cost of buying or selling all the various securities available through a window, account, or arrangement, despite the fact that participants and beneficiaries may not have the interest or expertise to purchase or sell each or any such security." The FAB accordingly advises that the annual disclosure include "…a general statement that such fees exist and that they may be charged against the individual account of a purchasing or selling participant or beneficiary, and directions as to how the participant can obtain information about such fees in connection with any particular investment." It should also "… advise participants and beneficiaries to ask the provider of the window, account, or arrangement about any fees, including any undisclosed fees, associated with the purchase or sale of a particular security through a window, account, or arrangement, before purchasing or selling such security."

INSIGHT

Plan recordkeepers will have information on basic account maintenance fees readily available and can present it in the quarterly statement of account activity. However, detailed fee schedules for trading activity are generally provided by the brokerage window vendor and will likely appear on separate trading statements.

Disclosures for Designated Investment Alternatives

Specific information must be disclosed for each of the plan's DIAs. The FAB offers clarification on which investments are considered DIAs, what needs to be disclosed, and how the disclosures are delivered.

Annual Comparative Chart. Plan administrators are permitted to include extra information on the comparative chart as long as it is accurate and does not mislead participants. The FAB covers two examples of information that goes above and beyond what is required. First, the DOL says it is acceptable to provide more recent returns than the 1-, 5- and 10-calendar year annual returns. Thus, it would be permissible to report year-to-date information, if desired. However, to ensure appropriate comparability, the same end date must be used for all DIAs and their associated benchmarks. Second, the DOL says "since inception" data may be provided even if not required, as long as it is not inaccurate or misleading.

If there is a change in the fee and expense information provided in the annual comparative chart, there is no requirement to revise the chart and reissue it to plan participants. However, the website presentation of the information does have to be updated and should specify the date of the update.

COMPLIANCE ALERT: To the extent a change affects information in the annual disclosure notice of investment alternatives and fees, the regulation does require that participants receive a change notice within the 30- to 90-day window in advance of the change. Although there is no explicit requirement to issue a new comparative chart if information changes midyear, the DOL broadly hints that the fiduciary should consider its prudence and loyalty duties when considering whether or not to issue the information in any additional format or venue

When Is a Model Portfolio a DIA? The FAB offers an example of a plan with ten core DIAs and three model portfolios. The portfolios are composed of different combinations of the DIAs based on a risk-based allocation. A plan that offers model portfolios merely as a means to allocate a participant's investments to a risk-based (or age target date) strategy based on combinations of the plan's DIAs would not have to treat the models as DIAs unless the portfolios are set up as separate entities that invest in the DIAs. This is not to be confused with risk-based or target date investments that are managed by the plan or a designated investment manager, and where the participant obtains an interest in the investment. The plan administrator must explain how the model portfolio functions. Where the portfolio is not a DIA, the disclosure must still explain how the portfolio differs from the DIAs in the plan.

Closed Options. The DOL confirms that a DIA closed to new investments is still subject to the investment related-disclosure requirements. The DOL believes that the disclosures are just as important to a participant when it comes to deciding whether to transfer out of a DIA as they are when it comes to deciding whether to invest in a DIA.

DIA Treatment for Brokerage Windows/Investment Platforms. The FAB initially affirms that, although brokerage windows and similar arrangements that permit participants to select investments other than those offered directly by the plan are required to disclose plan-related information and fees, the investments offered through the window are generally not subject to the investment-related disclosure requirements. These investments are generally not treated as DIAs.

However, the DOL then expresses concern that "a failure to designate a manageable number of investment alternatives raises questions as to whether the plan fiduciary has satisfied its obligations under section 404 of ERISA." The DOL believes that participants may not be financially sophisticated enough to select from a large number of alternatives.

Even if the plan fiduciary selected multiple DIAs as plan options, the FAB specifies that “if, through a brokerage window or similar arrangement, non-designated investment alternatives available under a plan are selected by significant numbers of participants and beneficiaries, an affirmative obligation arises on the part of the plan fiduciary to examine these alternatives and determine whether one or more such alternatives should be treated as designated for purposes of the regulation.”

For investment platforms, the FAB further states that when a platform holds more than 25 investment alternatives and does not identify any DIAs, “the Department, as a matter of enforcement policy, will not require that all of the investment alternatives be treated, for purposes of this regulation, as designated investment alternatives if the plan administrator—

- makes the required disclosures for at least three of the investment alternatives on the platform that collectively meet the ‘broad range’ requirements in the ERISA 404(c) regulation, 29 CFR § 2550.404c-1(b)(3)(i)(B); and
- makes the required disclosures with respect to all other investment alternatives on the platform in which at least five participants and beneficiaries, or, in the case of a plan with more than 500 participants and beneficiaries, at least one percent of all participants and beneficiaries, are invested on a date that is not more than 90 days preceding each annual disclosure.”

INSIGHT

Although initially this FAQ seems to be focused on sponsors that offer an investment platform *in lieu* of a lineup of DIAs, the response expands the scope into a broader discussion of how an investment in a brokerage window can become a de facto DIA for purposes of the ERISA Section 404(a) disclosure obligation. This interpretation, championed by DOL representatives as their view of current law, goes beyond the original language of the regulations and has generated significant discussion in the retirement community. Based on the language in the FAB and subsequent informal comments, it seems apparent that DOL has concerns about the use of brokerage windows and open investment platforms in defined contribution plans.

Disclosures Required for Unregistered DIAs. For DIAs registered under either the Securities Act of 1933 or the Investment Company Act of 1940, the final regulations only require plan administrators to furnish copies of prospectuses (or short-form/summary prospectuses), on participant request. Previously, plan fiduciaries who sought ERISA Section 404(c) protection not only had to provide prospectuses on request, but also had to provide prospectuses in connection with the participant’s initial investment in those investment alternatives – whether the participant requested a prospectus or not.

Although fiduciaries need no longer furnish prospectuses that were not requested, the FAB makes clear that, on participant request, fiduciaries must supply a document "similar" to a plan prospectus, or short-form/summary prospectus – even for unregistered investment alternatives. For example, the FAB specifically allows for the use of a bank collective fund's operating summary (referred to as a "written plan" in the banking regulations) or a mutual fund fact sheet to meet this requirement. When such a "similar" document does not already exist, the FAB provides that the materials used by a plan fiduciary to select and monitor the DIA ordinarily would satisfy the requirements.

COMPLIANCE ALERT: Plan administrators need to understand how they will fulfill requests to provide prospectus-type documents for unregistered investment alternatives. This may require consultation with counsel to determine if any existing materials meet this requirement or whether a new document must be created and maintained. If a service provider is fulfilling participant requests for fund information on behalf of the plan fiduciary, periodic review of its procedures for doing so may be worthwhile.

Calculation of Total Annual Operating Expense. The final regulations did not specifically address the situation in which a plan accounts for general and administrative expenses paid from plan assets by deducting these amounts from the returns provided to participants (as opposed to directly reducing participant accounts). This is typically done by creating a separately managed trust account even if it solely invests in a registered mutual fund. Participants acquire units of the DIA, not shares in the underlying assets. Expenses paid from the plan reduce the unit value – and the rate of return credited to participant accounts – rather than the number of units held by participants. Practitioners questioned whether this unitized fund could be considered an unregistered DIA that would calculate its TAOE by adding the general and administrative expenses paid from the plan to the expense ratio of the underlying plan assets.

The FAB confirms that a plan can create its own unregistered DIA so long as the TAOE disclosed to participants includes both the underlying expenses of the investments and the administrative expenses paid from the trust that are netted out of participant returns. Further, investment returns quoted to participants must reflect these additional expenses.

The FAB also addresses one of the requirements on how to calculate the TAOE (i.e., sum of certain specified fees and expenses for the alternative's most recently completed fiscal year, expressed as a percentage of the alternative's average net asset value for that year) for an unregistered investment by stating that a plan is in compliance with the regulations if it calculates the net asset value not less frequently than monthly.

COMPLIANCE ALERT: The FAB makes clear that although plans can create their own unregistered investment alternatives by embedding expenses in the returns provided to participants, they no longer can rely on materials (e.g., quarterly fund fact sheets) provided by the plan's investment managers to comply with these regulations if the TAOE and returns quoted don't reflect the additional plan expenses paid from plan assets.

Website Requirements

The FAB indicates that some flexibility exists for providing a plan website to comply with the website address requirement. Alternatives provided include contracting with a third-party administrator to establish and maintain a website, adding the required information to the existing plan sponsor website, or using the DIA issuer's website. The plan administrator will not be held responsible for the completeness and accuracy of information used to satisfy the disclosure and website requirements when the plan administrator reasonably and in good faith relies on information received from or provided by a plan service provider.

INSIGHT

The FAB endorses the "multi-click" approach, as widely anticipated. That is, the website does not have to display all of the required supplemental investment information on a single landing page. The landing page should be designed with the average participant in mind so that information can be accessed without difficulty.

Model Glossary

The final regulation requires fiduciaries to provide a glossary to assist participants in understanding DIAs. The DOL affirmed its belief that plan administrators are in the best position to produce suitable glossaries with their service providers and, therefore, does not intend to publish a sample glossary. It references two glossaries, one prepared by the American Bankers Association and another by the SPARK Institute and the Investment Company Institute, which has been endorsed by a number of other industry groups.

Buck Can Help

- Meet with and educate HR and the plan's administrative committee about the disclosure rules
- Evaluate providers' ability to support full compliance
- Review vendor disclosures for completeness and identify any gaps
- Calculate the TAOE and prepare materials for unregistered funds
- Develop communications that integrate multiple required disclosures
- Perform fee benchmarking and assess reasonableness
- Review investments to determine how recordkeeping expenses are financed

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.
© 2012 Buck Consultants®, L.L.C. All Rights Reserved