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The Department of Labor Fee Transparency Initiatives: Part 3 - Mandatory Investment and Fee and Expense Disclosures to Plan Participants

In this *Benefits Brief*, we will provide a general overview of Department of Labor regulations requiring fiduciaries of defined contribution plans (like profit sharing and 401(k) plans) which permit participants to direct the investment of their account to provide detailed information about the plan's investment options and the applicable fees and expenses to the plan's participants.¹ These regulations are the third of three Department of Labor initiatives to improve the transparency of fee and expense information in tax-deferred retirement plans.

General Overview

Briefly stated, plan administrators are required to disclose to participants² in writing, specific information about each of the plan's designated investment alternatives, including information about each alternative's investment objective, principal strategy and risks, performance history, and the applicable fees and expenses as well as information about the procedures for making and changing investment elections and restrictions on participant investment authority; these disclosures must be made prior to enrollment and at least annually. The form of the disclosure is mandated to enable the comparison of the plan options among themselves and to appropriate industry benchmarks. Plan administrators must also disclose to each participant the actual amount of expenses being paid from his or her account on a quarterly basis.

Effective Date

For the initial disclosures required to be delivered before a participant can first direct the investment of his or her account, the information must be provided within 60 days from the later of: (i) the first day of the first plan year that begins on or after November 1, 2011 or (ii) the effective date of the mandatory service provider fee disclosure requirements (*i.e.*, July 1, 2012). For calendar year plans, this means the initial disclosures must be made by August 30, 2012.

¹ Department of Labor Reg. § 2550.404a-5.

² For simplicity, the term "participant" is used in this *Benefits Brief* to refer to all individuals to whom these disclosure obligations apply. See **Required Recipients** section below.

For the initial disclosures required to be made quarterly (i.e., the quarterly statement of fees and expenses actually deducted from the participant's account), the information must be provided within 45 days of the end of the quarter in which the initial disclosures (described above) are required to be furnished to participants. In the case of calendar year plans, this means the first quarterly disclosure will be due no later than November 14, 2012, which is the 45th day after the end of the second quarter – the quarter in which the initial disclosure was required.

Covered Plans

A “covered plan” for purposes of these rules is a defined contribution pension plan within the meaning of the labor code provisions of ERISA³ that permits participants the opportunity to direct the investment of all or part of their account under the plan.⁴ For the most part that definition includes defined contribution plans (i.e., 401(k), profit sharing, and money purchase pension plans) of private employers and Section 403(b) tax-sheltered annuity, profit sharing, and 401(k) plans of tax-exempt, nongovernmental employers other than churches; excluded are primarily governmental plans; plans of churches which have not elected to be covered by ERISA; individual retirement accounts and annuities, including simplified employee pensions (or SEPs) and “SIMPLE” IRAs; Section 457(b) plans of governmental and tax-exempt employers; and plans covering only a sole business owner, a sole business owner and his or her spouse, a self-employed individual, or self-employed individuals and their spouses (so-called “owner only” plans).⁵

Despite public comments urging them to do so, the Department of Labor specifically declined to exempt “small plans” as a category from these disclosures. Rather, so long as a covered plan provides for participant investment direction for all or part of a participant's account, the disclosures must be made regardless of the number of eligible employees.

Required Recipients

The disclosures must be made not only to current employees who are participating in the plan (i.e., those currently making salary deferral contributions in the case of a 401(k) or 403(b) plan) but also to employees who are not currently participating (i.e., eligible employees who have not elected to make a deferral contribution) and to any other individual entitled to direct the investment of his or her account under the plan, including former employees who have not received a distribution of their vested benefit, beneficiaries of deceased participants, and alternate payees under a qualified domestic relations order. The Department of Labor determined that disclosure should be made to current employees who are not currently contributing under the theory that the notice would serve as an important reminder of their eligibility to do so.

³ 29 U.S.C. § 1001 et. seq. ERISA is the acronym for the Employee Retirement Income Security Act of 1974, the federal law governing most employee benefit plans.

⁴ Plans which are not participant-directed and only permit participants to elect a participant loan should not be subject to these disclosures.

⁵ While not legally required to provide these disclosures, fiduciaries of exempted plans should consider the prudence of providing this information to their plan participants.

General Disclosure Requirements

In General: The disclosures must be written in a manner calculated to be understood by the average participant. Except where otherwise required, fees and expenses can be expressed as a monetary amount, a formula, a percentage of assets, or per capita charge.

Inclusion with Other Disclosures: The **Plan Related Information - Initial and Annual Disclosures** (*discussed below*) may be made as part of the summary plan description so long as it is distributed at the required frequency. The **Plan Related Information - Quarterly Disclosures** (*i.e., the actual expense information discussed below*) may be included as part of the required participant quarterly benefit statement.

Use of Electronic Technologies: These disclosures can be made using the DOL's existing regulations governing the use of electronic technologies. Although the requirements are quite specific, they are fairly easy to satisfy, at least with regard to current employees who use those technologies as a regular part of their day-to-day employment duties. In addition, interim guidance from the Department of Labor authorizes an alternative procedure for information not included as part of the quarterly benefit requirement for participants without worksite access as well as relaxed standards for information that may be disclosed as part of the quarterly benefit statement.⁶

Plan Related Information - Initial and Annual Disclosures

On or before the date on which a participant can first direct his or her account and at least annually thereafter, the plan administrator must provide the following information based on the latest information available to the plan:

General:

- An explanation of the circumstances under which participants may give investment instructions;
- An explanation of any specified limitations on those instructions, including restrictions on transfer to or from a designated investment alternative⁷;
- A description of or reference to plan provisions relating to the exercise of voting, tender and similar rights under a designated investment alternative and any restrictions on those rights;
- An identification of any designated investment alternatives offered under the plan;
- An identification of any designated investment managers; and

⁶ EBSA Technical Release 2011-03 (September 13, 2011).

⁷ A designated investment alternative is any investment option designated by the plan for investment by participants (*i.e.*, the core mutual fund line-up). It does not include a "self-directed brokerage account" or similar arrangements that enable participants to select investments beyond those designated by the plan.

- A description of any “self-directed brokerage accounts” or similar plan arrangements that permit participants to select investments beyond the designated investment alternatives.

Administrative Expenses:

- An explanation of any fees and expenses for general plan administrative services (e.g., recordkeeping, accounting, legal, etc.) which may be charged against participant accounts and are not reflected in the total operating expenses of any designated investment alternative, as well as the basis upon which those charges will be allocated (e.g., pro rata or per capita) or will affect the participant’s account.

Individual Expenses:

- An explanation of any fees or expenses that may be charged against the participant’s account on an individual rather than a plan-wide basis (e.g., participant loan fees, qualified domestic relations order fees, investment advice fees, brokerage window fees, commissions, front or back-end load or sales charges, redemption fees, transfer fees and similar expenses, and optional rider charges in annuity contracts) which are not reflected in the total annual operating expense of any designated investment alternative.

Investment Related Information - Initial and Annual Disclosures

Based on the latest information available to the plan, the plan administrator must provide to each participant on or before the date he or she can first direct his or her account and at least annually thereafter, the following information with regard to each designated investment alternative offered under the plan:

Identifying Information:

- The name of each designated investment alternative; and
- The type or category of the investment (e.g., money market fund, balanced fund [stocks and bonds], large-cap stock fund, employer stock fund, employer securities, etc.).

Performance Data:

- For each designated investment alternative with respect to which the return is not fixed (e.g., a mutual fund), the average annual total return⁸ of the investment for the 1-, 5-, 10-calendar year periods (or for life of the alternative, if shorter) ending on the date of the most recently completed calendar year, together with a statement indicating that an investment’s past performance is not necessarily an indication of how the investment will perform in the future.

⁸ To a large extent, the regulations incorporate Securities and Exchange Commission regulations to describe how investment performance and expense information, such as the “average annual total return,” must be calculated.

- For each designated investment alternative with respect to which the return is fixed or stated for the term of the investment (e.g., a guaranteed investment contract),⁹ both the fixed or stated annual rate of return and the term of the investment. If the issuer reserves the right to adjust the rate of return prospectively, the disclosure must specify the current rate of return, the minimum rate of return guaranteed under the contract, if any, and a statement advising participants that the issuer may adjust the rate prospectively and how to obtain (e.g., telephone or website) the most recent rate of return.

Benchmarks:

- For each designated investment alternative with respect to which the return is not fixed, the name and returns of an appropriate broad-based securities market index over the 1-, 5-, and 10-calendar year period (or for the life of the alternative, if shorter) for the same periods as the performance information is provided. The index cannot be administered by an affiliate of the issuer, its investment adviser, or a principal underwriter unless the index is widely recognized and used.

Fee and Expense Information—Investments Without a Fixed Return:

- The amount and description of each shareholder-type fee (i.e., fees charged directly against a participant's investment, such as commissions, sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, account fees, and purchase fees which are not included in the total annual operating expenses of any designated investment alternative) and a description of any restriction or limitation that may be applicable to the purchase, transfer, or withdrawal of the investment in whole or part (e.g., round trip, equity wash, or other restrictions);
- The total annual operating expenses of the investment expressed as a percentage (i.e., expense ratio);
- The total annual operating expenses of the investment for a one-year period expressed as a dollar amount for a \$1,000 investment;
- A statement indicating that fees and expenses are only one of several factors that a participant should consider when making investment decisions; and
- A statement that the cumulative effect of fees and expenses may substantially reduce the growth of a participant's account and that participants may visit the Department of Labor Employee Benefits Security Administration's website for an example demonstrating the long-term effects of fees and expenses.

Fee and Expense Information – Fixed Return Investments:

- The amount and description of any shareholder type fees and a description of any restriction or limitation that may be applicable to a purchase, transfer or withdrawal of the investment in whole or in part.

⁹ The regulations treat money market and stable value funds as investments without a fixed rate of return, in contrast to guaranteed investment contracts and certificates of deposit, which are considered to have a fixed rate of return.

Internet Website Address: An Internet website address that is sufficiently specific to provide participants access to the following information regarding each designated investment alternative:

- The name of the issuer;
- The alternative's objectives or goals;
- The alternative's principal strategies (including a general description of the types of assets held by the investment) and principal risks;
- The alternative's portfolio turnover rate;
- The alternative's performance data updated on at least a quarterly basis, or more frequently if required by applicable law; and
- The fee and expense information described in the preceding two subsections.

Glossary:

- A general glossary of terms to assist participants in understanding the designated investment alternatives, or an Internet website address that is sufficiently specific to provide access to a glossary along with a general explanation of the purpose of the address.

Annuity Options:

- If a designated investment alternative is part of a contract, fund or product that permits participants to allocate contributions toward the future purchase of a stream of retirement income payments guaranteed by an insurance company, the information described below with respect to the annuity option to the extent such information is not otherwise included in the investment related fees and expenses described above.

Disclosure Format for Investment Related Information

The **Investment Related Information** described in the preceding section must be furnished in a chart or similar format that is designed to facilitate the comparison of that information for each designated investment alternative. It must include the date and a statement indicating the name, address and telephone number of the person to contact for the information to be provided upon participant request; it must also include a statement that additional investment related information, including current performance information, is available at the listed website address; and it must include a statement indicating how to request, free of charge, paper copies of the website information required for annuity options and fixed-income investments (*discussed below*).

The regulations provide a model format, which, if accurately completed for each designated investment alternative, will satisfy the comparative format requirement.¹⁰ While use of the model format is not mandatory, the best practice will be to use it absent some strong countervailing reason. Additional information may be added to the disclosure so long as it is not inaccurate or misleading. For example, it would be permissible to also include “net” total annual operating expense information to reflect the fees charged after any fee waivers or reimbursements by the alternative’s investment manager.

Plan Related Information - Quarterly Disclosures

At least quarterly, the plan administrator must provide each participant with a statement that describes:

Administrative Expenses:

- The dollar amount of administrative fees and expenses that were actually charged during the preceding quarter to the participant’s account for such services, whether by liquidation of shares in the account or the deduction of dollar amounts;
- A description of the services to which the charges relate (e.g., plan administration, including recordkeeping, accounting services, legal, etc.); and
- If applicable, an explanation that in addition to these fees and expenses, some of the plan’s administrative expenses for the preceding quarter were paid from the total 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, etc.).

Individual Expenses:

- The dollar amount of the individual fees and expenses that were actually charged during the preceding quarter to the participant’s account for such services whether by liquidation of shares in the account or the deduction of dollar amounts; and
- A description of services to which the charges relate (e.g., loan processing fees).

Special Disclosure Timing and Content Rules

“Annually” and “Quarterly”:

The requirement that disclosures be made annually or quarterly are not necessarily tied to a particular calendar year or quarter. For example, “at least annually” means that it must be made at least once in any 12-month period without regard to whether the plan operates on a calendar or fiscal year basis. Similarly, “at least quarterly” means at least once in any three-month period, without regard to whether the plan operates on a calendar or fiscal year basis.

¹⁰ The model format can be found at: <http://webapps.dol.gov/FederalRegister/PDFDisplay.aspx?DocId=24323> starting at page 34 of the PDF version.

Disclosures Before First Investment:

With respect to the **Plan Related Information** disclosures, the obligation to provide information on or before the first investment will be deemed satisfied by providing the participant the most recent annual disclosure and any subsequent updates to that information (*see Updates/Changes in Information subsection below*). Similarly, with respect to the **Investment Related Information** disclosures, the obligation to provide information on or before the first investment will be deemed satisfied if the participant is provided the most recent annual disclosure made.

Updates/Changes in Information:

If there is a change in the **Plan Related Information** disclosures, each participant must be furnished a description of the change at least 30 but not more than 90 days in advance of the effective date of the change, unless the inability to provide advance notice is due to events that were unforeseeable or circumstances beyond the control of the plan administrator. In that case, the notice must be furnished as soon as reasonably practicable. The regulations contain no materiality standard for changes so this means that any changes in this information will require updated disclosures.

Disclosures to be Provided Subsequent to Investment:

To the extent voting, tender or similar rights are passed through to participants under the terms of the plan, subsequent to the investment in a designated investment alternative the plan administrator must provide any materials provided to the plan relating to the exercise of those rights relating to a particular designated investment alternative.

Disclosures Provided Upon Participant Request:

The plan administrator must provide the following information upon the participant's request:

- Copies of prospectuses (or, alternatively, any short-form or summary prospectus permitted by the Securities and Exchange Commission), or similar documents relating to designated investment alternatives that are provided by entities that are not registered under the Securities Act of 1933 or the Investment Company Act of 1940.
- To the extent provided to the plan, copies of any financial statements or reports and similar materials relating to the plan's designated investment alternatives.
- A statement of the value of a share or unit of each designated investment alternative as well as the date of valuation.
- A list of assets comprising the portfolio of each designated investment alternative which constitutes "plan assets" and the value of each such asset (or the proportion of the investment which it comprises).

Special Rules for Particular Investment Options

The special rules described below apply solely for purposes of the **Investment Related Information** disclosures:

Annuity Options:

In the case of a designated investment alternative that is a contract, fund or product that permits participants to allocate contributions toward the current purchase of a stream of retirement income payments guaranteed by an insurance company, the plan administrator must provide each participant with the following information with respect to each such option in lieu of the **Investment Related Information** (*up to the Glossary subsection*):

- The name of the contract, fund or product;
- The options, objectives and goals (e.g., to provide a stream of fixed retirement income payments for life);
- The benefits and factors that determine the price (e.g. age, interest rates, form of distribution) of the guaranteed income payments;
- Any limitations on the participant's ability to withdraw or transfer amounts allocated to the option (e.g., lock-ups and any fees or charges applicable to withdrawals or transfers);
- Any fees that will reduce the value of amounts allocated by participants to the option, such as surrender charges, market value adjustments, and administrative fees;
- A statement that guarantees of an insurance company are subject to its long-term financial strength in claims-paying ability; and
- An Internet website address that is sufficiently specific to provide participants with access to: the name of the option's issuer and of the contract, fund or product; a description of the option's objectives or goals; a description of the option's distribution alternatives/guaranteed income payments (e.g., payments for life, payments for a specified term, joint and survivor payments, optional rider payments), including any limitations on the right of a participant to receive such payments; a description of the costs and/or factors taken into account in determining the price of benefits under an option's distribution alternatives/guaranteed income payments (e.g., age, interest rates, other annuitization assumptions); a description of any limitations on a participant's right to withdraw or transfer amounts allocated to the option and any fees or charges applicable to the withdrawal or transfer; and a description of any fees that will reduce the value of amounts allocated by participants to the option (e.g., surrender charges, market value adjustments, administrative fees).

Fixed Rate Investments:

In lieu of the internet website address disclosures described above, in the case of a designated investment alternative with respect to which the return is fixed for the term of the investment, the plan administrator must provide an Internet website address that is sufficiently specific to provide participants with access to: the name of the alternative's issuer; the alternative's objectives or goals (e.g., to provide stability of principal and guarantee of minimum rate of return); the alternative's performance data (*described above*) updated at least quarterly, or more frequently if required by applicable law; and the alternative's fee and expense information described (*described above*).

Employer Securities:

Extensive alternative disclosures apply in the case of a designated investment alternative designed to invest in qualifying employer securities, including a disclosure of the importance of maintaining a well-balanced and diversified portfolio.

Target Date or Similar Funds:

The Department of Labor reserved for future regulations the additional disclosures that will be required for target maturity funds and similar funds (i.e., funds in which the investment strategy is tied to a participant's projected retirement age).

Interplay with ERISA Section 404(c) Protection

Under current law, fiduciaries in plans which contain certain investment options and in which participants are provided specific disclosures are protected from any loss which is a result of a participant's exercise of investment direction. Qualification as an "ERISA Section 404(c) plan" is totally voluntary but many plan sponsors and fiduciaries have chosen to avail themselves of the ERISA Section 404(c) protection by structuring their plans with the requisite investment options and by satisfying the necessary participant disclosures and other regulatory requirements. Issuance of the participant disclosure regulations will make compliance with the ERISA Section 404(c) requirements much easier as most of the disclosure obligations which were previously necessary to satisfy ERISA Section 404(c) are now mandated under the new regulations regardless of whether the plan is intended to be an "ERISA Section 404(c) plan."

Consequences of Failure to Provide Disclosures

The regulations provide that the investment of plan assets is a fiduciary act governed by the fiduciary standards of ERISA. Among those standards is the obligation of fiduciaries to act prudently and solely in the interest of plan participants and beneficiaries. The Department of Labor interprets this requirement to impose an obligation to ensure that participants and beneficiaries who are responsible for the investment of their account are made aware of their rights and responsibilities and are provided with sufficient information to make informed investment decisions. Compliance with the regulations, therefore, is deemed to constitute satisfaction of that fiduciary duty.

It naturally follows that a failure to provide the required disclosures will constitute a breach of fiduciary duty. A fiduciary is personally liable to the plan for losses arising from a breach of fiduciary duty. Stated a little differently, a fiduciary is personally liable to make participants “whole” for the consequences of his or her breach even if she did not personally benefit. Of course, a participant would still have to prove damages resulting from the breach of fiduciary duty. In addition, a breach of fiduciary duty could subject the fiduciary to penalties imposed by the Secretary of Labor as well as other DOL enforcement action.

Here, the regulatory obligations are imposed upon the “plan administrator.” It should be noted that even where the employer/plan sponsor itself is designated as the plan administrator, other persons, including officers, directors and managers of the entity, could be considered fiduciaries when they act on behalf of the employer/plan sponsor.

Special rules apply to protect plan administrators who reasonably and in good faith rely upon information provided by a plan service provider or the issuer of a designated investment alternative. In those instances, the plan administrator will be protected from liability for the completeness and accuracy of the information provided to participants. Furthermore, special rules apply where information needed to calculate the 5 - and 10 - year investment returns is not readily available. In that case, estimates may be used but participants must be apprised that estimates are being utilized.

Concluding Thoughts and Suggested Plan Sponsor and Fiduciary Actions

For many plans, these regulations will cause a dramatic change from past practice in the amount of information provided to participants. Plan administrators should therefore begin their planning now to address how they will comply with these new mandates by the effective date and thereafter. At the outset, responsible plan administrators will want to start a dialogue with their recordkeeper, investment advisor, and other plan service providers to determine the level of assistance those providers will be able to provide, especially with regard to the quarterly actual expense reporting and the website maintenance requirements. Once the commitment from the plan service providers is obtained, the written service agreement between the parties should be updated as necessary to reflect that allocation of responsibilities.

Plan administrators will also want to begin consideration of the procedures that will be needed to provide notification to eligible, but non-participating employees.

Plans administrators who are not presently using e-mail and other electronic technologies to make participant disclosures would be wise to determine whether the regulatory prerequisites to use of those technologies can be satisfied and whether the use of electronic disclosures is appropriate for all or part of the required recipients.

Given the volume of information that will be required to be provided, plan sponsors and administrators may want to consider the desirability of distributing a “heads-up” notice in advance of the regulatory deadline to alert participants to the upcoming disclosures.

Plan sponsors and plan administrators would also be prudent to prepare for anticipated participant questions once the disclosures are made. A recent AARP study reflected that 71% of those polled were unaware that they were paying *any* fees in their 401(k) plan and those that did know that fees were being charged were mostly unfamiliar with the amount being charged or their impact on their retirement savings. If this study is indicative of a sponsor's plan participants, a prudent sponsor would want to begin anticipating questions that may arise once participants review these disclosures and how those questions will be answered.

Finally, plan fiduciaries who have not recently undertaken a review of their plan, including a review of fees and expenses, should consider doing so at this time. Given the immediacy of the participant disclosure deadline, plan sponsors and fiduciaries would be well-advised to start the process now to review their plan so that changes in the fund line-up (or even changes to less expensive providers or platforms), if necessary, can be implemented in advance of the required disclosures.

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