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U.S. Department of Labor Releases FAQs on Implementation of Participant-Level Fee Disclosures

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On May 7, 2012, the U.S. Department of Labor ("DOL") published guidance in the form of frequently asked questions ("FAQs") relating to the participant-level fee disclosure requirements contained in the final regulations issued under Sections 404(a) and 404(c) of the Employee Retirement Income Security Act of 1974 ("ERISA") (the "Participant Disclosure Regulation").

FAQ Highlights

Plan administrative expenses. The FAQs expand on the level of detail that should be provided when disclosing fees and expenses for administrative services, and clarifies that if administrative expenses are not charged against a participant or beneficiary's account and are instead paid by the employer, they generally are not required to be disclosed.

Total annual operating expenses. The FAQs clarify how to report total annual operating expenses for certain designated investment alternatives other than mutual funds, such as unregistered funds, funds of funds, managed accounts that invest in mutual funds, and stable value funds.

Brokerage windows. The FAQs explain that brokerage windows, self-directed brokerage accounts, and other similar plan arrangements are not considered "designated investment alternatives" themselves. However, if a significant number of participants and beneficiaries select otherwise non-designated investment alternatives through the window, the plan fiduciary has an affirmative obligation to examine those alternatives to determine whether one or more should be treated as "designated" for purposes of the regulation.

Web site disclosures. The FAQs indicate that the final rule should be interpreted to require that the average annual total returns for fixed return investment alternatives required to be disclosed on a Web site must be measured for 1, 5 and 10 calendar year periods ending on the date of the most recently completed calendar quarter (as opposed to the most recently completed calendar year).

Transition relief. If initial disclosures made when the rules are in effect do not reflect the new information contained in the FAQs, the DOL stated that, for enforcement purposes only, it will take into account whether plan administrators and covered service providers have acted "in good faith based on a reasonable interpretation of the new regulations" and established a plan for complying with the requirements of the new guidance in future disclosures.

Background

On October 20, 2010, the DOL issued the Participant Disclosure Regulation, which established new fiduciary requirements for disclosures to participants and beneficiaries in participant-directed individual account plans, such as section 401(k) plans. The Participant Disclosure Regulation generally requires administrators to disclose to plan participants and beneficiaries who have the right to direct the investment of assets held in their plan accounts various plan-related and investment-related information, including fees and expenses that may be charged against their plan accounts. (See Proskauer's client alert on the Participant Disclosure Regulation here).

In addition, on February 3, 2012, the DOL published final regulations under section 408(b)(2) of ERISA requiring certain covered service providers to furnish specific fee information to plan administrators that will facilitate their compliance with the Participant Disclosure Regulation. Accordingly, the DOL's FAQs also serve as guidance concerning the fee disclosure requirements under 408(b)(2). (See Proskauer's client alert on the 408(b)(2) fee disclosure rules here).

The following discussion summarizes the guidance provided by the DOL, organized by topic.

Scope: Covered Individual Account Plans

The FAQs clarify that plans with both participant-directed and trustee-directed investments must satisfy the plan-related and investment-related disclosure requirements for the participant-directed investments, but need not provide investment-related information for the trustee-directed investments.

The FAQs also explain that, while the Participant Disclosure Regulation applies to ERISA-covered tax-sheltered annuity programs under Internal Revenue Code Section 403(b), there is a limited exception if the following conditions are satisfied: (i) the contract or account was issued to a current or former employee before 2009, (ii) the employer ceased to contribute to the contract or account (or to have any obligation to make contributions) before 2009, (iii) all of the rights and benefits of the contract or account are legally enforceable by the individual owner of the contract without employer involvement, and (iv) the individual owner is fully vested in the contract or account. In that case, the DOL will not take enforcement action against plan administrators who reasonably determine that obtaining the information necessary to meet the investment-related disclosure requirements with respect to any designated investment alternative that is an annuity contract or custodial account described in Section 403(b) would be impracticable or impossible.

Disclosure of Plan-Related Information: General

The FAQs provide that plan administrators choosing to furnish plan-related and investment-related information together in a single document do not need to duplicate the identification of the designated investment alternatives under each disclosure. Such duplication is only required if the plan separately discloses plan-related and investment-related information.

The FAQs also clarify that the requirement under the regulation that a "designated investment manager" be identified refers to an ERISA Section 3(38) investment manager designated by a plan fiduciary and made available to participants and beneficiaries to manage all or a portion of their individual accounts.

Disclosure of Plan-Related Information: Administrative Expenses

The FAQs make clear that the sufficiency of the fee and expense disclosures (i.e., whether they are described in sufficient detail to be understood by the average plan participant) depends on the particular facts and circumstances, including whether the fees and related services are known at the time of disclosure. When fees are known at the time of disclosure, the plan administrator must disclose the cost of the service to each participant and the plan's allocation method (e.g., pro rata or per capita). When the services or fees are not known at the time of the disclosure, the explanation must convey the known facts and circumstances, such as how fees and expenses will be paid for any services the plan administrator reasonably expects the plan to use. In that case, it is permissible (but not necessary) for the administrator to estimate the expense amount based on the plan's fees for the prior year if the administrator has no reason to believe they will be substantially different.

Further, when certain service provider fees are offset by any revenue sharing payments received from the plan's designated investment alternatives, the plan administrator should state the possibility and likely effect of any fee reduction in the disclosures, but should still treat the situation as if the fees are known at the time of disclosure (i.e., the fees and method of allocation must still be disclosed, even where fees will likely be reduced or eliminated by the fee sharing arrangement). The FAQs also explain that any administrative expenses paid from the general assets of the sponsoring employer, or paid from plan assets that have been forfeited, need not be disclosed because such expenses are not charged against the individual accounts of participants. Disclosure would not be necessary even if the plan document permits participant accounts to be charged for expenses, but the plan has never historically done so.

The FAQs further provide that fees and expenses charged against individual accounts, whether by liquidating shares of the account or by deducting dollars, must be disclosed as plan-related information (i.e., as administrative expenses or individual expenses). A plan administrator does not have the discretion to disclose the charges as part of the total annual operating expenses of the designated investment alternative.

The Participant Disclosure Regulation requires that, where applicable, disclosures include a statement that 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 (for example, pursuant to a revenue sharing arrangement). The regulation does not require identification of the specific plan administrative expenses paid or the specific designated investment alternative making the payment. However, the FAQs note that the required statement of quarterly payments applies even if all administrative expenses were paid from a revenue sharing or other arrangement and no fees were charged against participants' individual accounts. Also, the plan may include the revenue sharing explanation in each quarterly statement, even if revenue sharing payments from a designated investment alternative are made on a semiannual and not a quarterly basis.

Disclosure of Plan-Related Information: Brokerage Windows

The FAQs provide important information about the level of detail needed to satisfy the disclosure requirements with respect to "brokerage windows," "self-directed brokerage accounts," and other similar arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan. While the FAQs do not explain how detailed the disclosure needs to be, they do provide the following guidelines:

(1) At a minimum, the description must provide sufficient information to enable participants and beneficiaries to understand how the window, account, or arrangement works, including how and to whom instructions should be given, any account balance requirements, any restrictions or limitations on trading, how the arrangement differs from the plan's designated investment alternatives, and whom to contact with questions.

(2) The plan administrator must also explain any fees and expenses that may be charged against a participant's account on an individual (rather than a plan-wide) basis in connection with the window, account, or arrangement, including any fees needed to open or access the account or to stop or cancel the account, any ongoing expenses necessary to maintain the account (including inactivity and minimum balance fees), and any commissions or fees charged in connection with the purchase or sale of a security. Where fees charged on an individual basis are unknown or variable, the requirements of the Participant Disclosure Regulation should be satisfied by a general statement that such fees exist and may be charged against the individual account of a purchasing or selling participant, and directions as to how the participant can obtain information about such fees. Further, the statement should advise participants to ask the provider of the window, account, or arrangement about such fees before purchasing or selling such security.

(3) The plan administrator must disclose to participants the dollar amount of expenses actually charged against their individual accounts, and a description of the services to which they relate, during the preceding quarter in connection with any window, account, or arrangement.

The FAQs also clarify that plans providing brokerage windows, self-directed brokerage accounts, or similar arrangements must disclose the required annual fee and expense information to all participants and beneficiaries and not just those who have affirmatively elected to use such arrangements, even if only a small percentage of the plan's participants have so elected. Similarly, participants are not required to take a loan in order to receive disclosures about the fees and expenses associated with plan loans.

Investment-Related Disclosures for Closed Investments

The FAQs provide that investment-related disclosures are required for designated investment alternatives that are closed to new investments, but in which participants maintain prior investments. However, the plan administrator may choose to provide the disclosures only to those participants and beneficiaries that remain invested in the closed investment alternative.

Investment-Related Disclosure of Benchmark Information

The DOL has previously recognized a plan administrator's ability to furnish blended benchmark returns for designated investment alternatives that are balanced funds. The FAQs reiterate the permissibility of blending more than one broad-based securities market index and provide that the plan administrator may use the target asset allocation of the designated investment alternative (e.g., 50% stocks, 50% bonds) to determine the weightings of the indexes used in creating the additional benchmark, provided that the target is representative of the actual holdings of the investment alternative.

Investment-Related Web Site Disclosures

The FAQs address various alternative options available to plan administrators in complying with the Web site address requirement, including contracting with a third party administrator or recordkeeper to establish and maintain a Web site, or using Web site addresses provided by issuers of its designated investment alternatives. In so doing, the administrator may reasonably and in good faith rely on the information provided by a plan service provider or issuer in meeting the Web site requirement.

In addition, the FAQs clarify that (i) the Web site landing page need not include all of the required supplemental investment-related information regarding a designated investment alternative, but must be sufficiently specific to lead the participant to such information, and (ii) the Web site must provide return information for a plan's designated investment alternatives updated on at least a quarterly basis; this requirement includes performance data, such as the average annual total return for 1-, 5-, and 10-year periods ending on the date of the most recently completed calendar quarter.

The FAQs emphasize that information made available on the Web site must be accurate and updated as soon as reasonably possible following a change.

Glossary Requirement

As clarified in the FAQs, the DOL currently has no intention of publishing a sample glossary. However, the FAQs list two examples of glossaries submitted by industry groups: one developed by the American Bankers Association (which can be accessed here), and one developed by the SPARK Institute and the Investment Company Institute and endorsed by the American Benefits Council, among other groups (which can be accessed here).

Disclosure Through Comparative Format

The FAQs confirm that the Participant Disclosure Regulation does not require plan administrators to provide a unified comparative chart; instead, they may choose to furnish multiple comparative charts as supplied by the plan's various service providers. However, the charts must be supplied at a single time in a single mailing or transmission to facilitate a comparison among investment alternatives under the plan.

Further, the FAQs state that the Participant Disclosure Regulation does not require the plan administrator to furnish more than one comparative chart annually, even if there is a change to a designated investment alternative's fee and expense information after the disclosure.

For designated investment alternatives with variable rates of return, a plan administrator may provide more recent average annual total return information on the comparative chart than the end of the most recently completed calendar year (such as the most recently completed calendar month or quarter), but must use the same ending date for all designated investment alternatives and associated benchmark information.

In addition, although the model comparative chart furnished by the DOL as part of the final Participant Disclosure Regulation includes "since inception" performance and benchmark information for designated investment alternatives, the FAQs explain that a plan administrator is only required to furnish such performance data for investment alternatives that have been in existence for less than 10 years.

Disclosure of Investment-Related Information Upon Request

For designated investment alternatives that are not registered under the Securities Act of 1933 or the Investment Company Act of 1940, the Participant Disclosure Regulation requires the plan administrator to furnish copies of prospectuses or, alternatively, the administrator may provide short-form or summary prospectuses, which must reflect the latest information available to the plan administrator.

The regulations also require "similar" documents to be provided for all other designated investment alternatives under the plan. Whether or not a document is "similar" will depend on the facts and circumstances. The FAQs note, for example, that in connection with a bank collective investment fund, bank fund facts sheets ordinarily may be used to satisfy the "short-form or summary prospectus" disclosure requirement. In cases where such documents do not exist, copies of the materials used by a plan fiduciary to prudently select and monitor designated investment alternatives ordinarily would satisfy the disclosure requirement.

Form of Disclosure

The FAQs clarify that plan administrators are permitted to furnish the required disclosures along with, or as part of, other documents, rather than as stand-alone documents.

Definitions

Designated Investment Alternatives: Managed Accounts and Brokerage Windows

The FAQs explain that a "designated investment alternative" does not include the option for participants to appoint a designated investment manager to allocate the assets in their individual accounts among the plan's designated investment alternatives based on a particular investment strategy. However, the plan must still identify the designated investment manager and all information regarding the fees associated with the service.

The FAQs also note that for plans with model portfolios that merely allocate account assets among specific investment alternatives (and in which the participants do not acquire an equity or similar interest in an entity that invests in the designated investments), the portfolios themselves will ordinarily not be treated as a "designated investment alternative," although the plan administrator must still explain how the model portfolio functions and how it differs from the plan's designated investment alternatives. [1]

Brokerage windows, self-directed brokerage accounts, and other similar plan arrangements are not considered "designated investment alternatives" themselves. Accordingly, while plan administrators are required to disclose plan-related information regarding these arrangements, the investment-related disclosures do not apply to them.

However, while a "designated investment alternative" will only exist where the plan has specifically identified certain investment alternatives as available under the plan, the FAQs also warn that a failure to designate a "manageable number of investment alternatives" under the plan raises questions about whether the plan fiduciary has satisfied its obligations under Section 404 of ERISA.

If a plan offers non-designated investment alternatives through a brokerage window or similar arrangement and a "significant number" of participants and beneficiaries select these alternatives, the plan fiduciary has an affirmative obligation to examine these alternatives and determine whether one or more should be treated as designated for purposes of the regulation.

The FAQs further explain that, pending further guidance, the DOL will not require plans with platforms holding more than 25 investment alternatives to treat all investment alternatives as "designated investment alternatives" for purposes of the Participant Disclosure Regulation, as long as the plan administrator: (1) 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 Section 404(c) regulations; and (2) 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.

Total Annual Operating Expenses

The FAQs offer several points of clarification to assist plan administrators in calculating the total annual operating expenses for both registered and unregistered investment alternatives.

They explain that a plan offering a registered fund-of-funds as a designated investment alternative must include, in its calculation of the annual operating expenses, the acquiring fund's total annual operating expenses (proportionately reflecting the annual operating expenses of all funds in which it invests), in accordance with the required Securities and Exchange Commission Form N-1A. The same principles apply to unregistered investment alternatives that invest in acquired funds or trusts. While the Participant Disclosure Regulation offers no specific requirement for how often such alternatives must calculate their net asset values in order to determine their average annual net asset value, an unregistered designated investment alternative ordinarily will be in compliance with the regulation if it calculates its net asset value at least monthly in order to determine its average net asset value for the year.[2]

Paragraph (h) of the Participant Disclosure Regulation sets forth two methodologies for calculating the total annual operating expenses of an investment alternative, depending on whether it is registered or unregistered. The FAQs clarify that a designated investment alternative is not "registered" even though it invests solely in a mutual fund that itself is registered under the Investment Company Act of 1940. It therefore must use the methodology for unregistered investment alternatives, which requires the plan's general administrative expenses charged to the designated investment alternative to be reflected in the alternative's total annual operating expenses, and consequently the alternative's average annual total return.

Finally, the FAQs provide that where a fund expense that is paid from the assets of a designated investment alternative reduces the alternative's rate of return, the expense must be disclosed by including it in the total annual operating expenses of the designated investment alternative. The FAQs offer the following example: a plan offers a stable value fund as one of its designated investment alternatives. The fund manager purchases an insurance contract designed to smooth the rate of return of the alternative's underlying fixed income investments and pays the expense from the assets of the fund, reducing the alternative's rate of return. The cost of the insurance must be disclosed as part of the total annual operating expenses of the investment alternative.

Dates: Transitional Rules

As previously set forth in the Participant Disclosure Regulation, administrators must furnish the initial disclosures to participants and beneficiaries by August 30, 2012 (60 days after the July 1, 2012 effective date of the Section 408(b)(2) fee disclosure regulations). However, if the first day of the first plan year beginning after November 1, 2011 is later than July 1, 2012, then initial disclosures must be provided no later than 60 days after the first day of the plan year.

The first quarterly disclosures are required for most plans no later than November 14, 2012 (45 days after the end of the third quarter in which the disclosure is required). The initial quarterly statement must only reflect the fees and expenses deducted for the calendar or plan-year quarter covered by the statement and not fees and expenses deducted prior to the third quarter.

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IRS Circular 230 Disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this document is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code, or (ii) promoting, marketing, or recommending to another party any transaction or matter that is contained in this document.

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[1] Note that a plan administrator has the option to include additional information in the comparative chart and may treat model portfolios as designated investment alternatives, as long as the information is not inaccurate or misleading.

[2] Designated investment alternatives registered under the Investment Company Act of 1940 must value their net assets at least monthly in order to calculate their average net assets for the year in Form N-1A.

Related Professionals

- **Pamela A. Onufer**
  Special Pension Investment Counsel
- **Adam W. Scoll**
  Partner
- **Robert M. Projansky**
  Partner
- **Steven D. Weinstein**
  Partner
- **Ira G. Bogner**
  Managing Partner