REGULATION

PARTICIPANT DISCLOSURE REGULATIONS: CHALLENGES FOR RECORDKEEPERS

BY BRUCE L. ASHTON, APM; FRED REISH, APM; AND JOSHUA WALDBESER

The duty to make the disclosures under the new regulations falls on the plan administrator or sponsor but recordkeepers are the ones preparing the notices to participants and maintaining information on their websites. While this isn't news, there are challenges that recordkeepers face that may not be well-understood.

In October 2010, the Department of Labor (DOL) issued a final regulation requiring broad disclosures of fees, expenses, and certain plan and investment-related information to the participants in covered plans.[1] Covered plans are defined contribution plans, such as 401(k), ERISA-covered 403(b), and other defined contribution plans in which the participants are able to direct the investment of their accounts into "designated investment alternatives" (DIAs).[2] (This means that the disclosures aren't required in defined benefit pension plans or pooled defined contribution plans in which the trustee or an investment manager makes all

investment decisions.)

The purpose of the regulation, which was issued under Section 404 of ERISA, is to ensure that defined contribution plan participants are aware of charges against their accounts and information about the investments available under the plan. While participants can't be required to direct the investments of their accounts, if they choose to do so the regulation is designed to provide them with information on how to direct the investments and enable them to make informed investment decisions.

The responsibility under ERISA for providing the required information and materials falls on the plan administrator [as defined in ERISA Section 3(16)], but as a practical matter, carrying out this responsibility will almost always be delegated to a plan's recordkeeper, since it's the entity with access to information and systems that capture and retain the information needed to make the disclosures. Thus, while the recordkeeper isn't bound by ERISA to comply with the regulatory requirements, it may have contractual obligations to do so or may elect to undertake to provide the disclosures as a service to maintain its client relationships. The purpose of this article is to address the impact of the regulation on recordkeepers, and in particular, to identify some of the administrative challenges they face.

THE 404(a)-5 REGULATION

The disclosures required by the regulation fall into two general categories: plan-related information and investment-related information. The plan-related information includes (i) general information about the right to self-direct the participant's account and information identifying the DIAs or describing self-directed brokerage account arrangements that exist under the plan, (ii) information about administrative expenses borne by the participant's account, and (iii) individual expenses associated with transactions involving a participant that aren't plan-wide expenses (such as those related to taking a participant loan or obtaining approval of a qualified domestic relations order). Disclosure of the plan-related information must be made before a participant can begin directing plan investments, and annually thereafter. The first such notice must be given August 30, 2012.

The required "investment-related" information relates only to the plan's DIAs.[3] The regulation requires that information about the type of investment; performance history over the previous one, five and 10 years; applicable benchmarks, expense ratios, other expenses; and purchase, withdrawal, or transfer restrictions be provided.

The regulation specifies that this information must be in chart or other comparative format. The information must also be provided before the participant may first direct his account and annually thereafter. [Note that under the final service provider disclosure regulation under ERISA Section 408(b)(2), recordkeepers and broker/dealers are required to provide this information about DIAs offered by the plans to which they provide services at the time the service arrangement is entered into or, if the DIAs aren't known at that date, as soon as the DIAs are designated. This issue is discussed later in this article.]

Other information must be available on an Internet website or furnished on request, including (i) prospectuses and certain other materials that must be furnished only upon a participant's request, and (ii) certain materials regarding voting or tender rights in a DIA, such as an employer stock account, to the extent the rights flow through to the plan's participants.[4]

Beginning no later than November 14, 2012, participants must be provided with quarterly statements of the administrative and/or individual fees and expenses that were charged to their accounts in the previous quarter. This includes descriptions of the services that gave rise to the fees and, if applicable, explanations that some administrative expenses were paid through the operating expenses of one or more DIAs, such as through 12b-1 fees or revenue sharing arrangements. Investment-related information isn't required to be disclosed quarterly.

The investment-related information probably creates the most administrative challenges for recordkeepers, especially for certain types of investments such as model asset allocation portfolios (to the extent they're treated as DIAs). It would appear that the information available on request (which will generally be made available on a website) doesn't present significant burdens.

DISCLOSURE OF RECORDKEEPING EXPENSES

One of the plan-related disclosures that must be furnished to participants is a description of administrative expenses, such as recordkeeping expenses, that may be charged to all accounts in a plan. In addition, actual recordkeeping and other administrative fees that are either deducted directly from plan accounts or paid by liquidating investment shares must be described in the quarterly fee statements, along with an explanation of the underlying services provided for those fees.

Some plan sponsors may be concerned that their participants aren't aware they're paying administrative expenses, through their accounts or otherwise, even though this is both permissible and common practice. These sponsors may be concerned that the disclosures could lead to participant claims of wrongdoing or disruptions in the workplace. To avoid this, some plan sponsors are looking at alternative ways to avoid directly charging these expenses.

If these types of expenses are paid through the operating expenses of one or more DIAs—that is, paid through

revenue sharing so that the fees aren't deducted directly from participant accounts or paid through liquidation of investment shares—the quarterly dollar amount disclosure isn't required. Instead, the participants must be provided with 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 DIAs (*e.g.*, through revenue sharing arrangements, 12b-1 fees, sub-transfer agent fees, etc.) without specifying the amount.

Other arrangements through which this type of disclosure would be possible include using bank collective investment trusts (CITs) with recordkeeping fees "built in," group annuity contracts where recordkeeping expenses can be spread across underlying accounts as operating expenses or paying for administrative expenses through expense recapture accounts or out of forfeitures.

The choice of whether and how to have participants pay administrative costs is a fiduciary decision that must be made by the responsible plan fiduciary. It's up to the plan sponsor to decide whether to embark on an education program to make sure that participants understand the expenses that are disclosed in their quarterly statements or to change to other investments through which the expenses can be absorbed through the expense ratios of the investments. That said, recordkeepers may find it helpful to discuss this issue with their clients to understand the client's objectives and to assess whether alternative approaches to this disclosure requirement are available and appropriate.

OBTAINING INFORMATION RELATED TO DIAs

The investment-related information to be furnished to participants includes a chart of the disclosures regarding each DIA's historical performance, operating expenses, fees, and certain other information. Keep in mind that the disclosures under 404(a)(5) are required in order for the plan administrator to satisfy its fiduciary duty. Failure to make the 404(a)(5) disclosures would be a fiduciary breach. This fact may create additional challenges and concerns to the extent a recordkeeper contractually undertakes to assist the fiduciaries in fulfilling this obligation, especially in the context of the investment-related information.

Because of the regulatory environment in which they operate, most of the information should be readily obtainable for mutual funds offered on recordkeeping platforms. That is, the securities laws already require periodic disclosures of much of the information needed to make the investment-related disclosures for DIAs under the regulation (although in a different format). For other types of investments, however, the data may not be as readily available. In the case of managed accounts, CITs, and especially asset allocation models that constitute DIAs, obtaining the necessary data will likely prove difficult without cooperation from the issuer. In some cases, it may even be impossible.

Consider, for example, an asset allocation model composed of the investment options available under the plan. It's not clear that these models would be considered DIAs, since the DOL hasn't issued guidance on this issue, and some commentators have suggested that they wouldn't be considered DIAs. But where a participant is able to choose a model on the recordkeeper website, click on the link and have her account automatically populated with the allocation called for in the model (as opposed to manually having to make the allocations in the account), it's not difficult to imagine that the DOL would determine the model to be a DIA.[5]

Assuming this to be the case—and assuming the model is composed of mutual funds—the performance, expense, and other data of each fund included in the model will be reasonably available. But consolidating the information into a disclosure chart for the model itself will be difficult at best.

If the information is unavailable, the recordkeeper has relatively few options. It can inform its client, the plan administrator, that the information can't be obtained and leave it to the client to decide what to do. From a client-relations perspective, this is hardly a satisfactory approach.

Another option is to inform the investment provider that it can't recordkeep the portion of the plan that's attributable to assets in those DIAs. This is also a less than ideal solution, since the creator of the model (the "investment provider" for this purpose) may well be the plan's financial advisor, with whom the recordkeeper has a long-standing and beneficial relationship.

In the absence of regulatory guidance—and there's no indication of when or if such guidance will be forthcoming—it appears that the only reasonable approach is to make a good faith effort to comply, though there's no assurance this approach will be accepted by the DOL or ultimately by the courts.

If the recordkeeper decides to proceed on this path, it should do so on a collaborative basis with its client and the plan adviser, so that the affected parties are informed of the decision and possible consequences. It would also appear to be advisable for the disclosures to the participants to include an explanation of the basis on which the information was developed, especially in light of the stated goal of the regulation—to provide participants with information they need to make informed decisions.

It would also be advisable to review the provisions of the recordkeeping contract related to providing the participant disclosure services. It's worth noting that the service provider disclosure regulation

under Section 408(b)(2) indicates that a recordkeeper providing information regarding DIAs may rely on information provided to it by certain unaffiliated third parties. The inclusion of a specific provision to this effect in the recordkeeping agreement with the plan would seem to be appropriate. It might also be appropriate to consider other provisions, such as an exculpatory provision for the recordkeeper in the event a third party fails, refuses, or is unable to provide needed information and/or a commitment by the recordkeeper to inform the plan administrator if this were to occur.

Regardless of how the contract addresses this issue, the recordkeeper can't fulfill its contractual obligations where it can't obtain the information necessary to do its job. Thus, notifying the plan administrator of its inability to recordkeep a non-compliant portion of a plan may not put the recordkeeper in a substantially worse position than it otherwise would be in. There are additional and potentially more serious consequences for a recordkeeper that continues to provide services in the absence of necessary information, as discussed in the next section of this article.

INVESTMENT DISCLOSURE REQUIREMENTS FOR RECORDKEEPERS

In addition to the participant disclosure regulations that are the primary focus of this article, the DOL has also issued a separate set of rules under ERISA Section 408(b)(2)[6] that require "covered service providers" to ERISA plans to furnish the responsible plan fiduciaries with detailed information about the services they provide and the compensation they expect to receive, effective on and after July 1, 2012. Recordkeepers to participant-directed defined contribution plans are "covered service providers" that must provide this information to their clients, and the timing requirements that apply to a certain group of these disclosures may prove to be especially challenging.

Keep in mind that Section 408(b)(2) provides an exemption from ERISA's prohibited transaction rules that permits recordkeepers and other service providers to receive compensation from a plan, so long as the service contract or arrangement is reasonable.[7] The regulation issued under 408(b)(2) is designed to ensure that plan fiduciaries receive adequate information to determine that a service arrangement is indeed "reasonable" so that it doesn't trigger a non-exempt prohibited transaction.

One of the requirements of that regulation applicable to recordkeepers for participant-directed plans is that they furnish the responsible fiduciary and the plan administrator the information the plan administrator needs to satisfy its obligations under the participant disclosure regulation. In other words, the fiduciary obligation of the plan administrator has essentially been shifted to the recordkeeper in order to avoid engaging in a prohibited transaction.

While this requirement may not be considered onerous in general, there is an aspect of the rule that could prove especially problematic. That requirement relates to the timing of these disclosures. The information must be provided to fiduciaries (i) before the recordkeeper's service contract is first entered into, extended, or renewed (as applicable), or (ii) in the case of an investment product that hasn't yet been designated as a DIA, as soon as practicable, but no later than the date that it's designated as a DIA.

From a practical standpoint, it's often not possible to designate a plan's DIAs before the recordkeeping

contract is entered into, which means that they'll need to be designated at a later date. But the question then arises as to when "designation" occurs. Is it the date the plan fiduciaries decide on the investment lineup, the date this is communicated to the recordkeeper, or some later date when the parties determine whether it's feasible for the designated investments to be offered by the plan?

In the case of a provider that offers a relatively discrete number of investment alternatives, such as, for example, an insurance company that offers a set number of funds through a group annuity contract, it may not be unreasonable to expect the recordkeeper to keep performance data, expense ratios, and similar information for a significant number of investment products that are designated as DIAs on hand.

But in the open architecture situation, where the recordkeeper's platform may have available 1,000 or more investment alternatives, each of which could be designated for a plan, it would be a near impossibility for the recordkeeper to provide the required information on a timely basis unless the plan sponsor has committed to inform the recordkeeper about which few specific products are being considered as potential DIAs well in advance of the designation.

In any case, recordkeepers need to perform a significant amount of up-front information gathering to comply with these rules. In doing so, it's permissible to use current disclosure materials from a DIA that's a mutual fund or publicly-traded security, or a product issued by a regulated insurance company or financial institution, as long as the recordkeeper isn't affiliated with the issuer and in good faith has no reason to believe that the information is incomplete or inaccurate (and informs the fiduciary that it's not making representations as to completeness or accuracy).

If the required investment-related disclosures aren't provided to responsible plan fiduciaries according to these timing requirements, the recordkeeping arrangement will be deemed to not be reasonable under 408(b)(2).

This brings us back to the risks of recordkeeping the portion of a plan for which the investment issuer doesn't cooperate in providing necessary data. If a recordkeeper provides services with respect to a DIA for which it hasn't procured the investment-related information (and thus can't provide the required disclosures) this will result in both violations of the participant disclosure rules (a fiduciary breach for the client) and a non-exempt prohibited transaction for the recordkeeper. The consequences of a non-exempt prohibited transaction include significant excise taxes under the Code,[8] as well as undoing the transaction by returning the compensation the recordkeeper has received from the plan under the arrangement.[9]

CONCLUSION

Recordkeepers have generally been providing disclosure materials to participants for 404(c) purposes for years. In addition, the compliance dates of the DOL regulations were delayed more than once, which provided additional time to become familiar with the nuances of the rules and to make system changes to be able to meet the regulatory requirements. Nevertheless, as we have shown, there are potential challenges that recordkeepers should be prepared to address. PC

Bruce L. Ashton, APM, is a partner (Los Angeles);

Fred Reish, APM, is a partner (Los Angeles);

Joshua Waldbeser is an associate (Chicago) in Drinker Biddle & Reath LLP.

[1] 29 CFR §2550.404(a)-5. In addition to the active participants—that is, those with an account balance in the plan, the regulation specifies that the disclosures must be furnished to eligible employees who are not actively participating in 401(k) and other elective contribution plans, alternate payees under QDROs, and surviving spouses and other beneficiaries who have plan accounts. Throughout this article, references to "participants" are intended to encompass all of these parties.

[2] The "DIA" is an important concept in the regulation. It means any investment alternative designated by the plan into which participants may direct the investment of assets held in, or contributed to, their accounts, but excludes brokerage windows, self-directed brokerage accounts, or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan.

[3] This description generally applies to the information required with respect to mutual funds and other DIAs that do not have fixed rates of return. Special rules apply to DIAs that are either fixed-return investments or annuities, and certain information, such as historical returns, need not be provided for these other types of DIAs. For this purpose, stable value and money market funds are not considered to have fixed rates of return. Other information, including the website address for each DIA and certain general statements regarding fees and expenses, must also be furnished.

[4] The fact that prospectuses must only be provided on request and may be provided through a website is a significant change from the 404(c) regulation which required actual delivery of prospectuses immediately before or after a participant invested in an alternative subject to the securities law prospectus delivery requirement.

[5] This conclusion should not be construed to mean that an asset allocation model is a DIA or that the authors believe this to be the only proper conclusion.

[6] The final Fiduciary Disclosure Regulations can be found at 29 CFR §2550.408(b)-2.

[7] Section 406(a) of ERISA prohibits plan fiduciaries from causing a plan to enter into certain transactions with "parties in interest," a term which includes any service provider to the plan. In the absence of an exemption from these "prohibited transaction" rules, a service provider that accepts compensation from a plan is in violation of ERISA.

[8] A 15% excise tax applies to the "amount involved" in any non-exempt prohibited transaction, and a 100% excise tax may also apply if the prohibited transaction is not unwound within certain timeframes.

[9] There is no direct guidance on what "correction" will be required in this situation. The return of all compensation by the recordkeeper would be the most extreme form of correction.