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A Client Alert from Paul Hastings

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## *Adrift in a Sea of Disclosure: New DOL Rules Require Disclosure of Plan Fees to Participants*

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Last Thursday, the Department of Labor issued final regulations under ERISA Sections 404(a) and 404(c) requiring plan administrators to disclose certain plan and investment-related information, including fee and expense information, to an estimated 72 million participants in individual account plans with participant-directed investments (e.g., 401(k) plans). The regulations take effect 60 days after publication in the Federal Register and apply to plan years beginning on or after November 1, 2011 (for calendar year plans, this means January 1, 2012).

Although the regulations refer to “required” disclosures, it is unclear whether the Department of Labor intended to create a mandatory set of disclosures or merely to provide a set of disclosure requirements that, if satisfied, would provide a safe harbor for demonstrating fiduciary compliance with the duty to disclose. Nevertheless, plan administrators are well advised to treat the disclosure requirements as mandatory (and the balance of this Client Alert assumes that they truly are required).

The regulations are the last part of a three-part fee disclosure project initiated by the Department of Labor in response to the wave of participant lawsuits brought against both employers and financial institutions relating to “revenue sharing” and other fee arrangements, and the adequacy of fee-related disclosures. The other two parts, which previously were finalized, are changes to Form 5500, Schedule C, requiring significant reporting of service provider compensation, and final regulations under ERISA Section 408(b)(2) -- the prohibited transaction exemption for the provision of services to ERISA-covered plans -- requiring significant fee disclosure by service providers to plan fiduciaries. Please see our prior Client Alerts for an in-depth analysis of those two components.<sup>1</sup> Of the three components, the newly issued final 404(a)/404(c) regulations have the greatest potential to lead to participant questions, complaints, and litigation regarding plan fees.

Part I of this Client Alert highlights the action items plan sponsors and service providers need to implement to address these final regulations. Part II of this Client Alert summarizes key changes from the proposed regulations.<sup>2</sup> Part III summarizes the final regulations.

### **Part I: Action Items**

#### Plan Sponsors

- Decide who will be responsible for ensuring compliance and consider whether such entity's charter or investment policy statement should be amended

- Decide whether to voluntarily comply with the final regulations earlier than required
- Implement a schedule for making timely required annual disclosures (some plan sponsors intend to make disclosures every 11 months to ensure they do not inadvertently violate the disclosure requirements (a policy of making disclosures every December would appear to violate the regulations if more than 365 days passes between disclosures)
- Decide whether to use the Department of Labor's model disclosure form or whether to create a customized disclosure form
- Take stock of existing service provider contracts and determine whether any amendments are needed
- Collect information that must be disclosed from all plan service providers (e.g., from investment advisors and managers)
- Determine whether the plan offers investment alternatives that are not registered under the Investment Company Act of 1940 and, if so, obtain advice from securities and ERISA counsel on how to address fee disclosures related to those investments
- Consider whether changes to the plan's investment line-up are warranted in light of the required disclosures (e.g., the addition of low-cost index funds)
- Implement a process to address possible participant questions and complaints (e.g., ensure that benchmark data is readily available to demonstrate that fees are reasonable in relationship to comparable funds)

#### Plan Service Providers

- Furnish the investment-related information disclosures in a chart or similar format that permits straightforward comparison of the plan's designated investment alternatives in accordance with the final regulations
- Ensure that market data has been accounted for to support the reasonableness of fee arrangements

## **Part II: Overview of Key Changes in Final Regulations**

1. 404(c) regulations now expressly provide that compliance with 404(c) does not protect plan fiduciaries from liability for imprudently selecting or monitoring plan investment options.

*Note: This language previously appeared in the preamble to the original 404(c) regulation and some courts have declined to adopt the Department of Labor's view because it was not set forth in the regulation itself.*

2. The proposed regulations required several disclosures to be provided on or before the date a participant was first *eligible* to participate in the plan. The final regulations require that these disclosures be made on or before the date on which the participant can first direct his or her investments. For participants who already have this right, the disclosure must be provided within 60 days after the date the regulations first apply to the plan (i.e., January 1, 2012 for calendar year plans).

3. Under the final regulations, participants must be notified of *any* changes to plan-related information that was previously disclosed to participants, and this disclosure must be made at least 30, but not more than 90, days *in advance* of the effective date of the change. There is an exception for changes that are unforeseeable or due to circumstances beyond the control of the plan administrator, in which case notice must be provided as soon as practicable. This is a significant change from the proposed regulations, which only required notification of “material” changes and permitted notice as late as 30 days *after* the change.
4. The final regulations add to the disclosure of plan-related information a description of any brokerage windows, self-directed brokerage accounts, or similar arrangements that permit participants to select investments outside the plan’s designated investment options, as well as a description of any fees and expenses associated with such a feature.
5. The final regulations require a disclosure to the effect that the cumulative effect of fees and expenses can substantially reduce the growth of participants’ accounts and that participants can visit the Department of Labor’s Employee Benefit Security Administration website for an example demonstrating the long-term effect of fees and expenses as well as to obtain other information.
6. The final regulations require that a website be maintained that provides certain information regarding each of the plan’s designated investment alternatives (Investment Alternative Website) and that participants be told how to request and obtain, free of charge, a paper copy of the information required to be maintained in the Investment Alternative Website.
7. The final regulations require that participants be provided, either in the required disclosures or on the Investment Alternative Website, a general glossary of terms needed to understand the plan’s investment alternatives.
8. The final regulations eliminate the proposed regulations’ requirement to disclose the type of management utilized by the investment (e.g., active or passive management).
9. The final regulations require the disclosures to show the impact of the total annual operating expenses of each designated investment alternative for a one-year period expressed as a dollar amount for each \$1,000 investment.
10. The final regulations eliminate the proposed regulations’ requirement to disclose the assets comprising a designated investment alternative’s portfolio based on comments received that such a requirement would impose a significant burden on designated investment alternatives that are not subject to registration.
11. The final regulations added a new method for unregistered, designated investment alternatives, such as bank collective investment funds and employer securities, clarifying how such investments may determine their total annual operating expenses.
12. The final regulations provide that special rules for target date funds will be forthcoming from the DOL.

### **Part III: Summary of Final Regulations**

All individual account plans that permit participant-directed investments are subject to the new regulations, not just 401(k) plans. Disclosures generally must be made on or before the date that a

participant first becomes eligible to direct his or her account investments and annually thereafter (the plan administrator can satisfy the initial disclosure requirement by providing new participants with the most recent annual disclosure and any required subsequent updates).

The plan administrator is responsible for making the disclosures, but the plan administrator will not be liable for using incomplete or inaccurate information to satisfy these requirements as long as the information was provided by a plan service provider or investment alternative issuer, and the plan administrator relied reasonably and in good faith on the information. The required disclosures fall into two broad categories: (1) plan-related information (including general and individual expenses) and (2) investment-related information (including performance and fee disclosure).

### **Plan-Related Information**

Plan administrators must disclose the following plan-related information (based on the latest information available to the plan) to all participants (i.e., those who are eligible to participate in the plan, regardless of whether they do) and beneficiaries (i.e., those who actually have the right to direct the investment of assets in their accounts):

General plan information: (1) how participants and beneficiaries may give investment instructions; (2) any plan-level limitations on such instructions or on transfers to or from investment alternatives; (3) the plan's designated investment alternatives, designated investment managers, and any brokerage window and similar features that would permit a participant to invest outside the plan's designated investment options; and (4) plan provisions relating to voting, tender, and similar investment alternative rights.

Administrative expense information: (1) any fees for general plan administrative services that may be charged to participant accounts and not reflected in the annual operating expenses of any designated investment alternatives and how they are allocated to participant accounts (e.g., investment advisor fees); (2) quarterly statements of the dollar amounts actually charged during the preceding quarter to individual accounts and descriptions of the services to which they relate; and (3) if applicable, an explanation that some of the plan's other administrative expenses for the preceding quarter were paid from the operating expenses of one or more of the plan's designated investment alternatives (for example, through revenue sharing, 12b-1 fees or sub-transfer agent fees).

Individual expense information: (1) any fees and expenses that may be charged against the participant's account rather than on a plan-wide basis and which are not reflected in the total annual operating expenses of any designated investment alternative (e.g., fees to process loans, QDROs, fees for investment advice or brokerage windows, commissions, front or back-end loads or sales charges, redemption fees, transfer fees and similar expenses, and optional rider charges in annuity contracts); and (2) quarterly statements of the dollar amounts actually charged during the preceding quarter to individual accounts and descriptions of the services to which they relate.

Additional rules for annuities: There are additional disclosure requirements for annuity investment alternatives.

Manner of disclosure: The plan-related information may be disclosed in the Plan's summary plan description as part of the quarterly benefit statement, using the Department of Labor's model disclosure form or in another format altogether. Participants must be furnished with a description of any change in the disclosed information at least 30 days, but not more than 90 days, before the effective date of the change unless the inability to provide such advance notice is due to unforeseeable

events or circumstances beyond the control of the plan administrator, in which case notice of such change must be furnished as soon as practicable thereafter.

### Investment-Related Information

Plan administrators must disclose the following investment-related information:

General information: name and type or category (e.g., money market, large cap fund) of each designated investment alternative.

Performance data: (1) for designated investment alternatives with returns that are fixed or stated for the term of the investment, both the fixed or stated annual rate of return and the term of the investment and, if applicable, a statement advising participants that the issuer may adjust the rate of return prospectively and how to obtain the current rate of return; and (2) for designated investment alternatives for which the return is not fixed, the average total return of the investment for 1, 5 and 10 calendar year periods (or, if shorter, for the life of the alternative) ending as of the most recently completed calendar year as well as statement indicating that past performance is not necessarily indicative of future performance.

*Note: For plan years beginning before October 1, 2021, if a plan administrator reasonably and in good faith determines that it does not have the information on expenses attributable the plan necessary to calculate the five- and 10-year average total returns for designated investment alternatives that are not registered under the Investment Company Act of 1940, the plan administrator may use a reasonable estimate of such expenses or the plan administrator may use the most recently reported total annual operating expenses of the designated investment alternative as a substitute for such expenses (as long as it discloses to participants the basis on which returns were calculated).*

Benchmarks: for designated investment alternatives that do not have a fixed rate of return, the name and returns of an appropriate broad-based securities market index over the 1, 5 and 10 calendar year periods (or, if shorter, for the life of the alternative) comparable to the performance data periods disclosed above, and which is not administered by an affiliate of the investment alternative issuer, its investment advisor, or a principal underwriter unless the index is widely recognized and used.

Fee, expense, and investment limitation information: For designated investment alternatives with returns that are not fixed, (1) the amount and a description of each shareholder-type fee (i.e., fees charged directly against a participant's investment and not included in the total annual operating expenses of the investment alternative, such as commissions or sales loads) and any restriction or limitation that may apply to a purchase, transfer, or withdrawal of all or a portion of the investment; (2) total annual operating expenses of the investment expressed as a percentage (e.g., expense ratio) calculated in accordance with the regulations; (3) the total annual operating expenses of the investment for a one-year period expressed as dollar amount for a \$1,000 hypothetical investment (assuming no returns and based on the expense ratio calculated under clause (2)); (4) a statement indicating that fees and expenses are only one of several factors that participants and beneficiaries should consider when making investment decisions; and (5) a statement that the cumulative effect of fees and expenses can substantially reduce the growth of a participant's account and that participants can visit the Department of Labor's Employee Benefit Security Administration website for an example demonstrating the long-term effect of fees and expenses and other information. For designated investment alternatives with fixed returns, the amount and description of any shareholder-type fees and a description of any restriction or limitation that may apply to a purchase, transfer, or withdrawal

of all or a portion of the investment. The regulations specify certain information to be provided by designated investment alternatives other than registered mutual funds that are intended to replicate the information provided in connection with registered funds.

Employer Stock: Many of the normal disclosure rules do not apply to employer stock funds. For example, the normal disclosure rules with respect to fee, expense, and investment information (see prior section) in clauses (1), (2), (3), above apply only if participants acquire units of participation rather than actual employer stock. In addition, disclosure of the importance of a well-balanced and diversified investment portfolio is required.

Investment Alternative Website: The address of an Internet website that is sufficiently specific to provide the following information regarding each designated investment alternative: (1) the name of the issuer; (2) the alternative's objectives or goals; (3) the alternative's principal strategies (including a general description of the types of assets held) and principal risks; (4) the alternative's portfolio turnover rate; (5) the alternative's performance data described above, updated at least quarterly or more frequently if required by applicable law; and (6) the alternative's fee and expense information as described above. The disclosures required by clauses (2), (3), and (4) must be consistent with SEC Form N-1A or N-3, as appropriate.

Glossary: A general glossary of terms designed to assist with the understanding of the plan's designated investment alternatives, or an Internet website that is sufficiently specific to provide access to such a glossary along with a general explanation of the purpose of the Internet website address.

Other information: The following must be provided either prior to the date on which a participant can direct his or her investments and annually thereafter, or on request: (1) copies of prospectuses (or, a short-form or summary prospectus approved as to form by the SEC); (2) copies of financial statement or reports relating to the plan's designated investment alternatives, to the extent provided to the plan; (3) a statement of the value of a share or unit of each designated investment alternative as well as the date of the valuation; and (4) a list of the assets comprising the portfolio of each designated investment alternative and the value of each such asset (or its proportion of the investment).

Manner of disclosure: The investment-related information must be disclosed in chart or similar format designed to make it easier for participants to compare the information presented for each of the designed investment alternatives. The Department of Labor issued the attached model comparative chart that, if tailored to reflect a plan's investment-related information, will satisfy this disclosure requirement.

### **Failure to Provide Information on Request**

Although the information required by the final regulations automatically must be disclosed, plan administrators might face a \$110 per day penalty under ERISA Section 502(c) if they fail to provide the required disclosures to a plan participant on request.



If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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**MODEL COMPARATIVE CHART**

***ABC Corporation 401k Retirement Plan***

*Investment Options – January 1, 20XX*

This document includes important information to help you compare the investment options under your retirement plan. If you want additional information about your investment options, you can go to the specific Internet Web site address shown below or you can contact [insert name of plan administrator or designee] at [insert telephone number and address]. A free paper copy of the information available on the Web site[s] can be obtained by contacting [insert name of plan administrator or designee] at [insert telephone number].

***Document Summary***

This document has 3 parts. Part I consists of performance information for plan investment options. This part shows you how well the investments have performed in the past. Part II shows you the fees and expenses you will pay if you invest in an option. Part III contains information about the annuity options under your retirement plan.

**Part I. Performance Information**

**Table 1** focuses on the performance of investment options that do not have a fixed or stated rate of return. Table 1 shows how these options have performed over time and allows you to compare them with an appropriate benchmark for the same time periods. Past performance does not guarantee how the investment option will perform in the future. Your investment in these options could lose money. Information about an option’s principal risks is available on the Web site[s].

Table 1—Variable Return Investments								
Name/ Type of Option	Average Annual Total Return as of 12/31/XX				Benchmark			
	1yr.	5yr.	10yr.	Since Inception	1yr.	5yr.	10yr.	Since Inception
<b>Equity Funds</b>								
A Index Fund/ S&P 500 www. website address	26.5%	.34%	-1.03%	9.25%	26.46%	.42%	-0.95%	9.30%
						S&P 500		
B Fund/ Large Cap www. website address	27.6%	.99%	N/A	2.26%	27.80%	1.02%	N/A	2.77%
						US Prime Market 750 Index		
C Fund/ Int'l Stock www. website address	36.73%	5.26%	2.29%	9.37%	40.40%	5.40%	2.40%	12.09%
						MSCI EAFE		
D Fund/ Mid Cap www. website address	40.22%	2.28%	6.13%	3.29%	46.29%	2.40%	-0.52%	4.16%
						Russell Midcap		
<b>Bond Funds</b>								
E Fund/ Bond Index www. website address	6.45%	4.43%	6.08%	7.08%	5.93%	4.97%	6.33%	7.01%
						Barclays Cap. Aggr. Bd.		
<b>Other</b>								
F Fund/ GICs www. website address	.72%	3.36%	3.11%	5.56%	1.8%	3.1%	3.3%	5.75%
						3-month US T-Bill Index		
G Fund/ Stable Value www. website address	4.36%	4.64%	5.07%	3.75%	1.8%	3.1%	3.3%	4.99%
						3-month US T-Bill Index		
Generations 2020/ Lifecycle Fund www. website address	27.94%	N/A	N/A	2.45%	26.46%	N/A	N/A	3.09%
						S&P 500		
					23.95%	N/A	N/A	3.74%
						Generations 2020 Composite Index*		

\*Generations 2020 composite index is a combination of a total market index and a US aggregate bond index proportional to the equity/bond allocation in the Generations 2020 Fund.

**Table 2** focuses on the performance of investment options that have a fixed or stated rate of return. Table 2 shows the annual rate of return of each such option, the term or length of time that you will earn this rate of return, and other information relevant to performance.

<b>Table 2—Fixed Return Investments</b>			
<b>Name/ Type of Option</b>	<b>Return</b>	<b>Term</b>	<b>Other</b>
H 200X/ GIC www. website address	4%	2 Yr.	The rate of return does not change during the stated term.
I LIBOR Plus/ Fixed- Type Investment Account www. website address	LIBOR +2%	Quarterly	The rate of return on 12/31/xx was 2.45%. This rate is fixed quarterly, but will never fall below a guaranteed minimum rate of 2%. Current rate of return information is available on the option's Web site or at 1-800-yyy-zzzz.
J Financial Services Co./ Fixed Account Investment www. website address	3.75%	6 Mos.	The rate of return on 12/31/xx was 3.75%. This rate of return is fixed for six months. Current rate of return information is available on the option's Web site or at 1-800-yyy-zzzz.

## Part II. Fee and Expense Information

**Table 3** shows fee and expense information for the investment options listed in Table 1 and Table 2. Table 3 shows the Total Annual Operating Expenses of the options in Table 1. Total Annual Operating Expenses are expenses that reduce the rate of return of the investment option. Table 3 also shows Shareholder-type Fees. These fees are in addition to Total Annual Operating Expenses.

<b>Table 3—Fees and Expenses</b>			
<b>Name / Type of Option</b>	<b>Total Annual Operating Expenses</b> As a Per % \$1000		<b>Shareholder-Type Fees</b>
<b>Equity Funds</b>			
A Index Fund/ S&P 500	0.18%	\$1.80	\$20 annual service charge subtracted from investments held in this option if valued at less than \$10,000.
B Fund/ Large Cap	2.45%	\$24.50	2.25% deferred sales charge subtracted from amounts withdrawn within 12 months of purchase.
C Fund/ International Stock	0.79%	\$7.90	5.75% sales charge subtracted from amounts invested.
D Fund/ Mid Cap ETF	0.20%	\$2.00	4.25% sales charge subtracted from amounts withdrawn.

Bond Funds			
E Fund/ Bond Index	0.50%	\$5.00	N/A
Other			
F Fund/ GICs	0.46%	\$4.60	10% charge subtracted from amounts withdrawn within 18 months of initial investment.
G Fund/ Stable Value	0.65%	\$6.50	Amounts withdrawn may not be transferred to a competing option for 90 days after withdrawal.
Generations 2020/ Lifecycle Fund	1.50%	\$15.00	Excessive trading restricts additional purchases (other than contributions and loan repayments) for 85 days.
Fixed Return Investments			
H 200X / GIC	N/A		12% charge subtracted from amounts withdrawn before maturity.
I LIBOR Plus/ Fixed- Type Invest Account	N/A		5% contingent deferred sales charge subtracted from amounts withdrawn; charge reduced by 1% on 12-month anniversary of each investment.
J Financial Serv Co. / Fixed Account Investment	N/A		90 days of interest subtracted from amounts withdrawn before maturity.

The cumulative effect of fees and expenses can substantially reduce the growth of your retirement savings. Visit the Department of Labor’s Web site for an example showing the long-term effect of fees and expenses at [http://www.dol.gov/ebsa/publications/401k\\_employee.html](http://www.dol.gov/ebsa/publications/401k_employee.html). Fees and expenses are only one of many factors to consider when you decide to invest in an option. You may also want to think about whether an investment in a particular option, along with your other investments, will help you achieve your financial goals.

**Part III. Annuity Information**

**Table 4** focuses on the annuity options under the plan. Annuities are insurance contracts that allow you to receive a guaranteed stream of payments at regular intervals, usually beginning when you retire and lasting for your entire life. Annuities are issued by insurance companies. Guarantees of an insurance company are subject to its long-term financial strength and claims-paying ability.

Table 4—Annuity Options			
Name	Objectives / Goals	Pricing Factors	Restrictions / Fees
Lifetime Income Option  www. website address	To provide a guaranteed stream of income for your life, based on shares you acquire while you work. At age 65, you will receive monthly payments of \$10 for	The cost of each share depends on your age and interest rates when you buy it. Ordinarily the closer you are to retirement, the more it will cost you to buy a	Payment amounts are based on your life expectancy only and would be reduced if you choose a spousal joint and survivor benefit.

	<p>each share you own, for your life. For example, if you own 30 shares at age 65, you will receive \$300 per month over your life.</p>	<p>share.</p> <p>The cost includes a guaranteed death benefit payable to a spouse or beneficiary if you die before payments begin. The death benefit is the total amount of your contributions, less any withdrawals.</p>	<p>You will pay a 25% surrender charge for any amount you withdraw before annuity payments begin.</p> <p>If your income payments are less than \$50 per month, the option's issuer may combine payments and pay you less frequently, or return to you the larger of your net contributions or the cash-out value of your income shares.</p>
<p>Generations 2020 Variable Annuity Option</p> <p>www. website address</p>	<p>To provide a guaranteed stream of income for your life, or some other period of time, based on your account balance in the Generations 2020 Lifecycle Fund.</p> <p>This option is available through a variable annuity contract that your plan has with ABC Insurance Company.</p>	<p>You have the right to elect fixed annuity payments in the form of a life annuity, a joint and survivor annuity, or a life annuity with a term certain, but the payment amounts will vary based on the benefit you choose. The cost of this right is included in the Total Annual Operating Expenses of the Generations 2020 Lifecycle Fund, listed in Table 3 above.</p> <p>The cost also includes a guaranteed death benefit payable to a spouse or beneficiary if you die before payments begin. The death benefit is the greater of your account balance or contributions, less any withdrawals.</p>	<p>Maximum surrender charge of 8% of account balance.</p> <p>Maximum transfer fee of \$30 for each transfer over 12 in a year.</p> <p>Annual service charge of \$50 for account balances below \$100,000.</p>

Please visit [www.ABCPlanglossary.com](http://www.ABCPlanglossary.com) for a glossary of investment terms relevant to the investment options under this plan. This glossary is intended to help you better understand your options.

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<sup>1</sup> Attention ERISA Plan Sponsors: Get Ready Now For New Form 5500 Requirement to Disclose Compensation Paid to Plan Service Providers (October 2009), available at [www.paulhastings.com/publications](http://www.paulhastings.com/publications); DOL Issues Interim Final Rule on ERISA Plan Service Provider Fee Disclosures (July 2010), available at [www.paulhastings.com/publications](http://www.paulhastings.com/publications).

<sup>2</sup> The proposed regulations were published at 73 F.R. 43013 (July 23, 2008). For a summary of the proposed regulations, please see our client alert, Overview of Recent Department of Labor ERISA Service Provider Fee Disclosure Initiatives (August 2008), available at [www.paulhastings.com/publications](http://www.paulhastings.com/publications).