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Department of Labor Releases Guidance on New Disclosure Rules

Guidance contains clarifications of participant-level disclosures and "good faith" standard for enforcement purposes.

On May 7, the U.S. Department of Labor (DOL) released guidance, in the form of "frequently asked questions" (FAQs), on its new plan participant and service provider disclosure rules under DOL Regulations 404a-5 and 408b-2, respectively. This guidance, contained in Field Assistance Bulletin 2012-02, focuses mainly on the participant disclosure rules. According to a news release announcing the guidance, DOL is working on a second set of FAQs focused on the service provider disclosure rules.

Most of the 38 FAQs provide helpful clarifications on the scope of the participant disclosure rules and the specific disclosure requirements. However, some of the answers provided raise new compliance questions or additional issues that will need to be considered. Still other questions being raised by the industry remain unanswered.

The last part of the guidance deals with transition relief issues, including the interrelationship of the participant disclosure requirements with the disclosure conditions of the fiduciary safe harbor for participant-directed plans under section 404(c) of ERISA. Because the transition relief applies to both disclosure rules as well as section 404(c), we address that relief first.

Transition Relief under New Disclosure Rules

"Good Faith" Nonenforcement Policy

DOL had been asked to grant transition relief for "good faith" efforts to comply with both the participant and service provider disclosure rules, particularly as to compliance with any guidance issued shortly before the effective dates (such as these FAQs).

DOL noted in the guidance that it understands that many plan administrators and service providers have already started to implement changes to their systems to comply with the new rules, and that it may be difficult or costly to make further system adjustments in advance of the disclosure deadlines. Nevertheless, DOL said that, in light of the significance of these rules and the already extended delay in implementation, it does not believe it appropriate to grant further extensions. For enforcement purposes, however, DOL said that 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.

Assuming that DOL investigators are flexible in applying this good-faith rule, it should be helpful in avoiding liability for technical noncompliance. In addition, it would be important for courts to take DOL's announced policy into account in the event of litigation.

With the service provider disclosure rules, there is the further concern that noncompliance would result in the failure to meet an exemption from the ERISA prohibited transaction rules. DOL senior staff has indicated that it understands the desire for additional transition relief under those rules and is considering how best to proceed.

Coordination with Section 404(c) Disclosure Requirements

At the same time that DOL adopted the new participant disclosure rules, it also significantly modified the disclosure conditions of section 404(c). The new disclosure conditions—which were effective for plan years beginning after November 1, 2011, and are therefore already in effect for many plans—generally operate by reference to the participant disclosure rules. With the delay in the initial disclosure date, it was unclear whether the failure to provide the initial disclosures after the effective date of the section 404(c) changes would be considered noncompliance with the section 404(c) rules.

DOL has now clarified that a plan need not furnish the participant disclosure information before it must be furnished under the new regulation to maintain section 404(c) status.

Participant Disclosure (404a-5) Rule Clarifications

The FAQs on the participant disclosure rules under Regulation 404a-5 respond to a number of issues that practitioners have raised regarding how to apply the disclosure requirements. We focus below on certain key issues, and then provide a list of the other general issues and areas covered.

Brokerage Windows/Nondesignated Fund Options

Under the regulation, a “brokerage window”—a brokerage account available to plan participants for making investments beyond the plan’s designated investment alternatives—is not subject to the detailed disclosure requirements for designated investment alternatives. Nevertheless, the plan-related information is required to include information about the brokerage window. This raised the question of how detailed the information regarding the brokerage window must be.

After confirming that plan administrators must provide information regarding a brokerage window, how it works, and its fees and expenses, DOL noted that the specific amount of the fees associated with purchases and sales of securities, such as mutual fund front-end loads, may vary across available investments and not be known in advance. Therefore, it would be sufficient to include a general statement that such fees exist and may be charged to a participant, with directions as to how the participant can obtain information about such fees in connection with a particular investment.

Another question raised was whether the plan administrator need furnish disclosures regarding the brokerage window arrangement only to those participants who affirmatively elected to use the arrangement. DOL responded that the required information must be furnished to all participants, not just those who have elected the brokerage window arrangement, so that they all have sufficient information to make informed decisions about whether to direct their investments into such arrangement. DOL compared this to the disclosure of fees and expenses associated with plan loans—a participant is not required to take out a loan to receive that disclosure.

Separately, DOL addressed the question of whether an “investment platform” of registered mutual funds, where the plan fiduciary selected the platform but did not specifically designate any of the funds, is itself a “designated investment alternative.” DOL concluded that a platform consisting of multiple investment alternatives would not itself be a designated investment alternative, but that whether the individual investment funds on the platform are designated investment alternatives may depend on whether they are specifically identified as available under the plan. DOL noted prudence and other fiduciary issues that could be raised by the failure to designate a manageable number of designated investment alternatives. Pending further guidance, though, DOL said that as a matter of enforcement policy, where a platform holds more than 25 investment alternatives, DOL will not require that all of the investment alternatives be treated as designated investment alternatives if the plan administrator does the following:

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) regulation (this appears to assume a plan that has no investment alternatives outside the funds on the investment platform).
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 1% of all participants and beneficiaries, are invested on a date that is not more than 90 days preceding each annual disclosure.

DOL is clearly not comfortable with the concept of being able to avoid the disclosure requirements through designation of an “investment platform” rather than specific investments, particularly where the plan fiduciaries appear to be using this approach to avoid any responsibility for the plan’s investment funds. The DOL staff has indicated that it also is responding to the further possible argument that using such an arrangement would absolve a fiduciary from liability for selection and monitoring of the plan’s investment options. While DOL has provided enforcement relief where the described conditions are met, that leaves unanswered questions about the basic duties and obligations of fiduciaries with respect to the investment alternatives on such a platform.

In its discussion of the fiduciary responsibility implications of the described approach, DOL draws parallels between relying on such an “investment platform” and use of an open brokerage window arrangement. It states that fiduciaries have a general duty of prudence to monitor a plan’s investment menu and that if, through a brokerage window or similar arrangement, a significant number of participants select certain nondesignated investment alternatives, the plan fiduciary has “an affirmative obligation . . . to examine these alternatives and determine whether one or more such alternatives should be treated as designated for purposes of the regulation.” DOL has not previously suggested a need to monitor the investments accessible through a brokerage window, and, if there is indeed such an obligation, the standards for doing so (beyond the described nonenforcement policy, which would apply solely for purposes of the new disclosure requirements) would be unclear.

“Designated Investment Alternative” Status Issues

DESIGNATED INVESTMENT MANAGERS/MANAGED ACCOUNTS

The regulation requires that the disclosure identify both the plan’s “designated investment alternatives” and its “designated investment managers,” but while the regulation defined the term “designated investment alternative,” it did not define a “designated investment manager.” In the FAQs, DOL has defined a “designated investment manager” as an ERISA section 3(38) investment manager that is designated by a plan fiduciary and made available to the plan’s participants and beneficiaries to manage all or a portion of the assets held in, or contributed to, their individual accounts. These arrangements also are commonly referred to as “managed accounts.” DOL added that the manager could either be free to invest in any investment, or could be limited under its arrangement with the plan to investing in the plan’s designated investment alternatives.

A separate FAQ makes clear that an investment management service that a participant may select to allocate his or her account assets among the plan’s investment options—the same type of arrangement DOL described as within the “designated investment manager” category—is not a “designated investment alternative” under the regulation. Therefore, the detailed investment-related information disclosure requirements for designated investment alternatives, including the placement of performance and expense information in the comparative chart, do not apply. Instead, the plan-related information disclosure requirements apply. Thus, the plan administrator must (1) identify the designated investment manager, (2) provide information regarding fees associated with this service, and (3) provide at least quarterly statements of the charging of those fees and expenses against participant accounts, along with a description of the services to which the charges relate. DOL added, consistent with its position in the regulation, that a plan fiduciary will be responsible for the prudent selection and monitoring of the designated investment manager.

The main concern with treating an investment management service as a designated investment alternative was with the ability to disclose the service’s investment performance, which could vary depending on the participant’s level of utilization of the service. DOL’s response alleviates those concerns.

MODEL PORTFOLIOS

A separate question has been whether "model portfolios"—portfolios that describe investment strategies made up of the plan's designated investment alternatives—are themselves designated investment alternatives for which disclosures must be provided.

DOL responded that this will depend on the particular arrangement. If the model portfolio is clearly presented to the plan participants as "merely a means of allocating assets" among the plan's investment options, it would not be considered a "designated investment alternative." However, if, in choosing a model portfolio, the plan participant acquires an interest in an equity security, unit participation, or similar interest in an entity, that portfolio would ordinarily be a designated investment alternative. DOL added that if the plan offers only model portfolios made up of investments not separately designated under the plan, each model would have to be treated as a designated investment alternative.

Whatever the case, said DOL, the plan administrator should clearly explain how the model portfolio functions, including how it differs from the plan's designated investment alternatives.

As with investment management services, the concern has been how to determine the required disclosures, including the calculation of investment performance and total annual operating expenses, for model portfolios in the event they were considered designated investment alternatives. DOL said that it understands that some plans and service providers are currently able to calculate and provide this information. Others will have to create mechanisms for doing so consistent with the rules of the regulation for those model portfolio arrangements that, according to DOL, are subject to the disclosure requirements.

DOL added that even where a model portfolio is not treated as a designated investment alternative, plan administrators may still treat the portfolio as such and include its information in the comparative chart, subject to the requirements of the regulation as well as Securities and Exchange Commission (SEC) guidance on the use of investment results derived from model portfolios (which requires the inclusion of certain disclosures when describing model portfolio performance).

Revenue-Sharing Disclosures

The only disclosure requirement in the regulation regarding "revenue sharing" practices—the payment of plan expenses through fees charged against plan investments—is to disclose in quarterly participant statements the fact that plan expenses are paid through revenue sharing. Given the contrast with the more specific disclosure of revenue-sharing practices required in the service provider disclosure regulation, DOL received several questions asking whether such a general disclosure is sufficient, and whether variations in revenue-sharing arrangements would require different disclosures.

DOL confirmed that, where revenue sharing is used to pay plan expenses, all that is required is the quarterly explanation that some of the plan's administrative expenses for the preceding quarter were paid out of the plan's designated investment alternatives. It is not necessary to identify specific plan expenses being paid or the specific investments making the payments. Nevertheless, the rules do not preclude a more detailed explanation, if so desired.

One question described an arrangement under which the plan had agreed to pay a monthly recordkeeping fee that would be reduced by revenue-sharing payments, and the revenue sharing had generally exceeded the monthly fee. The question was whether disclosure of the recordkeeping fees was still required. DOL responded that, since the recordkeeping fees were known at the time of disclosure and could be charged against participant accounts, disclosure is required. The disclosure could explain that the recordkeeping fees would be reduced by revenue-sharing payments and the effect of those payments on the deductions from participant accounts.

DOL also indicated that the revenue-sharing explanation is required every quarter during which revenue-sharing payments are used to pay a plan's administrative expenses, even if there are no administrative charges to plan accounts during a particular quarter, resolving an apparent ambiguity in the regulation's language.

Furnishing Multiple Comparative Charts

In the preamble to the final Regulation 404a-5, DOL had said that nothing in the regulation precludes plan administrators from combining multiple documents to create the comparative chart. This was in response to comments on behalf of 403(b) plans, which traditionally have used a number of unrelated investment providers who might therefore be providing separate disclosure information. However, the examples given suggested that this approach may be limited to dividing the comparative chart into groupings by type of fund or by issuer, and that use of separate charts would not be compliant.

DOL has indicated in the FAQs that a plan administrator may furnish multiple comparative charts or documents that are supplied by the plan's various service providers or investment issuers, provided that they are furnished to participants in a single mailing or transmission at the same time and are designed to facilitate comparisons. DOL limited the preamble language to prohibiting the separate distribution of comparative documents. Thus, the FAQs have clarified that, contrary to what was implied in the preamble, separate charts can in fact be used. This clarification should be helpful in facilitating compliance by 403(b) plans.

Application of Fund Expense Disclosures to a Fund-of-Funds Arrangement

One of the requirements of the regulation is the disclosure of the "total annual operating expenses" of a designated investment alternative. Questions had been raised as to how to apply this rule to a "fund-of-funds," which is a fund that invests in other funds, since there could be expenses charged not only at the fund-of-funds level but also within each of the "acquired" funds in which it invests.

DOL responded that the fund-of-funds' total annual operating expenses must reflect the operating expenses of the acquired funds. This is based on SEC guidance for funds-of-funds that are registered open-end investment companies. While DOL's discussion focused on a fund-of-funds that is a registered fund, it indicated that the same principles apply to unregistered entities that invest in acquired funds or trusts.

Questions also have been raised as to how to calculate the portfolio turnover rate—another required disclosure—for fund-of-funds arrangements. DOL's guidance did not address this issue.

Stable Value Fund "Wrap Fees"

In a stable value fund arrangement, the fund's investments may take the form of a "synthetic guaranteed investment contract," under which a portfolio of fixed-income assets is covered by a "wrap" contract that enables the fund to value those assets and pay out plan participants based on the assets' "contract" or "book" value. A question that had been raised was whether the "wrap fees" charged by the wrap contract providers should be treated as part of the stable value fund's total annual operating expenses. The argument that such fees should not be included was by analogy to brokerage fees, which are not part of the expense ratio of a registered mutual fund under SEC guidance, but it was not clear that wrap fees could be analogized to brokerage fees.

DOL has taken the position that the cost of "wrap" coverage must be included in the total annual operating expenses of a stable value fund for disclosure purposes, since that cost reduces the fund's rate of return.

Effect of Payment of Plan Expenses from Forfeitures

Where plan expenses are paid from amounts forfeited under the terms of the plan, it appeared to many that there would be nothing to disclose under the regulation because there would be no charge against participant accounts. DOL has confirmed that this would be the case.

In one fact pattern described to DOL, any expenses that exceeded plan forfeitures would be paid by the plan sponsor. This meant that there would be no situation in which participant accounts would be charged, so that no disclosure of plan expenses was necessary. In a second fact pattern, it was possible under the terms of the plan that participant accounts could be charged if forfeitures were insufficient, but the plan had a written commitment from the plan sponsor that it would pay administrative expenses not covered by forfeitures. DOL agreed that no disclosure would be required in this situation as well, and that disclosure could in fact be confusing. DOL added that if circumstances were to change such that participant accounts might be charged, the plan administrator would be required to so notify the plan participants.

Under DOL's approach, if the plan includes the common provision that administrative expenses are the obligation of the plan, unless paid for by the plan sponsor, and there is no express limitation on charging those plan expenses to participant accounts, disclosure of those expenses would appear to be required.

Additional Matters Addressed by FAQs

- **Closed or "frozen" investments** – The investments are still covered by the disclosure requirements, despite being closed to new investment, because participants need information to decide whether to transfer out of these investments. However, closed investment disclosure could be limited to those participants who remain invested in that investment.
- **Updating investment information** – The comparative chart need be updated only annually, but website information must be updated as soon as reasonably possible following a change (e.g., to fee and expense information) to maintain accuracy, and should reflect the date of the most recent update. DOL noted that fiduciary responsibilities may require separate notification to participants of important changes before the next annual comparative chart is distributed.
- **Using more recent performance information in a comparative chart** – This is permitted, so long as the same ending date is used for all designated investment alternatives and associated benchmarks to ensure comparability. This means that the chart can reflect performance as of the most recent month-end or quarter-end, rather than only year-end.
- **Other issues addressed include the following:**
  - A plan that has both participant-directed and trustee-directed investments is covered by the regulation.
  - Coverage of 403(b) plans—no enforcement action will be taken if the requirements of the regulation are not met with respect to certain pre-2009 frozen 403(b) plans.
  - Naming designated investment alternatives for purposes of investment-related disclosure is sufficient to "identify" those alternatives for purposes of plan-related disclosure, if contained in a single document, so that the list need not be repeated in the plan-related disclosure section.
  - Use of a "blended" benchmark is permitted, in addition to the required benchmark, based on the investment's target asset allocation, so long as the blended benchmark returns are not inaccurate or misleading—which should be the case if the target asset allocation is representative of actual holdings of the investment over a "reasonable" period of time (e.g., the same periods covered by the required benchmark's returns).
  - DOL described alternative ways of complying with the website address requirement (e.g., using website of the plan sponsor, recordkeeper, or issuer of an investment alternative).
  - Website address "landing page" need not itself include all of the supplemental investment-related information, so long as it is sufficiently specific to provide access to that information without difficulty.
  - Performance information for designated investment alternatives is required to be available on the website and, although there is no specific requirement regarding frequency of updating that information, the information should be accurate and reasonably current.
  - Additional performance information may be included in the comparative chart, so long as such information is not inaccurate or misleading.
  - Level of specificity required in explaining fees and expenses for general plan administrative services will depend upon facts and circumstances.
  - References to sample investment glossaries prepared by industry groups have been provided (DOL does not intend at this time to publish its own sample).

- DOL described the types of documents that can be used to satisfy disclosure on request requirements for investment options that are not registered funds (e.g., bank collective investment funds and separately managed accounts)—specifically, those containing information that corresponds to that contained in a registered fund's short-form or summary prospectus, for example, the written plan or fund fact sheet for a bank collective investment fund.
- Ability to include the required disclosures with, or as part of, other documents—need not be furnished as a stand-alone document.
- DOL described the expense disclosure required for an unregistered trust account that invests solely in a registered mutual fund (a so-called "unitized" investment option). If plan administrative expenses are paid out of the account, they must be reflected in the account's total annual operating expenses and average total annual return, which consequently will differ from those of the underlying mutual fund.
- Effective dates for disclosure are confirmed—initial disclosures generally by August 30, 2012, and quarterly statements (for most plans, including calendar year plans) by November 14, 2012 (which, DOL clarified, must reflect only those fees and expenses for the quarter to which the statement relates).

We look forward to updating you further when DOL releases its second set of FAQs.

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