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DEATH TO THE PROSPECTUS REQUIREMENT!

The New 401(k) Participant Disclosure Rules

CENTRE FOR FIDUCIARY EXCELLENCE

Death to the Prospectus Requirement! The New 401(k) Participant Disclosure Rules

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The Department of Labor is on a roll. Faced with widespread government, industry, and public concern about the level of disclosure and fees in qualified plans, they announced plans early in 2007 to deliver three new initiatives by the end of 2008: substantially increased disclosures on the annual form 5500; a new point-of-sale disclosure; and a new participant disclosure. As of July 22, 2008, when they published the proposed participant disclosure regulations, they have delivered on all three initiatives. Currently all three are scheduled to become effective as of January 1, 2009. It will be a brave new world of transparency and disclosure in 2009 and beyond. This article focuses on the new participant disclosures.

PRE-2009 DISCLOSURE

Current level of industry transparency: murk.

It has historically been a rare sponsor or participant who has the faintest idea what his or her plan actually costs. One of my favorite anecdotes is that of the plan sponsor who interviewed me several years ago as the fifth of five vendors in his company's vendor search process. I walked in with the plan advisor to find the chairman of the investment committee with his feet on the table, exhausted from the marathon of presentations, who said, "Pete, before you begin, let me just tell you that Vendor X is free and you're going to have to beat that." I responded that, since I was disinclined to write him a check, I had better leave. The story has a happy ending (my firm was ultimately hired), but it has always confounded me that this highly intelligent business person, who was surely aware that Vendor X is not a charitable institution, was nonetheless buying into the "It's free" thing. Any experienced retirement plan professional could tell a dozen similar stories.

The Current Disclosure Rules[1]

Financial service providers are governed by multiple entities, but each individual provider or fiduciary is generally governed primarily by a single entity. For example:

[1] This section is taken with minor changes from *401(k) Fiduciary Governance: An Advisors Guide* (ASPPA 2008; available at www.asppa.org).

Insurance Companies	State Insurance Commissioners
Mutual Fund Companies	Securities and Exchange Commission (SEC)
State Banks	State Banking Departments
National Banks	OCC or OTS[2]
State RIAs	States
Larger RIAs	SEC
Broker/Dealers	FINRA (formerly NASD and NYSE)
ERISA Fiduciaries	Department of Labor (DOL).

Regulations and methods of oversight vary widely between these government bodies and Self-Regulating Organizations (SROs). For example, mutual fund disclosures are much more detailed than those required of collective investment trusts (banks) or insurance separate accounts (insurance companies). Compensation disclosure is generally required for a fee-only RIA, yet is not required by a commission-based insurance agent or stockbroker. Yet when any of the above is a fiduciary, ERISA trumps all.

Here are some facts about the current disclosure rules and how they affect sponsors:

- **Disclosure Not Required for Salespeople**. Commission-based salespeople are generally not required to disclose their compensation if they are non-fiduciaries (though there is an argument that the act of choosing one's compensation is a fiduciary act of itself, and creates a *de facto* conflict of interest[3]—an example of ERISA trumping other regulations).
- **No Clear Disclosure Requirement for Fiduciaries or Vendors**. There is no *explicit* requirement for fiduciaries and vendors to disclose their compensation, though there is such an explicit requirement in the new 408b-2 regulations[4]—one of the three DOL initiatives scheduled to become effective in January 2009. The burden is therefore on the responsible fiduciary to understand the compensation of its service providers and other fiduciaries, from whatever source derived. There is perhaps an implied duty for fiduciaries to disclose fees due to the existing 408b-2 regulatory requirement that a provider's contract be reasonable—the implication being that compensation must be known for the contract to be reasonable—but this is

[2] Office of the Comptroller of the Currency and Office of Thrift Supervision
[3] See *The ERISA Outline Book* by Sal Tripodi, Chapter 13.
[4] 29 CFR 2550.408b-2(c)

implication, not regulation[5], which is why DOL took pains to spell the disclosure requirement out in the new 408b-2 rules.

- **"Brother's Keeper" Disclosures Not Required**. No regulating body requires any service provider to disclose someone else's fees. For example, there is no requirement for an RIA to disclose the fees of a recordkeeper it recommends. Similarly there is no requirement for a recordkeeper to disclose the fees of the mutual funds available on its platform—those disclosures are regulated elsewhere, though the SEC is taking a strong interest in this question as of the time this is written. Also the new 408b-2 rules, again, contain provisions that call for "bundled" arrangements to include compensation from all bundled parties in their fee proposals.
- **Recordkeepers Are Relatively Unregulated**. None of the regulating bodies mentioned above oversees recordkeepers. This does not mean recordkeepers are not subject to any regulations, only that they are less heavily regulated and audited than certain other entities. Note, however, that the American Society of Pension Professionals and Actuaries (ASPPA) now has an ASPPA Recordkeeper Certification, developed with the help of the Centre for Fiduciary Excellence (CEFEX) in a move toward more intensive self-regulation.
- **DOL Disclosure Documents Are Not Comprehensive**. The only disclosure documents we have from DOL are the Form 5500, Schedules A and C, and the informal DOL model fee disclosure. The Schedules A and C are incomplete disclosures of certain items only, not total cost summaries. Note, however, that the new 408b-2 regulation requires a more comprehensive point of sale disclosure than has previously existed, and that the new 5500 Schedule C rules require more annual disclosure, though the Schedule C disclosures, in particular, will not be comprehensive for all plans as discussed below.
- **Mutual Funds Are More Reliably Transparent Than Collective Funds or Separate Accounts**. SEC governs mutual fund sales materials, cost disclosures, and operations. Performance figures, transactions, and therefore financial statements are standardized and audited. But bank collective funds and insurance separate accounts are not subject to the same rules governing mutual funds, and the uniformity, amount, and perhaps reliability of

[5] This changes in 2009, since one of the three initiatives mentioned above is an amended 408b-2 regulation which requires explicit contractual terms and fee disclosure. But this section is about the pre-2009 state of affairs, and that means the old 408b-2 governs until then. We have at least one other reference by DOL to a fiduciary disclosure requirement, albeit only in the limited context of a fiduciary custodian who keeps "float" as part of its compensation. See DOL AO 93-24A and FAB 2002-3.

information is less than for mutual funds as a general rule. For example, every mutual fund has a prospectus and Statement of Additional Information (SAI) with prescribed format and content; collective funds and separate accounts do not. DOL took this into account when crafting the participant disclosure requirements since plans use a variety of investment vehicles, not just mutual funds.

So the current state of affairs, until the three transparency initiatives from DOL go into effect on January 1, 2009, is that we have a mishmash of rules from a variety of sources, none of which requires comprehensive, transparent disclosure in a format useful to retirement plan fiduciaries and participants.

THE NEW PARTICIPANT DISCLOSURE REGULATIONS

On July 22, 2008 DOL published a new proposed regulation—the 404a-5 Regulation[6]—and proposed amendments to the old 404(c) regulation[7]. The changes, along with the other two DOL transparency intiatives (5500 and 408b-2) are intended to cure the current state of affairs—the mishmash of rules with no single disclosure source that is helpful to fiduciaries and participants. The two regulations will henceforth work in tandem and are summarized below.

A New Explicit Requirement: Loyalty and Prudence Require Disclosure

The four basic fiduciary duties under ERISA §404(a)(1) can be summarized as loyalty, prudence, diversification, and following a plan's governing documents. DOL states in the new regulation that the duties of loyalty and prudence carry with them a now explicit obligation to make certain disclosures to participants who direct their own investments. Failure to make these disclosures is henceforth a breach of the Exclusive Purpose Rule[8] and/or the prudence requirement[9] according to DOL[10].

[6] 29 CFR 2550.404a-5
[7] 29 CFR 2550.404c-1
[8] The ERISA version of the common law duty of loyalty, found in ERISA §§403(c) and 404(a)(1)(A), with a similar provision—the Exclusive Benefit Rule—found as one of the qualification requirements in IRC §401(a)(2). For an in-depth discussion of the Exclusive Purpose Rule see Chapters 4 and 5 of *401(k) Fiduciary Governance: An Advisors Guide* (ASPPA 2008; available at www.asppa.org).
[9] The Fiduciary Duties of ERISA §404(a) are described collectively as "the prudent man standard of care." The second of the four duties is the requirement to discharge duties "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." Again, see *401(k) Fiduciary Governance* for a detailed discussion.

What Must Be Disclosed? Plan and Investment Information

The information that must be disclosed includes two broad categories of information: ***plan*** and ***investment*** information. There is specific guidance about format and content, including a requirement that basic data on each investment be provided in a spreadsheet or comparative format (picture a typical plan's fund menu, with both cost and performance data, with appropriate benchmarks listed for comparison). This information must be provided before or upon a participant's eligibility for the plan and annually thereafter. There is a heavy emphasis on comprehensive cost disclosure. In practice this requirement will probably be fulfilled by a combination of disclosures in the plan's enrollment materials and Summary Plan Description.

Quarterly Disclosure of Billed Expenses

In addition, a new mandatory quarterly disclosure requirement calls for participants to be shown the actual dollar amount of fees deducted from their accounts in excess of the expenses of the investments (which are available elsewhere). So the comprehensive initial/annual disclosure shows all of the information that is pertinent to good participant decision-making, including the fees that *might* be charged, while the quarterly disclosure shows the fees that have *actually* been charged to a participant's account in excess of fund expense ratios. In practice this requirement will be fulfilled by adding one or two line items to quarterly participant statements.

The Regulation does not state that separate line items are required: one for the participant's share of plan level administrative expenses and others for event fees charged only to the participant, such as loan or QDRO fees. But an additional breakdown would almost certainly be required since the regulation requires that the disclosure of event fees show both the amounts and what services incurred the charge. This may be challenging to program into recordkeeping systems without a proliferation of seldom-used line items (e.g., one each for QDRO, distribution, loan, etc.).

For example, any recordkeeping system has the means to show fees deducted against a participant's account, but imagine a participant who is charged, in the same quarter, both an annual loan fee of $75 and a QDRO fee of $250. During that same quarter the participant is charged $150 in trustee, advisory, and recordkeeping fees in excess of the expense ratios of the funds. Further imagine that the funds used on this 401(k) platform

[10] Remember that it is the Judicial Branch of our government—the courts—that is the ultimate arbiter of what the law means, not the Agencies (DOL, IRS) of the Executive Branch. But naturally the courts can be expected to give great deference to these DOL rules.

have average expense ratios of just .30%--very cheap relative to the marketplace, but with the consequence that billed expenses are higher even though total expenses are lower than costs for competing products. What would this participant see?

Suppose the vendor shows a single line item for all fees: the total is $475 for the quarter. Since the new rule requires that event fees must be accompanied by an explanation, there must be a supplemental line somewhere explaining how the $475 is broken down. If, instead, the vendor uses multiple line items, there would be three in this quarter. Obviously there will be programming required before the quarterly disclosure rule can be easily met by industry vendors.

How do Participants React to Seeing Fees on Their Statements?

My firm's 401(k) business is fee only, and we therefore show all deducted fees on a participant's statement every quarter already, so we have some insight into how people react. The short version is that when participants go from **not** seeing fees to suddenly seeing a charge appear, a few are mad. We have learned that part of the education process for new clients is to emphasize to participants that they will see these charges *before* they see the first statement. We explain that these are charges that they were paying before but were not seeing. This satisfies most participants, but the HR director will nonetheless get a few complaints.

I usually tell the HR director, in advance, "Out of your 200 people you have three—and you probably know exactly who they are—who will stomp through your door to complain if you charge them a nickel." (HR manager smiles—he/she does in fact know three such people.) But the door stomping is a one-time phenomenon, and in 23 years of billing clients a fully disclosed fee, we have never had a problem that was not easily solved. So it does take some effort to adjust to a transparent world, but it's a better place to live.

One final point about how participants react to seeing explicit fees: consider the impact on owners, executives, and employees with large balances. A doctor with a $1 million account balance who is charged a .50% fee, or $1250 per quarter, will sit up and pay attention the first time he or she notices the charge. One point we make to such participants is that they were paying basis point charges before but were not seeing them. Would they prefer not to see them? And it helps when what they used to pay is equal to or greater than what they currently pay: we can then say, "You're now paying the same or even less, but you're seeing exactly what you pay."

Again, it takes some adjusting to live in a transparent world, but it's a better place: as long as your total fees are competitive, clients pay the fees just as they would if you hid them. The difference is that now they *know*, and you can never be fired just because your competitor tells your client what you had neglected to mention—how much you are paid. The corollary, of course, is that if you charge too much, you're about to take an overdue pay cut. And if you charge too much and someone else gets to your client before you do, your pay cut will be 100%.

ERISA §404(c) Compliance is Now Linked to 404a-5 Compliance

Anyone who has read ERISA §404(c) and the 404c-1 regulation—which provide conditional relief from liability for fiduciaries when participants exercise control over the investments in their accounts—knows that it is full of exhaustive detail about disclosures that must be made to participants in order for 404(c) relief to be available. Under the new rules, the majority of these exhaustive disclosures have been deleted from the 404c-1 regulation, moved (with changes) to the 404a-5 regulation, and replaced with the following simple statement:

> …a participant or beneficiary will be considered to have sufficient information if the participant or beneficiary is provided…The information required pursuant to 29 CFR 2550.404a-5…

In other words, under the old 404(c) regulation, there was a long list of participant disclosures. Fail to make the disclosures and you would not be eligible for relief from liability for participant investment decisions. Whereas the disclosures were optional under 404(c), since 404(c) protection itself is optional, they wanted the disclosures to be mandatory for all participant directed plans. Therefore they put the disclosures under their regulations for ERISA §404(a) (the basic fiduciary duties) instead of 404(c), and simply cross-referenced the new rules, saying that 404(c) compliance now requires 404a-5 regulatory compliance. By moving the list of disclosure obligations into the list of basic fiduciary duties, DOL turned the formerly optional disclosures into an ***affirmative fiduciary obligation*** for all participant directed plans.

THE PROSPECTUS REQUIREMENT IS DEAD! LONG LIVE THE PROSPECTUS REQUIREMENT

I always hated the prospectus requirement.

DOL's 404c-1 regulations currently require that for any security or mutual fund subject to securities law prospectus requirements that is available in a participant directed plan, the plan fiduciary must give a prospectus to all participants whether they ask for it or not. *401(k) Fiduciary Governance: An Advisory's Guide* describes the prospectus requirement as follows:

> As a practical matter, the prospectus requirement is virtually ignored in the 401(k) industry today. Vendors do not mail stacks of a dozen 80-page prospectuses to every participant; sponsors do not hand stacks of prospectuses out; advisors do not carry boxes of prospectuses to every enrollment meeting and make sure every participant gets his or her stack. As a practical matter, no one wants the prospectuses. The very few who do want to read the prospectuses (all 800+ pages in a typical plan) don't mind asking for them. But the fact that the rule is expensive, unwanted, and unworkable does not change the fact that compliance requires delivery of stacks of paper and the attendant deaths of innocent trees.

This was a bad rule, created with the best of intentions, and the ERISA Advisory Council told DOL as much in 2004 when it examined this issue and recommended that the delivery of a prospectus be changed from a "push" requirement (information that is pushed out to participants whether they want it or not) to a "pull" or on demand requirement. DOL listened and made it so.

Deleted

DOL therefore proposed amending the 404c-1 regulation in several places, including lengthy section that lists the required disclosures to participants. That entire section has been deleted and replaced, more or less, with the simple requirement to provide the "information required pursuant to 29 CFR 2550.404a-5." One of the disclosures in the deleted section was the prospectus requirement—it's gone.

So the prospectus requirement is in fact dead—assuming, of course, that the new rules are finalized with this change intact. It seems unlikely that the public comments will include any substantial objections, so it seems likely that plans can achieve 404(c)

compliance without "push" distribution of prospectuses as of 1/1/2009, or whenever the regulations actually become effective.

Long Live the Prospectus Requirement…As an On Demand Disclosure

DOL recognizes that requiring the giving of prospectuses is still sensible, just not useful and probably even counterproductive when forced out to those who do not want them. The new 404a-5 rule therefore switches the prospectus requirement from "push" to "pull." Under the new rules, fiduciaries need only give prospectuses when participants request them.

FIDUCIARIES ARE RESPONSIBLE FOR INVESTMENT SELECTION AND MONITORING

DOL took pains to emphasize this point in the Preamble:

> The Department also is taking this opportunity to reiterate its long held position that the relief afforded by section 404(c) and the regulation thereunder does not extend to a fiduciary's duty to prudently select and monitor designated investment managers and designated investment alternatives under the plan. Accordingly, it is the Department's view that a fiduciary breach or an investment loss in connection with the plan's selection of a designated investment alternative is not afforded relief under section 404(c) because it is not the result of a participant's or beneficiary's exercise of control.

Plan sponsors routinely conclude, incorrectly, that when participants pick their own funds from the vendor's menu the sponsor is off the hook—that the vendor is responsible for the funds and the participant for his or her own choices. This is false: fiduciaries are only afforded relief under ERISA §404(c) if they meet the requirements for relief, namely those listed in the DOL's 404c-1 regulation, and the relief only extends to the participant's choices. The fund lineup is the responsibility of the sponsor or of a trustee or discretionary fiduciary hired by the sponsor explicitly for this purpose (currently the exception, not the rule). DOL is attempting to mitigate the widespread tendency for sponsors to misperceive who is responsible for what.

THE THREE DOL TRANSPARENCY INITIATIVES TAKEN AS A WHOLE

Here again are the three new sets of proposed regulations from DOL that are slated to become effective January 1, 2009, with a brief summary of each. This is a watershed event: a major turning point in how the industry is regulated and how services are

provided, and is part of a larger movement that has been gathering momentum for years—a movement toward transparency, fiduciary service, and a focus on outcomes.

New 5500 Disclosures Under Schedules A and C

Service providers, including brokers, RIAs, recordkeepers, and others, will now be required to provide detailed compensation disclosures on the Schedule A and/or C, but the Schedule C service provider schedule will remain limited in that the $5,000 threshold still applies—below that limit for a single provider, no reporting is required—and the Schedule C disclosures only apply to large plan filers, those with 100 or more participants. Since most plans are small plan filers, and because the smaller large plan filers often have vendors whose compensation is below the $5,000 threshold, the 5500 will by useful as a transparency tool primarily for larger plans only. Even for those larger plans, however, there is no assurance that the 5500 data will represent a truly comprehensive listing of fees and expenses, but it will greatly increase overall transparency.

Rules for Contracts and Fee Proposals Under 408b-2

The old regulation under ERISA §408(b)(2) provided the means for vendors to provide services and get paid for doing so, which would otherwise be a prohibited transaction. The basic rule is that no one may provide a service or receive compensation from an ERISA plan unless the service is reasonable, the compensation is reasonable, and the contract or arrangement is reasonable.

Where the old rules were very general, however, the new rules are specific and require detailed disclosures, specific contract terms, and that vendors comply with those contract terms. Failure to meet these requirements is a *de facto* prohibited transaction. The new 408b-2 rules will therefore be a powerful new tool for achieving transparency at the plan sponsor or fiduciary level, but not at the participant level. Also it will remain the case that any vendor's 408b-2 disclosure will not be a comprehensive disclosure except in the case of certain fully bundled arrangements: different providers will offer separate disclosures: someone must still collate the data.

The new 408b-2 rules have other powerful implications as well. For a discussion of a major ethical dilemma and decision facing brokers and broker/dealers who serve qualified plans, see "The 401(k) Broker's Dilemma" in the summer 2008 edition of *ABA Trusts & Investments*.

Pulling it All Together: The 404a-5 Participant Disclosures

What distinguishes the participant disclosure is that it is solely the plan fiduciary's responsibility, not the vendors' responsibility. The fiduciary is obligated to pull together the data from the vendors' 408b-2 disclosures, put them into a consolidated format, and pass the information on to participants, who will then see a comprehensive picture of fees charged against their accounts.

The only portion of fees that would not show up in the participant disclosures are those paid by the sponsor, which would naturally not have to be disclosed to participants. One consequence of this is that sponsors will need to decide in advance how much of plan fees they will pay or not pay. Most vendors have a mechanism for collecting their fees from the plan if they are not paid directly by the sponsor, and in some cases the sponsor has the freedom to pay a particular invoice or not. In future, those sponsors who decide what to pay *ad hoc* with each invoice should probably stop this practice and simply decide in advance how fees will be handled to simplify the disclosure process.

Summary of the Three Initiatives in Action

The 408b-2 rules apply at point of sale and periodically thereafter, providing fiduciaries with a clear understanding of fees and conflicts of interest to allow good decision-making at the plan level. Participants will generally never see the 408b-2 documents. Annually the sponsor/fiduciary will be able to compare the 408b-2 disclosures to what was actually charged during the year by reviewing the 5500, but only if the plan and vendor are large enough to warrant disclosure. Participants will receive an initial/annual disclosure explaining all fees that they may pay from their accounts, then will be able to compare those disclosed fees to fees actually charged on a quarterly basis via the quarterly statement disclosures.

Understanding plan fees will remain complex, and sponsors will still require the assistance of a professional consultant or advisor to ensure they are fulfilling their fiduciary duties, but an appropriate level of transparency will finally be in reach, consistently across the industry, when the new rules become effective.

SUMMARY OF THE 404A-5 DISCLOSURE REGULATION

- Fiduciaries must take steps to ensure that participants, on a regular and periodic basis, are made aware of their rights and responsibilities with respect to their accounts and are provided sufficient information regarding the plan, including fees and investment alternatives, to make informed decisions.
- Effective for plan years beginning on or after January 1, 2009.
- Plan-related information that must be disclosed includes:
  - General Plan Information (e.g., how to give investment instructions, restrictions on transfers, voting/tender rights, identification of investment options and managers). Must be updated within 30 days of a material change.
  - Administrative Expense Information: an initial/annual description of any fees and how they are charged; a quarterly statement of fees actually charged to a participant in excess of fund expense ratios.
  - Individual Expense Information (i.e., event processing fees charged at the individual level, such as for loans and QDROs): an initial/annual description of any event fees and how they are charged; a quarterly statement of fees actually charged to a participant in excess of fund expense ratios and a listing of what services were performed for those fees.
- Investment-Related Information to be disclosed includes:
  - Information provided automatically ("pushed" to participants whether they ask for it or not): investment name, web address, category, whether active or passive, performance history, appropriate benchmark history, fee data. No fee data need be given for fixed accounts such as GICs and stable value funds with guaranteed rates. Fee data is extensive and includes surrender charges, MVAs, redemption fees, mortality & expense charges, total expense ratio, etc. Also required is a statement that fees are only one factor to consider in making decisions.
  - A variation in the venerable "past performance is no guarantee of future results" is now an ERISA requirement, not just a securities law requirement.
  - Comparative format: investment data above must be given on a spreadsheet or similar format to facilitate comparison.
  - Info on voting/tender rights if passed through.
  - Info provided on request: prospectus; financial statements or reports such as a mutual fund's statement of additional information (SAI); share/unit values; underlying assets where those assets are plan assets.

- The initial/annual disclosures can be done on the SPD[11] as long as the SPD is then given annually. By extension we can infer that the required information could probably be provided in an SMM[12] which is updated annually to avoid re-issuing the entire SPD every year.
- The quarterly cost disclosures can be done on the ERISA/PPA-mandated pension benefit statements (i.e., the quarterly statements).
- DOL provided a model disclosure that provides assurance that the "comparative format" requirement is met if the fiduciary correctly uses the model form.
- Fiduciaries are still obligated to prudently select and oversee plan investments.
- These disclosures must be distributed in accordance with current DOL regulations on participant disclosures, including the electronic distribution rules. For example, it's not sufficient for the sponsor to give "push" info on request, leave it in the break room, post it on the bulletin board, or make it available via a single computer kiosk available to all employees—these are not accepted delivery methods.[13]
- Self-directed brokerage accounts and open option arrangements are not included in the definition of "designated investment alternative" and are thus not subject to the disclosure requirements for investment options.

SUMMARY OF CHANGES TO THE 404C-1 REGULATION

- The requirement in 404c-1(b)(2)(B) to ensure the participant has sufficient information to make decisions has been mostly deleted and replaced with new, much shorter language.
  - One interesting change: the wording "…a participant will <u>not</u> be considered to have sufficient information unless…" has been changed to: "…<u>will</u> be considered to have sufficient information if the participant or beneficiary is provided…" This may be a minor change but it implies a less rigid stance in how the Department will view 404(c) regulatory compliance.
  - Several pages of required participant disclosures have been deleted and now appear, in altered form, in the new 404a-5 regulation. In other words, they've been transferred from optional (only required for purposes of

[11] Summary Plan Description
[12] Summary of Material Modifications, the short document summarizing any changes to an SPD during the 5-10 year gap between SPD mandatory delivery times.
[13] See 29 CFR 2520.104b-1 and the discussion of it in Chapter 3 of *401(k) Fiduciary Governance: An Advisors Guide.*

404(c) compliance) to mandatory (a basic fiduciary duty under the prudence and loyalty obligations of ERISA §404(a)).
    - 404(c) compliance now requires compliance with the new 404a-5 rules.
- The prospectus requirement is gone! Moved to 404a-5 and transformed into an "on demand" disclosure requirement.
- The following was added in order to clarify that 404(c) does not eliminate a fiduciary's obligation to oversee plan investments: "Paragraph (d)(2)(i) of this section does not serve to relieve a fiduciary from its duty to prudently select and monitor any designated investment manager or designated investment alternative offered under the plan."
- Other than those noted above, the only other changes were minor wording and cross-reference changes.

NUMBERED SUMMARY OF THE 404A-5 PARTICIPANT DISCLOSURE REGULATION

Below is a more detailed outline of the new regulation's provisions with the actual numbering of the regulation preserved to aid further study. The full text is included as Appendix A.

> (a) General. In participant directed plans, the fiduciary duties of prudence and loyalty require that plan fiduciaries "…must take steps to ensure that such participants and beneficiaries, on a regular and periodic basis, are made aware of their rights and responsibilities with respect to the investment of assets held in, or contributed to, their accounts and are provided sufficient information regarding the plan, including fees and expenses, and regarding designated investment alternatives, including fees and expenses attendant thereto, to make informed decisions with regard to the management of their individual accounts."
>
> (b) Satisfaction of duty to disclose. Starting in 2009, fiduciaries must meet these disclosure requirements for all participants who are permitted to self-direct. Following paragraphs (c) and (d) below will constitute compliance.
>
> (c) Disclosure of plan-related information. Must provide the following:
>
> (1) General.
>
> (i) On or before the date of plan eligibility and at least annually thereafter:
>
> (A) An explanation of the circumstances under which participants and beneficiaries may give investment instructions;

(B) An explanation of any specified limitations on such instructions under the terms of the plan, including any restrictions on transfer to or from a designated investment alternative;

(C) A description of or reference to plan provisions relating to the exercise of voting, tender and similar rights;

(D) An identification of any designated investment alternatives offered under the plan; and

(E) An identification of any designated investment managers; and

(ii) Must provide an update within 30 days in the event of a material change in any of the info above;

(2) Administrative expenses.

(i) Initially and annually, an explanation of any fees or expenses and how they're charged (e.g., pro rata or per capita);

(ii) At least quarterly, a statement that includes:

(A) The dollar amount actually charged during the preceding quarter, and

(B) A description of the services provided for that particular amount (e.g., recordkeeping).

(3) Individual expenses [think of these as "event processing" fees such as loan or distribution expenses].

(i) Initially and annually, a description of event fees that may be charged, and

(ii) At least quarterly, a statement that includes:

(A) The dollar amount actually charged during the preceding quarter, and

(B) A description of the services.

(d) Disclosure of investment-related information. A fiduciary (or a person or persons designated by the fiduciary to act on its behalf), based on the latest information available to the plan, shall:

(1) Information to be provided automatically. Provide to each participant initially and annually the following information for each investment alternative –

(i) Identifying information. Such information shall include:

(A) name of investment;

(B) Web address leading to additional info on the investment;

(C) Category (e.g., large value, money market),

(D) Whether actively or passively managed;

(ii) Performance data. For fixed accounts provide fixed rate of return and term[14]. For non-fixed accounts such as bond or stock mutual funds provide 1, 5, and 10 year performance. Include the beloved disclaimer, "that an investment's past performance is not necessarily an indication of how the investment will perform in the future.";

(iii) Benchmarks. Show 1, 5, and 10 year performance for appropriate index for each alternative except fixed account;

(iv) Fee and expense information. For non-fixed accounts:

(A) The amount and a description of each shareholder-type fee (i.e., fees charged directly against a participant's or beneficiary's investment), such as sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, account fees, purchase fees, and mortality and expense fees;

(B) The total annual operating expenses (e.g., expense ratio); and

(C) A statement indicating that fees and expenses are only one of several factors that participants and beneficiaries should consider when making investment decisions. For fixed accounts disclose a description of any shareholder-type fees that may be applicable to a purchase, transfer or withdrawal of the investment in whole or in part;

[14] Note that this requirement is general enough as to require clarification: net or gross yield? Many stable value funds, for example, have their performance reported to participants gross of fees, not net, but the regulation does not speak to this.

(v) Disclosure on or before date of plan eligibility. Initial disclosure can be met by providing most recent annual disclosure.

(2) Comparative format. Furnish the information described in paragraph (d)(1) in a chart or similar format that is designed to facilitate a comparison; as well as:

(i) contact info for requesting additional information, and

(ii) A statement that more current investment-related information may be available at the listed Website. Additional information may also be provided; it's not limited to what's listed here;

(3) Information to be provided subsequent to investment. Provide info on voting or tender rights if such rights are passed through to participants;

(4) Information to be provided upon request–

(i) Prospectuses or similar documents if no prospectus exists (e.g., for insurance separate accounts or bank collective funds).

(ii) Financial statements or reports, such as statements of additional information and shareholder reports, to the extent such materials are provided to the plan;

(iii) Share or unit values; and

(iv) A list of underlying assets and their values to the extent those assets are plan assets (i.e., the underlying securities in a mutual fund are NOT plan assets per DOL regulations, while the underlying assets in separate accounts or collective funds are plan assets and therefore subject to this requirement);

(e) Form of disclosure.

(1) The information may be provided as part of the plan's summary plan description or quarterly statement (i.e., the quarterly pension benefit statement required by ERISA as amended by PPA and subsequent DOL regulations) so long as those documents are provided at the appropriate frequencies.

(2) The quarterly disclosure of administrative and event fees can also be done on the quarterly statement.

(3) Use of the model disclosure in the Appendix to the regulation constitutes safe harbor compliance with paragraph (d)(2) of this section (i.e., the requirement to

provide the information in a comparative format), but other formats are permitted.

(4) Except for the quarterly dollar amount disclosures, fees and expenses may be expressed in terms of a monetary amount, formula, percentage of assets, or per capita charge.

(5) Must be written in a manner calculated to be understood by the average plan participant.

(f) Selection and monitoring. Nothing herein is intended to relieve a fiduciary from its duty to prudently select and monitor providers of services to the plan or designated investment alternatives offered under the plan.

(g) Manner of furnishing. The disclosures must be given in accordance with the current 29 CFR 2520.104b-1 regulation, including the electronic distribution provisions[15].

(h) Definitions. For purposes of this section, the term –

(1*) Designated investment alternative* means any investment alternative designated by the plan. Does not include "brokerage windows," "selfdirected brokerage accounts," or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan.

(2) Average annual total return means returns as calculated under Item 21 of Securities and Exchange Commission Form N-1A for open-ended mutual funds.

(3) Total annual operating expenses means annual operating expenses, expressed as a percentage, calculated in the same manner as under Instruction 3 to Item 3 of Securities and Exchange Commission Form N-1A for open ended mutual funds.

(4) *At least annually thereafter* means at least once in any 12-month period, without regard to whether the plan operates on a calendar or fiscal year basis.

(5) At least quarterly means at least once in any 3-month period, without regard to whether the plan operates on a calendar or fiscal year basis.

[15] For a detailed discussion, see Chapter 3 of *401(k) Fiduciary Governance: An Advisor'S Guide.*

JUDGMENT

Being generally immune to the unwritten credo of the pension community calling for authors to remain formal and neutral[16] when discussing laws and regulations, I will venture an opinion on the new rules: I like them. They seem well-considered and likely to accomplish their stated purpose of enhancing retirement savings in America. Doubtless other technicians, who will review the rules in greater depth in the coming months, will come up with valid criticisms and necessary fixes, which I trust DOL to make. But in broad outline the basic concept is elegant and appropriate: fiduciaries of participant-directed plans have an affirmative obligation to ensure participants have enough information to make informed decisions—with prescribed format and content—and 404(c) protection is not available unless this basic obligation is first met. When combined with the additional transparency initiatives DOL has already completed—the new 5500 rules and the 408b-2 contract rules—the new participant disclosures round out a sensible array of regulations that accomplish what Congress has recently been attempting to legislate: transparency and accelerated fee competition.

The industry is changing: from a culture of product sales by non-fiduciary brokers and vendors who leave everything up to the sponsor but have superb golf handicaps, to a culture of consultative fiduciary service, transparency, and an emphasis on outcomes. When the DOL's three transparency initiatives achieve Final Regulation status, presumably in time for the January 2009 deadlines, the industry will take a major step in this new, and right, direction.

[16] And really boring.

Appendix: Full Text of the Proposed 404a-5 Participant Disclosure Regulation

This version of the proposed regulation was copied from the DOL's pdf document, footnotes removed, and formatting added to aid readability (i.e., the subsections have been indented since federal regulations are virtually unreadable otherwise). To see DOL's actual document, which includes the Preamble, footnotes, and the proposed 404c-1 amendments, visit http://www.dol.gov/federalregister/PdfDisplay.aspx?DocId=20959.

(a) General. The investment of plan assets is a fiduciary act governed by the fiduciary standards of section 404(a)(1)(A) and (B) of the Employee Retirement Income Security Act of 1974, as amended (ERISA), 29 U.S.C. 1001 et seq. (all section references herein are references to ERISA unless otherwise indicated). Pursuant to section 404(a)(1)(A) and (B), fiduciaries must discharge their duties with respect to the plan prudently and solely in the interest of participants and beneficiaries. Where the documents and instruments governing an individual account plan, as defined in section (3)(34), provide for the allocation of investment responsibilities to participants or beneficiaries, fiduciaries, consistent with section 404(a)(1)(A) and (B), must take steps to ensure that such participants and beneficiaries, on a regular and periodic basis, are made aware of their rights and responsibilities with respect to the investment of assets held in, or contributed to, their accounts and are provided sufficient information regarding the plan, including fees and expenses, and regarding designated investment alternatives, including fees and expenses attendant thereto, to make informed decisions with regard to the management of their individual accounts.

(b) Satisfaction of duty to disclose. For plan years beginning on or after January 1, 2009, the fiduciary (or fiduciaries) of an individual account plan must comply with the disclosure requirements set forth in paragraphs (c) and (d) of this section with respect to each participant or beneficiary that, pursuant to the terms of the plan, has the right to direct the investment of assets held in, or contributed to, his or her individual account. Compliance with paragraphs (c) and (d) of this section will satisfy the duty to make the regular and periodic disclosures described in paragraph (a) of this section.

(c) Disclosure of plan-related information. A fiduciary (or a person or persons designated by the fiduciary to act on its behalf) shall provide to each participant or beneficiary the plan-related information described in paragraphs (c)(1) through (3) of this section, based on the latest information available to the plan.

(1) General.

(i) On or before the date of plan eligibility and at least annually thereafter:

(A) An explanation of the circumstances under which participants and beneficiaries may give investment instructions;

(B) An explanation of any specified limitations on such instructions under the terms of the plan, including any restrictions on transfer to or from a designated investment alternative; 87

(C) A description of or reference to plan provisions relating to the exercise of voting, tender and similar rights appurtenant to an investment in a designated investment alternative as well as any restrictions on such rights;

(D) An identification of any designated investment alternatives offered under the plan; and

(E) An identification of any designated investment managers; and

(ii) Not later than 30 days after the date of adoption of any material change to the information described in paragraph (c)(1)(i) of this section, each participant and beneficiary shall be furnished a description of such change.

(2) Administrative expenses.

(i) On or before the date of plan eligibility and at least annually thereafter, an explanation of any fees and expenses for plan administrative services (e.g., legal, accounting, recordkeeping) that, to the extent not otherwise included in investment related fees and expenses, may be charged to the plan and the basis on which such charges will be allocated (e.g., pro rata, per capita) to, or affect the balance of, each individual account, and

(ii) At least quarterly, a statement that includes:

(A) The dollar amount actually charged during the preceding quarter to the participant's or beneficiary's account for administrative services, and

(B) A description of the services provided to the participant or beneficiary for such amount (e.g., recordkeeping).

(3) Individual expenses.

(i) On or before the date of plan eligibility and at least annually thereafter, an explanation of any fees and expenses that may be charged against the individual account of a participant or beneficiary for services provided on an individual, rather than plan, basis (e.g., fees attendant to processing plan loans or qualified domestic relations orders, fees for investment advice or similar services charged on an individual basis), and

(ii) At least quarterly, a statement that includes:

(A) The dollar amount actually charged during the preceding quarter to the participant's or beneficiary's account for individual services, and

(B) A description of the services provided to the participant or beneficiary for such amount (e.g., fees attendant to processing plan loans).

(d) Disclosure of investment-related information. A fiduciary (or a person or persons designated by the fiduciary to act on its behalf), based on the latest information available to the plan, shall:

(1) Information to be provided automatically. Provide to each participant or beneficiary, on or before the date of plan eligibility and at least annually thereafter, the following information with respect to each designated investment alternative offered under the plan –

(i) Identifying information. Such information shall include:

(A) The name of the designated investment alternative;

(B) An Internet Web site address that is sufficiently specific to lead participants and beneficiaries to supplemental information regarding the designated investment alternative, including the name of the investment's issuer or provider, the investment's principal strategies and attendant risks, the assets comprising the investment's portfolio, the investment's portfolio turnover, the investment's performance and related fees and expenses;

(C) The type or category of the investment (e.g., money market fund, balanced (stocks and bonds) fund, large-cap fund); and,

(D) The type of management utilized by the investment (e.g., actively managed, passively managed);

(ii) Performance data. For designated investment alternatives with respect to which the return is not fixed, the average annual total return (percentage) of the investment for the following periods, if available: 1-year, 5-year, and 10-year, measured as of the end of the applicable calendar year; as well as a statement indicating that an investment's past performance is not necessarily an indication of how the investment will perform in the future. In the case of designated investment alternatives with respect to which the return is fixed for the term of the investment, both the fixed rate of return and the term of the investment;

(iii) Benchmarks. For designated investment alternatives with respect to which the return is not fixed, the name and returns of an appropriate broad-based securities 90 market index over the 1-year, 5-year, and 10-year periods comparable to the performance data periods provided under paragraph (d)(1)(ii) of this section, and which is not administered by an affiliate of the investment provider, its investment adviser, or a principal underwriter, unless the index is widely recognized and used;

(iv) Fee and expense information. For designated investment alternatives with respect to which the return is not fixed:

(A) The amount and a description of each shareholder-type fee (i.e., fees charged directly against a participant's or beneficiary's investment), such as sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, account fees, purchase fees, and mortality and expense fees;

(B) The total annual operating expenses of the investment expressed as a percentage (e.g., expense ratio); and

(C) A statement indicating that fees and expenses are only one of several factors that participants and beneficiaries should consider when making investment decisions. In the case of designated investment alternatives with respect to which the return is fixed for the term of the investment, the amount and a description of any shareholder-type fees that may be applicable to a purchase, transfer or withdrawal of the investment in whole or in part;

(v) Disclosure on or before date of plan eligibility. The requirement in paragraph (d)(1) of this section to provide information to a participant on or before the date of plan eligibility may be satisfied by furnishing to the participant the most recent annual 91 disclosure furnished to participants and beneficiaries pursuant to paragraph (d)(1) of this section and any material

changes to the information furnished to participants and beneficiaries pursuant to paragraph (c)(1)(ii) of this section.

(2) Comparative format. Furnish the information described in paragraph (d)(1) of this section in a chart or similar format that is designed to facilitate a comparison of such information for each designated investment alternative available under the plan; as well as:

(i) a statement indicating the name, address, and telephone number of the fiduciary (or a person or persons designated by the fiduciary to act on its behalf) to contact for the provision of the information required by paragraph (d)(4) of this section, and

(ii) A statement that more current investment-related information (e.g., fee and expense and performance information) may be available at the listed Internet Web site addresses (see paragraph (d)(1)(i)(B) of this section). Nothing herein, however, shall preclude a fiduciary from including additional information that the fiduciary determines appropriate for such comparisons, provided such information is not inaccurate or misleading;

(3) Information to be provided subsequent to investment. Provide to each investing participant or beneficiary, subsequent to an investment in a designated investment alternative, any materials provided to the plan relating to the exercise of 92 voting, tender and similar rights appurtenant to the investment, to the extent that such rights are passed through to such participant or beneficiary under the terms of the plan;

(4) Information to be provided upon request. Provide to each participant or beneficiary, either at the times specified in paragraph (d)(1), or upon request, the following information relating to designated investment alternatives –

(i) Copies of prospectuses (or any short-form or summary prospectus, the form of which has been approved by the Securities and Exchange Commission) for the disclosure of information to investors by entities registered under either the Securities Act of 1933 or the Investment Company Act of 1940, or similar documents relating to designated investment alternatives that are provided by entities that are not registered under either of these Acts.

(ii) Copies of any financial statements or reports, such as statements of additional information and shareholder reports, and of any other similar materials relating to the plan's designated investment alternatives, to the extent such materials are provided to the plan;

(iii) A statement of the value of a share or unit of each designated investment alternative as well as the date of the valuation; and

(iv) A list of the assets comprising the portfolio of each designated investment alternative which constitute plan assets within the meaning of 29 CFR 2510.3-101 and the value of each such asset (or the proportion of the investment which it comprises);

(e) Form of disclosure.

(1) The information required to be disclosed pursuant to paragraphs (c)(1), (c)(2)(i), and (c)(3)(i) of this section may be provided as part of the plan's summary plan description furnished pursuant to ERISA section 102 or as part of a pension benefit statement furnished pursuant to ERISA section 105(a)(1)(A)(i), if such summary plan description or pension benefit statement is furnished at a frequency that comports with paragraph (c)(1) of this section.

(2) The information required to be disclosed pursuant to paragraphs (c)(2)(ii) and (c)(3)(ii) of this section may be included as part of a pension benefit statement furnished pursuant to ERISA section 105(a)(1)(A)(i).

(3) A fiduciary that uses and accurately completes the model format set forth in the Appendix will be deemed to have satisfied the requirements of paragraph (d)(2) of this section.

(4) Except with respect to the dollar amounts required to be included under paragraphs (c)(2)(ii)(A) and (c)(3)(ii)(A) of this section, fees and expenses may be expressed in terms of a monetary amount, formula, percentage of assets, or per capita charge.

(5) The information required to be prepared by the fiduciary for disclosure under this section shall be written in a manner calculated to be understood by the average plan participant.

(f) Selection and monitoring. Nothing herein is intended to relieve a fiduciary from its duty to prudently select and monitor providers of services to the plan or designated investment alternatives offered under the plan.

(g) Manner of furnishing. Disclosures under this section shall be furnished in any manner consistent with the requirements of 29 CFR 2520.104b-1 of this chapter, including paragraph (c) of that section relating to the use of electronic media.

(h) Definitions. For purposes of this section, the term –

(1) *Designated investment alternative* means any investment alternative designated by the plan into which participants and beneficiaries may direct the investment of assets held in, or contributed to, their individual accounts. The term "designated investment alternative" shall not include "brokerage windows," "selfdirected brokerage accounts," or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan.

(2) Average annual total return means the average annual profit or loss realized by a designated investment alternative at the end of a specified period, calculated in the same manner as average annual total return is calculated under Item 21 of Securities and Exchange Commission Form N-1A with respect to an open-end management investment company registered under the Investment Company Act of 1940.

(3) Total annual operating expenses means annual operating expenses of the designated investment alternative (e.g., investment management fees, distribution, service, and administrative expenses) that reduce the rate of return to participants and beneficiaries, expressed as a percentage, calculated in the same manner as total annual operating expenses is calculated under Instruction 3 to Item 3 of Securities and Exchange Commission Form N-1A with respect to an open-end management investment company registered under the Investment Company Act of 1940.

(4) *At least annually thereafter* means at least once in any 12-month period, without regard to whether the plan operates on a calendar or fiscal year basis.

(5) At least quarterly means at least once in any 3-month period, without regard to whether the plan operates on a calendar or fiscal year basis.

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In 1988 he graduated with a degree in Linguistics from the University of Virginia, where he was selected for the prestigious Echols Scholar Program. He accepted a commission in the U.S. Marine Corps and served in the first Gulf War as Executive Officer of an infantry company. He left the Marines as a Captain in 1993.

Pete is the author of *401(k) Fiduciary Governance: An Advisor's Guide*, a textbook for 401(k) advisors and consultants. He is a frequent speaker on the subject of qualified plans and fiduciary risk management for groups that include the Institute for International Research, American Society of Pension Professionals and Actuaries (ASPPA), the Financial Planning Association (FPA), National Institute of Pension Administrators (NIPA), The American Bankers Association (ABA), The International Forum, the ERISA Fiduciary Guild, and various employee benefit organizations. As the principal author of the "ERISA Boot Camp" workshop series he delivers workshops across the country annually. As the author of more than 20 articles and white papers his work has appeared in *Financial Planning* Magazine, the *Journal of Financial Planning, The ASPPA Journal*, *Employee Benefits News, ABA Trust & Investments,* and other venues. A paper written with co-author Gregory W. Kasten, "Post Modern Portfolio Theory," won first prize in the 2005 Annual Call for Papers of the *Journal of Financial Planning*.

Pete is Past President of the Lexington Employee Benefits Council and is an active member of the Financial Planning Association and American Society of Pension Professionals and Actuaries ASPPA). He lives with his three children, Jettie, David, and Andrew, in the horse country of Central Kentucky.