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M I C H E L L E B A R T L E T T

New Disclosure Requirements for Participant-Directed Plans

In a development with implications for most 401(k) plan sponsors*, the Department of Labor ("DOL") has issued new proposed rules requiring, starting in 2009, that plan sponsors provide participants in "participant-directed" plans with periodic reports summarizing plan rules, investment options, and plan expenses.

*And other participant-directed individual account qualified plans.

These proposed regulations are among several significant new rules pertaining to 401(k) plans and related defined contribution plans. (Other rules issued since 2007 by DOL include requirements that plan vendors provide detailed fee disclosure to fiduciaries, and that fiduciaries report fee information on Form 5500.) These rules are motivated by controversy and litigation over fees, expenses and revenue-sharing practices in plan investments and administration. The rules will affect both "bundled" and unbundled plans.

Plan sponsors must react with unusual speed to the new proposed regulations. The new rules are **mandatory**, and are proposed to become **effective January 1, 2009**. Please be sure to see the action steps at the end of this memo.

In a participant-directed plan, each participant may direct how his or her account is to be invested, typically from a "menu" of investment options selected by the plan sponsor. Plans of this type have become increasingly popular (and now account for the majority of 401(k) plans) because they permit each participant to choose his or her own investment strategy and level of investment risk. The Department of Labor, however, has expressed concern that participants may not always be provided with sufficient information to make informed, prudent decisions from among the available investment choices – a concern that has now led to the proposed new rules. Many plan fiduciaries and investment providers are also being sued over excessive costs and inattention to "revenue sharing." The new rules will raise awareness of problems we've preached about for decades. The result will be more information for participants, and better-considered investment and administrative programs.

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These proposed rules, once final, would be *mandatory*, and apply to all participant-directed plans. They thus differ from the already existing rules under Section 404(c) of the Employee Retirement Income Security Act of 1974 (“ERISA”). The 404(c) rules are optional: If a plan sponsor complies with those requirements, including making available a diverse set of investment choices and providing participants with minimum levels of disclosure and information, the plan sponsor and other plan fiduciaries will not be held responsible for investment choices made by the participants themselves. By contrast, the new rules were issued by DOL under ERISA Section 404(a), which contains the fundamental “prudence” and other standards that apply to all plan fiduciaries. The Department has effectively taken the position that failure to satisfy these new disclosure rules for participant-directed plans will itself represent a breach of fiduciary duty, regardless of the participants’ decisions. The results could be disastrous for plan fiduciaries: participants could easily “tag” fiduciaries for years of reduced investment returns due to excessive costs or uncaptured “revenue sharing” monies.

For those plan sponsors who do intend to satisfy Section 404(c), the new regulations take the place of most of the disclosure currently required under the existing 404(c) regulations. In one very welcome development, the rules effectively eliminate the previous requirement of providing participants a prospectus (if any) immediately before or after the first investment in any fund. A prospectus (as well as other information) still must be provided if a participant requests it. The DOL has also made a point of revising the 404(c) regulations to make clear that in every case plan sponsors retain fiduciary liability prudently to select and monitor the available investment alternatives under a plan.

We recommend that plan sponsors retain fee-based, unconflicted, fiduciary investment advisors with respect to selection of the menu of funds. We also recommend that this advisor also give advice on the reasonableness of costs and service in administrative, custodial, and similar arrangements. Any “revenue sharing” should also be identified and properly applied.

Between the fiduciary advisor (with respect to the menu of funds and reasonableness of costs) and ERISA Section 404(c) (making participants responsible for their investment allocations) plan fiduciaries should achieve good results, and be optimally insulated from liability.

The new mandatory rules, contained in Proposed Regulation § 2550.404a-5, are quite specific both as to what information must be disclosed and as to the form in which it must be provided to participants. The required information is of two general types:

- **“Plan-related” information.** This includes such things as the circumstances under which participants can make and change investment elections; limitations on elections; voting, tender and related investment rights; and identification of investment options and investment managers. Importantly, the proposed rules also require detailed disclosure of plan expenses charged to participants’ accounts, including quarterly breakdowns of the amount of expenses. This breakdown would reflect both plan-wide expenses, (such as investment advice, administration, legal, or audit) and individual expenses, such as qualified domestic relations order expenses) charged to each participant’s account.

NOTE that only such expenses paid by the plan would be disclosed. Any expenses paid by the plan sponsor would not be involved. Keep in mind that there is no "free lunch." Administration in a "bundled arrangement" is not free. It may be paid for by transfer payments ("revenue sharing) from mutual funds to the administrator. In such situations, the service that appears "free" is actually being paid for by participants, in the form of higher expense loads that now must be disclosed. Fiduciaries should determine the reasonable cost of the administration, and whether the revenue sharing exceeds that reasonable cost. Fiduciaries should seek to recapture any excess and utilize it for plan purposes, or for allocation to participants.

- **“Investment-related” information.** This includes descriptive data about each investment option, including, for each option, a reference to a Web site providing detail about the investment’s portfolio, strategies and risks. The plan sponsor must also provide performance data and fee/expense information for each investment alternative. The performance information must include investment returns over 1-year, 5-year and 10-year periods (assuming the investment has been in existence for that long), and the same data for an appropriate benchmark. Expense information must include the amount and description of each “shareholder-type fee” such as sales loads and redemption fees, as well as the total annual operating expenses of the investment, expressed as a percentage.
- **Fee disclosure by service providers.** The proposed participant disclosure rules are one of several new disclosure initiatives by the DOL. A second consists of proposed regulations under ERISA Section 408(b)(2) which require service providers such as investment managers, recordkeepers and third party administrators, among others, to disclose the fees they charge to their ERISA plan clients, including “bundled” and revenue sharing arrangements. These proposed regulations, which will become effective 90 days after they are finalized, also require that a plan’s arrangements with such a service provider be reflected in a written agreement. Most existing agreements will require modifications as a result of the new rules.

- **New Form 5500 reporting requirement.** The rules and instructions governing Form 5500 Schedule C have also been changed to require disclosure of compensation that a service provider receives, “directly or indirectly,” for services to a plan. Revenue sharing items such as 12b-1 fees are among the types of compensation that must be reported under these new rules. The new Form 5500 reporting rules were issued with an effective date of January 1, 2009, although the DOL has recently offered an extension of up to a year in cases where service providers do not have in place the systems necessary to capture and report the required information.
- **Mapping.** Although not part of the new regulations, fiduciaries should also be aware of the following new requirement, effective 1.1.08: Mutual funds and other investments may be replaced from time to time, and perhaps in particular after a review of mutual fund and administrative costs suggested by the new regulations. Typically, a participant's existing investment in a current fund is automatically moved (“mapped”) to the replacement fund. Usually, the replacement fund has similar attributes to the current fund (e.g., they are both “large cap value equity funds.”) Pension Protection Act amended ERISA Section 404(c) to require, as a condition of 404(c) protection in such mapping situations, that participants be provided comparison information on the old and new funds at least 30 and no more than 60 days before the transition. Other requirements apply.

The proposed regulations require that the “investment-related” information described in the new regulations be provided in “comparative format,” in a chart designed to facilitate a comparison among the investment alternatives. The DOL has included in the proposed regulations a model chart (see attached) that may be used for this purpose: A plan sponsor doesn’t have to use this model form, but doing so will ensure compliance under the proposed regulations. By contrast, much of the required “plan-related” information can simply (and may already) be included in the plan’s summary plan description, or in participants' benefit statements, in the case of quarterly breakdowns of expenses charged to each participant’s account.

The plan related and investment related information must be provided to each participant on or before the date he or she becomes eligible under the plan, and at least annually thereafter (except for breakdowns of expenses charged to each participant’s account, which must be provided quarterly). The rules are proposed to become effective for plan years beginning on or after January 1, 2009, meaning that calendar year plan sponsors have only a few months in which to prepare.

These proposed rules appear against the backdrop of recent litigation and DOL activity that have focused increasing attention on plan fees and expenses. It seems likely the new requirements, with their emphasis on disclosing plan expenses and investment fees, will further heighten the visibility of this issue. As a result, in coming months plan sponsors would be well-advised, in addition to gathering the data necessary for complying with the new rules, to reassess the level and allocation of fees and expenses charged under any participant-directed plan.

NOTE--NON ERISA PLANS: These DOL rules of course apply only to ERISA plans, which leaves out governmentals and most 403(b)'s, for example. Sponsors of these plans should nonetheless consider the import of these rules. The logic behind them may apply equally to any fiduciaries, whether regulated by state laws or ERISA. And a careful review of fees and expenses could benefit any defined contribution plan.

ACTION STEPS:

1. Plan expenses must be identified. This may require some analysis, especially in "bundled arrangements." This may also lead to unpleasant revelations about costs, or lost revenue sharing, which may call for negotiations and changes to investment and administrative arrangements. (Simply put, you may be paying too much for investments or administration, or may be letting service providers keep too much revenue sharing, or you may be making both mistakes. This should be corrected.) If you have a bundled arrangement, you will now discover that in fact, you aren't getting "free" plan administration. And what about custody? And how much "revenue sharing" are mutual funds sending to your providers (and not to the plan or participants?)

2. Your method of allocating expenses should be examined, properly documented, and disclosed to participants. Some expenses cannot be charged to the plan (example: discretionary plan design costs.) Others ("administrative expenses," which include most necessary costs of plan operations) may be charged to the plan. This requires a method of allocating the expenses to participants' accounts. The allocation may be either prorated based on account balance size, or may be charged equally to all participants' "per capita" (depending on the kind of expense.) Other expenses may be charged directly to the participant that incurs the expense (e.g., reviewing a participant's QDRO.)

3. Your administrative systems must reflect expenses on participants' statements as separate line items. This may require a breakdown based on type of expense.

4. You must prepare the necessary comparisons of plan investments. This is a good job for your investment advisor (if any.) This is also a good time to review

the funds you offer, from the standpoint of performance against benchmarks, adherence to asset class, expenses, net return, and revenue sharing (if any.)

5. You should inventory all plan service provider arrangements and make sure the providers are required, under a written agreement, to provide disclosure about the fees and other compensation they receive as well as additional information necessary to comply with the new DOL rules. You should also take steps to ensure this information will be properly reported as required under the new Form 5500 Schedule C rules.

6. In the face of these new fiduciary obligations, and the microscope the government and plaintiffs' attorneys are using on investments and costs, you should also do the following:

***Make sure your fiduciary bodies (in-house, in particular) have been properly chartered, to be sure their decisions have authority (and to be sure the persons who serve are optimally protected from liability.)**

***Review and update your investment policy.**

***Have your fiduciary liability insurance reviewed. We find many gaps and mistakes in these policies.**

***Review agreements with your service providers (investment advisors, administrative providers, custodians) to be sure they are properly stepping-up to their responsibilities. Most such agreements should be revised in light of the new series of DOL rules.**

***Be sure your plan documents, summary plan descriptions, online resources and other materials meet the new disclosure requirements and properly deal with expenses.**

***Be sure your processes and documents meet ERISA sections 404(c) and 404(a) (and the new regulations) so that participants (not you) remain responsible for their investment allocations.**

FOR HELP WITH YOUR COMPLIANCE PLAN, CONTACT ONE OF THE FOLLOWING SKA ATTORNEYS:

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