Participant Disclosures: Where Advisers Need to be Involved

Fred Reish, esq.

Fred.Reish@dbr.com
www.linkedin.com/in/fredreish

April 2013

Drinker Biddle

Fiduciary Responsibility for Participant Disclosures

The legal burden—the fiduciary responsibility for participant disclosures—is placed on the ERISA plan administrator (ERISA §3(16))—typically the plan sponsor or the plan committee.

However, as a practical matter, plan fiduciaries will rely on service providers to draft and distribute the disclosures.

Reliance by Plan Administrator

The 404a-5 regulation provides:

> *A plan administrator **will not be liable** for the completeness and accuracy of information used to satisfy these disclosure requirements when the plan administrator **reasonably and in good faith relies** on information received from or provided by a plan service provider or the issuer of a designated investment alternative."* [Emphasis added.]

continued . . .

Plan Sponsor Fiduciary Responsibility

Continued . . .

The key issue is, how do plan fiduciaries develop a reasonable and good faith belief?

One approach is a checklist for 404a-5 participant disclosures.

Participant Disclosures

The 404a-5 regulation requires the plan administrators of participant-directed plans to disclose:

- Plan-related information:
  - General information.
  - Administrative expenses.
  - Individual expenses.

  } both descriptive and dollar amounts

- Investment-related information in comparative chart format.

Timing of Disclosures

The disclosures must be provided:

- On or before the date on which a "**participant**" or beneficiary can first direct investments.
- At least annually thereafter.
- Quarterly statements regarding administrative and individual expenses.
- Website disclosures.
- Information on request.

Investment-Related Disclosures

The comparative chart for designated investment alternatives (DIAs) include the following information:

- Performance for 1, 5 and 10 years, as compared to "broad based" benchmark.
- The total annual operating expense or expense ratio expressed as a percentage and as a dollar amount per $1,000 invested.
- Any "shareholder-type fee" or restriction.

continued . . .

Investment-Related Disclosures

Continued . . .

Website information including:

- Portfolio turnover rate.
- Objectives and goals.
- Participant strategies and risks.
- Updated fee and performance information.

Issues for Disclosures

There are disclosure issues with the following services:

- Asset allocation models
- Designated investment managers.
- Administrative services and expenses.
- Brokerage accounts

Field Assistance Bulletin (FAB) 2012-02R

In 2012, the DOL issued a FAB that provided detailed answers to questions about the application of the 404a-5 regulation.

Some of those answers were surprising to the benefits community and present disclosure issues for advisers.

Asset Allocation Models (AAMs)

In Question and Answer (Q&A) 28 of the FAB, the DOL asked:

> *A plan offers ten designated investment alternatives. The plan also offers three model portfolios (labeled 'conservative,' 'moderate,' and 'growth') made up of different combinations of the plan's designated investment alternatives. Is each model portfolio a designated investment alternative under the regulation?*

Asset Allocation Models

If a model portfolio is treated as a designated investment alternative (or DIA), then certain disclosure requirements apply.

For example, the participants would need to be given information about the expense ratio of the model portfolio, its historical performance, expenses per thousand, and so on.

Disclosures by Recordkeepers

Also, under the 408(b)(2) regulation, recordkeepers **must provide participant disclosure information about designated investment alternatives** to plan administrators . . .

> *. . . reasonably in advance of entering into the arrangements or, if not designated at that time, not later than the date the investment is designated.*

- Role of the adviser.

Asset Allocation Models (AAMs)

In the Answer, the DOL concluded that, if certain requirements are met, an AAM will not be considered a DIA.

Instead, it would be viewed as a service to assist participants in deciding which investments to use and how much to invest in each.

- Query regarding drafting and distribution of disclosures.

Asset Allocation Models

First Requirement:

The AAMs must be *"clearly presented to the participants and beneficiaries as merely a means of allocating account assets among specific designated investment alternatives."*

In other words, the model cannot be presented as if it is an investment in its own right.

- How and when are these participant disclosures made?

Asset Allocation Models

Second Requirement:

The investment cannot be in an "entity," but instead must be an investment directly in the underlying mutual funds. The DOL states:

> *. . . if, . . . in choosing a model portfolio, the plan participant acquires a . . . unit participation or similar interest in an entity that, itself, invests in some combination of the plan's designated investment alternatives, such model portfolio ordinarily would be a designated investment alternative.*

Asset Allocation Models

Third Requirement:

The participant should be given a description of the model portfolio and how it works.

Unfortunately, that guidance is susceptible of different interpretations. Our recommendation is that the description explain the differences between them, *e.g.*, conservative and growth allocations.

Asset Allocation Models

Fourth Requirement:

The participant disclosure materials *"also must explain how it [that is, the model] differs from the plan's designated investment alternatives."*

The disclosure materials should describe the model as being an asset allocation strategy or service and describe the underlying designated investment alternatives as being the "investments."

Asset Allocation Models

Fifth Requirement:

Finally, the AAMs cannot include investments that are not designated investment alternatives.

Some RIAs have been using investments in their AAMs (for example, emerging market funds) that are not available to participants for direct investing. In that case, the AAM would be considered a DIA and the detailed disclosure rules for DIAs would apply.

Asset Allocation Models

Other Considerations:

Careful thought needs to be given to the description of related issues.

That would include, for example, the description of the removal of an investment from the plan's line-up—and, therefore, from the AAM; the re-balancing of the portfolio and how it occurs; and any changes to the allocations in the portfolio.

- Recommend: Written descriptions.

Designated Investment Managers

In Q&A 4 of the FAB, the DOL introduces the concept of a “designated investment manager” or DIM. A DIM is an ERISA 3(38) investment manager that is selected by the plan fiduciaries and made available to participants to manage their accounts.

Designated Investment Managers

Some RIAs have, in lieu of modifying their asset allocation models, decided to provide participant investment services as DIMs. That is at least partially because a DIM can use investments above and beyond the designated investment alternatives.

A DIM must manage a participant's account "***on a participant-by-participant basis***."

Designated Investment Managers

If a plan offers a DIM, a description of the DIM's services and fees must be included in the materials distributed to participants initially and annually.

Keep in mind that "participants" include all eligible employees, even if they are not deferring and do not have account balances.

Designated Investment Managers

Also, the investment management fees for the DIM must be disclosed, as dollar amounts, to participants quarterly—assuming they are charged to the participant's account.

If the fees are charged to plan as a whole, then they would be disclosed in pro-rated dollar amounts as administrative fees, rather than individual fees.

Administrative Expenses

Q&A 5 of the FAB describes the disclosure of administrative expenses, which include RIA fees that are paid by the plan (and, ultimately, reduce the participants' accounts).

The Q&A explains that those expenses can, in the initial and annual disclosures, be explained as "***a monetary amount, formula, percentage of assets, or a per capita charge***."

Administrative Expenses

That information must be included in the participant disclosures, initially and annually. Those disclosures must also include a description of the services.

The disclosures must also describe whether the fees are charged to the participants' accounts and, if so, on what basis (*e.g.*, pro rata).

- How will these disclosures be drafted and distributed?

Administrative Expenses

If the plan sponsor pays the fees or if the fees are paid from a forfeiture account or expense recapture account (and not directly from participants' accounts), these disclosures are not required.

If it is not certain whether the amounts will be paid through participants' accounts, a conditional disclosure can be made.

Administrative Expenses

In addition to the narrative disclosure, the quarterly statements of participants will also include the dollar amount of administrative expenses (including RIA fees) that is charged to their individual accounts.

- Note regarding expense recapture accounts and forfeiture accounts.

Brokerage Accounts

Q&A 13 of the FAB describes three categories of requirements:

> The first disclosure is a general description of the brokerage account, including how to set one up; the account balance requirements, if any; any restrictions or limitations on trading; and whom to contact with questions. That disclosure needs to be in writing and delivered initially and annually to all participants and beneficiaries.

continued . . .

Brokerage Accounts

Continued . . .

The second requirement is that the participants be given "***an explanation of any fees and expenses that may be charged against the individual account of a participant or beneficiary***" in connection with the brokerage account.

continued . . .

Brokerage Accounts

Continued . . .

In addition, the DOL said that participants should be "advised" in writing to ask the broker-dealer "***about any fees, including any undisclosed fees, associated with the purchase or sale of a particular security through a window, account or arrangement, before purchasing or selling such security***."

continued . . .

Brokerage Accounts

Continued . . .

The third, and final, requirement is that participants be given information about the actual dollar amounts charged to their accounts—at least quarterly. The disclosures can be made more frequently than quarterly, for example, on confirmations and monthly brokerage statements.

The disclosures of the dollar amounts of fees and expenses may be more detailed than many broker-dealers can satisfy.

Consequences

These changes require that advisers work with recordkeepers to develop and distribute appropriate participant disclosures.

FRED REISH, ESQ.

1800 Century Park East, Suite 1400
Los Angeles, CA 90067
(310) 203-4047
(310) 229-1285 [fax]
Fred.Reish@DBR.com www.linkedin.com/in/fredreish

www.drinkerbiddle.com

CALIFORNIA | DELAWARE | ILLINOIS | NEW JERSEY
NEW YORK | PENNSYLVANIA | WASHINGTON DC | WISCONSIN