New York Law Journal

SERVING THE BENCH AND BAR SINCE 1888

WWW.NYLJ.COM

An ALM Publication

VOLUME 242—NO. 77

TUESDAY, OCTOBER 20, 2009

Outside Counsel

Expert Analysis

Effects of the 401(k) Fair Disclosure and Pension Security Act

By **Bernard F. O'Hare**

This article discusses how employers providing 401(k) plans to their employees will be affected by the 401(k) Fair Disclosure and Pension Security Act of 2009 in the realm of fee disclosure under legislation currently pending in the U.S. House of Representatives. There are other provisions of the proposed legislation, including the provision of investment advice, which are not discussed here.

Requirements

On April 21, 2009, Representatives George Miller (D-Ca.) and Robert Andrews (D-N.J.) introduced the Fair Disclosure for Retirement Security Act of 2009 (HR 1984) and the Conflicted Investment Advice Prohibition Act of 2009 (HR 1988), respectively. These bills were consolidated to create the 401(k) Fair Disclosure and Pension Security Act of 2009 (HR 2989).

HR 2989 was introduced to the House Education and Labor Committee on June 23, 2009. By a 29-17 party-line vote with democratic support, the committee voted that the bill be reported the next day and sent to the House Ways and Means Committee.

Although Representative Miller's prior 401(k) Fee Disclosure Bill stalled in this committee in 2007, the highly publicized effects on employees' retirement funds in the recent economic downturn will likely pressure representatives to support some type of 401(k) fee disclosure legislation. In addition, the shift from a republican to a democratic majority in the House may result in increased support, as democrats have traditionally supported 401(k) fee disclosure legislation.

The act is divided into three Titles:

"Title I—401(k) Fair Disclosure for Retirement" requires the following:

- 401(k) service providers must disclose all fees to participants and beneficiaries and provide advance notice of fee changes;
- 401(k) service providers must provide information comparing investment options in a format easily understandable to the typical plan participant and beneficiary; and
- Employees must have the option of investing in a passively managed index fund.

"Title II—Prohibition of Conflicted Investment Advice" requires the following:

- Investment advisers must be independent and may not receive compensation from the plan administrator (the employer) for their advice directly nor can they enter into unrelated contracts for goods and services which may produce a conflict of interest and
- Employers must enlist in a program to be established by the Secretary of Labor educating employees about investment risks, debt, savings, and the importance of preparing for retirement.

"Title III—Transitional Funding Relief for Defined Benefit Plans" allows the following:

- A party that elects to use a yield curve in lieu of a segmented interest rate in 2009 may revoke that election without the Secretary's consent in 2010 and
- Miscellaneous recategorization of fees, extensions, and minor amendments to ERISA and the Internal Revenue Code.

> If this bill becomes law, employers must ensure all 401(k) statements meet these more stringent disclosure requirements.

This article focuses on the fee disclosure and does not address the investment advice and the funding relief provisions set forth under Titles II and III of the proposed legislation.

Effective dates for each subsection vary; some provisions are effective on the day of enactment, some take effect at the end of 2009, and others do not take effect for a year after enactment. In addition, some provisions require the Secretary of Labor to create rules and guidelines within a certain period of time following enactment (usually 270 days), and parties must comply with those rules within a specified period of time.

Overall, this legislation will require investment managers and employers to provide extensive information to employees about the details of their 401(k) plans and ensure investment advisers are "independent." Although some of these provisions target investment managers, employers should be aware of the requirements of the proposed legislation to protect the best interests of their corporate assets and the retirement savings of their employees.

Disclosure of Fees

As noted above, one of the requirements under Title I of the act is that 401(k) service providers must disclose all fees to participants and beneficiaries and provide advance notice of fee changes. [ERISA §111(a)]. In the words of Rep. Miller, "in these difficult economic times, workers need simple and complete information in order to make better educated decisions about their retirement plans."[1] To achieve this goal, HR 2989 mandates special reporting and disclosure rules for individual account plans that provide for participant choice among investment plans. The following fee disclosure requirements take effect one year after the enactment of this act.

If the service provider fails to comply with these disclosure requirements, the provider may be fined up to $1,000 a day with respect to each violation every day the

BERNARD F. O'HARE *is a partner at Patterson Belknap Webb & Tyler, where he concentrates in employee benefits and executive compensation.* AILEEN M. McGILL, *a 2009 summer associate at the firm, and* MERIDITH BOGART KRELL, *an employee benefits associate, assisted in the preparation of this article.*

provider is not in compliance. The fine may not exceed 10 percent of the amount involved. Employers are not subject to penalties for a service provider's failure to comply with these disclosure requirements. This subsection modifies Employee Retirement Income Security Act (ERISA) §502.

What plans are affected. §111(a)(10)(A). The following fee disclosure requirements only apply to plans subject to ERISA in which the total fees charged for services are reasonably expected to exceed $5,000 per year. The Secretary of Labor may adjust this total to a lesser amount for small plans or adjust this amount, generally, as she finds appropriate.

Service Disclosure Statement. §111(a)(1). The employer may not enter into a contract for services to a 401(k) plan unless the employer has received a statement specifying the services to be provided, and expected annual charges.

Disclosure of Financial Relationships. The service disclosure statement must disclose any payment to be provided to the service provider for investment services provided to the employer's plan from any entity other than the plan or the accounts of the participants. This disclosure must also disclose any similar arrangements benefiting the service provider, including the extent to which the service provider may benefit from the offering of its own proprietary investment products or those of third parties.

Disclosure of Impact of Share Classes. This statement must also disclose that the share prices of certain mutual fund investments in the plan may be different from prices outside the plan due to different share classes.

Disclosure of Certain Arrangements in Connection with Free or Discounted Services or Reimbursements by Service Providers. If services are provided without any explicit charge, or for charges set at a discounted rate, the statement must specify the manner, extent, and amount by which consideration is otherwise obtained for those services.

Fee Disclosure Statements. §111(a)(2). Under HR 2989, the plan administrator of an individual account plan (the employer), or any official acting on the employer's behalf must demand a statement from the investment services provider with the following information.

Fees and Services. The statement must specify the services for the plan that will be provided and the expected total annual charges for these services, displayed prominently in a format understandable to the typical plan administrator.

Categorization of Fees. The statement must specify the component charges in the following categories:

(A) charges for administration and recordkeeping,

(B) transaction based charges,

(C) charges for investment management, and

(D) all such charges not described in subparagraph (A), (B) or (C).

The charges in (A) and (C) must be presented in the written statement as an aggregate total dollar amount, and, in addition, each of these total charges may also be presented as a percentage of assets. The charges in (B) must be itemized separately as dollar amounts or as percentages of the applicable base amounts.

Estimations. The service provider may provide a reasonable estimate of total annual charges based on the fees charged in previous years, or a reasonable estimate based on the plan's participants and beneficiaries. If the service provider provides this estimate, it must indicate that it is an estimate.

Overall, this legislation will require investment managers and employers to provide extensive information to employees about the details of their 401(k) plans and ensure investment advisers are 'independent.'

Updating. The service provider must provide to the plan administrator an updated statement containing fees and a description of the services provided. The service provider must issue a statement to the plan administrator describing any material change to fees or services "as soon as is reasonable after the occurrence of the change is known." This statement, or a statement indicating there have been no changes to fees or services, must be issued at least once a year.

Electronic Delivery Permitted. Any of these disclosures may be provided through an electronic medium, which may be modified as the Secretary deems appropriate to accommodate new technologies and the interests of plan sponsors, service providers, and participants.

Providing Information

A second requirement under Title I states that 401(k) service providers must provide information comparing investment options in a format easily understandable to the typical plan participant and beneficiary. [ERISA §111(b)].

Unlike the fee disclosure statement discussed in Section I, employers, not investment managers, are responsible for the following information provided they sponsor plans that permit participant investment directions. The employer or plan administrator must disclose all available investment options to employees and include more information than previously required in quarterly benefit statements. These requirements take effect one year after the enactment of this act.

Any employer or plan administrator who does not provide a statement to participants and beneficiaries in accordance with §105(a)(2)(B)(ii) or 111(b) may be assessed by the Secretary a civil penalty of up to $100 a day during the period of noncompliance.

Disclosures to Participants and Beneficiaries: Advance Notice of Available Investment Options. §111(b)(1). The employer must provide employees with notice of the investment options before a reasonable period prior to the earliest date provided for under the plan for the participant's initial investment of any contribution made on behalf of such participant and the effective date of any material change in investment options.

If the plan provides for immediate eligibility or an automatic contribution arrangement, this notice may be provided within any reasonable period prior to such initial investment.

Information Included in Notice. §111(b)(2). This notice must indicate which components of the charges are paid by the participant or beneficiary, and must indicate how these charges are to be paid. The notice must also set forth, with respect to each available investment option, the name of the option, a description, its risk level, whether the option is diversified, whether the option is actively or passively managed, and where to obtain more investment information. The notice must also include a statement explaining that investment options should not be evaluated solely on the basis of its charges, but only on careful consideration of other factors such as risk, objectives, strategies, and historical returns.

Plan Fee Comparison Chart. §111(b)(3). The notice must include a plan fee comparison chart, comparing services and investment charges among different plans. The chart must be easily understood by the typical participant, and must include further information as the Secretary deems necessary for participants and beneficiaries to assess the services and charges.

The chart must present fees in dollar amounts, or as a formula, such as a percentage of assets in a manner easily understandable to the typical participant.

The chart must list the charges in the following categories, which are slightly distinct from the categories of the fee disclosure statement: asset-based charges specific to investment, asset-based charges not specific to investment, administrative and transaction-based charges, and all other charges. The charges must be further described, however, indicating the extent to which each charge is for investment management, transactions, plan administration and recordkeeping, or other identified services.

In addition, the chart must specify (as amounts or percentages) the fees assessed in connection with the option and the historical return and net fees and expenses. The investment manager may provide an estimate for fees and charges, but this is not required. If the provider issues an estimate, however, it must disclose the basis of its assumptions.

Electronic Delivery Permitted. Any of these disclosures may be provided through an electronic medium, which may be modified as the Secretary deems appropriate to accommodate new technologies and the interests of plan sponsors, service providers, and participants.

Quarterly Benefit Statements. §105(a)(2). This provision amends ERISA §105. Quarterly benefit statements must now provide the following information:

- the starting balance of the account;
- contributions made during the quarter, itemizing separately totals for employer and totals for employee contributions;
- investment earnings or losses during the quarter;
- actual or estimated charges which reduce the account during the quarter in dollars or as an expense ratio;
- any other direct charges to the participant or beneficiary;
- the ending balance;
- the participant's asset allocation to each investment option, expressed as an amount and as a percentage; and
- how to obtain the most recently updated version of the plan fee comparison chart.

If the plan has 100 or fewer participants and beneficiaries, the plan may provide the pension benefit statement on an annual rather than a quarterly basis.

Other Information. The plan administrator (the employer) may include other information in the quarterly pension benefit statement. The plan administrator may also include a reasonable estimate of charges or percentages and shall indicate any estimate as being an estimate, based on reasonable assumptions included in the statement.

Assistance to Small Employers (with one hundred or fewer employees). The Secretary must make available to small employers education and compliance materials and services designed to assist these employers in finding affordable investment options. The Secretary must also provide materials that compare investment performance and charges for these options on an ongoing basis.

Assistance to Plan Sponsors and Plan Participants and Beneficiaries. The Secretary must provide assistance to plan sponsors and beneficiaries with any questions regarding compliance with these requirements.

Electronic Delivery Permitted. Any disclosure required may be provided through an electronic medium.

Good Faith Compliance Prior to Secretary's Regulations. The Secretary shall issue final regulations under the amendments made by this section not more than 270 days after the date of enactment. Any act or practice in advance of the issuance of final regulations under the amendments by this section which is in good faith compliance with the requirements of these amendments shall be treated as compliance with any final regulations.

Investment Option

A third requirement under Title I of the act is that the employer must ensure employees have the opportunity to invest in a passively managed index fund. [§102].

With respect to employers sponsoring plans with participant directed investments and who seek fiduciary relief under ERISA §404(c) concerning the investment choices made by those participants, the proposed amendments to ERISA will require plan providers to include a passively managed investment fund as an investment option "designed to be representative of the United States investable equity market (including representation of small, mid, and large cap stocks) or the United States investment grade bond market (including Treasury, agency, non-agency, and corporate issues) or a combination thereof."

This investment option must be described in the terms of the plan as offered without any endorsement of the government or plan sponsor. Failure to include this investment option will be considered a forfeiture of the fiduciary protection from a participant's exercise of investment discretion provided in ERISA §404(c).[2]

The Secretary must issue regulations in accordance with this section 270 days after its enactment, and the regulation will take effect with these amendments one year after the statute's enactment.

Department of Labor Review

Section 103 of the act states that, among other items, the Secretary of Labor shall annually audit a representative sampling of individual account plans covered by this title to determine compliance.

Conclusion

Past efforts to pass 401(k) fee disclosure legislation have failed. However, the recent economic downturn may provide lawmakers with the springboard they need to push this bill through both houses of Congress. Undisclosed 401(k) fees may not be the cause of recent events in the financial industry but lawmakers have utilized the publicity from recent events to rally support for this bill. If this bill becomes law, employers must ensure all 401(k) statements meet these more stringent disclosure requirements and investment advisers are considered "independent" under these provisions.

A reader may question whether this additional disclosure (given the complexity of the new requirements) may lead to more confusion among participants, rather than more clarity. If that is the case, then less retirement savings may result. However, if the bright light of disclosure brings to an end certain inappropriate fee sharing arrangements and greater transparency, then worthwhile goals will have been achieved. Of course, though the ultimate impact of the legislation on retirement savings may be unclear, the burden on employers and plan service providers will undoubtedly increase in making certain that the new statutory requirements (if enacted) are met.

1. Comments of George Miller, 401(k) Fair Disclosure for Retirement Security Act 2009 available at http://edlabor.house.gov/blog/2009/04/401k-fair-disclosure-for-retir.shtml.
2. "[N]o person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such participant's or beneficiary's exercise of control…." 29 U.S.C. 1104(c)(1)(A)(ii).