The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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House Education and Labor Committee Approves Fee Disclosure and Investment Advice Bill

[23605]

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TO: PENSION MEMBERS No. 33-09
FEDERAL LEGISLATION MEMBERS No. 7-09
BANK, TRUST AND RECORDKEEPER ADVISORY COMMITTEE No. 28-09
BROKER/DEALER ADVISORY COMMITTEE No. 39-09
OPERATIONS COMMITTEE No. 13-09 RE: HOUSE EDUCATION AND LABOR COMMITTEE APPROVES FEE DISCLOSURE AND INVESTMENT ADVICE BILL

The House Education and Labor Committee on June 24 approved H.R. 2989, the "401(k) Fair Disclosure and Pension Security Act of 2009." H.R. 2989 combines fee disclosure provisions in H.R. 1984, [1] and investment provision provisions introduced in H.R. 1988. [2] H.R. 2989 also includes limited funding relief for defined benefit plans. A copy of the bill's text is attached.

The bill was approved by the Education and Labor Committee by a vote of 29-17, largely along party lines. A number of amendments were offered and defeated during the bill's mark-up, including an amendment that would have substituted all of the bill's fee disclosure provisions. [3] Because H.R. 2989 includes provisions amending the tax code, it has also been referred to the House Ways and Means Committee for consideration. No action on the bill has been scheduled by the Ways and Means Committee at this time.

Summary

H.R. 2989 would require certain disclosures to be provided by service providers to fiduciaries of 401(k) and similar plans and by fiduciaries to plan participants and beneficiaries, and would effectively require that each participant directed plan offer either a total U.S. stock market index fund, a total U.S. bond market fund, or an index fund that combines the two.

The service provider disclosure would require that fees be broken out into four categories (regardless of how the service is priced) including breaking out investment management from plan administration and recordkeeping. The bill provides that the "offering" of an investment option is considered a service subject to the bill's disclosure.

The bill would require disclosure regarding a plan's investments and fees be provided to participants upon enrollment, annually, and in advance of changes in investment options. The bill also would require more information on participants' quarterly benefit statements, including an estimate of the fees attributable to the participant's investments during the quarter.

Finally, the bill would repeal the investment advice provisions in the Pension Protection Act of 2006 and would place new detailed requirements on investment advice to plan fiduciaries and participants. These restrictions would, among other things, prevent those who manage investments used in a plan from providing investment advice (even under a fee-leveling arrangement) except through a computer model.

Revised Index Fund Requirement

H.R. 2989 includes a mandated index fund that has been modified from previous versions of H.R. 1984. The bill would provide that ERISA § 404(c) [4] will not be available to a plan fiduciary unless the plan includes at least one investment option meeting two requirements:

- The investment option must be a "passively managed investment with a portfolio of securities 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." [5]
- The plan's terms must describe the investment option "as offered without any endorsement of the Government or the plan sponsor.''

The bill provides that an index investment will not fail to qualify solely by reason of a failure

to invest in all or substantially all equities or bonds in the market, if the methodology used to select the equities or bonds is designed to approximate in a reasonable manner the broad experience of the market.

Disclosure to Plan Administrators

The bill would prohibit a plan administrator of an individual account plan [6] from contracting with a service provider unless the plan administrator receives, at least reasonably in advance of entering into the contract, a single written statement which describes the services that will be provided to the plan in connection with the contract and provides the expected total annual charges and an allocation of those total annual charges among four components. The offering of an investment option to a plan is specifically included as a contract for services covered by the bill. [7]

The total annual charges must be allocated into the following components:

- charges for plan administration and recordkeeping;
- transaction-based charges; [8]
- charges for investment management; and
- other charges as specified by the Department of Labor.

The annual charges for plan administration and recordkeeping and investment management must be presented as an aggregate total dollar amount (and also may be presented as a percentage of assets). Transaction-based charges may be presented either as a dollar amount or as a percentage of the "applicable base amounts." Reasonable estimates may be used but must be based on the previous year's experience, except in the case of a new plan, in which case the estimate must be based on a reasonable estimate, taking into account the plan's participants and beneficiaries. [9]

The single written statement must include a number of disclosures regarding conflicts of interest, share class, and discounted services:

- *Payments and services from affiliates and third parties.* The service provider must disclose any payment, or the amount representing the value of any services, provided to the service provider (or its affiliate) pursuant to or in connection with the contract. The disclosure must describe the amount and type of any payment made or credit received, and is required regardless of whether the person providing the services is affiliated with the plan, the plan sponsor, the plan administrator, or any other plan official. This information may be presented in terms of a formula, if the application of the formula is described.
- *Other similar relationships.* DOL may specify "similar" relationships benefiting the service provider that must be disclosed. This must include the extent to which the service provider or an affiliate may benefit from the offering of its own proprietary investment products or those of a third party, including cross-selling of affiliated products or services to the plan sponsor or participants.

- *Mutual fund share classes.* The single written statement must disclose, to the extent applicable, "that the share prices of certain mutual fund investments that are available to the plan may be different from the share price outside of the plan due to the existence of different share classes and provide the basis for those differences."
- *"Free or discounted" services.* If services are provided without explicit charge or at discount or subject to rebate, the single written statement must specify the consideration otherwise obtained by the service provider or an affiliate, the plan, or the plan sponsor for the services, directly or indirectly, by charges against participant accounts.

Under the bill, every contract for services must require that the service provider provide an updated written statement describing any material change as soon as reasonable after the change is known. The contract must provide that the single written statement is provided at least annually. If no change in the information has occurred, then a written statement setting forth this fact must be provided.

The bill provides that nothing in the law shall be construed to require any service provider to provide any services and provides that nothing in the law affects the obligations of plan sponsors and fiduciaries under ERISA's fiduciary rules.

Disclosure to Participants of Investments and Fees

The bill would require the plan administrator of a participant-directed individual account plan to provide information on investment options and fees reasonably prior [10] to the date of a participant's initial investment (or the effective date of any material change in investment options). The notice also must be provided each plan year. The notice may be combined with the default investment notice required by ERISA § 404(c)(5). The notice must specify which components of charges for each investment option are payable by the participant and how these components will be paid.

For each available investment option, the notice must provide:

- the name of the investment option;
- information effectively describing the investment objectives of the option (such as a description of a broadly recognized asset class);
- the risk level associated with the option;
- whether the option is diversified among various classes of assets to minimize the risk of large losses or should be combined with other options to obtain such diversification;
- whether the investment option is actively or passively managed in relation to an index and the difference between active and passive management;
- where, and the manner in which, additional plan-specific, option-specific, and generally available investment information regarding the option may be obtained; and
- a statement explaining that investment options should not be evaluated solely on the basis of the charges for each option but should also be based on careful consideration of other key factors, including the risk level of the option, the investment objectives of

the option, the principal investment strategies of the option, and historical returns derived by the option.

The plan administrator must include a plan fee comparison chart comparing actual service and investment charges (including charges for the "offering of an investment option") that will or could be assessed against the account of the participant with respect to a plan year. The fees listed on the comparison chart must be in the form of a dollar amount (although percentage of assets may also be listed). The chart must include examples that demonstrate how the charges will be assessed against the account of the participant.

The comparison chart must provide information in relation to four categories of charges:

- Charges that vary depending on the investment options selected by the participant, including expense ratios and investment-specific asset-based charges. The information relating to these charges must include a statement noting any charges for investment options that pay for services other than investment management.
- Charges assessed as a percentage of the total assets in the account of the participant, regardless of investment option selected.
- Administration and transaction-based charges that are not assessed as a percentage of total assets and are either automatically deducted or result from certain transactions engaged by the participant. [11]
- Any other charges that may be deducted from participants' accounts not described above.

In addition, each charge must be described by whether it is for investment management, transactions, plan administration and recordkeeping, or other identified services. The fee comparison chart must include appropriate and consistent benchmarks, indices, or other points of comparison that may be used by beneficiaries to compare each investment option's historical returns, net of fees and expenses, for the previous year, 5 years, and 10 years (or since inception, if shorter).

Reasonable and representative estimates for the information required above are allowed, as long as they are identified as estimates and based on the previous year's experience except in the case of a new plan, in which case they must be based on a reasonable estimate, taking into account the plan's participants and beneficiaries.

Regulations Regarding Specified Products

DOL may prescribe regulations identifying investment options that provide a guaranteed rate of return and that do not identify specific fees and prescribe alternative disclosures of cost and performance measures that correspond to the particular circumstances of the option.

Definitions

The bill includes the following definitions which generally apply to both the service provider and participant disclosures:

- *Charge*: in connection with any service provided to the plan or any financial product provided to the plan in which plan assets are invested, any fee, credit, or other compensation charged or paid for the service or product, including money and any other thing of monetary value to be received by the provider of the service or product, or its affiliate, in connection with the service or product.
- *Service*: a service provided directly or indirectly to, or with respect to, the plan or a service provided directly or indirectly in connection with a financial product in which plan assets are to be invested.
- *Contract or arrangement*: in connection with any two or more parties, any contract or arrangement entered into between or among such parties, and any extension or renewal thereof.
- *Service provider*: in connection with a service, a person directly or indirectly providing the service.

Quarterly Benefit Statements

The bill would modify the new PPA pension benefit statement by adding new requirements for participant-directed plans. For the portion of the account for which the participant has the right to direct investments, the following information must be provided:

- the starting balance and ending balance of the account;
- contributions made during the quarter, itemized by employer and employee contributions;
- investment earnings or losses during the quarter;
- actual or estimated charges [12] which reduce the account during the quarter expressed in dollars or, if estimated, the estimated dollar amount derived from an expense ratio, which may be expressed as a specific date estimate based on reasonable disclosed assumptions (such as the previous year's expense ratio);
- any other charges to the participant in connection with the account;
- the participant's asset allocation, expressed as an amount and as percentage; and
- how to obtain the most recently updated fee comparison chart.

The quarterly benefit statement may, but is not required to, provide the historical return and risk of each investment option and the estimated amount that the participant needs to contribute each month so as to retire at his or her Social Security retirement age.

If a plan has fewer than 100 participants, the plan may comply with the pension benefit statement requirements on an annual rather than quarterly basis.

Use of Electronic Media and Model Notice

The bill provides that the service provider or participant disclosures may be made by electronic medium under rules prescribed by DOL issued not later than one year after enactment, which must be similar to those applicable under the Internal Revenue Code for participant notices. DOL's rules must provide for a method, designed so not to be unduly burdensome, to obtain a paper copy upon request.

DOL is directed to prescribe a model statement and notice for the service provider and participant disclosures.

Enforcement

The bill provides a $1,000 per day penalty for a service provider (as defined earlier), subject to a maximum penalty of 10 percent of the "amount involved," if the plan administrator disclosure provision is violated. [13] The bill also provides for a $100 per day penalty for a plan administrator or service provider that fails or refuses to provide the participant investment disclosure or the quarterly benefit statement.

DOL is required to notify the applicable regulatory authority if DOL determines that a service provider is engaged in a pattern or practice that precludes compliance by plan administrators and to widely disseminate the service provider's identity.

Investment Advice Provisions

Title II of H.R. 2989 would repeal the investment advice provisions of the Pension Protection Act of 2006 [14] and would impose new requirements for those providing investment advice to participants or plans.

The bill would modify the general fiduciary provision of ERISA (section 404(a)) to provide that a fiduciary of a participant-directed individual account plan may not arrange for an investment adviser to provide investment advice to the plan or to participants unless the adviser is an "independent investment adviser" (described below). The independent investment adviser must provide a written notification prior to the initial provision of advice of the past performance and historical rates of return of the investment options available with respect to the plan and comparisons of the options to relevant benchmarks, and must state that the adviser is acting as a fiduciary of the plan in connection with the provision of the advice.

The bill would provide that the plan sponsor and any other person who a fiduciary (other than the independent investment adviser) has no duty to monitor the specific investment advice given by the independent investment adviser to any particular recipient of the advice and is not liable for any loss which results from such specific investment advice given by the independent investment adviser. But the plan sponsor or other person who is a fiduciary would still be required to prudently select and periodically review an independent investment adviser.

The bill requires the Secretary of Labor to review prior advisory opinions and exemptions under which advice programs have been provided and to submit a report to Congress.

Definition of Independent Investment Adviser

The bill would create a detailed definition of "independent investment adviser." In order to satisfy the definition, a person must be a fiduciary by reason of providing investment advice described in ERISA section 3(21)(A)(ii) to a participant or the plan and meet one of two criteria—either be completely fee leveled and unaffiliated with plan investments or provide advice solely under a computer model.

Unaffiliated registered adviser option. To meet this criteria, the adviser must be registered as an investment adviser under the Investment Advisers Act of 1940 or under state laws in which the adviser maintains its principal office and place of business, or a registered representative thereof. Second, the adviser may not be a "plan investment provider," which generally means a person that creates or manages any investment in which any individual account plan invests. [15] Third, the adviser's compensation either (a) is not received from anyone that markets, manages or provides any investment in which plan assets of the plan are invested or (b) does not vary based on investment option selected. Finally, the adviser must provide a number of initial and annual disclosures and representations.

Computer model option. To meet this alternative criteria, the advice must be provided pursuant to a computer program meeting detailed requirements. These requirements are similar to those required for computer model advice under the Pension Protection Act provision, [16] including:

- limiting advice providers to certain regulated entities like registered investment advisers, insurance companies and brokers or their affiliates;
- a requirement that the computer model take into account all of a plan's investment options;
- a requirement that the model be certified by an unaffiliated investment expert;
- a requirement that the only advice under the program be that generated by the computer model; [17]
- annual audits of the advice program;
- maintenance for six years of records demonstrating compliance; and
- detailed disclosure by the advice provider.

Effective Date

The bill would generally make the new disclosure, index fund, and investment advice requirements effective for plan years or quarters beginning, or for contracts entered into, one year after enactment.

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Attachment

endnotes

[1] See Institute Memorandum to Pension Members No. 19-09, Federal Legislation Members No. 3-09, Bank, Trust and Recordkeeper Advisory Committee No. 18-09, Broker/Dealer Advisory Committee No. 22-09 and Operations Committee No. 8-09 [23419], dated April 24, 2009.

[2] See Institute Memorandum to Pension Members No. 30-09 [23576], dated June 22, 2009.

[3] For a copy of the amendments offered at the mark-up, see http://edlabor.house.gov/markups/2009/06/401k-fair-disclosure-and-pensi-1.shtml. An amendment offered by Rep. Brett Guthrie (R-KY) relating to the defined benefit provisions was approved, and is attached.

[4] ERISA § 404(c) provides relief for plan fiduciaries when a plan allows participants to direct the investment of their account. Essentially, fiduciaries are relieved from losses resulting from the investment decisions of participants.

[5] It therefore appears that an S&P 500 index fund, the type of fund commonly used in 401(k) plans, would not qualify.

[6] The plan administrator disclosure requirements apply to all ERISA-governed individual account plans (not just participant-directed 401(k) plans), including ERISA covered 403(b) plans and other defined contribution plans.

[7] It is unclear whether this would subject a mutual fund (or its underwriter and/or distributor) to the requirements of the bill or simply refers to recordkeepers that contract with plans and offer access to a menu of investments.

[8] This would appear to apply to sales loads and transaction costs associated with acquiring or selling a plan investment, as well as charges for accessing specific plan services such as loans. It is not clear whether or not this includes commission costs for a mutual fund's portfolio trading.

[9] This disclosure requirement applies only if the total charged for services equals or exceeds $5,000. The Department of Labor may specify a lesser threshold for small plans and a greater threshold for other plans and may make annual adjustments.

[10] Another provision of the bill requires DOL to issue regulations providing a shorter period for situations similar to those for blackout notices (i.e., in ERISA § 101(i)(2)(C)), but not less than 10 days. This suggests that in ordinary circumstances more than 10 days notice is required. The bill would allow plans with immediate eligibility or that have an automatic contribution arrangement to provide the information within any reasonable period prior to initial investment.

[11] The bill gives as examples fees charged to participants to cover administration, compliance, and recordkeeping costs, plan loan origination fees, possible redemption fees, and possible surrender charges.

[12] For this purpose, the term “charge” has the meaning above.

[13] In other words, the $1,000 per day penalty applies to the service provider if the plan administrator enters into a contact with a service provider without receiving the necessary disclosures.

[14] See Institute Memorandum to Pension Members No. 49-06, Federal Legislation Members No. 5-06 and 529 Plan Members No. 13-06 [20250], dated August 4, 2006. In its current form, the bill only repeals the amendments that the PPA made to ERISA. The corresponding amendments to the Internal Revenue Code, which affect IRAs and similar accounts, are not affected.

[15] The bill includes some exceptions from this general definition of “plan investment provider,” including plan sponsors who create investments for their own plans, recordkeepers and others who make available non-affiliated investments, and persons who are authorized by a participant to exercise control over the account, if the assets are not invested in an affiliated investment.

[16] The effect of the provision would be that computer model advice currently provided pursuant to the Department of Labor’s SunAmerica advisory opinion (2001-09A) would need to be restructured to comply with the detailed computer model provisions of the bill (or be provided in a way that meets the “unaffiliated” adviser criteria).

[17] The PPA included a provision suggesting that participants could request advice other than that generated by the model. This bill does not contain that provision.
