The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 24345

June 3, 2010

House Passes Fee Disclosure Bill

[24345]

June 3, 2010

TO: PENSION MEMBERS No. 20-10
FEDERAL LEGISLATION MEMBERS No. 2-10
BANK, TRUST AND RECORDKEEPER ADVISORY COMMITTEE No. 14-10
BROKER/DEALER ADVISORY COMMITTEE No. 18-10
OPERATIONS COMMITTEE No. 13-10 RE: HOUSE PASSES FEE DISCLOSURE BILL

The House of Representatives passed the "Defined Contribution Fee Disclosure Act of 2010," as sections 321 through 325 (subtitle B of Title III) of H.R. 4213, the American Jobs and Closing Tax Loopholes Act of 2010. [1]

Overview

The bill is a hybrid of the 401(k) Fair Disclosure and Pension Security Act of 2009 (H.R. 2989), introduced by Rep. George Miller (D-CA) and passed out of the Education and Labor Committee on June 24, 2009, [2] and the Defined Contribution Plan Fee Transparency Act of 2009 (H.R. 2779), introduced by Rep. Richard Neal (D-MA). [3] The combined product addresses many of the concerns that the Institute raised about H.R. 2989. For example, the bill does not include a requirement that 401(k) plans offer a particular type of index investment nor any provisions restricting the availability of investment advice. In addition, the provisions regarding disclosure from plan service providers have been streamlined and revised significantly. As with both H.R. 2989 and H.R. 2779, the bill requires service providers to allocate their compensation to different components, but the bill includes protections for service providers similar to those in H.R. 2779.

The bill includes funding relief for single employer and multiemployer defined benefit plans. The bill would also extend, through 2010, the provision for tax-free distributions from IRAs for charitable purposes. [4]

Amendments to ERISA and Internal Revenue Code

The bill makes largely parallel amendments to ERISA and the Internal Revenue Code. The bill would create a new ERISA section 111, which requires certain disclosures from plan

service providers to plan administrators, and a new section 112 requiring certain disclosures from plan administrators to plan participants. In addition, the bill would amend the current benefit statement requirements in section 105 of ERISA.

The bill would create new sections 4980J and 4980K of the Code largely mirroring the substantive requirements of the ERISA sections, with failure to comply resulting in excise tax penalties. An excise tax imposed on a service provider or plan administrator would offset any ERISA penalty imposed. There are some differences in terminology related to different terms used by ERISA and Code, but the most significant difference between the ERISA and Code provisions is in the plans covered. DOL would be the primary regulator responsible for issuing regulations implementing the bill.

Plans covered

The ERISA provisions requiring disclosure from service providers to plan administrators would apply to any individual account plan subject to title I of ERISA. The ERISA provisions requiring disclosure from plan administrators to participants and requiring new disclosures on benefit statements would apply to any individual account plan subject to title I of ERISA that permits participants to exercise control over assets in their account.

The Code provisions requiring disclosure from service providers to plan administrators would apply to any defined contribution plan described in clauses (iii) through (vi) of Code section 402(c)(8)(B), namely, qualified defined contribution plans, 403(a) plans, 403(b) plans, and governmental 457(b) plans. The Code provisions requiring disclosure from plan administrators to participants and requiring new disclosures on benefit statements would apply to these same plans if they permit participants to exercise control over the assets in their account.

Disclosure from service providers to plan administrators

The bill requires that a service provider that enters into a contract or arrangement to provide services to an individual account plan must provide to the plan administrator a single written disclosure meeting certain requirements. The disclosure must be presented in a manner which is easily understood by the typical plan administrator and must be provided before the contract or arrangement is entered into, but DOL has the authority to provide the time and manner in which the disclosure is made. The service provider must provide an annual statement for each plan year after the plan year covered by the initial statement, and must provide an updated statement if any event or change during the plan year makes the statement materially incorrect. The updated statement is required not later than 30 days after the service provider knows, or exercising reasonable diligence would have known, of the event or change.

The disclosure consists of seven parts. First, the disclosure must include a detailed description of the services which will be provided to the plan by the service provider, the amount of “total expected annual revenue” with respect to those services, the manner in which the total expected annual revenue will be collected, and the extent to which that revenue varies between specific investment options. “Total expected annual revenue” is defined to mean any amount expected to be received during the plan year from the plan (including amounts paid from participant accounts), from any participant or beneficiary, or from the plan sponsor, in connection with the contract or arrangement. It also includes any

other amount expected to be received during the plan year by the service provider in connection with service activities undertaken by the service provider or any other person with respect to the plan. It does not include fees and charges for participant-initiated transactions. Total expected annual revenue may be expressed as a dollar amount or as a percentage of assets (or a combination).

Second, in any case in which a service provider is providing recordkeeping with respect to an investment option, the service provider must provide the plan administrator the information needed to satisfy the participant disclosure requirements with respect to that investment option. To the extent DOL provides in regulations, this requirement does not apply if the service provider receives from the plan administrator written notification that the necessary information is provided by another service provider pursuant to a contract or arrangement to provide services to the plan.

Third, the service provider must disclose any investment options offered under the plan with respect to which the service provider provides substantial investment, trustee, custodial, or administrative services. In addition, the service provider must disclose whether it expects to receive revenue with respect to any investment option (and the amount) for services undertaken by another person with respect to the plan.

Fourth, the service provider must disclose the "total expected annual revenue" which is properly allocable to (i) administration and recordkeeping, (ii) investment management, and (iii) any other services or amounts. DOL must provide rules for defining total expected annual revenue and for the appropriate and consistent allocation among these components, but the entire amount must be allocated and no amount may be taken into account in more than one component. If the service provider has disclosed total expected annual revenue as a percentage of assets, the percentage must be properly allocated among these components.

Fifth, in the case of amounts to be received as fees or charges in connection with participant-initiated transactions (other than loads, commissions, brokerage fees and other investment related transactions), the disclosure must include a fee schedule describing each fee and the manner in which it is collected.

Sixth, in the case of investment options with more than one share class or price level, DOL must prescribe regulations for the disclosure of the different share classes or price levels available. The regulations must provide guidance on the basis for qualifying for the different share classes or price levels.

Seventh, to the extent DOL provides in regulations, a service provider must separately disclose the transaction costs (including sales commissions) for each investment option for the preceding year or the plan's allocable share of those costs for the preceding year.

The bill provides that the disclosure requirements do not apply to a contract or arrangement in a plan year if the service provider does not expect to receive at least $5,000 with respect to the plan for the plan year. In that case, the service provider must simply provide the plan administrator with a statement that the service provider does not expect to receive at least $5,000. In addition, service providers who expect to receive "de minimis" annual revenue need not provide this statement. DOL has the authority to adjust the dollar threshold.

The bill defines service provider to include (but apparently not be limited to) any person

providing administration, recordkeeping, consulting, investment management services, or investment advice to an individual account plan under a contract or arrangement. [5] The bill includes a provision that treats multiple persons as a single service provider for purposes of the disclosure. Under the rule, all persons that would be treated as a single employer under section 414(b) or (c) of the Internal Revenue Code are treated as single employer, except that the percentage thresholds – ordinarily 80 percent – are lowered to 20 percent for purposes of the rule requiring disclosure of any investment option with respect to which the service provider provides substantial service, and to 50 percent for all other purposes. [6]

Disclosure from plan administrators to participants

The bill would require the plan administrator of a participant-directed individual account plan to provide information on investment options prior to the date of a participant's initial investment. The information must also be provided prior to any change in the investment options available under the plan, unless advance notice is impracticable, in which case, as soon as practicable. If any event or other change causes the information to be materially incorrect, the plan administrator must provide corrected information within 30 days after the plan administrator knew, or exercising reasonable diligence would have known, of the event or change.

For each investment option, the notice must set forth:

- the name of the investment option;
- a general description of the option's investment objectives and principal investment strategies, principal risk and return characteristics, and the name of the option's investment manager;
- whether the option is designed to be a comprehensive, stand-alone investment for retirement that provides varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures;
- the extent to which 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 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 of the option.

Participants must also be provided a "plan fee comparison chart" comparing the service and investment charges 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 may be either in the form of a dollar amount or a formula. 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 annual operating expenses and investment-specific asset-based charges. Except as provided in DOL regulations, the information relating to these charges must include a statement noting any charges for investment options that pay for services other than investment management. There must also be a generic example describing the charges that would apply during an annual period with respect to a

$10,000 investment in the investment option.
- 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 in by the participant. [7]
- Any other charges that may be deducted from participants' accounts.

This fee comparison chart must also include, for each investment option, the historical returns, net of fees and expenses, for the previous year, 5 years, and 10 years (or since inception, if shorter). For the same periods, the chart must include the returns of an appropriate benchmark, index or other point of comparison. DOL may issue regulations providing guidelines and a safe harbor for the selection of an appropriate benchmark, index or other point of comparison.

As part of this disclosure, participants must be told that they have a right to request a copy of the statements received by the plan administrator from service providers; if requested, it must be provided within 30 days of the request.

Quarterly benefit statements

The bill would modify the 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 different asset classes that the participant's account is invested in and the percentage of the account allocated to each class;
- the starting balance and ending balance of the account;
- total contributions made during the quarter, itemized by employer and employee contributions;
- total fees and expenses directly deducted from the account and an itemization of the fees and expenses;
- a statement of the net returns for the year to date, expressed as a percentage, and a statement whether those net returns include the fees and expenses deducted from the account;
- for each investment option, the percentage of the account invested in the option, the starting and ending balance, the investment option's annual operating expenses, and whether the deducted fees and expenses include the annual operating expenses of the investment option;
- 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 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 of the option; and
- how to obtain the most recently updated investment information provided to new participants.

For purposes of disclosing the annual operating expenses of an investment option, expenses may be expressed as a dollar amount or percentage of assets (or a combination), and may be based on an estimate using reasonable assumptions if the plan administrator indicates that it is an estimate. If expressed as a percentage of assets, the disclosure must include either an estimate of the expenses for the quarter in dollar amounts or an example

describing the expenses that would apply during the quarter with respect to a hypothetical $10,000 investment in the option.

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.

Penalties

DOL may assess a penalty of up to $1,000 per day on service providers who fail to provide the required statement to plan administrators. The total penalty for any plan for a plan year may not exceed the lesser of 10 percent of the assets of the plan or $1,000,000. No penalty can be assessed on a service provider who exercised reasonable diligence and provides the required information within 30 days after the service provider knew, or exercising reasonable diligence would have known, that the failure existed. In addition, DOL may waive any penalty that is excessive or inequitable relative to the failure.

DOL may assess a penalty of up to $110 per day on plan administrators for failure to provide the required participant disclosures, up to the lesser of 10 percent of the assets of the plan or $500,000. Similar protections for inadvertent failures and excessive penalties apply.

Similar excise taxes are imposed by the parallel tax provisions, with similar protections for inadvertent failures and excessive penalties. The bill provides that any excise taxes imposed on a service provider or plan administrator will offset any ERISA penalties imposed by DOL.

DOL must notify the "applicable regulatory authority" in any case DOL determines that a service provider is engaged in a pattern or practice that precludes compliance by plan administrators in providing the required disclosures to participants. DOL also must conduct an annual audit of a representative sampling of plans to determine compliance with the law and report those results to Congress. Finally, DOL must issue a report, in consultation with the Treasury Department, making recommendations to consolidate, standardize and streamline the reporting and disclosure requirements.

Regulatory grant

Along with various regulatory directions and authority grants throughout the bill, DOL can prescribe regulations or other guidance to the extent DOL determines necessary or appropriate to carry out the bill's purposes, including regulations or other guidance which:

- provide "safe harbor and simplified methods" for service providers making the required allocations among various fee components;
- provide special rules for the application of the rules to investments with a guaranteed rate of return, investments with an insurance component, and employer-sponsored retirement plans funded through an individual retirement account;
- address disclosures with respect to investments provided through participant-directed brokerage trading;
- address the disclosure of information that is not proprietary to the service provider; and
- provide rules to allow service providers to consolidate information to satisfy the requirements with respect to all service providers to a plan.

Electronic disclosure

The bill states that the participant disclosure requirements may be provided through an electronic medium under rules DOL must prescribe within one year of enactment. These rules must be similar to those applicable under the Internal Revenue Code with respect to notices to participants in pension plans. DOL must regularly modify these rules as appropriate to take into account new developments, including new forms of electronic media, and to fairly take into consideration the interests of plan sponsors, service providers, and participants. The rules must provide for a method for the typical participant to obtain the disclosure in writing on paper without undue burden.

Effective date

The bill would be effective for plan years beginning after December 31, 2011. Contracts or arrangements to provide services to a plan in effect on January 1, 2012 are treated as new contracts or arrangements entered into on January 1, 2012. Until 12 months after final DOL regulations are issued, a service provider or plan administrator is treated as having complied with the bill if the service provider or plan administrator complies with a reasonable good faith interpretation.

Michael L. Hadley
Associate Counsel

endnotes

[1] The base text of H.R. 4213 is available here: http://waysandmeans.house.gov/media/pdf/111/HWC_711_xml.pdf. The Defined Contribution Fee Disclosure Act provisions are on pages 168 through 228 of this version. Prior to passage of the bill on the House floor, a few changes were made to the fee disclosure language in a "Manager's Amendment," available here: http://waysandmeans.house.gov/media/pdf/111/HR4213_Managers_Amendment.pdf. This memo describes the bill's provisions as amended by the Manager's Amendment.

[2] See Memorandum 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 and Operations Committee No. 12-09 [23605], dated July 2, 2009.

[3] See Memorandum to Pension Members No. 28-09, Federal Legislation Members No. 5-09, Bank, Trust and Recordkeeper Advisory Committee No. 25-09, Broker/Dealer Advisory Committee No. 32-09 and Operations Committee No. 11-09 [23564], dated June 19, 2009.

[4] Internal Revenue Code section 408(d)(8).

[5] The bill does not include a provision in H.R. 2989 that defined "service" to include a service provided indirectly in connection with a financial product in which plan assets are to be invested.

[6] H.R. 2779 included a similar controlled group rule but without the lowered thresholds.

[7] 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.