2012 ISSUE BROCHURE

RISING TO THE CHALLENGE OF THE NEW FEE DISCLOSURE REQUIREMENTS: A PRACTICAL GUIDE

By: NAGDCA Publications Committee and Executive Board

Many sponsors of public DC plans face a quandary: Should or shouldn't they adhere to the new Department of Labor (DOL) regulations governing fee disclosures as a best practice? And, if so, how?

As of this year, the DOL requires most DC plan sponsors governed by the Employee Retirement Income Security Act (ERISA) to comply with two sets of regulations: the 408(b)(2) Provider Fee Disclosure and the 404(a)(5) Participant Fee Disclosure. While these federal regulations apply directly only to those plans governed by ERISA, according to NAGDCA's 2011 DC Survey, 94.2% of public plans intend to comply with the disclosure regulations as a best practice.

408(b)(2) Provider Fee Disclosure Regulation

The 408(b)(2) Provider Fee Disclosure Regulation requires, in order to avoid a prohibited transaction, DC plan sponsors to obtain from covered service providers:

- A written description of services to be provided;
- Information on whether the services provided to the plan by the provider are done in a fiduciary capacity; and
- Description of all direct and indirect compensation received by the provider.

Plan sponsors and providers have already faced a number of challenges in complying with this regulation. Namely, the DOL was delayed in finalizing the regulation (it was not finalized until early 2012, even though it is effective this year). Plan sponsors have also grappled with how the required information should be formatted, how frequently plan sponsors need to receive these disclosures, and how they can obtain certain information, such as detailed expense information regarding self-directed brokerage accounts. Going forward, challenges will include how to benchmark the information provided, and what actions plan sponsors should take if the disclosures reveal conflicts of interest or excessive compensation.

404(a)(5) Participant Fee Disclosure Regulation

Compliance with the ERISA Section 404(a)(5), or participant fee disclosure regulations, promises to be even more challenging. Under 404(a), ERISA plan sponsors are required to provide a plethora of disclosures to participants—and indeed, in many cases, to all eligible employees. This includes plan-related information such as:

- General plan information: Information about the structure and mechanics of the plan;
- Administrative expense information: An explanation of fees and expenses charged for general plan administrative services;

- Individual expense information: An explanation of fees and expenses that may be charged to or deducted from the account of a specific participant based on the actions taken by that person; and
- Revenue sharing information: The existence of revenue sharing must be disclosed to participants. However, specific revenue sharing amounts do not have to be broken out.

Plan sponsors must also disclose investment-related information, including:

- Performance data: Information about historical investment performance;
- Benchmark information: The name and returns of an appropriate benchmark over one-, five- and 10-year periods;
- Fee and expense information: Total operating expenses—expressed both as a percentage of assets and as a dollar amount per $1,000 invested; and
- Internet website: Address to a site containing additional information (e.g., a glossary of investment terms) about the investment options.

Plan Sponsor Issues

The list of concerns by plan sponsors and vendors who seek to support participant disclosure compliance is extensive, including:

- Lack of clarity regarding the appropriate required performance benchmarks;
- Uncertainty as to whether certain investments require specific disclosures;
- How to calculate certain required fund characteristics;
- Difficulty in gathering and aggregating data for non-registered funds;
- Concerns about how to validate data; and
- In general, lack of Department of Labor guidance on compliance.

According to the NAGDCA DC Survey about two-thirds (64.7%) of plan sponsors said they have or will develop a communication regarding plan fees, 25% were not sure, and 10% did not intend to (presumably relying on an outside source for this). More than a third (38.6%) said they didn't know whether such disclosures would cause participants to migrate to lower cost options, but the majority thought the disclosures would not result in a change to the fund lineup or a change to the fee structure. More than three quarters (77.9%) believed that their plan providers would comply with the new DOL regulations regarding fee disclosure for their non-ERISA plans, while the remaining (22.1%) were unsure.

The remainder of this paper will explore the value to public DC plan sponsors of adhering to these disclosures, as well as best practices in adherence. The vendor and the participant fee disclosures will be explored separately, as the value, implications, and best practices in adherence differ meaningfully between the two.

Applicability to Public DC Plan Sponsors

Even though compliance is not mandated for non-ERISA plans, it is still expected that most public sector plan sponsors will embrace the regulations, if not entirely, at least in principle; and there may be good cause for doing so.

The primary rationale for the DOL, in issuing the regulations, stems from the concept that an informed buyer will make better purchases. In the case of the 408(b)(2) Provider Fee Disclosure Regulation, the DOL is specifically seeking to close an "information gap" whereby service providers know more than their plan sponsors because they have better access to information about the expenses associated with the products they are making available to retirement plans. Given that the law ultimately requires that the plan sponsor make sure that the plan services and products are being provided at a reasonable cost, it makes sense that the rules around proper disclosure be more clear and direct in order to assist in this reasonability assessment.

The rationale behind the 404(a)(5) Participant Fee Disclosure Regulation is similar. Basically, it is assumed that a retirement plan participant who has access to a consolidated, fee disclosure document will be able to make better investment decisions.

Ultimately, for most non-ERISA plan sponsors, the decision on whether or not to comply with the regulations may come down to a question of what is best practice. Many public sector plan sponsors already embrace ERISA requirements related to fiduciary standards and thus follow the applicable sections related to operating the plan prudently and in the best interests of plan participants and beneficiaries. Some sponsors even go so far as to reference ERISA section 404(c) in their policies for administering the plan. In fact, in some states (California and Florida are examples), state law specifically references applicable ERISA sections under the statutes related to fiduciary standards for the administration of the plans. So again, the decision on whether or not to comply with the new disclosure regulations may just be an extension of what plan sponsors have already determined to be a best practice–that is following, at least in principle, the standards set forth under ERISA.

If plan sponsors accept the rationale that better information will lead to more informed participants (and plan sponsors), then the new disclosure regulations will probably be viewed in a positive light. One can certainly envision plan sponsors, armed with new fee information, negotiating better plan service and product packages for their participants. In turn, participants may use the new information provided to make changes to their retirement plan investment allocation by seeking out, everything else being equal, investment funds with lower fees; or perhaps they may now be inclined to put some pressure on their employers to be more active in pushing for lower cost service and investment providers. However, not all forms of information disclosure lead to desired outcomes. Information could be provided in the wrong format or in too great of volume to be effective. In the case of the new disclosure regulations plan sponsors should be cognizant of creating information overload, and thus working counter to the very positive things that are being sought with these disclosures. Before taking action based on newly disclosed information, plan sponsors should engage in a broad marketplace analysis of what other plans are paying and what services they are receiving for the payment.

Best Practices in Vendor Fee Disclosure

It appears that the vast majority of plan recordkeepers and other service providers operating in the public sector plan marketplace will attempt to provide plan sponsors and participants with disclosure information that at least meets the spirit of the regulations. Therefore, plan sponsors who intend to comply will need to establish prudent practices for dealing with their assumed responsibilities under the regulations. Under the 408(b)(2) Provider Fee Disclosure Regulations, the plan sponsor responsibilities, can be summarized simply as:

1) receive the required disclosure information, and
2) assess whether or not the disclosed fees/expenses are reasonable.

As noted earlier, recordkeepers and other service providers should be providing a thorough description of the services they are providing and how they are compensated for those services. Under the regulations, compensation is very broadly defined and includes anything of monetary value. Service providers are expected to provide a clear statement of what the plan is paying directly, indirectly and through credits for proprietary investments and products. Plan investment disclosures should include information related to transaction compensation, operating expenses and any other ongoing expenses.

Once all of the required information has been received, plan sponsors should be able to determine whether or not the compensation is reasonable. In making this reasonability assessment, plan sponsors may consider benchmarking or comparing relative plans. This will entail gathering similar compensation information from similarly situated plans. Survey services provided by organizations like NAGDCA or databases provided by advisory firms may help in this endeavor. The end result might be a reexamination of service provider relationships with an eye towards reducing costs or improving services. In fact, the industry has already seen instances of recordkeepers and other service providers changing their business and pricing practices in light of the new regulations. A plan that conducts an RFP on a regular basis will have data that will help in determining the reasonableness of fees charged. Cleaner and more direct lines of compensation are being developed to make the information easier to decipher and possibly lower costs. Plan sponsors, and ultimately plan participants, should benefit from these standardized disclosures.

Best Practices in Participant Fee Disclosures

Plan sponsors who seek to adhere in some way with the 404(a)(5) Participant Fee Disclosure Regulation have some alternatives:

1) use the existing recordkeeper-provided disclosure, or
2) create a custom disclosure leveraging what recordkeepers have developed or other samples in the marketplace.

While a good case can be made for public fund plan sponsors to leverage recordkeeper-produced vendor fee disclosures to produce a more understandable description of plan expenses, the case for doing so with respect to participant disclosures is less compelling. Among the common reasons a public DC plan sponsor might wish to leverage the participant fee disclosures would be the goal of meeting ERISA standards and/or participant education.

Intent to Meet ERISA Standards

The goal of meeting ERISA standards by leveraging the recordkeeper-produced disclosures may be challenging—at least in 2012. A large investment consulting firm[1] recently surveyed major recordkeepers, working with both public sector and private plans, on their best practices in supporting the participant fee disclosure requirements. While all the recordkeepers surveyed reported that they would support ERISA DC plan sponsors in compliance, only a quarter reported that they would provide the same support for all non-ERISA DC plan sponsors.

In addition, several providers are unsure of when they will provide full support for non-ERISA plan sponsors. It is quite possible that several will not be able to provide support for non-ERISA plan sponsors during the same time period when they are rolling out disclosures required for ERISA plan sponsors. For plans that require ERISA compliance under local law, or in their governing documents, this could introduce logistical challenges. A number of providers indicated that they would provide only partial support or full support for certain non-ERISA DC plan sponsors, but only upon request. A few said they would not support non-ERISA plan sponsors at all. Several recordkeepers gave as their rationale for lack of support that they had "some questions remaining regarding application of the SEC no-action letter, but we understand the SEC is sympathetic and likely to extend these provisions to non-ERISA plans." The no action letter relates to concerns related to Rule 482 of the Securities Act of 1933, which governs advertising and marketing of the plans. ERISA plans received a no-action letter[2] from the SEC in October of 2011, but the letter failed to specifically provide relief for non-ERISA plans. Several providers are currently pursuing another no-action letter from the SEC before finalizing their service plans for non-ERISA plans, which could delay the provision of services.

[1] Source: Callan Associates Inc.
[2] http://www.sec.gov/divisions/investment/noaction/2011/dol102611-482.htm

Even when recordkeepers intend to provide support, there can be a number of challenges—as outlined above. Specific to non-ERISA plans, recordkeepers have noted that it can be challenging to provide annual notices to all eligible employees as the regulation calls for. The required data may not be available since non-discrimination testing is not done in these plans but can be an important data source. In addition, recordkeepers have expressed concern about obtaining data for non-registered funds. Recordkeepers indicated in the survey[1] that the responsibility for data aggregation would fall to contractual third parties such as Morningstar or Lipper Analytical. However, with collective trusts, separate accounts, and fund-of-funds, recordkeepers say they will rely on the investment manager, trustee/custodian, or even the plan sponsor.

Fund-of-funds pose a particular challenge in that data is likely to come from multiple sources and if the recordkeeper is not willing to aggregate it, the burden will fall to the plan sponsor to sort the data. For example, if a plan's fund-of-funds product consists of a mutual fund and a separate account, the custodian would be able to calculate the requisite turnover ratio for the separate account (because it can look through to the underlying holdings), but would have to rely on another source for the mutual fund turnover ratio. If the custodian could get the mutual fund turnover from another source, the custodian would then have to agree to weight the turnover ratios to accurately reflect the average turnover of the fund-of-fund options. The custodian would then have to arrange a feed to the recordkeeper so that they could incorporate the required data into the appropriate participant disclosures (such as the plan's web site). Keep in mind that all parties involved—the investment manager, recordkeeper, custodian, etc.—consider it the ultimate responsibility of the plan sponsor to ensure proper compliance.

In the survey[1], recordkeepers noted a number of additional issues in ensuring compliance, including:

- creating an automated process for generating disclosures and updating the information contained in the disclosures
- accurately reporting plan restrictions
- customizing the regulatory notice
- supporting the cost of distribution

This latter point is of particular interest. As cited above, in certain instances, the trustee/custodian must be recruited in order to assemble the necessary data. In some cases, these parties intend to charge plan sponsors for the work involved. Costs for distribution can also be a factor. Within the regulation, the annual notices must be provided not just to plan participants, but to all eligible employees. Delivering notices via regular mail to all eligible employees can be a costly effort. If electronic delivery is desired, obtaining email addresses for all eligibles can be a herculean task and the regulation limits the ability to transmit the notices to participants electronically. Additionally, because non-ERISA plans are not subject to non-discrimination testing, many plans and recordkeepers will not have complete contact information for non-participating eligible employees. According to the survey[2], more than 60% of recordkeepers intend to charge for distributing paper copies of the participant disclosures. It is ironic—given the fact that the disclosure regulations were originally intended to place downward pressure on plan fees—that adhering to the disclosures could actually result in increased plan fees.

A related concern is that many of the providers surveyed have indicated that due to the short time horizon for compliance with the final regulation and the need for uniformity, the disclosures they are providing to plan sponsors are generated through a logic-based process pulling from their recordkeeping databases. As a result, customizing information can be challenging, especially if this should require additional data inputs or altering the manner in which the information is displayed or calculated.

Participant Education

Leveraging the recordkeeper-produced participant disclosures may be even less compelling if the intent is participant education. As mentioned above, the disclosures do have a plethora of data. However, because the document is a regulated disclosure, the language tends to be both broad and boilerplate—much the same as the language found in a typical mutual fund prospectus. In certain instances, recordkeepers have been so conservative in their interpretation of the requirements, that the actual information provided is of little practical value. An example is in the annual statement, where it is required that performance benchmarks must be incorporated over the required time periods. The DOL's language as to what constitutes a reasonable benchmark asserts that the benchmark must be "a broad-based securities market index." Some recordkeepers have taken this to mean that only well-recognized investable benchmarks such as the S&P 500 may be used—and these recordkeepers are using such benchmarks for everything from large cap stock funds to target date funds. Clearly, comparing the typical well-diversified target date fund to the S&P 500 is of little value in truly understanding the fund's relative performance. Other recordkeepers have taken such a literal approach to the requirements that the information provided actually becomes confusing and even potentially misleading. For example, the regulation requires that fees that are explicitly deducted from the participants' accounts must be shown in the annual disclosure. Meanwhile, in the quarterly statement, the existence of revenue sharing—an embedded fee—must be acknowledged. As such, for a plan in which all administrative expenses are paid through revenue sharing, the annual disclosure may assert that no administrative fees are deducted from the participant account. However, the quarterly statement would then refer to the existence of plan administrative expenses. This is technically true, but potentially confusing to participants since it all hinges on the word "deducted." Technically, revenue sharing is not a deducted charge, so it needn't be acknowledged on the annual disclosure (but could be footnoted if the plan sponsor desires), only the quarterly statement.

Of course, some recordkeepers have gone the extra mile to create helpful and informative cover letters and pay attention to using simple language and a user-friendly disclosure format. However, even then, the educational content of the disclosures remain constrained by the fact that it is a regulated document designed for use with many plan types.

Doing it Yourself - Two Case Studies

One plan sponsor who has created their own participant disclosure document with the help of their recordkeeper is New York State Deferred Compensation Plan. The plan sponsor leveraged the resources of its recordkeeper in developing the disclosure—but ultimately devised a notice that met its own needs.

There are a number of key differences between the NYSDCP approach and that of recordkeepers strictly adhering to the DOL regulation. For one, the NYSDCP participant disclosure is mainly limited to disclosures regarding fees. This has the beneficial effect of avoiding the risk that the fee disclosures become lost among other details and information. This focus also allowed NYSDCP's participant disclosure to be limited to one page (front and back). DC plan educators know that when it comes to effective communication, shorter is better. Further, because the NYSDCP participant disclosure is not actually a regulated disclosure, it was able to eschew boilerplate language, and was written in concise, plain English that is ultimately far more accessible and understandable to participants.

On the other hand, the NYSDCP participant disclosure does leverage some of the strengths of the DOL required participant disclosures. For example, it has a table translating expense ratios into costs to the participant per $1,000 invested. Research has shown that investors have a very difficult time understanding the impact of fees as expressed in percentages—they are more likely to grasp the impact of dollar costs. Also, as required by the DOL's regulation, it explains individual transaction fees and explains investment management fees. Finally, and very importantly, it provides essential information regardless of what is required by the DOL's regulation. For example, the NYSDCP participant disclosure goes into detail about how revenue sharing is handled by the plan—which, again, is not required within the annual disclosure—but is definitely valuable information for participants.

Summarizing the best practices to be gleaned from the NYSDCP participant disclosure:

- Keep it short – time-pressed participants are unlikely to wade through long disclosure documents.
- Keep it focused – if the disclosure contains too much information, messages can get lost in the details.
- Take advantage of the fact that the disclosure isn't actually a regulated disclosure – feature easily accessible language over boilerplate.
- Leverage the strengths of the DOL required fee disclosures – the DOL received considerable feedback from the industry in developing its participant disclosures, and plan sponsors can benefit by selectively leveraging the concepts developed by the DOL as a result of that input.
- Don't be too literal – just because the DOL participant disclosure doesn't require something, doesn't mean it isn't valuable information. Include whatever makes the most sense for your plan and participants.

Another plan sponsor, the Florida Retirement System Investment Plan (a defined contribution plan), took a different approach and has chosen to issue a full disclosure statement. Although as a governmental plan it is exempt from the fiduciary provisions in Title I of ERISA, Florida law incorporates select ERISA provisions by reference in s. 121.4501, Florida Statutes. Because Florida law requires the Investment Plan to be ERISA-like in design, a full disclosure statement was determined to be the right choice for the plan.

Using a full disclosure template provided by its recordkeeper, the Investment Plan made slight modifications to the template and customized it for features specific to its plan. Prior to finalizing the disclosure, the Investment Plan provided a copy of the disclosure to its global tax counsel for an independent review. Tax counsel made several modifications and the final disclosure is an amalgamation of the recordkeeper, tax counsel, and the Investment Plan, consolidating the best practices of each.

The Investment Plan will issue the disclosure with the 2nd quarter statements mailed to Investment Plan members in July 2012. The disclosure will also be posted online on the plan's website MyFRS.com. One interesting twist is the disclosure will also be provided to Florida Retirement System members who are participating in the FRS defined benefit plan (Pension Plan). These members must be notified because they are potential future members of the Investment Plan since the majority of these members retain a second election which they could use to join the Investment Plan at any time during their active careers.

Conclusion

ERISA applicability aside, prudent practice would warrant knowing what is being paid for services related to the retirement plan and to whom. Due to the recent, intense focus the regulations have brought to the fee disclosure subject, the plan sponsor disclosure regulations should shine a better light on plan related expenses regardless of whether or not non-ERISA sponsors follow them to the letter. More fee transparency and better documentation for all plan types are expected outcomes of the regulations; and this can certainly be viewed positively by plan sponsors across the spectrum.

Non-ERISA plans seeking to comply with the spirit or the letter of the new participant fee disclosure requirements for ERISA plans will face different logistical hurdles. It would appear that the effect of trying to comply with the new regulations will drive increased transparency, and with it, adoption of more institutional models. However, it also appears clear from the initial response of the industry that for plan fee disclosures to be meaningful and helpful, plan sponsors will need to take steps to customize them. Thankfully, this has the potential to both reduce their size, and increase their utility for non-ERISA plan sponsors.

In addition, there are a number of items that require resolution for non-ERISA plan sponsors planning to comply, including the receipt of the SEC no-action letter for the industry, as well as the technological lag facing some providers that will affect the timeline for being able to support the new disclosures for NAGDCA members. As a result, plan sponsors will have opportunities to be creative in serving the needs of their participants, and navigating the variable capabilities of the provider universe.