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## Death to the Prospectus Requirement! The Future of 401(k) Disclosure

by Pete Swisher, CPC, QPA

Question: What do you call a rule that requires an 800-page participant disclosure?  
Answer: The question speaks for itself.

**T**ransparency frenzy grips Congress, and new laws are coming. But the DOL has been hard at work to improve transparency and disclosure since at least 2007, when it announced three major transparency initiatives. Two of the three are on hold while the President and Congress look at ways to take transparency to a higher level. But the DOL did a good job on its new rules, though naturally some think otherwise, and these rules will be back once Congress has weighed in.

The purpose of this article is to examine the likely future of disclosure in light of the current impetus for reform, with a special focus on the prospectus requirement of DOL Reg. §404c-1 and its cautionary tale of good intentions gone awry.

Beware! If you haven't started changing your business practices to conform to the new rules (which don't exist yet), you're way behind. The article, therefore, concludes with some action guidelines.

### Setting the Stage: The 404(c) Rules

The DOL's §404c-1 regulation provides the details of how fiduciaries may avail themselves of the optional protections of ERISA Section 404(c), which provides conditional relief from liability for participant investment choices. The regulation currently requires that for any security or mutual fund subject to securities law prospectus requirements that is available in a participant directed plan, the plan fiduciary must give a prospectus to all participants **whether they**



**ask for it or not.** The book, *401(k) Fiduciary Governance: An Advisor's Guide*, describes the prospectus requirement as follows:

*As a practical matter, the prospectus requirement is virtually ignored in the 401(k) industry today. Vendors do not mail stacks of a dozen 80-page prospectuses to every participant; sponsors do not hand stacks of prospectuses out; advisors do not carry boxes of prospectuses to every enrollment meeting and make sure every participant gets his or her stack. As a practical matter, no one wants the prospectuses. The very few who do want to read the prospectuses (all 800+ pages in a typical plan) don't mind asking for them. But the fact that the rule is expensive, unwanted and unworkable does not change the fact that compliance requires delivery of stacks of paper and the attendant deaths of innocent trees.*

This rule was a bad rule, created with the best of intentions, and the ERISA Advisory Council told the DOL as much in 2004 when it examined this issue and recommended that the delivery of a prospectus be changed from a “push” requirement (information that is pushed out to participants whether they want it or not) to a “pull” or on demand requirement.<sup>1</sup>

The DOL listened and made it so. They killed the prospectus requirement and replaced it with a sensible “on demand” requirement in the proposed participant disclosure rule of DOL Reg. §404a-5 (and the concurrent amendment to §404c-1, removing the prospectus language). Alas, the proposed change is on hold.

Is the future of transparency one of “more is better”? Will we all asphyxiate after chopping down Earth’s forests to make paper for quarterly disclosure encyclopedias? Or can the trees yet be saved? The answer will arise from a combination of existing rules like the prospectus requirement, the new rules Congress will soon hand us, and the form in which the DOL’s three transparency initiatives ultimately emerge.

## The DOL’s Three Transparency Initiatives

The Department of Labor was on a roll in 2008. Faced with widespread government, industry and public concern about the level of disclosure and fees in qualified plans, they completed three significant initiatives begun in 2007 (or before):

- Substantially increased disclosures on the annual Form 5500;
- A new point-of-sale disclosure (408b-2); and
- A new participant disclosure rule (404a-5).

As of July 22, 2008, when the DOL published the proposed participant disclosure regulations, they had delivered on all three initiatives.

Since then, two of the three have been withdrawn under pressure from Congress and the new Administration. I predict these rules **will be back** because the DOL did a good job given the constraints it faced. The new laws we’re sure to see will naturally require the DOL to make revisions, but those parts of the three proposed regulations that made the most sense will probably resurface. A review of the three initiatives is therefore in order.

### New 5500 Disclosures

Is your firm collecting the following data systematically, in a way that is easily transferable to client Forms 5500?

- All indirect compensation, including commissions, 12b1s, shareholder servicing fees, finders’ fees, sub-transfer agency fees, soft dollar payments, float, marketing fees, conference booth fees and any other thing of value;
- All direct compensation (fees charged);
- The breakdown among the various parties who receive portions of the compensation available; and
- Small gifts and gratuities such as lunches and other entertainment expenses, both from you to a client or vendor and vice versa.

Service providers, including brokers, RIAs, recordkeepers and others, are now required to provide detailed compensation disclosures on the Schedule A (used for insurance contract and agent disclosures) and/or C (for other service providers), though not universally. The Schedule C service provider schedule will remain limited in that the \$5,000 threshold still applies—below that limit for a single provider, no reporting is required—and the Schedule C disclosures only apply to large plan filers, those with 100 or more participants. Since most plans are small plan filers (80%), and because the smaller large plan filers often have one or more vendors whose compensation is below the \$5,000 threshold, the 5500 will be useful as a transparency tool primarily for large plans. Even for those larger plans, however, there is no assurance that the 5500 data will represent a truly comprehensive listing of fees and expenses, though it will clearly increase overall transparency.

The 5500 reporting rules are the only one of the three initiatives not suspended. The DOL has provided a one-year extension to allow service providers to get their systems up to speed, but the new regulation is final and effective as of January 1, 2009.

### Rules for Contracts and Fee Proposals under 408b-2

Have you rewritten your service agreement in the past 18 months? If not, start writing. RIAs and brokers (and therefore their broker/dealers) are especially affected, because these groups traditionally have had only cursory engagement agreements or none at all.

The long-standing DOL regulation under ERISA §408(b)(2)<sup>2</sup> provided the means for vendors to provide services and get paid for doing so, which would otherwise be a prohibited



<sup>1</sup> See the report of the 2004 Advisory Council at [www.dol.gov/ebsa](http://www.dol.gov/ebsa).

<sup>2</sup> DOL Reg. §408b-2, or just “408b-2” these days.

transaction. The basic rule is that no one may provide a service or receive compensation from an ERISA plan unless **the service is reasonable, the compensation is reasonable and the contract or arrangement is reasonable.**

Where the old rules were very general, however, the proposed rules were specific and required detailed disclosures, specific contract terms, and that vendors comply with those contract terms. Failure to meet these requirements would be a *de facto* prohibited transaction. The new 408b-2 rules, if made effective, will therefore be a powerful new tool for achieving transparency at the plan sponsor or fiduciary level, but not at the participant level. Also, it will remain the case that any vendor's 408b-2 disclosure will not be a comprehensive disclosure except in the case of certain fully bundled arrangements: different providers will offer separate disclosures. Someone must still collate the data.

The new 408b-2 rules have other powerful implications as well. For a discussion of a major ethical dilemma and decision facing brokers and broker/dealers who serve qualified plans, see "The 401(k) Broker's Dilemma" in the summer 2008 edition of *ABA Trust & Investments*. The dilemma is this: brokers who are fiduciaries are often **unacknowledged fiduciaries** because their broker/dealers will not let them acknowledge fiduciary status. Serving as an unacknowledged fiduciary is arguably a prohibited transaction (PT) under current rules and is *clearly* a PT under the DOL's 2008 revision. Since the problem of unacknowledged fiduciary service is widespread, this one seemingly minor tweak to the rules could have major ramifications for the industry.

The DOL's amendment to Reg. §408b-2(c) is on hold, but my money is on this rule coming

back: it makes too much sense. And because it's a paradigm shifter (due to the unacknowledged fiduciary problem and the need for detailed service agreements even for brokers), providers ignore it at their peril.

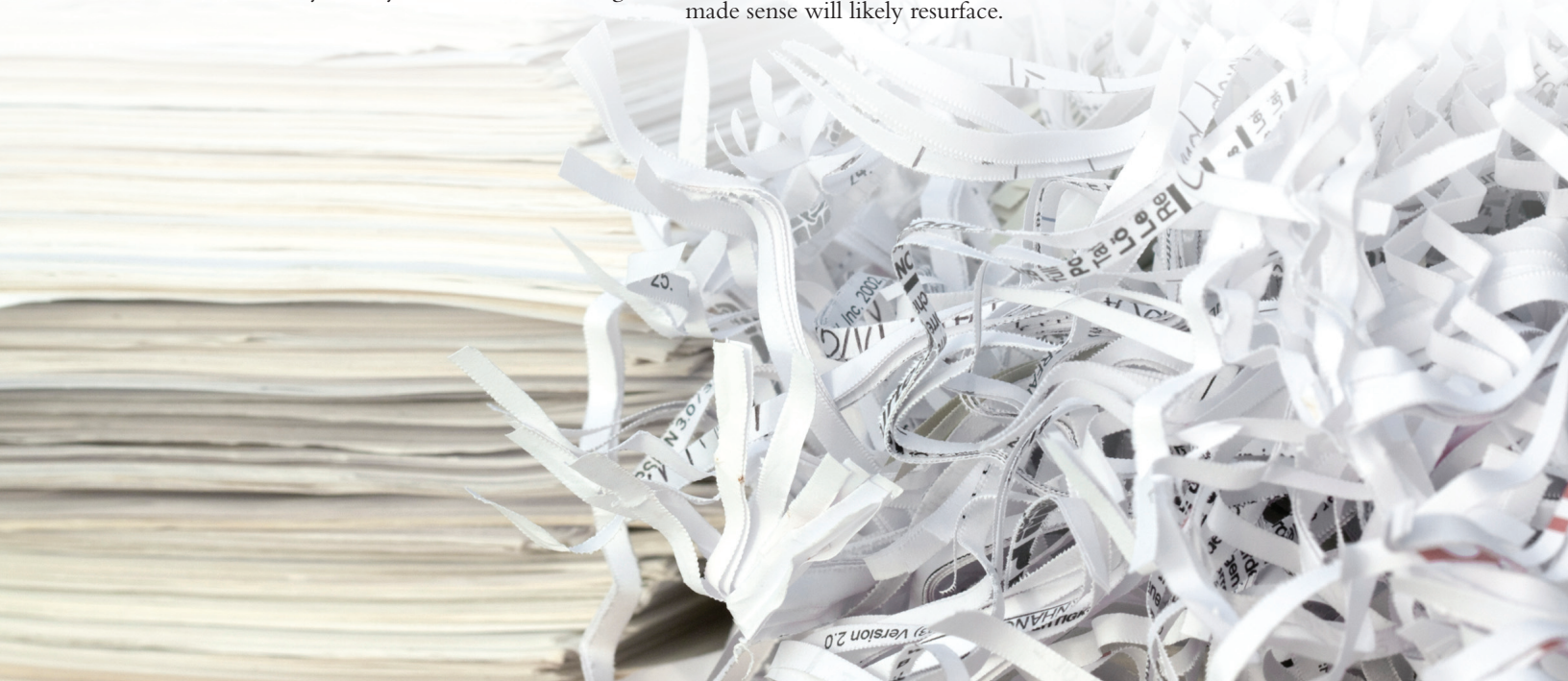
#### The 404a-5 Participant Disclosures

The final initiative was a rule requiring participant disclosure, Reg. §404a-5, plus an amendment to §404c-1. Since participant transparency is Congress' big thing at present, it seems reasonable to expect that these changes will resurface in a substantially altered form if at all. My expectation is that, again, the proposed rules made enough sense that we can expect to see them again, but in this case Congress is clearly stepping in to legislate more detailed and stringent requirements.

What distinguished the DOL's participant disclosure is that it would be solely the plan fiduciary's responsibility, not the vendors' responsibility. The fiduciary would be obligated to pull together the data from the vendors' 408b-2 and quarterly disclosures, put them into a consolidated format and pass the information on to participants, who will then see a comprehensive picture of fees charged against their accounts. The DOL took the position that such disclosure is a *basic fiduciary responsibility* to participants, implied under ERISA §404(a)(1), the Prudent Man Rule, for all participant-directed plans.

Opinions ran strong on 404a-5 when the DOL first published it. One commentator went so far as to call it the "Anti-Participant Rule" due to his perception that disclosures which don't go far enough can actually be worse for participants than the previous lack of disclosure. My own feeling, again, is that the DOL did a good job given the state of current law, and parts of their effort that made sense will likely resurface.

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## How the Prospectus Requirement Almost Died...And Might Still

The DOL's proposed 404a-5 participant disclosure rule was paired with an amendment to DOL Reg. §404c-1, the ERISA §404(c) regulations, which would have changed the prospectus requirement from a "push" to a "pull" requirement. Instead of having to give prospectuses to every participant whether he or she asks for them or not, the proposed changes would have meant that delivery of prospectuses on demand would be sufficient. This change is perfectly reasonable, but unless the DOL's proposals come back, this change is itself dead.

## So When Do We Get to Watch the Hangin'?

I feel like I got all dressed up and took the family to town for a Sunday hangin', only to arrive and find that the bad guy had escaped. The wife and kids were so disappointed. The 404(c) prospectus requirement deserved to die. Is it now going to go free because of the transparency pendulum's current position in its backswing? Or will justice prevail?

## Counterpoint: Prospectuses are Good

**Question:** If Bernie Madoff had been running a mutual fund instead of a hedge fund, would his fraud have succeeded?

**Answer:** No.

Mutual funds are carefully regulated and, as a result, quite safe. They may lose money from bad markets or bad investments, but not because the fund manager turns out to have no compunctions about robbing widows and charities. The prospectus is a good thing; it is a formal disclosure that, combined with other rules, forces mutual funds to play fair. Just because no one reads it doesn't mean it's not useful. The 404(c) prospectus *requirement*, on the other hand, is a bad thing, but only because the "push" requirement is unreasonable.

Bernie Madoff and the countless other investment frauds that have emerged over the years provide us with a crucial lesson: transparency works.

## But Not All Funds Are Required to Have Prospectuses

The 404c-1 prospectus requirement says that fiduciaries only have to pass on to participants prospectuses for funds that *have* a prospectus. Since insurance company separate accounts and bank collective trusts are not mutual funds, they don't

have prospectuses and thus are not subject to the prospectus requirement. Group annuities, however, are contracts that have prospectuses, so the plan level prospectus might logically be a document that must be passed through.

Weigh the absence of the need for delivery of a prospectus to every participant against the absence of the disclosure that a prospectus provides. There are pros and cons. The bottom line, again, is that prospectuses are a good thing; it's the "push" nature of the current prospectus requirement that makes no sense.

## The Moral of the Prospectus Story

Disclosure reduces malfeasance. A high level of transparency reduces fraud and improves fee competition by giving the people who know what to look for (professionals) a way to find it. Participants, on the other hand, can't generally be bothered to spend more than three minutes annually on their retirement—the single largest purchase of their lives. They rarely read what we currently give them, and they won't read the new stuff, either. So transparency at the *fiduciary* level is critical, but transparency at the participant level should lean toward simple disclosures that can be supplemented with details **upon request**. Such is the lesson of the prospectus requirement.

## Proposals From Congress

At the time this article is being written, several proposals for transparency reform are making their way through Congress. The most important is probably The 401(k) Fair Disclosure for Retirement Security Act of 2009 (H.R. 1984), introduced in April by Representatives George Miller (D-CA) and Rob Andrews (D-NJ). Key provisions include:

- Amends ERISA to establish a new disclosure requirement for the Administrator under a new §111;
- Requires providers to disclose to employers all fees assessed against the participant's account, broken down into four categories: administrative fees, investment management fees, transaction fees and other fees (would require some bundled vendors to break these costs out separately). Note that this requirement roughly matches what would have been required under DOL's Reg. §408b-2(c);
- The \$5,000 threshold applies: disclosure would only be required for service providers whose compensation was \$5,000 per year or more [a lesser standard than 408b-2(c) would have required, since the DOL did not propose that the threshold would apply];

- Requires service providers to disclose financial relationships and potential conflicts of interest to plan sponsors (again, as in 408b-2);
- Quarterly statements would be required to list all fees subtracted from the account in one number, but the worker could request more detailed fee information from his or her plan administrator (not unlike the DOL's Reg. §404a-5); and
- Requires the use of at least one index fund if the plan is to be eligible for ERISA §404(c) relief.

## The Future of Transparency

The current bills before Congress, combined with the DOL's three transparency initiatives, allow us some scientific guesses. Here are some principles it would seem wise to assume will ultimately find their way into regulations:

- From 408b-2(c) we might expect:
  - Comprehensive disclosure by vendors to fiduciaries at point of sale; and
  - Disclosure of more than just costs, but also compensation and conflicts of interest (the "Three Cs" of reasonable compensation<sup>3</sup>).
- From the new 5500 disclosure rules we can expect:
  - Increased disclosure of commissions, revenue sharing, client lunches and other forms of compensation that require us to track those items and faithfully report them.
- From 404a-5 we might expect:
  - A fiduciary standard requiring plan fiduciaries to assemble and provide to participants in participant-directed plans a meaningful disclosure document; and
  - If we're lucky, the death of the prospectus requirement.
- From Congress we might expect:
  - Participant disclosures similar to the DOL's 404a-5 approach;
  - Fiduciary disclosures from vendors similar to the DOL's 408b-2 approach;
  - Potential disclosure of fund transaction cost estimates;
  - Breakdown of costs that requires bundled providers to estimate the portion of fees going to each department of their companies (e.g., recordkeeping, investments, trust, etc.);
  - Mandatory inclusion of at least one index fund; and
  - Additional regulations from the DOL providing details of how any new laws

will be enforced (e.g., we might expect to see the DOL's three initiatives put back into play, with changes, plus an additional regulation implementing the new ERISA §111).

## What You Should Already Be Doing to Prepare

- Preparing a detailed service agreement that conforms, at least in spirit, with the DOL's "final" but on hold 408b-2 regulation. Your agreement should present a compelling value proposition and accurately reflect what you do and how you get paid. (This practice is arguably an ERISA requirement already, and the DOL's 408b-2 revision just made it official.);
- Collecting data on all indirect compensation you receive, including all forms of revenue sharing, float and soft dollars;
- Collecting data and setting guidelines for soft dollar payments such as travel, education (does your vendor send you to conferences?), meals and entertainment, both from and to clients and other parties;
- Collecting data on all payments you make to third parties or parties in interest;
- Refining systems for preparing and distributing participant disclosures that conform, at least in spirit, with the DOL's Final/on hold 404a-5 regulation. While you're at it, consider conforming to HR 1984; and
- Revising your form ADV Part II if you're an RIA and matching up the language you use with that in your new service agreement.

## Conclusion

Prospectuses are good; the prospectus requirement is bad. Transparency is good, but too much disclosure forced down to participants is bad. It's not yet clear how many trees will die once the rulemaking is done, but genuine (though still incomplete) transparency is coming, and you should already be preparing your firm for the new paradigm. And with any luck, the prospectus requirement will soon die a gentle death and serve as a model for future disclosure. ↗



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