Washington update: The changing face of 401(k) plan regulation
Prepared by The Wagner Law Group

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All investments involve risk, including possible loss of principal.

Important note: The Wagner Law Group has prepared this white paper on behalf of Legg Mason & Co., LLC. This paper highlights recent and proposed changes in the law, which are expected to significantly impact defined contribution retirement plans subject to the Employee Retirement Income Security Act (ERISA) of 1974, as amended, and the financial advisors who support and advise sponsors of these plans. Future legislative and regulatory developments may significantly impact the legal analysis provided herein. Please be sure to consult with your own legal counsel concerning such future developments.

This white paper is intended for general informational purposes only, and it does not constitute legal, tax or investment advice on the part of The Wagner Law Group or Legg Mason & Co., LLC and its affiliates. Plan sponsors and financial advisors should consult with their own legal counsel to understand the nature and scope of their responsibilities under ERISA and other applicable law.

INVESTMENT PRODUCTS: NOT FDIC INSURED • NO BANK GUARANTEE • MAY LOSE VALUE
Executive summary

Calendar year 2010 was a year of tremendous regulatory activity for 401(k) plans and similar retirement vehicles, leading to new rules impacting both plan sponsors and plan participants. Some of these regulatory changes have already been finalized and are being taken into effect, while others will be finalized by government agencies in the near future. To fully understand all the rule changes, it is useful to group them into the following five categories, based on the governmental policy objectives that launched them:

Policy objective #1
Improving transparency of services and fees in the 401(k) market
• 408(b)(2) fee disclosures for plan sponsors — final rule effective on July 1, 2012

Policy objective #2
Greater accountability for providers of investment-related services to plans
• Broader “Investment Advice Fiduciary” definition — proposed rules issued but re-proposal pending

Policy objective #3
Helping plan participants make better investment decisions
• Participant-level fee disclosures — final rule effective on August 30, 2012 for calendar year plans
• Participant-level investment advice — final rule effective on December 27, 2011

Policy objective #4
Making savings last through retirement
• Lifetime income options — regulators conducting pre-rule-making study; proposed tax rules issued

Policy objective #5
Improving disclosures for target-date funds
• Target-date disclosures — proposed rule issued
Plan sponsors should consider how these policy objectives address particular concerns in our current retirement system. Although many of the rule changes have not yet been finalized, plan fiduciaries can take action today by voluntarily implementing these pending requirements as “best practices” with the assistance of the plan’s financial advisor. For example, advisors can help plan sponsors obtain current fee information (similar in form to the 408(b)(2) Fee Disclosures that must be provided by covered service providers to plan sponsors by July 1, 2012) to evaluate and monitor the plan’s service providers prudently. Financial advisors can also help sponsors improve the level of education provided to participants in the key areas that have been targeted in the government’s policy objectives (e.g., plan services and fees, strategies for making savings last through retirement, TDFs).
Introduction

Calendar year 2010 was a year of tremendous regulatory activity for 401(k) plans. Federal agencies under the leadership of the Obama administration unleashed a torrent of new rules and proposals, impacting both plan sponsors and plan participants. Some of these regulatory changes have already been finalized and are scheduled to take effect in the near future.

Others are proposed regulations that will be finalized by the relevant government agencies in the near future. It is likely that the final version of these proposals will be in line with their current form, which have been publicly endorsed by the White House and by the applicable agency heads serving in the President’s cabinet. Moreover, because these regulatory changes are not subject to congressional approval, a Republican-led House of Representatives (that went into effect on January 5, 2011) is unlikely to hamper the administration’s rule-making agenda.

2010 timeline for regulatory developments impacting retirement plans

<table>
<thead>
<tr>
<th>Date</th>
<th>Event Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>2/2/10</td>
<td>IRS/DOL jointly issue RFI on lifetime income options</td>
</tr>
<tr>
<td>5/6/10</td>
<td>SEC/DOL jointly issue investor bulletin on TDFs</td>
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<td>7/16/10</td>
<td>DOL issues interim rules for 408(b)(2) fee disclosure</td>
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<td>10/20/10</td>
<td>DOL finalizes rules for participant fee disclosure</td>
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<tr>
<td>11/30/10</td>
<td>DOL proposes TDF disclosure</td>
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<tr>
<td>1/21/11</td>
<td>SEC staff report on fiduciary standards</td>
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<tr>
<td>2/2/12</td>
<td>IRS proposes rules on plan annuities</td>
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<tr>
<td>8/30/12</td>
<td>Participant fee disclosure rules</td>
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<tr>
<td>3/2/10</td>
<td>DOL proposes participant investment advice rules</td>
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<tr>
<td>6/16/10</td>
<td>SEC proposes TDF marketing rules</td>
</tr>
<tr>
<td>7/16/10</td>
<td>Dodd-Frank Act enacted (impacting advisors)</td>
</tr>
<tr>
<td>9/14/10</td>
<td>IRS/DOL hearing on lifetime income options</td>
</tr>
<tr>
<td>10/22/10</td>
<td>DOL proposes new fiduciary definition</td>
</tr>
</tbody>
</table>
Even the most sophisticated practitioners are finding it challenging to stay abreast of all this regulatory activity. To fully understand and appreciate the looming changes, it is useful to identify the governmental policy objectives that gave birth to them. For this purpose, the key policy objectives can be categorized as follows.

- Improving the transparency of services and fees in the 401(k) market
- Greater accountability for providers of investment-related services to plans
- Helping plan participants make better investment decisions
- Giving participants ways to make their retirement savings last a lifetime
- Improving disclosures for target date funds ("TDFs")

In the remainder of this paper, we will discuss each of these policy objectives and review how the upcoming regulatory changes are designed to fulfill them.
Governmental policy objectives for rule changes

Policy objective #1
Improving transparency of services and fees in the 401(k) market

Final rule effective on July 1, 2012

The governmental policy objective to improve fee transparency in the 401(k) plan industry is based, in large part, on the groundwork laid by the U.S. Government Accountability Office (“GAO”), also known as the “investigative arm” of Congress.

Over the last five years, the GAO has issued a series of reports calling attention to the problem of “hidden” fees and potential conflicts of interests among service providers in the 401(k) market. These concerns have resulted in a major piece of rule-making from the U.S. Department of Labor (“DOL”), one that will require providers to deliver fee disclosures to plan sponsors for the first time.

By July 1, 2012, service providers will need to deliver newly mandated notices under Section 408(b)(2) of ERISA (“408(b)(2) Fee Disclosures”) to their existing plan sponsor clients. These 408(b)(2) Fee Disclosures must describe the services provided as well as the compensation directly or indirectly received by the provider. After July 1, 2012, 408(b)(2) Fee Disclosures will only need to be delivered whenever a provider agrees to renew or extend its services, or whenever it enters into a new service arrangement with a plan client. There is a great deal of anticipation surrounding this new disclosure requirement, which is designed to plug a gaping “hole” in the regulatory oversight of ERISA plans. As succinctly explained by the DOL, without the requirement for 408(b)(2) Fee Disclosures, plan fiduciaries have a duty to consider a service provider’s compensation from all sources, but service providers are not obligated to disclose compensation from other sources” (emphasis added).¹ The DOL’s final rules under Section 408(b)(2) create the desired symmetry between the fee information that sponsors must review to satisfy their fiduciary duties and the fee information that providers must proactively disclose to plan sponsors.

The current reality is that providers are not obligated to furnish fee information under ERISA, and plan sponsors may be unaware of the “indirect” compensation that providers may receive through the plan’s investments. For example, a plan’s record-keeper may receive ongoing payments from the funds in the plan’s menu for its services as an administrative intermediary between plan participants and each fund. However, if the plan sponsor is unaware of the amount, or even the existence, of the flow of payments from such funds to a provider, it has no way of determining whether these “hidden” fees are reasonable. These costs are typically embedded in the expenses of the plan’s investment funds, which can hurt participants by cutting into their investment earnings.

¹ Preamble to DOL’s interim final regulations under Section 408(b)(2) of ERISA (July 16, 2010), 75 FR 41600.
The use of plan assets to pay a service provider’s fees is a prohibited transaction under Section 408(b)(2) of ERISA, unless the services are provided under a “reasonable arrangement” for reasonable compensation. This statutory provision represents an important safeguard for participants under ERISA, forcing plan sponsors to protect them from excessive fees. The DOL’s 408(b)(2) Fee Disclosure rules, which were finalized on February 2, 2012, provide that a service arrangement will qualify as a “reasonable arrangement” only if the service provider delivers its 408(b)(2) Fee Disclosures to the plan sponsor before entering into the service arrangement with the plan. The disclosure requirement applies to fiduciary advisors, record-keeping platforms and certain types of service providers that receive indirect compensation (e.g., broker/dealers).

Plan sponsors will need to review a provider’s 408(b)(2) Fee Disclosures carefully. As fiduciaries, plan sponsors have a duty to establish that the provider’s fees are reasonable before engaging the provider on behalf of the plan. The 408(b)(2) Fee Disclosure rules were originally scheduled to become effective on July 16, 2011, but the DOL pushed it back to July 1, 2012 to give service providers the additional time needed for compliance.

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2 The 408(b)(2) Fee Disclosures are only required if service fees are expected to equal or exceed $1,000. In addition to fiduciary advisors and record-keeping platforms, the new disclosure rules also apply to providers of the following services to the extent they receive any indirect compensation: accounting, actuarial, appraisal, banking, consulting, custodial, insurance, investment, legal, brokerage, or administrative services.
Policy objective #2

Greater accountability for providers of ‘investment advice’ to plans

The DOL’s preliminary proposal to change the definition of “investment advice” is little more than four pages — double spaced. But, if the DOL retains the basic concepts from its initial proposal, this undersized package of rules could turn the retirement plan industry on its head, placing new limits on the ways in which pension consultants and advisors may advise plan sponsors and participants.

ERISA has a “functional” approach for determining whether a person is subject to its minimum fiduciary standards. For example, if an advisor actually provides any “investment advice” to a plan sponsor, it automatically becomes a fiduciary (“Investment Advice Fiduciary”) to the plan under ERISA. Thus, an advisor can become a fiduciary, even if it is not formally appointed to serve as one.

The DOL’s current “investment advice” regulations have not been updated since 1975. Under these existing rules, a person is deemed to provide investment advice only if it meets a five-factor test. As part of this test, an advisor provides investment advice whenever there is a mutual understanding with the plan client that the advisor will be making recommendations on a regular basis that will serve as the primary basis for plan investment decisions.

On October 22, 2010, the DOL issued a preliminary set of proposed regulations, which substantially liberalized the test for “investment advice,” broadly.

### Comparison of ‘investment advice’ definitions

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<tr>
<th>Nature of advice</th>
<th>Existing regulations</th>
<th>Newly proposed regulations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advice on (a) value of investments, or (b) purchasing or selling investments...</td>
<td>Advice on (a) value of investments, (b) purchasing or selling investments, or (c) management of investments...</td>
<td></td>
</tr>
<tr>
<td>Frequency of advice</td>
<td>...rendered on a regular basis...</td>
<td>...(which may be provided on a one-time or regular basis)...</td>
</tr>
<tr>
<td>Expectation of parties</td>
<td>...under a mutual agreement or understanding...</td>
<td>...under an agreement or understanding (which may or may not be mutual)...</td>
</tr>
<tr>
<td>Reliance on advice</td>
<td>...that the advice will serve as the primary basis for plan investment decisions, and...</td>
<td>...that the advice may be considered in plan investment decisions, and...</td>
</tr>
<tr>
<td>Individualized advice</td>
<td>...that the advice will be individualized based on the needs of the plan.</td>
<td>...that the advice will be individualized based on the needs of the plan or participant. 3</td>
</tr>
</tbody>
</table>

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3 If the advisor is a fiduciary or a registered investment adviser under the Investment Advisers Act of 1940, the advisor is automatically deemed to be providing investment advice even if there is no agreement or understanding that the advice may be considered in plan investment decisions and that the advice is individualized based on the needs of the plan or participant.
expanding the circumstances in which advisors would be viewed as Investment Advice Fiduciaries. The DOL has announced that it will be re-proposing its rules to reflect the large volume of comments provided by the public, but it appears that the DOL intends to retain the same basic framework for its rule-making. Under the DOL’s preliminary proposal, a person is deemed to provide investment advice (assuming the other aspects of the test are met) if there is any understanding that the advice may be considered for purposes of plan investment decisions. To be considered investment advice, recommendations no longer need to be provided on a regular basis, meaning that even one-time advice could be viewed as fiduciary investment advice.

In addition, under the DOL’s preliminary proposal an advisor will not become an Investment Advice Fiduciary if it can demonstrate that the plan client knows that the advisor is acting as a seller of securities, whose interests are adverse to the plan client, and is not providing impartial advice. There is a specific safe harbor for advisors who merely provide investment “education” to participants, and another for record-keeping platforms disclosing that they do not provide impartial advice.

Financial advisors are often associated with two types of firms: (i) non-fiduciary broker/dealers that earn variable rates of compensation based on the investments selected by the plan, or (ii) registered investment advisers (“RIAs”) serving plans in a fiduciary capacity for a level fee. The DOL’s pending regulations, if adopted in a form similar to its preliminary proposal, would cause many broker/dealers to become fiduciaries (assuming they do not reduce their level of service). However, ERISA prohibits fiduciary advisors from receiving variable compensation, due to the conflict that arises from the incentive to recommend investments which pay them the highest fees. If a broker/dealer advisor is treated as an Investment Advice Fiduciary as a result of the DOL’s proposal, one possible strategy for complying with ERISA would be to pursue “dual registration” as a RIA, enabling the advisory firm to charge a level fee to the plan in order to eliminate any prohibited conflicts of interest. Alternatively, broker/dealer advisors could continue to maintain their non-fiduciary status by making the DOL’s proposed disclosures (e.g., investment advice is not impartial), but this approach may have a “chilling” effect on client relationships. Other approaches to achieving compliance with ERISA may be available, and each advisory firm will need to decide upon a compliance approach in the event that the liberalized definition of Investment Advice Fiduciary set forth in the DOL’s proposal is adopted.

In what appears to be a parallel regulatory project, the U.S. Securities and Exchange Commission (the “SEC”) conducted its own study of the different standards of conduct that apply to advisors, as directed by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). The SEC staff, in its report issued on January 21, 2011, recommended that the same fiduciary standard that applies to RIAs be imposed on all broker/dealers with regard to retail customers. However, it appears that the SEC is seeking further comments from the public on this matter. Although these recommendations under the Dodd-Frank Act are not formally linked to the DOL’s proposal, it is interesting to note that both agencies are seeking to impose higher standards of conduct on broker/dealers.
Policy objective #3

Helping participants make better investment decisions

Given the prominence of 401(k)-style plans, the success of our current retirement system hinges on the average participant’s aptitude for choosing investments. Unfortunately, according to the DOL, there is a “growing concern” that participants do not consider the “information critical to making informed decisions.”4 These concerns have resulted in two rules, one in final form on fee disclosures and another in proposed form on participant advice.

Participant-level fee disclosures

Final rule effective on August 30, 2012 for calendar year plans

For plan years beginning on or after November 1, 2011, sponsors of plans with participant-directed investments will have a new fiduciary obligation to provide disclosures to participants. These disclosures must be provided on or before the time a new participant can first direct investments under the plan, and they must also be provided to all eligible employees and enrolled participants annually. For calendar year plans, employers will need to start delivering these disclosures to participants no later than August 30, 2012.5

The DOL has created a “model” disclosure form, which may have caused confusion among certain readers due to the fact that the model only covers the investment-related portion of the required disclosures.6 Along with these investment-related disclosures, which must be provided annually to participants, plan sponsors must also include plan-related disclosures concerning the administrative service fees charged to the plan. Participants must also receive quarterly statements with the actual dollar amount charged to their accounts for such services.

Overview of information required for participant-level fee disclosures

<table>
<thead>
<tr>
<th>Disclosure</th>
<th>Timing</th>
<th>Disclosure items</th>
<th>DOL model disclosure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plan-related</td>
<td>Annual disclosure and for new participants</td>
<td>Explanation of fees for plan-level and participant-level services (e.g., plan loan) charged to participant accounts</td>
<td>Not covered in DOL model</td>
</tr>
<tr>
<td>Investment-related</td>
<td>Annual disclosure and for new participants</td>
<td>Comparative chart with investment performance, benchmark data and fees for all investment menu options</td>
<td>Covered in DOL model</td>
</tr>
<tr>
<td>Plan-related</td>
<td>Quarterly statements</td>
<td>Actual dollar amount for fees charged to plan account, with description of relevant services</td>
<td>Not covered in DOL model</td>
</tr>
</tbody>
</table>

The new disclosure rules offer one significant administrative benefit for plans that are designed to comply with ERISA Section 404(c).7 Under the existing 404(c)-related rules, generally, a fund prospectus must be delivered to a participant before his or her initial investment in the fund. As a practical matter, this rule forces many plans to include a cumbersome number of fund prospectuses in the enrollment kits for new participants. However, the investment-disclosure requirements under ERISA Section 404(c) will no longer require the automatic delivery of fund prospectuses to new participants, so long as the annual and quarterly disclosures are provided under the DOL’s new disclosure rules.

4 Preamble to DOL final regulations on fiduciary requirements for disclosure in participant-directed individual account plans (October 20, 2010), 75 FR 64910.

5 The DOL has provided a one-time grace period to plan sponsors for when they first become subject to the new disclosure requirement. For example, a plan sponsor with a calendar year plan would have until August 30, 2012 to deliver the required disclosures to new participants entering the plan on January 1, 2012.

6 The DOL’s model “comparative chart” disclosure is available at: http://www.dol.gov/ebsa/participantfeerulemodelchart.doc.

7 If a plan with participant-directed investments is operated in compliance with the requirements under ERISA Section 404(c) and the related DOL regulations, the plan sponsor is relieved of any fiduciary responsibility over the investment allocation decisions made by individual plan participants.
Participant-level investment advice

The prohibited transaction rules under ERISA make it unlawful for fiduciary advisors to provide participant-level advice if it is conflicted. Advisors that earn variable rates of compensation (e.g., broker/dealer earning 12b-1 fees from the plan’s funds at different rates) that vary with the investment choices of participants are ordinarily prohibited from providing participant-level advice. To overcome this hurdle, the DOL issued proposed rules on March 2, 2010, which were ultimately finalized and became effective on December 27, 2011.8

Under these regulations, participants may receive investment advice so long as the plan’s individual financial advisor and the advisory firm both receive level compensation which does not vary with the investment decisions made by participants. Affiliates of the advisory firm are allowed to earn additional compensation under the DOL proposal, which is likely to benefit record-keeping platforms affiliated with mutual funds.9

Alternatively, the regulations allow an advisor earning variable compensation to provide allocation advice to participants if such advice is based on an objective computer model that applies generally accepted investment theories. When the DOL issued its initial proposal, it also commented that the historical performance of individual funds (as opposed to the historical performance of an asset class) may be an inappropriate criterion for a computer model’s advice.10 In light of its perceived bias in favor of passively managed index funds, the agency’s comment drew heavy criticism from the public, and the final version of the DOL’s rules eliminated any potential tilt in favor of index funds.

8 These regulations were issued pursuant to a statutory prohibited transaction exemption under the Pension Protection Act of 2006. These regulations replace a prior set of final rules issued under the Bush administration, which were withdrawn under the Obama administration before they had a chance to take effect.

9 For example, if a plan receives both administrative and investment services from a mutual fund complex, the advisory affiliate within the complex would be allowed to charge the plan a level fee for providing participant-level advice. In addition, the record-keeping affiliate within the complex would be able to charge the plan an administrative service fee, and the fund managers within the complex would be allowed to receive management fees from the mutual funds included in the plan’s menu.

10 Preamble to DOL proposed regulations on participant investment advice (March 2, 2010), 75 FR 9360.
**Policy objective #4**

**Making savings last through retirement — lifetime income options**

As millions of “baby boomers” reach retirement age, more and more Americans are beginning to draw down on their retirement savings. To enhance the retirement security of workers, the Obama administration has made “promoting the availability of guaranteed lifetime income products” a policy objective, to help participants reduce the risk that they will outlive their retirement assets.\(^{11}\)

The DOL, Internal Revenue Service (“IRS”) and the U.S. Treasury Department jointly issued a Request for Information (“RFI”) on February 2, 2010, requesting comments on how the existing rules might be modified to encourage the annuitization of defined contribution plan benefits. The RFI was a pre-rule-making starting point for the agencies, which attracted nearly 800 comment letters from the public. The agencies then held a two-day hearing beginning on September 14, 2010, focusing on specific areas of concern raised by the public. While the agencies did not make any announcements concerning the likely areas for proposed regulations, the narrow topics of interest explored during the hearing signaled a number of possibilities for rule-making in the near future.

### Joint hearing held by DOL and IRS/Treasury on lifetime income options

<table>
<thead>
<tr>
<th>Topic</th>
<th>Items discussed</th>
<th>Possible regulatory response</th>
</tr>
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<tbody>
<tr>
<td>Participant concerns</td>
<td>Concerns raised by participants regarding complexity of lifetime income options</td>
<td>DOL requires enhanced disclosures for any lifetime income options and related fees</td>
</tr>
<tr>
<td>Investment products</td>
<td>Insurance and non-insurance solutions for providing retirement income within or outside of a plan</td>
<td>IRS provides guidance on interaction of tax-qualification rules and lifetime income products</td>
</tr>
<tr>
<td>Participant education</td>
<td>Encouraging plan sponsors to provide retirement income education to participants</td>
<td>DOL creates safe harbor for providing education on retirement income without any fiduciary liability</td>
</tr>
<tr>
<td>Disclosure of benefits</td>
<td>Whether participants might benefit from knowing what accounts would be worth if converted to annuities</td>
<td>DOL requires disclosure of equivalent annuity value for each participant’s account balance</td>
</tr>
<tr>
<td>Fiduciary duties</td>
<td>Fiduciary duties that apply when plan sponsor selects lifetime income options for plan</td>
<td>DOL creates safe harbor for plan fiduciaries on how to select lifetime income options prudently</td>
</tr>
</tbody>
</table>

The IRS/Treasury has already pushed ahead with its rule-making efforts by issuing two sets of proposed regulations on February 2, 2012. One set of proposed rules would encourage defined benefit plans to offer “split” payment options, where participants may elect to receive a portion of their accrued benefit as an annuity and the other portion as a lump sum. This proposal is designed to eliminate the “all or nothing” choice that many pensioners currently face when deciding between a lump sum or an annuity. The other set of proposed rules allows 401(k) plans to offer “longevity annuity” investments, which are annuities that begin payments at an advanced age, such as age 80. Under current law, longevity annuities are not considered an attractive investment for plans, since plans generally must commence minimum distributions by age 70½.

\(^{11}\) Annual Report of the White House Task Force on the Middle Class, February 2010.
Policy objective #5

Improving disclosures for target-date funds

The SEC has noted that “market losses incurred in 2008, coupled with the increasing significance of target-date funds in 401(k) plans, have given rise to a number of concerns about target-date funds.”12 Precipitated by the unexpected volatility exhibited by a number of TDFs in 2008, regulators have been paying close attention to how they are promoted by fund companies and utilized by plans.

The DOL and the SEC held a joint public hearing dedicated to exploring various public policy concerns surrounding TDFs in June 2009, leading to an Investor Bulletin published on May 6, 2010 jointly by both agencies to better educate employers and participants.13 Shortly thereafter, on June 16, 2010, the SEC issued a set of proposed regulations which would require certain disclosures to be included in marketing materials for TDFs, with the aim of reducing the potential for investor confusion.

The DOL recently proposed its own set of regulations on November 30, 2010, which would require special disclosures for participants whenever TDFs are designated as the qualified default investment alternative (“QDIA”) for 401(k)-style plans.14 This proposal would amend the current QDIA regulations, which officially approved the use of TDFs as a QDIA in 2007. As expected, since the issuance of the DOLs final QDIA regulations, the amount of plan assets invested in TDFs has ballooned, increasing from only $37 billion in 2003 to roughly $360 billion as of October 2011.15

The DOL proposal would amend the QDIA regulations by requiring additional information to be included in the annual QDIA notice to participants about the applicable TDF series used as the plan’s default investment. As proposed, the QDIA notice would need to discuss the types of assets held by the TDF, its historical performance, fees and expenses, a graphical representation of how its asset allocation changes over time (i.e., glide path), the relevance of the stated target date, disclaimers about investment risk, and other related disclosures.

The DOL’s proposal would also amend its participant-level fee disclosure regulations to require enhanced disclosures for any TDF investment options in the plan menu. (The participant-level fee disclosure rules become effective August 30, 2012 for calendar year plans, as discussed above.) As modified by the DOLs proposal, the comparative investment chart that must be delivered annually to participants would need to be expanded to include an appendix with the required information for TDFs. The appendix would have to disclose much of the same information required by the proposed QDIA notice modification. The DOL expects both the appendix to the annual comparative chart as well as the additions to the annual QDIA notice to each be approximately two pages in length.

When it released its proposal, the DOL also confirmed that it would be publishing “a series of tips intended to assist plan fiduciaries in obtaining and evaluating relevant information when selecting and monitoring TDFs as investment options for participant-directed retirement plans.”16 The DOL’s “tips” are intended to serve as guidelines for assessing the unique characteristics of TDFs when plan fiduciaries evaluate them in accordance with their duty of prudence under ERISA. (For additional information on how to evaluate TDFs, be sure to read Legg Mason’s Fiduciary Guidebook for Target Date Funds.)

12 Preamble to SEC proposed rule on investment company advertising – target-date fund names and marketing, SEC Release Nos. 33-9126, 34-62300, IC-29301 (June 16, 2010).
14 The QDIA rules provide guidance to plan sponsors on how they can add a default investment option to a plan in accordance with a fiduciary safe harbor making participants responsible for their “passive” decision to invest in the QDIA. Among other requirements, the default investment option must satisfy the requirements of a QDIA, and participants must receive annual QDIA notices.
15 Remarks before the ICI 2011 Securities Law Developments Conference by Eileen Rominger, Director, SEC Division of Investment Management, on December 13, 2011.
16 DOL proposed regulations on target date disclosures (November 30, 2010), 75 FR 73987.
Action items for plan sponsors

From a legal perspective, the regulatory changes discussed in this paper are administrative rules “interpreting” existing statutory law (federal administrative agencies cannot create new statutory law, a power reserved exclusively for Congress). In other words, rather than creating new fiduciary duties, these regulatory changes are merely interpretive requirements for complying with existing fiduciary duties under ERISA.

Accordingly, these practices, which plan sponsors will be compelled to observe in the near future, can also be viewed as de facto “best practices” for sponsors to follow today in accordance with their existing fiduciary duties. With this perspective in mind, sponsors should consider adopting the following practices right now:

• **Evaluate the plan’s service providers.** Sponsors should ask the plan’s service providers for enhanced information concerning their qualifications, services and fees (including any indirect compensation), so that they can prudently evaluate their providers in accordance with their duties under ERISA. For additional detail, be sure to read Legg Mason’s white paper “Fee Transparency and Best Practices for Plan Sponsors.” They should also ask providers when their 408(b)(2) disclosures will be provided, which must be delivered to existing plan clients no later than July 1, 2012.

• **Enhance education for participants in key areas.** It is common for plan sponsors to provide some form of investment education to participants. However, many participants do not receive:

  1. information which compares investment options as effectively as in the DOL’s model chart (which will not become mandatory until August 30, 2012 for calendar year plans)
  2. sufficiently detailed information concerning the plan’s fees and services
  3. education on withdrawal strategies for making savings last through retirement and budgeting for post-retirement expenses
  4. a meaningful description of the plan’s TDFs (Target Date Funds) that includes a glide path illustration, a discussion of the relevant investment characteristics and other key information

Plan sponsors should consider providing better education to their participants in these four areas. The simple act of writing down the plan’s educational objectives can be a helpful exercise, which can then be used to develop a game plan for delivering enhanced informational materials to the plan’s participants in the designated areas.
Conclusion

It is important for plan sponsors to understand how the DOL’s pending rules are going to impact them in the near future. They should also recognize the fact that these changes are coming about as a direct result of particular policy concerns and perceived problems in the current retirement system.

As fiduciaries, plan sponsors should be proactive in managing their plans, adopting practices which address these problems, and financial advisors can provide valuable assistance. For example, advisors can help sponsors obtain current fee information (similar in form to the 408(b)(2) Fee Disclosures that must be provided by July 1, 2012) to evaluate and monitor the plan’s service providers prudently. Advisors can also help plan sponsors develop educational objectives to improve the level of participant education in the key areas that have been targeted in the government’s policy objectives (e.g., plan services and fees, strategies for making savings last through retirement, TDFs). Taking these steps can help assure the success of the retirement plan, and also facilitate a smooth transition to the new regulatory rules as they currently go into effect and in the near future.
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