404a-5 disclosures to participants: Best practices for plan sponsors

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 includes suggested guidelines and practices that plan sponsors, and the financial professionals who work with plan sponsors, should consider concerning Section 2550.404a-9 of the U.S. Department of Labor regulations issued under the Employee Retirement Income Security Act of 1974 (ERISA) and the related disclosures required for plan participants. Future legislative or regulatory developments may significantly impact these suggested guidelines and practices and the related matters discussed in this paper. Please be sure to consult with your own legal counsel concerning the disclosure obligations under Section 2550.404a-5 and any related 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 other fiduciaries should consult with their own legal counsel to understand the nature and scope of their responsibilities under ERISA and other applicable law.

The Wagner Law Group is not affiliated with Legg Mason, Inc.
Introduction

Plan sponsors are now subject to new participant-level disclosure rules issued by the U.S. Department of Labor (the “DOL”). Under these new rules, beginning in 2012, employers sponsoring 401(k)-style plans must deliver certain disclosures (the “404a-5 Disclosures”) to plan participants in accordance with Section 2550.404a-5 of the DOL regulations (the “404a-5 Regulations”). The 404a-5 Disclosures include both annual disclosures (the “Annual Disclosures”) that must commence by August 30, 2012 and quarterly fee disclosures (“Quarterly Fee Disclosures”) that must commence by November 14, 2012 in the case of calendar year plans.

Some plan sponsors are concerned that their participants may be confused by the detailed fee information included in the 404a-5 Disclosures. Others are concerned that their participants may be caught off guard and may react negatively when they see this fee information for the first time.

Fortunately, plan sponsors can take action today to help minimize the possibility of any negative reactions to the 404a-5 Disclosures. While not required by the 404a-5 Regulations to do so, plan sponsors may wish to consider following the “best practices” described in this paper to help prepare participants for the new the 404a-5 Disclosures and to help them digest those disclosures in a way that aids their understanding and appreciation of their plan.

1 Under the 404a-5 Regulations, the “plan administrator” is responsible for making the required disclosures. The plan sponsor is customarily designated to serve as the plan administrator, but a plan’s instrument is also permitted to designate an alternative person.
Purpose of 404a-5 disclosures

Plan sponsors and other fiduciaries must carry out their duties under the plan prudently and solely in the interest of the plan’s participants in accordance with Section 404(a)(1)(A) and (B) of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”). These duties are sometimes referred to as the fiduciary duties of “prudence” and “loyalty.” In the case of a plan that allocates investment responsibilities to its participants, the plan sponsor’s duties of prudence and loyalty now include a duty to deliver Annual Disclosures and Quarterly Fee Disclosures to participants in accordance with the 404a-5 Regulations.

As expressly provided in the 404a-5 Regulations, the purpose of the 404a-5 Disclosures is to provide sufficient information regarding the plan, including fees and expenses, to participants so that they are able to make informed decisions with regard to the management of their individual plan accounts. In addition, the 404a-5 Disclosures must be delivered to participants on a regular basis so that participants can be made aware of their rights and responsibilities with respect to the investment of their plan accounts. Although plan sponsors are responsible for delivering the 404a-5 Disclosures, they are expected to rely on the services of the plan’s recordkeeper or third party administrator (“TPA”) to actually prepare and deliver the required disclosures.
Overview of 404a-5 disclosures

The 404a-5 Regulations include detailed and technical rules concerning the required content for the Annual Disclosures and Quarterly Fee Disclosures. A summary of the key disclosure items is provided below.

Annual disclosures

The Annual Disclosures must be provided to each participant before they can first direct the investments in their account and annually thereafter. The key information required in the Annual Disclosures is as follows:

• Investment instructions. An explanation of how participants may give investment instructions and a list of the plan’s designated investment alternatives (the “DIAs”).

• Administrative fees. An explanation of any administrative service fees charged against participant accounts (e.g., recordkeeping fee) and any administrative fees charged on an individual basis (e.g., loan fee).

• Comparative chart. A chart that provides a side-by-side comparison of the DIAs in the plan menu in the following respects: (1) type or category of investment, (2) performance and benchmark data, and (3) fee and expense information.

• Website address. An Internet website address that provides access to information regarding each DIA as follows: (1) DIA’s issuer, (2) investment objectives and principal strategies, (3) portfolio turnover rate, (4) updated quarterly performance data and (5) fees and expenses.

• Glossary. A glossary of investment terms to assist participants in understanding the DIAs or an Internet website address that provides access to this glossary.

Quarterly fee disclosures

Under the 404a-5 Regulations, individual statements must be provided on at least a quarterly basis, with the dollar amounts charged against the participant’s account for any administrative service fees (e.g., recordkeeping fee) and any fees charged on an individual basis (e.g., loan fee). Rather than issuing separate statements, recordkeepers and TPAs are expected to make the required Quarterly Fee Disclosures by disclosing them as line item charges on participant benefit statements, which must also be provided on at least a quarterly basis under ERISA.

Other disclosures

Once participants invest their accounts in any DIA, any materials provided to the plan relating to voting or other similar rights must be passed through to the participant. Upon request, the participant must receive a copy of a DIA’s prospectus, financial statements, a statement of the value of a share or unit of the DIA, and other information.

1 The 404a-5 Regulations also require an explanation of any transfer restrictions or other limitations on investment instructions, a description of the plan provisions relating to the exercise of voting and similar rights relating to an investment in a DIA, the identity of any designated investment managers and a description of any brokerage window.

2 Administrative fees only need to be disclosed under the 404a-5 Regulations to the extent they are not already reflected in a DIA’s total annual operating expenses.

3 The performance and benchmark data for each DIA must be provided for 1-, 5- and 10-year periods (or for the life of the DIA, if shorter). The fee and expense information generally must include each DIA’s total annual operating expenses and certain other information. Special disclosures are also required for any DIA that is in the form of an annuity. The comparative chart must include a number of other required descriptions and statements.

4 Upon request, the plan sponsor must also provide a list of the assets comprising the portfolio of any DIA that is deemed to be holding plan assets within the meaning of the DOL regulations, and the value of each asset (or proportion of the investment which it comprises).
Deadline for initial disclosures

The “plan year” is the annual period used to determine certain plan records as defined in a plan’s governing document. A plan sponsor’s deadline for commencing 404a-5 Disclosures varies, depending on when its plan year begins, as summarized in the chart below:

<table>
<thead>
<tr>
<th>Start date for plan year</th>
<th>Deadline for commencing annual disclosures</th>
<th>Deadline for commencing quarterly fee disclosures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other than August 1st, September 1st or October 1st</td>
<td>August 30, 2012</td>
<td>November 14, 2012 (Statement for calendar quarter ending Sept. 30, 2012)</td>
</tr>
<tr>
<td>August 1st</td>
<td>September 30, 2012</td>
<td>November 14, 2012 (Statement for calendar quarter ending Sept. 30, 2012)</td>
</tr>
<tr>
<td>October 1st</td>
<td>November 30, 2012</td>
<td>February 14, 2013 (Statement for calendar quarter ending Dec. 31, 2012)</td>
</tr>
</tbody>
</table>
Anticipating negative responses from participants

If plan sponsors do not provide the necessary context and education to participants concerning the new 404a-5 Disclosures, participants may become confused or react negatively when they see the relevant fee information for the first time. If left unchecked, individual participants may respond unfavorably to the 404a-5 Disclosures in any of the following ways:

Potential legal claims
As a worst-case scenario, one or more disgruntled participants may consider filing a legal claim under ERISA or lodging a complaint with the DOL if they believe the plan’s fees are unreasonably excessive.

Walking away from the plan
Participants who resent the plan’s fees and expenses may stop contributing to the plan. If the terms of the plan permit them to do so, participants with the current ability to withdraw money from the plan may take distributions.

Other disclosures
Unsatisfied participants may question and/or complain about the plan’s fees, lowering morale in the workplace and undermining the value of the plan to other participants.

Fortunately, plan sponsors can anticipate these responses and take action today to help minimize the likelihood of the worst-case scenario and any other negative reactions. Summarized below are four emerging “best practices” that plan sponsors can use to help participants evaluate fees in their proper context and to make sure they do not lose sight of the value of participating in a tax-qualified plan.
Best Practice #1:
Fiduciary review of fees and expenses

As discussed above, the worst-case scenario is one in which a disgruntled participant considers taking legal action because they believe the plan’s fees are excessive. To protect themselves against potential fiduciary liability under ERISA, plan sponsors should conduct a fiduciary review of all plan fees and investment expenses as soon as practicable, if they have not done so already.

Plan sponsors have a duty to ensure that the plan’s fees and expenses are reasonable as part of their general fiduciary duty of loyalty under ERISA. There is a similar requirement under ERISA Section 408(b)(2) and the prohibited transaction rules, which allow plan assets to be used to pay a service provider if the service arrangement and fees are reasonable. Effective July 1, 2012, covered service providers must also furnish comprehensive fee disclosures to the plan sponsor in accordance with the related DOL regulations under ERISA Section 408(b)(2).

These 408(b)(2) disclosures are an ideal starting point for a plan sponsor’s fiduciary review of the plan’s fees and investment expenses. A well-documented review of the reasonableness of these fees and expenses can help demonstrate that the plan sponsor has prudently fulfilled its fiduciary duties under ERISA. Plan sponsors should always keep in mind that their duty to ensure the plan’s fees are reasonable should never be misinterpreted as a requirement to select the “cheapest” investment or provider. For suggestions on how a prudent review may be conducted, be sure to review Legg Mason’s “Fee Transparency and Best Practices for Plan Sponsors.”

Best Practice #2:
Participant communication on new annual disclosures

A plan sponsor should consider posting or delivering a participant communication explaining the 404a-5 Disclosures to participants to prepare them for the commencement of the Annual Disclosures. This participant communication should be provided, ideally, at the same time the initial Annual Disclosures are provided to participants.

This communication should reference the fact that the plan sponsor is monitoring the reasonableness of the plan’s fees and expenses (and, if applicable, the plan sponsor has completed its review of such fees and expenses) and explain the significance of the plan’s administrative fees and investment expenses. Reminding participants that the plan sponsor is monitoring the reasonableness of the plan’s fees and expenses can help discourage any potential disgruntled participants from filing a legal claim against the plan sponsor in the first place. It can also help manage participants’ expectations so that they appreciate the complexity and the realistic costs of operating any plan. A sample communication is included in the attached Appendix A (Initial Participant Communication on New 404a-5 Disclosures).
Best Practice #3: 
Special meeting on advantages/reasonable costs of plan participation

The purpose of a retirement plan is to provide a valuable benefit to employees, giving them the ability to save for retirement on a tax-deferred basis through their workplace. Unfortunately, participants who are caught off guard by the new 404a-5 Disclosures may resent the fact that they are being charged to participate in the plan. They may even stop participating, defeating the employer’s purpose for establishing the plan.

To help participants appreciate the value of the plan, the plan sponsor should consider holding a special group meeting for participants to educate them on the advantages of participating in the plan. Participants should be made to understand that reasonable costs are expected for the operation of any tax-qualified plan. The meeting should also highlight the benefits of saving for retirement and participating in the plan. Plan sponsors may wish to seek assistance from qualified financial professionals to help provide this type of education to participants.

One of the key messages to convey during this meeting would be that, while there are reasonable costs associated with investing through the plan, a tax-qualified plan is one of the few ways in which employees can reduce their current taxes and save on a tax-deferred basis. At the meeting, the plan’s key features should be explained, and participants should be encouraged to take advantage of the plan’s resources (e.g., website features, education and investment materials).

Best Practice #4:
Follow-up communication on new quarterly fee disclosures

As contemplated under the 404a-5 Regulations, the quarterly benefit statements of participants will need to disclose the dollar amounts charged to each participant’s account. In the case of calendar year plans, this requirement becomes effective with the benefit statement for the quarter ending September 30, 2012, which must be delivered to participants by November 14, 2012.

Because these Quarterly Fee Disclosures must be disclosed as line item charges on their statements, participants may still be startled when they see these charges, even after hearing about the plan sponsor’s fiduciary review and even after attending a meeting dedicated to reviewing the advantages and reasonable costs of plan participation. To address these potential concerns, plan sponsors should consider sending a follow-up communication to participants when the Quarterly Fee Disclosures commence, in order to reinforce the value of plan participation and the reasonableness of plan fees. A sample communication is included in the attached Appendix B (Follow-Up Participant Communication on Quarterly Fee Disclosures).
Conclusion

The new 404a-5 Disclosures are designed to provide participants a great deal of new information about the plan’s administrative fees and investment expenses. To help demonstrate the reasonableness of these fees and expenses, plan sponsors should conduct a fiduciary review in a prudent manner. With the assistance of the plan’s financial professional, plan sponsors can also hold a special group meeting for participants, dedicated to educating them on the reasonable costs and advantages of plan participation.

Plan sponsors should also consider sending or posting two separate communications to participants to coincide with the initial commencement of the Annual Disclosures and the subsequent commencement of the Quarterly Fee Disclosures. By following these simple guidelines, plan sponsors can help participants understand the plan’s fees and expenses and also help them appreciate the advantages of plan participation.
Appendix A
Initial Participant Communication on New 404a-5 Disclosures

EXPLANATION OF NEW 404A-5 DISCLOSURES FOR PLAN FEES AND EXPENSES

Date: ____________, 2012

To: Participants in the _____________ Plan

RE: New 404a-5 Disclosures for Participants

Thank you for your continued interest in participating in the [ABC Plan] (Plan). The Plan is a tax-qualified plan subject to various regulatory requirements. As the Plan’s sponsor, [The Employer] (Company) commits substantial resources to operating the Plan for the benefit of its eligible employees. The Company also relies on service providers to administer the Plan for a fee. Participants are responsible for the investment of their accounts, and each investment option under the Plan also has its own fees and expenses.

New 404a-5 Disclosures.
In accordance with recent changes in federal law, participants in the Plan will begin receiving annual “404a-5” disclosures about the Plan’s menu of investment options as well as the fees and expenses payable in connection with the operation of the Plan and its investments.

You will receive your first annual disclosure by [August 30, 2012], which will include general plan information and an explanation of the Plan’s administrative expenses. The annual disclosures will also include a side-by-side comparison of each investment option with important investment performance and fee information. Starting with the quarter ending on [September 30, 2012], your benefit statements will show any administrative expenses charged to your account as a separate line item.

Advantages and Reasonable Cost of Plan Participation.
One of the distinct advantages that the Plan provides for participants is the ability to reduce current taxes and to save for retirement on a tax-deferred basis. Numerous services are required for the day-to-day operation of the Plan, and participants can expect a reasonable cost to be incurred when participating in any tax-qualified plan for this reason. Participation in the Plan is voluntary, and eligible participants can take advantage of the Plan’s features as a way to help them reach their retirement goals.

Monitoring Fees and Expenses.
As the sponsor of the Plan, the Company [recently completed a review of the Plan’s fees and it] intends to monitor the Plan’s fees on an ongoing basis to ensure they remain reasonable. The new 404a-5 disclosures are designed to increase fee transparency for participants, and we are providing this information to help participants make informed decisions regarding the investment of their Plan accounts.

[We will be holding a group meeting about the Plan in the near future, to further discuss the advantages and costs of participating in the Plan. An announcement for the meeting date and time will follow shortly.]
EXPLANATION OF NEW FEE DISCLOSURES
IN PLAN BENEFIT STATEMENTS

Date: ______________, 2012

To: Participants in the ______________ Plan

RE: Quarterly Fee Disclosures for Participants

This communication is a follow-up to the Explanation of New 404a-5 Disclosures for Plan Fees and Expenses that was previously provided by [The Employer] (Company) to the participants of the [ABC Plan] (Plan).

Quarterly Fee Disclosures
Similar to other types of investment accounts for individual investors, there is a reasonable administrative cost for maintaining Plan accounts and processing investment and benefit transactions for you and the Plan’s other participants.

As previously announced, starting with the calendar quarter ending on [September 30, 2012], your benefit statements will show the quarterly administrative expenses charged to your Plan account as a separate line item. This information is being provided to you in accordance with recent changes in federal law regarding disclosures for Plan participants.

Fees Charged for Necessary Administrative Services
Any fees charged to your account are used to pay the Plan’s administrative service providers. These providers are responsible for maintaining participant accounts, accepting contributions from the Company, executing and settling investment trades, performing regulatory tests required to maintain the tax-qualified status of the Plan, processing benefit transactions and performing other necessary services on behalf of the Plan.

Advantages and Reasonable Cost of Plan Participation
The Company established the Plan for the purpose of giving eligible employees the ability to grow their accounts on a tax-deferred basis with the aim of helping them save for their retirement. Numerous services are required for the day-to-day operation of the Plan, and participants can expect a reasonable cost to be incurred when participating in any tax-qualified plan for this reason.

As previously announced, the Company intends to monitor the Plan’s administrative fees on an ongoing basis to ensure these fees remain reasonable. Participation in the Plan is voluntary, and eligible participants can take advantage of the Plan’s features as a way to help them reach their retirement goals.
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