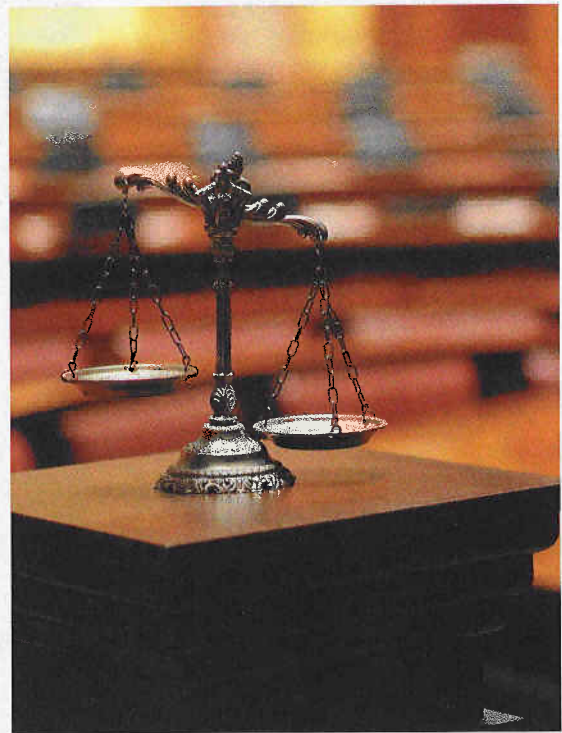


# DISCLOSURE OBLIGATIONS COULD BE BROADER THAN DOL REGULATIONS

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Though the DOL's final disclosure regulations broadly define the rules, court decisions may add new and different considerations.

Effective August 30, 2012, calendar-year retirement plans that permit participants to direct the investment of their individual accounts are required to provide disclosures to participants of investment-related information, including charts with side-by-side comparisons of investment options, as well as information relating to fees and expenses. The goal of the new rules is to enable participants to make informed decisions about the

management of their accounts.<sup>1</sup>

To assist plan sponsors in delivering the required information to participants, as well as enabling sponsors themselves to meet their fiduciary duty of securing investment, recordkeeping, and other services at a fair price, final regulations requiring plan service providers to disclose to ERISA plans certain information regarding the services they provide and the

<sup>1</sup> The preamble to the final rules states, "When a plan assigns investment responsibilities to the plan's participants and beneficiaries, it is the view of the Department that the plan fiduciaries must take steps to ensure that participants and beneficiaries are made aware of their rights and responsibilities with respect to managing their individual plan accounts and are provided sufficient information regarding the plan, including its fees and expenses and designated investment alternatives, to make informed decisions about the management of their individual accounts." 75 Fed. Reg. 64909, 64910 (Oct. 20, 2010).

compensation they receive for such services went into effect July 1, 2012. Compliance with these plan-level disclosure rules is necessary to enable a service relationship between a plan and a service provider to qualify for an exemption under section 408(b)(2) of ERISA from ERISA's prohibited transaction rules.

The development of the government's fee disclosure initiatives coincided with two waves of innovative class actions by attorneys for plan participants that began with the collapse of the high-tech bubble in the year 2000. Its first manifestation was the so-called stock-drop cases in which participants responded to losses incurred as a result of specific corporate events by claiming that the inclusion of an employer stock fund on a plan's investment menu was imprudent and, therefore, a violation of ERISA. A new round of stock-drop cases was stimulated by losses incurred in the sub-prime mortgage crisis of 2007-2008.

The second wave of class actions began in 2006 when approximately three dozen cases were filed claiming that plan fiduciaries had breached their duties by failing to understand or monitor the indirect compensation paid to plan service providers. This resulted in the payment of excessive compensation in violation of ERISA. Both the stock-drop and the excess-fee cases assert a duty to disclose that is broader than the impending disclosure regulations and therefore needs to be understood by those who advise plans and plan sponsors.

## DUTY TO PROVIDE INFORMATION IN STOCK-DROP CASES

A claim frequently made in stock-drop litigation is that plan fiduciaries are required to disclose information on investment matters, such as non-public information pertaining to an investment option consisting of employer stock. Such claims are grounded in ERISA's duty of loyalty that derives from the statutory requirement that a plan be operated for the exclusive purpose of providing benefits to plan participants and beneficiaries.<sup>2</sup>

There is a considerable body of case law stating in general terms that plan fiduciaries must provide participants with material information related to their rights and benefits under a plan. The facts in the cases adopting this position, however, have usually involved information related to administrative matters, such as benefits eligibility and the calculation of benefits or situations in which disclosure was required to correct a prior misstatement. The recent case of *In Re Citigroup ERISA Litigation*, however, is typical of many appellate courts in refusing to extend the reach of the general duty reflected in these cases to investment matters.<sup>3</sup>

There are a number of policy reasons that the courts articulate for limiting the duty to disclose. They include the fear that requiring plan fiduciaries to forecast how non-public information might affect the value of company stock would not only put plan fiduciaries in the position of being investment advisers but would also give plan participants a

favoured position over nonparticipants with respect to market information to which participants aren't entitled. The latter assumes that such communications to a large number of participants can somehow be restricted, which seems unlikely. If the information did become generally known, the participants would lose any benefit from having it.

In most cases, plan fiduciaries will have provided a general warning to plan participants in a summary plan description (SPD) or other communication of the risks of investing plan funds in an undiversified investment subject to volatility, such as a single-company stock fund. The courts have generally found this to meet any affirmative duty to disclose investment information with respect to an employer stock fund.

A vigorous dissent in the *Citigroup* case argued that even though there is no specific ERISA requirement to disclose material information regarding the expected performance of plan investment options, the importation of common law trust standards into ERISA requires participants to receive complete factual information about an investment. This would enable them to make informed investment decisions, particularly where plan assets are "severely threatened." The Department of Labor agrees with this position and has filed an amicus brief supporting a rehearing of the *Citigroup* decision.<sup>4</sup>

<sup>2</sup> ERISA §404(a)(1)(A)(i).

<sup>3</sup> The Second Circuit Court of Appeals in *In Re Citigroup ERISA Litigation*, 2011 WL 4950368 (2nd Cir. 2011) denied any affirmative duty to disclose nonpublic information regarding the expected performance of the Citigroup stock, stating: "We decline to broaden the application of these cases to create a duty to provide participants with nonpublic information pertaining to specific investment options." The *Citigroup* case involved a claim that the defendants had breached their duty of loyalty to participants by failing to provide them with complete and accurate information regarding the Citigroup stock which was a plan investment alternative in light of the company's exposure to the risks associated with the subprime securities market. Other cases that have rejected similar disclosure claims include *Edgar v. Avaya, Inc.*, 503 F.3d 340 (3rd Cir 2007), *Lanfear v. Home Depot, Inc.*, 2012 WL 1580614 (11th Cir. 2012) and *Fisher v. J.P. Morgan Chase & Co.* 2012 WL 1592208 (2nd Cir. 2012).

<sup>4</sup> The Department of Labor disagrees with the judicial holdings that fiduciaries are not required to provide plan participants with specific nonpublic information regarding plan investments in employer stock and has filed several amicus briefs opposing this position. In a brief supporting a rehearing in the *Citigroup* case, the Department took the position that "public disclosure may be the simplest and most effective way of ensuring that the market price reflects the true value of the companies' stock and that plan participants can protect their interests." *In re Citigroup ERISA Litigation*, amicus brief, dated December 6, 2011. Thus, the Department's apparent position is that when a nonpublic event has the potential to negatively affect the stock price of a plan sponsor, plan fiduciaries must either stop further plan purchases of the stock or publicize sensitive and confidential matters of the plan sponsor of which they may have little knowledge.



## MISREPRESENTATION

Plaintiffs in stock-drop cases frequently assert a second theory of liability based on the alleged inaccuracy of communications by company officials as to the plan sponsor's expected performance. Under the seminal Supreme Court decision of *Varity Corp. v. Howe*, however, liability for misstatements is limited to those who speak to participants in a fiduciary capacity and doesn't extend to communications made in a corporate capacity.<sup>5</sup> Thus, where corporate officers who are not fiduciaries make statements to plan participants about the prospects of company stock, and those statements turn out to be inaccurate (or the company itself makes false or misleading SEC filings) such communications will generally not result in liability on the part of plan fiduciaries because they were made in a corporate rather than a fiduciary capacity.<sup>6</sup>

## DUTY TO PROVIDE INFORMATION IN EXCESS-FEE CASES

The discussion of the affirmative duty to disclose investment-related information in the context of excess-fee cases is not as well grounded in the statutory provisions of ERISA as it is the stock-drop cases. *Hecker v. Deere*, which dismissed the plaintiffs' claims regarding excess fees on the ground that the marketplace efficiently regulated the price of plan services, also held that there was no duty to disclose revenue sharing arrangements between service providers without discussing what the source of that duty might have been.<sup>7</sup>

In the view of the Seventh Circuit Court of Appeals, it was sufficient that participants were told about

the total fees imposed by the plan's various funds, which enabled them to direct their dollars to lower-cost funds. How the service providers allocated fees among themselves wasn't something that had to be disclosed. The court's apparent view that revenue sharing isn't a particularly useful thing to know resolved any issue as to an affirmative duty to disclose. The failure of the plaintiffs to identify any particular dollar amount that was fraudulently stated resulted in the disposal of the plaintiffs' misrepresentation claims.

The Seventh Circuit's position in *Deere* with respect to the relevance of revenue sharing information has been partially refuted by the plan-level disclosure regulations relating to indirect compensation. Under those rules, indirect compensation is compensation received by a service provider from any source other than a covered plan or the plan sponsor.<sup>8</sup> Indirect compensation encompasses revenue sharing payments made by one service provider to another. They must be disclosed to a plan fiduciary in all instances, even where a service provider wouldn't have been required to disclose compensation coming directly from a plan.<sup>9</sup>

Further, the recipient of indirect compensation must not only identify the payer and the services for which the indirect compensation is received, but must also describe the payer's arrangement with the recipient that resulted in the payment.<sup>10</sup> The Department of Labor has indicated that the latter requirement is intended to enable a plan fiduciary to analyze why the payer is compensating the service provider that has received the indirect compensation, thereby rejecting the Seventh Circuit's judgment that such information

isn't critical to an evaluation of a plan's investment alternatives.<sup>11</sup> However, the disclosure of indirect fee information under the regulations must be made only to plan fiduciaries, not plan participants. In that respect, the regulations don't disturb the outcome in *Deere*.

On the issue of required fee disclosures, the *Deere* case represents only one pole of judicial opinion. *Braden v. Wal-Mart Stores, Inc.* held that service providers that are plan fiduciaries must disclose material information that could adversely affect a participant's interests.<sup>12</sup> According to the *Braden* court, materiality turns on the effect that the information would have on a reasonable participant's decisions about how to allocate his or her investments among the plan's investment options.

The Eighth Circuit Court of Appeals agreed that there was no privity duty to disclose revenue sharing payments. But by the same token it held that a claim that disclosure of such payments should have been made could be resolved only as a factual matter after a trial. *Braden* never went to trial because the parties ultimately settled the case. Given that the determining factor is materiality, however, the Eighth Circuit's holding would make it difficult to determine when plan participants should be presented with evidence of revenue sharing or arguably relevant investment issues.

Moreover, if *Braden* had gone to trial, the issue of whether revenue sharing information should have been provided to plan participants wasn't the only disclosure issue that would have been presented to the jury. Additional issues for the jury's consideration would have been

<sup>5</sup> 516 U.S. 489 (1996).

<sup>6</sup> See e.g., *In Re Citigroup ERISA Litigation and Fisher v. J.P. Morgan Chase & Co.* supra.

<sup>7</sup> *Hecker v. Deere*, 556 F.3d 575, rehearing denied, 569 F.3d 708 (7th Cir. 2009), cert. denied \_\_\_ U.S. \_\_\_ (2010).

<sup>8</sup> 29 CFR §2550.408b-2(c)(1) (viii)(B)(2).

<sup>9</sup> 29 CFR §2550.408b-2(c)(1) (iii)(C).

<sup>10</sup> 29 CFR §2550.408b-2(c)(1) (iv)(C)(2).

<sup>11</sup> See preamble to final §408(b)(2) regulations, 77 Fed. Reg. 5632, 5637 (Feb. 3, 2012).

<sup>12</sup> 588 F.3d 585 (8th Cir.2009).

whether plan fiduciaries had a duty to disclose that certain funds on the plan's investment menu charged higher fees than comparable funds, that the plan sponsor had access to more cost-efficient institutional funds, and that the selection of funds for inclusion on the plan's investment menu wasn't necessarily based on cost. According to the Eighth Circuit, a rational trier of fact could have found that the failure to disclose this information would mislead participants in the process of making investment decisions. This line of thinking appears to leave open-ended the matters that must be disclosed to plan participants.

## **CONCLUSION**

The Department of Labor's participant-level disclosure regulations require sponsors of individual account plans that permit

participant investment to furnish participants with a defined set of facts pertaining to features of the plan, as well as expense and performance information relating to the plan's investment options. The plan-level disclosure regulations are broader in scope in that the recipients of service provider information, including but not limited to compensation received by providers, are the plan fiduciaries of most ERISA retirement plans.

The plaintiffs' bar doesn't view these regulations as the limit of a plan fiduciary's obligation to disclose and believes that disclosure is appropriate as to any matter that is material to a plan participant's decision whether to invest plan funds in a particular investment alternative.

Most courts have declined to follow this view and restrict the scope of ERISA-required disclosure. However, those courts

that have accepted materiality as the standard for whether disclosure is required seem willing to mandate communication to participants on a broad range of unanticipated matters extending beyond service provider fees. **PC**



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