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Regulatory Update

Regulation of Target-Date Funds—A Look Back and A Look Ahead

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Since the Department of Labor finalized the "qualified default investment alternative" regulations in 2007, the market has seen a dramatic growth in assets allocated to so-called "target-date" or "life cycle" funds. Along with the growth in assets in these funds has come a growth in regulatory interest, particularly in the wake of the market turbulence over the last few years.

This column provides a brief background on target-date funds, surveys regulatory interest in target-date funds over the past few years, summarizes expected new regulatory initiatives and closes with suggestions for plan fiduciaries with target-date funds.

Background

A "target-date" or "life cycle" fund is an investment vehicle in which the asset allocation of the investment vehicle adjusts over time, generally reducing volatility in the portfolio as an employee approaches retirement age. The manner in which the asset allocation changes over time is often referred to as the "glidepath."

The names of these funds often make reference to an employee's expected year of retirement, such as a "2030 Fund" or a "2040 Fund," for those employees expecting to retirement in approximately 20 years or approximately 30 years, respectively. Although target-date funds are available in the retail investment market, most of the assets in target-date funds are attributable to employer-sponsored individual account plans, such as 401(k) plans. A target-date fund may consist of a mix of other funds, which are often referred to as the underlying funds.

For ease of reference in this column, we will refer to these vehicle as "target-date funds." Target-date strategies, however, can take a number of different legal forms—from registered mutual funds, to unregistered collective investment funds, to individually managed separate accounts. The different investment structures may have different implications for plan fiduciaries with respect to fees, disclosures and other operational considerations.

One cause of the relatively recent growth in popularity of target-date funds is that the Department of Labor (the "DOL") identified target-date funds as one of investment strategies that could qualify as a "qualified default investment alternative" (or "QDIA"). The QDIA rules provide certain limited fiduciary protection to plan fiduciaries when a plan participant fails to provide investment direction with respect to amounts held in the plan. If such amounts are invested in a QDIA, such as a target date fund, the plan fiduciary will not be liable for any loss that is the direct and necessary result of

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investing a participant's account in the QDIA. The plan fiduciary remains responsible, however, for the prudent selection and monitoring of the QDIA. Thus, it is important that plan fiduciaries understand the structure and operation of their target-date funds and stay informed of regulatory developments in this area.

In addition to the benefits of QDIA status, some plan sponsors may also find target-date funds appealing as a method of overcoming participant inertia with respect to investment selection and asset allocation. A participant may not feel equipped or inclined to select among numerous funds offered under the plan, but may be more inclined to make a single investment selection based on projected retirement date.

Target-Date Funds and the Market Decline

Much of the current legislative and regulatory focus on target-date funds arose in the wake of the market decline of late 2008 and 2009. While nearly all investment options suffered historic losses during this period, target-date funds drew particular attention, perhaps due to the significant losses in some target-date funds with a near term retirement date. In early 2009, the Senate Special Committee on Aging, led by Senator Herb Kohl of Wisconsin, held a hearing on retirement security that focused on regulation of target-date funds. At the hearing, Senator Kohl called on the Secretary of Labor and the Chairwoman of the SEC to review target-date funds and consider additional regulation.

On June 18, 2009, the DOL and the SEC jointly held a one-day hearing on target-date funds, the purpose of which was to determine if additional guidance by either the DOL or the SEC would be helpful. The hearing featured 36 witnesses, who addressed a wide range of topics including risk levels and asset allocations, disclosure requirements, conflicts of interest and fees. Both the DOL and the SEC indicated at the hearings that they were considering appropriate regulatory responses to issues presented regarding target-date funds.

DOL and SEC Investor Bulletin on Target-Date Funds

In May 2010, the DOL and SEC jointly issued an Investor Bulletin on Target-Date Retirement Funds. The Investor Bulletin, which is written in plain English and is targeted to 401(k) plan investors and other individual investors, provides an overview of target-date fund basics and then describes how an investor should evaluate a target-date fund. The Investor Bulletin advises investors not to rely solely on the date stated in the target date fund, but instead to consider the target -date fund's asset allocation over the life of the fund and at the target-date. The Investor Bulletin also notes that funds with the same target-date may have different investment strategies and asset allocations.

In the Investor Bulletin, the DOL and SEC identify the follow factors for investors considering investing in a target-date fund:

- Investment style (does the investor prefer an "active role" versus a "hands-off approach"?).
- Strategy and risks of the target-date fund and the underlying funds.
- The change in the investments over time (including whether the most conservative investment mix will occur at or after the target-date).
- When the investor will access the money in the target-date fund.
- Fees (both the target-date fund's fees and the fees of any underlying funds).

Although not formal or binding guidance, the Investor Bulletin does reveal some of the issues that appear to be of interest to the DOL and SEC, such as asset allocation and risk, an understanding of the glidepath and when it reaches its most conservative mix (whether at or after the target-date) and fees.

SEC Proposed Regulations and Comments

On June 16, 2010, the SEC published a proposed rule in the Federal Register that focused on the manner in which target-date funds that are mutual funds are named and described in fund marketing materials. While much of the burden of the proposed rule may fall on those investment providers who sponsor target-date funds, the SEC's proposed rule could also have an affect on the participant communications for which plan sponsors are responsible. Thus, the proposed rule may be of interest to plan sponsors for this reason, as well as for a glimpse into how the SEC is thinking about target-date funds.

Specifically, the SEC's proposed rule would require that:

- Target-date funds that include the target date in their names disclose the fund's asset allocation at the target-date immediately adjacent to the first use of the fund's name in marketing materials.
- Marketing materials for target-date funds include a table, chart or graph depicting the fund's asset allocation over time, together with a statement that would "highlight the fund's final asset allocation."[1]
- Marketing materials for target-date funds include a statement to the effect that a target retirement date fund should not be selected solely on age or retirement date, is not a guaranteed investment and that the stated asset allocation may be subject to change.
- Marketing materials for target-date funds avoid statements that (a) emphasize a single factor as the basis for determining if an investment is appropriate and (b) imply that investing in the target-date funds is a "simple investment plan or that it requires little or no monitoring by the investor."[2]

The SEC solicited comments on the proposed rule and received over 50 responses. Several commenters noted the discrepancy between information that may be helpful to an individual retail investor versus information that may be helpful to a plan participant. The plan participant, in contrast to the retail investor, does not have the ability to choose among target-date fund families available in the market as that choice will have already been made by the plan sponsor.

Another common theme in the comments was that target-date funds were intended to help address the inaction that has been shown to exist when 401(k) plan participants are presented with too many choices. While plan sponsors and others in the industry work diligently to educate participants about investment alternatives and asset allocation, studies in behavioral finance suggest that it is very difficult to overcome inaction through education alone. Thus, the SEC's proposed rule may run counter to the efforts of plan sponsors to offer target-date funds as simpler alternatives to selecting among other available investment options.

In September, several key members of Congress urged the SEC to expand the reach of the proposed regulations to cover all target-date funds, not just those that operate as mutual funds.

What's Ahead for Regulation of Target-Date Funds?

There is currently no timeframe for the SEC to finalize its proposed rules. Target-date fund providers, however, can expect that the SEC is currently reviewing comments on the proposed rule and that some form of a final rule will follow.

While the DOL has not yet issued any new regulations on target-date funds, it did announce an upcoming rulemaking to amend the QDIA regulations to "provide more specificity to fiduciaries as to the investment information that must be disclosed in the required notice to participants and beneficiaries."[3] The DOL also stated that the amendment "will enhance the information that must be disclosed concerning target-date, or similar age-based qualified default investment alternatives."[4]

Depending on the outcome of the mid-term elections and other legislative priorities, Congress may also decided to focus on target-date funds in the coming months.

What Should Plan Sponsors Be Doing?

While waiting for the regulatory dust to settle, plan sponsors that offer target-date funds, and their advisors, may wish to review their plans' offerings in light of the some of the themes that have been highlighted in the hearings, the Investor Bulletin and the SEC's proposed rule.

- ***Review the glidepath and understand level of risk at each stage***. Plan fiduciaries should understand the glidepaths of their target -date funds and, importantly, should understand when the most conservative asset allocation occurs. Is it at the target-date? Or does glidepath take into account time after retirement?
- ***Review target-date fund fees***. Plan fiduciaries should understand the fees paid in connection with the target-date fund at all levels—both at the target-date fund level as well as at the level of the underlying funds and evaluate the reasonableness of these fees in comparison to other investment options.
- ***Review target-date fund communications***. Plan fiduciaries should periodically review the communications provided to plan participants to confirm that the target-date fund descriptions provide the information about the asset allocation, risk and fees, particularly in light of any final SEC rules issued on the subject.

While it seems likely that target-date funds will continue to be a popular investment option, and that assets allocated to these funds will continue to grow, both the SEC and the DOL appear poised to expand and clarify the types of disclosure these options will require. As with all investment options, plan fiduciaries should take care to review target funds on a regular, periodic basis and remain aware of regulatory developments that may affect their obligations.

Notes

1. 75 Fed. Reg. 35920, 35920 (June 23, 2010).
2. Id. The proposed rule would provide that such statements would be viewed as misleading for purpose of Rule 156 under the Securities Act of 1933.
3. Department of Labor, Semiannual Regulatory Agenda, 75 Fed. Reg. 1,25 (Apr. 26, 2010).
4. Id.

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