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DOL revisiting target date fund proposal in light of SEC advisory committee recommendation

The Department of Labor recently reopened the comment period on its 2010 proposed target date fund disclosure rule. Over the past four years, the DOL has coordinated the development of this rule with a related SEC proposed rule on target date fund disclosures. DOL reopened the comment period in response to an SEC advisory committee recommendation that target date fund disclosures include a "glide path" illustration designed to allow investors to measure the risks involved in different target date fund investments. The SEC had already reopened its comment period to provide an opportunity for feedback on the recommendation.

Background

The Pension Protection Act of 2006 amended ERISA to allow relief for a plan fiduciary who, in the absence of investment direction by the participant, invests a participant's account in a specified qualified default investment alternative (QDIA). The DOL, in turn, included target date funds in regulations defining appropriate QDIA investments. (See our December 21, 2010 *For Your Information.*) Target date funds (TDFs) — also known as lifecycle funds — are investments that change their asset mix of equity and fixed income exposures based on the participant's age, target retirement date, and/or life expectancy, with the idea of decreasing portfolio risk (as defined by market volatility) as the retirement date approaches and age increase.

The 2008 drop in the equity markets, and the varying performance of TDFs during that crisis, raised concerns about TDF investors' understanding of the nature and risks of different TDF options.

> For example, a TDF may be structured as either "to" retirement or "through" retirement. TDFs structured "to" retirement shift from equities to fixed income quickly as a retirement target date approaches, based on an expectation that participants will move the money out of the TDF at retirement. TDFs structured "through" retirement contemplate participants keeping their funds invested in the TDF after retirement to take advantage of potential equity gains. Accordingly, "through" funds make the shift to fixed income investments more gradually to factor in an actuarial life expectancy of 20-30 years after retirement. These two types of TDFs would experience very different investment returns in the case of a drop in the equity markets near an investor's retirement age.

As a response to these concerns, in late 2010, the DOL issued a proposed rule that would modify existing participant disclosure rules to include additional information about a plan's QDIA, including the name of the issuer, fund objectives and strategy, historical performance along with a statement that the past is not an indication of future performance, and fund fees and expenses. If the QDIA is a TDF, the proposed rule would also require plan administrators to:

- Explain the TDF's asset allocation, how it will change over time (a concept known as the TDF's "glide path"), and the point at which the allocation will reach its most conservative point — and provide a chart, table, or other graphic illustrating these changes.
- If the name of the fund includes the investment's target date, provide an explanation of the age group for which the investment is designed and the relevance of the target date.
- Provide a statement that a participant or beneficiary could lose money, could suffer losses near and after retirement, and that there is no guarantee that the TDF will provide adequate retirement income.

What is a TDF's glide path?

A glide path is the manner in which a TDF's asset allocation will change over time until reaching its most conservative point.

SEC rulemaking on target date funds

The DOL has generally coordinated its TDF-related rulemaking activities with the SEC. The SEC, for its part, has simultaneously been developing a rule that would require additional investor disclosures about TDF funds in an effort to promote understanding and lessen confusion about these funds' characteristics and risk factors. The SEC's proposed rule would also require a chart, table, or other graphic illustrating the TDF's glide path.

Additionally, in 2013, the congressionally created SEC Investor Advisory Committee (Committee) reviewed the SEC's proposed rule and recommended that the SEC develop a TDF glide path illustration based on a standardized measure of risk that would permit investors to compare different TDF funds. The motivation behind this recommendation is to provide investors an accurate and easily comparable portrayal of fund risk in a format that is both objective and sufficiently flexible to enable comparisons among different TDFs. The illustration would either replace or supplement the proposed asset allocation glide path illustration. The Committee also recommended that the SEC require TDF prospectuses to disclose and explain the policies and assumptions used to design the TDF offerings and attain the target risk level over the life of the fund.

In April 2014, the SEC reopened the comment period on its proposed TDF rule to solicit comments on the Committee's recommendations. The SEC comment period closed on June 9, 2014.

Comments submitted by securities industry professionals criticized the new recommendations. These professionals questioned the utility of a glide path illustration given the many different types of risks relevant to TDF investments. The Investment Company Institute, for example, which represents mutual funds, wrote that because "all risk measures have certain inherent limitations," requiring a glide path illustration "may confuse and even possibly mislead" TDF mutual fund investors. However, consumer and employee rights groups praised the Committee's recommendations. The AFL-CIO, for example, urged the SEC to adopt the Committee's recommendation that any asset allocation illustration be paired with — if not replaced by — a glide path illustration based on a standardized measure of risk that incorporates the view that the asset allocation of a TDF is "an unreliable proxy for risk."

Volume 37 | Issue 78 | June 23, 2014

New DOL comment period

Meanwhile, on June 4, 2014, in response to the SEC's reopening of the comment period for its TDF rulemaking, the DOL reopened the comment period on its own proposed TDF rule. In reopening the comment period, the DOL stated that it specifically seeks comments on the Committee's recommendations, including the development of a glide path illustration based on a standardized measure of fund risk. It also welcomes comments on other matters affecting the proposed rule. Comments must be submitted by July 3, 2014.

Comments on prior versions of the DOL's proposed rule have encouraged careful coordination between the DOL and the SEC. Failure to coordinate could result in inconsistent disclosure requirements between the two entities and generate confusion on the part of plan sponsors as well as participants and beneficiaries. Acknowledging this point, the DOL has continued to consult with SEC staff while working on the TDF rule. Given this background, the DOL is likely to pay close attention to the recent comments that the SEC received, and, generally, to the substance of the SEC's final rule. Nevertheless, some TDFs offered by retirement plans are not regulated by the SEC's mutual fund rules. Depending at least in part on the comments it receives on its own proposed rule, it is possible that the DOL's final rule will diverge from the SEC's in meaningful ways, given the different needs of participants/beneficiaries and retail investors.

In closing

Plan sponsors offering TDFs as part of their investment line up, and other retirement plan stakeholders involved with TDF investments, should carefully review the Committee's disclosure related recommendations. In thinking about the benefits and burdens of the recommendations, they should consider whether or not these additional disclosures will bring value to plan participants and beneficiaries.

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