

## SEC and DOL to Hold Joint Hearing to Examine Target Date Funds

May 27, 2009

On May 12, the Securities and Exchange Commission (SEC) and the U.S. Department of Labor (DOL) issued a press release announcing that they will hold a joint one-day hearing on June 18, 2009 to explore the issues relating to target date or lifecycle funds.<sup>1</sup> The press release indicated that the hearing will address the concern that, as target date funds (TDFs) and similar investment vehicles grow in popularity, it will become increasingly important that investors, including 401(k) participants and plan sponsors, are able to effectively evaluate these investment options and safeguard their interests.

### Target Date Funds

The basic premise behind TDFs is the gradual automatic shift toward more conservative asset allocations as the fund approaches its “target date” and a participant nears his or her targeted retirement date. The apparent simplicity and safety of this model has made TDFs attractive investment vehicles for retirement plans. Typically, the adjustments in asset allocation, often called the “glide path,” will move from a more aggressive allocation toward a more conservative allocation over time, with a greater concentration in cash and fixed-income elements as the fund approaches its target date. For retirement plan investors the target date is typically the participant’s anticipated retirement date. The idea is that, by reducing exposure to investment risk over time, the risk that a sudden decline in the market will cause enormous losses in a participant’s retirement account is progressively decreased. This transition to a more conservative investment is especially important for those participants nearing retirement and in retirement because they may soon need to rely on the returns generated from these funds, as they no longer earn employment income.

### What Prompted the Joint Hearing?

In recent years, TDFs have grown in popularity as investment alternatives within retirement plans as well as college saving funds. Assets in TDFs have expanded from \$2 billion in 1997 to approximately \$183 billion in 2007, and the number of investment firms offering such funds has grown from 4 to 37 over the same time period.<sup>2</sup> The growth in popularity received a boost when the DOL issued regulations

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1. The hearing is scheduled to take place in the plaza auditorium of the DOL’s Francis Perkins Building, 200 Constitution Ave., N.W., Washington, D.C., from 9:00 a.m. to 5:00 p.m. ET.

2. William E. Nessmith and Stephen P. Utkus, *Target Date Fund Adoption*, January 7, 2009, at <http://www.indexuniverse.com/sections/research/5196-target-date-fund-adoption-.html>. The figures do not include target date money that is held in nonfund vehicles. (Source: Strategic Insight.)

under the Pension Protection Act allowing age-based TDFs to serve as Qualified Default Investment Alternatives (QDIAs). Under the QDIA rules, a fiduciary is granted relief from liability under the fiduciary duty provisions of ERISA for investment outcomes if, absent participant investment direction, and with appropriate and timely notice, a participant's retirement plan account is invested in a QDIA. TDFs are often added to plans in conjunction with an automatic enrollment program, sometimes coupled with automatic escalations in the rate of participant contributions.

Recently, concerns have been raised about the use of TDFs in various types of accounts and their recent investment performance. Additionally, concerns have been raised as to whether some TDFs, to be competitive on returns, may have taken a more aggressive position than warranted with respect to their glide path, causing investors to pay the price in terms of the current market volatility. In a speech before the Mutual Fund Directors Forum on May 4, SEC Chairman Mary Schapiro said that recent investment results from TDFs have been "troubling," including an average loss in 2008 among 31 funds with a 2010 target retirement date of almost 25%.<sup>3</sup> Ms. Schapiro told the audience that the SEC will be "closely reviewing target date funds' disclosure about their glide paths and asset allocations" in order to achieve better alignment with investor expectations. The concerns regarding TDFs are generally related to two issues:

- Whether TDFs' glide paths have resulted in a greater-than-appropriate level of market risk at or approaching the target date.
- Whether TDFs provide adequate disclosure concerning the level of risk at various points on the glide path, but particularly when the fund is at or approaching the target date.

At the same time, Avatar Associates LLC has asked the DOL for an advisory opinion as to whether the tiered use of proprietary funds in a TDF or other fund-of-funds structure could give rise to conflicts of interest under ERISA. The request was somewhat unexpected given that mutual fund assets are not subject to regulation under ERISA.

In an effort to address the concerns raised about TDFs, the SEC and DOL decided to hold the joint one-day hearing to explore these issues. It appears possible that regulations could be adopted that would directly affect TDFs, as well as the responsibilities of plan sponsors and other fiduciaries that deal with these investment vehicles.

### **Possible Regulatory Approaches**

Based on public discussion to date, the SEC and DOL have a number of approaches available to increase the regulation of TDFs, although it is not clear what, if any, action will be taken.

- **Mandated Asset Allocation.** The potential for large variation in the percentage of equity holdings among different funds with the same targeted retirement date can expose participants' retirement savings to very different risks, which they likely would not anticipate based on the stated target dates. Future regulation of TDFs may be aimed at mandating specific asset-composition requirements in order for the funds to remain QDIAs.

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3. Mary L. Schapiro, Speech by SEC Chairman to the Mutual Fund Directors Forum Ninth Annual Policy Conference: Critical Issues for Investment Company Directors (May 4, 2009), at <http://sec.gov/news/speech/2009/spch050409mls.htm>.



## **New York**

Craig A. Bitman 212.309.7190 [cbitman@morganlewis.com](mailto:cbitman@morganlewis.com)

## **Philadelphia**

I. Lee Falk 215.963.5616 [ilfalk@morganlewis.com](mailto:ilfalk@morganlewis.com)  
Timothy W. Levin 215.963.5037 [tlevin@morganlewis.com](mailto:tlevin@morganlewis.com)  
Steven D. Spencer 215.963.5714 [sspencer@morganlewis.com](mailto:sspencer@morganlewis.com)  
Marianne R. Yudes 215.963.5490 [myudes@morganlewis.com](mailto:myudes@morganlewis.com)  
David B. Zelikoff 215.963.5360 [dzelikoff@morganlewis.com](mailto:dzelikoff@morganlewis.com)

## **Pittsburgh**

Lisa H. Barton 412.560.3375 [lbarton@morganlewis.com](mailto:lbarton@morganlewis.com)  
Lauren B. Licastro 412.560.3383 [llicastro@morganlewis.com](mailto:llicastro@morganlewis.com)

## **Washington, D.C.**

Daniel R. Kleinman 202.739.5143 [dkleinman@morganlewis.com](mailto:dkleinman@morganlewis.com)  
Donald J. Myers 202.739.5666 [dmyers@morganlewis.com](mailto:dmyers@morganlewis.com)  
Michael B. Richman 202.739.5036 [mrichman@morganlewis.com](mailto:mrichman@morganlewis.com)  
Steven W. Stone 202.739.5453 [sstone@morganlewis.com](mailto:sstone@morganlewis.com)  
Christopher A. Weals 202.739.5350 [cweals@morganlewis.com](mailto:cweals@morganlewis.com)

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