

DOL Proposes Disclosure Rules for Target Date Retirement Funds

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At the end of November, the U.S. Department of Labor (DOL) proposed disclosure rules for target date retirement funds used as investment options in participant-directed 401(k) and other individual account plans. The proposal would amend both the DOL regulation on “qualified default investment alternatives” (QDIAs), which was adopted in 2007, and the DOL regulation on participant-directed plan disclosures, which was just adopted in October 2010. It would require much more specific disclosures to plan participants on the features of target date retirement funds. In addition, the proposal would conform the QDIA disclosure requirements to the new participant-directed plan disclosure rules. The comment period on the proposal closes on January 14, 2011.

Background

The concept of a QDIA was added to the law by the Pension Protection Act of 2006, in new Section 404(c)(5) of ERISA. This provision provides a framework under which, subject to certain initial and annual disclosure and other requirements, plan fiduciaries can be relieved of liability for any losses resulting from an investment made in a fund that qualifies as a QDIA on behalf of a participant who does not make an investment election. The effect is to extend the fiduciary liability exception for participant-directed individual account plans in Section 404(c)(1) of ERISA to “default” investments. These are investments made in the absence of instructions from a plan participant (for example, for participants who are automatically enrolled in a plan).

Under DOL’s 2007 final regulation on the QDIA requirements, one of the four defined QDIA categories covers investment funds or model portfolios that change their asset allocations and associated risk levels over time based on a participant’s age, target retirement date, or life expectancy. Partly as a result of this recognition of target date funds in the DOL regulation, such funds grew in popularity. They then received increased attention as a result of the 2008 market decline, during which 2010 target date funds, which were in theory the most conservatively invested, suffered significant and varying levels of investment losses. This attracted scrutiny from DOL and the Securities and Exchange Commission (SEC), prompting a joint public hearing in June 2009. The two agencies subsequently published a joint “Investor Bulletin” on target date funds, and the SEC proposed rules on disclosure for target date funds that are registered as investment companies under federal securities law (which is the case for many, but not all, such funds).

DOL has now proposed its own rules on disclosures to plan participants, which are outside the scope of the SEC proposal. These rules are similar to the proposed SEC rules, although not as detailed. In

addition, DOL intends to publish a series of tips to assist plan fiduciaries in evaluating and monitoring target date funds as investment options for participant-directed plans.

Changes to the QDIA Regulation

The first part of the proposal would amend the disclosure conditions of the QDIA regulation to more specifically describe certain investment-related information that must be included in the required initial and annual QDIA notices to plan participants.

Many of these changes reflect the new participant-directed plan disclosure rules that were adopted in October 2010, and are not limited to target date funds. The general requirement to describe a QDIA's investment objectives, risk and return characteristics, and fees and expenses would be replaced by six separate, more specific disclosure elements, including investment objectives and goals, principal strategies and risks, historical performance data, and fees and expenses (including fees charged directly against investments, annual operating expenses, and additional ongoing expenses). DOL left open for comment whether, to simplify compliance and avoid confusion, the QDIA disclosures should just incorporate the new, more specific participant-directed plan rules by reference.

The last of the new disclosure elements would deal specifically with target date and similar funds. According to the proposal, the description of the fund would need to satisfy three requirements:

- It must explain the fund's asset allocation, how the asset allocation will change over time, and the point in time when the investment will reach its most conservative asset allocation. This explanation must include a chart, table, or other illustration of the change in asset allocation over time, in a manner that does not "obscure or impede" a participant's understanding of the information.
- If the fund is named or described with reference to a particular "target" date, then the notice must explain the age group for which the investment is designed, the relevance of the target date, and any assumptions about a participant's contribution and withdrawal intentions on or after that date.
- The notice must state that the participant may lose money by investing in the QDIA, including losses near and following retirement, and that there is no guarantee that the investment will provide adequate retirement income.

DOL asked for comments on the extent to which this rule should take into account the disclosure elements or concepts in the SEC's proposed target date funds disclosure rules (see discussion below).

DOL also proposed conforming changes to other parts of the QDIA regulation, generally to cross-reference the rules under the participant-directed plan disclosure regulation to achieve a consistent disclosure standard.

Changes to the Participant-Directed Plan Disclosure Regulation

To ensure that all participants, even those not invested in a QDIA, receive the same information about target date funds, DOL proposed to include the same three disclosure requirements for target date funds

in the participant-directed plan disclosure regulation. This information would be provided as an appendix to the chart being used to satisfy the general investment-related information requirements.

Electronic Disclosure

Consistent with its recent statements in connection with the adoption of a final participant disclosure regulation, DOL announced that it would be undertaking a review of its safe harbor rule on the use of electronic media for furnishing information to plan participants, and would soon be requesting public comments and views on this topic. Pending the issuance of further guidance, participant disclosures can be furnished electronically under the existing safe harbor. Any further guidance in this area would also govern the proposed disclosure rules. DOL encouraged interested persons to respond to its upcoming comment request.

Effective Date

The amendments would be effective 90 days after publication of a final rule in the *Federal Register*. DOL asked for comments on whether to use a different effective date.

Comparison to Proposed SEC Rules

The SEC's proposed rules on disclosures by target date funds that are registered investment companies are more specific in many respects than the proposed DOL rules. The SEC is approaching this area from the perspective of regulating the advertising materials used to market these types of funds, to address concerns about investor misunderstanding of such funds and their associated risks. Following are the principal points of the SEC's proposed rules, as contrasted with DOL's proposal:

- **SEC:** Fund sales literature may not suggest that the fund is an appropriate investment because of the emphasis it places on a single factor (such as an investor's age or tax bracket) for determining that the investment is appropriate, or make representations, express or implied, that investing in the fund is a "simple investment plan" or requires "little or no monitoring by the investor." According to the SEC, such statements could be misleading.

DOL: The DOL proposal does not address the use of such statements.

- **SEC:** A target date fund advertisement must advise an investor of the following:
 - (1) To consider factors in addition to age or retirement date, including risk tolerance, personal circumstances, and complete financial situation
 - (2) That an investment in a target date fund is not guaranteed and may lose money, including at and after the target date
 - (3) The extent to which the intended percentage allocation of the fund may be modified without a shareholder vote

DOL: The DOL proposal covers only the second point, requiring a statement to the same effect on risk of loss, but also emphasizing that there is no guarantee of adequate retirement income. It

does not deal with the importance of considering factors in addition to age and retirement date, nor does it deal with the ability to modify the fund's asset allocation without a shareholder vote.

- **SEC:** A target date fund advertisement must disclose the percentage asset allocation of the fund at the date included in the fund name (the target date), or, if dated after the target date, the actual asset allocation as of the most recent quarter-end.

A print advertisement must also include a prominent table, chart, or graph depicting the percentage asset allocations over the entire life of the fund at intervals not exceeding five years, including the inception date, the target date, and the "landing point" (the point at which the fund reaches its "final" asset allocation). If the advertisement relates to a single fund, then it must also include the asset allocation as of the most recent calendar quarter, and the table, chart, or graph must clearly depict both the actual allocations from inception through the most recent calendar quarter and future intended allocations. If it relates to multiple funds with different target dates that have the same allocation pattern, it may include separate presentations for each fund or a single presentation for all the funds. The advertisement also must include a statement explaining the asset allocation changes over time, the landing point and what happens at the landing point, and whether the allocations may be modified without a shareholder vote.

- A similar provision applies these same disclosure requirements in simplified form to radio and television advertisements.

DOL: DOL's proposal includes a parallel requirement to disclose a fund's most conservative asset allocation and an illustration of the change in asset allocation over time, but with less specificity on the form and content of the disclosure.

Observations

The DOL proposal represents the latest development in an ongoing regulatory and legislative focus on target date funds, which, in addition to the DOL-SEC hearing noted above, has included congressional oversight hearings. Legislators and regulators are concerned that plan participants do not understand these funds and how they should be used in a retirement investment portfolio, and these concerns were heightened by the losses suffered in the recent market downturn by many funds that were intended for those close to retirement.

While the DOL proposal deals only with disclosures to plan participants (DOL intends to issue separate guidance specifically for plan fiduciaries), the proposed rules nevertheless warrant attention from plan fiduciaries. To the extent that plan fiduciaries have responsibility for the selection and monitoring of target date funds as plan investment options (a matter currently being litigated), they need to understand the nature of the products and how one target date fund series can differ from another. The overriding message of the recent activity is that these investment products are more complicated than the regulators and others initially appreciated, and the proposed rules, with their detailed disclosure requirements, highlight that complexity.

If you have any questions or would like more information on any of the issues discussed in this LawFlash, please contact the authors, **Donald J. Myers** (202.739.5666; dmyers@morganlewis.com) and **Michael B. Richman** (202.739.5036; mrichman@morganlewis.com), or any of the following Morgan Lewis attorneys:

Chicago

Louis L. Joseph	312.324.1726	louis.joseph@morganlewis.com
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New York

Craig A. Bitman	212.309.7190	cbitman@morganlewis.com
Thomas M. Hogan	212.309.6778	thogan@morganlewis.com

Philadelphia

I. Lee Falk	215.963.5616	ilfalk@morganlewis.com
Vivian S. McCardell	215.963.5810	vmccardell@morganlewis.com
Steven D. Spencer	215.963.5714	sspencer@morganlewis.com
Marianne R. Yudes	215.963.5490	myudes@morganlewis.com
David B. Zelikoff	215.963.5360	dzelikoff@morganlewis.com

Pittsburgh

Lisa H. Barton	412.560.3375	lbarton@morganlewis.com
Lauren B. Licastro	412.560.3383	llicastro@morganlewis.com

Washington, D.C.

Benjamin I. Delancy	202.739.5608	bdelancy@morganlewis.com
Stuart P. Kasiske	202.739.6368	skasiske@morganlewis.com
Daniel R. Kleinman	202.739.5143	dkleinman@morganlewis.com

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