

## Why Did The Department of Labor (DOL) and Securities Exchange Commission (SEC) Publish Tips on Target Date Funds?

Dave Rowe of Highland Capital Advisors, LLC presents an overview of a joint publication from the DOL and SEC in May of 2010 intended for individual investors and a publication from the DOL in February of 2013 intended for ERISA fiduciaries. Dave also provides some context around the explosive growth of target date retirement funds and the implied concerns these regulatory agencies have with respect to their use.

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### Q Can you provide some historical perspective on this topic?

A This topic stems from the evolution of three core themes: first, the primary role defined contribution retirement plans have with most Americans; second, the transition from trustee-directed defined contribution (“DC”) plans to participant-directed DC plans; and third, the relative failure of participant education programs and advances in the application of behavioral economics.

Despite the intention to maintain a participant-directed investment policy, many DC plan fiduciaries find themselves having to make a default investment election for participants who fail to make an affirmative election. This might happen, for example, where an employer makes a profit sharing contribution or adopts an automatic enrollment policy. Prior to the Pension Protection Act of 2006 (“PPA”), most plan sponsors chose a conservative principal preservation option like a money market fund or stable value fund as the default election to minimize the likelihood of loss. The downside, of course, is that a principal preservation investment strategy rarely aligns with the investment time horizon of most participants. That said, without a fiduciary safe harbor, plan sponsors were reluctant to adopt a more balanced (that is, equity weighted) investment strategy. PPA amended ERISA to provide a safe harbor for plan fiduciaries investing participant assets in qualified default investment alternatives (“QDIAs”) in the absence of participant investment direction.

### Q What is a qualified default investment alternative (“QDIA”)?

A DOL regulations under ERISA 404(c) provide relief from fiduciary liability for investment outcomes from participant directed DC plans provided, in part, that participants “exercise control” over the investments in their plan accounts. By adopting the PPA safe harbor, a participant will be deemed to exercise control if, in the absence of an affirmative investment election, the plan fiduciary invests the participant’s assets in a QDIA. Of course, there are many other requirements that are beyond the scope of this discussion. That said, in terms of the particular type of investment vehicle, a QDIA may generally be a: life-cycle or targeted-retirement-date fund; balanced fund; or professionally managed account.

Of note, a principal preservation option is specifically not included as an acceptable QDIA. Further, the timing of these new rules collided with the financial meltdown of 2008 and stress-tested the QDIAs that many DC plans adopted. The outcry provided fuel for the critics of the DC system, as well as those lobbying for Wall Street reform and consumer protection. According to Morningstar, some target date fund investors lost as much as 41 percent during calendar year 2008 compared with a 37 percent drop in the S&P 500 Index during the same period.

### Q Why did the DOL and SEC publish “Investor Bulletin: Target Date Retirement Funds” in May of 2010?

A The first sentence of this bulletin reads, “Investment for retirement can be complex.” Indeed. Among the types of QDIAs specified in the regulations, target date funds by far, and for good reason, have garnered the highest adoption rates. Unlike static-risk based funds, target date funds are intended to pivot off of a participant’s age as a primary indicator of his or her investment time horizon. Further, target date funds “de-risk” over time by gradually reducing exposure to higher risk asset classes like equities and certain bonds. Admittedly, it’s far from perfect. However, it’s a quantum leap relative to how many plan participants have historically made asset allocation decisions from a core menu of funds. Nonetheless, the risks are not well understood by DC plan participants and the joint bulletin attempts to raise the awareness of these risks, as well as the variability among the many different types of target date funds.

## Q Why did the DOL publish “Target Date Retirement Funds—Tips for ERISA Plan Fiduciaries?”

A The amount of money being directed into target date funds is astonishing. According to Boston-based research firm Cerulli Associates, target date fund assets are projected to double to \$1.1 trillion by 2017. Further, the DOL has made it clear that DC plan fiduciaries are bound to the prudent selection and monitoring of a QDIA just as they are for the prudent selection and monitoring of the core fund menu. Some observations are as follows:

- By their nature, target date funds can suggest a product lifecycle in excess of 20, 30, or 40 years. It's unreasonable to believe that the underlying management and structure of these products or the global capital markets that weigh heavily on their design won't change over time.
- The proprietary nature of most target date funds squarely contradicts with the open investment architecture philosophy adopted by many participant-directed plans. Adopting a custom target date fund solution using some or all of the investment alternatives offered in the core menu is one way to neutralize this contradiction.
- The variability in “to” versus “through” glide paths should be considered in relation to the objectives of the plan as well as the needs of the plan participants.
- The ability to personalize the glide path for individual circumstances should be addressed.
- Plan participants need to understand the risks associated with target date fund choices. Terms like alpha, beta, and standard deviation are meaningless to plan participants, so plan fiduciaries and their advisors need to provide participants better education and creative tools to understand and quantify risk.

## Q What should ERISA fiduciaries do with this information?

A The 2013 DOL publication is a call to action for DC plan fiduciaries. In addition, on April 11, 2013, the SEC's Investor Advisory Committee adopted recommendations to rewrite its 2010 proposed rule on target date retirement funds. Accordingly, DC plan fiduciaries are advised to consider the following:

- Does the plan intend to comply with ERISA 404(c)?
- Does the plan intend to adopt a QDIA?
- Do the plan fiduciaries have the requisite skills to evaluate QDIAs, or should they employ the expertise of a qualified investment consultant?
- How are QDIAs addressed in the plan's investment policy statement?

- How does a target date fund strategy compare to the selection of core investment menu options?
- Does the QDIA align with the needs of the participants?
- How does the QDIA relate to the provider of recordkeeping services, as well as the pricing of recordkeeping services?
- Who is taking responsibility for the development and distribution of required notices and disclosures?
- Would it be advantageous to conduct a re-enrollment campaign to “reset” all participant investment elections through an affirmative process or default in the case where an affirmative election is not made?
- Would it be advantageous to implement a custom target date strategy based on the core menu of funds?

## Q How does a custom target date fund compare to a proprietary offering?

A Many recordkeeping firms offer custom target date fund offerings. These generally fall into two categories, designated investment alternatives and model portfolios.

Designated investment alternatives are typically unitized funds made up from investment funds that may, but not necessarily, reside on the core investment menu. Designated investment alternatives require additional disclosure around performance and fees in an identical fashion to funds that reside on the core menu. One of the advantages of this approach is that a fund manager can include certain asset classes that, depending on individual circumstances, may not be desirable as a core menu option.

Model portfolios are typically asset allocation overlays using some or all of the investment funds that reside on the core investment menu. These are not designated investment alternatives and do not carry the added burden of disclosure around performance and fees as these disclosures are made at the individual fund level. One of the advantages of the model portfolio approach is that a matrix of target date funds can be readily deployed to enable participants to elect a glide path that is both age and risk adjusted. Sometimes, this is done by moving participants forward or backward along a single uniform glide path. Other recordkeeping platforms allow for multiple glide paths.

Regardless of the approach taken, custom target date funds offer the following advantages:

- The underlying funds go through a regular performance evaluation process and individual fund managers can be replaced as needed without replacing the entire strategy.
- The underlying asset allocation can be more transparent to both plan fiduciaries and plan participants.

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now require the upfront disclosure of revenue sharing, it might be argued that this is a significant difference and that the Department would no longer consider its theory to be applicable. In the future, plan sponsors should know when revenue sharing is part of a platform provider's compensation and, after taking into account direct fees paid by the plan, may seek another provider if total compensation exceeds what the market will bear.

Still, this may not satisfy the Department of Labor which asserted

the nonexercise theory on the eve of the new disclosure regulations' effective date. Indeed, the Department's concern may have been with the breadth of the provider's authority over mutual fund and share class options contained in its annuity contract. The Department referred to this factor several times in its amicus brief and claimed that the annuity contract did not comply with Advisory Opinion 97-16A. While the *Liemkuehler* contract provided that the insurer would not substitute any shares constituting plan assets without notice to or approval by

the plan's participants, it appears that it did not incorporate all of the advisory opinion's procedural requirements for obtaining negative consent. Accordingly, platform providers would be well advised to reexamine their contractual arrangements for the purpose of ensuring that they conform as nearly as possible with the advisory opinion, including its negative consent features. ❖

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### ► Q&A

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- Plan fiduciaries have greater control over the glide path, the composition of asset classes represented along the glide path, the share classes of the funds used, and the mix of active and passive investment strategies.
- Plan fiduciaries can increase economies of scale by incorporating the core menu investment options into the custom target date fund strategies thereby allowing for faster share-class upgrades.
- The cost of the model portfolio strategy may be nothing more than the weighted average expense ratio of the underlying funds.

### **Q** What can a plan fiduciary do to protect the plan, the participants, and themselves?

**A** There are several things that DC plan fiduciaries can do. Process is king and a robust governance structure is essential. I suggest that fiduciaries start by establishing clear lines of authority including limitations. Further, plan fiduciaries need to ensure that these lines of delegation are coordinated among the many parties responsible for administering the plan and harmonized among various governing documents.

- Generally, responsible parties fall into three broad categories including discretionary fiduciaries, nondiscretionary fiduciaries, and nonfiduciaries. Governing

documents could involve articles of incorporation, bylaws, board resolutions, committee charters, plan documents, trust agreements, investment policies, vendor service agreements, fund prospectuses, participation agreements, and other policy related documents.

- Neutralize potential conflicts of interest or make sure they have been addressed to the satisfaction of responsible fiduciaries.
- Periodically measure plan fees and benchmark plan service provider arrangements. Make sure that all covered service provider disclosures under ERISA 408(b)(2) are complete and accurate. Consider having all service providers self-certify their covered service provider status.
- Communicate with all concerned parties, especially plan participants. Let them know what you are doing to make sure they have access to the right products and services for their needs.

The use of target date investment strategies is expected to grow significantly. This presents enormous opportunities for asset gatherers like mutual funds, banks, and insurance companies. As public advocates, the DOL and SEC have a duty to ensure these strategies grow for the right reasons. DC plan fiduciaries are advised to demonstrate that they are using an appropriate strategy that is designed for the exclusive benefit of plan participants. Plan participants are advised to understand the risks these strategies present, as well as how those risks coordinate with other retirement assets or sources of retirement income they may have. ❖

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## Compliance Check for Your (or Your Client's) Plan—Issues To Consider

Jeffery Mandell, Esq.

*This article and Michael Coyne's article of this issue complement one another.*

Employers should, from time to time, evaluate and consider plan issues. These issues often are not foremost to employers. Although complacency is natural, the failure to timely address and dig somewhat into key matters very often fosters or exacerbates problems.

The list below notes some of the matters that plan sponsors should probe. Although not exhaustive, the list represents several of the problems we encounter on a daily basis for our clients. This list applies to most all plans, be they 401(k), ESOP, other qualified plans, health, welfare or flex plans, severance plans, or deferred compensation arrangements.

1. Is the plan's design achieving the employer's goals? For example, are participants able to contribute (or have the employer contribute) as much as they desire, is the plan failing the "ADP" or other IRS tests, thus returning (or not making) contributions to certain employees?
2. Especially with plans that have adoption agreements, has an experienced person ensured there are no conflicts, confusion, unintended results or omissions (all of which could lead to unfavorable consequences)?
3. Is the employer (and/or you) appropriately documenting fiduciary processes and decisions?
4. Do you and/or the employer know its legal fiduciary responsibilities and exposure?
5. Are plan operations strictly consistent with the plan terms? For example, are

the plan's eligibility and contribution allocation provisions correctly applied? Is the plan cashing out small balances on time?

6. Do the employer's Form 5500s accurately report plan matters or do they contain errors inviting governmental inquiry (such as incorrectly coding plan features or benefits)? Are Form 5500s timely filed? Has an expert carefully checked the preparer's forms, at least occasionally?
7. Is the testing data accurate, thus leading to accurate eligibility, allocation and vesting operatives and also collect testing results? Have the tests periodically been reviewed by counsel, in good part to ensure the testing methodologies are correct? For example, very often the coverage tests are incorrectly applied to plans with 401(k), matches and/or profit sharing contributions—meaning the test results are wrong.
8. Is the third party administrator reviewing the employer's data for obvious mistakes. There are all kinds we see such as an employee reported as being an HCE but who owns 0 percent of the employer and who made \$50,000 that year. Or is the employer uninformed or stretched too thin, thus on its own with its data?
9. Is the correct compensation as defined in the plan used to calculate employee and employer contributions?
10. Are plan failures corrected and documented in accordance with the applicable Internal Revenue Service and Department of Labor guidance? The

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