

## **Regulation and Compliance—New Proposed Rule for Target Date Funds**

Target date funds are a popular choice for 401(k) participants and other clients content to turn over investment decisions for their retirement funds to professional fund managers. In fact, since their inception in the mid-1990s, assets held by these funds have grown to approximately \$270 billion.<sup>i</sup> Target date funds received approximately \$43 billion in net new cash flow during 2009, \$42 billion during 2008, and \$56 billion during 2007, compared to \$22 billion in 2005 and \$4 billion in 2002.<sup>ii</sup>

Recently, target date funds have become more prevalent in 401(k) plans as a result of the designation of these funds as a qualified default investment alternative (QDIA) by the Department of Labor pursuant to the Pension Protection Act of 2006. The QDIA designation provides liability protection for an employer who sponsors a defined contribution plan and places contributions of those plan participants who have not made an investment choice into a target date fund or other QDIA. According to one study, 70 percent of U.S. employers surveyed now use target date funds as their default investment.<sup>iii</sup>

Basically, participants select funds with target dates at, or near, their retirement date. The idea is that the fund manager will reallocate assets along the way, generally shifting away from more aggressive equity investments to more conservative debt instruments as the target date nears. The schedule by which a target date fund's asset allocation is adjusted is commonly referred to as the fund's "glide path." The glide path typically reflects a gradual reduction in equity exposure before reaching a "landing point" at which time the asset allocation becomes static. For some target date funds, the landing point occurs at or near the target date, but for a significant majority, the landing point occurs after the target date. In fact, for some funds, the landing point is reached a significant number of years – as many as 30 – after the target date.

The major benefit of target date funds to clients is that they are designed to make it easier for investors to hold a diversified portfolio of assets that is rebalanced automatically among asset classes over time without the need for each investor to rebalance his or her own portfolio repeatedly. Managers of target date funds have stated that, in constructing these funds, they attempt to address a variety of risks faced by individuals investing for retirement, including investment risk, inflation risk, and longevity risk. Balancing these risks involves tradeoffs, such as taking on greater investment risk in an effort to increase returns and reduce the chances of outliving one's retirement savings.

*Target funds drew unwanted attention when, according to Morningstar, during the 2008 bear market, many funds with target dates of 2010 suffered large losses due to heavy allocation to stocks (in some cases, 50 to 60 percent of total assets). The average fund with target date of 2010 horizon lost 25 percent in 2008 (compared to losses for the Standard & Poor's 500 Index (S&P 500), the Nasdaq Composite Index (Nasdaq Composite), and the Wilshire 5000 Total Market Index (Wilshire 5000) of approximately 37%, 41%, and 37%, respectively).*

## **Background on Target Date Funds**

Even prior to issuance of the SEC proposed rule, several concerns with target date funds had surfaced. These concerns centered on investor confusion about how such funds actually work. First, there were concerns that many investors did not understand that funds with the same target date could have different asset allocations. Equity exposure has been found to range from approximately 25 percent to 65 percent at the target date and from approximately 20 percent to 65 percent at the landing point.<sup>iv</sup>

Another concern was that investors often do not understand that fund assets are not necessarily converted to cash or near cash at the target date. In fact, many fund managers remain significantly invested in equities well beyond the target date to offset the potential for longer life expectancies and increasing costs of healthcare and other items during one's retirement years.

## **SEC Concerns**

In addition to these widely shared concerns about target date funds, the SEC also expressed a number of other concerns that led to its

proposed rule. First, it cited the continuing shift away from reliance on defined benefit plans and Social Security as the primary sources of retirement funds to defined contribution plans in which the individual exercises investment control and bears the investment risk. Relying on Department of Labor sources, the SEC noted that Department of Labor data indicate that the number of active participants in defined benefit plans fell from about 27 million in 1975 to approximately 20 million in 2006, whereas the number of active participants in defined contribution plans increased from about 11 million in 1975 to 66 million in 2006. In addition, the SEC referenced a recent hearing held by the Department of Labor on target date funds. One concern expressed at the hearing had to do with the naming convention of target date funds. Although fund names usually include a date, for example 2010, to indicate their target dates, investors may not appreciate the differences in asset allocations of different funds with the same target date, the different glide paths of the various funds, and the different approaches the funds may take from

target date to landing point. Another concern expressed at the meeting was that investors may not fully appreciate the risk associated with target date funds and may even wrongly believe that such funds guarantee a secure retirement on the target date. According to the SEC:

*“The (marketing) materials typically presented a list of funds with different target dates and invited investors to choose the fund that most closely matches their anticipated retirement date. Even though the marketing materials for target date funds often included some information about associated risks, they often accompanied this disclosure with slogan-type messages or other catchphrases encouraging investors to conclude that they can simply choose a fund without any need to consider their individual circumstances or monitor the fund over time.”*

To better educate the public about target date funds, the SEC recently posted a consumer-education piece on its website.<sup>v</sup>

### **Proposed Rule**

The proposed rule seeks to address the concerns over target date funds on several levels. Specifically proposed are amendments to rule 482 under the Securities Act and rule 34b-1 under the Investment Company Act that, if adopted, would require a target date fund that includes the target date in its name to disclose the fund’s asset allocation at the target date immediately adjacent to (or, in a radio or television advertisement, immediately following) the first use of the fund’s name in marketing materials. Also proposed are amendments to rule 482 and rule 34b-1 that, if adopted, would require enhanced disclosure in marketing materials for a target date fund regarding the fund’s glide path and asset allocation at the landing point, as well as the risks and considerations that are important when deciding whether to invest in a target date fund. Finally, the SEC proposes amendments to rule 156 under the Securities Act that, if adopted, would provide additional guidance regarding statements that could be misleading in marketing materials for target date funds and other investment companies.

### **Bottom Line**

Now is your chance to weigh in on this proposed rule. Electronic comments may be sent to the SEC at <http://www.sec.gov/rules/proposed.shtml>. Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-12-10. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission’s Internet Web site: <http://www.sec.gov/rules/proposed.shtml>.

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<sup>i</sup> Based on Commission staff analysis of data as of March 31, 2010, obtained from Morningstar Direct.

<sup>ii</sup> Investment Company Institute, 2010 Investment Company Fact Book, at 173, Table 50, (2010).

<sup>iii</sup> Margaret Collins, Target-Date Retirement Funds May Miss Mark for Unsavvy Savers, Bloomberg (Oct. 15, 2009) (citing a Mercer, Inc. study of more than 1,500 companies).

<sup>iv</sup> Based on Commission staff analysis of registration statements filed with the SEC.

<sup>v</sup> See Investor Bulletin: Retirement Funds (May 6, 2010), available at <http://www.sec.gov/investor/alerts/tdf.htm> and [http://investor.gov/investor-bulletin-target-date-retirement-funds/?preview=true&preview\\_id=1154&preview\\_nonce=908a042f2f/](http://investor.gov/investor-bulletin-target-date-retirement-funds/?preview=true&preview_id=1154&preview_nonce=908a042f2f/). This brochure is also posted on the Department of Labor's Web site and is available at <http://www.dol.gov/ebsa/pdf/TDFInvestorBulletin.pdf>.