

## DOL Offers Tips on TDFs

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As of this writing, the stock market is trading at all-time highs, and the share of 401(k) assets invested in target date funds ("TDF"s) continues to increase, obscuring troubling aspects of these plan investments that were exposed in the recent economic downturn. Many plan participants lack the time, ability or inclination to properly manage the investment of their plan accounts, and TDFs provide a simple means of obtaining appropriate investment allocation and periodic rebalancing that results in an increasingly conservative asset mix as a participant nears retirement. The simplicity, however, is deceptive, and the nature of these funds (for example, their fund of funds structure as well as their blueprint for changing the asset mix over time known as the glidepath) has fiduciary implications.

*Fiduciary Duties.* 401(k) plan fiduciaries, like other retirement plan fiduciaries, are governed by the duty to act solely in the interest of participants and beneficiaries and to carry out their responsibilities "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise with like character and like aims." As applied to the selection of plan investment options, this prudence standard requires an objective process to obtain information about the investment, thereby enabling its evaluation.

*Proposed Regulations.* On November 30, 2010, the DOL published proposed revisions to its qualified default investment alternative ("QDIA") and participant-level fee disclosure regulations, specifying information that will have to be provided to participants regarding TDFs. The proposal, which has not been finalized, also announced that

the DOL would publish a series of tips to assist plan fiduciaries in obtaining and evaluating relevant information when selecting and monitoring TDFs. This commitment was fulfilled on February 28, 2013 by the release of general guidance on "What to Remember When Choosing Target Date Funds."

### *Comparing and Selecting TDFs.*

The DOL suggests that the process for comparing and selecting a TDF should entail consideration of the fund's prospectus, which would include the fund's historical performance as well as fee and expense information. Other characteristics of a particular TDF revealed in its prospectus, most obviously its target date, glidepath, and the point at which it reaches its most conservative asset allocation (the "landing point"), would enable the plan fiduciary to determine how well the investment aligns with the ages and likely retirement dates of participants.

Beyond the prospectus, the DOL recommends that TDF providers be questioned on the impact that plan demographics such as defined benefit plan participation, salary levels, turnover rates, and withdrawal patterns, will have on the investment. For example, if participants typically cash out shortly after retirement, it would be important for the fund to have reduced its potential volatility by reaching its landing point at such time. The glidepaths of some funds reach their most conservative investment allocation earlier than others, and some reach this point only a number of years after retirement or the target date. The latter are more suited for plans in which participants tend to receive lifetime installments.

*Periodic Review.* Noting that plan fiduciaries are required to periodically review a plan's investments to determine their continuing suitability, the DOL gives its strong view (stating it more forcefully than a mere tip)

that the review should examine whether there have been any significant changes to the TDF's characteristics or the plan's objectives since the TDF's original selection. TDF modifications requiring attention include changes in the management team or a shifting of the fund's investment strategy, as well as whether or not the original investment strategy has been effectively implemented. A change to the TDF or to the plan's objectives for the TDF could require that the fund be replaced.

### *Understanding TDF Investments.*

The DOL wants plan fiduciaries to understand the strategies and risks, not only of the TDF, but also of its underlying investments and the asset classes into which they are divided. It is also critical to understand the TDF's glidepath (including the rate at which it shifts its portfolio from equities to fixed income investments in order to reduce risk), as well as when it reaches its landing point and whether that occurs at or after the target date. Much of this information can be obtained from the fund's prospectus and other offering materials. The DOL points out that employees should also understand these TDF features so that they can know if the TDF is an appropriate investment for them.

*Fees and Expenses.* An essential part of a fiduciary's duty is to determine whether an investment's fees and expenses are justified by its performance. In the case of a TDF, an understanding of such charges should be acquired not only with respect to the TDF, but also as to its underlying funds. Thus, it is assumed that the plan fiduciary will examine the expense ratios of the underlying funds and that, if their total is substantially less than the overall fees and expenses charged by the TDF, the fiduciary will ascertain the reason for the difference and seek justification.

*continued on page 9* ►

► **Legal Update**

*continued from page 3*

*Proprietary vs. NonProprietary Funds.* TDFs typically have a “fund of funds” tiered investment structure under which the TDF actually invests in other mutual funds, which in turn invest in portfolio securities. A conflict of interest may arise under this structure because many TDFs invest exclusively in affiliated mutual funds. From a product development perspective, when a fund family creates a TDF, it has a financial incentive to include as many affiliated underlying funds as possible in the TDF, thereby increasing its aggregate compensation through the fees paid to the underlying fund managers. The DOL recommends that a plan fiduciary ask the plan’s investment provider if it can create a customized nonproprietary

TDF consisting of the plan’s existing core funds. Such a nonproprietary TDF would provide the advantage of diversifying the fund’s investment managers. The DOL notes that this might result in additional costs and administrative complexity, but interestingly, does not mention the potential for eliminating excessive fees that might result from manipulation of a proprietary TDF’s underlying investments.

*Employee Communications.* The DOL requires plan fiduciaries to furnish participants with general information about TDFs, as well as details relating to the particular TDFs that are actually offered by the plan. Participants need this information to determine if a TDF would be a good fit for them. Moreover, the participant-level disclosure regulations that went into effect in 2012 require the delivery

to participants of specific fee and expense information about TDFs.

*Information Sources.* As a matter of prudence, if a plan fiduciary does not possess the necessary expertise to evaluate an investment, the fiduciary must seek outside advice or assistance, as necessary. The DOL notes that TDFs are a relatively new investment option, but that there are a number of commercially available sources of information and services relating to TDFs to assist fiduciaries in the review process.

*Documentation.* Finally, the DOL indicates that the selection and review process for a TDF should be documented, including how the fiduciary reached its decision to make a TDF available. ❖

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