

BRUCE L. ASHTON  
HEATHER BADER-ABRIGO  
MARC L. BENEZRA  
PASCAL BENYAMINI  
JOSEPH C. FAUCHER  
STEPHEN I. HALPER  
MARTIN M. HEMING  
JONATHAN A. KARP  
JAMIE LEE KIM  
MEENA P. KOTAK  
JEFFREY D. LEWIS\*\*

**REISH & REICHER**  
A PROFESSIONAL CORPORATION  
ATTORNEYS AT LAW  
11755 WILSHIRE BOULEVARD  
10<sup>TH</sup> FLOOR  
LOS ANGELES, CALIFORNIA 90025-1539  
TELEPHONE (310) 478-5656  
FACSIMILE (310) 478-5831

Direct Fax: (310) 776-7822  
www.reish.com  
fredreish@reish.com

DAVID H. MAURER  
LELAND J. REICHER  
C. FREDERICK REISH\*  
JASON C. ROBERTS  
STACIE R. SMILEY  
MARK E. TERMAN\*  
MICHAEL A. VANIC  
GARY A. WEXLER  
NICHOLAS J. WHITE

OF COUNSEL  
ADAM M. COHEN

\*ALSO ADMITTED IN DC  
\*\*ALSO ADMITTED IN MT

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**VIA ELECTRONIC MAIL - e-ori@dol.gov**

Employee Benefits Security Administration  
Office of Regulations and Interpretations  
U.S. Department of Labor  
200 Constitution Ave, N.W., Room N-5655  
Washington, DC 20010

**Re: Comments on Questions Posed in Notice of Hearing on  
Target Date Funds**

Ladies and Gentlemen:

We are writing in response to your inquiry about whether additional guidance by either EBSA or the SEC on “target date” or “lifecycle” funds and other similar investment options (“TDFs”) would be helpful.

This comment letter focuses on the need for guidance from the Department of Labor. More specifically, the missions of the two agencies are, with regard to the issues being considered, separate and distinct. As this letter will explain, in our view there is a greater need for protection of the interests of participants in 401(k) plans (“participants”) than there is for the protection of the interests of retail investors (“individual investors”).

**Background**

While the SEC generally takes a disclosure approach, the fiduciary standard of ERISA imposes an affirmative duty on plan sponsors to act prudently and to act in the best interest of the participants and beneficiaries. Those are very different perspectives, requiring different solutions. Further, the needs of participants, who to a large degree are “reluctant” or “non-engaged” investors, are quite different from those of individual investors outside of 401(k) plans, who are either “engaged” in the process or who are assisted by a knowledgeable broker-dealer or registered investment adviser. To the contrary, most 401(k) participants do not receive individualized advice in a “one-on-one” setting. Instead, they are given enrollment booklets and asked to direct their own investments. Or, alternatively, they default and the plan fiduciary makes investment decisions for them.

Generally speaking, the individual investor first decides to invest and then makes a decision to purchase shares in a particular fund. For the individual investor, the SEC provides guidance for people who are, for the most part, engaged in, and knowledgeable about, investing

in mutual funds. For those who are fully engaged, and want to do the work themselves, SEC guidance is designed to inform them about the risks and issues for investing directly in mutual funds. For engaged investors who want to use the services of a broker, or RIA firm, the SEC guidance provides information for the adviser and investor to review together. This description may not cover every situation, but we believe it is generally correct. In addition, our belief is that the average investor who uses an adviser to pick mutual funds, or who picks his own, has a higher net worth and greater financial sophistication than the average 401(k) participant. So, the SEC-protected investor is, when it comes to mutual funds, more engaged, knowledgeable and experienced.

On the other hand, the DOL serves two constituencies. The primary concern of the DOL is to protect the interests of participants. Most observers believe that the typical 401(k) plan participant is not engaged in, or knowledgeable about, investing. (Many, if not most, 401(k) participants make an initial decision to save--or defer--and then must select among the investment options in their plan, with little, if any, training or education and, in most cases, without individualized consultation with an adviser. In other words, they are committed savers and reluctant investors.) Because of the lack of sophistication, 401(k) plans and participants have adopted target date funds (and other portfolio solutions for investing) much faster than individual investors. That is because TDFs are a "solution" for the lack of investment knowledge by 401(k) participants, who generally do not have access to individualized one-on-one advice from advisers (which is more available to individual investors). Stated slightly differently, engaged individual investors work with advisers (or work on their own) to develop individualized portfolios, while 401(k) participants generally use pre-packaged portfolios--both to hold down the cost and to compensate for the fact that the "investors," *i.e.*, 401(k) participants, do not meet individually with advisers.

As a practical matter, the DOL also has a second constituency, plan sponsors, in their roles as fiduciaries. As fiduciaries, plan sponsors must prudently select and monitor the investments that are offered to the participants, including TDFs--both as investment alternatives and as QDIAs. So, as a legal matter, while the DOL protects the interests of the participants, as a practical matter the DOL can better accomplish that objective by educating plan sponsors about their fiduciary responsibilities and about how to fulfill those responsibilities.

In addition to selecting TDFs for affirmative participant election, plan sponsors also use them as qualified default investment alternatives, or QDIAs. In fact, it is commonly believed that the inclusion of TDFs as an investment category that is eligible for the QDIA "fiduciary safe harbor" is a primary factor for the rapid growth in popularity in TDFs. In that regard, our understanding is that TDFs have been much more widely accepted by 401(k) plans than by individual investors (which is consistent with the needs of the relatively unsophisticated 401(k) participants and their lack of individualized portfolio advice). Because of that, the Department may be the most important regulatory voice on the structure of TDFs. Stated slightly

differently, our belief is that no major provider can afford to have its TDFs fall outside of the definition of a QDIA. Rather than allowing that to happen, it is probable that every major TDF provider (and perhaps every TDF provider) would alter the structure of their funds to satisfy any regulatory requirements under ERISA section 404(c)(5). As a result, we recommend that the Department focus its regulatory effort on reviewing TDFs in light of their role as QDIAs and, if changes are needed, in making changes to the regulation under ERISA section 404(c)(5).

### **Comments on Questions**

With this background, we will comment on the four questions posed by the SEC and DOL. Those questions are:

1. *How TDF managers determine asset allocations and changes to asset allocations (including glide paths) over the course of a TDF's operation;*

At this juncture, it seems obvious that, for fiduciaries to engage in a prudent process to select a TDF suite, they need to review a reasonably well-defined statement from the manager of the TDFs about the asset allocations and the changes to those allocations. That would include, of course, the glide path. However, my current experience is that the managers of TDFs are not providing that information to plan sponsors and that, therefore, plan sponsors (other than perhaps the largest plans) are not reviewing and evaluating that information.

In addition, that information should be communicated to participants so that they can better understand the characteristics of their potential investments. Investment experts commonly state that the asset allocations and glide path are the most important factors in the performance of TDFs. Yet, very little, if any, information is given to the participants about those factors.

In addition, there is an emerging issue of the duration of the glide path. Some TDF managers end the glide path at the targeted date (that is, the glide path of a 2010 fund ends in 2010 and does not change thereafter). Other TDF managers extend the glide path for 5, 10, 15 years or more beyond the targeted date. Plan sponsors need to evaluate the glide path, but there is little, if any, information about how to do that.

That analysis should be broken down into at least two distinct categories. The first is from an investment perspective, that is, does the glide path make sense in terms of a prudent investing program, especially as a

participant reaches the end of the accumulation phase? The second is on the basis of plan experience. For example, if retiring participants commonly take cash distributions and roll the money into IRAs, is that inconsistent with a glide path that extends beyond the targeted date? One might argue that it is not--because, while participants were subject to additional market volatility before retirement, they did not have the opportunity to recover from any market losses immediately preceding retirement because, for example, they rolled over into a more conservative investment or they used their plan distribution to purchase an annuity. On the other hand, there is a countervailing argument that if, as a matter of plan experience, retired participants leave their money in the plan and take distributions, a continuation of the glide path in the post-retirement years may make sense. One might also argue that, if the participants are educated, during their accumulation years, about the post-retirement glide path, and they have been given enough information to understand that, when they take a distribution of their retirement benefits, they need to roll over into a similarly structured investment vehicle, so that the glide path has a chance to complete its strategy. Similarly, plan fiduciaries need to understand that they are making that decision and that they need to communicate fully and accurately with the participants about the reason for the decision and the consequences of the decision.

This concept was explained in the comments of Richard Whitney of T. Rowe Price Group, Inc., which were presented at the June 18<sup>th</sup> hearing:

“ . . . some funds are designed to enable investors to gradually draw down their balances over time, while others are designed to facilitate transferring lump-sum balances to other income generating strategies, such as annuities. Both objectives are reasonable, but they place different demands on participants and lead to dramatically different investment designs and most important, dramatically different equity weightings.”

While both designs may be appropriate from an investment perspective, they may not both be appropriate for a particular plan. As Mr. Whitney's comments explain, if a plan or a participant contemplates using annuities at retirement, a TDF whose glide path ends at the targeted maturity date would be more appropriate.

Unfortunately, our experience is that plan sponsors and participants--other than, perhaps, at the largest companies in America--are not being given that explanation or, in many cases, the information necessary to do that evaluation.

These issues are similar, but not identical for QDIAs. For example, it appears, at least at first blush, that if a plan defaults participants into a TDF with an extended glide path, the fiduciaries have made some decision that it is in the best interest of the participants to be invested in that way. To make such a decision, one would assume that the fiduciaries evaluated the issue, examined relevant data and information, and made an informed decision. However, my current experience is that is not happening.

Also, there is language in the preamble to the QDIA regulation that suggests that fiduciaries do not need to take into account special circumstances regarding the participants (for example, whether the company also sponsors a defined benefit plan, whether the participants are low-paid and have little in the way of investment sophistication, and so on). We recommend that the Department reconsider that language. It seems to us that the Department has established a lower standard for the selection of QDIAs than exists for the selection of TDFs for participants who affirmatively direct their investments. However, that is problematic from several perspectives. As a practical matter, plan sponsors select one line-up of TDFs that is used for both purposes. As a result, it is logically difficult to understand why, for the QDIA purpose, the standard would be lower than the standard for selecting the same funds for affirmative investing. Also, as we are now learning, plan sponsors must exercise some responsibility in selecting these investments in a manner that are appropriate for the needs, and the abilities, of the participants, even where they are used as QDIAs.

Recommendation:

- a. The Department should issue guidance on the selection and monitoring of TDFs. The guidance should be illustrative of the types of considerations (non-exclusive) that fiduciaries should take into account in the process of evaluating TDFs. The guidance should be from the Department (*e.g.*, as an advisory opinion, field assistance bulletin or general information letter).

- b. The Department should issue guidance on the information to be provided to participants about investments in participant-directed plans and, in particular, about TDFs.
- c. The Department should amend its QDIA regulation to provide that, for an investment to be eligible to be a QDIA, the mutual fund or the fiduciary manager must provide specified information about the asset allocation and glide path to the plan fiduciaries.
- d. The Department should amend its QDIA regulation to require that participants must be provided with specified information about the asset allocation and glide path. Included in that information would be an explanation of whether the glide path extends beyond the targeted date and the significance to the participants.

2. *How they select and monitor underlying investments;*

As with information about asset allocation and glide path, fiduciaries need to understand how the TDF manager selects and monitors the underlying investments.

While one would hope that the competitive marketplace would resolve this issue, there are regular rumors within the 401(k) industry that some TDF providers are including proprietary funds of inferior quality or are using start-up funds to get them adequately capitalized. Regardless of whether those accounts are accurate or not, there is a need for greater transparency if, for no other reason, than to provide investors and fiduciaries with confidence in the process.

Also, it is well known that many TDF managers use only proprietary funds. That is an obvious conflict of interest. That does not mean that the manager has succumbed to the conflict, but instead it means that there is a potential for the manager to favor the mutual fund management company over the interests of plans and participants. To the extent that fiduciaries could review descriptions of the processes used for monitoring and removing funds and managers--and understand them--that would restore confidence and would enable fiduciaries to determine if the managers were adhering to a reasonable process. It would also, as a side effect, alert fiduciaries to the potential for inappropriate conflicts.

Our experience is that plan sponsors and participants are not currently being given information about this subject.

Recommendation:

- a. As with our prior recommendation, we believe the Department's guidance should educate fiduciaries that a prudent process would take into account (i) conflicts of interest of the TDF managers and (ii) an understanding of the process for selecting, monitoring, and removing and replacing funds and/or managers in the TDFs.
  - b. We also recommend that the Department amend its QDIA regulation to require that, for a TDF to be eligible to be a QDIA, the mutual fund or fiduciary manager must provide a meaningful description of its process for selecting, monitoring, removing and replacing the underlying funds and/or managers.
3. *How the foregoing, and related risks, are disclosed to investors; and*

In representing a number of plan sponsors, investment advisers and investment providers, our experience is that the only information given to participants about risks is generic and virtually meaningless. By and large, it is form language that is designed to protect the investment management firm, but not to meaningfully inform the investor or participant. For example, in some prospectuses, the general descriptions of the 2010 fund and the 2050 fund are identical.

Recommendation:

For both defaults and affirmative investment elections, participants should receive information that is adequate to reasonably educate them on the purpose of the investment and the strategy that is being used to accomplish that purpose. It should, at the least, discuss asset allocation, glide path and the underlying investments. It should provide information about each targeted date and how that fund differs from the others in the suite.

4. *The approaches or factors for comparing and evaluating TDFs.*

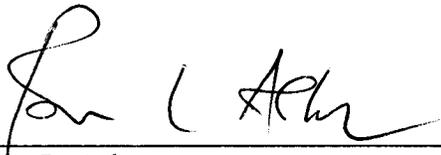
In representing investment advisers and consultants, our experience is that the advisory and plan sponsor communities have not developed an

agreed-upon set of standards for evaluating target date funds. However, they are in the process of developing the criteria and the procedures for determining both the general acceptability of the design and management of a fund and in determining its specific suitability for the demographics of a particular workforce. We suggest that the Department solicit additional input from the consulting community on this point.

We hope this information has been helpful. More importantly, though, we encourage the Department to accept that it has a unique responsibility under ERISA's fiduciary provisions, and that the responsibility is markedly different from the role and perspective of the Securities and Exchange Commission.

Very truly yours,

  
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C. Frederick Reish

  
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Bruce L. Ashton

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