

MEMO# 27091

March 7, 2013

Department of Labor Issues Guidance Regarding the Selection of Target Date Funds by Plan Fiduciaries

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TO: PENSION COMMITTEE No. 5-13

PENSION OPERATIONS ADVISORY COMMITTEE No. 5-13 RE: DEPARTMENT OF LABOR ISSUES GUIDANCE REGARDING THE SELECTION OF TARGET DATE FUNDS BY PLAN FIDUCIARIES

The Department of Labor recently issued guidance regarding the selection of target date funds ("TDFs") by plan fiduciaries. [\[1\]](#) The guidance, titled "Target Date Retirement Funds – Tips for ERISA Plan Fiduciaries," provides basic information on TDFs as well as guidance for fiduciaries in selecting TDFs as plan investment options. As you may recall, in April 2010, the Institute (jointly with the American Benefits Counsel) submitted a letter ("2010 letter") to the Department with a list of recommended items for plan fiduciaries to consider when selecting and monitoring target date funds. [\[2\]](#) The guidance addresses some, but not all, of the recommended items.

In the guidance, the Department includes the following recommendations for plan fiduciaries when choosing target date funds:

- Establish a process for comparing and selecting TDFs. The guidance recommends that plan fiduciaries engage in an objective process to obtain information that will enable them to evaluate the prudence of any investment option made available under the plan. The guidance also states that plan fiduciaries should consider how well the TDF's characteristics align with eligible employees' ages and likely retirement dates - but offers no explanation as to how such an analysis should be conducted. The guidance further states that "[I]t also may be helpful for plan fiduciaries to discuss with their prospective TDF providers the possible significance of other characteristics of the participant population, such as participation in a traditional defined benefit pension plan offered by the employer, salary levels, turnover rates, contribution rates and withdrawal patterns." However, the guidance offers no explanation as to what weight or significance a plan fiduciary should place in these factors. The Institute's 2010 letter recommended that the list of items for consideration by plan fiduciaries include plan and participant characteristics.
- Establish a process for the periodic review of selected TDFs. The guidance

recommends that plan fiduciaries periodically review the plan's investment options to ensure that they should continue to be offered and states that, at a minimum, this review should include examining whether there have been any significant changes in the information the fiduciary considered when the option was selected or last reviewed. The Department does not include any guidance regarding the factors that should be considered in such a review. The Institute's 2010 letter recommended that the list of items for consideration by plan fiduciaries include the investment performance of the TDF, its component investments, and the benchmarks available to evaluate and monitor the TDF's investment performance.

- Understand the fund's investments. The guidance states that, in choosing TDFs, plan fiduciaries should understand the fund's allocation in different asset classes (stocks, bonds, cash), individual investments, and how these will change over time. Further, the guidance states that plan fiduciaries should understand the fund's glide path, including when the fund will reach its most conservative asset allocation and whether this will occur at or after the target date. The discussion regarding TDF basics includes a brief description of the difference between a "to retirement" versus a "through retirement" glide path approach and the guidance states that funds with a "through retirement" approach are generally for employees who don't expect to withdrawal all of their 401(k) account savings immediately upon retirement, but would rather make periodic withdrawals over the span of their retirement years. The Institute's 2010 letter recommended that the list of items for consideration by plan fiduciaries include the TDF's asset allocation and glide path and whether the TDF reaches its final asset allocation at the target retirement date or after the target retirement. Additionally, although the Institute's 2010 letter recommended that the list of items for consideration by plan fiduciaries include asset management/structure issues (such as the retirement date increments between the offered TDF, active versus passive management, and whether the TDF uses its own managers, third party managers, or a combination of both), the guidance does not specifically address such issues.
- Review the fund's fees and investment expenses. The guidance states that TDF fees can vary significantly and therefore suggests that plan fiduciaries understand the fees and expenses, including any sales loads for the TDF. With respect to TDFs that invest in other funds, the guidance recommends that the plan fiduciary consider the fees and expenses for both the TDF and the underlying funds and states that, if the expense ratios of the individual funds are substantially less than the overall TDF, the plan fiduciary should ask what services and expenses make up the difference. The Institute's 2010 letter recommended that the list of items for consideration by plan fiduciaries include the total fees charged by the TDF and whether there are fees charged to the sponsor or participant in addition to the investment fees of the underlying investments.
- Inquire about whether a custom or non-proprietary target date fund would be a better fit for your plan. The guidance discusses the difference between a "pre-packaged" product which uses only the vendor's proprietary funds as the TDF component investments and a non-proprietary TDF. With respect to the use of a non-proprietary TDF, the Department states that such a product may offer advances by including component funds that are managed by fund managers other than the TDF provider itself, thus diversifying participants' exposure to one investment provider. The guidance adds that there are some costs and administrative tasks involved in creating a custom or non-proprietary TDF and they may not be right for every plan. The guidance appears to imply that investment in mutual funds of the same provider may

lead to a less diversified or less prudent overall investment portfolio than investing in funds of multiple providers and therefore has implications beyond TDFs. We have contacted the Department to express our concern and have requested a meeting with them to discuss this issue.

- Develop effective employee communications. The guidance recommends that plan fiduciaries plan for employees to receive appropriate information about both TDFs in general, and about individual TDFs offered through the plan. The guidance also references the Department's final participant disclosure regulation and notes that the Department is working on regulations to improve disclosures made to participants specifically about TDFs.

As you may recall, the Department previously issued proposed amendments to the existing rules on qualified default investment alternatives under ERISA §404(c)(5) and participant disclosure under ERISA §404(a) to require additional disclosure about target retirement date funds and similar investments. [3] In May 2012, the Department re-opened the comment period in connection with an investor testing study sponsored by the SEC relating to the SEC's separate proposal on target date fund marketing materials. [4] The Department's most recent Regulatory Agenda indicates that the Department expects to issue final target date regulations in November 2013. [5] The Institute's 2010 letter recommended that the list of items for consideration by plan fiduciaries include participant disclosure and education .

- Take advantage of available sources of information to evaluate the TDF and recommendations you received regarding the TDF selection. The guidance notes that, although TDF's are relatively new investment options, there are an increasing number of commercial information sources to assist plan fiduciaries in their decision-making and review process.
- Document the process. The guidance states that plan fiduciaries should document the selection and review process, including how they reached decisions about individual investment options.

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endnotes

[1] The guidance is available here: <http://www.dol.gov/ebsa/pdf/fsTDF.pdf>.

[2] See Memorandum to Pension Committee No. 7-10, Pension Operations Advisory Committee No. 6-10 [24121], dated April 5, 2010.

[3] For a description of the proposed rule, see Memorandum to Pension Members No. 57-10, SEC Rules Members No. 131-10, Small Funds Members No. 79-10, Advertising Compliance Advisory Committee No. 6-10, Transfer Agent Advisory Committee No. 79-10, Bank, Trust and Recordkeeper Advisory Committee No. 51-10, Operations Committee No. 38-10 [24754], dated December 2, 2010. For the Institute's comment letter on the DOL proposal, see Memorandum to Pension Members No. 5-11, SEC Rules Members No. 8-11, Advertising Compliance Advisory Committee No. 2-11, Transfer Agent Advisory Committee No. 6-11, Bank, Trust and Recordkeeper Advisory Committee No. 6-11, Operations

Committee No. 3-11 [[24878](#)], dated January 14, 2011.

[4] The Institute submitted comment letters to both the SEC and the DOL on the SEC's study. See Memorandum to Pension Members No. 22-12, SEC Rules Members No. 42-12, Small Funds Members No. 15-12 [[26185](#)], dated May 23, 2012 (letter to SEC); Memorandum to Pension Members No. 26-12, SEC Rules Members No. 58-12, Small Funds Members No. 24-12 [[26287](#)], dated July 10, 2012 (letter to DOL).

[5] See Memorandum to Pension Members No.; 6-13, Bank Trust and Retirement Advisory Committee No. 1-13, Broker/Dealer Advisory Committee No. 1-13, Operations Committee No. 2-13, Transfer Agent Advisory Committee No. 5-13 [[26838](#)], dated January 7, 2013.

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