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DALLAS, TEXAS

SIGNIFICANT DEPARTMENT OF LABOR REGULATORY CHANGES

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I. **Broader "Fiduciary" Definition**

The fiduciary standards under ERISA are "the highest known to the law."[1] And unlike securities laws which generally allow you to mitigate conflicts of interest through disclosure, ERISA requires you to either eliminate the conflict or satisfy the strict conditions of a prohibited transaction exemption. Consistent with the Obama Administration's campaign to reduce conflicts of interest in the 401(k) plan industry, on October 21, 2010, the DOL released its proposed regulations to modify the existing regulatory definition of an "investment advice fiduciary." These rules, if adopted, would broaden the existing regulatory definition of "investment advice" under ERISA considerably.

A. Overview of Existing Regulatory Definition

Under the current regulation, a person is deemed to provide fiduciary investment advice if:

(1) such person renders advice to the plan as to the value or advisability of making an investment in securities or other property
(2) on a regular basis,
(3) pursuant to a mutual agreement or understanding (written or otherwise)
(4) that such services will serve as a primary basis for investment decisions, and
(5) that such person will render advice based on the particular needs of the plan.

It should be noted that this 5-factor definition of "investment advice" is much more narrow than the definition under federal securities law. For example, the Investment Advisers Act of 1940 has a rather expansive view of the advisory activity that is subject to regulation as investment advice.

B. Two Specific Changes to Existing Regulatory Definition

The proposed regulations, if adopted, would make two specific changes to the existing definition of "investment advice." Under the existing rule, advisors are deemed to provide investment advice if, among other requirements:

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[1] Donovan v. Bierwirth, 680 F.3d 263 (2d Cir.), cert. denied, 459 U.S. 1069 (1982).

- there is a "mutual" understanding or agreement that the advice will serve as the "primary basis" for plan investment decisions, and

- the advice is provided on a "regular basis."

However, under the DOL's proposed rulemaking, an advisor is deemed to provide investment advice if there is any understanding or agreement that the advice "may be considered" in connection with a plan investment decision, regardless of whether it is provided on a regular basis. Under both the existing and the proposed rules, advice will constitute "investment advice" only if it is individualized advice for the particular plan client.

C. Safe Harbor for Avoiding Fiduciary Status

In addition to broadening the existing "investment advice" definition, the proposal effectively introduces a safe harbor that advisors would need to follow to avoid fiduciary status.

Generally, to avoid being characterized as an investment advice fiduciary under the proposed regulations, an advisor must be able to "demonstrate" that the plan client knows, or reasonably should know, that (a) the advice or recommendations are being made by the advisor in its "capacity as a purchaser or seller" of securities or other property, and (b) the advisor is not undertaking to provide "impartial investment advice." The proposal generally does not specifically require a written disclosure to be provided to the plan client, but the proposal clearly contemplates and encourages written disclaimers.

D. Two Specific Activities Exempted Under Safe Harbor

The proposed rules further state that investment education within the meaning of the DOL's longstanding guidance on non-fiduciary education, as provided under Interpretive Bulletin 96-1, shall not constitute investment advice.

Furthermore, investment advice shall not include a platform provider's marketing or making investment alternatives available to a plan (without regard to individual needs of a plan) or providing general financial information to assist a plan fiduciary's selection or monitoring of such investment alternatives, so long as the platform provider discloses in writing that it is not providing impartial investment advice.

E. Potential Impact on Financial Advisors

If the proposed regulations were finalized in their current form, brokers currently advising 401(k) plan sponsors and participants in a non-fiduciary capacity would undoubtedly need to change their service model and re-define their role as plan advisors. To avoid fiduciary status, they would effectively be forced to furnish written disclaimers to plan clients, stating that they are not providing impartial advice, as contemplated under the proposed DOL guidance.

If they failed to provide any disclaimer, a broker could be viewed as an "investment advice fiduciary" and any variable compensation, such as 12b-1 fees, received by the broker would trigger a non-exempt prohibited transaction under ERISA. The penalties for a prohibited transaction generally include a right of rescission by the plan client, a "first tier" 15%-per-year excise tax and a "second tier" 100% excise tax, and a 20% civil penalty on any amounts recovered through DOL action.

Alternatively, a broker serving as a plan fiduciary could avoid these penalties by becoming a dual-registered investment adviser. This action would enable it to charge an asset-based fee (such as a wrap-fee), eliminating the problems associated with variable compensation.

F. Potential Impact on Other Providers

The proposed regulations, by their terms, would impact platform providers directly. To comply with the proposed safe harbor, they would need to disclose in writing that they are not providing impartial investment advice. This may have a substantial impact on platform providers that deliver advisory services regarding the selection of plan investment alternatives, especially those delivering such services in exchange for any type of direct or indirect compensation. Like brokers, platform providers offering advisory services could provide non-conflicted advice by adopting an asset-based fee, although this change would similarly require the provider to become registered as an investment adviser.

Similarly, TPAs that also provide advisory services in exchange for variable compensation would need to either provide the required disclaimers, or register as investment advisers in order to provide their advisory services for a level fee in a non-conflicted manner.

G. Outlook for DOL Proposed Regulations

This regulatory proposal is consistent with the Administration's aim to reduce conflicts in the 401(k) plan industry, and it aims to impose ERISA's fiduciary standards on a large segment of financial professionals who do not currently hold themselves out as fiduciaries. If adopted, the proposed regulations would force them to adopt fee-leveling, change the nature of their services so that they are not viewed as providing fiduciary advice, or otherwise eliminate any perceived conflicts of interest. Given the significance of the DOL's rulemaking, the proposed regulations are expected to draw heavy comments. Written comments on the proposed regulations may be submitted to the DOL on or before February 3, 2011. Due to the considerable interest expressed by various segments of the employee benefits and financial services communities, the DOL is also holding a public hearing on March 1, 2011.

H. New Fiduciary Standard for Brokers Under The Dodd-Frank Act.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which was enacted on July 21, 2010, is expected to impact the standard of conduct of those financial advisors who provide their services as registered representatives of broker-dealers. Although these rules under the Dodd-Frank Act are unrelated to the DOL's regulatory initiative to broaden the "fiduciary" definition under ERISA, they are expected to impact the standard of care that brokers must adhere to when advising their clients, including retirement plan clients.

Under the powers conferred by the Dodd-Frank Act, the U.S. Securities and Exchange Commission (the "SEC") is authorized to issue regulations that will impose on broker-dealers the same fiduciary standard that applies to investment advisers under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). Under the Advisers Act, investment advisers have a fiduciary duty to act solely in the best interests of the client and to make full and fair disclosures of all material facts, including conflicts-related disclosures. However, under current law, brokers are generally only subject to a duty of "suitability," which requires the broker to recommend investments that are suitable for the specific investor. The recommended investment does not have to be in the best interests of the client. Many brokers who advise plan clients do so in a non-fiduciary capacity, so they are not subject to ERISA's fiduciary standards under current DOL regulations. Thus, non-fiduciary advisors are allowed to make recommendations which are conflicted, skewed to investments that generate higher fees, without any restriction under ERISA or the Advisers Act.

As required under the Dodd-Frank Act, on January 21, 2011, the SEC's staff published its study on the different standards of conduct that currently apply to broker-dealers and investment advisers. In sum, the SEC staff's report recommended that the SEC consider rulemakings consistent with the authority already granted to the SEC under the Dodd-Frank Act, to create a uniform fiduciary standard that would apply to both brokers and investment advisers when they provide personalized investment advice to retail customers. The report did not provide any guidance on the extent to which plan clients would be viewed as retail customers. Of the 5 commissioners serving on the SEC, the 2 Republican appointees released a separate statement, criticizing the report and making the following points: (i) the SEC staff's report does not reflect the views of the SEC or its individual commissioners, (ii) the report failed to properly evaluate the existing standards of care applicable to broker-dealers and investment advisers as required by the Dodd-Frank Act, and (iii) additional study, rooted in economics and data, is required to support any recommendation for a uniform fiduciary standard.

No Congressional approval is necessary for the SEC to proceed with its rulemaking, and it is somewhat unclear if the SEC staff will conduct any type of follow-up study. Depending on how the SEC decides to exercise its rulemaking authority under the Dodd-Frank Act, brokers who advise plan clients and participants may be significantly impacted and may be subject to new conflicts-related disclosure requirements. These changes would be in addition to any future regulatory changes imposed by the DOL concerning when and how a broker could be viewed as providing fiduciary "investment advice" for ERISA purposes.

II. Fee Disclosures to Participants

On October 14, 2010, the DOL finalized its regulations concerning the fee and investment-related disclosures that must be provided to participants in 401(k) plans and other defined contribution plans with participant-directed investments. The final regulations are generally consistent with the DOL's 2008 proposed rules, reflecting modest changes based on comments received by the agency.

In its press release announcing the issuance of these final rules, the DOL explained that existing law did not require plans to provider workers with "the information they need to make informed investment decisions regarding the investment of their retirement savings," such as fee and expense information. However, the new rules would enable the estimated 72 million affected participants "to meaningfully compare the investment options under their plans."

A. Types of Plans Covered

The new participant disclosure requirements only apply to participant-directed individual account plans, such as 401(k) plans, and they do not apply to defined contribution plans with employer-directed investments.

Many participant-directed plans are designed to comply with the requirements of ERISA Section 404(c), a provision which relieves plan sponsors of any fiduciary responsibility for the investment allocation decisions of individual participants. However, the new participant disclosure requirements cover all participant-directed plans, even if they are not designed to comply with ERISA Section 404(c). The fiduciary obligation to provide the mandatory disclosures is generally imposed on the plan sponsor.

B. Coverage of Participants

The new disclosure requirement applies to all eligible employees, and not merely participants who have actually enrolled in the plan. Thus, the entire eligible employee population will need to receive the relevant disclosures on an ongoing basis. The required disclosures include both plan-related information and investment-related information.

C. Annual and Quarterly Disclosure of Plan-Related Information

Under the DOL's final regulations, participants must be furnished general information about the plan annually, including an explanation of how participants may give investment allocation instructions and information concerning the plan's investment menu. Plan participants must also receive an annual explanation of the *general administrative service fees* which may be charged against their accounts as well as any *individual expenses* charged for individualized services (*e.g.*, plan loan processing fee). With respect to new participants, this information must be provided before they can first direct investments under the plan.

Participants must also receive certain information on a quarterly basis. They must receive statements that include the quarterly dollar amounts actually charged to their plan accounts as general administrative service fees and as individual expenses, as well as a description of the relevant services.

The annual and quarterly fee disclosures for general administrative services and individual expenses only apply to the extent such fees are not already reflected in the total annual operating expenses of the plan's investments. For example, if a service provider is wholly compensated through indirect compensation flowing from a plan's investment funds (*i.e.*, the provider's fees are already reflected in each fund's per-share market value or "NAV"), the provider's fees and services would not be subject to these annual and quarterly fee disclosures. However, if any portion of the fees for general administrative services are paid from the total annual operating expenses of any of the plan's investments (*e.g.*, through revenue sharing or 12b-1 fees), an explanation of this fact must be included in the quarterly statements.

D. <u>Annual Disclosure of Investment-Related Information</u>

Plan participants must receive certain fee and performance-related information relating to the plan's various investment alternatives in a comparative format, for which the DOL has created a "model comparative chart." This information must be provided on or before the date on which a participant can direct investments, and annually thereafter.

The comparative information which must be provided includes: (a) the name and type of investment option, (b) investment performance data, (c) benchmark performance data, (d) fee information, including both the *total annual operating expenses* of each investment alternative and any *shareholder-type fees* which are not reflected in the total annual operating expenses, such as commissions and account fees, and (e) the internet website address at which additional information is available.

E. <u>Information That Must Be Available Upon Request</u>

Upon request, participants must be provided copies of fund prospectuses (or other corresponding documents) as well as any shareholder reports and related financial statements provided to the plan.

F. <u>Form of Disclosure</u>

The annual disclosures required under the DOL's regulations may be provided separately or as part of the plan's summary plan description ("SPD") or participant benefit statements. The required quarterly statements may also be provided separately or as part of the plan's participant benefit statements. All disclosures must be written in a manner calculated to be understood by the average participant.

G. <u>Impact on Plan Sponsor's Other Fiduciary Duties</u>

As expressly provided in the new DOL regulations, a plan sponsor's compliance with the new disclosure rules will not relieve it of its fiduciary duty to prudently select and monitor the plan's providers and investments.

The new regulations modify the DOL's existing regulations under ERISA Section 404(c). As discussed above, a plan sponsor can be relieved of any responsibility over the investment allocation decisions of individual participants, provided that the regulatory conditions under Section 404(c) are satisfied. To comply with the applicable investment-disclosure requirements under the 404(c) regulations, as modified by the DOL's new rules, participants simply need to receive the annual and quarterly disclosures required under the new regulations.

H. Effective Date

Although the DOL's participant disclosure regulations have been finalized, they have a delayed application date. The new disclosure requirements will be imposed on plan sponsors for plan years beginning on or after November 1, 2011. In the case of calendar year plans, they will go into effect on January 1, 2012.

I. Potential Impact on Administrative Service Providers

The new regulations will clearly have the greatest impact on third party administrators ("TPAs") and bundled service providers. Given the fact that the DOL's final regulations are generally consistent with its 2008 proposed rulemaking, providers that have already modified their systems based on the DOL's proposed rules are likely to require modest changes only.

There will be one administrative advantage under the new participant disclosure regime. Under existing 404(c) regulations, participants generally must receive a copy of a fund's prospectus prior to the participant's initial investment in such fund. As a practical matter, this burdensome requirement forced recordkeepers to deliver copies of all the plan's fund prospectuses to all new participants. However, as modified by the new rules, prospectuses will only need to be provided upon request by a participant.

J. Potential Impact on Financial Advisors

Under the new regulations, there is no special disclosure requirement for the fees and services of brokers receiving indirect compensation only (*e.g.*, 12b-1 fees and other types of revenue sharing payments). If the broker's compensation is fully reflected in the total annual operating expenses of the plan's investments, the annual and quarterly fee disclosures of plan-related information, as discussed above, would not apply. To the extent the broker's advisory services were deemed general administrative services, an explanation that a portion of the fees for such services were being paid from the total annual operating expenses of the plan's investments would have to be included in the quarterly statements. However, whether a broker's advisory services should be characterized as general administrative services is somewhat unclear under the new regulations.

With respect to registered investment advisers ("RIAs"), it is similarly unclear if a RIA's separate advisory fee (unrelated to the total annual operating expenses of the plan's investments) should be characterized as a general administrative service fee or a shareholder-type fee. If the advisory fee is deemed to be a general administrative service fee, it would need to be reflected in both the annual and quarterly disclosures, although the RIA's advisory fee would not have to be separately itemized. If the RIA's advisory fee can be categorized as a shareholder-type fee, they presumably would not have to be reflected in the quarterly disclosures as a general administrative service fee.

Even if the impact of the new regulations on many financial advisors will be indirect, it is likely to be significant. Given the detailed level and comparative nature of the disclosures that will be provided to participants, many will scrutinize their respective plan's investments and fees. The enhanced disclosures may also prompt them to pressure plan sponsors, asking "hard" questions about the performance of the plan's investments as well as the size of plan fees. This pressure is likely to reinforce the heightened scrutiny of 401(k) fees that is already being applied in the retirement plan market.

III. Default Investments: Target Date Funds

A. Performance Issues Concerning Target Date Funds. Target date funds are popular default investment vehicles for 401(k) plans. As a legal matter, these investment products are typically established as mutual funds (*i.e.*, open-end investment companies registered under the Investment Company Act of 1940), although these products can also be formed as bank collective funds and other pooled investment vehicles. Target date funds are a type of balanced fund, with investments in a mix of asset classes. They are designed to provide a convenient investment solution for individual investors who do not want to be burdened with the responsibility of finding the right mix of assets for their retirement investments. The defining characteristic of a target date fund is its "glide path," which determines the overall asset mix of the fund over time. The fund's asset allocation automatically becomes more conservative (i.e., higher allocation to fixed income investments and lower allocation to equity investments) as the fund gets closer to its target date.

Despite the immense popularity of these financial products, Congress and regulators have voiced deep concerns regarding the design of target date funds, especially funds with near-term target dates. The average investment loss for funds with a target date of 2010 was roughly -25% due to the market turmoil in 2008, with individual fund losses running as high as -41%, according to an analysis by the SEC.[2]

B. Administration's Proposals for Target Date Funds.

1. Retirement Policy Objectives.

In light of the surprising level of volatility across a number of target date funds intended for the oldest of retirees, the Obama Administration now seeks to improve the

[2] Based on SEC staff analysis of data as of October 14, 2009, as presented in the testimony of Mr. Andrew J. Donohue, Director, SEC Division of Investment Management, before the United States Senate Special Committee on Aging on October 28, 2009.

"transparency of target date and other default retirement investments."[3] Specifically, the Administration aims to require "clear disclosure regarding target-date funds, which automatically shift assets among a mix of stocks, bonds, and other investment over the course of an individual's lifetime. Due to their rapidly growing popularity, these funds should be closely reviewed to help ensure that employers that offer them as part of 401(k) plans can better evaluate their suitability for their workforce and that workers have access to good choices in saving for retirement and receive clear disclosures about the risk of loss."[4]

2. SEC and DOL Comments at Senate Hearing.

The Administration's announcement is consistent with comments made by senior representatives of both the U.S. Securities and Exchange Commission and the DOL at a hearing before the Senate Special Committee on Aging on October 28, 2009.[5] At this hearing, the Director of the SEC's Division of Investment Management reported that it was focusing on the regulation of target date funds, with a view towards making recommendations in 2 areas: (1) fund names (e.g., use of a target year in the name of the fund), and (2) fund sales materials. The Assistant Secretary of Labor of EBSA reported that the DOL was re-examining its regulations for "qualified default investment alternatives" (QDIAs) to ensure meaningful disclosure is provided to participants and that it was also considering more specific guidelines for selecting and monitoring target date funds as a default investment and as an investment option. Both agency representatives acknowledged that additional rules were necessary to protect plan participants, and both agencies appear to favor enhanced disclosure with respect to target date funds.

3. SEC / DOL Co-Publish Investor Bulletin on Target Date Funds.

On May 6, 2010, the DOL and the SEC issued joint guidance on target date funds entitled, "Investor Bulletin: Target Date Retirement Funds," proving basic guidance concerning the features of target date funds, and the ways to evaluate a target date retirement fund that will help increase awareness of both the value and risks associated with these types of investments. As announced in its Regulatory Agenda and as recently confirmed by Assistant Secretary Borzi, the DOL will also be issuing a "best practices" fiduciary checklist later this year, which is designed to assist small and medium-sized plan sponsors evaluate and select target date funds

[3] *Budget of the U.S. Government, Fiscal Year 2011*, Office of Management and Budget.
[4] *Annual Report of the White House Task Force on the Middle Class*, February 2010.
[5] Testimony Concerning Target Date Funds by Andrew J. Donohue, Director, Division of Investment Management, U.S. Securities and Exchange Commission, Before the United States Senate Special Committee on Aging, October 28, 2009; Testimony of Phyllis C Borzi, Assistant Secretary of Labor, Employee Benefits Security Administration Before the Special Committee on Aging, United States Senate, October 28, 2009.

4. SEC Proposal to Change Advertising Rules for Target Date Funds.

The SEC voted unanimously on June 16, 2010, to propose rule amendments requiring target date funds to clarify the meaning of the date in a target date fund's name and to enhance the information provided in advertisements to investors. Under the proposed rules, if adopted, marketing materials for target date funds that include a date in their name would also have to include the fund's expected asset allocation at the target date as a "tag line" immediately adjacent to the fund's name. The newly proposed rule would also require the marketing materials to include a visual depiction, such as a chart or graph, showing a fund's glide path over time. Marketing materials would also have to include a statement of the target date fund's asset allocation at the "landing point" (i.e., when the fund becomes most conservative) and when the fund will reach the landing point. In addition, the marketing materials would need to state that a target date should not be selected solely based on age or anticipated retirement date; that the fund is not a guaranteed investment and that asset allocations may be subject to change without a vote of shareholders

5. DOL Issues Proposed Rules on Target Date Disclosures.

On November 30, 2010, the DOL published its proposed regulations on target date disclosures. The proposed rule would amend its existing QDIA regulations (29 CFR 2550.404c-5) as well as its recently finalized participant-level fee disclosure regulations (29 CFR 2550.404a-5), requiring specificity as to the information that must be disclosed to participants concerning investments in target date funds.

a. Proposed Changes to QDIA Regulations.

Background. The QDIA regulations, which were issued pursuant to the Pension Protection Act of 2006, provide fiduciary relief to sponsors of 401(k)-style plans that feature a default investment choice for participants. If the applicable conditions are satisfied, the plan's automatic investment of a participant's account in a default investment choice (in the absence of actual investment directions from the participant) is deemed to be a participant-directed action. Thus, defaulted participants alone (and not the plan sponsor) are held responsible for the plan's automatic investments. Among other regulatory requirements necessary for the plan sponsor to obtain this relief, the default investment choice must meet the requirements of a QDIA, and the plan sponsor must furnish a QDIA notice to participants explaining the default arrangement.

Proposed Changes for QDIA Notice. Under the DOL's proposal, with respect to any target date fund series selected as the plan's QDIA, the QDIA notice would need to explain how its asset allocation changes over time and when its most conservative asset allocation is reached (*i.e.*, landing point), as well as include an illustration of the fund's glide path. If the name of the target date fund includes a reference to a particular date (*e.g.*, "Retirement 2050 Fund"), the QDIA notice would also need to explain the relevance of the date and the intended age group. If applicable, the QDIA notice would also need to include a disclaimer that the target date fund may lose money near and following retirement.

Although the DOL's proposal focuses on target date disclosures, it also proposes general changes to the QDIA notice requirement that would apply to any type of QDIA (*e.g.*, balanced fund). As proposed, with respect to <u>any default investment choice</u> selected as the plan's QDIA, the QDIA notice would need to describe the investment's objectives and principal strategies, including the types of assets held by the investment choice. The QDIA notice would also need to include historical investment performance and a disclaimer that past performance is not necessarily an indication of how the investment will perform in the future.

b. <u>Proposed Changes to Participant-Level Fee Disclosure Regulations</u>.

<u>*Background*</u>. As discussed above in section II, the DOL recently finalized its participant-level fee disclosure regulations on October 14, 2010. The regulations will require annual and quarterly disclosures of plan-related fee information and annual disclosures of investment-related information to participants, effective with plan years beginning on or after November 1, 2001. The annual investment-related disclosures are required to be provided in the form of a comparative chart.

<u>*Proposed Appendix for Annual Comparative Chart*</u>. Under the DOL's proposed change to its participant-level fee disclosure regulations, the annual comparative chart with investment-related disclosures would need to be supplemented with an appendix that includes additional information about any target date fund series included in the plan's menu of investment options. This appendix would be required, even if the target date fund series is not utilized as the plan's default investment option. The information required in the appendix is substantially similar to the applicable information required under the proposed change to the QDIA notice, as described above (*i.e.*, explanation of glide path and any reference to a particular date in the fund's name, disclaimer regarding investment losses near and following retirement).

c. <u>Informal Follow-Up Guidance</u>. The DOL informally stated during its web chat on January 4, 2011 that a target date fund's prospectus is unlikely to satisfy the proposed requirement for target date disclosures. Thus, once the target date disclosure rules are finalized, plan fiduciaries (or their administrative service providers) will need to develop customized disclosures for target date funds, which are expected to be roughly 2 pages in length. The DOL also informally stated that it does not intend to develop a "model" target date disclosure for a plan's QDIA notice or the appendix to the annual comparative chart.

The comment period for the public to provide feedback on its proposed regulation ended on January 14, 2011, and the DOL has not yet indicated when it is likely to finalize its proposed rule. We anticipate that the DOL will prioritize finalization of the interim final regulations under ERISA Section 408(b)(2) and the participant investment advice regulations, and then pursue finalization of its target date disclosure regulations.

C. Conflicts of Interest in Fund-of-Funds Structure. Target date funds typically have a "fund of funds" tiered investment structure. Instead of investing in portfolio securities directly, the target date fund actually invests in other mutual funds, which in turn invest in portfolio securities. A conflict of interest arises in this fund-of-funds structure because many target date funds invest in affiliated mutual funds.

From a product development perspective, when a fund family creates a target date fund, it naturally has a financial incentive to include as many affiliated underlying funds as possible in the fund-of-funds product, increasing its aggregate compensation through the fees paid to the underlying fund managers. Such compensation would be in addition to any wrap-fee that is charged directly by the manager of the target date fund. In the report prepared by the Senate Special Committee on Aging, it was reported that target date funds have higher expense ratios than the rest of the core portfolio in 401(k) plans.[6] Furthermore, although many target date funds invest in affiliated underlying funds exclusively, the reality is that many fund families do not have "best in class" funds for each and every applicable asset class.

A related conflict arises with respect to the mix of funds that underlie the target date fund. Because equity funds typically pay higher fees than other funds, the fund family has an incentive to design the target date fund so that it has a higher exposure to equity, increasing its aggregate fees at the expense of plan participants and also increasing the product's expected volatility. This conflict arises at the product design stage and persists to the extent the fund manager has the discretion to increase allocations to underlying equity funds. The Senate Special Committee on Aging, as well as the DOL, have observed that target date funds have what appears to be an over-concentration in equity investments. Thus, even in funds with a target date of 2010, underlying equity funds constituted up to 68% of assets, which in turn contributed to recent volatility and investment losses.

Although an investment manager for a target date fund is permitted to invest in affiliated underlying funds under the Company Act, it would not be permitted to manage the target date fund's investment in this conflicted manner if it were actually subject to the fiduciary standards under ERISA.

D. DOL Advisory Opinion 2009-04A (Requested On Behalf of Avatar Associates).

1. Fiduciary Status of Asset Managers. Generally, when a person or firm manages the assets of an ERISA plan, the person or firm becomes a fiduciary with

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[6] *Target Date Retirement Funds: Lack of Clarity Among Structures and Fees Raises Concerns*, Summary of Committee Research, United States Senate Special Committee on Aging (October 2009).

respect to the plan and is subject to the standard of care mandated under ERISA. However, there is a general exception that applies when a plan invests in shares of a mutual fund.

- Under Section 401(b)(1) of ERISA, when a plan invests in a security issued by a registered investment company, "the assets of such plan shall be deemed to include such security but shall not, solely by reason of such investment, be deemed to include any assets of such investment company." Thus, when a plan invests in shares of a mutual fund, the underlying assets of the mutual fund are not deemed to be plan assets.

- Under ERISA Section 3(21)(B), a plan's investment in a registered investment company "shall not by itself cause such investment company or such investment company's investment adviser" to be deemed to be a fiduciary. Accordingly, the mutual fund's investment adviser is generally not deemed to be a fiduciary of the plan investing in such mutual fund.

The combined effect of these rules is to create a carve-out from ERISA's fiduciary rules for mutual fund investment managers. To illustrate its significance, let's assume that a plan sponsor has appointed a professional asset manager to invest a segment of the plan's portfolio in U.S. large cap securities. The appointed asset manager would clearly be a fiduciary subject to ERISA's fiduciary requirements. Similarly, if the plan sponsor decided to invest this segment of the plan's portfolio in a bank collective fund investing in U.S. large cap securities, the bank managing this collective fund would automatically be deemed a plan fiduciary. However, if the plan sponsor were to invest this segment of the plan's portfolio in a U.S. large cap mutual fund, the fund's manager would not be subject to any of ERISA's fiduciary requirements.

2. <u>Are Mutual Fund Managers Ever Subject to ERISA</u>? *The Wagner Law Group* believes that the managers of target date funds can as a matter of law be held responsible for their conduct as ERISA plan fiduciaries in certain instances. Section 3(21)(B) of ERISA provides that a plan's investment in a mutual fund "shall not <u>by itself</u> cause such [fund] or such [fund's] investment adviser or principal underwriter to be deemed to be a fiduciary (emphasis added)." This wording demonstrates that the exception whereby target date fund advisers escape fiduciary status does not apply in all instances and is not absolute.

In the firm's recent request to the DOL on behalf of Avatar Associates, it requested clarification on the scope of this exception as applied to target date funds investing in other affiliated mutual funds. In its response letter, Advisory Opinion 2009-04A, the DOL declined to rule that the investment advisers to such funds should be viewed as fiduciaries to investing plans.

3. Plan Sponsors Are Alone in Fiduciary Responsibility. The implications of the DOL ruling are clear and may be surprising to many plan sponsors. A participant who is defaulted into a QDIA is responsible for his or her passive decision, or "negative" election, to invest in this specific investment option. However, the preamble to the DOL's final regulations on QDIAs states that the plan fiduciary continues to have the obligation to prudently evaluate, select and monitor any investment option that will be made available to the plan's participants, including any option that is used as a default investment for a plan with an automatic enrollment feature. The Assistant Secretary of Labor of EBSA, in her testimony regarding QDIAs before the Senate Special Committee on Aging, stated that "[the plan sponsor] continues to have the obligation to prudently evaluate, select, and monitor any investment option that will be made available to the plan's participants and beneficiaries." In other words, the plan sponsor remains responsible for ensuring that the QDIA, just like any other option in the plan's investment menu, is a prudent investment choice.

Since the managers of target date funds do not have any fiduciary duty under ERISA with respect to the plans investing in them, plan sponsors alone are responsible for the selection and monitoring of target date funds and the construction, management and oversight of their portfolios of underlying funds. Unfortunately many plan sponsors incorrectly believe that they do not need to evaluate the target date fund's underlying investments, and they wrongly assume that fund managers have accepted this responsibility as ERISA fiduciaries on their behalf.

E. Congressional Scrutiny of Target Date Funds.

On December 16, 2009, U.S. Senator Herb Kohl (D-WI), chairman of the Senate Special Committee on Aging, announced his intent to introduce legislation that would require target date fund managers to take on ERISA fiduciary responsibility in order for such funds to be eligible for designation as the plan's QDIA. Senator Kohl was quoted as taking issue with the fact that "[m]any target date funds are composed of hidden underlying funds that can have high fees, low performance, or excessive risk" and concluding that "there is no question that we need greater regulation and transparency of these products." Unlike the Obama Administration's regulatory proposal to improve disclosure with respect to target date funds, Senator Kohl's legislative proposal involves imposing ERISA's fiduciary standards on target date fund managers. Due to the nature of ERISA's prohibited transaction rules, Senator Kohl's proposal would require substantial changes to the current "fund of funds" structure and fee arrangements in many target date fund products.

IV. Establishing A Game Plan for Clients

Given the likelihood that these changes will impact many (if not all) plans, financial advisors should strongly consider developing a "game plan" to help plan clients make sense of these rule changes.

A. Fee Disclosures to Participants

There is a good chance that a significant number of plan participants will be "caught off guard" by the new fee disclosures delivered to them, once the new rules go into effect. Additionally, as a result of the anticipated feedback from participants and their ongoing scrutiny of the plan's fees, plan sponsors may also become more sensitive to the level of the plan's fees. Fortunately, plan sponsors have roughly a year to prepare for the new disclosure regime. For calendar year plans, the DOL's participant disclosure rules will not take effect until January 1, 2012. During this critical interim period, advisors should help plan sponsors prepare for this change. Advisors can discuss the new disclosure rules with the plan's recordkeeper, to determine the extent to which the newly mandated fee disclosures are (or are not) already being provided to participants. The advisor can also meet with participants to discuss the new fee disclosures, and integrate a review of this information into investment education sessions with participants. If the plan sponsor is concerned with the potential reaction and scrutiny from participants, advisors can remind the sponsor that a prudent review of the plan's investments and services is the best defense against fiduciary liability, and that the sponsor can always strengthen its fiduciary review process if it has any concerns.

B. Target Date Disclosures. Although the DOL has not yet finalized its proposal concerning the required disclosures for target date funds, it is clear that there is a concern that participants are not getting the appropriate information and education. As a "best practice," advisors can help provide meaningful information about the plan's target date funds to participants right now. Participants need to focus on the key features of a target date investment, such as its glide path, landing point and its potential volatility. While educating participants about target date funds, advisors should also work with plan sponsors to ensure that they are prudently evaluating the target date fund series in the plan's menu, especially if it is being utilized as a QDIA. In light of the level of investment losses sustained by all types of target date funds in recent years, plan sponsors should pay particular attention to the expected volatility and equity/fixed income mix of target date funds intended for participants who are already in or nearing retirement (e.g., 2015 Retirement Fund).

C. Broader "Fiduciary" Definition. The DOL's proposal to broaden its "investment advice fiduciary" definition is likely to "shake up" the retirement plan industry, forcing many (if not all) retirement plan advisors to provide their services in a fiduciary capacity for a level fee. If the DOL's proposal is adopted in its current form, any advisor that is unwilling to advise plan clients on these terms may, as a practical matter, be forced out of the retirement plan business in its entirety. Given the significance of this anticipated change, financial advisors should evaluate and re-consider their business model for ERISA plan clients, especially those who do not currently hold themselves out as plan fiduciaries.

Recordkeepers are constantly adapting and developing new types of arrangements, and they may be able to offer assistance with the problems associated with variable compensation (which in the case of a fiduciary advisor is prohibited under ERISA's prohibited transaction rules.) For example, working with recordkeeping platforms that are able to offer level payouts may be one possible approach. Advisors can also explore the use of ERISA budget accounts (also known as ERISA fee recapture accounts) as a means for leveling the compensation payable to the advisor. Advisory firms that currently receive variable compensation may also wish to consider providing investment advice to ERISA plans as a dual-registered RIA, which would enable the firm to charge a level asset-based fee. There are no "one size fits all" solutions for all firms, especially since every advisor's service model will need to be fully compliant with both ERISA and securities law. However, financial advisors and advisory firms should strongly consider the potential impact of the DOL's proposal in the near future, and investigate potential and possible solutions in the days ahead.

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