

Message From The Firm

Bruce Ashton and I recently returned from the ASPPA Annual Conference in Washington, D.C. As a part of that trip, we had the opportunity to listen to government speakers and engage in dialogue with a number of government officials.

Based on those speeches and meetings, it appears that 2010 will be an eventful year for changes in government regulation of 401(k) plans. The primary movers of change will be three regulatory packages that the Department of Labor is working on. Those are:

1. Participant investment advice. The Department of Labor has re-written the existing participant investment advice regulation and has sent it to the Office of Management and Budget (OMB) for approval. The "best bet" is that the regulation will be approved by the OMB in December or January and then released as a re-proposed regulation. There will be a short comment period, followed by an issuance of the final regulation.

The impact on plan sponsors is that, once the regulation is effective, there will be greater availability of participant-level investment advice. Undoubtedly, a number of broker-dealers, mutual fund complexes, investment advisers and other financial service firms will put together advisory packages for plans such as yours. I expect that, by the end of 2010, you will be receiving information about those programs.

2. Plan-level disclosure. The DOL is re-writing the so-called 408(b)(2) regulation, which will require that service providers make disclosures to plan sponsors about their services, compensation and conflicts of interest. The DOL has substantially re-written the regulation and plans to complete

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The Plan Sponsor's Ability to Evaluate Conflicts of Interest

*By Fred Reish (FredReish@Reish.com) and
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When making decisions about their retirement plans, plan sponsors have a duty to understand and evaluate conflicts of interest that could impact the plan. In some cases, plan sponsors are prohibited from entering into transactions that

involve conflicts of interest.

Those conflicts fall into two broad categories. The first is where the plan sponsor has a conflict. The second is where a service provider has a conflict of interest.

On the former, a plan sponsor must put the interest of the participants ahead of its own when making decisions about retirement plans. For example, if a bank told a plan sponsor that it would get a lower interest rate on its corporate loans, or a larger extension of credit if the administration of the plan was placed with the bank, the plan sponsor would have a conflict in making that decision. That is because, from a corporate perspective, it would be in the plan sponsor's benefit to get the better loan. However, from a retirement plan perspective, it may or may not be in the best interest of the participants. But, in this case, the plan sponsor cannot avoid the conflict simply based on the

quality of the bank's 401(k) services. That is because ERISA strictly prohibits the plan sponsor from gaining any advantage from its use of plan assets. Even if the arrangement is favorable to the employees, it is strictly prohibited by ERISA.

Some conflicts are not prohibited by law, but even then, a plan sponsor must evaluate the conflict and act in the best interest of the participants.

If you are interested in knowing more about this subject, take a look at our White Paper on conflicts of interest for plan sponsors. It is located at www.reish.com/publications/pdf/whitepprmar09.pdf.

The balance of this article is about the second type of conflicts – those involving service providers.

So that you fully appreciate the legal responsibility, let's look at what the DOL says:

*With regard to the prudent selection of service providers generally, the Department has indicated that a fiduciary should engage in an objective process that is designed to elicit information necessary to assess the provider's qualifications, quality of services offered and reasonableness of fees charged for the service. **The process also***

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Target Date Funds Under Scrutiny



By Fred Reish (FredReish@Reish.com)

The investment losses of target date funds in 2008 has drawn the attention of both the politicians and the regulators. They are particularly concerned about the losses incurred by participants who are close to retirement age, for example, those who are investing in the 2010 fund.

The average losses for 2010 funds in 2008 was approximately 25%, while the 2010 fund of one mutual fund company lost over 40%. Those are staggering losses for participants who were told, in effect, that they were appropriately invested based on their age. The Senate's Special Committee on Aging has recently held hearings on target date funds, the reasons or the losses, the descriptions and communications of the purpose and structure of the funds, and other issues. In June, the Department of Labor and the Securities and Exchange Commission held joint hearings on similar issues.

What is the likely outcome?

While it appears that target date funds will continue to enjoy the status of a qualified default investment alternative (QDIA) and, as a practical matter, will continue to be structured in much the same way, there will be a much greater focus on those funds, including:

- What does the year (for example, 2010) in the name of the fund really mean?
- How does the manager of the target date fund make decisions about the operation of the fund?
- What information should be communicated to plan fiduciaries and participants about the character and risk of their funds?

What does that mean for plan sponsors and the officers who serve as fiduciaries?

- Target date funds are now subject to the same scrutiny as other mutual funds. They must be prudently selected and monitored and, if they are not satisfactory, they must be removed and replaced.
- When engaging in that process, plan sponsors should focus primarily on the funds for their older employees, such as the 2010 fund, 2015 fund and 2020 fund. That is because—surprisingly—the greatest differences in the design of the funds are for older employees. And, in those later years, when account balances are the highest, the funds can produce the greatest gains or the greatest losses.
- Plan sponsors should ask their advisers and providers, at the least, the following two questions:

- Are my target date fund aggressive or conservative when compared to the universe of target date funds?
- Are my target date funds designed for the glide path to end at retirement or does the glide path continue for years beyond that?

Equipped with that information, plan sponsors need to decide whether the design of the target date fund is appropriate for their participants.

As the preceding statement suggests, plan sponsors need to focus on the needs of their participants. For example, a law firm might use aggressive target date funds because, by and large, the employees of a law firm have flexibility to retire earlier, or retire later, depending on the investment performance and size of their 401(k) accounts. However, an employer with a workforce where

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its work by January. It is most likely that it will be issued as a final regulation with a delayed effective date.

The impact on plan sponsors is that they will be receiving considerably more information about services, compensation and conflicts. While the information on services will probably not surprise plan sponsors, the same cannot be said about indirect compensation (or revenue sharing) received by providers and about conflicts of interest. When the regulation is effective and, therefore, the providers have to give that information to plan sponsors, plan sponsors will be expected to read and evaluate those materials. From a practical perspective, plan sponsors should work with 401(k)-focused advisers who can help them through that process.

3. **Participant disclosures.** The DOL is also working on increasing disclosures to participants about investments and expenses, among other things. That regulation appears to be moving together with the 408(b)(2) regulation . . . or perhaps a little behind it. As a result, there is less information available about its status or timing.

Once that regulation is effective, it appears that plan providers will carry the burden of satisfying its requirements. That is, for all except the largest plans, we believe that providers will satisfy the disclosure requirements on behalf of plan sponsors. Nonetheless, plan sponsors need to be aware of the disclosures and should be prepared for questions from their employees about the expenses that are being paid through the plan, among other matters.

So, it looks like 2010 will have a full plate of developments. From our perspective, those developments will probably be disruptive in the short term. However, in the long run, they should increase the transparency of plan expenses, investments and services and, in due course, the knowledge level of plan sponsors and participants.

-Fred Reish

'Tis the Season for Annual Notices!



By Heather Bader-Abrigo (HeatherAbrigo@Reish.com)

Every year, around this time, many plan sponsors have just distributed various notices to employees eligible to participate in the plan, plan participants and beneficiaries. Here, we will focus on the annual QDIA notices and auto-enrollment notices that should have already been handed out no later than December 1, 2009. Our goal is to give you some tips on distributing these notices with less stress!

We begin with the annual QDIA notice. The annual QDIA notice must be handed out to those participants and beneficiaries who have been previously defaulted into the QDIA, and who did not thereafter direct their investments. ERISA §404(c) extends fiduciary relief for decisions to invest plan assets in a QDIA. A QDIA is a type of investment, such as target maturity funds or models (e.g., lifecycle or target date funds), balanced funds or models (including risk-based lifestyle funds) and managed accounts, that

satisfy the requirements for a qualified default investment alternatives (as defined by the Department of Labor "DOL"). The notice must advise those participants that, if they continue to fail to direct the investment of their account they will continue to be invested in the QDIA. The notice must also satisfy the content requirements of DOL Regulation §2550.404c-5. In order to satisfy the content requirement of the DOL Regulation, many plan sponsors will attach a fund fact sheet and incorporate the contents into the notice.

While the DOL requires that the notice set forth the QDIA's expenses, fees and risks, for many, this means attaching the fact fund sheet from the previous year. However, some of that information may have changed. Therefore, don't rely on last year's fund fact sheet. Request a new fund fact sheet and go through it to make sure it has what it needs to comply with the DOL regulation. The last thing you want is an inaccurate QDIA notice which can affect ERISA 404(c) protection.

For those plans which have a qualified automatic enrollment arrangement, each employee who is eligible for the plan must receive a notice that describes the arrangement. Further, the notice must advise the employee that he or she has the right to make different elective deferrals to the plan or not defer at all. The notice should also describe how those contributions will be invested should the participant not provide investment direction.

To avoid automatically enrolling a participant in the plan who later decides they do not want to defer into their account, get this notice to participants as soon as you can. Thus, with more time, you might avoid having to deal with forfeited employer contributions and distributions to participants.

One of the best and last tip that we can provide is to have the annual notices sent via electronic mail, when possible. Both the DOL and Department of Treasury have adopted regulations regarding

electronic notices. If you can satisfy the Regulation, you will be able to reach your participants faster and more economically.

We hope that all of these tips will help in getting the notices out with less stress. If you did not get these notices out timely, please make sure you contact your legal advisor regarding your options. ❖

PLANSPONSOR's 15 Legends of the Retirement Industry

This is our 9th installation of the 15 "Legends." In our future newsletters and bulletins, we will be featuring the other Legends that were selected by PLANSPONSOR. Fred Reish was selected as one of the 15 "Legends of the Retirement Industry." These "Legends" are individuals who have, in the past decade and a half, made a lasting contribution to the nation's retirement security.

Asset management has changed in the last 15 years; possibly, the most dramatic change of all has been on quantitative thinking on the investment process. Quantitative thinking is behind virtually every successful asset management strategy today.

Academics like Bill Sharpe and Harry Markovitz rightfully deserves the credit of these views, but a handful of asset management executives like Tom Leob, Co-founder and Chairman of Mellon Capital, Nick Lopardo at SSgA and Patricia Dunn at BGI, translated these views into investment products.

In the 1970s and 1980s, Leob "led Wells Fargo's pioneering efforts in index fund management, tactical asset allocation, and enhanced equity strategies. He also introduced equity trading strategies that have been widely adopted in the investment management and brokerage communities."

Congratulations to Tom Leob and a handful of his colleagues at Wells Fargo for "first testing the logic" and contributing to today's defined contribution industry.

Target Date Funds

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the employees lack that kind of flexibility (or where there may be large layoffs in a recession) may decide that large investment losses pose a greater threat to its employees than any benefit that would be gained from large investment gains. In other words, those plan sponsors might select a conservative target date line-up.

This is just the beginning of this story. There is much more to come, including reports from those hearings and the possibility of additional regulation and disclosure. ❖

Addressing 403(b) Plan Issues



By Bruce Ashton (BruceAshton@Reish.com)

Though not as well known as 401(k) plans, 403(b) arrangements hold a large portion of American workers' retirement savings.

And while they have largely avoided regulatory scrutiny over the last several decades, the IRS and DOL are increasing their oversight, in part through new guidance – the final 403(b) tax regulations that went into effect this year are the best example – and greater audit activity. This is the first of a two part article addressing issues that private sector 403(b) sponsors need to be concerned about, with some recommendations on how to deal with them.

First, some background: 403(b) plans are the retirement savings vehicle for public educational institutions and 501(c)(3) tax-exempt entities. They must comply in form and operation with provisions of the Internal Revenue Code and the new tax regulations. However, only the plans of certain tax-exempts fall outside the DOL's "safe harbor" rules and become subject to ERISA – *e.g.*, where the employer makes contributions or exercises control over the plan, *e.g.*, by selecting a single investment provider or approving loans, hardship distributions or QDROs.

So what are some of the common issues for ERISA-governed 403(b) plans?

- 1. ERISA Plan – *The Problem:*** Many tax-exempt entity plans fall outside the "safe harbor" rules for avoiding ERISA coverage, but fail

to recognize it. *The Consequences:* ERISA imposes requirements in addition to those under the new tax regulations, including reporting and disclosure rules, fiduciary duties and prohibited transaction restrictions. Failure to comply can impose personal liability and penalties on plan officials. *Recommendation:* Have the plan reviewed by a knowledgeable expert and take immediate corrective action to come into compliance if required.

- 2. Non-Amender – *The Problem:*** The 403(b) regulations require all plans – both ERISA and non-ERISA – to have a written plan by the end of 2009, but it's likely that at least some won't meet the deadline. *The Consequences:* If the plan fails to comply, IRS officials have said, "there is no 403(b) plan" – which means employees lose their tax savings. *Recommendation:* Create a written plan as soon as possible. While there is no current IRS correction program that permits retroactive adoption of a plan, we believe the IRS will adopt one in 2010, though it will require payment of a penalty to use it.
- 3. Governing Documents – *The Problem:*** ERISA plans must contain certain provisions in addition to those required in the tax regulations. ERISA also requires that plans adopt a participant loan policy (if loans are permitted) and a QDRO policy, and an investment policy statement is highly

desirable. *The Consequences:* Failure to have an ERISA-compliant document can expose the employer and plan officials to liability and penalties for breach of fiduciary duty. *Recommendation:* Have the plan document reviewed by a knowledgeable expert to ensure compliance with ERISA requirements if required.

- 4. Deposit of Deferrals – *The Problem:*** ERISA and the tax regulations require employee deferrals to be deposited on a timely basis – as soon as practicable after pay day in the case of ERISA plans. *The Consequences:* Failure to deposit the funds timely requires the plan sponsor to add lost earnings when they are put into the plan and can also cause penalties and potential loss of the tax benefits of a 403(b) plan. Late deposits must be reported on the annual Form 5500 by ERISA plans. *Recommendation:* Set up procedures to deposit the funds timely. For any late deposits, correct the failure immediately and add lost earnings (the DOL has a "calculator" on its website for figuring out how much to deposit). The DOL has a correction program that should be used in some cases, and we anticipate that the IRS will add this to its voluntary correction programs in the future.

403(b) plans haven't become more complicated; they've always been subject to a lot of rules, especially if they are covered by ERISA. Until now, however, the enforcement of those rules has been somewhat lax. That's changing and 403(b) plan sponsors are well-advised to understand how to comply.

In the next issue, we'll discuss additional issues and how to handle them. ❖

New World RFPs



By Fred Reish (FredReish@Reish.com)

Many plan sponsors use the RFP (request for proposal) process to select plan providers and, particularly, recordkeepers.

Generally speaking, the RFP process is the most effective method for determining the proper pricing for the particular plan, as well as the services and features that are available from the provider.

However, in my opinion, almost all RFPs are fundamentally flawed.

That is because, based on the requests that I have seen, they focus on features rather than results.

I believe that an RFP should, at the least, ask for the following information:

1. Based on reasonable assumptions, what is the benefit adequacy ratio (including social security benefits) of the plans that you recordkeep?

The RFP should also request information about the assumptions and methodology for determining benefit adequacy.

2. What is the average participation rate of the plans that you recordkeep?

Average participation rate should be defined as the percentage of eligible employees who are actually deferring into the plan.

3. What is the average deferral rate of the participants who are deferring into plans that you recordkeep?

Average deferral rate would be defined as the deferrals as a percentage of pay of the participating employees.

These questions focus on results and not on features. While features may be attractive, they are not meaningful unless they are effective.

Think about it. What matters more to the success of a plan than those

three results . . . benefit adequacy, participation rates, and deferral rates? Is an attractive website more important? Is the speed with which phone calls are answered more important? What about the redundancy of the databases? All of those features and services are important. However, they are not primary . . . they are secondary to the primary purpose of a 401(k) or 403(b) plan, which is to provide adequate benefits at retirement.

Going forward, why not ask the important questions? If the providers cannot answer those questions, that suggests that they aren't focused on those issues. Do you want to "partner" with someone who is not focused on benefit adequacy, high participation rates, and adequate deferral rates? (To be fair, many providers are just now developing these reports; however, your expectation in the future should be that they will be able to provide that information.)

It is time to re-visit our thinking about the best way to evaluate 401(k) and 403(b) providers. Employee-deferral plans are maturing. They are no longer the bright, shiny coin where excitement about features and services is enough. Instead, they should be measured on results. ♦

Target Date Funds: Testimony by Morningstar

John Rekenhaller, Vice President of Research for Morningstar, recently testified before the U.S. Senate Committee on Aging concerning target date funds.

In his testimony, he stated that, while Morningstar was generally supportive of target date funds, they had at least five concerns. Those concerns included:

1. High expense ratios. A material variation in fees among the target date fund families, ranging from 0.19% to 1.82% . . . that is a range of over 900%.
2. The use of proprietary (in house) funds within the target date family. In his testimony, Rekenhaller raised concerns about single fund families being experts at managing investments in all of the asset classes that should be included in a target date fund. Some providers avoid that problem by using sub-advised funds, where they seek out experienced advisory firms for the particular kinds of investments.

3. Lack of management ownership. Morningstar finds that there is little personal ownership of target date funds by the managers of those funds. That concerns the Morningstar people, because they have found that mutual funds with a high percentage of management ownership tend to perform better.
4. Variation in glide paths among the shorter-dated funds. By "shorter-dated" funds, Rekenhaller is referring to the 2010 funds, 2015 funds and 2020 funds, where there is the greatest variation in the allocations to equities. In other words, 2010 funds vary more to a much greater degree than 2050 funds . . . surprisingly.
5. Lack of transparency. Rekenhaller bemoans the fact that even Morningstar has difficulty with the transparency of target date funds. In his testimony, he states: "In gathering the data for its *Industry Survey*, Morningstar struggled to collect even the basic stock/bond/cash information for some of the

target-date funds. Details such as the allocations between domestic and international stock, or corporate and government bonds, were even harder to obtain. If Morningstar with its market presence and staff of data experts scrambled to learn the characteristics of the industry's target-date funds, then surely the every day employee who seeks to learn more about his default investment faces real difficulties."

Undoubtedly, the current "re-examination" of target date funds is going to produce changes. The testimony of experts, such as Rekenhaller, will accelerate that change and, hopefully, will ensure that the right changes are made.

A copy of the Morningstar testimony is being distributed together with this newsletter. A copy can also be obtained from our law firm website at www.reish.com/publications/pdf/rekenhaller09.pdf.

Plan sponsors should consider these issues in selecting and monitoring their target date funds.

SEC Focus on Investments for Retirees and Participants

There is an increased focus by the Securities and Exchange Commission on fraud and abusive investment practices by people who sell investments to 401(k) participants and retirees. In an October 22, 2009 speech, Mary L. Schapiro, Chair of the SEC, said the following:

Retirement Investments

Enforcement activity alone will not fully restore investor confidence. Curtailing fraud is critical but just as critical is curtailing industry practices that do not put the interests of investors first. This is particularly important as an ever increasing percentage of America's workers are relying on their own investment decisions to fund their retirements.

The statistics bear this out. During the three decades between 1975 and 2005, the number of active participants in traditional defined benefit plans dropped from 26 million to 21 million. Meanwhile, those who actively participated in defined contribution plans increased five-fold from 11 million to 55 million.

In my view, financial service firms should engage in responsible product development in the retirement market. Barraging investors with retirement products that feature the latest financial gimmick or marketable fad will not ultimately serve investors' interests.

America's future retirees deserve products that they can understand and evaluate. This means that complex fee arrangements or product descriptions should be discarded in favor of simple, clear disclosure.

Our future retirees should have access to products that will help them meet their retirement goals

without imposing inappropriate risks. Products offering enhanced leverage and avant-garde investment techniques may be appealing to those investors that want to speculate. But they are not the type of investment products that belong in the retirement portfolio of the average American seeking to provide for security in retirement.

In addition, extolling the eye-popping results of the short-term performance of certain investment products, without focusing on the long-term implications or risks, can result in disappointed investors and potentially angry plaintiffs—not to mention an SEC prepared to be aggressive in enforcing the investor protection rules.

These types of disclosure, product development and marketing issues surrounding retirement products will be areas of focus in the coming year for those of us at the SEC. The burden imposed on those investing for retirement is significant, especially after the market events of last year and we must be committed to assisting those investing for retirement.

As a word of warning to plan sponsors, be careful about the people to whom you give access to your facilities and employees. If they are giving investment advice on your 401(k) or 403(b) plans, you have a duty to prudently select and monitor them. Have you fulfilled that duty? What are you doing to monitor? Even if they give advice only on other investments, and don't involve the retirement plan, you may have "endorsed" those salespeople by giving them access—since you didn't give access to other salespeople. While allowing some salespeople onto your premises, but excluding others, you may have implicitly endorsed them to your employees, suggesting that you have properly vetted their credentials

Legislative Proposal for Cross-Testing

Congressman Lloyd Doggett from Texas—who sits on the House Ways and Means Committee—is introducing a legislative proposal entitled the "Retirement Fairness Act." More importantly, the proposal would eliminate cross-testing for benefits or contributions. The concern is the obvious one . . . that cross-testing allows older and higher compensated employees to receive allocations that he asserts are discriminatory.

Unfortunately, it does not appear that the Congressman gave consideration to the incentive that many believe that cross-testing gives to the formation of plans and/or to the rank-and-file contributions that are required for cross-tested plans.

ASPPA has already announced that it will vigorously oppose the proposal.

and practices. Are you prepared to stand behind that?

The message is not that plan sponsors should avoid using advisers to help their employees. Instead, it is that, as with your retirement plans, there is a responsibility to properly manage the situation. From a risk management perspective, if you don't want to do the needed investigation and proper documentation (including disclosures to your employees), then don't give access to those advisers. On the other hand, if you want to help your employees, then be prepared to take charge of the situation, do a proper investigation and impose reasonable requirements on the advisers to provide your employers with full disclosure, including compensation and conflicts of interest.

We have helped employers with these investigations, disclosures and agreements. Where the employer is willing to undertake the task, an advice program could provide a valuable service to the employees. ❖

H1N1 Virus – Balancing Workplace Safety and Employee Rights



By Mark Terman (MarkTerman@Reish.com)

The H1N1 virus threat raises questions for employers who need to provide a safe workplace without violating employee rights under the disability discrimination, privacy and other laws. Upon learning that an employee had the swine flu, one of our professional services firm clients asked for guidance; in particular, whether the employer has an obligation to tell – or not tell – the rest of the employees. We made a number of recommendations.

Rather than debate whether H1N1 infection is a “serious health condition” that triggers employee rights under federal and state disability discrimination law, and whether the pandemic poses a “direct threat” to others in the workplace that can supersede such employee rights, it is often best to approach H1N1 infection as a serious health condition that may be a direct threat. Since employees have privacy rights regarding their medical conditions, employers should treat all such information as a confidential medical record and not identify the individual by name to other employees or supervisors. Instead, the employer can say that “a worker” has been identified. Employers should encourage and, in some instances, require employees to engage in good preventative measures such as hand washing, sneezing and cough etiquette, proper tissue usage and disposal, avoiding close proximity with other workers, and working at other employer facilities or at home. Encourage the affected employee to go home for the benefit of themselves and others. Since employers must take reasonable measures to provide a safe workplace, employers must use good judgment whether to require the employee to go home and work from there, take sick days, or go on a leave of absence. Employers may require a written medical clearance from the

employee’s health care provider before the employee is permitted to return to work.

Soon after this client situation was resolved, the Equal Employment Opportunity Commission issued an interpretive memorandum, “Pandemic Preparedness in the Workplace and the Americans with Disabilities Act” provides guidance that is consistent with our recommendations. The EEOC also highlights that, ordinarily, an employer is prohibited from making further inquiries about an employee’s medical condition, except to determine what essential job functions an employee can and cannot do. However, during a pandemic, employers may make further inquiries, even if disability-related, if justified by a reasonable belief based on objective evidence that the severe form of pandemic influenza poses a direct threat.

The EEOC warns that employers may not, for example, require medical examinations of employees, such as measurement of employee body temperatures, unless the pandemic becomes wide spread in the community as assessed by state or local health authorities or the Centers for Disease Control and Prevention, ask whether employees have any medical condition that could make them more vulnerable to infection, or require employees to receive vaccines.

Find the EEOC guidance at www.eeoc.gov/facts/pandemic_flu.html. Centers for Disease Control and Prevention and California Department of Public Health resources are at www.cdc.gov/H1N1FLU/ and www.cdph.ca.gov. The Society of Human Resource Managers’ toolkit, “Doing Business During an Influenza Pandemic,” is at <http://tinyurl.com/yebufzr>. ❖

Fiduciary Training for Plan Sponsors

In recent months, we have conducted fiduciary training sessions for several 401(k) committees.

In most cases, the responses of the committee members were what we expected. For example, they were generally aware of the issues concerning expenses and revenue sharing, but wanted to know more about how to evaluate those items. As a result, we had good discussions about benchmarking and the services that are available today.

However, we were surprised—at least a little surprised—by the lack of awareness of two major issues.

The first was the need to prudently select and monitor the plan’s target date funds, even if that was the only target date line-up offered by the recordkeeper. On top of that, the committees, by and large, felt ill-equipped to handle that job.

While their advisers had done a commendable job of helping monitor the target date funds, the investment policy statements did not have good guidelines for that process, which suggested that the advisers and committee members had not devoted enough time to thoroughly discuss the issues involved in monitoring target date funds.

The second topic was the importance of thoroughly reviewing the service agreements with plan providers and advisers. For these plans, the relationships between the plan sponsors and the advisers and providers were working out well and there were no problems. Nonetheless, when viewed from the plan sponsor’s perspective, the service agreements contained provisions that attempted to significantly relieve both the providers and the advisers from liability for their mistakes. From our perspective in representing plan sponsors, a fair agreement requires that each person be responsible for the problems that they caused. However, many agreements try to go beyond that by disclaiming liability . . . even where the service provider fails to properly perform their job.

Both of these are significant issues, and we recommend that plan sponsors do a better job of updating their investment policy statements to have meaningful provisions on the selection and monitoring of target date funds and that they thoroughly review the agreements of their service providers with their attorneys.

Conflicts of Interest

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must avoid self dealing, conflicts of interest or other improper influence.

That is a difficult job because, while the provider knows about its conflicts, a plan sponsor may not. So, the starting point is for the plan sponsor to ask the provider to describe, in writing, all materials conflicts of interest that could impact the plan and/or the participants. That will be easier for some providers, but harder for others. For example, registered investment advisers, or RIAs, are required to provide plan sponsors with a Form ADV Part II, or a similar brochure, which discloses conflicts of interest, but other advisors may not have similar disclosure documents.

What are material conflicts of interest? Typically, but not always, a material conflict involves money. For example,

is your adviser receiving money from one of the providers or from the investments? If so, that creates a conflict where the adviser may favor the provider or the investment over the plan and the participants. It doesn't mean that the adviser will make biased decisions (and, in our experience, most do not), but it does mean that there is the potential for a biased decision.

What should you do if a service provider refuses to give you a written description of his material conflicts? The first alternative is to refuse to work with the service provider. Viewed from a legal perspective, the provider is refusing to support you in the fulfillment of your fiduciary responsibilities. You have to ask, is the benefit of working with this particular provider so great that you are willing to take on additional responsibility, and potential risk, in fulfilling your fiduciary duties?

Last year, there was a proposed Department of Labor regulation which

would have required service providers to disclose their material conflicts before entering into an agreement with a plan. Unfortunately, that regulation was held up by the prior Administration. However, the DOL is reworking that regulation as we write this article.

However, for the time being, if your provider refuses to give you the information (but you want to continue to work with that provider), you have a fiduciary duty to investigate in order to determine whether there are any conflicts. Among other things, that means that you need to carefully read all of the materials that the provider gives you—and you should probably have your ERISA attorney review those materials and advise you on potential conflicts as well.

Note: Once the 408(b)(2) regulation is effective, it will require most service providers to disclose their material conflicts of interest. ❖

Around the Firm

Speeches: At the ASPPA Annual Conference at Washington, DC, on November 1-4, **Fred Reish** presented “Co-Fiduciary Responsibility and Ethics” and **Bruce Ashton** presented “Staying Out of Trouble: Prohibited Transaction Case Studies.” On November 7, **Jason Roberts** co-presented “Investment Advice and You a Winning Combination” and “The Next Level: Key Focus Areas for Plan Advisors” at the NRP Annual Conference in Palm Springs. **Mark Terman** chaired the California CPA Education Foundation’s Employment Practices Conference on November 11, at Universal City, and presented a workshop on “Workforce Reduction and Alternatives.”

Quotes: On November 3, **Fred** was quoted in the article “Fred Reish Reviews Fiduciary Issues for 403(b)s,” published on *plansponsor.com*. On various November issues of *InvestmentNews*, **Jason** was quoted in the articles “One way to Break Into the 401(k) Market,” “Labor Department Cracking Down on Broker-Driven Rollovers,” “Labor Department Scraps Investment Advice Rule,” and “Labor Department to Rework Advice Reg.” On the November 19, **Joe Faucher** was quoted in the article “Fiduciary Liabilities: Are You Covered,” published on *cfo.com*.

Articles: In the November issue of the *Plan Sponsor* magazine, **Fred** wrote a column entitled “Directing the Plan.”

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Statement of John Rekenthaler

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Before the U.S. Senate Committee on Aging

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My name is John Rekenthaler. I am Vice President of Research for Morningstar. Thank you for inviting me to speak today before the Senate Committee on Aging.

Morningstar is a leading provider of independent investment research and the largest provider of mutual-fund research in the United States. Recently, Morningstar published a detailed report on target-date mutual funds, creatively titled *Target-Date Series Research Paper: 2009 Industry Survey*. My presentation today contains key findings from that report.

I would like to state upfront that Morningstar is generally supportive of target-date funds. Throughout its history, Morningstar has frequently criticized entire categories of funds for being gimmicky and/or overpriced. We are considerably more positive about target-date funds. We regard target-date funds as being a sound invention that meets a true investor need. By offering broadly diversified portfolios that change over time, target-date funds are a suitable choice for those who wish to delegate their investment decisions. They also are well suited for inactive owners who will not be making trades as they grow older and their situations change.

That said, there are certain concerns, given the extraordinary position that target-date funds now occupy as the default investment of choice for America's New Retirement Model. These concerns include:

- 1) Variation in fees
- 2) The use of proprietary (in-house) funds
- 3) Lack of manager ownership
- 4) Variation in glide paths among the shorter-dated funds
- 5) Lack of transparency

The first concern lies with fees. Overall, annual expense ratios for target-date mutual funds compare favorably with the expense ratios charged by other types of mutual funds. For example, on an asset-weighted basis, that is with the larger funds counting proportionately more in the calculation than the smaller funds, target-date funds have an average annual expense ratio of 0.69%. This is lower than the 0.82% figure for so-called "allocation" funds, which also invest in a broad mix of stocks and bonds.

However, the average conceals a very wide range among the 48 target-date fund families that we track. On the low end, one target-date family has an expense ratio of only 0.19%. On the high end, another has an expense ratio of 1.82% -- more than 9 times higher than the first family. The issue of expenses is particularly important with target-date funds because of their very long time horizons. Several fund families today offer funds with a 2055 date -- 46 years into the future! As the Committee well knows, the power of compounding greatly magnifies small differences over such a long time period.

For example, let's assume two target-date funds that invest in identical underlying assets, returning 7% annually. One fund boasts the industry's low expense ratio of 0.19% and the other has the industry's high expense ratio of 1.82%. Over the 46-year time period mentioned above, an initial investment made in the low-expense fund would become worth more than twice as much as the investment that was made in the high-expense fund. (A lump-sum investment of \$1,000 in the two funds would grow to \$20,708 and \$10,208, respectively.) Few employees who are defaulted into target-date funds through their 401(k) plans

will be aware of the expense differences that exist among funds, and fewer still will understand their very powerful effects.

The second concern is the tendency of target-date funds to invest solely in their own company's underlying funds. No reputable institutional investor would hand over his or her entire portfolio to a single asset-management firm. Instead, the institutional investor sifts among the many investment managers that make up the industry, seeking to purchase the best and lowest-cost options for various slices of the portfolio. One firm gets a portion of the portfolio's large-company stocks, another manages its short-term Treasuries, a third takes control of its emerging-market investments, and so forth. The institutional investor would not expect a single firm to excel at all types of investing. Yet that is implicitly the position taken by most fund families in running their target-date funds. It is difficult to square such a practice as being the best outcome for an investor – although of course from a business perspective, it is understandable that a target-date fund family would like to keep all of the assets collected in-house.

Third, we are worried by the low level of conviction placed by the industry's target-date investment managers in the funds that they run. Morningstar tracks how much money a target-date manager invests in his or her own funds, as this is an item listed in each fund's Statement of Additional Information. After all, target-date funds would seem to be the ideal way for a fund manager to "eat his own cooking" (as the saying goes), given that target-date funds are openly marketed as being suitable for every possible type of investor. Yet only two out of 58 target-date managers whom we track list \$500,000 or more invested in their own funds. Even more strikingly, 33 of the managers, or 57%, show nothing at all.

It is true that there are mitigating circumstances. In some cases, target-date managers can only invest in their funds through 401(k) plans, as those funds are not available in a retail account. In other cases, the managers hold a different version of their fund, one that is not a registered mutual fund but is instead an institutionally priced separate account that is available only for larger 401(k) plans. (However, this does beg another question, as the typical investor will not necessarily be able to avail himself of this lower-cost option.) But the point

remains: Manager ownership is light. Overall in the fund industry, managers who invest heavily in their own funds tend to outperform those who invest less. We would like to see fund managers more enthusiastically embrace target-date funds.

Fourth, there is a great disparity in the “glide paths” – the ratio of stocks to bonds that is held by a target-date series, as it changes over time – among the shorter-dated funds. The longer-dated funds tend to look quite similar. For example, the allocation to stocks for the 2040 funds in Morningstar’s database runs from 80% as a minimum to 95% as a maximum. Absent any mistakes from implementing the asset allocation, those funds will tend to perform fairly similarly. As the target-date series age, however, the funds drift apart. Some fund families focus on longevity risk, that is the risk that the retiree may outlive his or her assets. Therefore, they hold more equities. Other fund families are more concerned about market risk, and wish to minimize volatility by greatly reducing their funds’ stock positions.

As a result, the glide paths for the 2010 funds diverge sharply. At the upper end, two fund families have more than 70% of their 2010 funds’ assets placed in equities. Conversely, three families have fewer than 30% of their 2010 investments in stocks. This divergence in asset allocation resulted in a wide difference in performance during the dramatic 2008 market, when losses in the 2040 category ranged from a modest 9% to a breathtaking 41%. Morningstar’s point is not to praise those families that were positioned most conservatively, nor to condemn those that were hurt by their high equity exposure, but rather to consider the investor’s perspective. An employee defaulted into the first fund would have lost 9% on year, while one defaulted into second fund would lose 41%. Yet each employee would consider herself invested in an identical fund –as both funds carried the same “2010” label and were aimed at employees of exactly the same age. Who knew?

Fifth, transparency about target-date funds’ strategies can and must improve. In gathering the data for its *Industry Survey*, Morningstar struggled to collect even the basic stock/bond/cash information for some of the target-date funds. Details

such as the allocations between domestic and international stocks, or corporate and government bonds, were even harder to obtain. If Morningstar with its market presence and staff of data experts scrambled to learn the characteristics of the industry's target-date funds, then surely the everyday employee who seeks to learn more about his default investment, faces real difficulties.

Finally, we should note the tendency of the fund industry's secondary providers to "swing for the fences" in the attempt to distinguish themselves from the pack. This is a pattern that exists in all segments of the mutual-fund marketplace. The companies that offer a category's biggest funds are quite naturally interested in protecting their market share, and thus are relatively risk-averse when it comes to making investment innovations. The smaller providers, however, have little to lose and much to gain by trying something bold. Over the fund industry's history, such an attitude has led to many fund-industry innovations – but also to the industry's biggest flops.

The tendency of the smaller players to take big chances has been implicitly accepted by the industry, by regulators, and even by fund shareholders. The question is, whether such experimentation is appropriate for a default investment in a company-sponsored retirement plan. Morningstar worries when target-date funds purchase heavily leveraged bond funds that conducted over-the-counter derivative swaps, or when they buy new, opaque, and high-cost funds that use complex investment strategies. It is one thing to experiment in a defined-benefit plan, when the company rather than the employee is on the hook for any failures. It is a second thing to experiment as a retail mutual fund, when the investor actively chooses to buy the fund. But it is a third and altogether different thing to experiment on behalf of a default investor, and it is the default investor who directly bears the risk.

For the most part, Morningstar recommends improved disclosure as the prescription for addressing its five concerns. The principles for improved disclosure include:

- 1) Creating three new, selected data tables that would be used only for target-date funds (thereby acknowledging both the unusual investment

characteristics of target-date funds, and also their position of privilege within employee-sponsored retirement plans)

- a. A fee table comparing the fund's fees against the industry median fee, and the industry's cheapest fees. The table would illustrate the effect of compounding by showing how similar gross returns diverge on an after-cost basis over long time periods.
- b. A table showing the fund's use of proprietary mutual funds, again comparing to the industry median and the industry's lowest use. This would be accompanied by standardized language discussing the pros and cons of target-date funds using proprietary funds.
- c. A glide-path table that compares the fund's glide path against the industry median. In the discussion section, the fund company would be required to mention areas where it differs significantly from the median, and (briefly) the reasons for those differences. (It is fine for target-date families to differ from the consensus – but the investor should know when that is occurring, and understand why.)

- 2) Moving the manager ownership information that is currently contained within the obscure Statement of Additional Information to a position of greater prominence by being placed in the prospectus.

These changes would address all five of the concerns noted at the beginning of my testimony. They would not, however, address the final item of potential risk-taking by the smaller target-date families. That issue must await either a market solution – whereby fund families that disappoint are ruthlessly chased out of the business by a well-informed community of plan sponsors – or a tightened notion of the fiduciary responsibility engendered by target-date providers. But the latter is a subject for another discussion.

In summary, target-date funds are a useful and productive addition to the fund industry, and a clear benefit to employees who have 401(k) plans. They must improve further, however, if they are to fully earn their position of being at the heart of America's retirement future.

