Fund Democracy
Consumer Federation of America

June 18, 2009

The Honorable Hilda Soldis Secretary Department of Labor 200 Constitution Ave., NW Washington, DC 20210	The Honorable Mary Schapiro Chairman Securities and Exchange Commission 100 F St., NE Washington, DC 20549-1090

Re: 4-582 Target Date Joint Hearing

Dear Secretary Soldis and Chairman Schapiro,

We write on behalf of Fund Democracy and the Consumer Federation of America to comment on the regulation of target date funds. The recent decline in the equity markets has exposed improper asset allocations by many target date investment options in retirement and 529 plans. Excessive allocations to equities and other high-risk securities have substantially reduced retirement incomes for many Americans and made college unaffordable for many aspiring students. These improper allocations have been well-publicized, but neither the Commission nor the Department has yet taken steps to ensure that target funds are not used to mislead investors. We applaud your sponsorship of today's hearing on target date funds and hope that it will begin the process of improving investor protection for target date fund investors.

We strongly encourage the Commission and the Department to prohibit the use of misleading names by, respectively, target date mutual funds and target date investment options in retirement plans. Investments that use a date or other name that implies that they are appropriate for someone retiring or starting college in a particular year should be required to invest consistent with the generally accepted asset allocation for such a person. Similarly, the Department should clarify that investment options that are used as target date qualified default investment options – regardless of their name – must be invested consistent with the generally accepted asset allocation for someone the same age or with the same expected retirement date (or other specific factors known to the plan sponsor) as the auto-enrolled worker whose contributions are invested in such an option. Generally accepted asset allocation standards should be based on input from independent financial professionals.

Target Date Fund Asset Allocations

A target date fund allocates assets based on assumptions about when the investor's need for income is expected to change. In the retirement context, the target date is typically the year in which the investor expects to retire and begin to rely on his or her savings for retirement income. In the 529 plan context, the target date is typically the year in which the prospective student expects to matriculate and begin paying college expenses.

According to generally accepted financial principles, a portfolio that is expected to generate income should be allocated to ensure that the amount needed to be withdrawn in the near term is invested in less volatile instruments. For example, a retiring 65-year-old will immediately need income to live on. Conversely, amounts that will not be needed for many years should be allocated so as to minimize the effect of inflation and maximize risk-adjusted returns. The retiring 65-year-old generally should plan for his retirement account to produce income into his nineties. The part of the account that he will need for income during the early part of his retirement should be invested in short-term, low-volatility assets, and an additional substantial component should be in equities to allow for growth and to hedge against the effects of inflation. In contrast, all of an 18-year-old's 529 account should be invested in short-term, low-volatility assets because that account will be spent over the ensuing 4 years.

Many investors have unique characteristics, however, that militate for a non-standard asset allocation. For example, if a 65-year-old on the brink of retirement had $400,000 in taxable, short-term bond and money market funds and $100,000 in his 401(k) plan, he might appropriately choose to have 100% of his 401(k) invested in equities. The resulting overall 80%/20% debt/equity allocation would be fairly conservative, notwithstanding the 100% equity allocation in the 401(k) account. A parent similarly might prefer a high risk 529 plan account for a child who expected to matriculate in one year in light of the parent's overall portfolio, risk tolerance and tax situation. For these reasons, and in consideration of the efficiency benefits of investment allocations made according to free market decisions rather than government mandates, investors should be free to make their own allocation decisions (ideally, with the assistance of an independent investment professional acting as a fiduciary).

But target date funds do not operate in a pure free market context. They operate in a heavily regulated market where investors: rely on a certain level of investor protection, often do not obtain professional advice, and tend to do less research about their investments than they should. Just as investors expect that a "Stock Fund" will invest in stocks, they expect a "Target Date 2010 Fund" to invest consistent with generally accepted asset allocations for persons retiring in 2010. They do not expect that, after having chosen the name "Target Date 2010," a fund manager would not invest consistent with what one would typically expect. Nor would a 64-year-old, 401(k) beneficiary who was automatically enrolled in a target-date qualified default investment alternative *without his approval* expect that 80% of his account would be invested in equities. Nor would the parents of an 18-year-old headed to college expect the 529 plan option recommended for a high school senior to have a substantial equity component. These expectations are especially strong in the context of investments that purport to be a one-size-fits-all arrangement. The argument that these investors should have read the fine print, on the theory that it would have disabused them of their reasonable expectations, is completely detached from the reality of how target-date funds are sold and used.

Misleading Fund Names

The problem of misleading fund names has been with us for far too long. In 1996, Congress granted the SEC specific authorization to prohibit misleading fund names.[1] The SEC promptly proposed a misleading fund names rule in February 1997,[2] but the rule was dropped under industry pressure. Pursuant to a request from consumer advocates in 2000,[3] the SEC finally adopted the misleading fund names rule in 2001. The rule fell far short, however, of providing reasonable assurances that fund names that strongly implied a particular investment objective or style would stick to it. The rule allows "stock" funds to invest 100% of their assets in cash in emergency situations, "short-term bond" funds to risk substantial losses, "value" funds to invest primarily in growth stocks, and "target-date 2010" funds to invest more than 75% of their assets in equities.[4] The SEC has taken the position that no matter how strongly a particular fund name implies a particular investment objective or style, the name's potential to mislead investors can be entirely corrected through narrative disclosure that is often buried in fund documents. The SEC staff went out of its way to reassure fund managers that a fund that included the term "U.S. Government" in its name could nonetheless invest

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[1] *See* Pub. L. No. 104-290, 208, 110 Stat. 3416, 3432 (1996) (amending Investment Company Act Section 5(d)).

[2] *See* Investment Company Names, Investment Company Act Release No. 22530 (Feb. 27, 1997) ("Names Release").

[3] Letters to SEC from: Fund Democracy (June 28, 2000) *available at* http://www.funddemocracy.com/Holdings%20Petition.pdf, and Accompanying Memorandum (June 28, 2000) *available at* http://www.funddemocracy.com/Holdings%20memo.pdf; Financial Planning Association (June 28, 2000) *available at* http://www.funddemocracy.com/fpapetition.pdf; Consumer Federation of America, Arizona Consumers Council, Consumer Action, Consumer Federation of California, Consumer Fraud Watch, Consumers Union, Democratic Processes Center, North Carolina Consumers Council, Pennsylvania Citizens Consumer Council, and Virginia Citizens Consumer Council (Aug. 9, 2000) *available at* http://www.funddemocracy.com/Consumer%20Petition.pdf; National Association of Investors Corporation (Oct. 9, 2000) *available at* http://www.funddemocracy.com/NAIC%20Petition.pdf; AFL-CIO (Dec. 20, 2000) *available at* http://www.funddemocracy.com/AFL-CIO%20Petition.htm; International Brotherhood of Teamsters (Jan. 18, 2001) *available at* http://www.funddemocracy.com/Teamsters%20Petition.htm; *see also* Letter from Fund Democracy to Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises, House Committee on Financial Services (July 2003) (supporting amendment to H.R. 2420 that would prohibit misleading fund names) *available at* http://www.funddemocracy.com/Names%20Amendment%20ltr.pdf; Fund Democracy and Consumer Federation of America, *A Pro-Investor Blueprint for Reform* (Nov. 25, 2003) *available at* http://www.funddemocracy.com/mfblueprint2.pdf.

[4] *See* Josh Charlson, *Morningstar's To-Do List for Target-Date Regulators*, Morningstar.com (June 16, 2009) ("Among 2010 funds, we've seen strategic equity allocations from as low as 21% to as high as 79%.").

100% of its assets in securities issued by Fannie Mae and Freddie Mac.[5] As Professor Bullard testified before the Senate Banking Committee in 2004, the term "U.S. Government" implies that the fund will invest in government-guaranteed securities, which Fannie Mae and Freddie Mac securities are not.

The SEC's position directly contradicts its own characterization of Congress's intent when it granted the SEC specific authority to prohibit misleading fund names. The Commission stated that, "[I]n adopting amended section 35(d), Congress reaffirmed its concern that investors may focus on an investment company's name to determine the company's investments and risks, and recognized that investor protection would be improved by giving the Commission rulemaking authority to address potentially misleading investment company names."[6] Thus, Congress understood that "investors may focus on an investment company's name to determine the company's investments and risks" and that additional regulation was needed in this area. Yet the Commission has steadfastly rejected this view.[7] Indeed, no fund name is more likely to be relied on to determine a fund's investments and risks than a target date fund's name because a target date fund is, by its very nature, designed to offer a simple investment solution for the time-strapped investor.

Moreover, the SEC's disclosure-centric position effectively undermines investors' common law and federal securities law misrepresentation claims by suggesting that prospectus disclosure can be sufficiently cautionary to neutralize the effect of fraudulent fund names. This twisted extension of a kind of "bespeaks caution" approach to mutual fund disclosure fundamentally misunderstands the nature of retail investment products in the 401(k) marketplace and ignores the particular needs of 401(k) beneficiaries. In so doing, it undermines the intent of the federal securities laws, which is to protect investors and improve market efficiency, not strip investors of common law and federal claims and reward fund companies that attract assets through deception.

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[5] Letter from Paul F. Roye, Director, SEC Division of Investment Management, to Craig Tyle, General Counsel, Investment Company Institute (Oct. 17, 2003).

[6] Names Release, *supra* note 2.

[7] *See* Letter from Mary Schapiro, Chairman, Securities and Exchange Commission, to the Honorable Herb Kohl, Chairman, Senate Special Committee on Aging (Mar. 6, 2009) ("Given that there is variation among investment professionals regarding the appropriate allocation of assets as investors age, our review of target date funds has generally focused upon ensuring that prospectuses provide full disclose of the asset allocations in the funds and the corresponding strategies and risks related to these allocations. *By ensuring [that] funds provide full disclosure,* plan fiduciaries and investors are then able to assess the appropriateness of these funds as investment options." (emphasis added)); *but see* Remarks by Mary Schapiro, Chairman, Securities and Exchange Commission before the Mutual Fund Directors Forum Ninth Annual Policy Conference (May 4, 2009) (Commission will "consider whether the use of a particular target date in a fund's name may be misleading or confusing to investors and whether there are additional controls the SEC should impose to govern the use of a target date in a fund's name. As we pursue this analysis, we will have a special focus on the expectations of the millions of everyday Americans who use target date funds to invest for retirement and educational needs."). The regulatory issue is not the "appropriateness of these funds as investment options," but the appropriateness of their use of misleading names.

There is no excuse for permitting funds to use a name such as "Target-Date 2010" that implies the use of a generally accepted asset allocation, only to invest aggressively in equities and other highly volatile asset classes. A specific date in the name of a fund strongly implies an equity/fixed income allocation within an expected, generally accepted range, yet fund managers have used allocations that radically and dangerously depart from the range implied by the name that they chose for the fund. Participants in 401(k) plans who choose target-date funds are likely to be those who want a simple answer to the question of how to invest for retirement, and many are automatically placed in target-date funds as a plan's qualified default investment alternative. The name "Target-Date 2010" says to that investor: "This fund will invest in an appropriate mix of investments for someone retiring around the year 2010." In many cases, this message was a lie, and many investors who believed it experienced substantial losses as a result. The naming of target-date funds provides a textbook example of potentially misleading fund names, and the overly aggressive equity allocation of some of these funds has borne out our concerns.

Some have criticized this position as requiring that the government dictate how funds invest. This argument is a red herring designed to divert attention from the real issue. The only restriction that would apply would be to the ***names that funds are permitted to use***. The new rule would have no effect on any fund that chose a name that did not imply a particular investment objective or style. We strongly agree that, within reasonable restrictions reflected in the current law, free markets should determine what mutual funds invest in, not regulators. Requiring that ***all*** mutual funds invest only in a portfolio the returns of which will fall within a fairly predictable range would be inefficient, impracticable and inconsistent with basic principles of individual liberty. There are and should be mutual funds the variance of whose investment returns essentially match the scope of the fund manager's investment discretion.

Requiring that a fund that uses a particular name produce predictably variable returns, however, does not implicate these concerns. When Magellan Fund manager Jeff Vinik invested a large amount of the Fund's assets in fixed income securities prior to a run-up in the stock market in the late 1990s, the opportunity lost by its shareholders was a risk that they knowingly assumed. There is nothing about the name "Magellan Fund" that implies that its investment returns will reflect the variance that is characteristic of a particular market. Indeed, the name "Magellan" aptly suits a fund that may explore any and all investment opportunities around the globe. In contrast, it is misleading that a so-named "stock" fund can, consistent with its name, invest 100% of its assets in cash, or that something called a "short-term bond" fund could lose 40% of its value in a single year.

Fund managers actually have a financial incentive to over-allocate target date fund assets to equities, as illustrated in the following example. The Transition 2010 Fund's target equity allocation as of mid-2008 was 65 percent, with an additional 5 percent allocated to a commodity fund "designed for aggressive investors seeking total return over the long term." In contrast, the average target equity allocation for all target-date 2010 funds was 45 percent as of the end of 2008.[8] All of the assets of the Transition 2010 Fund are invested in affiliated underlying funds managed by the same manager, and all of them are higher-priced, actively managed funds.[9] The expense ratio of the Transition 2010 Fund's Class Y shares (the share class that a plan would purchase) is 1.25 percent, which includes expenses of 0.59 percent charged by the underlying affiliated funds. The expense ratios of the underlying funds are as follows:[10]

Equity & Commodity		Fixed Income	
Capital Appreciation	0.69%	International Bond	0.54%
Main Street	0.49%	Core Bond	0.49%
Value	0.54%	Champion Income	0.64%
MidCap	0.84%	U.S. Government	0.64%
Small- & MidCap Value	0.76%		
Global	0.70%		
Main Street Opportunity	0.69%		
Commodity Strategy Total Return	0.86%		
Average:	0.70%	Average:	0.58%

As indicated in this table, the average expense ratio for the underlying equity and commodity funds is 0.70%, which is 0.12 percentage points higher than the average expense ratio for the fixed income funds. Although the profitability of a particular fund depends on a variety of factors, equity funds generally are more profitable than bond funds, all other factors being equal. Thus, the manager of the Transition 2010 Fund may have a financial incentive to allocate a higher percentage of assets to its more profitable equity funds, which is precisely what the manager has done in this case. The 70 percent equity/commodity allocation is 78 percent higher than the average 45 percent equity allocation for all 2010 funds. Perhaps this difference reflects the fund manager's sincere

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[8] This figure is based on a search by Craig Israelsen of Target Date Analytics using the Morningstar Principia database as of December 31, 2008, of all funds with a 2010 target date. The figure reflects the simple average of the actual percentage of equity holdings of the funds as of December 31, 2008. Dr. Israelsen is a professor at Brigham Young University in Provo, Utah.

[9] It is unclear how an employer could fulfill its fiduciary duty in selecting plan investments without offering passively managed options. Under any reasonable understanding of a fiduciary standard, requiring that plan participants assume active management risk, not to mention the burden of higher fees, violates an employer's fiduciary duty to the plan and its participants. *See DiFelice v. U.S. Airways, Inc.*, 497 F.3d 410, 418 (4th Cir. 2007)(404(c) safe harbor "does not apply to a fiduciary's decisions to select and maintain certain investment options within a participant-driven 401(k) plan;" citing Department sources); *see also* Kenneth French, *The Cost of Active Investing* (Apr. 12, 2008) (estimating annual cost of active management to be 0.67%); Ross Miller, *Measuring the True Cost of Active Management by Mutual Funds* (Aug. 2005)(finding that actively managed funds' "active expense ratios" are more than six times higher than their published expense ratios of 1.15%).

[10] All of the expense ratios, including the 1.25 percent expense ratio for the 2010 Fund, reflect fees after a fee waiver. If the fund manager were to eliminate the waiver, the expense ratios would be higher. All of the expense ratios are based on Class Y shares.

view that a 64-year-old on the brink of retirement should have an aggressive, 70 percent equity/commodity allocation.[11] It would be practicably impossible to prove otherwise without a "smoking gun" document stating that the purpose of the allocation was, in fact, to increase the manager's profits. Nonetheless, that may be the conflicted manager's actual goal.

Fund managers also have an incentive to use an overly aggressive allocation to gain an unfair competitive advantage by creating a false impression of superior investment performance. Fund sponsors design and manage funds that will compete effectively with their competitors. As Morningstar's Don Phillips has often said, many funds outperform their fund categories by investing outside of their categories. When markets are rising, a target date 2010 fund that invests an inappropriately high percentage of its assets in equities will outperform its peers simply by making such a misleading asset allocation. No skill is involved, only heightened and hidden risk-taking. Permitting such funds to use a name such as "Target Date 2010" effectively enables this fraudulent practice.

In summary, fund managers have used names for target date funds that are inconsistent with the funds' asset allocations. They know that a particular name will create an expectation that the fund's assets will be allocated within a generally accepted range. They may have an economic incentive, however, to invest in an overly aggressive allocation that in many instances has cost investors dearly. The SEC should issue an interpretive position that that funds that use a name that suggests a particular target date, age, or year of matriculation must allocate their assets and otherwise operate consistent with a generally accepted portfolio for someone retiring or starting college in that year. The Commission should enlist the assistance of independent experts, such as the CFP Board, to recommend appropriate allocation ranges and update those recommendations on an annual basis.

The foregoing discussion of misleading fund names applies even more strongly to target date investment options in retirement plans. In that context, the employee is even more likely to rely on the name of the option because it has been specifically approved as an investment option by the plan sponsor. The Department therefore has an even greater obligation to ensure that plan sponsors and beneficiaries are not victimized by misleading investment option names and to impose the requirements described above on all target date investment options used in self-directed retirement plans.

529 Plans

The losses experienced by certain 529 plan investment options are even more a reflection of misleading information than in the retirement target date context. Whereas

[11] Overly aggressive equity allocations in target-date funds were fully discussed at last month's Senate Special Committee on Aging hearing: *Boomer Bust? Securing Retirement in a Volatile Economy*. The written and oral statements and testimony for this hearing are *available at* http://aging.senate.gov/hearing_detail.cfm?id=309027&.

there is a reasonable range of asset allocations that would be consistent with a 65-year-old's general expectations, no such range exists, for example, in the case of the parents of a 17- year-old who will begin to pay tuition only one year from the date of the investment. The parents would reasonably expect little or no loss of principal, yet many such parents have now been left unable to pay for their children's college education because of misleading practices of mutual fund managers and regulators' failure to enforce investor protection rules. Chairman Schapiro has stated that, in comparison with a target date retirement fund, "[a] target date fund underlying a college investment or so-called 529 plan, on the other hand, would need to more closely track its target date since it is far more likely that investors would need access to their investment at or near the fund's target date."[12] A number of 529 plans designed for 17- and 18-year-olds had more than 35% of their assets invested in equities.[13]

In addition, a 529 plan is offered by a government entity and accordingly comes with the express imprimatur of government approval. It is difficult to imagine an investment product where investors would be more likely to let down their guard and accept superficial representations about a fund's asset allocation as truthful. As with 401(k) plans, these investors do not even have a private prospectus claim under the federal securities laws against the funds. We are encouraged that the Commission's review of misleading target date fund names will include 529 plans and hope that equal measures of protection will be available to investors in both. The Commission should take steps to ensure that FINRA prohibits brokers (the plans themselves are beyond the SEC's jurisdiction) from selling 529 plans that designate investment options as age-appropriate unless the options invest consistent with generally accepted asset allocation principles for someone starting college on the target date. These allocations should be based on input from financial professionals, as discussed above.

Target Date Qualified Default Investment Alternatives

In 2007, the Department adopted regulations regarding the use of qualified default investment alternatives ("QDIAs") in 401(k) plans. An employer is allowed to enroll an employee automatically in a retirement plan only if the employee's account is invested in a QDIA and the employee has not provided any investment direction as to the account. A QDIA therefore is an investment that, by definition, has not been selected by the beneficial owner. The fact that the employee had access to a fund prospectus that described the fund's asset allocation is not an issue. The employee could not have made an informed investment decision because the employee has made no investment decision at all.

[12] In fact, is it just as likely that a retiree would need to access *some* of his or her account at the target date. The difference is that the retiree may need to access the account for income over a number of decades, whereas the entire 529 account must be designed to be able to be liquidated over a few years.

[13] *See* Jane Bryant Quinn, *College-Savings Plans Don't Need to Blow Up*, Bloomberg.com (June 16, 2009) ("no sensible adviser would say that it's safe to gamble on a rising market over any one- to two-year timeframes."); Jason Zweig, *Did Your College Savings Plan Blow Up on You?*, Wall. St. J. (Mar. 20, 2009)("'In some states, the asset allocation for the 16- to 18-year-olds looks as if it was designed by the 5-year-olds.'").

A QDIA is required to be appropriate "as a single investment capable of meeting a worker's long-term retirement savings needs." Four types of QDIA's have been approved, including:

> A product with a mix of investments that takes into account the individual's age or retirement date (an example of such a product could be a life-cycle or targeted-retirement-date fund) ["target date QDIA"].

Thus, a target date QDIA is required to constitute a single investment capable of meeting a worker's long-term retirement savings needs that takes into account the individual's age or retirement date.

If this standard means that a target date QDIA for a 64-year-old retiring in one year could have anywhere from 20% to 80% (or more) of its assets invested in equities, then the standard has no substance. The QDIA must be capable of meeting a worker's long-term retirement needs and reflect his or her age or retirement, but if virtually any level of equity risk would satisfy these requirements, then these requirements have no meaning. These requirements can only have meaning if the concept of a portfolio meeting long-term retirement needs limits the QDIA's asset allocation in some way. Similarly, accounting for a worker's age or retirement date can only have meaning if these factors limit the QDIA's asset allocation in some way.

The very concept of a QDIA necessitates strict substantive standards. A QDIA assumes, in the words of one industry executive, a "one size fits most" strategy, yet some target date funds would provide a suitable fit for *very few* workers who plan to retire in or around the target year. As noted above, some target date 2010 funds have invested as much as 70% of their assets in equities. We believe that it can never be appropriate for workers near retirement to have 70 percent of their retirement assets invested in equities ***without their having made a fully informed, conscious decision to do so.*** An investor in a QDIA, by definition, has not made any investment decision at all.

The Department should clarify that a target date QDIA must invest its assets consistent with the generally accepted asset allocation for someone at the same age or with the same expected retirement date as the employee who is defaulted into it. These allocations should be based on input from financial professionals, as discussed above. If an employer bases its evaluation on other relevant factors that it knows about auto-enrolled employees, then the target date QDIA may be designed to reflect those as well. Retirement plan beneficiaries should not have their retirement accounts subjected to abnormally high risk without their having made an informed decision to pursue such an investment strategy.

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The misallocation of assets in target date funds has had painful consequences for many investors. Many of them have had to lower their standard of living in retirement or to delay their retirement altogether. Others have had to delay or abandon dreams of sending their children to college. This has not been the inevitable result of the stock market decline or irresponsible investment decisions. It has been the result of misleading fund names and inappropriately diversified retirement and 529 plan investment options. We hope that you will move quickly to adopt the reforms

that we have proposed, which require minimal action of the part of the Commission and the Department. Thank you for your consideration of our comments.

Sincerely,

Mercer Bullard
President & Founder
Fund Democracy

Barbara Roper
Director of Investor Protection
Consumer Federation of America

cc: Richard Ketchum, Chairman and CEO, FINRA