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SEC Proposes New Advertising Disclosure Requirements for Target-Date Funds

BY THE INVESTMENT MANAGEMENT PRACTICE

Overview

The Securities and Exchange Commission ("SEC") has proposed new advertising and sales literature disclosure requirements for target-date funds.[1] These proposed disclosure requirements are a reaction to concerns relating to shareholder understanding of the risks associated with, and the differences among, target-date funds. These concerns have arisen as the result of the performance of certain target-date funds during the 2008-2009 market downturn.

These enhanced disclosure requirements would require target-date funds that include the target date in their name to disclose, immediately adjacent to the fund's name, the fund's asset allocation at the target date. The proposed rules would also require all target-date fund marketing materials to prominently disclose other information such as a table or graph of the fund's asset allocation (or "glide path") over time with a highlight of the fund's final asset allocation, as well as other information discussed below.

The Commission is accepting public comment on these proposed rules at this time. As currently proposed, a majority of the disclosure requirements (those requirements imposed through amendments to Rules 482 and 34b-1, as discussed below) would become effective 90 days after the adoption of the rule amendments. Other disclosure requirements (those imposed through amendments to Rule 156) would take effect immediately upon adoption of the rule amendments.

Target-Date Funds and Proposed Rules

In proposing the rule amendments, the SEC noted in the Proposing Release the increasingly prominent role that target-date funds are playing in the retirement plan marketplace. The SEC noted that today target-date funds registered with the SEC have more than $270 billion in assets under management and that their growth has been spurred by a number of factors, including their designation as "qualified default investment alternatives" for defined contribution plans by the Pension Protection Act of 2006.[2] The SEC also noted that target-date funds are designed to make investing more convenient by automatically changing their asset mix over a set period that typically corresponds to the investor's retirement date. This shift in asset allocation, or "glide path," results in a reduction in the target-date fund's equity exposure and an increase in more conservative holdings prior to reaching a "landing point," where the fund's assets become fixed. In some instances, the SEC noted, the landing point is on or near the target date, although the majority of funds do not reach their most conservative allocation until some time after their target date.

The Proposing Release states that the SEC is concerned about how target-date funds are named and marketed. These concerns were occasioned by investor reaction to some of the losses experienced by some target date funds in the 2008-2009 market downturn, particularly those that were near their target date. Following a joint hearing held by the SEC and the Department of Labor in June 2009, the Commission has proposed amending Rules 482 and 156 under the Securities Act of 1933, and Rule 34b-1 under the Investment Company Act of 1940 to require enhanced disclosure in advertising and sales literature for target-date funds.[3] The proposed amendments are discussed in further detail below.

The Proposed Amendments

A. The More Than Insubstantial Focus Test

The proposed rule amendments discussed below would apply only to advertisements and sales literature (whether in printed or electronic form) that "place a more than insubstantial focus on one or more target date funds." The "More Than Insubstantial Focus" test is therefore a key provision of the proposed rules and is entirely undefined. The Proposing Release states that the test is a facts-and-circumstances test and indicates that it is the SEC's intention to subject a broad range of materials to the requirements of the proposed rules. The Proposing Release indicates that materials relating exclusively to one or more target-date funds would clearly be subject to the new disclosure rules, as would materials relating to a broad range of funds such as fact sheets and websites that include materials for target-date funds. On the other hand, material that is not primarily focused on marketing target-date funds (such as pieces showing a complete list of all funds within a fund complex, together with their performance), may not meet the "More Than Insubstantial Focus Test." This will likely be a key area of industry concern if the proposed rules are not revised to provide greater clarity.

B. Funds that Use the Target-Date in Fund Name

The proposal would amend Rules 482 and 34b-1 to require funds that contain a target date[4] in their name to disclose, together with the first use of the fund's name, the fund's asset allocation on the target date. The fund's target date asset allocation would need to appear immediately adjacent to the fund's name when it is first used in marketing materials. For radio or television advertisements, it would need to follow immediately after the first use of the fund's name. In both cases, the information will be required to be presented in a manner reasonably calculated to draw the investors' attention.[5] For funds where the target date has already passed, the proposed rules would require marketing materials to disclose the fund's actual asset allocation as of the most recent calendar quarter ended. In addition, the proposed rules would require radio or television advertisements submitted for use prior to the landing point that use the target-date in their name to disclose the landing point, an explanation that the allocation of the fund becomes fixed at the landing point, and the intended percentage of allocations of the fund among types of investments at the landing point. Television advertisements submitted for use at or after the landing would not be required to make these disclosures.

The proposed rules do not prescribe the asset classes to be used (requiring only that the allocation be among "types of investments")[6] or the methodology for calculating the percentage allocations. The SEC cautions, however, that the selection of appropriate classes and calculation methodology remain subject to the anti-fraud provisions of federal securities laws. In the case of funds whose asset allocations are a range of potential exposure (i.e., 45-50% equities), the proposed rules permit disclosure of the range. However, the SEC cautions that in these situations it does not expect the ranges to be "broad," to be inconsistent with the prospectus, or that the actual allocations will deviate materially from the disclosed range.

C. All Target-Date Funds

The proposed rule amendments would also require a number of other disclosures applicable to advertisements and sales literature (whether in print or through an electronic medium) for all target-date funds, regardless of whether or not they use a target date in the fund's name, provided again that the advertisement or sales literature "place a more than insubstantial focus" on one or more target date funds, as discussed above. These proposed rules are discussed in further detail below.

I. Asset Allocation Table, Chart, or Graph and Landing Point Allocation

The proposal would amend Rules 482 and 34b-1 to require all target-date funds to include a prominent table, chart, or graph depicting the percentage allocations, or "glide path," among different investments (i.e., equity securities, fixed-income securities, and cash and cash equivalents) over the entire life of the fund. The table, chart, or graph would be required to present this information in periodic intervals of no longer than five years in duration. In addition, the proposed rules would require funds to clearly depict the actual percentage allocations among types of investments at the inception of the fund, the target date, and the landing point.[7] Further, advertisements or supplemental sales literature relating to a single target-date fund would also be required to show actual percentage allocations as of the most recent calendar quarter. Examples of the proposed tables, charts, and graphs are provided in the Proposing Release.[8]

The SEC noted in the Proposing Release that materials relating to multiple target-date funds with different target dates and the same pattern of asset allocations could include either separate presentations of the glide path for each fund or provide the required information in a single table, chart, or graph.[9] Target-date funds electing to present this information in a single table, chart, or graph would need to identify the periodic intervals and other required points using numbers of years before and after the target date.

In addition, target-date funds with asset allocations varying within a range (i.e., target date allocations of 40-50% equity securities, 40-50% fixed-income securities, 0-10% cash and cash equivalents) would be required to present the range in the table, chart, or graph. For marketing materials relating to a single target-date fund, ranges would need to be shown for future periods, although the fund would still be required to show its actual allocations for past periods.

II. Information Accompanying Asset Allocation Table, Chart, or Graph and Landing Point Allocation

The proposal would also amend Rules 482 and 34b-1 to require the inclusion of an explanatory statement immediately preceding the proposed table, chart, or graph of a fund's asset allocation. The statement would need to include the following information: (i) that the fund or funds' asset allocation changes over time; (ii) an explanation that the asset allocation becomes fixed at the landing point and the intended percentage allocations among types of investments at the landing point; and (iii) whether and the extent to which the intended percentage allocations among types of investments may be modified without shareholder vote.[10] The requirement for an explanatory statement relating to (i) and (ii) above would only apply to advertisements and supplemental sales literature relating to a single target-date fund submitted for publication prior to the landing point or multiple target-date funds with different target dates and the same pattern of asset allocations. It would not apply to advertisements and supplemental sales literature relating to a single target-date fund submitted for publication on or after the landing point.[11] The disclosure required by (iii) above would, however, apply to all materials, including materials used after the landing point has been reached.

The proposed rules do not require the table, chart, or graph requirement and explanatory statement to be used in radio or television advertisements.

III. Disclosure of Risks and Considerations Relating to Target-Date Funds

The proposed rules would also amend Rules 482 and 34b-1 to require target-date advertisements and supplemental sales literature to include a statement informing potential investors of certain risks and considerations to take into account prior to investing in a target-date fund.[12] The statement would need to inform the investor:

- To consider, in addition to their age or date of retirement, other factors, including the investor's risk tolerance, personal circumstances, and complete financial situation;
- That the target-date fund is not guaranteed and that it is possible to lose money by investing in the fund, even after the target date has passed; and
- Whether the fund's asset allocations may be subject to change and the extent to which the allocations of a target-date fund among types of investments may be modified without shareholder vote.

D. Other Proposed Rule Amendments

The SEC has proposed amendments to Rule 156 under the Securities Act of 1933 to provide more guidance regarding statements in investment company sales literature that are potentially misleading.[13] These amendments would apply to all types of investment companies, including target-date funds. The proposed rules would prohibit investment company sales literature from emphasizing a single factor, such as an investor's tax bracket, as the basis for determining that an investment is appropriate. Additionally, investment company marketing materials would no longer be permitted to make express or implied representations that investing in the securities of an investment company is a simple investment plan or that it requires little or no monitoring by the investor. The SEC notes in the Proposing Release that the exclusion of these statements from marketing materials would reduce the potential for investor confusion, encourage investors to consider multiple factors prior to making an investment, and highlight the need for investors to conduct a periodic review and assessment of a fund's performance.

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[1] SEC Release 33-9126; 34-62300; IC-29301, June 16, 2010 (the "Proposing Release").

[2] See Default Investment Alternatives Under Participant Directed Individual Account Plans, 72 FR 60452, October 24, 2007.

[3] The Proposing Release defines a "target-date" fund as an investment company that has an investment objective or strategy of providing varying degrees of long-term capital appreciation and capital preservation through a mix of equity and fixed-income exposures that change over time based on an investor's age, target retirement, or life expectancy.

[4] The proposed amendments define the term "target date" as any date, including a year, that is used in the name of a target-date fund. If no date is used in the name, the "target date" is the date described in the fund's prospectus as the approximate date that an investor is expected to retire or cease purchasing shares of the fund.

[5] The Proposing Release indicates that this prominence requirement is intended to be the same prominence requirement as is applicable to legends under Rules 482 and 34b-1.

[6] The proposed rules, however, do indicate that it would be inappropriate for a fund that invests in other funds to simply disclose investments in other investment companies as an asset class. In this case, it is expected that the target-date fund will look through to the underlying asset classes of the underlying fund when providing this disclosure.

[7] The proposed amendments define the term "landing point" as the first date, including a year, at which the asset allocation of a target-date fund reaches its final asset allocation among types of investments.

[8] See Proposing Release at 41-43.

[9] For example, a fund family advertising all of its target date funds in a single advertisement with all funds sharing a common glide path may elect to depict this information in one table, chart, or graph.

[10] The SEC did not set forth presentation requirements for this statement in the Proposing Release.

[11] The SEC reasons that this information is of little relevance to investors after the landing point is reached.

[12] Due to the importance of this information, the SEC has proposed that the statements be subject to the presentation requirements that currently apply to other important legend disclosures under Rules 482 and 34b-1.

[13] Under Rule 156, the determination for whether a statement involving a material fact is misleading depends on an evaluation of the context in which it is made. This includes general factors that could cause a statement to be misleading and circumstances where representations about past or future investment performance and characteristics or attributes of an investment company could be misleading.

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