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**INVESTMENT MANAGEMENT MARKETING****How To Make Target-Date Funds More Attractive To 401(k) Sponsors**

ABSTRACTED FROM: *Select Target-Date Strategies May Reduce Costs, Conflicts, Risks Managing 401(k) Plans*, July 2008, Pgs. 1, 6-7, 10-12

**Convenient but risky.** Although convenient, target-date mutual funds can pose a fiduciary risk when used in a 401(k) plan. Because plan participants vary widely in both their ability and their willingness to actively manage their retirement savings, companies often include target funds in their 401(k) plans. As explained in a newsletter from the Institute of Management and Administration (IOMA), a target fund highlights a particular date for retirement and adjusts the percentage of its assets in fixed-income and equity stocks, a process known as the *glide path*. As fund investors age and move closer to the targeted retirement year, investments follow the *glide path* automatically, becoming more conservative and more focused on debt instruments, without any action on the part of the investor. Using target-date funds in a 401(k) plan allows employee/participants to sign up and then forget about it. On its face, that sounds good, but plan sponsors risk being liable for poor fund selection.

**Double layer of expenses.** The plan sponsor is exposed to liability because, too often, target-date funds have high fees and are susceptible to accusations of self-dealing. If the target-date fund has a fund-of-funds structure and selects only from among its own family's funds, it may also be imposing a double layer of expense on investors: charging a fee for the target-date fund itself, plus a fee for each fund that is participating. Not all of the target-date funds carry the same expense ratio, and their relative performance in their investment category also varies. Critics allege that fund families put high-expense funds under the umbrella of a target-date fund for their own strategic purposes, notes the IOMA article, rather than for maximum return to the investors.

**Third-party manager can reduce sponsor's risk.** IOMA outlines several strategies to allay the concerns of plan sponsors and increase the attractiveness of target-date funds. For example, contractually transferring the liability for investment choices to a third-party investment manager reduces the sponsor's liability. One investment manager, Zacks IFE, accepts fiduciary responsibility for all investment aspects of the target-date plans that it offers, as allowed under ERISA Section 3(38). This

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leaves the plan sponsor liable only for selecting and monitoring Zacks. It keeps its own fees low and does not use proprietary products. Selecting from individual stocks and bonds, Zacks will customize target-date options for large plans. For plans under \$200 million, Zacks uses T.D. Ameritrade's target-date funds and makes T.D. Ameritrade the third-party investment manager for those investments. Another investment manager reduces the sponsor's fiduciary risk by selecting only exchange-traded funds, from which it receives no fees. Using passively managed, low-cost ETFs eliminates the self-dealing and conflict-of-interest issues.

**Offer an active management option also.** A well-selected target-date fund can solve many problems for sponsors as well as participants. In selecting these funds, however, plan sponsors must focus on costs, conflicts of interest, and fiduciary liability. Fund families can make adjustments to reduce the fees and the fiduciary risks of their target-date funds. For example, to reduce costs and self-dealing charges, Vanguard uses its own funds in target-date funds but has eliminated the duplication of fees. It charges only one low fee for the target-date fund itself. In addition, Vanguard offers a number of passively managed index funds that simply rise or fall with the markets. Vanguard executives suggest that these funds are ideal for retirement plans whose participants do not want to manage holdings actively. Nevertheless, participants should also have the option to manage their own investment choices, IOMA notes. To limit plan participants to just target-date funds carries a different potential for liability.

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## INVESTMENT MANAGEMENT COMPLIANCE & REGULATION

### Selling Investments To Chinese Investors, Thanks To QDII Program

ABSTRACTED FROM: *China's Qualified Domestic Institutional Investor Program: Opening The Door To Chinese Overseas Investment*

BY: Keith Robinson and Derek Newman, Dechert, Hong Kong  
*Investment Lawyer*, Vol. 15, No. 6, Pgs. 3-9

**Tepid reception, then expansion.** US financial service providers can avoid the difficulties of operating in China yet still reach Chinese investors, thanks to the country's Qualified Domestic Institutional Investor program. The QDII program allows Chinese banks, brokers, insurers, and money managers to bypass the strict foreign-exchange rules and invest their clients' money in foreign companies. Chinese investors initially greeted the severely limited choices of the program's 2006 rollout with indifference, explain Hong Kong-based attorneys Keith Robinson and Derek Newman. By 2007, the China Banking Regulatory Commission (CBRC) had expanded the range of QDII products that commercial banks may offer, while the Securities Regulatory Commission did the same for securities companies. China's Insurance Regulatory Commission has completed but not yet released comprehensive rules on insurance companies' QDII products. The program is also overseen by the State Administration of Foreign Exchange and the People's Bank of China, which unfortunately results in conflicting rules.

**Keeping banks and their clients from getting burned.** When the program first rolled out, banks could invest QDII assets only in fixed-income instruments. The banking regulators eventually broadened the options by including equities and mutual funds, but imposed diversification and other restrictions. For example, equities must be listed on a foreign stock exchange regulated by an authority that has signed a memorandum of understanding with the CBRC (as the SEC and its counterparts in the

United Kingdom, Japan, and several other nations have already done). The authors add that mutual funds must be public and approved by a signing authority. Another restriction resembles the American sophisticated-investor standard: a client must invest at least 300,000 yuan and, based on an evaluation process that the bank must devise, have experience in equity investing. A signing authority must approve any foreign investment manager employed to help the bank.

**More apt to sell like hotcakes.** Unlike the CBRC, the Securities Regulatory Commission insists on approving every QDII product. Still, securities companies' products might outsell those from the banks because the securities commission does not impose a sophisticated-investor standard and allows a broad range of investments—such as funds of funds, derivative securities, and illiquid assets—in many more countries. Regulations set investment-allocation standards and cover a number of other areas, the authors note. A company offering QDII products must satisfy financial tests (e.g., minimum net assets and assets under management); minimum experience requirements; and standards of corporate governance, fiscal soundness, and risk control. Foreign investment advisors retained by the company must have more than five years of experience, manage at least \$10 billion in assets, and be established and regulated in a country whose regulatory authority has signed a memorandum of understanding with the Securities Regulatory Commission. With certain exceptions, the company's QDII-asset custodian must be a qualified Chinese bank, and the QDII products can be sold only in a public offering that meets requirements on amount raised, number of investors, and risk disclosure.

**Will investors warm to the program?** QDII products overseen by the Securities Regulatory Commission were the first to be offered after the 2007 rule changes. Chinese investors' enthusiasm for them was high at the start but declined because of underperformance attributable to the worldwide turmoil in the markets and the yuan's appreciation against the dollar. Even if enthusiasm resurges, the securities and banking regulators together have authorized the equivalent of only \$50 billion in QDII products. Although that figure is likely to increase, American investment managers seeking QDII business should expect ferocious competition. Industry observers anticipate substantial investments of yuan in the United States and other countries eventually. Some American asset managers are already participating in the QDII program, as are US firms that provide administrative, distribution, and custodial services. Their compliance officers should watch for possible violations of the Foreign Corrupt Practices Act, the 1940 Act, and US statutes that prohibit money laundering, the authors warn.

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## BRIEFLY...

### FUND OPERATIONS & MANAGEMENT

#### INVESTORS GAIN WHEN INTERNATIONAL FUNDS TAKE THE FOREIGN TAX CREDIT

The Internal Revenue Code allows a foreign tax credit or "FTC" for American individuals and companies whose foreign transactions are subject to double taxation (i.e., by both the foreign country and the United States). The FTC directly reduces the amount of tax owed in the United States. Under IRC Section 853, a mutual fund that has more than 50% of its managed assets in foreign securities can elect to waive the tax credit and instead raise its deduction for paid dividends. The FTC passes through to the fund investors, each of whom then declares a proportionate share of the foreign taxes paid by the fund and takes the FTC on his or her tax return. Accounting professor Janie Casello Bouges, studying a random sample of 52 international funds, finds that funds making the Section 853 election distribute

\$0.05 more in after-tax dividends per share to their investors than funds not making the election. When set in the context of fund fees, this amount is significant. Not all international funds make the Section 853 election, despite its advantages for the investors. Perhaps the complexity of the tax calculation obscures the benefits of passing the FTC through, the author speculates; or maybe fund managers fear the fund's after-tax returns are understated by the formula the SEC requires for prospectus disclosure.

Abstracted from "When Mutual Funds Fail To Make Foreign Tax Elections: What Does The Investor Lose?" by Janie Casello Bouges. *Journal of Taxation of Investments*, Vol. 25, No. 3, Pgs. 33-42. Available from [www.civicresearchinstitute.com/jti.html](http://www.civicresearchinstitute.com/jti.html).

## INVESTMENT MANAGEMENT MARKETING

### DESPITE CURRENT SLUMP, INDIA'S MUTUAL FUNDS HAVE FUTURE EXPECTATIONS

The once-hot Indian mutual fund industry has cooled amid the 2008 global economic downturn. Although nervous domestic investors have cashed out significantly, the major chilling effect has been an exodus of foreign investors. However, Ruth David points out, many Indian fund managers remain optimistic because they see immense potential in the domestic market. Granted, the investment preferences of Indians—for traditional savings avenues such as real estate, gold, and insurance—are shifting rather slowly, and pension managers are not yet permitted to invest in mutual funds. The market downturn has temporarily hobbled efforts to expand the popularity of equity investing, while fund managers chafe under what they perceive as unfair regulation and needless bureaucracy. Yet Indian mutual funds nevertheless have a bright future on their home turf. One fund manager points out that the 30 million Indians who already invest in mutual funds represent less than 10% of India's growing middle class—a vast source of potential capital.

Abstracted from "Market Jitters Reflected In India's Mutual Fund Industry" by Ruth David. *Asiamoney*, Vol. 19, No. 5, Pgs. 20-21. Available from [www.asiamoney.com](http://www.asiamoney.com).

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