October 2004

Retirement Plans and the Great Mutual Fund Scandal

What Is a Plan Fiduciary to Do?

By Kenneth B. Tillou

During the past 2 years, the public has been inundated with reports of widespread misconduct by mutual funds and their managers. According to published studies (Zitzewitz E: Who Cares About Shareholders? Arbitrage-Proofing Mutual Funds. *J Law, Economics and Organization* (Oct. 2003); Zitzewitz E: How Widespread Is Late Trading in Mutual Funds? Stanford Graduate School of Business, Research Paper No. 1817 (Sept. 2003)), this misconduct accounts for an annual loss of approximately $5 billion a year due to the increased costs associated with market timing - quick trades to achieve short-term profits based on anticipated price swings -- and $400 million a year due to late trading -- an illegal practice allowing investors to buy or sell mutual fund shares at the fund's previously established net asset value (NAV) rather than the next day's NAV price.

Employee retirement plans subject to ERISA constitute a significant segment of the long-term investor community potentially harmed by late trading and market timing practices, raising the important issue of what fiduciaries who administer ERISA retirement plans must now do in the face of widespread mutual fund scandals. This article summarizes the steps that should be taken by trustees, investment committee members, and other fiduciaries of retirement plans governed by the Employee Retirement Income Security Act of 1974 (ERISA).

The Fiduciary Duty to Re-evaluate Component Mutual Funds

Section 404 of ERISA imposes on the fiduciaries who are responsible for investing ERISA retirement plan assets the duty to conduct themselves as prudent experts, a duty many courts have characterized as the highest standard of care known in American jurisprudence. Even in the typical 401(k) plan where participants are authorized to direct the investment of their own accounts from among a menu of investment options, the plan fiduciaries remain responsible for prudently selecting and periodically re-evaluating the continuing suitability of the investment options offered to their plan participants.

Therefore, ERISA requires that retirement plan fiduciaries now engage in a prudent, thorough decision-making process with respect to the implications of the mutual fund scandal on the plans, which they oversee. To meet this obligation of procedural prudence, ERISA retirement plan fiduciaries should take the following specific steps with respect to the mutual funds (and other pooled investment vehicles) offered under their plans:

Identify Implicated Funds and Managers

Plan fiduciaries need to determine whether any funds in which retirement plan assets are or have been invested 1) are under investigation by federal or state regulators, 2) have entered

into settlement agreements or are defendants in law suits arising from alleged late trading or marketing timing abuses, or 3) have otherwise been identified as engaging in or permitting late trading, market timing or other wrongful practices. A similar inquiry should be made as to whether the managers of any funds in which the plan assets are or have been invested are under investigation, have entered into settlement agreements, etc.

Decide Whether to Keep or Discontinue Implicated Funds

If an ERISA retirement plan has invested in an implicated mutual fund, the fiduciaries need to do two things: Determine whether to continue using that fund, and determine what loses, if any, plan participants have suffered as a result of the late trading or market timing and take reasonable actions to recoup those losses.

ERISA does not automatically require the fiduciaries of a retirement plan to terminate the plan's use of a mutual fund or a family of funds solely because the fund, the fund's mangers, or other funds within the same family of funds engaged in late trading or market timing abuses. Rather, ERISA requires fiduciaries to engage in what the U.S. Department of Labor (DOL) referred to in recent guidance as a "deliberative process" to determine whether or not to continue investing plan assets in the mutual fund in question. That guidance, in the form of a published statement by Assistant Secretary Ann Combs dated Feb. 17, 2004, provides that fiduciaries must weigh all relevant factors in determining whether to continue with a mutual fund involved in the late trading and market timing abuses. The DOL guidance does not provide any timetable for conducting such a review; but it behooves plan fiduciaries who have not already done so to commence the review process as soon as practicable. Notably, the DOL guidance also states that the late trading and market timing abuses were generally "unforeseeable." This implies that, at least in the eyes of the DOL, most fiduciaries would not be liable for failing to detect the problems before the scandal became public.

According to the DOL guidance, the factors to be considered in reviewing implicated funds include the nature of the alleged abuses, the potential economic impact on the plan, the remedial actions proposed or being taken by the fund and its managers, and the steps being implemented by the fund to limit the potential for further abuses. Within the category of economic impact on the plan, the fiduciaries would presumably look at the plan's rates of return during the period of alleged wrongdoing relative to peer funds and benchmark indices. One financial risk of retaining a tainted mutual fund is the risk that the fund will suffer a massive withdrawal by other investors. Such a "run on the bank" would undoubtedly hurt the fund's future performance, thereby triggering further withdrawals, and putting the fund into a sort of death spiral. Other relevant considerations would include the availability of adequate substitute funds for the mutual fund being replaced, the transaction cost of shifting funds, and the investment risk arising from any "black-out period" associated with changing fund options. Under the Sarbanes-Oxley Act of 2002 and applicable DOL regulations, the plan administrator would have to give 30 days' advance notice to all affected participants of any such black-out that will last longer than 3 days.

In the course of deciding whether to continue to use implicated mutual funds, fiduciaries should carefully document their investigation and all information considered. Where the fiduciaries regularly use outside investment advisors, those advisors should, of course, be consulted. In cases where an outside plan investment advisor is not regularly engaged, the fiduciaries may wish to engage such an expert on a limited basis for providing advice regarding the mutual funds in question. In using an outside investment advisor, the fiduciaries need to 1) ascertain whether the advisor has any financial relationships with the mutual fund or fund managers in question that might be viewed as undercutting the impartiality of the opinions rendered by the advisor, and if so address such conflicts; and 2) reach their own decisions without blindly relying on the outside advisor's opinions.

The recent DOL guidance suggests that the plan fiduciaries obtain directly from the mutual fund or fund managers in question any information needed for their review that the fiduciaries

cannot obtain from other sources. In that regard, the State of Maryland has developed a list of questions that should be posed to mutual funds regarding the mutual fund scandal. Those questions appear at www.nagd ca.org/resources/mutual_fund (11-03). doc_ and provide a useful starting point for identifying the information that fiduciaries should be gathering from their mutual fund providers.

Survey data released by Duke University and Financial Executives International in January 2004 indicate that while many retirement plans have already dropped tainted funds, a number of plans are taking more of a wait-and-see attitude or, after reviewing the situation, are continuing with the implicated funds or managers in reliance on promises of prompt correction and increased policing of anti-market timing rules. There appears to be some hesitancy to shift funds until all of the funds that have engaged in the abusive conduct have been identified (so as to avoid leaping from the frying pan into the fire). Anecdotal evidence also suggests that some plans are sticking with tainted mutual funds under the theory that the funds that have been stung will now be the most aggressive in preventing such abuses in the future.

Decide What to Do About Prior Losses

Apart from deciding whether to discontinue mutual funds implicated in the scandal, retirement plan fiduciaries must determine what steps, if any, to take to recover prior loses incurred as a result of market timing or late trading abuses. Such steps could include participation in class action lawsuits and settlements of such suits. According to the DOL guidance, the decision involving prior losses entails a cost/benefits analysis in which the likelihood and amount of potential recovery is to be weighed against the cost of litigation.

Review of Non-Implicated Funds

The same process that must be undertaken with respect to an implicated mutual fund also applies to funds that have not yet been identified as involved in after-hours trading or market timing. Plan fiduciaries should be conducting formal reviews on all mutual funds offered under their plans at least annually. Going forward, as part of that review, the fiduciaries need to inquire as to 1) whether the fund has been implicated or is under investigation; and 2) the fund's rules regarding, and the steps the fund is taking to preclude, after-hours trading, market timing and other known abuses. The Maryland questionnaire is a useful starting point for formulating a list of questions for the plan's mutual fund providers.

Communicate with Plan Participants

It is generally advisable for fiduciaries of an ERISA retirement plan to notify plan participants if any of the funds involved in the mutual fund scandal are or have been offered as investment options under the plan. Such notification would typically include general information regarding the steps the fiduciaries are taking to monitor the situation and, once known, the outcome of any deliberations on the status of the implicated mutual funds.

Adopting Plan Trading Restrictions in Response to the Scandal

When the mutual fund scandal first became public, ERISA plan fiduciaries primarily focused on what to do with the implicated mutual funds held in their plans. Gradually, however, retirement plan fiduciaries have also begun to focus on a related concern - prevention of market timing abuses by their own plan participants. If self-directing plan participants can engage in impermissible market timing practices under cover of the plan to the demonstrable detriment of other plan participants, the plan fiduciaries would seem to have some a duty under ERISA to prevent such abuses. Moreover, in the wake of the scandal most mutual funds are both exhibiting a new-found zeal for policing their existing anti-market timing rules and implementing new obstacles to market timing (eg, look-through disclosure of participant trades conducted in the name of the plan and significant redemption fees for short-term "in

and out" transactions). Limitations on free trading by plan participants, whether internal to the plan or externally imposed by the mutual providers, however, raise two ERISA concerns.

First, the ERISA Section 404(c) regulations that exonerate plan fiduciaries from responsibility for participant-directed investment decisions require that self-directing participants be allowed to trade plan investments with "reasonable" frequency. Most 401(k) plans in fact allow daily trading. If plans or mutual funds restrict the number of times a participant is permitted to trade a particular investment or funds impose redemption fees to discourage rapid "in and out" trading, such actions may violate the rule that participants be allowed to trade with reasonable frequency. The recent DOL guidance attempts to provide comfort on this issue by stating that "reasonable" redemption fees and "reasonable" limits on trading frequency to deter market timing do not in and of themselves run afoul of ERISA Section 404(c) regulations. The DOL guidance notes, however, that such limitations must be allowed under the terms of the plan and clearly disclosed to participants. Plan sponsors should, therefore, amend their plan documents to provide in the greatest possible detail that participant-directed trading frequency will be restricted in accordance with the rules of each plan-offered mutual fund as in effect from time to time (and in accordance with any other specific rules the plan promulgates). Plans should also make sure that investment descriptions furnished to plan participants adequately disclose any trading restrictions and are updated and re-circulated when those restrictions change.

Second, there is potential and perhaps ironic tension between procedures that might be implemented to stop "market timing" abuses by plan participants and the Sarbanes-Oxley Act restrictions on plan "black-out periods" that were enacted in response to the Enron scandal. ERISA Section 101(i) and DOL Regulation Section 2520.101-3 generally now require plan administrators to provide not less than 30 days advance written notice to a participant of any temporary suspension in his or her ability to conduct buy or sell transactions within the plan. This raises certain issues in the context of stopping abusive market timing by plan participants. For example, if a mutual fund refuses to honor a plan participant's trading instruction on the basis that the participant is "market timing" in violation of the mutual fund's rules, does that constitute a plan "blackout" that violates ERISA absent 30 days advance notice? Does the analysis change if the decision to prohibit the trade is made by the plan administrator or other fiduciary?

The recent DOL guidance states that "black-out period" concerns would arise if the trading restrictions were not "contemplated under the terms of the plan" documents. This suggests by negative implication that the "black-out period" rules are not implicated as long as the plan document provides for the trading restriction. It is uncertain how much detail the plan document would have to provide to satisfy this standard; obviously the more detailed the plan provision, the less the risk.

It should also be noted that under DOL Regulation Section 2520.101-3(d)(1)(ii)(D), a "black-out period" does not include a period in which trading of plan investments is restricted by reason of "any act" of the participant (eg, potentially, an attempted "in and out" trade) or an act of a party unrelated to the plan (eg, the mutual fund company) involving the account of the participant. The language of this regulation seems sufficiently broad to accommodate trading restrictions that are implemented by the plan's mutual funds to stop abusive market timing by plan participants, and such an interpretation hardly seems violative of the intent of Sarbanes-Oxley.

ERISA retirement plan fiduciaries need to promptly review all of their mutual fund and pooled investment offerings for continued suitability in light of the abuses exposed in the mutual fund scandal. Plan documents and investment-related disclosures to participants should also be updated if necessary to reflect and adequately communicate any trading restrictions applicable to participant-directed investments.

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