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Department of Labor Indicates That Companies Should Review 401(k) Plan Investment Options in Light of Mutual Fund Investigations

by Joshua H. Sternoff and Jocelyn M. Sturdivant

Review of Investment Funds Necessary to Fulfill Fiduciary Obligations

The Assistant Secretary for Employee Benefits Security at the U.S. Department of Labor ("DOL") issued a written statement this week indicating that 401(k) plan[1] fiduciaries should undertake a review of their plans' mutual fund investment options in light of recent investigations and other regulatory developments in the industry. The statement of Assistant Labor Secretary Ann Combs echoes earlier speeches she has made in the wake of scandals that have rocked the mutual fund industry, but is the first written guidance issued to date by DOL on this topic, which continues to be of growing concern to companies sponsoring 401(k) plans and the fiduciaries charged with overseeing them.

The statement acknowledges that investors (including 401(k) plan fiduciaries) generally could not have anticipated the late trading and market timing issues that have surfaced over the last several months and that have been the subject of intense regulatory and investigative scrutiny ever since. However, DOL indicates that now that these mutual fund issues are public and better understood, plan fiduciaries must assess the impact of these issues on their plans' investment options. This assessment, according to DOL, should include undertaking a "deliberative process" of reviewing the plan's investment options.

What a Plan Fiduciary Should Do

Protecting the Plan Committee Members, Board of Directors and Others Through a Review of Plan Documents: Make Sure Investment Decisions and Decision-Making Authority Are Consistent with the Plan

In the Enron case and other similar cases in the recent wave of ERISA litigation arising in the employer stock context, the courts are increasingly finding a greater number of fiduciaries potentially responsible for plan investment activities. The courts in these cases have focused in large part on the provisions of the applicable plan documents with regard to the delegation of investment responsibility among plan fiduciaries (*e.g.*, to a plan investment committee), as well as any responsibility retained under the plan by the Board of Directors or others responsible for appointing plan committee members. In some cases, courts have been willing to read broad fiduciary responsibility (and potential liability) into a Board's appointment function.

Many plan sponsors and their officers and directors may be surprised to learn who is responsible for what activities under the terms of existing plan documents, and as an initial matter in connection with a thorough review of investment options should ensure that these plan terms are consistent with the plan sponsor's practices with regard to plan investment decisions. The plan's investment policies and procedures should also be carefully reviewed to ensure that they are being complied with.

Broad Scope of Review: Mutual Fund Fees and Expenses

In conducting a review of the plan's investments, it is important for fiduciaries to keep in mind the need to address not only the issues of the day relating to market timing and late trading, but the overall picture as it relates to mutual fund investment options available under the plan. This includes not only a review of the funds' performance and investment orientation in light of applicable plan policies, but also a review of the fees and expenses. Particularly in light of

common industry practices such as fee bundling and revenue sharing arrangements, which are themselves now coming under increasing scrutiny,[2] plan fiduciaries often are not fully aware of the nature and amount of fees and expenses associated with the plan's investment in a particular fund. This information should be an important factor in fiduciary decision-making. A prudent overall investment program will include an understanding and assessment of these costs.

The SEC has proposed regulatory amendments to curb market timing, late trading, and other abuses in the mutual fund industry,[3] and has more recently set its sights on revenue sharing arrangements. ERISA plan fiduciaries should stay aware of these developments, so as to serve the best interests of the plans they manage.

Considerations if Plan is Invested in Funds Named in Late Trading/Market Timing Investigations

According to a recent survey, nearly half of all 401(k) plans include as investment options funds specifically named in investigations of market timing or late trading practices.[4] The fiduciaries of nearly half of these plans have made a determination to make a fund lineup change as a result. However, this may not be advisable for every plan. It should be undertaken only after a deliberative fiduciary review that takes into account all relevant facts and circumstances relating to both the plan and the fund in question.

The statement of Assistant Labor Secretary Combs identified a number of considerations for plan fiduciaries of plans that invest in a mutual fund implicated in the recent scandals:

- the nature of the alleged abuses;
- the potential economic impact of those abuses on the plan's investments;
- the steps taken by the fund to limit the potential for such abuses in the future; and
- any remedial action taken or contemplated to make investors whole.

In many cases, the affected funds have already disseminated this information to their investors. In others, the plan fiduciary may need to make specific inquiries of the fund in order to obtain the information necessary to its decision.

Fiduciaries should further consider:

- whether causing a plan to continue dealing with companies suspected of engaging in market timing or late trading activity will harm the best interests of the plan;
- the potential hazards of replacing funds implicated in the mutual fund scandal with equivalent alternatives;
- whether the documents governing the plan require the fiduciary to take certain actions in response to the scandal or restrict the fiduciary's ability to do so; and
- what level of diligence is appropriate for making the above determinations.

A Strategy for Effective Vigilance

ERISA plan fiduciaries need a reliable strategy for responding to new developments and resolving issues such as those discussed above. Fiduciaries can readily build such a strategy around a few basic components, such as the following:

1. A Commitment to Monitoring. First and foremost, ERISA plan fiduciaries should be committed to taking action when a new issue arises – if only to study the dimensions of the issue and the potential effects of the issue on their plans. Securities regulators have warned that the recent mutual fund scandal may be only the tip of the iceberg, and that other revelations of unfair practices in the mutual fund industry may follow.[5] Therefore, maintaining a watchful posture may be essential to limiting fiduciary liability and managing new issues that may affect plans.

2. A Sound Infrastructure for Decision-Making. Plan fiduciaries should have a reliable framework for deciding what actions to take when issues like the mutual fund scandals arise. In this regard, plan fiduciaries should be charged with keeping track of financial and legal developments as well as calling prompt meetings where meetings are warranted by the circumstances. Plan fiduciaries should also have a budget to seek outside advice if necessary and to the extent appropriate should keep minutes to document their actions.

3. A Thoughtful Process for Analyzing Issues. At the core of an effective response strategy is the process of conscientiously identifying and analyzing pertinent issues. The mutual fund scandal requires plan fiduciaries to give careful consideration to factors such as:

Relevance: How relevant is the issue to the plan? What is the extent of any harm to the plan? If the issue does not currently affect the plan, is there a possibility that it will in the future? Is there a public perception or a perception among plan participants that the issue affects the plan?

Answering these questions in the context of the mutual fund scandal may require fact-finding

regarding: (a) the policies and practices of the plan's service providers; (b) data concerning the possible effects of market timing and late trading activity on the plan; and (c) the results of governmental investigations. Plan fiduciaries must also be attuned to the concerns of plan participants and remain informed about public reactions to issues affecting plans. However, plan fiduciaries and participants may have markedly different reactions, and lack of participant concern should not lull plan fiduciaries into complacency.[6]

***Possible Remedies*: What is the range of possible remedies for any harm to the plan and what consequences are associated with those remedies? How are other plan fiduciaries responding to the issue?**

In the simplest terms, the mutual fund scandals require affected plan fiduciaries to decide whether to retain, modify, or terminate their arrangements with mutual fund companies implicated in the scandal. The decision by several large plan fiduciaries to terminate their arrangements with such companies may suggest a reasonable course of action for other plan fiduciaries to follow. However, numerous considerations may suggest a different course of action, including: (a) the cost and possible disruption associated with changing the plan's existing arrangements, including whether a change would necessitate a "blackout period"; (b) the relatively limited capacity that smaller plans may have to negotiate favorable new arrangements; (c) the risk that alternative mutual fund companies will perform less capably or will be implicated in the scandal in the future; and (d) the difficulty of measuring harm to the plan.

Plan fiduciaries that decide to retain or modify their existing arrangements with affected companies should consider obtaining from such companies:

- full disclosure of the extent of their market timing and late trading activities;
- indemnification for any losses that plan participants suffer from such activities;
- a detailed description of how such losses will be measured;
- covenants to refrain from such activities in the future; and
- a description of the procedures that the company will use to prevent such activities from recurring.

***Litigation Concerns*: Should the plan's fiduciaries sue affected mutual fund companies on behalf of the plan or join a class action suit against those companies?**

Here, plan fiduciaries must consider factors such as: (a) their ability to demonstrate any losses that the plan has suffered; (b) the cost and effort of pursuing litigation versus the amount of any damages that the plan is likely to recover (which could be relatively small in a class action suit); and (c) the possibility that other fiduciaries to the plan, such as third party trustees, or other shareholders will initiate litigation from which the plan can benefit (which may eliminate the need to duplicate such efforts).

4. A Strategy for Communicating with Plan Participants. Plan fiduciaries must also determine how to communicate with plan participants concerning issues like the mutual fund scandal, and whether to initiate such communication in the absence of participant inquiry.

This decision can be a very sensitive one, and depend largely on applicable facts and circumstances. In making a determination about communicating with participants, fiduciaries should bear in mind the growing case law under ERISA regarding fiduciary disclosure duties,[7] and may wish to consult with counsel.

Market Timing By Plan Participants

Another aspect of the mutual fund market timing issue of great relevance to plan fiduciaries involves the issue of mutual fund market timing engaged in by participants within an employer's 401(k) plan. Many plan sponsors and fiduciaries have questioned what steps they can or should take if market timing is detected by a particular participant. In one recent decision on this subject, Borneman v. Principal Life Insurance Co,[8] Principal Life Insurance Co. ("Principal"), acting in its capacity as investment manager for a 401(k) plan, imposed a $30,000 per day cap on trading in the international equity fund investments offered under the plan after determining that a plan participant's persistent market timing activity adversely affected the performance of those funds. The court challenged Principal's interpretation of the trading cap amount, but granted Principal's request for a summary judgment regarding the legality of the cap, finding that the plan's group annuity contract and the terms of the plan authorized Principal to impose the cap as a matter of fiduciary prudence.[9] The ruling may support the use of similar methods by other plan fiduciaries to restrain participant market timing activity.

In addition, Assistant Labor Secretary Combs' recent statement indicates that, in DOL's view, the imposition by a 401(k) plan of reasonable

redemption fees on sales of fund shares or reasonable restrictions on the number of times a participant may move in and out of a particular investment option, if permitted under the terms of the plan and clearly disclosed to plan participants, would not in itself cause the plan to fail to satisfy the conditions for fiduciary relief under Section 404(c) of ERISA.[10]

Notes

1. We have used the term "401(k) plan" herein for ease of reference. DOL's statement and the issues discussed herein are of equal importance to fiduciaries of other types of employee benefit plans that include mutual fund investment options for plan participants or otherwise invest in mutual funds.

2. *See* Paul Hastings Client Alert entitled "Regulatory Initiatives Target Revenue Sharing Arrangements in Mutual Fund Industry," Feb. 2004, reproduced at www.paulhastings.com.

3. For a discussion of the proposed amendments, see Paul Hastings Client Alert entitled "Regulatory Changes Proposed to Address Mutual Fund Late Trading and Market Timing Abuses," Jan. 2004, reproduced at http://10.5.5.89/media/news/media.493.pdf.

4. *See* "Almost Half of 401(k) Plans Tainted by Mutual Fund Scandal, Survey Finds," Pension & Benefits Daily (Jan. 23, 2004), reproduced at http://pubs.bna.com/ip/BNA/pbd.nsf/is/a0a7z4t821.

5. *See*, *e.g.*, Speech by SEC Commissioner H. Goldschmid, 12/04/03, reproduced at http://www.sec.gov/news/speec/spch120403hjg.htm.

6. For a discussion of the differing reactions of employers and employees to the mutual fund scandal, see "While Employers Are Concerned About the Mutual Fund Scandal, Employees Aren't" and the related survey, reproduced at www.401khelpcenter.com/401k/mutual_fund_scandal_review.html.

7 . Ethan Lipsig and Joshua H. Sternoff, "Fiduciary Disclosure Obligations," ERISA Fiduciary Law 2003 Cumulative Supplement (Susan P. Serota ed., The Bureau of National Affairs, Inc.) (2003).

8. 2003 U.S. Dist. Lexis 21453 (S.D. Iowa 2003).

9. For a similar result, see *Strauss v. Prudential Employee Savings Plan*, 253 F.Supp.2d. 438 (E.D.N.Y. 2003) (court upheld restrictions on market timing activity in a 401(k) plan).

10. Section 404(c) generally relieves individual account plan fiduciaries from liability for the results of participant investment decisions, and DOL has issued extensive regulations regarding the circumstances under which plans may qualify for Section 404(c) relief. *See* 29 C.F.R. Sec. 2550.404c-1.

Should you have any questions regarding this discussion or would like assistance with implementing any of our suggestions, please contact Josh Sternoff at (212) 318-6011, Mark Poerio at (202) 508-9582, Jocelyn Sturdivant at (202) 508-9567, or any other member of the Paul, Hastings ERISA – Institutional Investment Group listed below:

Lawrence J. Hass (212) 318-6401
larryhass@paulhastings.com

Ethan Lipsig (213) 683-6304
ethanlipsig@paulhastings.com

Mark Poerio (202) 508-9582
markpoerio@paulhastings.com

Joshua H. Sternoff (212) 318-6011
joshsternoff@paulhastings.com

Jocelyn M. Sturdivant (202) 508-9567
jocelynsturdivant@paulhastings.com

Eric R. Keller (202) 508-9524
erickeller@paulhastings.com

Stephen H. Harris (213) 683-6217
stephenharris@paulhastings.com

Beth Cheever (212) 318-6854
bethcheever@paulhastings.com

William P. Wesley Jr. (213) 683-6285
williamwesley@paulhastings.com

Nicole K. Watson (212) 318-6309
nicolewatson@paulhastings.com

Lynda M. Noggle (202) 508-9599
lyndanoggle@paulhastings.com

Larry A. Browning (212) 318-6738
larrybrowining@paulhastings.com