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Retirement Plans - Managing in the Mutual Fund Scandals

Daily news reports headline that federal and state law enforcement officials, including New York Attorney General Eliot Spitzer, are investigating trading practices at a number of the nation's leading mutual fund companies. Most instances allege "late-trading" and "market-timing." Many retirement plans, particularly 401(k) plans, use mutual funds as investment vehicles for plan assets. Plan fiduciaries have information, advice, questions and concerns coming at them from every direction. This Management Alert provides an overview of a plan fiduciary's responsibility, some background on recent developments and some suggestions on proceeding as a plan fiduciary.

Prudence — the Basic Fiduciary Duty

ERISA imposes on all plan fiduciaries the duty to act as a "prudent expert" — not merely a prudent person. Even if plan participants make their own investment decisions, as is the case in most 401(k) plans, the Department of Labor has made it clear that the plan fiduciaries have the fiduciary obligation to prudently select the investment alternatives that are available under the plan, as well as a residual obligation to periodically evaluate the investment alternatives to determine whether they should continue to be available as participant investment options. How to carry that out is the challenge to plan fiduciaries. According to Ann Combs, the Department's Assistant Secretary, fiduciaries must "be attentive to activities that materially affect the plan's investment in the mutual fund or expose the plan to additional risk." So, the first step is to understand what is happening. Then a plan fiduciary can begin to ask how the developments affect the mutual fund assets in his or her retirement plan and what to do, or not do, about that.

What Are Late Trading & Market-Timing?

"Late trading" is the term for purchasing, or canceling an existing order for, mutual fund shares at their closing price after the close of the market (4:00 p.m. ET). Because late traders typically trade based on news released after the closing bell, the law requires mutual fund trades made after the close to be processed at the next day's share value. Late trading is illegal.

"Market timing" refers to making rapid trades of mutual fund shares to take advantage of the effect of short-term market discrepancies between the price of a mutual fund's shares and the value of its underlying securities. For example, market timers

often trade international funds because the prices on the stocks held by such funds are generally hours out of date due to time-zone lags. Market timing is not necessarily illegal, but it may be a breach of the fund manager's fiduciary duty to other fund investors who are harmed by the increased transactional costs caused by market timing. This is particularly true if the mutual fund has procedures to detect and prevent market timers but the fund does not enforce those procedures. In addition, the managers of some mutual funds have been accused of market timing in their own funds based on inside information.

What Other Practices Have Been Alleged?

There has been an ongoing investigation for the past year into whether some brokers have improperly failed to give mutual fund investors the benefit of "breakpoints", which are lower load rates applicable to investors who make larger investments in the fund. However, this issue is not relevant to no-load funds, which are the type of funds most commonly used in retirement plans. In addition, some brokers have been accused of improperly marketing mutual funds by engaging in sales contests.

What Actions Can Fiduciaries Take?

Fiduciaries can rely on their own expertise or the expertise of an expert or consultant engaged to educate and advise the fiduciaries. Fiduciaries using a consultant should understand the nature and depth of the consultant's expertise and clearly outline — in writing — the reports and other advice expected from the engagement. Fiduciaries with their own expertise should document their expertise and actions in evaluating the mutual fund developments.

The following actions should be considered:

- ◆ Accelerate the review of funds that are under investigation for issues such as investment performance, expenses, volatility and style consistency. Many investment committees review the plan funds on an annual, or even less frequent, basis. If a fund has been implicated in the investigations, you should not wait for the next regularly scheduled review.

- ◆ Inform employees of any investigations into funds held by the plan and possible resources for additional information. Keep in mind that if your 401(k) plan uses the ERISA 404(c) safe harbor for participant investment decisions, the participants have the right to receive copies (upon request) of any information you receive from the mutual fund.
- ◆ Investigate the trading practices of each mutual fund in the plan's portfolio, and any corrective action that the fund has already taken.
- ◆ Carefully document the results of your review and the reasons for any action taken or not taken.

Plan fiduciaries may wish to consider actively communicating with mutual fund management in order to obtain the necessary information. The State of Maryland has posted a set of questions it will use at <http://www.nagdca.org/>. Fiduciaries may wish to develop their own set of questions tailored to the mutual funds in their particular plans.

Conclusion

While it is certainly too early to panic, no one knows how widespread the allegations will be. In fact, Attorney General Spitzer has made clear that "[i]t's a scandal that is still unfolding," and plaintiffs' attorneys have already established web sites to solicit clients for potential class actions. Therefore, it is important for plan fiduciaries to continue to monitor the mutual funds offered in their plans.

On November 20, 2003, Seyfarth Shaw held a teleconference client briefing discussing the responsibilities of ERISA plan fiduciaries in response to pending mutual fund industry investigations. If you were unable to participate, a summary is available by contacting a Seyfarth Shaw employee benefits attorney.

If you have questions about fiduciary responsibilities and the mutual fund developments, please contact the Seyfarth Shaw benefits attorney with whom you regularly work or any employee benefits attorney listed on our website at www.seyfarth.com.

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