

Spring 2005

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Recommended Citation

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FOLLOW THE MONEY: ERISA PLAN INVESTMENTS IN MUTUAL FUNDS AND INSURANCE

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Federal and state securities regulators have been investigating allegations of improper trading practices at a number of mutual fund families since last fall. Several firms have been charged with civil securities fraud related to their trading activities and some individuals have been charged with criminal activity. Rumors of more charges and lawsuits abound. Since most 401(k) plans and some pension plans are invested in mutual funds, plan sponsors and plan fiduciaries are trying to determine the prudent course of action if the funds in their retirement plans or their affiliates are involved in this growing scandal. In addition, actions by the Securities and Exchange Commission ("SEC") to prevent future abuses are likely to complicate the administration of 401(k) and other defined contribution plans.

As the investigation widens, both state and federal regulators have also begun to focus on fees paid by mutual funds to broker-dealers and pension consultants. The SEC is re-examining rule 12b-1, which permits payments from mutual fund assets for the costs of marketing and distribution of fund shares. Investors often use such payments to offset plan record-keeping, trust expenses and participant communication costs.

The Department of Labor ("DOL") is also investigating mutual fund practices in plans subject to the Employee Retirement Investment Security Act of 1974 ("ERISA").¹ This investigation is likely to focus on fiduciary responses to the mutual fund scandals and whether investment advisers and consultants received improper fees.

* President, Fiduciary Counselors Inc. Darren Spencer, Research Consultant, Aon Investment Consulting, Inc., provided invaluable research for this Article.

1. Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 29 U.S.C. §§ 1001-1461 (2000) and in scattered sections of the Internal Revenue Code, 26 U.S.C.).

I. MUTUAL FUND FEES

There are a variety of fees paid by mutual funds and their shareholders. Plan fiduciaries need to identify what fees are being charged and how those fees impact the plan's returns. In addition, they need to understand the extent to which those fees are being shared with the plan's investment advisers and service providers.

A. Operating Expenses

Every mutual fund pays fees to its investment adviser(s) and various service providers. Since February 2004, the SEC has required that fees be displayed in a table in the mutual fund prospectus.² Mutual fund fees are usually compared on the basis of the "total annual fund operating expenses" (shown on the fee table), which represents the fund's annual operating expenses expressed as a percentage of the fund's average net assets (sometimes called the "expense ratio"). The fee chart shows three categories of fees, which make up the fund's annual operating expenses:

1. Management Fees

Management fees consist of portfolio management fees and other fees paid to the fund's investment adviser. All funds have management fees, which can vary significantly. These fees must be approved by the mutual fund's independent board of directors (or trustees, depending on the fund's organizational structure).

2. 12b-1 Fees

Rule 12b-1 fees cover distribution costs and shareholder services. Distribution costs include advertising, printing and mailing of prospectuses and sales literature and compensation to brokers and others who sell fund shares. Shareholder services permitted to be paid with 12b-1 fees basically involve responding to investor inquiries and providing investors with information about their investments. Mutual fund investors paid over \$10 billion in 12b-1 fees indirectly in 2004.³ Of this amount, 52% went to pay for shareholder services after investment, primarily to banks, broker-dealers and 401(k) record keepers.⁴

2. Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Investment Company Act Release No. 26372, 69 Fed. Reg. 11,244, 11,246-48 (Mar. 9, 2004) (to be codified at 17 C.F.R. pts. 210, 239, 249, 270 and 274).

3. Investment Company Institute, *How Mutual Funds Use 12b-1 Fees*, FUNDAMENTALS, Feb. 11, 2005, at 2, available at <http://www.ici.org/stats/res/index.html#Fundamentals%20Newsletter>.

4. *Id.*

3. *Other Expenses*

Other expenses include any shareholder service expenses that are not already included in the 12b-1 fees, such as custodial expenses, legal and accounting expenses, transfer agent expenses and other administrative expenses. These fees are paid from the fund assets.

B. Shareholder Fees

In addition to the operating expenses paid by the mutual fund, and therefore shared by all investors, some mutual funds also have fees paid by shareholders based on their investments. These include loads, purchase fees, redemption fees, exchange fees and account fees.

1. *Loads*

Loads are amounts paid to brokers on the purchase or sale of mutual fund shares. A “front-end load” goes to the broker that sells the fund’s shares and reduces the amount invested in the fund. For example, if a plan invested \$100,000 in a mutual fund with a 5% front-end load, \$5,000 (5% of \$100,000) would go to the broker and only the remaining \$95,000 would be invested in the fund. The National Association of Securities Dealers (“NASD”) limits front-end loads to 8.5%.

A “back-end load” is a sales fee paid to the broker that sells the fund’s shares. The most common type of back-end load is the “contingent deferred sales load,” which typically decreases to zero if the investor holds his or her shares long enough.

Funds that advertise themselves as “no-load” funds may still charge other shareholder fees, such as those described below. They will also have operating expenses. Recent research by the Investment Company Institute indicates that 12b-1 fees are being used to replace front-end loads. In 2004, 40% of 12b-1 fees went to investment advisers and brokers who assisted clients in selecting their investments.⁵

2. *Purchase Fees*

Purchase fees are paid to the fund (not to a broker) to defray some of the fund’s costs associated with purchase of the fund shares.

3. *Redemption Fees*

Redemption fees are paid to the fund (not to a broker) when shareholders sell or redeem shares, to defray fund costs associated

5. *Id.*

with a shareholder's redemption. Redemption fees have recently been imposed to discourage market timing (rapid trading in and out of a fund). As discussed below, the SEC recently adopted a rule that permits redemption fees of up to 2% in order to discourage market timing.⁶

4. *Exchange Fees*

Exchange fees are fees imposed on shareholders if they transfer assets to another fund within the same family of funds.

5. *Account Fees*

Account fees are typically imposed on accounts with balances below a specified dollar amount.⁷

C. Fee Breakpoints and Share Classes

Some mutual funds charge lower sales loads for larger investments. The investment levels necessary to obtain a reduced sales load are commonly referred to as "breakpoints." If breakpoints exist, the SEC requires that the fund disclose them. In addition, the NASD prohibits its member brokerage firms from selling shares in amounts that are "just below" the fund's sales load breakpoint simply to earn a higher commission.

Many mutual funds offer more than one class of shares, sometimes based on the amount invested or the category of investor. The classes invest in the same investment portfolio and have the same investment objectives and policies, but will have different shareholder services or distribution arrangements with different fees and expenses, which will impact their returns. One class may have a front-end load while another is no-load but has 12b-1 fees. The SEC calculator can be useful in comparing these different classes, since the underlying investment performance is the same and the differences in returns are entirely attributable to the differences in the fee structure.

6. Press Release, SEC, SEC Adopts Mutual Fund Redemption Fee Rule, Proposes Rule to Define "NRSRO," Approves PCAOB Budget and Reviews FASB Accounting Support Fee, Release No. 2005-28 (Mar. 4, 2005), at <http://www.sec.gov/news/press/2005-28.htm>.

7. Because of the different types of fees associated with calculating the cost of a fund, the SEC website provides a mutual fund cost calculator that can help plan fiduciaries compare the costs of different mutual funds, at <http://www.sec.gov/investor/tools/mfcc/mfcc-int.htm> (last modified July 24, 2000).

II. SEC AND STATE INVESTIGATIONS OF 12B-1 AND OTHER FEES PAID BY MUTUAL FUNDS

The SEC has been investigating 12b-1 and other fees paid by mutual funds or their advisers to defined contribution plans and their service providers. In 1980, the SEC promulgated rule 12b-1 under the Investment Company Act of 1940, which allows mutual fund advisers to make payments from fund assets for the costs of marketing and distributing fund shares.⁸ Within 401(k) plans, these fees are typically used to offset plan record-keeping and participant communication costs.

The original justification for the plan fees, as put forth by the mutual fund industry in the 1970s, was that such fees help attract new shareholders into funds through advertising and by providing incentives for brokers to market the fund, thus resulting in lower costs through economies of scale. The 12b-1 fees are paid from the fund and therefore reduce the yield to the shareholders. A recent study by an SEC economist, however, found that “12b-1 plans are successful at attaining faster asset growth; however, shareholders do not obtain any of the benefits from the asset growth.”⁹ The increased growth benefits the fund adviser, by increasing its total fees, while not increasing the shareholders’ earnings.

The SEC has adopted a revision to rule 12b-1 that prohibits the use of directed brokerage by the mutual fund to broker-dealers in exchange for distribution of the fund.¹⁰ Prior to the rule change, the adviser to a mutual fund family could direct brokerage transactions to broker-dealers, who in exchange placed the funds in the brokers’ distribution networks. The SEC is likely to re-examine rule 12b-1 to determine whether it should be eliminated or modified further.

In June 2004, the SEC began an inquiry into payments to defined contribution plans and their consultants. The SEC issued a series of questions to mutual funds, asking them for information about a variety of plan expense reimbursement arrangements. Specifically, the SEC questionnaire asked funds to identify:

- Each type of direct payment made with respect to a defined contribution plan;

8. *Bearing of Distribution Expenses by Mutual Funds*, Investment Company Act Release No. 11414, 45 Fed. Reg. 73,898 (Nov. 7, 1980) (to be codified at 17 C.F.R. pts. 239, 270 and 274).

9. Lori Walsh, *The Costs and Benefits to Fund Shareholders of 12b-1 Plans: An Examination of Fund Flows, Expenses and Returns* (Apr. 26, 2004) (unpublished paper), available at <http://www.sec.gov/rules/proposed/s70904/lwalsh042604.pdf>.

10. *Prohibition on the Use of Brokerage Commissions to Finance Distribution*, Investment Company Act Release No. 26356, 69 Fed. Reg. 9726 (Mar. 1, 2004) (to be codified at 17 C.F.R. pt. 270).

- The type of entities to whom such payments are made (e.g., TPAs, consultants, record keepers, plan sponsors, etc.);
- Whether the payments were made pursuant to a written agreement;
- Whether the payments are based on a flat rate, a percentage of assets or some other basis;
- The type of plan covered by the arrangement (e.g., 401(k) plans, union plans, government plans, deferred compensation plans);
- Factors considered when entering into an arrangement;
- Payments made to retirement plan platforms offered by record keepers or consultants, including finder's fees, consulting fees and directed brokerage;
- The entities making and receiving such payments;
- The extent to which payments result in initial selection or different placement in defined contributions;
- Whether larger payments provide greater access to plan participants, either in person or through marketing materials, or inclusion in larger plans;
- Types of plan expenses eligible for reimbursement and monitoring to ensure that payments are only used for reimbursement of permissible plan expenses;
- Source of payments (e.g., 12b-1 payments);
- Copies of 12b-1 plans;
- Information about the top twenty-five defined contribution plans for which the fund or an affiliate made payment (including payments made in 2002, 2003 and, through 2004, the identity of the plan and the recipients of the payments and services provided);
- Information about the top ten recipients of payments if not related to the top twenty-five plans, measured by 2003 payments;
- Information provided to the fund's board of directors;
- Prospectus disclosure about the payments;
- Samples of any other disclosure about payments to defined contribution plans;
- Samples of materials used to describe payments related to defined contribution plans, including marketing materials and responses to RFPs;

- Any documents, received or sent, that refer to a rebate or any form of that word, including e-mails; and
- The three executives most familiar with payments related to defined contribution plans.

The purpose of the SEC investigation was to identify payments by mutual funds that are not permitted under 12b-1. Some of the SEC's questions, however, appear aimed at determining whether payments were used for legitimate plan expenses, which is actually an ERISA issue.

It is likely that the results of this SEC inquiry will be shared with the DOL, which is also auditing mutual fund practices. The DOL has long held the position that fiduciaries should be aware of all fees being paid through their investments. While the SEC will likely focus on improper payments by the mutual fund, the DOL is likely to focus on whether participants have received adequate disclosure and whether the payments were used for permissible plan administration or other fiduciary expenses.

The SEC and state officials, particularly the Attorney General of New York, have reached settlements with a number of financial institutions with regard to alleged improper mutual fund fee practices. Settlements reached with regulators or voluntarily offered by plans include:

Mutual Fund Fee Settlements		
Company (and Issue)	Investor Compensation and Penalties	Alleged Improper Practices
Citigroup Global Markets	\$20 million	Failure to disclose brokerage used to pay for "shelf space" for mutual funds Sale of Class B share to investors who qualified for Class A shares
Edward Jones	\$75 million	Failure to disclose revenue sharing payment, including directed brokerages
Franklin Templeton	\$20 million penalty to funds plus \$1 disgorgement \$14 million to funds plus \$4 million	Sales and marketing support payments

	California fines and reimbursement Canadian \$49.2 million (US \$42 million)	
MFS	\$50 million paid to the MFS Funds	Failure to disclose brokerage used to pay for "shelf space" for mutual funds
Morgan Stanley	\$50 million	Failure to disclose receipt of brokerage to pay for "shelf space" for mutual funds
Putnam	\$40 million to be repaid to funds	Failure to disclose brokerage used to pay for promotion of mutual funds

III. INSURANCE COMMISSION OVERRIDES AND OTHER PAYMENTS TO INSURANCE BROKERS

State officials have also been investigating potential abuses in connection with the sale of insurance products. Large national insurance brokers have had arrangements with insurance companies that provide for contingent payments, commonly called overrides, paid on the basis of the total amount of insurance that a broker's clients purchase from a particular insurance company. These overrides provide an incentive for brokers to steer business towards insurance companies with which they have these override arrangements.

On November 16, 2004, Eliot Spitzer, the Attorney General of New York, testified that: "Not only do insurance brokers receive contingent commissions to steer business, but many brokers, with the assistance and collusion of insurance companies, engage in systematic fraud and market manipulation in order to ensure that profitable and high volume business goes to a few selected insurance companies."¹¹ He specifically identified employee

11. Insurance Brokerage Practices, Including Potential Conflicts of Interest and the Adequacy of the Current Regulatory Framework: Before the Subcomm. on Financial Management, the Budget and International Security of the U.S. Senate Comm. on Governmental Affairs (prepared testimony of Eliot Spitzer, New York Attorney General), *available at* http://www.oag.state.ny.us/press/statements/insurance_investigation_testimony.pdf. (Nov. 16, 2004).

benefits as an area in which this practice occurred.¹²

In 2002, three brokerage firms comprised over 60% of the global insurance market.¹³ All have announced that they will no longer enter into contingency arrangements. Without admitting guilt, the two largest insurance brokers have settled with state regulators to resolve these issues. Marsh & McLennan Companies, Inc., agreed to pay \$850 million to compensate their clients. Aon has agreed to pay \$190 million. Complaints have also been filed against Universal Life Resources, Inc., a broker of insurance products to employee benefit plans and their participants.¹⁴

Criminal charges have been filed against executives at the American Insurance Group, Inc. ("AIG") and ACE, Ltd. Both companies announced that they were eliminating contingent commission arrangements. The New York Attorney General has announced that AIG is cooperating in the investigation and that he expects a civil resolution.¹⁵

IV. PAYMENTS TO ERISA FIDUCIARIES AND SERVICE PROVIDERS

ERISA provides that the assets of the plan must be "held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan."¹⁶ Assets of the plan must never "inure to the benefit of any employer"¹⁷ and plan fiduciaries must act "solely in the interest of the participants and beneficiaries . . ."¹⁸

Payments by a plan to a service provider will create a prohibited transaction, unless done in compliance with a statutory or regulatory exemption, since the definition of "party in interest" with whom transactions are prohibited includes all fiduciaries and service providers.¹⁹ Payments to service providers are normally permitted if they come within the statutorily prohibited transaction exemption for "necessary services." That exemption allows payment by a plan to a party in interest for any services if:

- The services are necessary expenses of the plan's establishment or operation;

12. *Id.* at 2.

13. *Id.* at 3 (citing Swiss Re market study).

14. *Id.* at 5.

15. Press Release, Statement by Attorney General Eliot Spitzer Regarding the AIG Investigation (Apr. 4, 2005), available at http://www.oag.state.ny.us/press/2005/apr/apr04b_05.html.

16. ERISA § 403(c)(1), 29 U.S.C. § 1103(c)(1). ERISA section 404(a)(1)(A), 29 U.S.C. § 1104(a)(1)(A), uses virtually identical language in describing how fiduciaries are to act.

17. ERISA § 403(c)(1), 29 U.S.C. § 1103(c)(1).

18. ERISA § 404(a)(1)(A), 29 U.S.C. § 1104(a)(1)(A).

19. ERISA § 3(14), 29 U.S.C. § 1002(14).

- The services are furnished under a reasonable contract or arrangement that permits termination by the plan without penalty to the plan on reasonably short notice; and
- The compensation paid for the services is reasonable.²⁰

A service is deemed “necessary” if it is “appropriate and helpful to the plan . . . in carrying out the purposes for which the plan is established or maintained.”²¹ The DOL believes the appropriate method for determining whether a contract or arrangement is reasonable is to apply a facts and circumstances test. Thus, the reasonableness can only be ascertained on a case-by-case basis.

Rule 12b-1 fees and other payments from mutual funds are often used to pay for bundled services provided to plans, such as record-keeping, trust services and participant communications. Record-keeping and trust services are clearly necessary plan services. Some mutual funds provide a sum of money that plan fiduciaries can use to defray plan expenses. Participant communication expenses can be paid by the plan as long as they relate to the plan paying for the communication. In 2001, the DOL issued a set of hypotheticals to clarify which expenses may be paid from an ERISA plan. One hypothetical included a discussion of allocating expenses when the communications involved more than one plan or a mixture of ERISA-covered benefits with other benefits provided by the employer, such as vacation and pay.²²

Another hypothetical involved individual benefit statements for a defined benefit plan and a booklet covering all benefits provided by the employer, whether provided through an ERISA-covered plan or otherwise (e.g., physical fitness center, limousine service, picnic).²³ The DOL concluded that the cost of individual benefit statements, although not required by ERISA or the Code, could be a reasonable plan expense. With respect to a booklet covering all benefits offered to employees, a plan could pay only its proportionate share of the cost of the booklet. The DOL noted that “[w]hile plan administrators and fiduciaries should be given considerable deference with regard to their disclosure decisions, plan administrators should be able to explain their disclosure decisions and justify the costs attendant thereto.”²⁴ Clearly the

20. ERISA § 408(b)(2), 29 U.S.C. § 1108(b)(2).

21. 29 C.F.R. § 2550.408b-2(b) (2005).

22. Employee Benefits Security Administration, Advisory Opinion Guidance on Settlor v. Plan Expenses, Hypothetical 5, <http://www.dol.gov/ebsa/public/programs/ori/advisory2001/setQ&Are.htm> (last visited Apr. 14, 2005).

23. *Id.*

24. *Id.*

National Office of the DOL has recognized the importance of employee communications and determined that the DOL should not place obstacles in the way of meaningful communication with the participants.

The DOL regulations give little guidance on the meaning of “reasonable compensation” or “reasonable contract” in connection with the provision of office space and services by a party in interest. Reasonable compensation “depends on the particular facts and circumstances of each case.”²⁵ Unreasonable compensation includes any excessive compensation (i.e., not deductible by a taxpayer as an ordinary and necessary business expense under I.R.C. § 162).²⁶ Compensation that is not excessive, the regulations caution, is not necessarily reasonable compensation.²⁷ At most, reasonable compensation should mean compensation commensurate with that paid by similar plans for similar services to unaffiliated third parties. However, reasonable compensation does not include any compensation to a fiduciary already receiving full-time pay from the employer sponsor or an employee organization containing participants.²⁸

The DOL has issued a booklet to help plan fiduciaries understand mutual fund fees, as well as fees paid in connection with bank and insurance products.²⁹ To assist plan fiduciaries in comparing these fees, the DOL has also provided on its website a form developed by the Investment Company Institute, the American Bankers Association and the American Council of Life Insurance.³⁰ Despite the fact that the form was developed by the trade associations for the mutual fund, banking and insurance industries, most plan fiduciaries have found difficulty getting the information from many offerors of these investment products. The new SEC disclosure rules, requiring publication of the fee chart in mutual fund prospectuses, will greatly assist plan fiduciaries, at least in comparing mutual fund fees.

Although the statutory exemptions provide that “the prohibitions of section 406 shall not apply,”³¹ both the DOL and the IRS have taken the position that the exemption for office space and necessary services does not encompass the prohibitions

25. 29 C.F.R. § 2550.408c-2(b)(1); Treas. Reg. § 54.4975-6(e)(2) (as amended in 1980).

26. Treas. Reg. § 1.162-1 (as amended in 1993).

27. 29 C.F.R. § 2550.408c-2(b)(5); Treas. Reg. § 54.4975-6(e)(6).

28. 29 C.F.R. § 2550.408c-2(b)(2); Treas. Reg. § 54.4975-6(e)(3).

29. Understanding Retirement Plan Fees and Expenses (May 2004), at <http://www.dol.gov/ebsa/publications/undrstndgrtrmnt.html>.

30. 401(k) Plan Fee Disclosure Form, available at <http://www.dol.gov/ebsa/pdf/401kefm.pdf> (last visited Apr. 22, 2005).

31. 29 C.F.R. § 2550.408c-2(b)(5); Treas. Reg. § 54.4975-6(e)(6).

against fiduciary conflicts of interest in ERISA section 406(b) and I.R.C. § 4975(c)(1)(E)–(F).³² However, a fiduciary does not have a conflict of interest if the services are provided to the plan without additional compensation, other than reimbursement of direct expenses.³³ A fiduciary may receive additional compensation if retained by a second unrelated fiduciary to provide the service to the plan. But mere approval by a second fiduciary does not suffice. The fiduciary receiving the additional compensation cannot exercise any “authority, control or responsibility” in his or her role as fiduciary to cause the plan to pay the additional amounts for services.³⁴ Thus, absent an exemption, a consultant who provides investment advice cannot recommend the purchase of insurance contracts that will give him commissions, even though the decision to purchase the contract is made by another fiduciary and the consultant makes full disclosure.³⁵

A plan fiduciary must “discharge his duties . . . in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with [Titles I and IV of ERISA].”³⁶ Thus, the plan cannot pay an otherwise permissible plan expense if the plan document provides that the plan sponsor will pay the expense. If the plan is silent about the payment of expenses, however, the DOL has stated that “the plan may pay reasonable administrative expenses.”³⁷ The plan may also be amended to eliminate a requirement that the employer pay administrative expenses, permitting the plan to pay these expenses prospectively.³⁸ In light of increasing regulation and enforcement, plan fiduciaries should follow certain guidelines to avoid potential legal action.

32. 29 C.F.R. § 2550.408b-2(a); Treas. Reg. § 54.4975-6(a)(1). Courts that have considered this issue and followed the agencies’ interpretation include *Donovan v. Daugherty*, 550 F. Supp. 390 (S.D. Ala. 1982) and *Gilliam v. Edwards*, 492 F. Supp. 1255 (D.N.J. 1980).

33. 29 C.F.R. § 2550.408b-2(e)(3); Treas. Reg. § 54.4975-6(a)(5)(iii).

34. 29 C.F.R. § 2550.408b-2(e)(2); Treas. Reg. § 54.4975-6(a)(5)(ii).

35. 29 C.F.R. § 2550.408b-2(f) Example (2); Treas. Reg. § 54.4975-6(a)(6) Example (2). In issuing this interpretation, the DOL promptly granted a class exemption that permitted insurance brokers to receive commissions, if the purchase of the insurance was approved by an unrelated plan fiduciary. Prohibited Transaction Exemption 77-79, 42 Fed. Reg. 32395 (Oct. 31, 1977), reprinted as amended in 49 Fed. Reg. 13208 (Apr. 3, 1984).

36. ERISA § 404(a)(1)(D), 29 U.S.C. § 1104(a)(1)(D).

37. U.S. DOL Advisory Opinion 97-03A (Jan. 23, 1997), available at <http://www.dol.gov/ebsa/programs/ori/advisory97/97-03.htm>.

38. *Id.* The DOL indicated that the expense of this amendment could not be charged to the plan.

A. Request Information from Investment Manager(s)

Plan fiduciaries should ask their investment fund manager(s) to provide them with the following plan information:

Written copies of their policies and procedures on late trading, market timing and fair value pricing;

- Information on what steps they are taking to prevent market timing and late trading;
- Frequent updates on the status of all internal or external investigations;
- Immediate notification of any significant changes in professional staff; and
- Notice of changes in assets under management as this information becomes available for public reporting.

If a plan has an ongoing investment adviser who monitors performance for the plan, then the adviser is almost certainly undertaking this investigation on behalf of all of its clients. In many cases, advisers talk with the fund managers directly and, because they represent a large number of plans, they can (and do) maintain frequent and in-depth contact. A report from the adviser may be all that is necessary if the adviser's recommendation is to keep the existing funds. However, plan fiduciaries should also make sure that they are aware of any potential conflicts of interest that their advisers may have, such as affiliation with the mutual fund adviser or receipt of 12b-1 fees or other fees that might affect their judgment.

B. Evaluate Alternatives

A plan fiduciary should evaluate developments in the field to determine what further action, if any, should be taken to protect plan participants. These actions may include:

- Exploring replacement of a fund;
- Pursuing claims on behalf of participants or participating in restitution paid by a fund; or
- Terminating a record-keeping relationship or other administrative relationship.

However, none of these actions should be taken precipitously, particularly changing funds or record keepers since that would be disruptive to participants.

If funds are changed without participant direction, plan fiduciaries may lose the protection of section 404(c) of ERISA, which absolves fiduciaries of responsibility for investment decisions made by participants. This protection applies only if the

participants actually make the investment decisions. In plans that designate asset categories, rather than particular funds, in their plan documents and summary plan descriptions, a good argument can be made that changing the fund in that asset category does not negate the participants' decisions to invest in that asset category. In any event, fiduciaries who make the decision to either retain the current funds or replace them with new ones will be held responsible for prudently selecting and monitoring the funds.

C. Communicate with Plan Participants

Participants typically read the newspapers and, therefore, harbor concerns about what is happening to their accounts. There is a natural tendency for plan fiduciaries to wait until all the facts are in and the decisions are made before communicating with plan participants. That is usually a mistake, since it allows employees' anxieties to grow. Instead, plan fiduciaries should communicate immediately that the appropriate fiduciaries are taking action by, for example:

- Requiring a detailed response from the fund manager regarding the allegations;
- Hiring outside counsel to advise on how best to protect plan participants;
- Requiring information from the managers of other funds; or
- Investigating alternative investment options as necessary.

In addition, in 401(k) plans, plan fiduciaries should remind the participants that they can change their investment elections at any time.

V. SETTLEMENTS AND CLASS ACTION PROCEEDINGS IN THE MUTUAL FUND TRADING SCANDALS

In addition to the mutual fund fee issues, both the SEC and state officials have been investigating trading practices of mutual funds and their shareholders. The two practices being attacked by regulators are late trading and market timing.

Late trading involves placing orders to buy or sell after the 4:00 p.m. (Eastern) close of the markets. Submitting a trade after the close is a "sure bet" because daily mutual fund transactions are priced at the closing net asset value ("NAV"), and the party entering the trade knows whether the mutual fund's value has gone up or down.

Market timing, on the other hand, involves large trades in and out of a fund in a short period to make quick profits as a result of short-term trends (the functional equivalent of day trading). Late trading is illegal. Market timing, while legal, may violate

representations made by the mutual fund that it does not permit large trades in and out within a short time period.

Both practices harm the remaining shareholders. Elliot Spitzer, the Attorney General of New York who has brought many of the civil fraud cases, has estimated that such practices have cost mutual fund shareholders over \$5 billion.

The Assistant Secretary who heads the DOL's Employee Benefit Security Administration issued a statement in February 2004 advising plan fiduciaries that they have an obligation to evaluate whether to participate in litigation or settlements arising out of the mutual fund trading scandals.³⁹ The same principle would apply to the mutual fund and insurance settlements discussed above. Plan fiduciaries must weigh the potential cost of participating in litigation against the potential and likelihood of recoveries for plan participants. Given the active enforcement activities of state and federal officials, yielding settlements for the benefit of investors, and the active plaintiffs' bar, it is likely that plan fiduciaries need only monitor litigation and then evaluate the resulting settlements, if any, to ensure that their participants' interests are protected. Plan fiduciaries should also assert claims on behalf of the plan and its participants when these settlement funds are distributed.

In her February 2004 statement, the DOL Assistant Secretary indicated that fiduciaries with funds involved in some wrongdoing should consider:

- 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.

Plan fiduciaries should investigate and be able to demonstrate that they have investigated these matters. The DOL has begun a broad sweeping investigation of mutual fund investments in plans and is likely to be looking at fiduciary responses to the trading scandals as well as the underlying abuses. All fiduciary actions and decisions should be documented, including any inquiries that were made about the trading and

39. Fiduciary Responsibilities Related to Mutual Funds: Statement of Assistant Secretary Ann L. Combs on the Duties of Fiduciaries in Light of Recent Mutual Fund Investigations (Feb. 17, 2004), *available at* <http://www.dol.gov/ebsa/newsroom/sp021704.html> (last visited May 15, 2005).

scandals issues. This will not only assist plan fiduciaries in complying with any DOL inquiry, it will also demonstrate that the plan fiduciaries had monitored the investments and made considered judgments, even if in hindsight it becomes apparent those decisions were wrong. Neither the courts nor the DOL is likely to challenge a thoughtful decision based on advice of disinterested experts, even in light of subsequent events.

Virtually every mutual fund manager received a subpoena for information from state or federal regulators, as part of a broad-based investigation designed to ferret out additional violations. In some cases, the fund adviser fired or otherwise disciplined individuals responsible for the improper trading and committed to make shareholders whole. In many cases, the SEC and state regulators have obtained settlements that require payments, including amounts characterized as penalties rather than compensation, to be paid to the mutual fund shareholders who were harmed by the improper practices. Settlements with securities regulators to date include:

Mutual Fund Trading Settlements		
Fund Family	Shareholder Compensation	Penalties
AIM	\$50 million plus \$15 million annual reduction in fees	\$30 million penalties (included in \$50 million to be distributed to shareholders)
Alliance Capital Management	20% annual reduction in fees for five years	\$250 million penalty
Banc of America	\$250 million restitution plus \$125 million penalty	\$125 million penalty (included in \$375 million to shareholders) \$400,000 NASD penalty
Fleet Boston	\$70 million restitution	\$70 million penalties
Franklin Templeton	\$50 million to shareholders	\$20 million SEC penalty (included in \$50 million to be distributed to shareholders) \$5 million Massachusetts fine
Freemont	\$2.1 million restitution	\$2 million Former CEO fined

		\$127,000
Invesco	\$325 million	\$110 million penalty (included in \$50 million to be distributed to shareholders)
Janus	\$100 million to shareholders plus \$25 million annual reduction in management fees for five years	SEC penalties of \$50 million (part of \$100 million to be distributed to shareholders) plus \$1.2 million Colorado penalties
MFS	\$225 million for market timing plus \$25 million annual reduction in management fees for five years	Administrative fine of \$1 million, to be used for educating investors, for market timing; \$50 million for directed brokerage
Pilgrim Baxter	Adviser to pay \$100 million Co-founders to pay \$80 million each	Penalties of \$20 million each for company and co-founders included in amounts to be distributed to shareholders
Putnam	\$108.5 million to shareholders and implementation of fund governance measures	Penalties of \$100 million (part of \$110 million to be distributed to shareholders)
Strong Capital	\$40 million for investor losses and \$35 million reduction in fees over five years.	\$40 million in civil penalties. Richard S. Strong, former Chairman, paid \$60 million in penalties and was barred for life from the money management business
State Street Research		\$1.5 million

Class action lawsuits involving allegations of late trading and market timing have also been brought against the various mutual fund families, including those in which the regulators have not

brought enforcement actions. These class action cases have been consolidated before a multi-district litigation panel of three judges in the U.S. District Court for Maryland.⁴⁰ The court has established a website for the mutual fund investment litigation,⁴¹ which will help plan fiduciaries and their advisers monitor the cases as they move forward. The cases have been brought under the federal securities laws, the Investment Company Act of 1940, the Investment Advisers Act of 1940 and various common law torts. The fund families are assigned to three separate tracks. The following chart shows the tracks and judges to whom the mutual fund families are assigned:

Judge Blake	Judge Davis	Judge Motz
<i>04-md-15861</i>	<i>04-md-15862</i>	<i>04-md-15863</i>
AMCAP	Alliance	AIM*
Artisan*	Franklin Templeton	Alger
Excelsior	NationsBank	Columbia
Federated	Pilgrim Baxter	INVESCO*
Scudder		Janus
Strong*		MPS
		One Group
		PIMCO
		Putnam

*These cases (and suits against T. Rowe Price, which were dismissed) were originally assigned to Judge Stamp who recused himself for conflict reasons. When reassigned, these cases retained their original designation in Track 4 (04-md-15864).⁴²

Given the number of cases already brought and the amounts recovered by the SEC and the New York Attorney General, there appears to be little reason for plan fiduciaries to expend plan assets to bring additional litigation. However, plan fiduciaries should monitor the cases and closely examine any settlements to ensure that the interests of their plans and participants are being adequately protected. Where settlements have already been negotiated with government regulators, it is likely that the civil cases will settle as well.

40. Letter from Judge J. Frederick Motz to Counsel, *In re Mutual Funds Investment Litigation*, No. 04-md-15863 (D. Md.) (Feb. 20, 2004), available at http://www.mdd.uscourts.gov/mdl_litigation/mdldocs/initialletter.pdf.

41. *Id.*

42. Letter from Judge J. Frederick Motz to Counsel, *In re Mutual Funds Investment Litigation*, No. 04-md-15864 (D. Md.) (Mar. 23, 2005), available at http://www.mdd.uscourts.gov/MDL_litigation/MDLDocs/Letterreassignmentofcases.pdf.

Plan fiduciaries still need to monitor these and other settlements and take whatever actions are necessary to make sure that their plan participants receive an appropriate share of the restitution and penalty payments. Plan fiduciaries should also keep in mind that the DOL issued Prohibited Transaction Exemption (“PTE”) 2003-39, a class exemption covering litigation settlements.⁴³

Although compliance with the exemption is only necessary if the opposing party is a party in interest to the plan, the exemption provides useful guidance on how to approach settlements. In particular, fiduciaries of plans that may have ERISA claims in addition to securities claims should make sure that any releases granted in a regulatory or securities litigation settlement do not adversely impact the ERISA claims, or they should obtain additional compensation for the plan and its participants for release of those claims.⁴⁴ The preamble to PTE 2003-39 indicates that compliance with class exemption is not necessary when the settlement is with a service provider, rather than with a fiduciary.

VI. REDEMPTION FEES TO PREVENT MARKET TIMING

In response to the market timing abuses, after originally proposing mandatory redemption fees, the SEC adopted a rule permitting plans to impose redemption fees of up to 2% on investors who traded in or out of a fund within seven days.⁴⁵ Some funds had already imposed redemption fees or trading restrictions. Plan fiduciaries should carefully review their plan documents, summary plan descriptions and other participant communications to insure that these redemption fees do not contradict previous statements made to participants indicating that there are no redemption fees. In her February 2004 statement, the Assistant Secretary indicated that the DOL was investigating trading restrictions and redemption fees in response to the market timing scandal. The statement indicated that reasonable restrictions and fees generally would not cause fiduciaries to lose the protections of section 404(c) of ERISA, which absolves fiduciaries of responsibility for the investment decisions made by participants. She emphasized, however, that such fees should be consistent with the terms of the plan and disclosed to plan participants. Plan

43. 68 Fed. Reg. 75632-01 (Dec. 31, 2003).

44. See generally Machiz, Hennessy & Capuano, *Understanding DOL's New Class Exemption for the Release of Claims and Extensions of Credit in Connection with Litigation*, BNA PENSION & BENEFITS REP., Jan. 13, 2004, at 1-8, available at <http://www.fiduciarycounselors.com/press/SettlementPTEarticleBNA.pdf>.

45. SEC, *supra* note 6.

fiduciaries should quickly communicate any redemption fees to plan participants and should seek to prevent such fees from being imposed on plan participants until such communications have gone out.

VII. CONCLUSION

Recent court decisions resulting from Enron and other corporate scandals have reiterated the well-established principle that plan fiduciaries have a duty to monitor plan investments and to take action, if necessary, to protect plan participants. Therefore, it is critical that plan fiduciaries (e.g., administrative or investment committees for retirement plans) employ a sound process to monitor the mutual fund and insurance investigations and settlements. In particular, plan fiduciaries should:

- Identify who has responsibility for monitoring and, if necessary, changing the investment funds in their plans;
- Determine whether any of the funds or fund managers are involved in the scandal;
- Obtain information from all mutual funds, investment managers and insurance brokers, including those that have not yet been named in any litigation, about their practices;
- Obtain information from their investment adviser and other consultants about any compensation they receive from mutual funds, insurance companies, their advisers, broker-dealers or other service providers to the plan;
- Make a decision as to whether to retain the troubled fund or service provider;
- Continue to monitor actions by the DOL, SEC and state regulators that may impact plans; and
- Be prepared to reconsider decisions as the situation unfolds.

Plan fiduciaries are likely to face increased scrutiny and administrative complexity as a result of the mutual fund scandals and the regulatory responses to those scandals. Precipitous action in the face of these kinds of scandals is almost never the correct response. Plan fiduciaries should take action, however, to inform themselves about whether there are any charges involving the funds in their plans or their affiliates.

Fiduciaries should consult their investment advisers and attorneys to determine what response, if any, is appropriate. Above all, fiduciaries should document any actions they have taken to monitor the situation and any expert advice they have obtained. Since there is no clear right answer about what

fiduciaries should do, demonstration that fiduciaries have properly monitored the situation and considered the available alternatives should protect fiduciaries if their decisions are subsequently challenged.

