

ERISA Fiduciary

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DOL Provides Fiduciary Guidance for Dealing with Mutual Fund Scandal

Since news of the mutual fund scandals broke in the Fall of 2003, many fiduciaries have become concerned about their obligations with respect to plan investment in mutual funds. In response, the U.S. Department of Labor ("DOL") recently issued guidance on how plan fiduciaries should respond to well-reported allegations of mutual fund abuses, including late trading and market-timing.¹ The new guidance, a brief but significant statement from Assistant Secretary of Labor Ann L. Combs, responds to numerous requests for the DOL's views on the mutual fund scandals. In addition to outlining factors that plan fiduciaries must consider in reviewing plan investments in mutual funds that are under investigation, the DOL statement notes that other pooled investment vehicles may be subject to similar abuses. The DOL also states that mutual funds may impose restrictions (such as redemption fees) without jeopardizing the availability of "section 404(c)" relief for fiduciaries of plans that make such funds available to plan participants. Finally, in addition to the guidance, the DOL also announced that it would be investigating ERISA issues relating to mutual fund investments and mutual fund advisers.

DUTY TO REVIEW FUNDS UNDER INVESTIGATION

Although the DOL notes in the statement that "late trading" and "market timing" abuses were unforeseeable, it also states that fiduciaries have a duty to assess the impact of these problems on their plans and review plan investments. The DOL also makes it clear in the statement that ERISA fiduciaries of plans that invest in mutual funds that are under government investigation should determine whether it is appropriate for the plans to continue to invest in those funds. According to the DOL, these determinations must be based on a "deliberative process" designed to allow the fiduciaries to make decisions that are "as well informed as possible under the circumstances."

Specifically, the DOL states that fiduciaries whose plans invest in mutual funds that are under investigation by government agencies (or that have recently settled investigations) should consider the following factors: (1) the nature of the alleged abuses; (2) the potential economic impact of those abuses on the plan's investments; (3) the steps taken by the fund to limit the potential for such abuses in the future; and (4) any remedial action

¹ Statement of Ann L. Combs, Assistant Secretary, Employee Benefits Security Administration, U.S. Dept. of Labor "Duties of Fiduciaries in Light of Recent Mutual Fund Investigations" <http://www.dol.gov/ebsa/newsroom/sp021704.html>.

taken or contemplated to make investors whole. The DOL also notes that fiduciaries should consider getting this information from the mutual funds themselves, if they have not already done so. The DOL guidance also states that fiduciaries may need to consider whether their plans should participate in securities lawsuits or settlements of such actions.² The DOL acknowledges, however, that determining whether and how to participate in any such matter requires a cost-benefit analysis that weighs the likelihood of recovery against the costs of litigation.

OTHER INVESTMENTS VEHICLES

The DOL's guidance pointedly notes that late trading and market timing abuses are not necessarily limited to mutual funds that have been identified as targets of government investigations. Other mutual funds and other pooled investment vehicles may be subject to the same kinds of abusive trading practices. As a result, the DOL statement indicates that fiduciaries should determine whether mutual funds or other types of investment funds have procedures and safeguards designed to limit exposure to these and other abuses.

Although the DOL acknowledged in the statement that the specific course of action a fiduciary should take depends on the particular facts and circumstances, the DOL guidance also states that fiduciaries must be guided by principles of acting reasonably, prudently and solely in the interests of plan participants and beneficiaries. The DOL does not offer specific suggestions on how fiduciaries should discharge these obligations, but fiduciaries should consider asking fund managers how they identify and police abusive trading practices as a way to start the analysis.

TRADE RESTRICTIONS CAN BE CONSISTENT WITH SECTION 404(C) REGULATIONS

Finally, the DOL guidance answers questions about whether restricting mutual fund trades at the plan level or making mutual funds that restrict investor trades available as participant investment options would affect the availability of the relief from fiduciary liability provided by

section 404(c) of ERISA and the DOL regulations under that section. Among other things, those regulations require that participants in a "section 404(c) plan" must be permitted to trade as frequently as appropriate in light of the volatility of the investment option. The DOL guidance specifically addresses the following:

- Whether a plan's offering of mutual funds or similar investments that impose reasonable redemption fees on sales of their shares would, in and of itself, affect the availability of relief under section 404(c) of ERISA.
- Whether reasonable plan or investment fund limits on the number of times a participant is permitted to move in and out of a particular investment during a particular period would, in and of itself, affect the availability of relief under section 404(c).

The DOL guidance states both these approaches "do not necessarily run afoul of the requirement that participants be permitted to trade with appropriate frequency in light of the volatility of the investment option." The DOL statement cautions, however, that any restrictions imposed must be "allowed under the terms of the plan and clearly disclosed to the plan's participants and beneficiaries." Further, the DOL statement indicates that "the imposition of trading restrictions that are not contemplated under the terms of the plan raises issues concerning the application of section 404(c), as well as issues as to whether such restrictions constitute the imposition of a 'black out period' requiring advance notice to affected participants and beneficiaries."

The new the DOL guidance offers no clarification on whether common "boilerplate" language permitting plan administrators to refuse investment directions is sufficient to allow fiduciaries to police trading abuses. Two recent court decisions may offer some comfort to plan administrators and fund managers, however. In *Straus v. Prudential Employee Sav. Plan*, 253 F. Supp. 2d 438 (E.D.N.Y. 2003), the court held that language in the plan document that permitted the plan administrator to "decline to implement investment instructions where it deems

² Any such settlement may require compliance with PTE 2003-39, the DOL's recently issued class exemption for settlements. Class Exemption for the Release of Claims and Extensions of Credit in Connection with Litigation, 68 Fed. Reg. 75362 (Dec. 31, 2003), PTE 2003-39.

appropriate” provided sufficient authority for a plan sponsor to adopt rules requiring participants who engage in high volume trading to make trade requests in writing and flatly forbidding “roundtrip” trades of \$75,000 or more. The court held that the administrator’s imposition of these rules did not constitute an impermissible “discrimination” against participants under section 510 of ERISA.

Similarly, in *Borneman v. Principal Life Ins. Co.*, 291 F. Supp. 935 (S. D. Iowa 2003), the court held that a manager of an insurance company separate account offered as an investment option in a 401(k) plan had the right to impose trading restrictions because the annuity contract provided that the manager “reserve[s] the right to defer or stop your ability to direct Contributions and transfers to a Separate Account.” The court rejected claims that the trading rules constituted a breach of fiduciary duty.³

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CONCLUSION

The DOL guidance helpfully suggests a framework for a prudent review of investments in mutual funds that are or have been under investigation. The guidance is also helpful in indicating that trading restrictions grounded in the plan documents and properly communicated to participants do not adversely affect the availability of the relief provided by section 404(c). The DOL’s observation that other mutual funds and pooled investment vehicles may be subject to the same types of abuses identified in investigations of mutual funds also should prompt plan fiduciaries to include these vehicles within the scope of their consideration of the issues. The announcement that the DOL is investigating mutual funds and other pooled investments should underscore this point.

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³ The court did, however, permit the plaintiffs to proceed with claims that the trading restrictions were misrepresented and that the employer, the insurer managing the separate account, improperly retaliated against them for their trading practices. The plaintiffs alleged they were threatened or were fired for frequent trading.



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