401(k) Sponsor Duties and Mutual Fund Wrongdoing

Insights
1.15.05

A number of employers have asked what steps should be taken by 401(k) plan sponsors to deal with recent news that certain mutual fund providers allowed "late trades" or "market timing" in some of their funds. According to a recent study by a Stanford University professor, late trading added approximately $400 million in annual costs to these funds while market timing transactions cost mutual fund shareholders an additional $5 billion annually.

As plan sponsors and/or fiduciaries of 401(k) plans that may have unknowingly used tainted mutual funds as investment vehicles, employers need to know their obligations and what actions should be taken. Many employers are receiving questions from plan participants about the mutual fund situation as news coverage expands and state attorneys general take action.

As discussed in more detail below, at a minimum 401(k) sponsors and fiduciaries should:

- conduct an investigation into the activities of their investment managers and mutual fund sponsors;
- document that investigation;
- draw conclusions and develop a course of action;
- implement their conclusions; and
- communicate with plan participants.

This outline will answer some of the most common questions we've received, and suggest a specific course of action.

1. What is "market timing" and "late trading," and how do these practices affect mutual funds?
"Late trading" is an illegal practice based on the 4:00 p.m. EST cutoff for mutual fund sales and pricing. Under exchange rules, mutual funds are priced once each business day at 4:00 p.m., EST. A sell or buy order for mutual fund shares must be made before 4:00 p.m. EST in order to be carried out at the 4:00 p.m. closing price. Orders made after 4:00 p.m. must be carried out at the 4:00 p.m. closing price on the following business day.

Under current practices, mutual fund sponsors receive notice of transactions from brokers or other middlemen for a few hours after 4:00 p.m., and complete these trades at the earlier 4:00 p.m.

closing price. The idea is that these orders were placed with the brokers before 4:00 p.m. and are merely being processed after this time.

In some cases, however, mutual funds have been accused of allowing a few favored investors to place initial orders after 4:00 p.m. In these cases, the traders knew the cost of the mutual fund at 4:00 p.m. based on readily available closing prices, and knew how the value of the underlying stocks in the mutual fund may have changed in the hours after 4:00 p.m. If the value went up, they could buy at the lower 4:00 p.m. price. If the value went down, they could sell at the higher 4:00 p.m. price.

By contrast, ordinary mutual fund investors – including plan participants who may have invested in funds subject to late trading – do not have the ability to time their purchases or sales, and instead absorb the gains or losses of the underlying stocks. The profits made by the late traders erode the value of the mutual funds and decrease ordinary shareholders' investments.

"Market timing" simply means that investors buy or sell a mutual fund on a daily or other frequent basis, jumping in or out of the market often, albeit at the 4:00 p.m. closing price. Rapid selling or buying of large numbers of mutual fund shares creates transaction costs to the funds, and in some cases requires fund managers to keep assets in cash which would otherwise be invested. These costs and the lack of investment returns on cash holdings would not occur except for the market timing activities, and so result in additional expenses and/or loss of income which is shared by all investors in the mutual fund.

Market timing is not illegal on its face, although in many cases mutual fund prospectuses state that market timing will not be permitted. According to news reports and allegations made in lawsuits, some mutual funds which stated in their prospectuses that timing would not be permitted were in fact allowing certain privileged investors to engage in this practice. The mutual fund sponsors allegedly received large fees from these market timers to allow them to continue their activities.

2. Must I take action on my 401(k) plan now?

At this juncture, there's no need to take hasty action. Many charges have been made and lawsuits filed, but no one knows the full extent of the facts. Some funds have been charged with allowing market timing only, while other funds and/or investment managers have been charged with allowing both timing and late trading. A few have also been charged with allowing their employees to buy and sell the funds they manage, creating an inherent conflict of interest with fund shareholders.

Acting quickly and without proper investigation may be the worst thing to do until more information is developed. To the extent market timing and late trading affect the value of a mutual fund, that damage has already been done and reflected in the current price of the fund. This, of course, assumes that the questionable or illegal practices have stopped at mutual funds that allowed them. Independent researchers who have looked into potential damages have estimated that the extra costs created by these activities equal approximately eight-one hundredths of a percent of the total invested in mutual funds.

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The bottom line is that while mutual fund sponsors and others may have broken their bonds of trust with shareholders and made millions of dollars in the process, the loss to an average investor or 401(k) plan participant is probably only a few dollars of decreased profits. And, since mutual funds are made up of underlying stocks whose valuation is not impacted by this scandal, it is unlikely that any run on a fund by investors will result in those staying in the fund losing their money. In any event, while certain investment managers such as Putnam have seen a large number of funds cancel asset management agreements, there has not been an equivalent effort by mutual fund holders to cash out. Nevertheless, if a significant number of investors pull out of a mutual fund, there could be additional transaction costs and administrative fees which will be divided among fewer fund shareholders.

There is also another reason not to panic and switch investment funds or managers. Investigators have just started to bring charges against fund families and insurers. It is possible that many major fund families or insurers engaged in questionable activities in at least some of their funds. Certainly, all the misbehaving has not yet come to light, and substantial additional charges involving as yet unnamed entities are anticipated. If this is the case, a fiduciary may later find that it has dumped one fund or insurer in favor of another that is equally culpable. And, if you are switching between providers, you may have gone through a painful transition, including the notorious "blackout period," when participants have no access to their accounts. This should be avoided if possible.

The essence of being a fiduciary is making prudent decisions, and these can only be made after a thorough and professional investigation. Precipitous actions do not meet these requirements.

3. What is a Plan fiduciary's obligation under ERISA or other laws?
ERISA is the federal law which governs employee benefit plans such as 401(k) arrangements. State and other laws generally do not apply to 401(k) plans. In the context of the mutual fund scandal, ERISA is the law plan fiduciaries need to be concerned with.

Plan fiduciaries have an obligation under ERISA to invest plan funds prudently and to monitor plan investments. In the context of 401(k) plans which allow participants to invest by selecting between a number of mutual funds, this means that the mutual funds offered must be suitable for a retirement plan and that the investment grouping must be monitored to make sure it remains suitable.

If a plan fiduciary becomes aware that a particular fund or investment manager has been charged with wrongdoing or suspects that wrongdoing has taken place, the fiduciary is obligated to investigate and take appropriate action.

4. What has the Department of Labor told fiduciaries to do?
Unfortunately, the Department of Labor's Employee Benefit Security Administration, the federal agency which oversees fiduciary issues in 401(k) plans, has been less than helpful in the current situation, stating only that it expects fiduciaries to act prudently under the circumstances. Apparently, it intends to offer no more advice on the subject.

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Ann Combs, an Assistant Secretary of Labor, noted to the ERISA Advisory Council in late 2003 that a fiduciary's responsibility is to "select and monitor" investment funds, and if the fiduciary has a concern that a problem exits, it "must investigate and make a determination." Combs also warned:

> "Fiduciaries . . . should not panic. The best course of action for the plan and the participants may not be abandonment of the investment. Such course of action might even be imprudent in the absence of an investigation into the problem by the plan fiduciary."

5. What specific course of action should plan fiduciaries follow?

In light of these pronouncements and the duties imposed by ERISA, we suggest the following course of action. Please remember, however, that every situation is different, and it would be unwise to simply embark on this process without seeking advice of counsel focusing on the specifics of your situation and how you should respond based on these specifics.

1. Review the grouping of investment funds available to plan participants under your plan to determine if any are involved in the ongoing scandal. This review should be in writing and records should be kept so fiduciaries can prove what steps were taken.

2. If the plan uses an investment manager or managers, review these entities to ensure that they have not been charged with wrongdoing. In particular, the fund fiduciaries should ask each mutual fund sponsor or investment manager:

   a. If it has been charged with any wrongdoing by any oversight agency or group, or if it is the subject of an investigation by any such agency or group. This would include internal investigations conducted by the fund sponsor or manager. If so, ask for a detailed written explanation of the charges or activities under investigation, and the sponsor or manager's response to these charges or investigations. If lawsuits have been filed, ask for copies of the complaints and any underlying material. If subpoenas have been issued, ask for copies and for responsive material.

   b. Ask specifically if the sponsor (or manager, where appropriate) has allowed market timing, late trades or personal trading by employees of the sponsor or related entities. If so, seek details as to what went on and what specific steps have been taken to protect against these practices in the future. Ask also what restitution is intended for mutual fund investors.

   c. If the sponsor has not engaged in these practices, ask what specific steps have been taken to ensure they do not occur.

   d. Ask what insurance protections are available to fund shareholders or clients of the manager. Ask also about the amounts of the policies and what limitations may be imposed. Ask for copies of the policies.

   e. Ask about governance of funds or investment managers, including who is on the board of directors, how the directors are picked and whether any are independent.

f. This is also a good time to determine if the funds' or managers' performances have been satisfactory. Perhaps an alternative fund or fund mix may be more appropriate. Also, carefully review fees to make sure they are still acceptable. Ask the fund or fund managers for disclosure of all fees taken from assets or otherwise.

3. If the evaluations described above result in any concerns, then a proper course of action must be developed and pursued. Alternative investments or managers must be considered. If the fiduciaries are not qualified to do this, outside experts should be brought in to advise them. You may want to renegotiate fees if they appear to be excessive.

4. If necessary, the fiduciary should ask for restitution and/or consider instituting litigation against the fund or manager, or joining existing litigation which may already have been filed. No settlement should be undertaken, however, without a thorough understanding of the amounts of loss which may have occurred.

5. Make sure the fiduciary documents all actions taken.

6. Communicate with plan participants about the investigation, the results, and what actions the fiduciaries intend to take or have taken in connection with these issues. Care should be taken not to panic participants, many of whom do not understand the current situation and who are worried that their life savings are in jeopardy.

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