

Employee Benefits Briefing

A bulletin designed to keep clients and other friends informed on employee benefits law matters

November 2003

ERISA FIDUCIARY DUTIES AND THE RECENT MUTUAL FUND INVESTIGATIONS

Mutual fund investments and other managed collective investment vehicles have many advantages for retirement plans. In particular, many 401(k) plans that are participant-directed have a menu of mutual funds (or other managed collective investment vehicles) from which participants make investment choices.

As a result, many plan fiduciaries (including fiduciaries of state and local government plans that are subject to state laws similar to ERISA) are asking what obligations they have in the face of the various investigations that have surfaced recently. The Securities and Exchange Commission, the New York Attorney General and others have announced investigations into what are commonly called “late trading” and “market timing” practices related to the purchase and sale of mutual fund shares. The Department of Labor has announced that it is gathering information about the practices. A fiduciary should review whether a change in any of the investment options is warranted at this time. While the situation is still developing, the following questions can serve as a general framework for a fiduciary’s inquiry into these matters:

What is the general nature of my fiduciary duty?

Fiduciary duties are usually allocated among plan fiduciaries by the documents establishing the plan. In most 401(k) plans, only one of the plan’s fiduciaries has the direct authority and responsibility to select the investment options that are available to plan participants. That plan fiduciary, typically the plan

investment committee or plan administrator, also has the principal responsibility for monitoring the continued appropriateness of those investment options. The overall standard for measuring continued appropriateness is ERISA’s “prudent person” standard. That standard places great importance on the procedural steps taken by the fiduciary under the particular circumstances to deal with the situation that has arisen. A well-reasoned decision process is what is expected, particularly in situations where there may be no “right” or “wrong” answer. A fiduciary wants to determine if the investment process is flawed resulting in harm to the participants. The following questions, then, should be those of the plan fiduciary who has these responsibilities.

How much information do I need as a fiduciary?

The press has reported extensively on the investigations. However, some of that reporting is incomplete and may be incorrect. The funds themselves have indicated they are still collecting the relevant information. Plan fiduciaries should review with their consultants, or with the fund itself, what information is available and how it affects the particular investment option. Many consultants have expended significant time and effort to understand the developing data. Many funds have already sent communications addressing these issues to their client plans. That information should be reviewed and analyzed. To the extent helpful, further information should be requested from the funds.

Should the fiduciary check funds not already specifically named in the investigation?

The investigation refers to practices that were unknown to most fiduciaries and that are not reported in generally published information. Thus, a fiduciary should attempt to obtain information on these issues about all present or contemplated fund options.

Is there a need to act quickly?

Normally, a fiduciary should proceed after obtaining and analyzing substantial credible information. However, if the practices disclosed or discovered reveal a continuing or developing potential for harm to the plan and its participants, a fiduciary may need to act on less than complete information. Again, the fiduciary should carefully evaluate the information available and determine if it is sufficient to support a particular course of action.

Does the initial selection process help in this subsequent inquiry?

Very likely the answer is yes. The fiduciary's initial selection of the mutual fund option should have emphasized factors that allowed the fiduciary to evaluate the fund's anticipated successful performance. If so, then this investigation can retrace the factors in that investigation as a template for further inquiry. For example, is the measured investment performance likely to be affected by the disclosures? Did the investment process change or will it change as a result of the investigations? Is the managers' ability to conduct research affected? Is there any harm to the fund and will the harm be remedied?

What other factors should the fiduciary examine?

Aside from the factors affecting the performance of the existing fund itself, the fiduciary should examine the overall effects of switching to a replacement fund. For example, is the replacement fund involved (or under a cloud of having been involved) in the same practices as the existing fund? Will the replacement fund require a change of recordkeeper? Does the replacement fund cover the same market

segment and have the same level of performance? Will the move to a replacement fund require a "blackout" and the special proceedings that go with it? What are the costs of moving to the replacement fund? How does the replacement fund compare under the general criteria used to select any fund?

Should participants be informed regardless of the course of action selected?

In two situations the answer will be clearly yes. First, the fiduciary has an obligation to respond truthfully to any inquiries initiated by plan participants. Second, participants need to be fully informed if the fiduciary has decided to replace an existing option. The fiduciary needs to provide accurate descriptions of the replacement fund. If the replacement fund has different risk-return characteristics, the participants need to know that information. In other situations, the disclosure of information will require an examination of the circumstances, including the fiduciaries' prior disclosure practices and an understanding of the needs of their plan participants.

Obviously, every situation requires an analysis of its particular facts. But fiduciaries following this line of questions will be well served. A decision that is based on accurate knowledge of the key information and that avoids any precipitous action will go a long way to protect the plan fiduciaries.

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