DOL Provides Guidance on ERISA Fiduciary Duties in Response to Mutual Fund Abuses

Since the announcements of state and federal investigations into mutual fund late-trading and market-timing abuses last summer, the fiduciaries of 401(k) plans, which typically use mutual funds as participant-directed investment options, have been faced with the issue of what steps to take in response. Many plan sponsors have been reviewing their mutual fund holdings, and some have dropped funds that have been prominently named in the investigations. Others have looked to the government for guidance.

Last October, Assistant Secretary of Labor Ann Combs, who heads the Employee Benefits Security Administration of the U.S. Department of Labor ("DOL")—the government agency that oversees ERISA enforcement—raised these matters in speeches to industry groups and the ERISA Advisory Council. She said that allegations of improper mutual fund practices must be factored into a plan fiduciary’s determination of whether a mutual fund investment continues to be appropriate for the plan. Her agency has now issued more detailed guidance, in the form of a statement by the assistant secretary posted on the DOL website, on considerations that fiduciaries should take into account in light of the reported late-trading and market-timing abuses, and on permissible restrictions that can be imposed on plan participants to reduce the risk of market timing. (The statement is available at http://www.dol.gov/ebsa/newsroom/sp021704.html). The statement provides useful information for both plan fiduciaries and mutual fund companies.

Prudence Considerations

The statement emphasizes that the fiduciaries’ conduct should be guided by the ERISA requirement that they discharge their duties prudently. The duty of prudence requires a deliberative process, which in turn requires the fiduciaries to make decisions based on as complete information as possible. Therefore, the fiduciaries should obtain, from the funds themselves, if necessary, information on:

- 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 future abuses
- any remedial action taken or contemplated to make investors whole

To demonstrate their prudence, the fiduciaries should document their decisions.

In addition, the fiduciaries may have to decide whether to participate in settlements or lawsuits. This will require them to weigh the costs to the plan against the likelihood and amount of potential recoveries.
The DOL guidance notes that funds that have not yet been identified by federal and state regulators may have been affected by the same late-trading and market-timing abuses. The fiduciaries, therefore, should review the same issues for all the funds used by the plan, and consider whether the funds have procedures and safeguards to limit their vulnerability to such abuses.

Restrictions to Deal with Market Timing

To address the market-timing problem, plan sponsors and fiduciaries have considered imposing trading limitations at the plan level. DOL acknowledged that such limitations raise the issue of whether the plan would no longer comply with the requirements of ERISA section 404(c), which, if met, relieves fiduciaries of participant-directed plans from liability for the results of the participants' investment decisions. One of these requirements is that the plan may impose only “reasonable” restrictions on the frequency with which participants may give investment instructions, specifying that a restriction is not considered “reasonable” unless it permits participants to give instructions "with a frequency which is appropriate in light of the market volatility to which the investment alternative may reasonably be expected to be subject."

DOL concluded that two approaches to limiting market timing do not run afoul of the “volatility” and other requirements of the section 404(c) rules. These are:

- Imposing reasonable redemption fees on sales of shares
- Imposing reasonable limits on the number of times a participant can move in and out of a particular investment within a particular period

DOL emphasized that these restrictions must be allowed under the terms of the plan and be clearly disclosed to the plan participants. If not, then they would not only raise issues under section 404(c), but also may require “blackout period” notices under the changes made to ERISA by the Sarbanes-Oxley Act of 2002.

DOL Reviews

DOL also took the opportunity to announce that it is conducting reviews of mutual funds, similar pooled investment funds and service providers to such funds for ERISA violations. These investigations are being coordinated with other federal agencies through the Administration’s Corporate Fraud Task Force. While the reviews would presumably focus primarily on the late-trading and market-timing issues, many expect scrutiny also of mutual fund fees, which are currently receiving attention from securities regulators and Congress. DOL last examined mutual fund fee issues in the late 1990s and issued guidance at that time highlighting the importance of fiduciary review of fees and fee disclosure.

Discussion

The DOL guidance is a reminder to plan fiduciaries of their responsibilities concerning mutual fund investments. A fiduciary of a plan that invests in funds of any family that has been implicated in the government investigations should obtain information about the allegations and the fund’s actions in response. If the plan regularly uses a consultant or adviser to assist in fund selection and review, the fiduciary should find out about any positions they have taken regarding particular funds or fund families. Even if none of the funds the plan holds has been involved in these investigations, the fiduciary should review the funds’ practices in the areas highlighted by those investigations, and consider whether steps can be taken to protect the plan’s investments. If the plan does not impose limitations to discourage market timing such as those described in the DOL guidance, the fiduciary should consider whether such limitations may be appropriate.

Mutual fund sponsors and other mutual fund service providers should be aware of these issues and be prepared to address them. They may need to respond to requests for information from plan fiduciaries and plan participants to deal with concerns about continued investment in the fund, or to requests for information from DOL investigators. DOL often conducts its investigations of fiduciary compliance by targeting plan
service providers such as mutual fund companies rather than individual plans, as a way to use its enforcement resources efficiently. As with any government investigation, being unresponsive to a DOL inquiry can prolong the DOL review and possibly lead to enforcement action.

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