

# Financial Services

MARCH 18, 2004 / NUMBER 11

## DOL Response to Mutual Fund Investigations

### Exercise of Fiduciary Duty

On February 18, 2004, Ann Combs, Assistant Secretary of the U.S. Department of Labor's Employee Benefits Security Administration, announced guidance (the "Guidance") for ERISA plan fiduciaries on the current mutual fund investigations involving allegations of market timing and late trading. The Guidance reminds plan fiduciaries that, as significant investors in mutual funds,<sup>1</sup> in assessing the impact of these problems on their plans' investments in funds, they must exercise their duties of prudence under ERISA and use a deliberative process to make as well informed a decision as possible under the circumstances. ERISA's basic fiduciary duty principles require that a plan fiduciary act reasonably, prudently, and solely in the interest of plan participants and beneficiaries.

For those funds that have been identified as under investigation, plan fiduciaries should consider (i) the nature of the alleged abuses and the potential impact of the allegations on the plans investment in the fund, (ii) the steps taken by the fund to limit the potential for abuse in the future, and (iii) any remedial

action taken or contemplated to make investors whole. The Guidance notes that because late trading and market timing abuses may extend to funds beyond those currently identified by federal and state regulators, plan fiduciaries need to consider whether they have sufficient information regarding the procedures adopted by any mutual funds offered under their retirement plans. It suggests that plan fiduciaries consider contacting the funds directly to obtain specific information.

Although the Guidance does not suggest a conclusion that plan fiduciaries should reach, the Guidance does emphasize that plan fiduciaries are required to follow prudent plan procedures in making their investment decisions and to document their decisions. In deciding whether to join class actions and settlements, fiduciaries will need to weigh the cost to the plan against the likelihood and amount of potential recoveries.

### Implications of Trading Restrictions under ERISA

In the Guidance, the DOL also addressed whether a plan's offering of mutual funds that impose reasonable redemption fees on sales of their shares would, in and of itself, affect the availability to plan fiduciaries of liability relief

<sup>1</sup> The Guidance notes that private sector pension and 401(k) plans subject to ERISA hold more than \$1.1 trillion of assets invested in mutual funds and similar pooled investment vehicles. The fund holdings of public sector plans are not included in this statistic.

under ERISA Section 404(c).<sup>2</sup> The DOL also mentions that similar questions had been raised regarding any limits, imposed either by the mutual fund or by the retirement plan itself, on the number of times a participant can move in and out of a particular investment within a particular time period.

Under ERISA Section 404(c), plan fiduciaries are not liable for losses arising from a plan participant's individual investment decisions. ERISA Section 404(c) imposes a number of requirements in order to provide this liability relief to the plan's fiduciaries for participant-directed plans. One such requirement is that any plan-imposed restrictions on the frequency of investment instruction be "reasonable," namely, that a plan participant be able to give investment instructions with a frequency that is "appropriate" in light of the expected market volatility of the investment option. In the Guidance, the DOL says that reasonable redemption fees do not affect the availability of relief under ERISA Section 404(c). In addition, the Guidance states that reasonable limits, imposed either by the fund or the plan, on the number of times a participant can move in and out of a particular investment within a specified time period would not, in and of themselves, be contrary to the DOL's Section 404(c) regulations, so long as those restrictions are allowed under the terms of the plan and are clearly disclosed to the plan participants and beneficiaries. If not so authorized and disclosed, these trading restrictions, according to the Guidance, could raise issues as to whether ERISA Section 404(c) applies, as well as whether such restrictions might constitute the imposition of a "blackout period" that would require advance notice under the DOL's "blackout period"

regulations.<sup>3</sup>

## DOL Investigations

In addition, in the press release that accompanied the announcement of the Guidance and in subsequent interviews, DOL indicated that it was conducting its own investigation of mutual funds and their service providers to determine whether there were any violations of ERISA in connection with market timing or late trading. According to reports, the DOL is focusing on investment companies and banks that offer 401(k) plan services and examining whether pension assets were used to facilitate late trading or market timing. The DOL's inquiries are reported to extend into revenue sharing arrangements, a not unexpected development after the SEC's recent investigative efforts regarding 401(k) recordkeepers and fund companies.<sup>4</sup>



If you have any questions about the information in this update, please contact one of the attorneys listed below or the Dechert LLP attorney with whom you are in regular contact:

Susan M. Camillo  
+1.617.728.7125 .....susan.camillo@dechert.com

Kathleen Ziga  
+1.215.994.2674 .....kathleen.ziga@dechert.com

Please visit us at [www.dechert.com/financialservices](http://www.dechert.com/financialservices).

<sup>2</sup> On February 25, 2004, the SEC voted to propose a new Rule 22 c-2 under the Investment Company Act of 1940 that would impose a mandatory 2% redemption fee on fund shares sold within five days of purchase. In the case of omnibus accounts, the rule requires that funds obtain the information they need to assess the redemption fee and to oversee the efforts of intermediaries to assess those fees and remit them to the fund. SEC Release 2004-23.

<sup>3</sup> "Notice of Blackout Periods Under Individual Account Plans," 29 CFR § 2520.101-3, 68 F.R. 3716, January 24, 2003.

<sup>4</sup> "401(k) Pay-to Play Deals Due for Scrutiny," Dow Jones Newswires, January 14, 2004.