Mutual Fund Scandals: Action Items for Public Sector DC Plan Sponsors

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The ethical scandals that erupted last year involving some of the nation's largest mutual fund companies have unleashed a torrent of legal actions, regulatory and legislative activity. As a result, governmental defined contribution (DC) plans must review -- and perhaps change -- how they manage their plans and interact with investment management companies.

Even if one's plan hasn't had relationships with any of the tainted mutual fund organizations, the overall environment has changed. This occasion offers an excellent opportunity to review basic questions of how fiduciaries are expected to meet their obligations to plan participants.

Defining Terms
Understanding "Where do we go from here?" begins with a review of the definitions of two practices that got funds in "hot water," ***after-hours trading*** and ***market-timing***. What do they really mean?

The answer is straightforward. **After hours trading** is the buying and selling of mutual fund shares after the 4:00 p.m. close of trading, but maintaining the ability to buy and sell mutual fund shares at the 4:00 p.m. price. Whereas a typical long-term investor makes a buy or sell decision prior to 4:00 p.m. and takes his chances on where the fund price will wind up at the end of the day, the investor who benefits from illegal after-hours trading can execute a trade knowing a profit is guaranteed.

The other key concept is **market timing**. This simply refers to the rapid in-and-out trading of mutual fund shares based on a strategy that seeks to exploit very short-term market activity, as opposed to the general direction of the market or of particular segments of the market based on economic fundamentals. The rapid trading of shares has proven to negatively affect the performance of the long-term shareholders of a particular fund.

While not illegal in itself, when market timing was conducted by traders acting upon knowledge of impending market activity that would have a predictable impact on the direction of the market or of an individual security - such as the performance of the domestic equity markets and their effect on the international equity markets - the practice is problematic.

Have any such practices involved funds offered by your plan? Following are some recent cases:

- **Fred Alger & Co.:** A former hedge fund investor processed 36 "round trip" transactions between March and August of 2003. All trades were submitted between 4:00 and 4:30 p.m. for processing. A former sales executive with the company pled guilty to one count of tampering with physical evidence in conjunction with the investigation by the New York Attorney General's office.
- **Putnam Investments:** Six of Putnam's portfolio managers were found to have worked in a coordinated manner to market time. The firm is also being investigated for the practice of "front-running," in which fund managers made trades for their own accounts prior to making similar trades on behalf of clients. In the fall-out, six portfolio managers and Putnam's CEO have left the firm or been fired.
- **Strong Capital:** The firm is alleged to have allowed Canary Capital to market time its funds. The founder of Strong Capital, Richard Strong, was accused of profiting from market

timing in Strong Capital funds. As this monograph went to press details of the final settlement were being worked out.

- **Charles Schwab:** The firm announced that it uncovered five market timing agreements involving U.S. Trust-advised Excelsior Funds. Schwab also discovered and reported the submission of after-hour trades in the Schwab Mutual Fund Marketplace.
- **Federated Investors:** A former hedge fund investor made 46 round-trip transactions over a six-month period in 2003 between a money market fund and six domestic equity funds. In exchange for preferential trading privileges, the hedge fund parked $10 million in a Federated-advised fund. Two additional short-term trading agreements were found.
- **Security Trust Company:** The firm submitted large bundled orders after 4:00 p.m. which included hedge fund trades, with the motivation of concealing investors' identities. (Security Trust Company is being dissolved.)
- **Canary Capital Partners:** The company has paid $40 million in restitution for violations stemming from market timing and late-day trading.

Plan Sponsors Duties

What can - and should - plan sponsors be doing in response to the investment management ethics meltdowns described above? Plenty. The place to begin is with a review of five basic principles governing the role of plan fiduciaries.

But, first, a quick reminder of who is a fiduciary, lest there be any confusion on that point. As NAGDCA reminds members in its informational brochure on "the basics of fiduciary responsibilities," ERISA defines a fiduciary as anyone who:

1. Exercises discretionary authority or control over the management of plan assets;
2. Renders, or has the responsibility or authority to offer investment advice for a fee or other compensation, direct or indirect for any of the plan assets; or
3. Has discretionary authority or responsibility in the administration of the plan.

What is expected of such people is that they should:

- Act solely in the interest of the plan and its participants;
- Maintain the plan for the exclusive purpose of providing benefits;
- Maintain the plan in accordance with the plan's governing documents and applicable laws;
- Diversify the plan's assets to minimize risk; and,
- Act with care, prudence and diligence in administering the plan.

Keep in mind that one cannot delegate the role of fiduciary to an outside party, regardless of the degree to which one can outsource administrative functions. That is, playing an active role in plan management is both desirable - and unavoidable. Therefore, fiduciaries should not expect contractors or law enforcement agencies to monitor all of the investment managers' activities on the fiduciaries' behalf.

Moreover, fiduciaries should be proactive in monitoring federal and state regulatory actions that could have an impact on a plan, and bring attention to issues potentially detrimental to participants.

Investment Policy Statements

In light of the mutual fund scandals, it is clearer than ever that fiduciaries should establish an investment policy statement (IPS). The IPS should identify:

- The roles and responsibilities of all involved in fund management;

- Plan objectives and types of investments to be offered;
- Guidance to plan fiduciaries regarding investment choices;
- The process for evaluating and monitoring investments; and,
- Criteria and procedures for removing and replacing plan investments.

Plans that use a third-party administrator (TPA) to administer investments should obtain and review the TPA's investment policy statement, or, alternatively, secure their commitment to follow the plan's IPS. It is also advisable to build into the administrative contract a statement that the TPA assumes a fiduciary duty to the plan.

When a Change Is Needed - Action Steps
The key to moving forward in accordance with one's fiduciary responsibilities is to be disciplined and methodical in devising and implementing a plan of action. While the drama of the fund scandals and the urgency of the questions that may have been raised by participants of plans using fund managers tainted by these scandals may suggest a rush to act, a panic-induced response would not be helpful.

Perhaps the best place to start is to take a careful look at the funds currently in the plan to determine whether any has been accused of abusive or illegal practices. Useful information is available both from the fund organizations themselves (including their Web sites), as well as independent reports. Note: If the answer is "yes," that doesn't necessarily mean that change is in order.

In any event, a macro review of the plan's investment options should cover such questions as:

- Is there significant overlap between the investment options available in the plan? (And, if so, does this help plan participants?)
- Does the current fund menu help satisfy the investment needs of participants and the overall investment objectives of the plan?
- Do the investment performance track records of individual funds merit maintaining of a particular fund in the line-up?

A review should also include an assessment of the overall fund organization(s).

The following questions are particularly urgent when directed to any of the fund companies implicated in the scandal. Specifically:

- Does the fund manager appear to have the ability to deliver strong performance in the future?
- Have there been changes to the management team since the problems were revealed?
- Have there been any significant organizational changes?
- Were the abuses isolated, or widespread?
- Is the current leadership experienced and stable?
- What commitments have been made by the fund organization to address the damages resulting from these investigations?
- Is the fund house committed to establishing and maintaining a strong compliance environment that places the interests of the investors first?

Answers to some questions can only be obtained by checking multiple sources. However, certain very specific inquiries must be made directly to the fund organizations, in writing. Such questions can include the following:

- Has the fund house been investigated or subpoenaed by regulators with regard to trading practices?
- Are there any pending litigation or administrative actions against the firm as a result?
- Has the fund house conducted an internal review to determine if inappropriate market timing or after hours trading has occurred, and what was the outcome?
- What internal controls does the fund house have in regard to employee trading?
- Has the fund house terminated any employee in connection with trading practice investigations?
- Describe any instance in which an investor or intermediaries such as brokers and retirement plan recordkeepers can initiate a purchase after the 4:00 p.m. Eastern time market close and receive that day's market closing price.
- How does the fund house verify that the original trade order was received prior to the 4:00 p.m. close?

Plan sponsors have a broad range of operational responses to offering a fund managed by a company caught up in scandal. One such response is to inform participants about the situation.

Assuming it is permitted under the terms of the plan document, plans may elect to close affected investment choices to new participants, or even close the option entirely. Such a decision, of course, would be based on a determination that participants would be better served by doing so than not, based on a careful assessment of the particulars of the case.

The issue of market timing by institutions also raises the issue of whether participants themselves have engaged in marketing timing that, while not illegal (assuming they aren't privy to inside information), may be incompatible with the purposes and policies of the plan. If so, new restrictions on the practice may be imposed, and enforced. (Such a change should not be implemented without clearance by plan counsel, of course.)

Whatever policy changes or actions are taken in response to the mutual fund scandals, the plan sponsor should heed the following three basic principles:

- Document actions and the reasons behind them.
- Use a written investment policy guideline for making decisions. And,
- Keep participants informed of all key decisions - and keep copies of communications.

Nobody said it would be easy to be a plan fiduciary. Now's the time to respond to the new, post-scandal environment to ensure that all plan audiences are well-served. And, don't go it alone. Resources are available to help through the entire process.

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