

# Corporate Finance Responsibilities re: 401(k) Mutual Fund Scandals



AFP

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March 1, 2002 – October 1, 2004 VP and Treasurer

## 401(k) Plans Scope and Scale

### At Year End 2003

- 401(k) plans held an estimated \$1.9 trillion in assets, comprising about 16% of the \$12.1 trillion retirement market in the US.
- Approximately 49% of 401(k) balances are in mutual funds (remainder with banks, insurance companies)
- \$992 billion, about 12% of overall mutual fund assets, are in 401(k) plans
- 67% of 401(k) balances are invested in equity securities (directly or indirectly); 16% in company stock
- 91 million people invest \$7.4 trillion in mutual funds

Investment Company Institute: FAQs about 401(k) Plans [www.ici.org/home/faqs\\_401k.html](http://www.ici.org/home/faqs_401k.html)

## ERISA

- The Employee Retirement Income Security Act (ERISA) is a federal law enacted in 1974
- Primary objective:
  - Protect benefit plan participants by establishing minimum (*pretty high*) standards for private sector retirement and health plans related to such items as:
    - Reporting and disclosure
    - Eligibility
    - Vesting
    - Funding
- Legislates that 401(k) plan fiduciaries operate in the best interest of the plan participants and beneficiaries
- Confers on plan participants the right to sue for benefit recovery and breaches of fiduciary duty

## Plan Fiduciaries are...

Main Entry: **fiduciary**

Function: *adjective, noun*

Etymology: Latin *fiduciaris*, from *fiducia* trust, transfer of a property on trust

**1** : of, relating to, or involving a confidence or trust <a guardian acting in his *fiduciary* capacity>

**2** : of or relating to a fiduciary or the position of a fiduciary <a *fiduciary* bond>

[Source](#): Merriam-Webster Dictionary of Law, © 1996 Merriam-Webster, Inc.

### ■ Individuals or entities that:

- Exercise discretionary control or authority over plan management or plan assets
- Have discretionary authority or responsibility for the administration of the plan
- Provide investment advice to the plan or have any authority or responsibility to do so

## Determination of Fiduciary Status Named or Functioning as...

### ■ Plan Fiduciaries can include:

- Plan Sponsor (Employer)
  - Corporate Officers and Employees
  - Board of Directors
  - Plan / Administrative Committee
- Plan Trustee, except when
  - Subject to direction of named fiduciary
  - Named fiduciary has appointed investment managers
  - Participants direct investments pursuant to ERISA 404(c)
- Investment Managers
  - Power to manage, acquire and dispose of plan assets
  - Registered under the Investment Advisors Act of 1940 or is a bank or insurance company
  - Must acknowledge fiduciary status in writing
- Investment Advisors

### ■ Fiduciaries are not:

- Service Providers (Attorneys, Consultants, Custodians) who do not exercise direct or indirect authority or control over the plan

## ERISA Fiduciaries duties include...

- ERISA mandates that fiduciaries carry out the following duties in order to protect Plan participants from losses and unreasonable expenses:
  - **Exclusive Benefit Rule** – all activities and transactions must be engaged solely in the interest of the participants and beneficiaries
  - **Prudent Expert Rule** – duties must be executed under the care, skill, prudence and diligence of an individual familiar with such matters
  - **Procedural Prudence Requirements** –
    - Select and monitor the performance of investment options
    - Select and monitor any service providers and insure that service provider fees and expenses are reasonable
  - **Diversification Rule** – investments must be diversified to minimize large losses
  - **Plan Document Rule** – Ensure that the plan is administered according to the Plan objectives and any Plan documents and conform with ERISA

## Business Actions vs. Fiduciary Actions

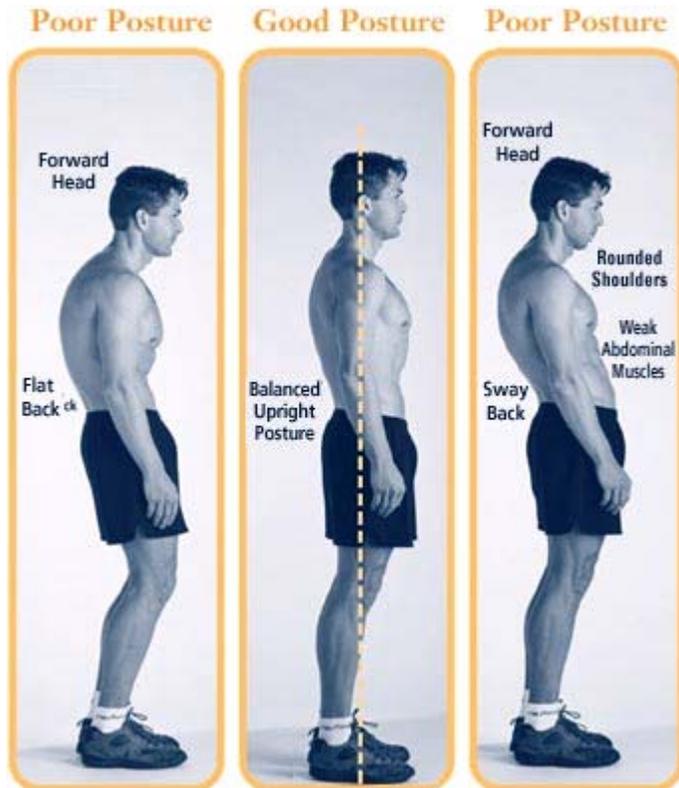
- Examples of business decisions and actions:
  - Establish the plan
  - Define the benefit package
  - Determine plan features
  - Collect contributions and apply as specified by plan
  - Amend or terminate the plan
  - Prepare plan reports for government agencies
  
- Whoever, the employer or someone the employer hires to, implements the business decisions and thereby exercises control or discretion over the plan, acts in a fiduciary capacity

## What if...

“Fiduciaries who do not follow these principles of conduct may be personally liable to restore any losses to the plan, or to restore any profits made through improper use of plan assets. Courts may take whatever action is appropriate against fiduciaries who breach their duties under ERISA including removal.”

-Department of Labor Website

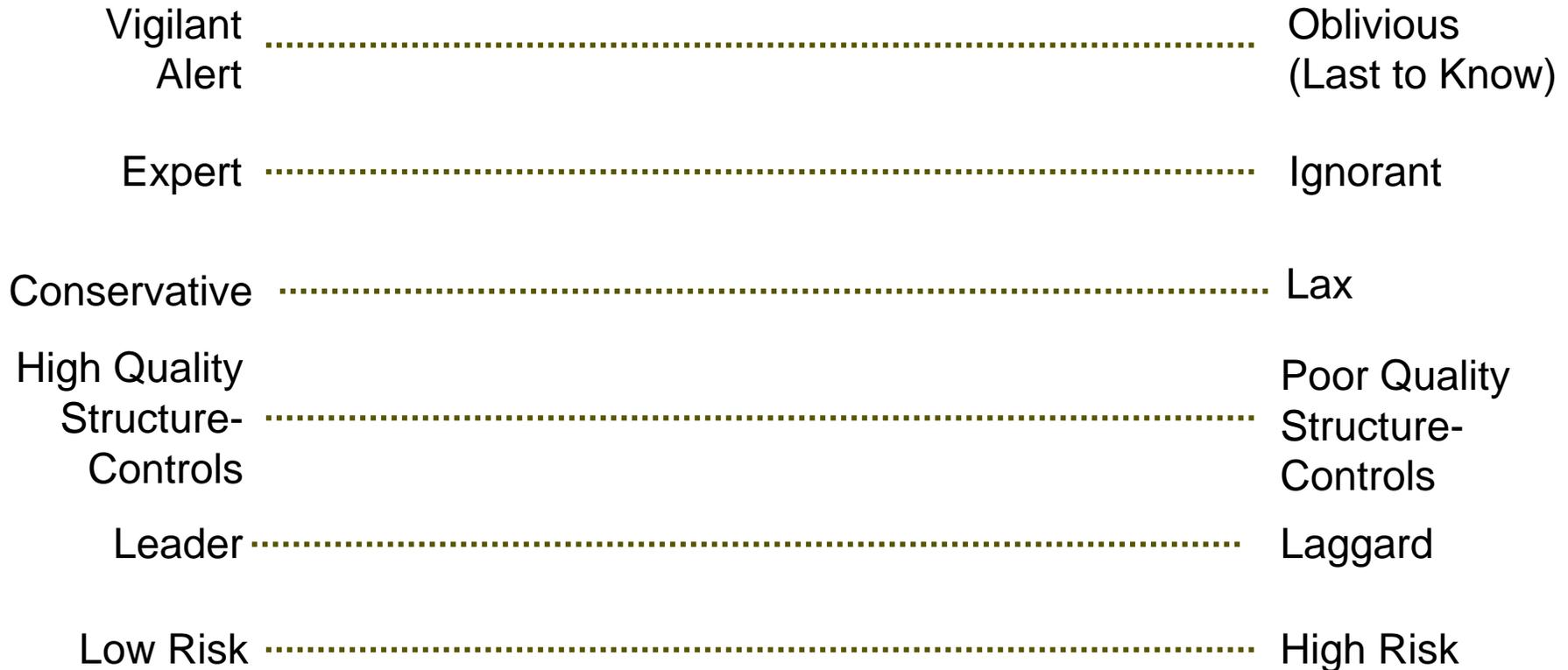
## Check your posture



- What you don't know, won't hurt you
  - Empty head – Good heart – Not!
- Following form without understanding why
- “Up on a tightwire, one side's ice and one is fire” Leon Russell, 1972
- Over compensate, Over kill, Over board

## Determining how your company adheres to ERISA is inherently subjective

There are wide ranging areas of latitude and discretion about what to do and how to do it. Consciously and deliberately assess | choose your position:



# Sampling of Corporate Approaches

Company	Accountability		QD Evaluation	
	Treasury	HR	Consultant	Plan Administrator
Old, Established, Large Employee Base	Department - experts	Business owner	😊😊😊	😊😊😊
Young, High Growth Medium Employee Base	Served on Plan Investment Committee	Business owner	😊😞	😊😊
Young, Small and Declining Employee Base	Inquiries from Plan Investment Committee	Primarily Accountable	😊?	😊😊😊

## When things go wrong...

### Acts of Omission

- Exposure
- Gaps
- Failure to perform duties

### Acts of Commission

- Perform duties well

==== Standard / Threshold (adjusts) =====

- Failure to perform duties well

## What can go wrong?

- 401(k) fiduciary breach lawsuits – Enron, Lucent, Worldcom, and many more
- Enron

Situation: September, 2003 Texas federal judge rules that Enron employees may sue Enron, it's Board, Plan Provider, responsible corporate officers for breach of ERISA fiduciary responsibilities

Issue: Plan structure resulted in undue concentrations in Enron stock (about 60% of assets.) Employees were unable to sell during plan provider switch. Executives were able to sell shares not held in the plan. 404(c) carve out compromised

Expectation: Despite sizeable fiduciary liability policy, responsible individuals will be held personally liable

# Department of Labor Actions

## ERISA Enforcement

Latest Enforcement Statistics	F.Y. 2001	F.Y. 2002	F.Y. 2003
Prohibited Transactions Corrected	\$330 million	\$398 million	\$460 million
Plan Assets Restored	\$139.2 million	\$189.7 million	\$169.8 million
Participant Benefits Restored	\$133.4 million	\$125.3 million	\$105.4 million
Plan Assets Protected	\$114.6 million	\$168.2 million	\$662.1 million
Voluntary Correction Programs	\$4.2 million	\$1.9 million	\$8.7 million
Total Monetary Results	\$721 million	\$883 million	\$1.4 billion
Number of Indictments	87	134	137

## Mutual Fund Scandal – What to do?

Word to the wise – across the board, exercise excellent “procedural prudence”

- ERISA Section 404(a)(1)(B) imposes upon fiduciaries a duty to investigate prudently the merits of any potential investment they might make
- DOL Reg. 2550.404a-1 “ERISA’s requirements are satisfied if the fiduciary has given appropriate consideration to those facts and circumstances that the fiduciary knows or should know are relevant to the particular investment”
- *Donovan v. Cunningham* – [ERISA’s] “test of prudence...is one of conduct and not a test of the result of performance of the investment. The focus of the inquiry is how the fiduciary acted in his selection of the investment, and not whether his investments succeeded or failed.”

## The Duty to monitor plan investments

- ERISA obligates fiduciaries to monitor, evaluate and remove problematic / inappropriate investments
- Develop, follow and document exercise of a substantive and prudent investigative process
  - Figure out what information is needed to make an informed, fact based decision
  - Gather, study and analyze the information
  - Ask the right questions and get answers, get expert help if ill equipped
  - Make an informed, fact based decision
  - Document and be able to demonstrate adherence to a prudent investigative process
- Caliber, performance and conduct of engaged experts must also be evaluated and monitored

## Statements by Ann Combs, DOL

“Although investors generally could not anticipate the late trading and market-timing problems...plan fiduciaries nonetheless are now faced with the difficult task of assessing the impact of these problems on their plans’ investments and on investment options”

“Duties of Fiduciaries in Light of Recent Mutual Fund Investigations” issued February 17, 2004

“ERISA requires that plan investment decisions, including the selection of mutual funds, must be prudent and solely in the interest of plan participants and beneficiaries. Allegations of improper mutual fund practices where a plan invested must be factored into the fiduciary’s determination of the continuing appropriateness of that investment”

-Speech in 2004

## Take action...

- Investigate
- If funds are under investigation
  - Ann Combs advises:
    - Consider the nature of the alleged abuses
    - Determine the potential impact of those abuses on the plan investments
    - Identify actions taken by the fund manager to limit the potential for future abuses and any remedial action taken to make investors whole
  - Review and leverage:
    1. State of Maryland ***Inquiry into Mutual Fund Trading Practices***
    2. Bruce Ruud's ***“The Mutual Fund Scandal: Steps for the Prudent Fiduciary”***
- Decide whether the fund is suitable or an inappropriate investment option and take appropriate action

## Checklists

### Maryland's Inquiry Into Mutual Fund Trading Practices

National Association of Government Defined Contribution Administrators website

[http://www.nagdca.org/resource/mutual\\_fund\(11-03\).doc](http://www.nagdca.org/resource/mutual_fund(11-03).doc)

### The Mutual Fund Scandal: Steps for the Prudent Fiduciary

By Bruce Ruud, President, Bruce Ruud & Associates, LLC

[http://www.401khelpcenter.com/401k/ruud\\_prudent\\_fiduciary.html](http://www.401khelpcenter.com/401k/ruud_prudent_fiduciary.html)

## Some strategies to limit liability in general

- Ensure that your plan structure, investment policy, processes and procedures are sound
- Emphasize and follow a fiduciary process
- Leverage advantages of Section 404(c)
- Obtain expert assistance and delegate fiduciary responsibilities where warranted
- Obtain fiduciary liability insurance
- Implement participant education programs
  - In support of informed participant decision-making

401(k) Plan Participants, Characteristics, Contributions, and Account Activity

Frequently Asked Questions About 401(k) Plans

**Investment Company Institute** <http://www.ici.org/>

Remarks of Assistant Secretary Ann L. Combs At the Kickoff of the Fiduciary Education Campaign - "Getting It Right"

**DOL** <http://www.dol.gov/ebsa/newsroom/sp051804.html>

Meeting Your Fiduciary Responsibilities

<http://www.dol.gov/ebsa/publications/fiduciaryresponsibility.html>

Various articles, reference materials

**Reish Luftman Reicher & Cohen – Employment Benefits Practice** <http://www.reish.com/pa/benefits/home.cfm>

COLLECTED WISDOM™ on the Ongoing Mutual Fund Scandal and Other Issues

**401K Help Center. Com**

[http://www.401khelpcenter.com/cw/cw\\_mf\\_scandal.html](http://www.401khelpcenter.com/cw/cw_mf_scandal.html)

## Speaker Biography

***Ms. Maeve Richard, VP Treasurer of McAfee, Inc.***, directs worldwide cash and investment management, risk management, credit and collections. Maeve has held various positions of increasing responsibility in corporate finance, pension investments, relationship management and treasury at SRI International, JP Morgan & Co., Levi Strauss & Co. and served as the Assistant Treasurer of Sun Microsystems. Maeve earned an A.B. degree in Political Economy, University of California Berkeley and a MBA from Graduate School of Business, Stanford University. Maeve is active in the community. A former board Member of Community Bank of the Bay and currently serves on the board of Handsnet, a human services online community, and is a mentor for CollegeTrack.