



***The AFP Conference  
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***The Mutual Fund Scandals  
Why Do We Care?***

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## *Today's Focus/Agenda*

- ▶ Mutual Fund Scandal Scope
- ▶ Multi-Pronged Mutual Fund Misconduct – Details and Definitions
- ▶ 401(k) Late Trading Case Study
- ▶ SEC Consultant Sweep
- ▶ Outlook for Retirement Plans, the Money Management/Mutual Fund Industry and Investment Consulting



## Will More Firms Be Named or Shamed?



Yes

Eliot Spitzer

Attorney General

State of New York

[www.oag.state.ny.us/press](http://www.oag.state.ny.us/press)

Mutual Fund Complexes

Broker Dealers

Hedge Funds (e.g. Canary, Millennium)

Bank Lenders (e.g. Bank of America, CIBC)

Insurance Companies' Annuity Funds (e.g. Conseco)

Trust Companies (e.g. Security Trust, Schwab)

Pension Consultants (e.g. Aon, Frank Russell, Mercer)

DC Providers





## Will More Firms Be Named or Shamed?

Yes

William H. Donaldson  
Chairman  
U.S. Securities and Exchange Commission

[www.sec.gov](http://www.sec.gov)

88 largest mutual fund complexes  
34 broker dealers  
24 pension consultants  
20 defined contribution providers





## **SEC Focus on 4 Types of Mutual Fund Misconduct**

- ▶ **Late Trading and Market Timing** of Mutual Fund Shares
- ▶ **Sales Practices** – Mutual funds have been criticized for not clearly disclosing marketing arrangements such as 12(b)1, revenue sharing and other incentives they pay for “shelf space” at retail brokerages and intermediaries that resell the funds
- ▶ **Share Classes** – Many funds are typically available in various classes depending on whether the investor pays a front-end or back-end load or some other type of fee. Investors may not always be properly informed on the fee levels that apply to the different classes. Also Supervision of Appropriateness of Different Classes of Shares at Broker Dealers may be inadequate or nonexistent (e.g. Prudential).
- ▶ **Breakpoints** – Some mutual fund investors may not have received discounts for volumes purchased to which they were entitled. Broker Dealer abuse of “Breakpoint” Discounts





# Mutual Fund Family Scandal Scorecard

Snapshot as of September 30, 2004

Source: Morningstar

	Late Trading	Market Timing	Mispricing
Alger	●	●	
Alliance Bernstein		●	
Columbia (BAC/Fleet/Nations)	●	●	
Excelsior (Schwab/UST)		●	
Federated	●	●	
Franklin		●	
Heartland			●
Invesco/AIM (AMVESCAP)		●	
Janus		●	
MFS		●	
One Group (JP Morgan)		●	
PBHG		●	
PIMCO		●	
Putnam		●	
RS Investments		●	
Scudder		●	
Seligman		●	
Strong		●	
Vanguard (Wellington)		●	
Wachovia (Evergreen)		●	





## **Definitions and Results** Often Practiced in Combination

- ▶ **Late Trading** – *“can be analogized to betting today on yesterday’s horse race.”*

Illegal per 1921 Martin Act and Forward Pricing Rule of 1968 and 17CFR Sec 270.22c-1(a) of Investment Company Act of 1940.

- ▶ **Market Timing** – *“Allowing timing is like a casino saying that it prohibits loaded dice, but then allowing favored gamblers to use loaded dice, in return for a piece of the action. “*

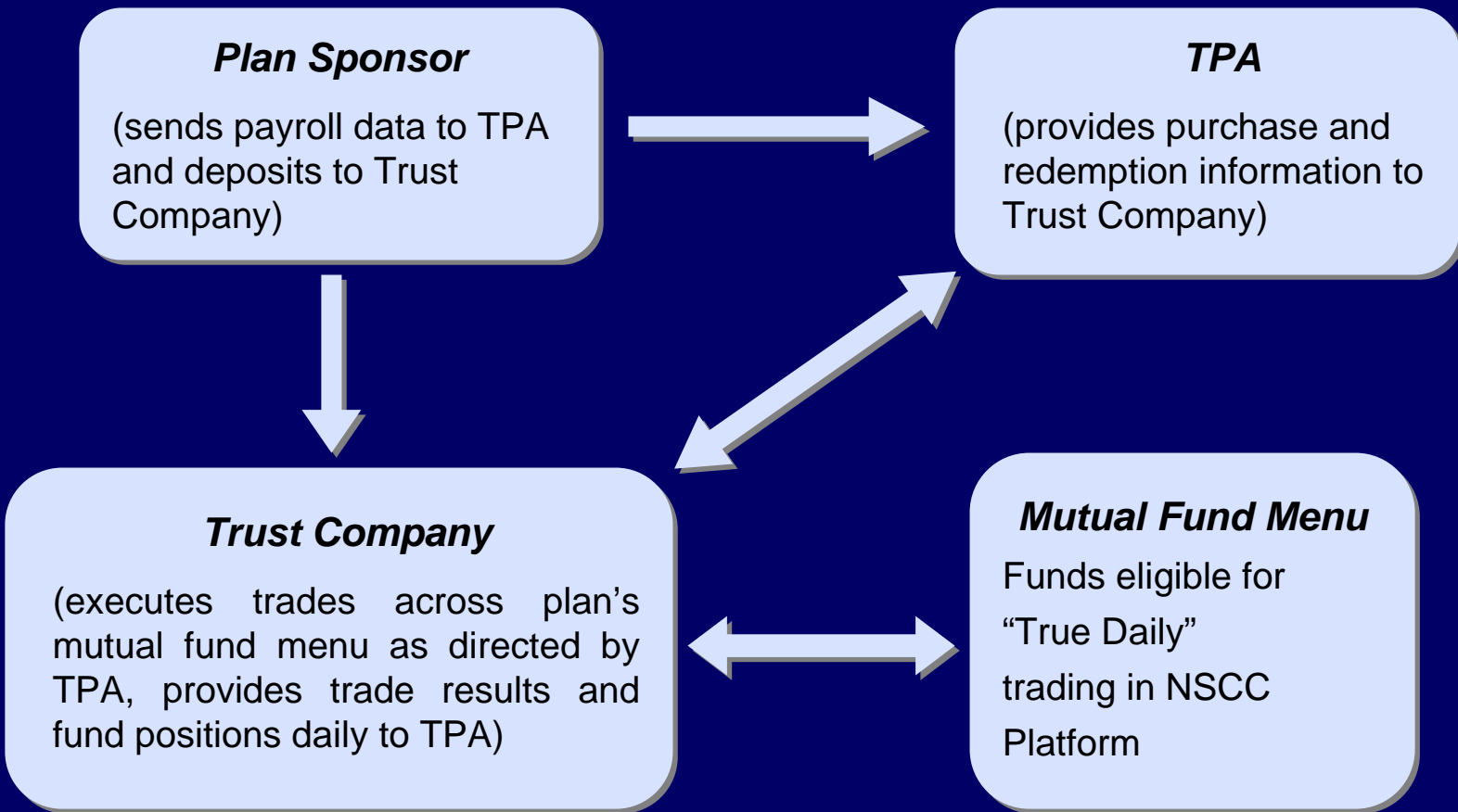
Unethical. Prohibited by most Mutual Fund Prospectuses.

- ▶ **Disclosure of Portfolio Holdings** – selective disclosure abuses





# 401(k) Retirement Plan Trading Platform





## *How Trades Are Executed*

- ▶ All trade elections received by TPA (Third Party Administrator) by 4:00 pm (Eastern Time or ET) market close
- ▶ TPA has until 9:00 pm ET to provide trading file to Trust Company
- ▶ Trust Company guarantees execution of trades at current day's mutual fund prices ("true daily") through NSCC platform
- ▶ Trust Company provides confirmation file of transactions and mutual fund positions to TPA next morning



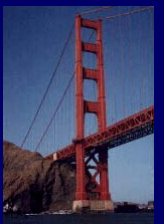
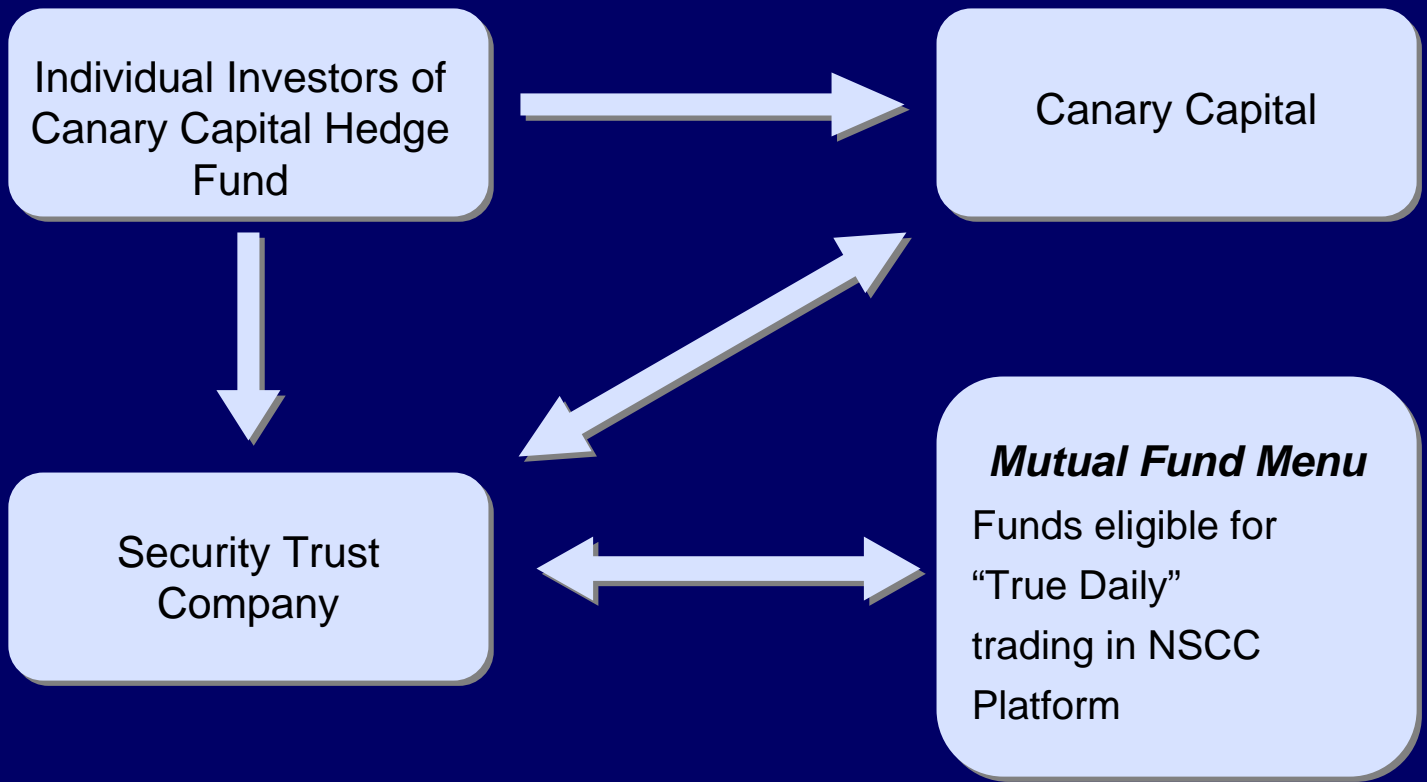
## 401(k) Participant Trade Example

- ▶ Sam logs into his 401(k) account and elects to rebalance his account to 50% Fund A and 50% Fund B. His election is completed at 3:00 pm ET.
- ▶ TPA collects mutual fund share prices and verifies prices by 7:00 pm ET.
- ▶ TPA determines that Sam has \$3,000 in Fund A and \$1,000 in Fund B.
- ▶ TPA provides trading file to Trust Company by 9:00 pm ET.
- ▶ Trading file includes following transactions:
  - ▶ *Sell: 111.111 shares of Fund A at \$9.00 per share to raise \$1,000.00.*
  - ▶ *Buy: 100.000 shares of Fund B at \$10.00 per share with the \$1,000.00*
- ▶ Trust Company executes the sale and purchase (Mutual Funds A and B guarantee execution on “true daily” basis) and provides confirmation file to TPA following morning.





# Canary Capital and Security Trust Company





## ***How Canary Capital and Security Trust Company Took Advantage by Late Trading***

***Canary Capital*** included purchases in trading file based on information learned after market closed, i.e. late trading (forward pricing).

- ▶ ***Example 1:*** Asian markets are up following close of US market. Based on this information, Canary Capital includes purchase instructions in trade file to Security Trust Company (STC) to buy into certain international mutual funds. The following day, the mutual fund shares are sold.
- ▶ ***Example 2:*** At 4:00 pm Pacific Time (after market has closed), Microsoft makes an announcement that earnings for the previous quarter are better than expected. Based on this information, Canary adds purchase instructions to trade file to STC to buy certain mutual funds that hold a high percentage of Microsoft. The following day, the mutual fund shares are sold.





## ***How Canary Capital and Security Trust Took Advantage by Late Trading***

***Security Trust Company*** agreed to make certain Canary Capital purchases within the accounts of Retirement Plans that they administered. This “piggybacking” was done to hide the transactions from mutual funds.

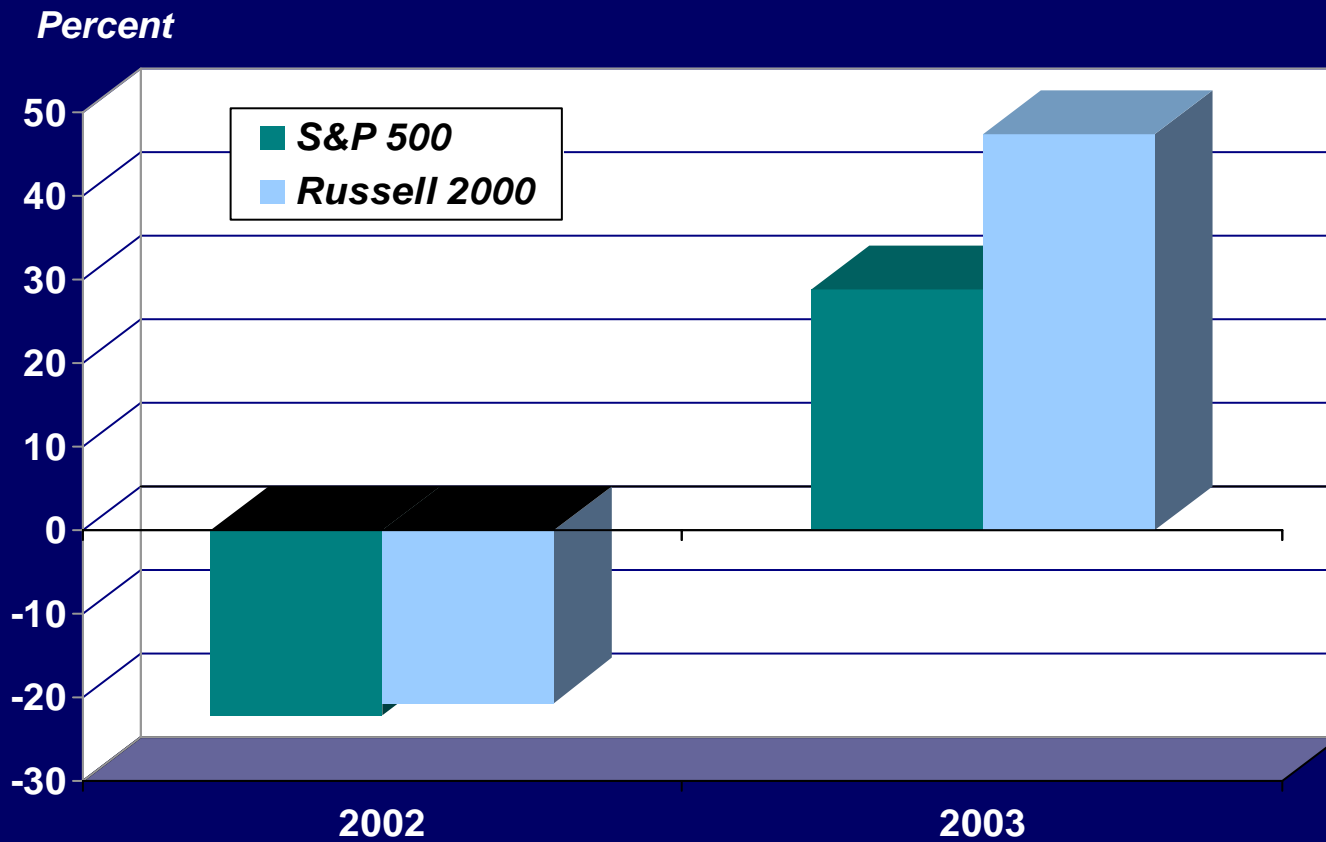
- ▶ ***Example:*** Canary includes a \$500,000 purchase of a particular International Mutual Fund in trading file. Rather than making the purchase in mutual fund accounts set up for Canary or in STC’s “house accounts” (omnibus accounts that STC uses for non-retirement customers), STC makes the purchase in a retirement plan omnibus account or in an individual retirement account that is set up in the name of a specific retirement plan. The following day, the mutual fund shares are sold.





# Better To Occur in 2003 Than in 2002

Total Return





## ***Bottom Line on Balances***

- ▶ Mutual Fund Company Flows Reflect Investor Reaction
- ▶ No Apparent Impact on Net Industry Flows Yet

***Source: Lipper, TrimTabs, ICI (Investment Company Institute)***





## *Tips for Greater Fund Transparency*

- ▶ Positioning of Key Metrics in Prospectuses, Annual Reports, Proxies
- ▶ Churn Ratio – Calculate on Share Class Basis vs. Portfolio Basis
- ▶ Turnover Ratio – Sum Shareholders Buying Plus Selling / Net Assets
- ▶ Commission-Cost Ratio

**Source:** *Lipper, TrimTabs*





## Will More Firms Be Named and Shamed?



- ▶ Lori A. Richards
- ▶ Director, Office of Compliance Inspections and Examinations
- ▶ U.S. Securities and Exchange Commission
  
- ▶ Pension Consultant Sweep
- ▶ Proactive
- ▶ 6 Years Ago
- ▶ December 2003 = First Tranche
- ▶ 12 page letter
- ▶ 24 consultants
- ▶ Defined Benefit and Defined Contribution Plans
- ▶ 23 Month Period: January 1, 2002 – November 30, 2003
  
- ▶ “Pay To Play”
- ▶ Conflicts of Interest
- ▶ Disclosure





# SEC Proposed Rules

<i>Release Number</i>	<i>Release Date</i>	<i>Details</i>
33-8358	Jan. 29, 2004	Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds
IA-2209	Jan. 20, 2004	Investment Adviser Code of Ethics
IC-26323	Jan. 15, 2004	Investment Company Governance
33-8347	Dec. 17, 2003	Disclosure of Breakpoint Discounts by Mutual Funds
IC-26288	Dec. 11, 2003	Amendments to Rules Governing Pricing of Mutual Fund Shares
33-8343	Dec. 11, 2003	Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings





# Corporate Treasurer's Perspective

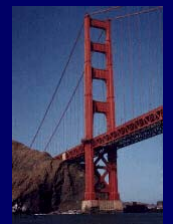
- ▶ Regulatory – Why Treasury Exercises Fiduciary Responsibility
- ▶ Exposure – Examples When Company is Exposed
  - ▶ Advice
  - ▶ Education
  - ▶ Performance
  - ▶ Expense Ratios
  - ▶ Company Stock
- ▶ Risk Management





# Forecast

- ▶ Headline Risk
- ▶ Impact on Profitability
- ▶ Some Players Will Be Acquired (e.g. Security Trust, Fremont, Strong)
- ▶ More Disclosure
- ▶ New Paradigm – Who Is Client?



# Worthwhile Websites



- ▶ Regulatory Resources

- ▶ [www.dol.gov](http://www.dol.gov)

- ▶ [www.irs.gov](http://www.irs.gov)

- ▶ [www.oag.state.ny.us/press](http://www.oag.state.ny.us/press)

- ▶ [www.occ.gov](http://www.occ.gov)

- ▶ [www.sec.gov](http://www.sec.gov)

- ▶ Industry/Impact Players

- ▶ [www.afponline.org](http://www.afponline.org) (Committee on Investment of Employee Benefit Assets)

- ▶ [www.ebri.org](http://www.ebri.org)

- ▶ [www.ici.org](http://www.ici.org)

- ▶ [www.sparkusa.org](http://www.sparkusa.org)



## Speaker Biography



**Ms. Mary Ellen Mullen** has over 30 years of institutional investment experience. Prior to partnering with Bridgebay, she provided consultative institutional sales solutions for a major West Coast financial institution for over 10 years. Institutional investment management applications included, but were not limited to 401(k), pension, balance sheet and foundations and endowments in corporate, insurance and health care industries.

Previously she was Principal and Director of Seattle Capital Management Company, the SEC-registered investment management subsidiary of Bank of America that she founded. She was responsible for over \$5 billion in fixed income assets ranging along the yield curve from Money Market Mutual funds that ranked in the top 15 of the Lipper Universes and large, short duration objective portfolios to endowment and retirement plans for Fortune 100 Companies such as Boeing. She managed large institutional fixed income and balanced portfolios for Bank of America's Seattle First National Bank. Fixed Income accounts included, but were not limited to Boeing, Rockwell and TRW. During this period, investment performance was consistently in the top quartile of the Frank Russell universes.

She began her career in Boston, MA as an equity technical analyst, managed the Chart Department at Loomis Sayles and Co., Inc. supporting Stock and Bond Research, as well as Sales and Marketing. As an Economic Research Analyst she handled three economic consulting clients: GM, New England Life and International Paper.

She holds a BA from Mount Holyoke College and an MBA in Finance from the University of Washington. She is a Chartered Financial Analyst and a member of the Association for Financial Professionals and the Association for Investment Management and Research.



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



AFP

Monday, November 8, 2004

Maeve Richard

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

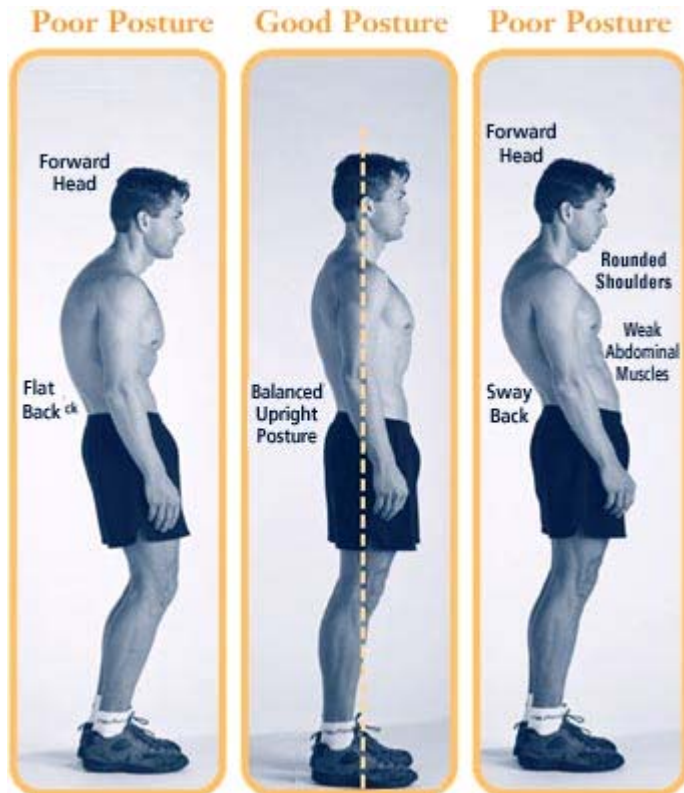
- Examples of business decisions and actions:
  - Establish the plan
  - Define the benefit package
  - Determine plan features
  - Collect contributions and apply as specified by plan
  - Amend or terminate the plan
  - Prepare plan reports for government agencies
  
- Whoever, the employer or someone 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

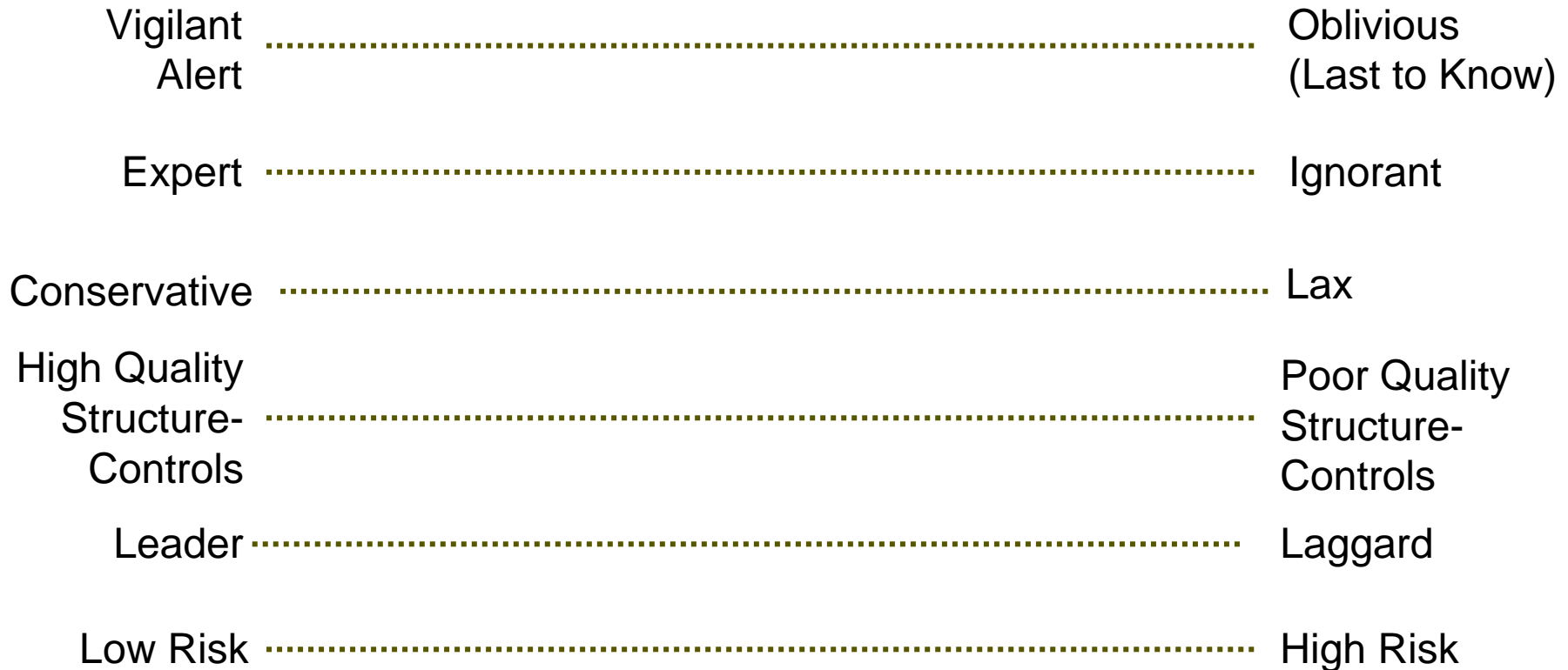
## Check your posture



- 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.