

SEC FAIR FUND SETTLEMENTS RELATING TO THE MUTUAL FUND TRADING SCANDALS

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Beginning in 2003, the SEC and state officials obtained settlements as a result of enforcement actions against mutual fund managers for late trading and market timing practices.¹ These settlements were put into what the SEC call “fair funds” to compensate investors who were harmed by the violation.² The first of these fair funds have begun distributions to shareholders. Plans that invested in the mutual funds during the period that the improper trading was alleged to have occurred will begin receiving checks from the fair funds. Fiduciaries of defined contribution (DC) plans will have to decide how to distribute those settlement proceeds to their participants. This article will discuss some of the options that DC plans have.³

Individual settlements and fair funds are listed on the SEC website at <http://www.sec.gov/divisions/enforce/claims.htm>. For each fair fund, the SEC appointed an independent distribution consultant (IDC) to establish a plan to distribute the monies from the settlement fund to the shareholders of the relevant mutual fund or series of funds harmed by the late trading or market timing. The IDCs in turn retained fund administrators to handle the actual distributions. Proposed distribution plans were

¹ Late trading involves placing orders to buy or sell after the 4:00 p.m. (Eastern) close of the markets. Since daily mutual fund transactions are priced at the closing net asset value (“NAV”), the party entering the trade knows whether the mutual fund's value has gone up or down and could buy or sell accordingly. Market timing, on the other hand, involves large trades in and out of a fund in a short period to make quick profits as a result of short-term trends (the functional equivalent of day trading). Late trading is illegal. Market timing, while legal, in some cases violated representations made by the mutual fund that it did not permit large trades in and out within a short time period.

² The SEC Fair Funds are created by section 308 of the Sarbanes-Oxley Act of 2002. Regulations governing the fair funds were issued by the SEC in 2004 and modified in 2006. 17 C.F.R. § 201.1100 available at <http://www.sec.gov/about/rulesprac2006.pdf>.

³ ~~This article will deal with the issues facing defined contribution plans.~~ Defined benefit plans generally will simply add the assets to the other assets in their trust fund. However, such plans may also face allocation issues if multiple plans are in a group trust or if some or all of the plan has been spun off in the interim. ~~These issues are outside the scope of this article.~~

published on the SEC website and comments received during the comment period following publication were also posted. The SEC regulations provide that the order approving or disapproving the plan should be entered within 30 days after the end of the final period allowed for comments but the SEC may allow a longer period for good cause shown.⁴ While most of these proposed distributions plans were issued in 2006, the SEC has found it necessary to delay the final orders in order to deal with issues raised in the comments, some of which include comments from parties representing plans or their service providers about the difficulties of allocating the recoveries within plans. As a result, the first distributions did not begin until earlier this year.

Four of the fair funds have received SEC approval of their distribution plans and three have begun distributions.⁵ Each has established a website to help investors understand the process. The first four funds making distributions, the periods covered by the settlement, and the fair fund websites are:

Funds or Advisor	Period	Fair Fund Website
Pilgrim Baxter	1998-2001	www.pbafairfundsettlements.com
Banc One Investment Advisors	1999-2003	www.settlementbanconeia.com
Columbia Management Advisors	1998-2003	www.columbiafairfund.com
Massachusetts Financial Services	2000-2003	www.rust-mfssettlement.com

Plans may have difficulty reconstructing daily participant-level investments in each of the mutual funds during these periods, particularly if a plan has changed record-keepers, changed investment options, or undergone a merger or transfer during this period.

The SEC in approving the various distribution plans has recognized that retirement plans may have difficulty in precisely ~~allocated~~ allocating the recovery in

⁴ 17 C.F.R. § 201.1104.

⁵ The distribution plan for the Massachusetts Financial Services (MFS) has been approved and distributions are expected to commence this fall. The order approving the MFS Plan of Allocation is available on the SEC website at www.sec.gov/divisions/enforce/claims/mfs.htm.

relation to the injury suffered by individual plan participants and that such an effort may not be cost effective (i.e., the cost of doing the ~~precised~~ calculation would eliminate or erode the recovery for the individual participant). As a result, each distribution plan provides simplified methods for allocating amounts within a ~~defined contribution~~ DC plan (generally called a “Non-IRA Retirement Account” or “NRA” in the distribution plans). The Pilgrim Baxter and Banc One distribution plans permit plans to allocate their fair fund distributions pro rata based on current account balances in each fund or to use the distribution to pay plan expenses if permitted by the plan.⁶ The Columbia Funds distribution plan permits plans to allocate the distribution using daily, monthly, quarterly or yearly balances.⁷ The MFS distribution plan permits ~~defined contribution~~ DC plans to: (i) allocate to current participants in each fund either pro rata based on current account balances or per capita; (ii) add the distribution to plan’s forfeiture account; or (iii) use any other administratively feasible method.⁸

On April 19, 2006, the DOL issued Field Assistance Bulletin 2006-1, which provided guidance about the SEC Fair Funds for plans subject to ERISA. FAB 2006-1 provided useful guidance to plan fiduciaries about how proceeds from the fair funds are to be allocated. The goal of the allocation methodology should be to allocate the recovery to the affected participants, but DOL recognized that there is a cost-benefit analysis in selecting and implementing an allocation method within a plan:

Prudence... at a minimum, would require a process by which the fiduciary chooses a methodology where the proceeds of the settlement would be allocated, where possible, to the affected participants in relation to the impact the market

⁶ Pilgrim Baxter Plan of Distribution ¶ 8.6.5.3.2; Banc One Modified Plan of Allocation at p. 19.

⁷ Columbia Funds Plan of Distribution ¶7.7(a)

⁸ MFS Plan of Distribution Exhibit G(1).

timing and late trading activities may have had on the particular account. However, prudence would also require a process by which the fiduciary weighs the costs to the plan or the participant accounts and ultimate benefit to the plan or the participants associated with achieving that goal.

. . . In deciding on an allocation method, the plan fiduciary may properly weigh the competing interests of various participants or classes of plan participants (e.g., affected versus current participants) and the effects of the allocation method on those participants provided a rational basis exists for the selected method and such method is reasonable, fair and objective. For example, if a fiduciary determines that plan records are insufficient to reasonably determine the extent to which participants invested in mutual funds during the relevant period should be compensated, the fiduciary may properly decide to allocate the proceeds to current participants invested in the mutual fund based upon a reasonable, fair and objective allocation method.

FAB 2006-1 also provides some useful guidelines for plan fiduciaries:

- If the IDC either makes available or requires a particular method for allocating to plan participants, the plan fiduciaries may follow the procedure laid out in the distribution plan. As discussed above, in the four distribution plans that have been approved to date, the IDCs have provided simplified alternatives specifically for ~~retirement~~-DC plans.
- If distributions to affected plan participants are not cost-effective, the plan fiduciaries may allocate them to current participants invested in the particular mutual funds or use the recoveries for other permitted purposes, such as plan expenses. These methods have been explicitly approved in all of these first four distribution plans except for the Columbia Funds. To the extent that even the simplified methods permitted by the Columbia Funds' distribution plan are not cost-effective or records are not available, FAB 2006-1 still permits plan fiduciaries to use this method.

- Where the cost of allocating a recovery is greater than the likely distribution, plan fiduciaries can establish an objective allocation formula that forfeits small amounts and reallocates them among other eligible accounts or participants.

While the distribution plans use \$1,000 as the *de minimis* amount for distributions to DC plans, that is likely to be too high a *de minimis* for distributions to participants. For current plan participants who are still in the mutual fund, the cost to allocate additional amounts into that investment option is likely to be relatively small. However, with respect to former participants, the plan will have the cost of distribution, including providing participants with the normal distribution options and tax notices, and plan fiduciaries should determine those costs in setting the *de minimis* threshold.

Neither the distribution plans nor FAB 2006-1 address all the ~~situations~~ issues that plan fiduciaries ~~will~~ may confront ~~when it is not cost effective to allocate based on historical investments or when the plan has imperfect records~~ in making cost effective allocations. For example, what if a particular mutual fund has been eliminated (possibly in response to the trading scandal)? Recoveries might be “mapped” into the most comparable fund option currently in the plan. What if the mutual fund was held in a prior plan that has been merged into the current plan and the current plan never held that mutual fund? Rather than allocate to all the current participants in the comparable fund option, plan fiduciaries might allocate to the current participants who were in the prior plan based on their account balances at the time of the merger. The bottom line, as DOL indicated in FAB 2006-1, is that fiduciaries should act prudently in making these allocation decisions.

Plan fiduciaries also have an obligation to make sure the plan receives its appropriate share of any fair fund for which it is eligible. The IDCs will be distributing to omnibus accounts where the mutual funds were held in the name of institutional trustees, record keepers or brokerage firms. In FAB 2006-1, the DOL concluded that the IDCs would not be considered fiduciaries for purposes of ERISA. However, intermediaries such as trustees and brokerage firms would be considered fiduciaries if they receive money from a fair fund for their omnibus account and they are then responsible for allocating the funds among their clients, including ERISA plans. An intermediary who is not otherwise a fiduciary may avoid fiduciary responsibility by declining to receive a settlement distribution on behalf of its omnibus account clients. However, the DOL indicated that such an intermediary would become a plan fiduciary if it failed to provide data to the fair fund administrator to allow the fair fund administrator to make the distribution. If the intermediate intermediary is no longer the record keeper, the intermediate intermediary should make efforts to transfer the funds to the new record keeper or plan fiduciary. Similarly, if the plan has terminated, the intermediate intermediary should make efforts to locate the plan sponsor or a responsible plan fiduciary but if a plan fiduciary cannot neither can be located, the intermediate intermediary fiduciary may reallocate the recovery funds to other eligible accounts.

Plan fiduciaries should have a process in place to allocate these fair fund distributions in a reasonable, fair and objective manner. Plan fiduciaries should also monitor the allocation process used by current or former record keepers or trustees that may be intermediaries to ensure that their plan receives its appropriate share of each fair

fund. To aid in this effort, Fiduciary Counselors has established a website to track the fair fund distribution plans on its ERISA Class Action Settlement Clearinghouse site (www.erisasettlements.com/fairfunds.htm)