Plan Fiduciary Concerns under Spitzer Complaint and Enron Decision

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Recent action by New York Attorney General Eliot Spitzer and a September 30 decision in the Enron 401(k) litigation have each raised important issues for plan fiduciaries to review. Set forth below is a brief summary of recent events, followed by a checklist of suggested actions that companies and fiduciaries should consider in light of these developments.

Attorney General Spitzer's Complaint

New York Attorney General Eliot Spitzer announced recently that he had settled claims against two hedge fund management firms arising out of certain "illegal trading schemes" that he alleges were entered into by the hedge fund with a number of mutual funds. The "schemes" involved two practices: (a) late trading, and (b) market timing. Late trading involves purchasing mutual fund shares at the 4 p.m. closing price after the market closes. The Attorney General's press release describes this practice as illegal because it allows an investor to purchase shares at prices that do not yet reflect events that occurred after the market closed. Market timing allows for quick in-and-out trading of mutual fund shares. While not illegal per se, these quick transactions result in certain arbitrage profits to the timer and impose costs and other burdens on the fund (such as maintaining liquidity to handle the market timers' transactions) that affect the performance of long term fund shareholders. The Attorney General's complaint states that the mutual funds that permitted these transactions did so in violation of published prospectuses indicating that the mutual funds had taken steps to discourage or prohibit these practices.

The mutual funds mentioned in Spitzer's complaint are alleged to have allowed market timing by the hedge funds. A more detailed discussion of these issues is set forth in the attached segment of a Special Report prepared by Hale and Dorr LLP's Investment Management Group.

Attorney General Spitzer's allegations arise under New York state law, but the nature of the claims has its counterpart under federal securities laws. Not only is Spitzer continuing to investigate mutual fund practices but, in the wake of his highly publicized actions, the SEC and other states are now also undertaking similar investigations. Morningstar, the well-known rating service for mutual fund performance, has posted a number of strongly worded articles on its website. The allegations and Morningstar's articles have been widely cited in newspaper articles as well. In light of this situation, what action should be taken by those who are responsible for selecting mutual funds for investment of a retirement plan's assets, whether by the fiduciaries or by the participants?

Enron Decision

On September 30, Judge Melinda Harmon of the United States District Court for the Southern District of Texas issued a 300-page decision that denied motions to dismiss certain claims in class action cases brought against a wide variety of officers and directors of Enron, as well as against its outside advisers. The central complaint of the complainants, Enron employees who had suffered losses as a result of their investment in Enron's stock under certain company retirement plans, was that the defendants, namely (i) Enron, (ii) individual officers involved in the administration of the retirement plans, and (iii) individual officers and board members with authority to appoint those serving on the plan administrative committee, breached their fiduciary duty under ERISA by continuing to permit or promote the plans' continued investment in employer stock or by failing to monitor such investments. The complainants also alleged that the defendants breached their fiduciary duty by failing to disclose a threat to the retirement security of the plan participants. All of these claims survived the motion to dismiss.

In considering a motion to dismiss, a judge is required to assume all the plaintiff's factual allegations are true. Of course, the highly publicized Enron case, which has included bankruptcy, criminal prosecution, and allegations of flagrant fraud, is hardly typical of the issues faced by most company plans that invest in company stock. Nonetheless the decision raises a number of issues for consideration.

Actions to Consider

In response to the issues raised by these important events, which will require continued monitoring as the mutual fund industry investigation and the ongoing litigation in the Enron case unfold, we have created a checklist for plans reviewing their fiduciary and investment provisions as follows:

Fiduciary/Investment Review Checklist

Review of Fiduciary Duty/Mutual Fund Offerings

1. 401(k) or profit sharing plans that seek to protect fiduciaries to the extent permitted under Section 404(c) of ERISA, which prescribes the manner in which plans can allow participants to elect from several investment choices, should review the requirements of that section and verify that the procedures necessary for Section 404(c) protection are being followed.
2. When 401(k) or profit sharing plans permit participants to elect among a number of mutual funds, it is advisable for those selecting the funds to be offered under the plan to obtain advice from an expert investment advisor that such funds are prudent investment choices. Generally, the mutual fund companies that offer the funds, even those that administer the plans for clients, will not take responsibility for offering such advice, although representatives will discuss the various investment alternatives.
3. In addition to obtaining advice when first offering the funds (either at the time the plan is

established or when the provider is changed), it is advisable to establish a regular monitoring process to determine, preferably with the help of an expert investment advisor, that the funds continue to be prudent choices for the plan. This regular monitoring process should include replacing funds that are no longer suitable with more suitable and prudent investment options.

4. In selecting or monitoring the funds made available under the plan, it is helpful to develop an investment policy to serve as a framework for such process. This policy should also be developed with the assistance of an investment advisor.
5. The fiduciary duty sections of the plan document should be reviewed to ensure that the language does not expand the fiduciaries' responsibilities. Judge Harmon described the Enron plan requirement to diversify plan assets as establishing conditions and terms that the fiduciaries were required to follow and that obligated them to balance that responsibility against their authority under the plan to invest 100% of the plan assets in company stock. She did not read the plan provisions concerning company stock as limiting the fiduciaries' obligation to diversify plan assets as ERISA permits.
6. Plan fiduciaries should request a review of company indemnity policies and consider the purchase of fiduciary liability insurance. Such policies not only provide protection if the company cannot fulfill its indemnity obligation but also relieve some of the financial burden on companies that are able to fulfill their obligations. As always, such insurance programs have important limits and impose restrictions on the manner in which litigation can be managed.
7. Consider obtaining investment advice or implementing a comprehensive investment education program for plan participants. Concerns are beginning to be raised about the plan participants' ability to adequately evaluate the many investment choices offered under a retirement plan. Obtaining this advice or education, which will be more thorough (and, in the case of investment advice, more personalized) than the annual education programs offered by many plan administrators, can help demonstrate the fiduciaries' effort to provide effective assistance to the plan participants.
8. Bearing out concerns that have existed for years, Judge Harmon in the Enron case concludes that, under the Enron plans, a broad category of board members and officers should be considered fiduciaries under ERISA. This category includes not only members of the plan's administrative committee but also members of the company's board of directors who are responsible for appointing the plan committee members and the plan trustee and who are, therefore, also considered responsible for monitoring the conduct of their appointees. Companies may want to consider identifying members of their administrative committees in their plan documents, perhaps by title, so that the identity of the plan administrative committee is part of the plan's design and not an independent decision of the board. Otherwise such a decision would be subject to the fiduciary rules and could subject board members to fiduciary status and liability under ERISA. In addition, the appointment of the plan trustee could be made by the plan administrative committee (under authority provided for in the plan document), rather than the board, and thereby limit the responsibility for this decision as well.
9. If the company plan currently offers one or more of the funds named in the complaint filed

by Attorney General Spitzer, any fiduciary with responsibility for selecting the funds offered under the plan should promptly review the issue of whether the fund continues to be an appropriate choice for investments under the plan. This review should be conducted with the advice of an expert investment advisor. The decision to stop offering the fund could allow employees to remain invested in the fund if they wish, or it could require that they change that investment. In addition, consideration should be given to following and potentially joining any of the class action suits that are being brought against these funds for damages arising out of their conduct.

Plans Offering Company Stock

10. Plans should verify their compliance with S-8 registration statement requirements and participant prospectus delivery requirements. Plans that offer participants the opportunity to invest their own 401(k) contributions in company stock are required to be so registered. More information on registration requirements applicable to retirement plans will be the subject of a future **Employee Benefits E-Alert**.
11. Special requirements under ERISA Section 404(c) apply if a plan offers company stock as an investment alternative and wishes to obtain Section 404(c) protection for the employer stock investment option. Specifically, plan participants must have the right to vote the employer stock held through the retirement plan (pass through voting) and there must be procedures in place to ensure the confidentiality of participant's transactions in company stock.
12. If company stock is provided as an investment choice, that design feature should be provided for in the plan document, as part of the overall plan design, as that provision is likely to be treated as a decision by the grantor rather than the fiduciary. Nonetheless, the fiduciaries responsible for monitoring investment choices should monitor the company stock fund under the prudence requirements, in the same way and with the same frequency as they monitor the other investment choices under the plan (see items 2 and 3, above).
13. If the company contribution is to be made in company stock, that fact should be stated in the plan document, along with any limitations on the participant's ability to sell those shares. Despite these explicit limits, the Enron decision suggests that the fiduciaries should monitor the status of the portion of the plan that is invested in company stock and that they may be obligated to sell or permit the sale of such stock if it ceases to be a prudent investment. Many courts have found that the burden on the fiduciary of directing or permitting the sale of company stock, notwithstanding plan language requiring its retention, is reduced if the matching portion of a plan that matches in company stock is treated as an ESOP. ESOPs are qualified retirement plans that are designed under ERISA primarily to invest in company stock. The ESOP can be used in tandem with salary reduction contributions under a 401(k) plan.
14. The Enron decision suggests that fiduciaries of plans with investments in company stock who have material nonpublic information about the company that might severely threaten

stock value cannot ignore their duty to participants who might be adversely affected by that information. However, given the dramatic nature of the nonpublic information in the Enron case, the decision provides little guidance on how fiduciaries should deal with less disastrous news. It does suggest, however, that the employees who have responsibility for administering the plan, perhaps as members of a plan committee, should be reviewed in order to determine if they are likely to possess such nonpublic information.

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