DOL Issues Guidance on Mutual Fund Settlements

On April 19, the U.S. Department of Labor (DOL) released Field Assistance Bulletin (FAB) 2006-1, which addresses a variety of issues in connection with distributions from settlement funds established to remedy late trading and market timing in mutual funds. The FAB provides detailed and helpful guidance to plan fiduciaries on how to allocate amounts received from the settlement funds among plan participants. However, as explained below, the guidance affecting banks, brokers, insurance companies, and other entities ("intermediaries") that receive mutual fund settlement proceeds for the benefit of ERISA-covered plans is troubling in that DOL takes the position that such an intermediary will be a "fiduciary" for ERISA purposes, even if the intermediary does not otherwise have a fiduciary role to ERISA-covered plans.

As noted elsewhere in this article's discussion of the pending mutual fund litigation, the law continues to develop in the market-timing and late trading area and further settlements can be expected.

Background – In connection with enforcement actions involving mutual fund late trading and market timing in the past few years, the Securities and Exchange Commission (SEC) has entered into settlement orders with ten or more mutual fund advisers and others involved in such activities. The settlement orders typically require the establishment of settlement funds to compensate mutual fund investors (both plan and non-plan) for losses resulting from late trading and/or market timing activities. Generally, an independent distribution consultant ("IDC") is appointed to administer the settlement fund and distribute the settlement proceeds to injured fund shareholders. In some cases, the IDC will be able to distribute settlement proceeds directly to the trustee of plans investing in the affected mutual funds. However, in many cases, plans hold their investments in mutual funds through so-called "omnibus" accounts with the mutual fund maintained by a bank, broker, insurance company or other intermediary. In these cases, IDCs may distribute a single lump sum to the intermediary and require the intermediary to further allocate the proceeds among its clients, including 401(k) and other plan clients. These allocations potentially give rise to ERISA fiduciary issues.

Overview – The FAB addresses the responsibilities of IDCs, intermediaries and plan administrators in connection with the distribution of proceeds of mutual fund settlement funds. DOL takes the view that proceeds distributed from a settlement fund for the benefit of an ERISA covered plan are "plan assets" that must be held in trust, administered and invested in accordance with ERISA's fiduciary responsibility rules. DOL further states that methodologies for allocating the proceeds must be consistent with ERISA's prudence requirement and may not violate the "solely in the interest" requirements under ERISA section 404. Based on this approach, the FAB discusses a number of issues arising in connection with the holding and administration of mutual fund settlement proceeds.

Role of Independent Distribution Consultants (IDCs) – Because the proceeds of these settlements become plan assets only upon distribution from the settlement fund, IDCs are generally not ERISA fiduciaries. This is true even if the IDC conditions a payment from the settlement fund on the recipient's use of a particular method to allocate the proceeds among plan participants or requires reports from intermediaries on how the proceeds are allocated.

Issues for Intermediaries – Because the settlement proceeds will be considered plan assets once distributed from a settlement fund, an intermediary that receives settlement proceeds on behalf of plan clients will generally be assuming fiduciary responsibilities with respect to the administration, management and control of the settlement proceeds, even if the intermediary is not otherwise a plan fiduciary. DOL notes that it would generally not be a fiduciary decision to decline the proceeds, unless the plan will be harmed. For example, if the intermediary declines to accept settlement proceeds and, as a result, the plan will not receive its share of the distribution, the intermediary's actions will be viewed as a fiduciary "exercise of discretion or control" over plan assets.

The FAB next addresses issues that intermediaries may face in their role as plan fiduciaries in connection with the settlement proceeds.

- Intermediaries are required to hold settlement proceeds in trust and manage the proceeds in accordance with ERISA's fiduciary responsibility rules pending distribution to clients.

- As an enforcement matter, DOL will consider intermediaries to have met their fiduciary duty to prudently select a distribution method if they follow the method compelled or made available by the IDC in a distribution plan approved by the SEC.

- If the IDC's distribution plan does not specify a method for distributing the settlement proceeds among the intermediary's omnibus account clients, then the intermediary will have to develop a "reasonable" method of distribution in accordance with ERISA's prudence and exclusive benefit rules. Intermediaries should, where possible, allocate proceeds among clients (including plans) in relation to how the late trading and market timing activities may have affected the individual clients.

- In identifying a prudent distribution methodology, a fiduciary may weigh the costs and benefits of the various alternatives. For example, if the cost of allocating a share of the settlement proceeds to a plan would exceed the projected amount payable to the plan, an intermediary could allocate the plan's share among other clients, so long as plans and other clients are treated similarly. Also, where it would be more cost-effective to do so, an intermediary could allocate the settlement proceeds among clients in an omnibus account according to the average share or dollar balance of the clients' mutual fund investments during the relevant period rather than based on actual transactions.

- Where services provided by an intermediary in allocating settlement proceeds are not included in its service contract with clients, the intermediary may charge plans for its "direct expenses" incurred but not for its usual and customary fees for these services, unless specifically approved by the plans.

Avoiding Fiduciary Status – Importantly, DOL notes that intermediaries might be able to avoid fiduciary status and related self-dealing issues if the receipt, allocation and distribution services are carried out in accordance with the direction and approval of appropriate plan fiduciaries. In this regard, DOL refers to a 2001 advisory opinion issued to our firm in connection with an insurance company demutualization. In that opinion, DOL agreed that where an insurance company provided advance notice to a plan fiduciary policyholder of options for allocating demutualization proceeds among plan participants and gave a reasonable period of time (at least 60 days) to select an option, the insurance company would not be a fiduciary by implementing the "default" option described by the insurer and "negatively elected" by the policyholder. DOL Advisory Opinion 2001-02A (Feb. 15, 2001).

Plan Administrators – DOL's guidance to plan administrators with respect to the allocation of settlement proceeds among plan participants is similar to the guidance provided to intermediaries. First, if the distribution plan provides a specific methodology for allocating proceeds among participants (on either a mandatory or suggested basis), DOL will view the plan fiduciary's application of this methodology as satisfying ERISA requirements.

If the distribution plan does not contain a method for allocating the proceeds among participants, then the plan administrator must determine a method for allocating the proceeds that relates to the impact of the market timing and late trading activities on individual participant accounts. Plan administrators are permitted to weigh the costs to the plan and participant accounts and the ultimate benefit to participants when trying to determine how to allocate settlement proceeds, taking into account matters such as the availability of plan records and the costs of different allocation methodologies.

For example, the FAB suggests that it may be permissible to allocate the proceeds to current participants (rather than participants who may have been in the plan at the time of the alleged activity) in some circumstances. In addition, if amounts are truly de minimis, the plan administrator might conclude that allocations are not cost-effective and use the amounts to pay plan expenses. Finally, plan fiduciaries should document the plan's receipt and use of the settlement proceeds.

IRS Issues – Unlike DOL, the IRS has not provided guidance on the plethora of plan qualification and distribution issues raised by the allocation and distribution of settlement proceeds. Issues in this area include –

- the need for nondiscriminatory allocations of earnings,
- whether the allocations involve "annual additions" under Code section 415,

- the application of participant and spousal consent and rollover notice requirements when the proceeds are distributed (e.g., to terminated participants).

IRS has addressed a handful of these issues in private letter rulings on settlements and insurance company demutualizations, but there is no comprehensive authority in this evolving area.