Employee Benefits Alert

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DOL Guidance on Distribution of Mutual Fund Settlements

Mutual funds often attract short-term shareholders who invest in mutual funds for very limited time periods as part of a short-term trading strategy. Industry observers often call these investors "market-timers." When these investors act in this manner, they cause the mutual funds to incur additional costs. In 2005, responding to that investment trend, the SEC created Rule 22c-2. The SEC's rule targeted the in-and-out investment practices of "market-timers" that may cause reduced returns to other policy holders. Rule 22c-2 created a mechanism to require market-timers to reimburse the mutual funds for costs incurred because of market-timer actions. Pursuant to the rule, SEC settlement funds were established to make distributions to investors who suffered losses because of market-timers.

Early this spring, the Department of Labor (DOL) issued Field Assistance Bulletin 2006-1, which described how proceeds from mutual fund settlements should be distributed to employee benefit plans — and more importantly, plan participants. Bulletin 2006-1 also outlined a fiduciary's ERISA responsibilities. First, subject to SEC approval, each mutual fund — or series of funds — must appoint an independent distribution consultant (IDC) who will establish a plan to distribute money from the settlement fund. The remainder of this *Alert* describes the employee benefit plan's responsibility.

Fiduciary Status

ERISA rules require that a fiduciary accept a distribution of settlement proceeds. (You may recall this issue surfaced in recent years through "demutualization" as some plans received a cash distribution when mutual companies became stock entities.) However, the DOL has recognized that, occasionally, the cost associated with a fiduciary receiving and distributing fund settlements may exceed the value of the actual distribution to plan participants. Therefore, the DOL notes that it might not be appropriate for a plan fiduciary to accept the settlement distribution. Having said that, the DOL requires that IDCs who make distribution of fund settlements have a distribution plan, and in instances where the IDC does not select a method for allocating proceeds, a fiduciary must step in and make a prudent business decision regarding the allocation of the settlement.

Who is a plan fiduciary?

To make this determination, one must first consider the nature of the settlement fund proceeds. If they are deemed to be "plan assets," then a person who is directing the administration (or management or distribution) of an employee benefit plan or its assets would then be considered a fiduciary (and would then be bound by ERISA's fiduciary duties). However, the DOL Bulletin stated that settlement fund proceeds do not constitute plan assets prior to their distribution by an IDC. Therefore, since the IDC is not handling plan assets, the IDC is not a fiduciary under ERISA. In addition, an IDC, in developing a distribution plan, would not be exercising any control or management over an employee benefit plan or it assets. Bulletin 2006-1 formalized the DOL's position that an IDC's development and implementation of a settlement fund distribution plan will not (in and of itself) cause an IDC to be considered a fiduciary.

Although an IDC will usually not be deemed an ERISA fiduciary, any intermediary (a person or entity receiving funds on behalf of employee benefit plan clients) will be considered an ERISA fiduciary because the intermediary will be receiving settlement fund proceeds, which are deemed to be plan assets when distributed. Since the settlement proceeds are plan assets, they must be held in trust and managed in compliance with ERISA.

Duties and Responsibilities

As noted above, IDCs are not generally deemed to be ERISA fiduciaries. However, if any other person or entity receives settlement fund proceeds resulting from market timing and late trading activities, the funds will be considered "plan assets" once they are distributed. Once the IDC initiates distribution, anyone exercising discretionary authority, administrative control, or otherwise directing the use of the plan asset proceeds will be deemed to be a fiduciary. An employer that sponsors a

retirement plan is always a fiduciary with respect to the plan and any plan assets.

Because distributed settlement proceeds are plan assets, the handling of those funds is regulated by ERISA's trust requirements. It will therefore be necessary for fiduciaries to hold these funds exclusively within a trust account. Fiduciaries receiving distributed fund settlements must also act prudently with regard to allocation of the funds; the fiduciaries will be deemed to have acted prudently if they follow the allocation parameters established by the IDC if the IDC's distribution plan is approved by the SEC.

If the IDC distribution plan has not been approved by the SEC, then fiduciaries are bound by their duty to act prudently and to act solely in the interest of beneficiaries. As such, fiduciaries must ensure that the distribution plan does not violate the "prudent person" standard of care. As an extension of a fiduciary's "prudent" standard of care, complete records should be maintained that document the plan's receipt of settlement funds and the use/distribution of those funds. Typically, the plan document will direct any further allocation of the funds. Plan sponsors should review their documents with their advisors to properly allocate the assets among plan accounts.

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