SPECIAL EDITION

Mutual Fund Investigations
May Warrant Fiduciary Action

Over the past two months, a number of mutual fund companies have found themselves the subject of state and/or federal investigations into improper trading. Recently, there have been two major developments with respect to these investigations: the filing of civil lawsuits alleging that Putnam Investments and two of its fund managers committed fraud through the improper trading of certain mutual funds, and remarks made by Employee Benefits Security Administration ("EBSA") Assistant Secretary Ann Combs regarding the duties of plan fiduciaries given the current climate surrounding mutual funds.

In September 2003, the New York Attorney General announced that his office was investigating Bank of America's Nations Funds, Janus, Strong Financial, and Bank One for engaging in improper trading practices, alleging that certain individuals and hedge funds engaged in late-day trading (making trades after mutual funds are no longer permitted to be traded for the day) and market timing (trading of international mutual funds while the international markets on which the shares are traded are closed). Subsequent announcements have been made by the New York Attorney General, the Massachusetts Secretary of the Commonwealth and the SEC regarding investigations or requests for information from additional mutual fund companies, including, but not limited to, Putnam Investments, Prudential Securities, Fidelity Investments, Morgan Stanley and Franklin Templeton. Yesterday, both the Commonwealth of Massachusetts and the SEC filed civil suits against Putnam Investments alleging that Putnam and some of its fund managers committed fraud as a result of the managers' use of late-day trading and market timing for personal gain. A class action lawsuit was also filed in federal court on behalf of individuals invested in a number of Putnam mutual funds. Putnam has released statements denying the allegations.

It is important to note that most of the companies mentioned in this update have not admitted to any wrongdoing, nor have they reached any publicized settlements with any of the agencies conducting investigations. However, in response to these allegations, several companies have agreed to reimburse some funds for fees related to improper or excessive trading, and more than one mutual fund has terminated a fund manager since the investigations were announced. Despite these corrective actions by some mutual fund companies, some mutual funds have experienced a significant outflow of shares following the public revelation that the fund was under investigation.

In two speeches given earlier this month, EBSA Assistant Secretary Combs commented on the current mutual fund investigations. She stated that “allegations of improper mutual fund practices where a plan is invested must be factored into the fiduciary’s determination of the continued appropriateness of that investment.” Additionally, she commented that there is an expectation that “fiduciaries will be attentive to activities that materially affect the plan’s investment . . . or expose the plan to additional risk.” Combs concluded that plan fiduciaries should engage in “more active communication” with mutual fund managers to comply with their fiduciary duties.

Based on the comments of EBSA Assistant Secretary Combs, plan sponsors, administrators, and other fiduciaries should keep informed as to the most recent developments in the mutual fund investigations. To the extent that plan assets are invested in funds that are the subject of an investigation, the plan’s fiduciaries should consider monitoring the status of such fund, and given Combs’ remarks, may even consider contacting the appropriate mutual fund manager to discuss the issue. Additionally, given Comb’s position that these investigations implicate the fiduciary duty of prudence, plan fiduciaries should periodically consider whether a particular mutual fund remains a prudent investment given the status of the investigations of such fund and the possible financial consequences to the fund as a result of such investigations.

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