



FIELD ASSISTANCE BULLETIN NO. 2006-01

DATE: APRIL 19, 2006

MEMORANDUM FOR: VIRGINIA C. SMITH, DIRECTOR OF ENFORCEMENT
REGIONAL DIRECTORS

FROM: ROBERT J. DOYLE
DIRECTOR OF REGULATIONS AND INTERPRETATIONS

SUBJECT: THE DISTRIBUTION TO PLANS OF SETTLEMENT PROCEEDS
RELATING TO LATE TRADING AND MARKET-TIMING

ISSUE:

What are the duties and responsibilities under ERISA of independent distribution consultants (IDCs), plan service-providers and fiduciaries with respect to the allocation and distribution of mutual fund settlement proceeds to plans and plan participants?

BACKGROUND:

Pursuant to Orders entered by the Securities and Exchange Commission (SEC) in several SEC enforcement matters alleging late trading and market timing activities, SEC distribution funds have been created for the purpose of making distributions to investors who suffered losses as a result of the conduct alleged in the matters. For each relevant mutual fund or series of funds, an independent distribution consultant (IDC) has been or will be appointed pursuant to SEC Orders to establish a plan to distribute the monies from the settlement fund to appropriate fund shareholders, subject to the SEC's approval.

A number of ERISA-covered plans will be entitled to settlement proceeds by virtue of their mutual fund investments. In some cases, plans will be the shareholder of record and receive their settlement distribution directly from the settlement fund. In other cases, an intermediary, e.g., a broker-dealer, underwriter, and/or record-keeper, will be the shareholder of record and plans, as well as non-plan investors, will receive their settlement distribution based on their interest in an "omnibus account" operated by the intermediary. When an intermediary is involved, we understand that distribution plans may provide an intermediary with the option of either receiving the settlement proceeds in a

lump sum and making the requisite distribution of proceeds to the individual investors in its omnibus account or providing the IDC the necessary client and transaction records, based on which the IDC will make distributions to the individual investors. In other instances, we understand that distribution plans will provide that the IDC will allocate and distribute settlement proceeds directly to all beneficial shareholders, including plans.

Under certain settlement agreements, mutual fund companies or settling parties may agree to pay the costs associated with allocations and distributions made by the IDCs with respect to omnibus account clients of intermediaries. However, in most instances it is anticipated that settlements will not provide for the costs associated with allocations among plans or, at the plan level, among plan participants and beneficiaries.

A number of issues have been raised by IDCs, intermediaries, plan sponsors, plan-level fiduciaries, and others regarding the application of ERISA's fiduciary responsibility rules to the distribution and allocation of these settlement proceeds. Among the issues raised are questions about whether and/or when settlement proceeds will become "plan assets" under ERISA and when an intermediary or other plan service-provider may become a "fiduciary" by virtue of its receipt and investment of such proceeds. Other issues concern the duties of a plan fiduciary with respect to the allocation of such proceeds among plans and participants and beneficiaries.

This bulletin provides general guidance to EBSA regional offices regarding the Department's views on the application of ERISA's fiduciary rules to parties involved in the distribution and allocation of mutual fund settlement proceeds to employee benefit plans and among the participants and beneficiaries of such plans.

ANALYSIS:

Independent Distribution Consultants (IDCs) – Allocation among shareholders

In light of the fact that some ERISA-covered employee benefit plans, as investors in the relevant mutual funds, will be entitled to a portion of the mutual fund settlement proceeds, questions have been raised as to whether an IDC, in developing and implementing a distribution plan, is subject to ERISA's fiduciary rules. It is the view of the Department that the development and implementation of settlement fund distribution plans will not, in and of itself, cause an IDC to become a fiduciary under ERISA.

Section 3(21) of ERISA defines a fiduciary as one who has or exercises discretionary authority or control in the administration or management of an employee benefit plan or exercises any authority or control respecting management or disposition of its assets. In determining whether particular funds constitute plan assets, the Department has issued regulations describing what constitutes plan assets with respect to a plan's investment in other entities and with respect to participant contributions. *See* 29 C.F.R. §§ 2510.3-101 and 2510.3-102. The Department also has indicated that the assets of an employee benefit plan generally are to be identified in other situations on the basis of "ordinary notions of property rights."¹

As discussed above, IDCs are appointed pursuant to SEC Orders to establish a plan to distribute the monies from the settlement fund to affected shareholders, and prior to implementation, distribution plans must be approved by the SEC. The IDC, in this capacity, has not been engaged to act on behalf of an employee benefit plan or plans and is not an agent of the plans. Moreover, we have been informed by the SEC that no mutual fund investor, including employee benefit plan investors, has an interest in or claims against settlement fund proceeds prior to their distribution to the affected shareholders.² For these reasons, in our view, under the regulations and applying ordinary notions of property rights, settlement fund proceeds, in whole or in part, would not constitute plan assets prior to their distribution by an IDC to affected plan shareholders or intermediaries acting on their behalf. Accordingly, an IDC, in developing and implementing a distribution plan, would not be exercising any authority or control in the administration or management of an employee benefit plan or its assets. Therefore, the development and implementation of settlement fund distribution plans will not, in and of itself, cause an IDC to become a fiduciary under ERISA.

This conclusion would not be affected by the fact that the IDC, as part of its distribution plan, applied a *de minimis* threshold for determining which shareholders, including plans, received distributions, or imposed conditions on the receipt of a distribution, such as conditioning receipt on the use of a particular allocation methodology at the participant-level³ or furnishing a report to the IDC on how the distributed funds were allocated among participants.

¹ *See* Advisory Opinion 2005-08A (May 11, 2005) and Advisory Opinion 92-24A (November 11, 1992).

² *See generally* 17 C.F.R. § 201.1100, *et. seq.* (SEC Rules on Fair Fund and Disgorgement Plans).

³ Among other things, an allocation methodology might include the use of a particular algorithm or a restriction on the depositing of proceeds in the forfeiture account of a plan.

Intermediaries – Allocation among omnibus account clients

Unlike IDCs acting under the auspices of the SEC, intermediaries, in receiving settlement fund proceeds, will be acting on behalf of their omnibus account clients, including employee benefit plan clients.⁴ The omnibus account clients, therefore, will have a beneficial interest in the settlement fund proceeds received by the intermediary, without regard to whether determinations have been made as to the specific entitlement of each omnibus account client. Accordingly, applying ordinary notions of property rights, settlement fund proceeds received by intermediaries on behalf of employee benefit plan clients will constitute plan assets and, as such, will be required to be held in trust and managed in accordance with the fiduciary responsibility provisions of Part 4 of Title I of ERISA.⁵

Without regard to whether an intermediary was a fiduciary with respect to an employee benefit plan prior to receiving a distribution of settlement proceeds, an intermediary receiving proceeds on behalf of an employee benefit plan would, in the view of the Department, be assuming fiduciary responsibilities upon receipt of such proceeds as a result of having discretionary authority or control respecting administration or management of an ERISA plan or exercising any authority or control respecting management or disposition of plan assets. The Department notes that the decision by an intermediary, who is not otherwise a fiduciary, to decline to receive a settlement fund distribution on behalf of its omnibus account clients would not, in and of itself, be viewed as a fiduciary decision. The intermediary's decision or related actions, however, may nonetheless give rise to fiduciary liability if such actions adversely affect the plan's right to receive proceeds in accordance with the IDC's plan of distribution.⁶

⁴ Some IDC plans may include ERISA plans within the definition of "intermediaries." This discussion of intermediaries is intended to include only those intermediaries that are not ERISA plans. Where ERISA plans are themselves shareholders of record, the fiduciaries of such plans are generally acting in a fiduciary capacity with respect to the settlements.

⁵ For example, any deposit of proceeds in funds managed by an intermediary or affiliate would be a transaction prohibited by section 406 of ERISA unless a relevant statutory or administrative exemption applies.

⁶ For example, if an intermediary elects not to receive settlement fund proceeds on behalf of its employee benefit plan clients and also refuses to provide client records and other information necessary for an IDC to make the required distributions, the intermediary would be considered to be effectively exercising discretion or control over plan assets and, thereby, subject to ERISA's fiduciary standards because its actions will have prevented the plan from receiving a share of the settlement.

As noted above, an intermediary in receipt of settlement fund proceeds will be required to hold the proceeds in trust and manage those proceeds in accordance with the fiduciary responsibility provisions of Part 4 of Title I. Among other things, an intermediary in discharging its responsibilities to act prudently and solely in the interest of plan participants and beneficiaries, in accordance with section 404(a) of ERISA, may have to invest the proceeds pending the development and/or implementation of a plan for distributing the proceeds to individual omnibus account clients. In such instances, the intermediary may also be responsible for developing and/or implementing a plan for allocating settlement proceeds among individual omnibus account clients.

If an IDC, as part of its distribution plan approved by the SEC, makes available to an intermediary or requires, as a condition to the distribution, that the intermediary utilize a particular methodology for allocating settlement fund proceeds among individual omnibus account clients, the Department will, as an enforcement matter, view the application of such methodology to the allocation of settlement fund proceeds among individual omnibus account clients as satisfying the requirements of section 404(a) with respect to the methodology for allocating assets to employee benefit plans. We note that while the use of a particular allocation methodology may be considered prudent, fiduciaries also need to ensure that implementation of the methodology (e.g., making allocations and distributions in accordance with such methodology) is carried out in a prudent manner.

In some instances, the intermediary will be responsible both for developing and implementing the plan for allocating proceeds among its omnibus account clients. As fiduciaries, intermediaries must be prudent in the selection of the method of allocating the proceeds among its clients in an omnibus account, including plans. Prudence in such instances would, at a minimum, require a process by which the fiduciary chooses a methodology where the proceeds of the settlement would be allocated, where possible, to the affected clients in relation to the impact the late trading and market timing activities may have had on the particular plan. However, prudence would also require a process by which the fiduciary weighs the costs and ultimate benefit to the clients associated with achieving that goal. For example, there may be instances where the cost of allocating an amount to a particular plan may exceed the projected amount of the proceeds with respect to which the plan might be entitled under a prudent methodology. In such instances (*i.e.*, where the cost to the plan is projected to exceed the benefit to the plan), an allocation plan would not be considered imprudent merely because it included an objective formula pursuant to which amounts otherwise allocable to a plan are forfeited and reallocated among other omnibus account clients, provided that any such formula applies to all omnibus

account clients, not just employee benefit plans, and does not permit the exercise of discretion by the intermediary.

Further, it is our view that an allocation plan would not fail to be “solely in the interest of participants,” for purposes of section 404(a)(1), merely because the allocation methodology does not result in an exact reflection of transactional activity of the clients, provided such method is reasonable, fair and objective. For example, if a fiduciary determines that it would be more cost-effective to do so, it may allocate the proceeds among clients in an omnibus account according to the average share or dollar balance of the clients’ investment in the mutual fund during the relevant period.

In some instances, the services rendered by intermediaries in connection with the receipt, allocation and/or distribution of settlement fund proceeds may involve services or compensation not contemplated in the service provider agreement between the employee benefit plan(s) and the intermediary. While an intermediary may charge plans for any direct expenses incurred in connection with receipt, allocation and/or distribution of settlement fund proceeds, an intermediary, as a plan fiduciary, cannot compensate itself from plan assets beyond direct expenses without violating the prohibited transaction rule of section 406 of ERISA.⁷

If the receipt, allocation and/or distribution services of the intermediary, and compensation for such services, are carried out in accordance with the directions and approval of appropriate plan fiduciaries, the intermediary may be able to avoid fiduciary status and issues relating to self-dealing under ERISA. However, determinations as to whether approval by a plan fiduciary has occurred would be factual in nature and would involve considerations such as language in relevant service contracts or whether the intermediary has disclosed to its employee benefit plan clients sufficient information concerning its proposed administration of the settlement proceeds so that the plan client reasonably can approve the arrangement based upon its understanding of the arrangement and related expenses.⁸

In some instances, an intermediary may receive settlement proceeds with respect to plans that have, since the event leading to the settlement, hired a new record

⁷ Advisory Opinion Nos. 2001-10A (December 14, 2001), 93-06A (March 11, 1993).

⁸ See Field Assistance Bulletin 2002-3 (November 5, 2002). See also Advisory Opinion 2001-02A (February 15, 2001). In this advisory opinion involving demutualization proceeds distribution, Prudential provided the policyholder advance notice of the allocation options and a reasonable period of time (here at least 60 days) to select an option. As long as the plan fiduciary actually chose the default allocation, its failure affirmatively to communicate that decision to Prudential did not cause Prudential to become a fiduciary by implementing that option.

keeper or intermediary for investments made by the plan. In such instances, the intermediary in receipt of the proceeds would still be considered a fiduciary with respect to plan assets in its possession and would be expected to transfer the assets to the plan's new record keeper or to an appropriate fiduciary of the plan.

An intermediary may also receive proceeds on behalf of plans that have terminated. In such instances, an intermediary should make reasonable efforts to deliver such assets to a responsible plan fiduciary (most likely, the plan sponsor) for distribution to plan participants or other appropriate disposition. If the intermediary is unable to locate a responsible plan fiduciary after a reasonable and diligent search, the intermediary may reallocate such proceeds among its other clients. Under no circumstances may an intermediary retain such assets for its own use.

Plan Fiduciary – Allocation among participants and beneficiaries

The following discussion focuses on the obligations of the plan fiduciary in allocating settlement fund proceeds among the plan's participants and beneficiaries. For purposes of this discussion, the fiduciary might be the plan sponsor, intermediary or other person charged with allocating the proceeds among participants and beneficiaries.

Similar to the allocation of settlement fund proceeds among plans, if an IDC, as part of its distribution plan approved by the SEC, requires, as a condition to the distribution, that the fiduciary utilize a particular methodology for allocating settlement fund proceeds among plan participants and beneficiaries, the Department will, as an enforcement matter, view the application of such methodology to the allocation of proceeds among participants and beneficiaries as satisfying the requirements of section 404(a) with respect to the methodology for allocating assets to participants and beneficiaries.

If an IDC's distribution plan provides, but does not require the use of, a methodology for allocating proceeds among plan participants and beneficiaries, the Department also will, as an enforcement matter, view the use of such methodology as satisfying the requirements of section 404(a)(1)(A) and (B) of ERISA with respect to a methodology for allocating assets to participants and beneficiaries. As noted above, while the use of a particular allocation methodology may be treated as prudent, fiduciaries also need to ensure that implementation of the IDC allocation methodology (e.g., making allocations to participants and beneficiaries in accordance with the methodology) is carried out in a prudent manner.

In the absence of guidance in the IDC's distribution plan with respect to allocations to a plan's participants and beneficiaries, fiduciaries must select a method or methods for allocating proceeds. In this regard, a plan fiduciary must be prudent in the selection of a method of allocating settlement proceeds among plan participants. Prudence in such instances, 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 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 addition, a fiduciary's decision must satisfy the "solely in the interest of participants" standard of section 404(a)(1) of ERISA. In this regard, a method of allocation would not fail to be "solely in the interest of participants" merely because the selected method may be seen as disadvantaging some affected participants or groups of participants. 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. Similarly, if a plan fiduciary determines that the cost to allocate the proceeds among participants whose accounts were invested in the mutual fund during the entirety of the relevant period approximates the amount of the proceeds, 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.

As plan assets, the proceeds of the settlement may not be used to benefit employers, fiduciaries or other parties in interest with respect to the plan. Sections 403(c) and 406 of ERISA. Such proceeds should not be used to offset an employer's future contributions to the plan, unless such use is permissible under the terms of the plan and would not violate applicable provisions of the Internal Revenue Code (e.g., such as when amounts involved would be considered "forfeitures" under the terms of the plan). However, we believe that a plan

fiduciary, consistent with its obligations under sections 404 and 406,⁹ may reasonably conclude that certain participant-level allocations that are not “cost-effective” (e.g., allocations to participant accounts of *de minimis* amounts) may instead be used for other permissible plan purposes, such as the payment of reasonable expenses of administering the plan.

It is the view of the Department that compliance with ERISA’s fiduciary rules generally will require that a fiduciary accept a distribution of settlement proceeds. The Department recognizes, however, that in rare instances the cost attendant to the receipt and distribution of such proceeds may exceed the value of such proceeds to the plan’s participants. In such instances, and provided that there is no other permissible use for such proceeds by the plan (e.g., payment of plan administrative expenses), it might be appropriate for a plan fiduciary to not accept the settlement distribution.

CONCLUSION

SEC settlement fund proceeds resulting from market timing and late trading activities will not be considered “plan assets” until distributed from the settlement fund. A party will be a fiduciary to the extent it exercises any authority or control over such plan assets following distribution by an IDC.

Settlement fund proceeds will upon distribution to a plan or an intermediary constitute plan assets and, therefore, will be required to be held in trust and managed in accordance with ERISA’s fiduciary responsibility rules. In general, as an enforcement matter, plan fiduciaries and intermediaries will be considered to satisfy their fiduciary duty to prudently select a method for allocating settlement proceeds if they utilize an allocation methodology provided or required by an IDC in a distribution plan approved by the SEC.

While plan fiduciaries generally have flexibility in designing a methodology for allocating settlement fund proceeds among the plan’s participants and beneficiaries, plan fiduciaries must ensure that the selected methodology does not otherwise violate the prudence and “solely in the interest” requirements of section 404(a).

Finally, plan fiduciaries should document appropriately the plan’s receipt and use of such settlement proceeds and work closely with their record-keepers and other service-providers in completing the process.

⁹ A violation of section 406 would arise, for example, if the plan document provides that the employer would pay plan expenses.

Questions concerning the information contained in this Bulletin may be directed to the Division of Fiduciary Interpretations, Office of Regulations and Interpretations, 202.693.8510.