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HEADLINE: Feelings Are Not Mutual In 401(k)'s

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BODY:

EMPLOYEES saving for retirement can't seem to catch a break. After nearly three years of painful bear-market losses, 2003 was shaping up as the year of the rebound, as a stock rally finally lifted portfolio values.

But before 401(k) investors could fully enjoy the fat returns on their third-quarter statements, revelations of improper trading by insiders and a few favored investors began to raise fundamental questions about the trustworthiness of mutual fund managers.

So what should the people who run and advise 401(k) plans do? Unfortunately, there are no simple answers. Some of the remedies being bandied about may be just as harmful to investors as the misdeeds at the heart of the spreading scandal.

But one thing has become increasingly clear: staying on the sidelines until the dust settles is no longer an option for 401(k) plans, which have entrusted an estimated $690 billion to mutual funds.

"Given the number of red flags, you cannot just sit on your hands and whistle in the dark and say, 'Gee, I hope none of the funds we've got are doing any of these things,'" said Eli Gottesdiener, an employee benefits lawyer in Washington. "Your duty is to pick up the phone ~ you call up, you ask questions and you get answers, or you move" from the fund company, he said.

A survey last week by Plan Sponsor magazine showed that more than 16 percent of respondents had already dropped a fund or a fund management company from their plan, and nearly 13 percent said that they were at least considering that step.

"The recent news brings a new set of facts to the table," said Ann Combs, assistant secretary for employee benefits security at the Labor Department. For 401(k) plan sponsors, Ms. Combs said, "your responsibility is not just to select the funds but to monitor them."

In the last few weeks, several companies have cleansed their plans of funds managed by Janus Capital and Putnam Investments, both of which have been implicated in the scandal.

Microsoft told employees that as of Friday, the Janus Balanced and Janus Worldwide funds would no longer be offered in its 401(k). Standard Insurance in Portland, Ore., has dropped the Janus funds in its plan, too.

Alaska Airlines and Nordstrom, the department store chain, have taken a more cautious approach. Nordstrom says it intends to dump the Putnam International fund, which regulators say was involved in abusive trading, but will continue to offer five other Putnam funds that have not been implicated in the accusations of improper trading.

"We are taking a look at our whole relationship with Putnam," said Shasha Richardson, a Nordstrom spokeswoman. "We want to have all the facts before we make any decisions. But we did want to act on

Putnam International in the best interests of our employees."

Alaska Airlines has announced that it is removing Putnam as the administrator of its retirement plan but will retain five Putnam funds in its 401(k), supplementing them with offerings by other companies.

RESPONDING to the scandal, however, can be more complex than plan sponsors may think. Consider the problem facing DuPont. As of Friday, the company closed two Janus funds to new investments, at least temporarily, said Tara Condon-Tullier, a company spokeswoman.

But the plan also offers a number of Merrill Lynch funds. And Merrill notified DuPont that DuPont employees might have been trading improperly in two of those funds. At Merrill's request, DuPont required employees to hold shares in the two funds for at least 15 days.

Then DuPont checked further and discovered similar problems in three other funds. So it prohibited frequent trading in them, too.

"Our whole focus is to protect all DuPont participants, which is why we have imposed these trading restrictions," Ms. Condon-Tullier said.

Other companies are determined to wait a while longer before deciding whether to take action. Ms. Combs, of the Labor Department, said that plan sponsors face a "delicate situation." Federal law requires that plans be operated solely for workers' benefit. "But in the end it is still a judgment call," she said.

Lawyers who advise plan sponsors say that every plan must carefully monitor regulatory and criminal investigations as they unfold ~ and keep a meticulous record of how they reach any decision. "Keep communication logs, document everything that's going on, keep a record of what you considered," said Carol McClarnon, an employee benefits lawyer at Sutherland Asbill & Brennan in Washington. "There isn't a right or wrong answer, at least at this point in time," she added. "But we're trying to encourage people to be really good about documenting how they reached whatever answer they made."

Some experts caution against hasty action. "We are just in the early stages of understanding the scope of the problem, and what the reforms and restitution will be," said Matthew Gnabasik, an employee benefits consultant in Chicago and the author of "Smart Choices: Selecting and Administering a Safe 401(k) Plan." (Blue Prairie Group, 2002). "Jumping to make a move now may not be in the best interests of the investor or the plan sponsor."

Indeed, one of the most vexing issues for plan sponsors is that the scandal is still unfolding. That means that even companies whose plans have no tainted funds may be in for a nasty surprise. So far, prosecutors or regulators have filed cases against executives at Fred Alger Management, Bank of America, Putnam Investments and Prudential Securities. But each week seems to bring news of a new scandal.

On Thursday, Pilgrim Baxter & Associates, which manages the PBHG funds, announced that the company's founders, Gary Pilgrim and Harold Baxter, had resigned after an internal investigation uncovered questionable conduct. And on Friday, the Charles Schwab Corporation confirmed that it had been subpoenaed for information about short-term trading patterns at one of its mutual fund subsidiaries.

ADISMAL roster of misbehavior has been described in regulatory and investigative complaints. Some fund management companies were found to have allowed favored customers and sometimes their own executives to conduct frequent trading in their funds, even when such trades were expressly prohibited by the funds' rules.

Others allowed certain customers to make their investment decisions long after the federal deadline of 4 p.m., an illegal practice known as late trading. And some fund managers provided certain customers with a list of their fund's portfolio holdings, which, in theory, could have permitted them to buy or sell ahead of the fund and reap profits at the expense of the fund investors.

Congressional testimony by regulators and investigators makes it plain that these misdeeds have been widespread across the mutual fund industry, even though fewer than a dozen fund companies are currently under investigation.

"It's like creeping water in the basement where you don't know how high it is going to rise," said Mr. Gnabasik, the benefits consultant. "The last thing a sponsor wants to do is jump to a new fund or fund company and then find out down the line that the new fund has a problem, too."

And while Morningstar Inc., the fund research firm, has recommended that individual investors pull their money out of tainted funds, it is not such a simple procedure for 401(k) plan participants.

"If you bail on one fund, quite often it is the only offering the plan has in that asset class," said Rick Meigs, president of401khelpcenter.com, an information clearinghouse for plan participants and sponsors. "You need to think through whether this is worth throwing off your asset allocation."

Mr. Meigs acknowledged that, for some investors, it comes down to personal revulsion. "If, in your gut, this appalls you and you just don't want to stick around in the fund or fund company that has been named, then by all means get out," he said. "But the better move for investors is to wait and see how this unfolds."

Midsize and large corporations, which typically have hundreds to thousands of participants, have the resources to aggressively monitor funds. In fact, there is a booming market in consultants who oversee 401(k) plan operations for them.

But the story is quite different ~ and more worrisome ~ at smaller businesses. "Sponsors with fewer than 100 employees represent a sizable part of the 401(k) universe, and the majority of these plans are doing nothing," Mr. Meigs said.

Stephen Butler, president of Pension Dynamics in Lafayette, Calif., which advises small-business 401(k) plan sponsors in the San Francisco Bay Area, said that his clients' response had been muted. "I have hundreds of clients, and less than a half-dozen have called me with concerns about their funds," Mr. Butler said. "The past few years have been so traumatic in terms of basic business, no one has had the time to focus on the quality of their 401(k)."

The human resource services division at Paychex, the big payroll processing service firm in Rochester, handles about 30,000 of the plans for very small businesses, and has heard almost no reaction to the scandal from its customers.

"Small-business people trust the system to work this out and are not focusing on this," said Anthony Tortorella, vice president for sales at the division. "They're small plans, the balances are small, and the average guy is out making their pizzas, building their houses or fixing their cars."

MS. COMBS said she was not worried that sponsors of small plans might not be on top of the unfolding scandal, and the monitoring obligations it placed on them, because she believed that most of them rely on third-party administrators. "They basically hand over the operation to someone else, who is going to be making the calls on this," she said.

But, she added, these issues will be raised as part of a new fiduciary education plan that her office will start in the next six months or so. "Post-Enron, we realized the need to do a lot of education on fiduciary responsibility. And this issue will certainly be part of that education."

Plan sponsors that are grappling with the scandal may soon face an equally pressing concern: how to deal with the various proposals for fixing the problems.

One proposal by the mutual fund industry, submitted to the Securities and Exchange Commission, would shorten the trading day for investors whose orders go through an intermediary, like a broker or 401(k) plan administrator.

Now those intermediaries must accept orders before 4 p.m. in New York, but can forward them to the fund companies after that deadline.

The new proposal would mandate that only orders actually received at the fund companies by the deadline would be eligible for that day's closing price. That would force intermediaries to impose an earlier cutoff for investors who want to make a trade at that day's price.

In recent testimony to a Congressional committee looking into fund trading abuses, Paul G. Haaga Jr., chairman of the Investment Company Institute, the mutual fund trade group, defended the proposal and urged the S.E.C. to incorporate it into the agency's response to the scandal. Yet in a footnote to his testimony, he noted that about 85 to 90 percent of fund purchases are made through an intermediary. As a result, he said, "in many cases, investors may no longer have the ability to obtain same-day prices" if the industry's plan is adopted.

Robert Wuelfing, president of the Spark Institute, the trade association for 401(k) plan administrators and record keepers, said this move would put many participants at a tremendous disadvantage to investors who deal directly with fund companies.

An investor who directly buys shares of the Fidelity Magellan fund, for example, can call Fidelity at 3:59 p.m. and get that day's closing price. But if the investor owns Magellan through an intermediary and places the same order with that intermediary at the same moment, the order will be filled at the next day's price.

"This is like stepping back 10 years when not all plans offered daily pricing," Mr. Wuelfing said. While he agrees that changes are needed to ensure that no illegal late trading occurs, he is frustrated that fund investors, including 401(k) participants, will pay the price for misdeeds of a few fund insiders. "The 401(k) fund investor is at risk of becoming a second-class citizen," Mr. Wuelfing said.

Besides the expense of monitoring the investigations and documenting the decision-making process, plan administrators will also pay a huge price for the computer technology necessary to put some proposed changes into effect. "It will take tens of millions of dollars to re-engineer the system," Mr. Wuelfing said.

Ms. Combs, the Labor Department official, said that a number of people had talked with her about how difficult this proposal would be at a practical level. "I am in a listening mode," she said. But the S.E.C. is taking the lead on this issue, she said.

"The S.E.C. is weighing the practical impact such a change will have against the need to prevent late trading," she said. "It's a question of balance."

BUT she noted: "It wasn't too long ago that we didn't have same-day pricing. I'm not saying we should go back to that, but it is not unprecedented."

Ms. McClarnon, the employee benefits lawyer, said her clients had expressed concern about such proposals, which would require considerable adjustments by everyone in the 401(k) world, whether or not they avoided tainted funds. She added, "One of my clients said it was the worst of both worlds: 'It will hurt the plan participants, but won't cure the problems.'"

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GRAPHIC: Photo: Rick Meigs, president of401khelpcenter.com, urged investors "to wait and see how this unfolds." (Photo by Shane Young for The New York Times)(pg. 10)

Chart: "Retirement Funds"

Some 45 percent of 401(k) plan assets were invested in mutual funds last year, up from 10 percent in 1991.

Graph tracks number of 401(k) plan assets and assets invested in mutual funds from 1991 to 2002.

(Source by Investment Company Institute)(pg. 10)