

LESLIE E. DEVANEY
ANITA M. NOONE
LESLIE J. GIRARD
SUSAN M. HEATH
GAEL B. STRACK
ASSISTANT CITY ATTORNEYS

JULIE DOI
DEPUTY CITY ATTORNEY

OFFICE OF
THE CITY ATTORNEY
CITY OF SAN DIEGO

Casey Gwinn
CITY ATTORNEY

CIVIL DIVISION
1200 THIRD AVENUE, SUITE 1100
SAN DIEGO, CALIFORNIA 92101
TELEPHONE (619) 533-5800
FAX (619) 533-5847

MEMORANDUM OF LAW

DATE: August 12, 2004

TO: SPSP/401(K) Trustee Board

FROM: City Attorney

SUBJECT: The Board's Fiduciary Duty Regarding the Janus Overseas Fund

QUESTION PRESENTED

Did the SPSP/401(K) [Plan]Trustee Board [Trustee Board] comply with its fiduciary duty when it voted to keep the Janus Overseas Fund [Overseas Fund] in the Plan's portfolio after it first voted to terminate and replace the fund due to allegations of market timing abuses, but subsequently received new information about the fund and its market performance, and was advised that an acceptable replacement for it had not been found?

SHORT ANSWER

Yes. There are four factors a fiduciary should consider when contemplating a change in a mutual fund being investigated by the government due to allegations of late trading or market timing. The Trustee Board considered information on three of the four factors when it decided to keep the Overseas Fund in the Plan's portfolio. Although it was missing information on the fourth factor and an investigation to obtain this information was not conducted before the Trustee Board made its decision, the Trustee Board most likely met its fiduciary duty because it is likely that a hypothetical prudent fiduciary that had the information would have made the same decision.

BACKGROUND

On June 30, 2002, the Overseas Fund, a fund in this Plan's portfolio, was placed on the "watch list"¹ in "watch status"² due to its poor performance. On March 31, 2003, the Overseas Fund was moved to "probation status"³ as a result of its continued poor performance. At the Trustee Board meeting on November 19, 2003, the Trustee Board's investment consultant, Milliman USA [Milliman], indicated that the Overseas Fund's performance had improved to the point that it would not recommend termination based on performance. However, Milliman recommended that the Trustee Board terminate the Overseas Fund because Janus Capital Group, Inc. [Janus], the mutual fund company that manages the Overseas Fund, had been involved in "market timing"⁴ abuses. The Trustee Board voted to terminate the Overseas Fund and to initiate a replacement search, intending to terminate the Overseas Fund when an acceptable replacement was found. A letter was sent in January 2004, with the fourth quarter statements to all plan participants informing them of Janus' involvement in market timing abuses and the Trustee Board's decision to terminate and replace the Overseas Fund.

After the meeting on November 19, 2003, Milliman conducted an extensive search for an international large-cap growth fund to replace the Overseas Fund. Milliman was unable to find a fund comparable to the Overseas Fund that would be an acceptable candidate to replace it. During this time, Milliman also learned that Janus Capital Management [Janus Capital], Janus' investment advisor, had implemented policies and procedures to prevent market timing. In a statement issued by the Independent Trustees of the Janus Funds [Janus Trustees], the Janus Trustees explained how market timing occurred, the impact of market timing on Janus funds, how restoration would be made to the funds, and internal processes and controls adopted by Janus Capital to prevent market timing. In addition, because Milliman was still monitoring the Overseas Fund, it learned that the Overseas Fund's performance in the market continued to be strong. As a result of Milliman's unsuccessful search for an acceptable replacement, the new policies and procedures implemented by Janus Capital, and the Overseas Fund's strong

¹ The "watch list" is used to monitor funds on quantitative and qualitative factors which assist in identifying, monitoring, and responding to performance and other organizational issues in a timely manner. *City of San Diego's SPSP & 401(k) Plans Draft Statement of General Investment Policies* (Mar. 25, 2003).

² "Watch status" means that the fund was being monitored for improvement and would move to the probation list if its performance did not improve. *Id.*

³ "Probation status" means that the fund was being analyzed and a replacement search would be initiated if the fund's performance did not improve. *Id.*

⁴ "Market timing" refers to the practice of shifting assets very quickly from one fund to another in an attempt to capitalize upon perceived short-term advantages of one fund over another. Timothy Price, *Update on Developments at Janus* (Sept. 24, 2003).

performance in the market, at the Trustee Board meeting on February 25, 2004, Milliman advised the Trustee Board to retain the Overseas Fund in the Plan's portfolio, and the Trustee Board voted to do so.

ANALYSIS

I. The Trustee Board's Duty of Prudence

The Trustee Board's fiduciary duty regarding the investment of plan funds is described in the Master Trust Agreement between the City and the Trustee Board. It provides that the Trustee Board must invest in securities pursuant to the standards set forth in article XVI, section 17 of the California Constitution. Master Trust Agreement § 5.2(b). This section of the California Constitution requires that members of the Trustee Board "discharge their duties . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use . . ." Cal. Const. art. XVI, § 17(c).

This same "prudent person" standard is codified in 29 U.S.C. § 1104, which defines a fiduciary's duties and responsibilities with respect to an employee benefit plan governed by the Employee Retirement Income Security Act of 1974 [ERISA]. Because the City's employee benefit plan is a government plan, the provisions of ERISA do not apply. 29 U.S.C. § 1003(b)(1). However, because there are no California cases that interpret the "prudent person" standard as it is defined in article XVI, section 17 of the California Constitution, it is likely that a court would use the "prudent person" standard as it has been interpreted for employee benefit plans governed by ERISA in determining the Trustee Board's fiduciary duty.

The "prudent person" standard is an objective standard. *Roth v. Sawyer-Cleator Lumber Company*, 16 F.3d 915, 917-18 (8th Cir. 1994), quoting *Katsaros v. Cody*, 744 F.2d 270, 279 (2d Cir. 1984). This standard focuses on a fiduciary's conduct in arriving at an investment decision, as opposed to its results, and is concerned with whether or not a fiduciary used appropriate methods to investigate and determine the merits of a particular investment. *Roth*, 16 F.3d at 918. See also *In re Unisys Sav. Plan Litigation*, 74 F.3d 420, 434 (3rd Cir. 1996). In this matter, the investment decision in question is the Trustee Board's decision to keep the Overseas Fund in the Plan's portfolio based on all the information it received from Milliman.

In making its decision to keep the Overseas Fund in the portfolio, the Trustee Board focused on the new policies and procedures implemented by Janus Capital, Milliman's report that no viable alternative to the fund had been found, and the Overseas Fund's improved and continued strong performance in the market. The fact that no viable replacement for the fund was found by Milliman is of little significance because the Trustee Board can support its decision to keep the Overseas Fund based solely on its strong market performance. In fact, in the November

19, 2003, Trustee Board meeting, Milliman indicated that the Overseas Fund's market performance did not justify a recommendation for termination and instead focused on market timing allegations as the reason for its recommendation to terminate the fund. At the February 25, 2004, Trustee Board meeting, Milliman again pointed to the Overseas Fund's strong performance in the market as a reason to keep the fund in the portfolio. As such, the effects of market timing on Janus funds are likely to be the determining factors in analyzing the Trustee Board's duty of prudence.

II. The Effects of Market Timing on the Trustee Board's Duty of Prudence

The Assistant Secretary of the United States Department of Labor's Employee Benefits Security Administration [Assistant Secretary] issued a guidance statement on the duties of an employee benefit plan fiduciary in light of allegations of late trading and market timing abuses on pension plans, further defining the "prudent person" standard when market timing abuses occur. In the guidance statement, the Assistant Secretary states that to discharge their duties prudently, "fiduciaries, deciding whether to make any changes in mutual fund investments or investment options, must make decisions that are as well informed as possible under the circumstances." Ann L. Combs, U.S. Department of Labor, *Fiduciary Responsibilities Related to Mutual Funds* (February 17, 2004) <<http://www.dol.gov>>. When specific funds are being investigated by the government due to late trading or other market-timing abuses, "fiduciaries should consider the nature of the alleged abuses, the potential economic impact of those abuses on the plan's investments, the steps taken by the fund to limit the potential for such abuses in the future, and any remedial action taken or contemplated to make investors whole." *Id.* "Plan fiduciaries should follow prudent plan procedures relating to investment decisions and document their decisions." *Id.* Thus, whether the Trustee Board acted within its fiduciary duty when it decided to keep the Overseas Fund in its portfolio will depend on the information the Trustee Board had in its possession when it made its decision. Following is an analysis of the factors to be considered, which were taken from the Assistant Secretary's guidance statement.

A. Nature of the Alleged Abuses

The nature of the alleged abuses was determined by an accounting firm hired by the Janus Trustees and through meetings with employees of Janus Capital. Update from the Independent Trustees of the Janus Fund 1. Based on the information it received, the accounting firm determined that ten investors participated in market timing. *Id.* Of these ten investors, one investor accounted for a substantial majority of the trading, and three investors had frequent trading activity. *Id.* In its update, the Janus Trustees gave more detail about the types of transactions undertaken by these investors. *Id.* As a result, it appears that the Trustee Board had sufficient information on the nature of the alleged abuses when it made its decision to keep the Overseas Fund in the portfolio.

B. Potential Economic Impact of Those Abuses on the Plan's Investments

The potential economic impact of market timing abuses on the Plan's investments has not been completely determined, although the impact does not appear to be significant. At the time the Trustee Board made its decision to keep the Overseas Fund in the portfolio, the Trustee Board did not have information on the economic impact of market timing on the Plan's investments. The Trustee Board only had information on the potential economic impact on Janus funds based on information obtained as a result of an investigation conducted by an accounting firm hired by the Janus Trustees, solely at the direction of the Janus Trustees, using information in the possession of the Janus Trustees and Janus Capital.

After the Trustee Board made its decision to keep the Overseas Fund in the portfolio, Milliman obtained information from Janus to determine the economic impact on the Plan's investments. As of September 5, 2003, when Janus was served with an examination request from the Securities and Exchange Commission [SEC], the total market value of Janus' seven funds involved in market timing was \$24.45 billion. Bill Cottle, *Memorandum: Janus Settlement with Regulatory Agencies* (May 24, 2004). At that time, the market value of the Overseas Fund was \$2.96 billion and represented 12.1% of the total market value involved in market timing. *Id.* As of September 30, 2003, the City had \$8.62 million invested in the Overseas Fund, which represented only 0.3% of the total funds invested in the Overseas Fund. *Id.* As such, it appears that the economic impact on the Plan's investments were minimal because the City's investments represented less than one percent of the total funds invested in the Overseas Fund at the time the fund was involved in market timing.

Although Janus recently reached a preliminary agreement with the SEC, the terms of the agreement should not have a significant impact on the Plan's investments. The preliminary agreement requires that Janus pay \$100 million to investors in the seven Janus funds involved in market timing. *Id.* In addition, \$25 million in fee reductions will occur. *Id.* At this point, the mechanics of payment and fee reductions have not yet been determined. However, given that the City's investments in the Overseas Fund were less than one percent at the time the fund was involved in market timing, it appears the amount that will be paid to the Plan's participants will be minimal, resulting in little economic impact on the Plan's investments.

Even though the Trustee Board made its decision to keep the Overseas Fund without having information on the economic impact on the Plan's investments, it appears that the Trustee Board's fiduciary obligations have still been met because it is likely that a hypothetical prudent fiduciary with this information would have made the same decision. Under the "prudent person" standard, "a fiduciary is obligated to investigate all decisions that will affect the pension plan . . ." *Roth*, 16 F.3d at 918, quoting *Schaefer v. Arkansas Medical Soc'y*, 853 F.2d 1487, 1491 (8th Cir. 1988). This includes supplementing data when necessary. *In re Unisys*, 74 F.3d at 435. However, the court in *Roth* also stated, "Even if a trustee failed to conduct an investigation

before making a decision, he is insulated from liability if a hypothetical prudent fiduciary would have made the same decision anyway.” *Roth*, 16 F.3d. at 919. Based on the information provided by Milliman after the Trustee Board made its decision to keep the Overseas Fund in the portfolio, it appears that the economic impact on the Plan’s investments will be minimal. As a result, it is likely that a hypothetical prudent fiduciary who had obtained this information prior to making any decision would have made the same decision as the Trustee Board, and the Trustee Board’s failure to conduct an investigation should not subject it to liability.

C. Steps Taken by Janus to Limit the Potential for Such Abuses in the Future

The Janus Trustees, their independent counsel, and the accounting firm hired by the Janus Trustees assessed the policies and processes used by Janus Capital to identify and deter market timing abuses. *Update from the Independent Trustees of the Janus Funds 2*. As a result of this assessment, several new policies and procedures have been implemented to prevent market timing in the future. *Id.* The new policies and procedures are as follows:

1. All new institutional client relationships will be reviewed and approved using a standard, centralized process.
2. Procedures for identifying frequent trading transactions and for enforcing frequent trading policies have been standardized and strengthened.
3. Tighter definitions of the circumstances in which redemption fees may be waived have been introduced.
4. New reports about both trading activity and redemption fees will be prepared and shared with the [Janus] Trustees on a regular basis.
5. Prospectuses for the non-money market funds are being revised to tighten language concerning the rights of investors to purchase, redeem, and exchange shares in the Janus funds.
6. The [Janus] Trustees have increased redemption fees from 1% to 2% on all funds that currently have redemption fees in place for shares redeemed or exchanged within three months of purchase.
7. New systems to facilitate the fair valuation process have been approved and valuation procedures and methodologies will continue to be reviewed.
8. Portfolio holdings for each of the Janus funds will be disclosed on a monthly basis with a 30-day lag.

9. The use of brokerage commissions to purchase research products or services from third parties will be prohibited as broker arrangements expire in 2004.

Id. at 2-3. In addition to the above policies and procedures, Janus Capital will continue to look for other ways to improve its processes and controls, and the Janus Trustees will closely monitor this process. *Id.* at 2. Because the Janus Trustees went into great detail in its update on new policies and procedures implemented by Janus Capital, it appears that the Trustee Board had sufficient information on the steps taken to limit the potential for market timing abuses in the future when it decided to keep the Overseas Fund in the portfolio.

D. Remedial Action Taken or Contemplated to Make Investors Whole

Janus Capital, at the request of the Janus Trustees, agreed to compensate the funds or their shareholders for the effects of market timing involving Janus funds. *Id.* When the Trustee Board made its decision to keep the Overseas Fund in the portfolio, compensation was going to be made in the following amounts:

1. The net gains realized by the ten investors on all of their transactions in shares of the Janus funds until they were banned from further investment.
2. An amount representing the opportunity cost of those gains had they been available to the funds.
3. Management fees earned by Janus Capital on investments of those investors in any of the Janus funds until they were banned from further investment.
4. Redemption fees that Janus Capital waived on any of the transactions of those investors.

Id. After the Trustee Board made its decision based on the above information, Janus and the SEC reached a preliminary agreement concerning settlement to shareholders in the seven Janus funds involved in market timing. The preliminary agreement calls for compensation to be made in an amount greater than Janus Capital or the Janus Trustees contemplated. Regardless of this fact, the Trustee Board had sufficient information when it made its decision to keep the Overseas Fund in the portfolio as the information consisted of action contemplated by Janus to make investors whole.

CONCLUSION

While the Trustee Board considered many factors when it decided to keep the Overseas Fund in the Plan's portfolio, the most important factors in determining whether the Trustee Board satisfied its fiduciary duty are those outlined in the statement issued by the Assistant Secretary because the statement was issued specifically to address concerns regarding a fiduciary's duty in light of late trading and market timing allegations. The Trustee Board considered information on the nature of the alleged abuses, steps taken by Janus to limit the potential for such abuses in the future, and remedial action taken or contemplated by Janus to make investors whole. However, the Trustee Board did not have information on the economic impact on the Plan's investments. Although the Trustee Board should have conducted an independent investigation into this issue prior to making its decision, the lack of an investigation should not be the deciding factor in determining whether the Trustee Board satisfied its fiduciary duty.

Because it is quite likely that a hypothetical prudent person would have made the same decision as the Trustee Board if he or she had information regarding the economic impact on the Plan's investments, the Trustee Board's failure to conduct an investigation into the economic impact on the Plan's investments should not subject it to liability. For these reasons, it is our opinion that the Trustee Board satisfied its fiduciary duty when it decided to keep the Overseas Fund in the Plan's portfolio.

CASEY GWINN, City Attorney

By

Julie Doi, Deputy City Attorney