THORNBURG INVESTMENTS

ARE YOUR 401(k) PLAN ASSETS SAFE?

The steady drumbeat of bad financial news in 2008 has increased concerns about the security of company 401(k) plans and other retirement savings. Fear caused by bankruptcy or forced takeovers of major financial institutions is felt by plan sponsors and plan participants alike who rightfully ask whether such events put plan assets held by these suddenly vulnerable institutions at risk. The good news is that while the value of plan investments may have dramatically declined, the security of such assets is protected by the Employee Retirement Income Security Act (otherwise known as "ERISA") that was enacted over 30 years ago as the result of a prior crisis involving the bankruptcy of a major employer, Studebaker-Packard Corporation.

What is the ERISA trust requirement and how does it protect retirement plan assets?

Once contributions made by an employer or by employees to a 401(k) plan have been identified as plan assets, ERISA requires that they be held in trust by one or more trustees. The trustee can be an individual, for example, the owner or CEO of the plan sponsor, or an institution, such as a bank or trust company. In the case of an individual trustee, the actual possession of plan assets will almost certainly be placed with an institutional custodian. There are two important things to remember about the trust requirement. First, neither a trustee nor a custodian has beneficial ownership of the plan assets. Instead, plan assets are treated as if owned by the plan participants. <u>Second, the trust is a legal entity that is separate from the employer, the trustee and any custodian. If any one of these entities were to go bankrupt, there would be no legal effect on the trust</u>.

What does a trustee do?

Generally speaking, a plan trustee has the power to decide how plan assets are invested. However, institutional trustees often do not want this power because it creates potential liability for bad investment decisions. Thus, it is usually the case that an institutional trustee will be a so-called "directed trustee" that receives investment instructions from the plan sponsor, plan participants or, in certain cases, from a professional investment manager. The fiduciary responsibilities of a custodian or a directed trustee are more limited than the duties of a discretionary trustee. However, the trustee (whether "directed" or "discretionary") or custodian is still required to determine that investment directions are made in accordance with the law as well as the terms of the plan and trust documents.

What is a trust?

The trust itself must be in writing and the trustee will generally be named either in the trust document or in the plan document. It is also possible for a trustee to be appointed by a plan official. These are not mere formalities, since, as noted above, they have the effect of placing legal title to plan assets in the hands of a party other than the plan sponsor or the plan's investment manager or adviser. <u>As a result of the trustee's legal title, the plan assets are insulated from the creditors of the employer or an investment manager or adviser so that even if they become insolvent, the assets will be available to pay benefits.</u>

What if something happens to the trustee?

The creditors of an insolvent custodian or trustee have no recourse against the assets of the trust which is regarded as a *separate legal entity*. Plan investments that are held in trust are completely separate from the trustee's personal or corporate assets as well as from the assets of any broker, investment manager or adviser. <u>Accordingly, a plan participant who wakes up one morning to find that the custodian or trustee of his 401(k) plan is the latest victim of the ongoing turmoil in the financial markets should have nothing to fear because the trust will continue on with the same assets. If the custodian or trustee has been acquired by another organization, it merely means that the custodian or trustee is under new management. And, if the custodian or trustee has gone bankrupt, the only difference will be the appointment of a new trustee.</u>

Are there any restrictions on trustees when they deal with plan assets?

<u>**Yes**</u>. The law requires that custodians, trustees and all other persons dealing with plan assets held in trust must *act for one purpose only*. That purpose is to provide benefits to plan participants and to defray the reasonable expenses of administering the plan. This is known as the "exclusive benefit rule" and requires undivided loyalty to the plan. In order to satisfy this rule, the trustee may not comingle plan assets with any other accounts and may not use them in a way that would favor its own or anyone else's interests.

The exclusive benefit concept is so strict that, except in certain situations involving clear mistakes, and even then, only within certain time limits, an employer cannot get back a contribution once it has been earmarked as a plan asset and contributed to the trust. Moreover, claims by creditors of a plan participant (not including domestic relations claims by family members) will not be honored. <u>The inability of creditors to attach plan assets is another example of the protected status of retirement plan assets. It does not matter whether the creditor is owed money by the employee, the employer, the trustee or some other party that has dealt with the plan.</u>

What if a plan's investment manager is dishonest?

Even when the power to manage plan assets does not rest with a plan trustee, the trustee remains responsible for ensuring that any instructions it receives concerning plan assets are issued by an authorized plan fiduciary and that the instructions are proper. Thus, even a directed trustee must ensure that the investment instructions it receives do not run afoul of legal prohibitions on transactions that involve conflicts of interest or that may be fraudulent. For example, if a directed trustee has information indicating that a company's public financial statements contain material misrepresentations that significantly inflate the company's earnings, the trustee could not simply follow a direction to purchase that company's stock on behalf of a plan at an artificially inflated price. <u>This helps to ensures that plan assets will continue to be managed completely separate from the assets of any investment manager as well as from the assets of the employer and the trustee itself.</u>

Are there any other protections for plan assets?

The Securities Investor Protection Corporation ("SIPC") provides up to $500,000 of insurance coverage when a brokerage firm fails owing cash and/or securities that are missing from customer accounts. For purposes of the $500,000 limit, the plan is treated as the customer and individual plan participants are not eligible for separate coverage. SIPC insurance protects plans whose securities were misappropriated, never purchased or stolen. For example, SIPC insurance is available to retirement plans seeking to recover losses incurred as a result of the Madoff Ponzi scheme.

When a bank or member financial institution fails, the Federal Deposit Insurance Corporation insures self-directed 401(k) accounts up to $250,000 per account. This coverage is also available to other types of defined contribution plans that allow participant investment direction.

Other sources of recovery include ERISA bonds which, by law, must cover every person that handles plan funds and that protect the plan against loss by reason of the fraud or dishonesty of such persons. The legally mandated coverage is 10% of plan assets up to $500,000. There is a $1 million maximum in the case of a plan holding employer securities.

What steps should I take to make sure that safeguards are in place?

- Check to see if you have an executed copy of your plan's trust document with the names of the plan trustees. This is often separate from the plan document which you should also possess.

- Ask to receive in writing a clear explanation of what would happen if your plan provider or custodian declared bankruptcy or were acquired by another financial institution.

- Ask to receive in writing the amount of insurance coverages for the plan and individual accounts.

- If you are a plan fiduciary, it is important that you perform due diligence on your investments and service providers as part of your responsibilities. You should document the procedures you have followed as well as your conclusions to demonstrate that you have acted properly within the standards of ERISA.

Summary and Conclusion

The events of the past several months have shaken confidence in our financial institutions and raised concerns among plan sponsors and plan participants about the safety of their retirement plan accounts. The good news is that there are safeguards in place for plans protected by ERISA.

Therefore, it is important to remember that, despite the upheaval in the securities and investment bank industries, your plan assets are safe.

This safety arises from the following factors:

- Plan assets held in a trust are separate from assets of the employer/plan sponsor, custodian, trustee, broker, investment manager or adviser.

- Such assets are protected from the creditors of an employer, custodian or trustee in the event of bankruptcy or insolvency.

- If a custodian or trustee has gone bankrupt or out of business, a new trustee will be appointed.

- Under the "exclusive benefit rule" of ERISA, retirement plan assets cannot be comingled with any other accounts of the employer, custodian or trustee.

- SIPC and FDIC insure 401(k) plans as well as other types of defined contribution plans that permit participant-directed investments.