Choosing Investment Options – a Fiduciary's Responsibility

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Discussion Overview

- Who is a Fiduciary?
- Sources and Standards of Fiduciary Duties
- Overview of Litigation
- Best Practices for Mitigating Liability

Who is a Fiduciary?

Fiduciary Defined

- An entity or individual may be a fiduciary either by **designation** or by **function**:
  - A fiduciary is any person or entity who makes, or has the authority to make, discretionary administrative or <u>investment decisions</u> related to the retirement plan.
    - Trustees are fiduciaries.
    - Anyone who chooses, evaluates, or monitors service providers
    - Anyone who can bind the plan through contracts related to the plan
  - A fiduciary is any person or entity who is named in a retirement plan or trust document as a fiduciary, *e.g.*, Advisory Committee, Investment Committee, Investment Officer.

- Internal Revenue Code § 4975(e)(3); ERISA § 3(21)

Who is Not a Fiduciary?

- The **settlor** establishes the terms of the plan, and amends or terminates the plan.
  - The settlor = Legislature/State/Municipality.
- Unless plan or statute provides otherwise, the settlor is <u>not</u> a fiduciary, but determines the scope of authority of the fiduciary.
  - The fiduciary must administer the trust and the plan for the benefit of the participants and their beneficiaries in accordance with the role assigned.
  - The fiduciary must implement decisions made by settlor in accordance with fiduciary duties.

Who is Not a Fiduciary?

- Entities/Individuals that solely perform administrative functions:
  - Receives contributions and applies to accounts,
  - Distribution of educational materials,
  - Implementing rules, and/or
  - Processing forms.

Sources and Standards of Fiduciary Duties

Sources of Fiduciary Duties

Fiduciaries are held to extremely high standards of conduct under the law.

Federal Law

- **Internal Revenue Code**
- **ERISA** (*not directly applicable, but excellent resource*)

State Law

- **Statutory fiduciary rules**
- **State Constitution**

Common Law

- **Restatement (Third) of Trusts** (*collection of common law*)
- **Uniform Management of Public Employee Retirement Systems Act (UMPERSA)** (even if not adopted by state – *excellent resource*)

Plan and Plan-Related Documents

- **Statutes**
- **Administrative Code**
- **Trust Documents**

ERISA

- Employee Retirement Income Security Act (ERISA) requires fiduciaries of ***private sector*** plans to discharge their duties with respect to a plan:
  - solely in the interest plan participants,
  - for the exclusive purpose of providing benefits to participants and defraying reasonable expenses of administering the plan,
  - with the care, skill, prudence, and diligence under the circumstances then prevailing,
  - that a prudent man acting in like capacity and familiar with such matters would use.

ERISA *(cont'd)*

- Adopts a "**prudent expert**" rule.
- ERISA ***does not apply to*** governmental plans.
  - However, ERISA derives from the common law of trusts, which does apply to governmental entities, and imposes standards similar to those under ERISA.
  - Courts often look to ERISA to determine if non-ERISA plan sponsors satisfied their fiduciary duties.
  - Non-ERISA plan sponsors sometimes defend against breach of fiduciary claims on the grounds that their conduct satisfied ERISA standards.

Restatement (Third) of Trusts

- The **Restatement (Third) of Trusts** is essentially a collection and summary of the common law trust rules.
- The Restatement is not binding authority, but is highly persuasive because it provides a compilation of how the law has developed through relevant case law and in many ways is considered a recitation of what the law *is*.
- Statutory fiduciary provisions under federal and state law derive from the common law that is carefully catalogued in the Restatement.
- Adopts a "**prudent investor**" standard.

Affirmative Fiduciary Duties

- Internal Revenue Code requires that 401(a) plan assets be held in trust.
- All powers held as a trustee – express and implied – are held in a fiduciary capacity.
- Every power or duty given to a trustee under state law must be exercised in accordance with fiduciary principles.

- Internal Revenue Code § 401(a); UMPERSA § 4(a); Restatement (Third) Trusts § 85, comment b(2)

Affirmative Fiduciary Duties *(cont'd)*

Duty of Loyalty	Duty to act solely in the interest of participants and beneficiaries.
	Duty to act for the exclusive purpose of providing benefits or paying reasonable plan expenses.
	Duty to act independently and without conflicts of interest.
	Duty to act impartially among differing interests.
Duty of Prudence	Duty to act with care, skill, prudence, and diligence of prudent person familiar with like matters.
	Duty to be informed.
	Duty to delegate responsibilities outside of expertise.
	Duty to diversify investments.

Duty to Follow Plan Document

Duty of Loyalty

- Internal Revenue Code's **Exclusive Benefit Rule**:
  - This is a qualification requirement under the Internal Revenue Code.
- State laws regarding conflicts of interest
  - Avoid self-dealing that serve personal or business interest

Duty of Loyalty *(cont'd)*

- ERISA **(private sector plans)** similarly requires fiduciaries to discharge their duties with respect to a plan for the ***exclusive purpose*** of
  - providing benefits to members and their beneficiaries; and
  - defraying reasonable expenses of administering the plan.

\- ERISA § 404(a)(1); *see also* UMPERSA § 7(1); Restatement (Third) of Trusts § 78.

Duty of Loyalty – Costs

- A fiduciary shall discharge duties with respect to a plan incurring only costs that are appropriate and reasonable to administer the plan.
  - Fee transparency.
  - Understand what and how fees are paid.
- Only plan expenses can be paid from trusts (as opposed to settlor expenses).

- Internal Revenue Code § 401(a)(2); ERISA § 404(a)(1)(A);UMPERSA § 7(5)

Duty of Loyalty – Practical Impact

- A fiduciary has a duty to act in the interest of the trust **as if it had no other competing interests to protect**.
  - Cannot act for fiduciary's own interest.
  - Cannot be influenced by the interest of any third person.
  - Must set aside the interests of the party that appoints the fiduciary.
    - Not an agent for the party that appoints fiduciary

Duty of Prudence

- If a fiduciary does not have the skills, must hire expert pursuant to a prudent process.
- State statutes may require certain types of expertise, *e.g.*, investment expertise.
  - May need experts to manage investments, fund selection, and oversight of investments

Duty of Prudence – Delegation

- Documentation should be clear and consistent with respect to the process of delegation.
- Specific duties and responsibilities of the delegate should be set out in writing, approved by the fiduciary, and accepted by the delegate.
- Delegation is a fiduciary act –
  - Must delegate prudently and in accordance with the written plan.
  - Must monitor delegate.
  - Fees and costs must be reasonable.

Duty of Prudence – Practical Impact

- Retain expertise when needed.
- Develop written processes and methods of evaluations for making investment decisions.
- Follow written procedures.
- Establish internal controls to verify written policies are updated regularly and implemented appropriately.

Duty of Prudence - Diversify

- In investing and managing assets of a retirement system, a fiduciary with authority to select assets shall diversify the investments.
- Fundamental to the prudent management of risk to allow participants the opportunity to diversify their individual accounts.

- UMPERSA § 8(2); Restatement (Third) of Trusts, § 90(b); ERISA § 404(a)(1)(C)

Duty of Prudence - Continuing Duty to Monitor

- Common law of trusts recognizes a **continuing responsibility** to monitor investments after initial selection:

  > *"[A] trustee's duties apply not only in making investments but also in monitoring and reviewing investments, which is to be done in a manner that is reasonable and appropriate to the particular investments, courses of action, and strategies involved*." Restatement (Third) of Trusts.

- Supreme Court in *Tibble v. Edison International* looked to common law in finding that trustee has a **continuing duty under ERISA** to monitor and remove imprudent investment options.

Continuing Duty to Monitor – Practical Impact

- Conduct regular investment reviews comparing with peer groups and benchmarks.
- Compare expenses and assets classes.
- Determine whether certain investments should be placed on a watch list or replaced.
- Consider adoption of Investment Policy Statement
  - Follow IPS

Duty to Follow Plan Documents

- Fiduciary duty to administer a plan in good faith in accordance with its **written terms – "by the book."**
  - Plan includes the statutes, administrative rules, and administrative procedures.
- Burden on fiduciary to understand the governing documents of the plans and the context in which the plans exist.

- ERISA § 404(a)(1)(C); Restatement (Third) of Trusts § 76.

Duty to Follow Plan Documents – Practical Impact

- Consider whether documents address revenue sharing or other unallocated amounts
  - How are these used?   Plan expenses? Allocated to participants?
  - How often distributed?

Negative Duties – Prohibited Transactions

A fiduciary may not:

Deal with plan assets in his or her own interest.

Pay unreasonable compensation for services performed.

Make a purchase for more than adequate consideration or a sale for less than adequate consideration (e.g. transactions involving the settlor).

Act on behalf of a party whose interests are adverse to the plan or participants.

Receive anything of value from any party in connection with a transaction involving plan assets.

Key Takeaways

Highest duty known to law.

Objective standard:

- Prudent "expert" standard.
- Good faith is not sufficient.
- If you don’t know, learn or hire an expert.

If it is not documented, it never happened.

What about participant directed investments?

Responsibilities

- Participant
  - Control and responsibility for investment outcomes
- Plan Fiduciary
  - Maintain the plan
  - Educate participants
    - Newsletters, pamphlets, website, workshops, seminars, etc.
  - Select and monitor investment options and service providers
  - Control Plan expenses

Mitigating Liability

Sovereign Immunity

- State constitution or statutes may provide some protection.
- May also have public officer protection or other State employee immunity or indemnification.
- Often will still require good faith demonstration.

The Focus is on Prudence

- Focus on procedural prudence.
- Courts have held the test of prudence is one of conduct and process, and not one of result.

  "*Trustees and fiduciaries are not insurers. Not every investment or management decision will turn out in the light of hindsight to have been successful. Hindsight is not the relevant standard*."

  – UMPERSA § 10(1); see also Restatement (Third) of Trusts

The Focus is on Prudence *(cont'd)*

- There is no one "right" way to achieve procedural prudence.
- Important to have a good, documented process.
- Critical to follow that process.
- Critical to retain expertise where needed and understand expert advice.

Managing Fiduciary Risk

- Know and follow plan documents.
- Adopt written prudent processes and procedures and follow them:
  - Governance Policy
  - Conflicts of Interest Policy
  - Ethics Policy
  - Charters for Committees
  - Investment Policy Statements
- Give appropriate consideration to facts and circumstances that fiduciary knows or should know are relevant.

Managing Fiduciary Risk *(cont'd)*

- Document decisions and the basis for decisions.
- Conduct periodic training of fiduciaries.
- Properly allocate fiduciary roles in writing.
- Ensure adequate fiduciary liability insurance coverage and indemnification.
- Retain expertise where needed.
- Conduct financial and management audits.

Managing Fiduciary Risk *(cont'd)*

- Due diligence in selecting and monitoring investment managers.
- Prudently select and monitor investments.
  - Consider whether there are too many options.
- Get competitive bids from service providers.
- Understand and negotiate plan fees and expenses.
- Negotiate contracts with service providers.
- Ensure that communications are accurate.
- Periodically solicit bids to confirm current terms are competitive.

Managing Fiduciary Risk *(cont'd)*

- For participant directed investments, consider formal participant education.
- Provide sufficient information to allow participants the ability to have informed decision making.
- Allow participants the opportunity to change investment selection on a regular basis.
- Document education offered and provided.

Questions?

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