

Delaware OST FIDUCIARY DUTIES

build
compliance

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PRESENTED BY

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Who is a Fiduciary?

Discussion Question

Sally is a well-respected financial consultant in a metropolitan area. A public pension board hires her to help provide training on financial literacy for board members. Although Sally is sometimes hired to manage fund assets by other entities, her services for the public pension board are specific to explaining financial concepts and understanding investment options.

Is Sally a fiduciary?



Fiduciary Defined

- Look to function and designation
- Function: Discretionary administrative or investment decisions related to the plan
 - *E.g. Trustees*
- Designation: Named in a plan, trust document, or statute as a fiduciary

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

Who is a Fiduciary?

- The Plans Management Board is administrator of the College Investment Plan (529 Plan), the Delaware Achieving a Better Life Experience Program (ABLE Plan), the State of Delaware Match Plan, State of Delaware 403(b) Plan, and the Deferred Compensation Program (collectively, “the Plans”). 29 Del. C. § 2722; see also Plans’ documents.
- The term “fiduciary” includes any “trustee” and “agents to the extent delegated duties by another fiduciary.” 12 Del. C. § 3301(d).

Other Fiduciaries May Include

- An employee, e.g. Executive Director
- An investment advisor

Who is *Not* a Fiduciary?

Settlor

- Not a fiduciary (unless plan or statute provides otherwise).
- Determines the scope of authority of the fiduciaries
- Settlor = State of Delaware

Administrative Entities

- Individuals or entities that perform purely administrative functions

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

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

ERISA Requirements of Fiduciaries

- Act solely in the interest of plan participants
- Act for the exclusive purpose of providing benefits to participants and defraying reasonable expenses of administering the plan
- Act with the care, skill, prudence, and diligence under the circumstances then prevailing
- Adhere to the "prudent expert" standard



Affirmative Fiduciary Duties

- 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.

Affirmative Fiduciary Duty: Duty of Loyalty

Duty to act impartially among differing interests

Duty to act solely in the interest of participants and beneficiaries

Duty to act independently and without conflicts of interest

Duty to act for the exclusive purpose of providing benefits or paying reasonable plan expenses

Affirmative Fiduciary Duty: Duty of Prudence

Duty to diversify investments

Duty to act with the care, skill, prudence, and diligence of a prudent person familiar with like matters

Duty to act for the exclusive purpose of providing benefits or paying reasonable plan expenses

Duty to delegate responsibilities outside of experience

Affirmative Fiduciary Duty: Duty to Follow Plan Document

1. Duty of Loyalty

Discussion Question

Sam is a board member on a public pension. His spouse has recently changed jobs, and now works for an employer that participates in the public pension on which he serves.

Is it a breach of Sam's fiduciary duty to continue serving on the pension board?

Duty of Loyalty: Exclusive Benefit Rule

"Under the trust instrument it [must be] impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the ***exclusive benefit of his employees or their beneficiaries.***"

- Code § 401(a)(2); see also Treas. Reg. § 1.403(b)-8(d)(2)(iii); Code § 457(g)(1)
- Code Sections 401(a), 403(b) and 457(b) each contain an “**exclusive benefit rule**”
- This is a qualification requirement under the Code



Duty of Loyalty: Exclusive Benefit Rule *(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
- Defraying reasonable expenses of administering the plan

Duty of Loyalty: Exclusive Benefit Rule *(cont'd)*

- ➔ Delaware Code § 2722(d), setting out the standard of care of the Plans Management Board, also incorporates the **duty of loyalty**:

"The Board, its subcommittees, and each of their members shall discharge their duties with respect to each Plan ***solely in the interest of the participants and beneficiaries of such Plan. . .***"
- ➔ State Employees', Officers' and Officials' Code of Conduct – 29 Del. Code Ch. 58

IRC DC Plans Exclusive Benefit Rule v. 529 and ABLE Plans

→ Governed by Different IRC Sections

- Not governed by same Code Sections
- Common law of trusts

→ Expressly Allowed by Statute

- 29 Del. Code § 2722(d)(2): Allows use of administrative fees to defray reasonable plan expenses from 529 and ABLE Plans.

→ Expressly Allowed by Trust

- Permits establishment of “Administrative Fund” to pay reasonable expenses and fees, including salary, marketing, and other administrative expenses

→ Consistent with Other 529 Plans

- Different legal landscape

Plan	Code Section
401(a) Match Plan	It must be "impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries. . . ." Code § 401(a)(2)
403(b) Plan	A custodial account under a 403(b) plan cannot be used for, or diverted to, purposes other than the exclusive benefit of the participant. Treas. Reg. § 1.403(b)-7(d).
457(b) Plan	Assets of a governmental 457(b) plan must be held in a trust for the exclusive benefit of the participants and beneficiaries. Treas. Reg. § 1.457-8(1).
529/529A Plans	Provides that the Board and subcommittees discharge duties in accordance with trust and applicable law. Establishes the prudent person standard and "authorizes the use of administrative fees from the Plan and Program to defray reasonable expenses of administering each Plan and Program, including marketing expenses, and to fund scholarship, match, or promotional programs as the Board, in its discretion, may establish. " 29 Del. Code § 2722(d)(2).

Duty of Loyalty: Plan Expenses *(cont'd)*

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

Duty of Loyalty: Independence *(cont'd)*

A trustee is to be independent of preconceived notions.

- "Many forms of conduct permissible in a workday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace."

- Meinhard v. Salmon, 164 NE 545, 546 (NY Ct. App. 1928)

- "Independence is required because it permits trustees to perform their duties in the face of pressure from others who may not be subject to such obligations."

- UMPERSA Comments on § 5

Duty of Loyalty: Independence *(cont'd)*

- Delaware Code Chapter 58 sets forth the laws regulating the conduct of Officers and Employees of the State.
- The Board must arrange for an annual financial audit of each of the Plans, to be provided annually to the General Assembly. 29 Del. C. § 2722(e)(7).
- *Stegemeier v. Magness*, 728 A. 2d. 557 (Del. 1999) (Absolute prohibition on self dealing by Trustee).

Duty of Loyalty: Impartiality

A fiduciary owes a duty of loyalty to **all participants and beneficiaries**, and respecting that duty requires the fiduciary to be **impartial among differing interests**.

Prevents application of assets for personal use, self-dealing, competition with trust, or improper benefit



Duty of Loyalty: Impartiality *(cont'd)*

- Balance the interests of retirees and active participants
- Balance the interests of different groups of participants
 - Teachers, state employees, police officers, local employees
- Balance roles with regard to different plans and trusts
 - 457(b) Plans, 403(b) Plans, 401(a) Plans

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

Requires **undivided loyalty** to members and beneficiaries.

2. Duty of Prudence

Discussion Question

Ben has served on the same public pension board for nearly five years. He is a retired public school teacher with a background in English literature. Prior to its quarterly meeting, the staff circulated an actuarial report that was due to be discussed at the board meeting. Ben briefly looked at the actuary report, but did not feel as though he understood the content enough to read it thoroughly. At the board meeting, Ben voted to approve the report without having looked at it again.

Did Ben uphold his duties as a fiduciary?

Duty of Prudence

- ➔ Delaware Code § 2722(d) incorporates the **duty of prudence**:

"The Board, its subcommittees, and each of their members shall discharge their duties with respect to each Plan solely in the interest of the participants and beneficiaries of such Plan and for the exclusive purpose of providing Plan benefits to participants and their beneficiaries, including defraying reasonable expenses of administering each such Plan, with ***the care, skill, prudence, and diligence*** under the circumstances then prevailing that a ***prudent person*** acting in a like capacity and familiar with such matters would use to attain the purposes of such Plan"

Duty of Prudence: Informed *(cont'd)*

The trustee must exercise reasonable effort and diligence in making and monitoring investments for the trust, with attention to the trust's objectives, including keeping informed of rights and opportunities associated with those investments.

Example: Obtain and consider relevant information about the trust, beneficiaries and investments.

Example: Look at plan operations and documents, especially high risk areas

May require securing and considering the advice of experts on a reasonable basis.

Duty of Prudence: Expertise and Delegation

If a fiduciary does not have the skills, he/she must hire an expert pursuant to a prudent process.

State statutes may require certain types of expertise, e.g. investment expertise.

Duty of Prudence: Delegation

- A fiduciary is able to delegate functions that a prudent fiduciary acting in a like capacity and familiar with those matters could properly delegate.
- A fiduciary has a duty to delegate responsibilities outside of the fiduciary's expertise.
- Delegation should not be overly broad and must be consistent with duties of care and caution, *e.g.* terms of delegation must be prudent.

Duty of Prudence: Delegation *(cont'd)*

Documentation should be clear and consistent

- Set out specific duties in writing
- Ensure all delegated acts are approved by the fiduciary
- Require the delegate accepts all assigned duties

Delegation is a fiduciary act

- Must delegate **prudently and in accordance with the written plan**
- Must **monitor** the delegate
- Fees and costs must be **reasonable**



Duty of Prudence: Delegation *(cont'd)*

"If you don't know jewelry,
know the jeweler."

- **Warren Buffett**

Duty of Prudence: Diversify *(cont'd)*

In investing and managing assets, a fiduciary with authority to invest and manage assets shall diversify the investments unless the trustee reasonably determines that it is not prudent to do so.

“The Board shall have the power and duty to maintain, invest, and reinvest the funds contributed into the Plans consistent with the standard of care . . .” Del. Code § 2722(e)(4).

Duty of Prudence: Continuing Duty to Monitor *(cont'd)*

- 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.
 - “The Board in the exercise of its sole discretion and without liability is specifically authorized to remove any of the Plans’ funds from any financial institution and to reinvest the funds in a similar or different investment alternative at another financial institution at any time.” Del. Code § 2722(e)(6).

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/funds should be placed on a **watch list or replaced**
- Consider adoption of **Investment Policy Statement**

3. Duty to Follow Plan Document

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
- Consistent interpretation and administration
- Timely update for legally required changes
- Timely correct plan errors

Burden on fiduciary to understand the governing documents of the plans and the context in which the plans exist.

4. Prohibited Transactions

Discussion Question

Barbara is a member of a public pension board. A good friend of hers is an actuary at a large, well-respected firm in the same city. When the public pension board needs to hire a new actuary, Barbara recommends her friend because her friend's firm is so well-respected and Barbara considers her friend very trustworthy. The board establishes a contract with this actuarial firm without comparing prices. Several months into the contract, the board learns that it is paying this firm a much greater rate than a smaller, local actuarial firm.

Did Barbara and/or the board breach a fiduciary duty?

Negative Duties: Prohibited Transactions

A fiduciary may not:

- Deal with plan assets in his or her own interest
- As to a “Disqualified Person”:
 - Pay unreasonable compensation for services performed
 - Make a purchase for more than adequate consideration or a sale for less than adequate consideration
- 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 it is not documented, it cannot be substantiated

Fee Litigation: Background

- Fee litigation began in 2006, primarily against **defined contribution** plan sponsors in the private sector
- Claimants typically allege **breach of fiduciary duties**
- Mixed outcomes in courts, but **settlements totaling in the millions** (e.g. \$62 million with Lockheed Martin, \$57 million with Boeing) have fueled litigation

Fee Litigation: Specific Allegations

Breach of Duty of Loyalty

- "Locked in" investments favoring record keeper
- Too many investment options leading to investment paralysis
- Excessive fees for plan administration that benefited record keeper

Breach of Duty of Prudence

- Unreasonable administrative fees (e.g. revenue sharing, lack of competitive bids, asset-based vs. flat fees)
- Selecting and retaining investments with high fees and poor performance
- Investment options too numerous
- Flawed process for selecting and monitoring investments.
- Multiple record keepers increasing costs
- "Locked in" arrangement with vendor

Breach of Duty of Independence

- Use of plan information to market other products outside the plan

Mitigating Liability



Statutory/Qualified Immunity

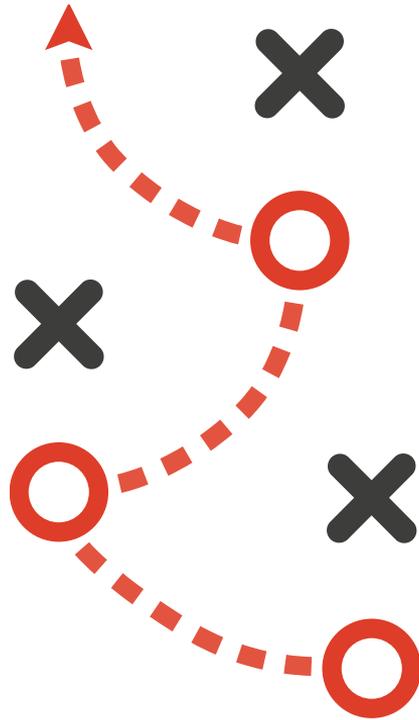
- State Constitution or Statutes may provide some protection
- May also have public officer protection or other State employee immunity
- Delaware law provides statutory/qualified immunity
 - 29 Del. Code § 2722(f)(2)
 - Ch. 40, title 10

The Focus On Process *(cont'd)*

- 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

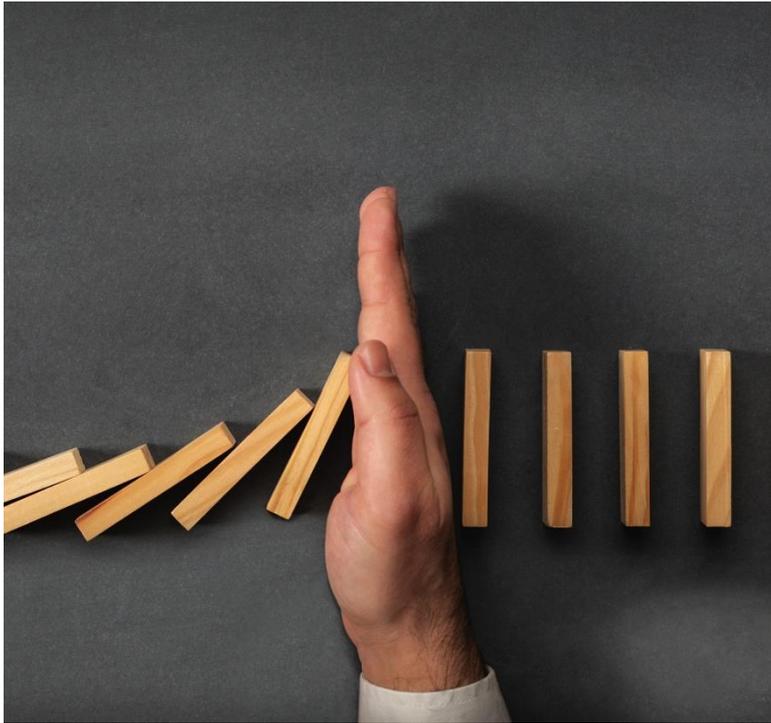


The Focus On Process *(cont'd)*

- 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 Manual
 - Vendor Management, Cybersecurity, and Other Policies
 - 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
- Retain expertise where needed
- Properly allocate fiduciary roles in writing
- Conduct financial and management audits

Managing Fiduciary Risk *(cont'd)*

- Due diligence in selecting and monitoring investment managers
- Prudently select and monitor investments
- Understand and negotiate plan fees and expenses
- Get competitive bids from service providers
- Negotiate contracts with service providers

Managing Fiduciary Risk *(cont'd)*

- For delegated duties:
 - Properly select those to whom duties are delegated
 - E.g. monitoring performance of investment manager and supervisory staff
- Retain expertise where needed
- Consider fiduciary insurance
- Avoid conflicts of interest

Other Topics to Watch

- ESG (“Environmental, Social, Governance”)
 - Department of Labor (“DOL”) Field Assistance Bulletin 2018-01
 - ESG factors can be “tie-breakers”
 - June 23, 2020 – DOL issued a proposed regulation (30 day comment period has expired)
 - Provides that fiduciaries must compare investments based solely on economic factors
 - Prohibits use of ESG fund as a default
- Voting Proxies/DOL Guidance
 - DOL provided updated guidance on the voting of proxies in Interpretive Bulletin 2016-01 (“IB”)
 - Consistent with the common law of trusts, the fiduciary act of managing plan assets that are shares of stock includes the voting of proxies appurtenant to those shares
 - A delegating fiduciary is responsible for monitoring the fiduciary’s procedures and actions
 - May be new guidance from DOL.

Questions?



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