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The Ins and Outs of Fiduciary Duties – Limiting Your Exposure

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EXPECT EXCELLENCE®

Fiduciary Training

- Fiduciary Duty Generally
- Monitoring Investments
- Monitoring Expenses
- Monitoring Operations

FIDUCIARY DUTY GENERALLY

Take-Aways

- What is required of fiduciaries is prudence, not perfection.
- The hallmark of a prudent fiduciary is a prudent process.

What Do We Mean By Fiduciary?

Fiduciary

– noun

1. a person to whom property or power is entrusted for the benefit of another.

– adjective

2. of or pertaining to the relation between a fiduciary and his or her principal: a fiduciary capacity; a fiduciary duty.

For ERISA purposes, fiduciaries include individuals or entities who manage an employee benefit plan and its assets on behalf of plan participants. (Highest standard of care under American law.)

Who is a Fiduciary?

Two types of fiduciaries for ERISA purposes:

1. Named Fiduciaries
2. Functional Fiduciaries

Who is a Fiduciary (continued)?

1. Named Fiduciaries
   - ERISA requires that every plan have one or more "named fiduciaries" designated by the plan with general authority for plan operation and administration
   - Named Fiduciaries are fiduciaries by designation and definition (e.g., Plan Sponsor, Plan Administrator)
   - Named Fiduciaries are personally liable for all aspects of plan operation unless duties properly delegated to another fiduciary or co-fiduciary

Who is a Fiduciary (continued)?

2. Functional Fiduciaries
   - ERISA employs a functional test – fiduciary status determined based on functions performed rather than title or position
   - Functional Fiduciaries include anyone exercising:
     - authority or control over plan assets;
     - discretionary authority over the plan's management; and
     - discretionary authority or responsibility in the plan's administration.
   - Settlor vs. Fiduciary

ERISA Fiduciary Duties

ERISA § 404 – The Big Four Fiduciary Duties:

- Duty of Loyalty (Exclusive Benefit Rule)
- Duty of Procedural Prudence
- Duty to Diversify Investments
- Duty to Follow Plan's Terms (consistent with ERISA)

ERISA Fiduciary Duties (continued)

1. Duty of Loyalty (Exclusive Benefit Rule)
   - Act solely in the best interests of plan participants and beneficiaries
   - Act for exclusive purpose of providing plan benefits and defraying reasonable expenses of administering the plan
   - Okay to have multiple hats - the trick is wearing just one at a time

ERISA Fiduciary Duties (continued)

2. Duty of Procedural Prudence

- ERISA requires that fiduciaries act with the care, skill, prudence and diligence that a prudent person familiar with such matters would employ
- "Prudent expert" standard – acting with a "good heart and empty head" is not enough
- Don't (always) have to be right – but must be prudent
  - Gather required information from competent sources
  - Evaluate information objectively and make decision
  - Document your decision-making process and your support for final decision reached

ERISA Fiduciary Duties (continued)

3. Duty to Diversify Plan Investments
   - Diversify to reduce risk of large losses (unless clearly prudent not to do so)
   - Requirement is diversification, not that all plan assets be invested solely in "conservative" investments
   - Investment decisions must be made on an individual facts and circumstances basis depending upon:
     - Nature of the plan and plan participants
     - Size of plan and plan assets being invested
   - Current financial conditions

ERISA Fiduciary Duties (continued)

4. Duty to Act in Accordance with Terms of the Plan
    - Must do as the plan documents say or require
        - Unless the terms of the plan are inconsistent with ERISA or would result in breach of fiduciary duties
    - Must know what the plan says
    - Must know what ERISA requires/allows
    - Duty to obtain expert assistance when needed

ERISA Fiduciary Duties (continued)

Other General ERISA Fiduciary Duties

- Establish and maintain a trust for plan assets
- Obtain fidelity bond covering all persons handling plan assets
- Follow strict code of conduct avoiding self-dealing, conflicts of interest, and other "prohibited transactions"
- Assume personal liability for fiduciary breaches

MONITORING INVESTMENTS

Big Picture Concerns

- Are the plan assets safe and are they still appropriate?
- Are plan participants receiving appropriate communications?
- Is plan governance in place?
- Should any changes be made to the plan's investment strategy or investments?

Overview of Steps

- Determine objectives
- Develop investment strategy
- Hire Investment Advisor or Investment Manager
- Document decisions in an Investment Policy Statement
- Monitor investments/investment options
- Take appropriate action
- Coordinate decisions with plan recordkeeper
- Document decisions

Develop Investment Strategy

- Plan Architecture
  - Equities
    - Value – core – growth
    - Large – mid – small
    - Foreign
  - Active or passive management
  - Fixed income
    - Stable value
    - Core
  - Default funds including Qualified Default Investment Alternatives (QDIA)

Prepare Investment Policy Statement

- ERISA requires a plan to have a procedure for establishing and carrying out a funding policy
- Will be requested in an IRS or DOL Audit
- Provides a framework for selecting and evaluating investments/investment options
- Balance between
  - Too strict → can't possibly meet the guidelines
  - Too loose → doesn't provide structure
- Dynamic
  - Change as circumstances change

Monitor Performance

- Performance of fund relative to peers and index
- Process used by fund managers
- Fund managers themselves
- Price/expense ratio of fund

MONITORING EXPENSES

Basic Rule

- Plan fiduciaries must monitor everything on which plan assets are spent
- “Exclusive Benefit Rule”

Primary Objectives

- It is fine for your provider to make a reasonable profit
- Plan sponsors should be able to demonstrate that fees collected by provider are:
    - Permissible according to DOL guidelines
    - Commensurate with the services being provided, and
    - In line with what's available in the marketplace

You Have a Problem if You Say…

- We have no idea how much our plan is costing us or where to start to figure it out.
- Our participants want to know why they have to pay 50 basis points (0.50%) for the S&P 500 Index Fund when they buy it for 20 basis points (0.20%) outside the plan.
- The broker who set our plan up never calls on us.
- We don't have to worry about our fees, because we get everything for "free."

You Have a Problem if You Say...(continued)

- We like our provider, but they only let us use their (proprietary) funds in our plan.
- Our provider has not talked to us about fees in a long time.
- Our provider discloses soft dollars (open disclosure), but I don't understand the numbers or how they relate to the market.

Understand What You Are Paying

- Review your documents
  - Plan/Trust document
  - Fund prospectuses
  - Provider service and investment contracts
- Insist on full and open disclosure from your provider
- Benchmark against the market
- If you don't have the expertise, consider retaining someone who does (prudent expert rule)

Implement Ongoing Processes To:

- Monitor
  - On an ongoing basis
- Adjust
  - Appropriately
- Document activities
- Communicate with participants
  - When necessary
  - DOL may require certain information be delivered to participants

MONITORING OPERATIONS

MONITORING OPERATIONS

- Beyond investment and traditional fiduciary issues, don’t lose sight of keeping plan working properly and qualified
- Be sure plan document terms are followed
    - Eligibility
    - Vesting
    - Loan defaults
    - Forfeitures
- Keep plan up to date with legal and regulatory requirements and changes

What the IRS is looking for:

- Late deposits of participant deferrals and loan repayments
- Failure to properly apply plan’s definition of compensation
- Failure to properly update the plan document
- Failure to follow eligibility provisions
- Incorrect employer contributions
- Failure to properly apply plan’s vesting provisions
- Improper use of plan forfeitures

What if there is a problem?

- IRS (and DOL) programs exist to fix them
  - General correction principles require that participants be put back in the position they would have been had the problem not occurred

Best Practices

Best Practices

- Hold regularly scheduled committee meetings (quarterly)
- Have a process for selecting/monitoring investments and reviewing fees
  - Investment Policy Statement (IPS)
  - Understand & regularly review fees paid by plan
- Document the process
  - Committee minutes

Questions?