

# Understanding Your Fiduciary Responsibility

*An Executive Guide to Reducing Risk and Liability*

*Doing the right thing, from the right perspective, with the right frame of mind, is core to being a good fiduciary.*

# The Changing Fiduciary Landscape

In a bygone era, being a “fiduciary” was an enviable position – it was considered an honor if you were fortunate enough to be asked to serve as one. Fiduciaries were the “trustworthy,” whose sole purpose was to serve as the guardian of another’s property. But the pendulum has swung dramatically over the past few years with the onset of corporate scandals from Enron to the mutual fund industry’s events. Fiduciaries, their motives and their actions have come under increased scrutiny. Does this mean that being a fiduciary will never again be viewed as a noble position? More likely, the landscape has changed for the duration, and heightened scrutiny will be the norm. The pendulum will eventually end up in the middle, but fiduciaries will have to be even more vigilant in performing their functions lest the increased attention and review find litigatable error. All this makes understanding your role as a fiduciary more important than ever.

Under the regulatory setting of the Employee Retirement Income Security Act (ERISA) and the current litigious climate, you may ask, “Why would I want to be a fiduciary?”. You may not have the luxury of choice in the matter. Being a fiduciary—and a good one—is part and parcel of the role you fulfill in your organization. “How can I best serve in my capacity as a fiduciary?”, is the question you should be asking. This Executive Guide can help you navigate your role as your plan’s fiduciary.

This guide is intended to be more of a thought process map rather than a detailed reference manual. It’s designed to provoke you to think like a fiduciary each step of the way on your fiduciary journey and help you realize what questions you need to ask. Your answers will vary based on your situation, but through the process of understanding the issues, establishing appropriate decision making parameters, analyzing salient information, and drawing prudent conclusions, you will develop a better understanding of your role as a fiduciary.

In six steps, you will be able to better execute on your role as a retirement plan fiduciary. The first three steps will examine what is required of fiduciaries of retirement plans to assist with reducing fiduciary risk. The last three steps will discuss common characteristics of successful fiduciaries and how they help limit fiduciary liability.

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## PART I

# On Being a Fiduciary: Minimizing Risk

## *Who Is A Fiduciary?*

Under ERISA, wanting, or more appropriately not wanting, to be a fiduciary is not a choice that you may be able to make. ERISA defines a fiduciary on the basis of what functions he or she performs, without regard to whether they've consented to being fiduciaries or have accepted the liabilities associated with that position. The only way to not be a fiduciary is to be aware of the actions or functions that would make you a fiduciary, and not perform them. We can only protect ourselves through knowledge of the duties placed on us as fiduciaries, a thorough understanding of how to properly discharge those duties, and by implementing "prudent" tactics appropriate to manage and minimize risk.

## STEP ONE: We Perform Fiduciary Functions - We Are Fiduciaries



The first step to minimizing fiduciary risk is to realize what functions we perform which make us fiduciaries and to admit that when we perform those functions, we are fiduciaries. Thus, we become aware of the fiduciary obligations that are attached to our work. In the common law, being a fiduciary was a position to which one had to agree to occupy – especially considering the potential for significant liability that a fiduciary would be exposed to. ERISA altered the landscape for fiduciaries of employee benefit plans by realizing that the complexity of plan operation and administration requires the employment of, and delegation to, many individuals to handle various parts of a plan. Only by defining a fiduciary through functional roles could ERISA authors ensure that the appropriate obligations and standards of care were attached at all levels and to all people performing these important functions. ERISA is clear – perform one of the functions enumerated as making you a fiduciary and you are a fiduciary. No questions asked. Even if you never intended to become a fiduciary; you are a fiduciary. That said, ERISA defines a fiduciary as a person who performs any or all of these three broad functions:

- Exercises discretionary authority in the management of the plan
- Is paid for regularly providing investment advice
- Exercises any discretionary authority in the administration of the plan

Let's take a closer look at these functions, how they are distinct, and how they overlap.

### *Control and Authority*

First, a fiduciary is one who exercises any discretionary authority or control with respect to management of the plan, or exercises any authority or control with respect to management or

one who controls plan assets or their disposal a fiduciary with respect to the plan. No exercise of discretion is necessary to be deemed a fiduciary here. If you can control plan assets or can remove them from the plan's trust, you are a fiduciary, even though it is beyond the scope of your authority to do anything discretionary with it. Touch the money, and be a fiduciary.

### *"Plan Administrator" vs. plan administrator*

Clearly the legal Plan Administrator, charged by ERISA with responsibility specifically for these tasks, is a fiduciary. Care should be taken to distinguish the legal Plan Administrator from those who administer a plan, including recordkeepers like us, third party administrators, and others handling the routine day-to-day processing activities. Under ERISA, the Plan Administrator is defined as the person identified in the plan document as such, and absent such a designation, the Plan Administrator is the plan sponsor.<sup>1</sup> The Plan Administrator under ERISA is the person (or committee) ultimately responsible for management of the plan.

### *Employer Functions*

Not everything a plan sponsor does with respect to the plan gives rise to fiduciary responsibility. The plan sponsor may wear many other hats – most notably as a "settlor" – which is not an

**ERISA is clear – perform one of the functions enumerated as making you a fiduciary and you are a fiduciary.**

disposition of plan assets. The distinction between one who exercises discretionary control over plan management and one who exercises any control over the assets is important. Under the first part of the definition, you become a fiduciary if you have discretionary decision-making authority – that is, you are performing more than "ministerial" functions such as checking forms for completeness before processing distributions. This clause implies the exercise of judgment in making decisions. The latter part of the definition makes any-

ERISA “hat.” The settlor of a trust is the one who establishes the trust for some purpose and settles it (usually by funding it, or performing some other action which causes it to exist independently of the settlor). Functions performed by the plan sponsor as settlor are outside of the scope of ERISA and plan sponsors have wide latitude in making decisions as the settlor. ERISA does not mandate that employers sponsor a retirement plan, nor does it specify (with some limitations) the design that any sponsored plan must take. These decisions are settlor functions.

### *Plan Design = Employer Function*

When making decisions concerning plan design, or the desirability of amending a plan, the plan sponsor is functioning as a settlor and may exercise discretion without incurring any fiduciary responsibility or liability. For example, a plan sponsor may choose to design a plan that covers only one classification of employees, or employees working at only one division of the employer. Provided that the classification used for determining which employees are eligible to benefit from the plan is consistent with the coverage and non-discrimination rules imposed on plans by the Internal Revenue Code,<sup>2</sup> the plan sponsor has a free hand to implement such a plan without assuming any fiduciary liability for the discretionary decisions made with respect to its design. Once the plan has been designed (or amended) and the plan sponsor starts wearing the Plan Administrator hat, the administrator functions must be performed consistently with the fiduciary obligations placed on it by ERISA.

### *Employer vs. Administrator Hats*

There are times when the plan sponsor will function as settlor, and other times when the plan sponsor will function as an administrator. The plan sponsor must be cognizant of when it is functioning as settlor or administrator and act accordingly. Keeping the two

distinct is important. For example, it would be unwise to empower a fiduciary committee to make plan design changes (or to otherwise function in a settlor capacity). To do so may create a conflict where it is believed that fiduciary decisions are unduly influenced by corporate concerns and not consistent with prudent fiduciary process. This isn't to say that a plan committee

## *A fiduciary is anyone who provides investment advice to the plan or its participants, on a regular basis or as part of regularly provided services, for compensation – whether direct or indirect.*

shouldn't be engaged in recommending various plan design changes to management, but only that the basis of the recommendation should be consistent with their fiduciary obligations. That is, it would be appropriate for a committee to recommend changes in plan design that would encourage participation or provide alternate means of investing (such as life-stage or “pre-mix” investment options), which would be consistent with fiduciary functions, but it may not be appropriate for management to task such a committee to find ways to reduce costs associated with plan operation, which would be a purely settlor function.

### *Investment Advice*

Second, a fiduciary is anyone who provides investment advice to the plan or its participants, on a regular basis or as part of regularly provided services, for compensation – whether direct or indirect. The cousin or uncle who provides a hot tip to a participant does not ascend to fiduciary status because of such advice, because it isn't regularly provided (or part of regularly provided services) and (hopefully) there is no compensation for the tip. Generally, for the advice to give rise to fiduciary obligations, the giver of the advice must do so with the intention that it be followed – whether the plan sponsor or participants actually follow it or not – as part

and parcel of services provided to the plan with some regularity (whether exclusively investment related or bundled with other services or consulting), for which some remuneration is received.<sup>3</sup> The requirement that the advice be paid for does not mean that the plan, the plan participants or the plan sponsor need pay the advisor. The compensation may be indirect – in many cases

coming directly from the investments (particularly mutual funds) in which the plan invests (through 12(b)-1 fee programs or other revenue sharing arrangements) or through trading or brokerage commissions received by an advisor through the use of the advisor's trading facilities. A broker or consultant who regularly provides investment monitoring and advice with respect to investment selection would be a fiduciary if they receive compensation from any source in connection with the advice given about the plan.

Any manager of plan assets, of course, would be a fiduciary with respect to the plan. Managers of mutual funds in which the plan invests are not fiduciaries with respect to plans investing in their funds because mutual fund assets (the individual stocks, bonds and other securities that the manager selects) are not considered plan assets.<sup>4</sup> The assets held by the plan are the units in the mutual fund, which themselves are considered securities, owned by the plan's trust. Think of it this way: If a plan were to buy individual securities issued by Sears Roebuck & Co., the management of Sears would not be considered a fiduciary of the plan by virtue of their handling of their inventories held in the stores and warehouses of the company because the plan has no right to claim any of those specific inventory items as being owned by the plan. Rather, the

plan only has a pro-rata right to the profit generated by the sales of those items of inventory through the payment of dividends or increases in the value of the security owned. Similarly, when a plan invests in a mutual fund, the plan has no claim to any of the underlying securities owned by the mutual fund and only has a pro-rata claim on the earnings of the fund.

The same would be true if a plan invests in a contract issued by an insurance company, where the return generated to the plan was wholly dependent on the success of the insurance company as a whole and its ability to generate profits. These contracts are generally considered “general account” products, and no specific identifiable assets managed by the insurance company can be allocated to the owner of the contract.<sup>5</sup> Conversely, if a plan’s trust invests in an insurance company “separate account” product (where the plan actually has an interest in identifiable assets “managed” by the insurance company) or a group, common, or collective trust sponsored by a bank or trust company (the units in which, which are evidence of the trust’s ownership interest in the fund, are not considered “securities” under applicable law), the insurance company or manager of the group, common, or collective trust is considered a fiduciary with respect to the plan because each plan invested in the separate account product or collective trust is deemed to own a pro-rata share of each of the underlying investments held by the insurance company or trust.

### *Outsourcing Your Fiduciary Responsibilities*

A popular misconception is that if a plan sponsor hires an investment advisor to select, monitor, advise, or

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otherwise provide expertise on plan investments, if not actually managing them directly, then the plan sponsor is relieved of those fiduciary obligations. Unfortunately, the selection, monitoring, and replacing of advisors or investment managers by the plan sponsor is a fiduciary function and with one exception, a plan sponsor has co-fiduciary liability with them for all of their actions. The one exception is if a plan sponsor hires an investment advisor registered under the Investment Advisor Act of 1940 who acknowledges in writing that he or she is a fiduciary with respect to the plan, the plan sponsor is relieved of any co-fiduciary liability for the actions of the advisor in managing plan assets. ERISA provides this limited relief simply to encourage plan sponsors who may not be sophisticated investors to

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hire that expertise for the benefit of the plan and its participants. The exception only applies to the actions of the registered investment advisor. Should the plan sponsor or other fiduciary actually undertake any investment-related activity, the plan sponsor or that fiduciary will be liable for those activities.

In any event, the plan sponsor or other fiduciary who engages the services of a registered investment advisor or any other fiduciary or service provider is always liable for proper selection and

monitoring to determine whether their continued engagement is still appropriate. This is considered a primary fiduciary function and may never be delegated away or indemnified against.

### *Discretionary Authority and Responsibility*

Third, a fiduciary is anyone who has any discretionary authority or responsibility in the administration of the plan. This seems to overlap broadly with the first definition of a fiduciary above, and it does, but it differs in subtle but important ways. A fiduciary with discretionary authority or control over management of the plan or its assets is primarily dealing with where and how the plan will be administered, or where the assets will be held and invested. A fiduciary that has discretionary authority over the administration of the plan

makes day-to-day decisions in the operation of the plan, such as interpreting the plan documents, determining who is eligible to participate in the plan, and who the other fiduciaries will be. The Plan Administrator is also a fiduciary under this definition.

### *Fees and Value*

One of the most important functions of a fiduciary charged with responsibility

ity for the administration of the plan is determining what fees are appropriate for the plan and whether the plan is receiving value for the fees it pays. For several years, the Department of Labor (DOL), which is the main fiduciary enforcer under ERISA, has taken the position that the plan sponsor, in its role as a fiduciary, must understand how much is being paid for each service performed on behalf of the plan (including investment management, participant services and education, and sponsor services), that the services are appropriate for the plan, and that the amounts are reasonable. The DOL has taken the position that any expense borne by the plan needs to be known, evaluated, and approved by a fiduciary. In general, this means that the fiduciary must be aware of the totality of services being provided on behalf of the plan, including all optional services which may be of value, and evaluate the value of those services against the cost to the plan and ultimately the participants. This means that fiduciaries, usually plan sponsors, must have information about all of the sources of revenue received by service providers and a sense of the total amount of revenue generated from all of those sources, especially through revenue sharing from investment providers. Otherwise, the fiduciary would have no basis on which to determine whether the costs to the plan are justified by the value received from the services. Unofficially, DOL representatives have indicated that they will be auditing service providers to gain an understanding of the various sources of revenue to the provider as well as the extent to which those sources, and the amount of revenue received, is disclosed to plan sponsors. In those cases where it appears that a service provider is not diligent in providing that information, the DOL intends to review the provider's client list and inquire amongst the plan sponsors as to how they are fulfilling their fiduciary duties, as plan administrators, to ascertain whether the service provider is providing sufficient value to justify the cost. In appropriate cases, the DOL may take action against plan sponsors who cannot verify their diligence on fees.

## HOW TO DETERMINE WHAT VALUE IS RECEIVED FOR FEES BEING CHARGED TO YOUR PLAN.

Determining what fees are being charged to your plan is generally easy. Most of the fees are obvious, such as the expense ratios that various mutual funds charge against investor assets, which are disclosed in prospectuses and periodic reports, and any participant-level fees, such as recordkeeping costs and transaction fees, which are generally itemized on participant statements. Others may be buried in net return figures, but usually must be disclosed at least on a gross basis to investors. The DOL has provided a spreadsheet that contains virtually all of the possible fees that may be charged against a plan, or its investment funds, and is a good starting point for determining what fees are being levied.

What is really important, though, is not what the fees are, but who is receiving those fees and what value the plan receives in exchange for those fees. Obviously, the investment management fees paid to the investment company are part of the equation and may be the easiest to evaluate. Ask, **“Are the returns of the fund consistently sufficient to warrant paying the level of fees the manager charges?”** Ranking investment funds against peers will help in evaluating whether the level of management fees is justified. All things being equal, the lower the management fees, the better. Unfortunately, all things are not equal very often, so be cognizant of the value added through style purity, discipline, proprietary investment models, and even brand recognition, which can go a long way in creating a comfortable environment for participants.

## THE FEE QUESTION TO ASK

Other fees may be more difficult to track and indeed, even some of the disclosed investment management fees may be used for purposes other than supporting the investment manager. Plan sponsors should always ask their service providers, **“What are all of the sources of revenue you receive in administering this plan and what is the total amount you receive for your services?”** Plan sponsors can only determine the value of services provided if they know the proportion of the total fees the plan is paying for those services. This is true even if the total fees seem reasonable for the total services. If the investment manager is willing to provide all of its investment services and still share some of its investment management fees with a service provider, the question arises as to who should benefit from the investment manager's willingness to perform those services for less than

the stated management fee. It may be that this “revenue sharing” arrangement is indeed appropriate as providing a stream of income to the service provider to perform its services, but a prudent fiduciary would need to know the amounts involved prior to reaching that conclusion. A fiduciary may also take into consideration that revenue sharing may be applied to plan expenses that may otherwise be charged, such as audit fees, legal fees and the like, resulting in a reduction in the plan’s administration costs. Revenue sharing takes many forms – sharing of investment management fees; receipt of 12b-1 fees; sub-transfer agency fees; finder’s fees or new money commissions (usually coupled with contingent deferred sales charges, or CDSCs, levied against assets removed from the investment within a certain time limit), and other less tangible ways limited only by one’s imagination.

A plan fiduciary’s responsibility is to uncover all of the sources of revenue for each of the parties responsible for providing services to the plan and if paid for by the plan (either directly, or against the assets or earnings of the plan), to determine if the value received by the plan is worth the cost to the plan. If not, the fiduciary must take appropriate steps to reduce the costs borne by the plan (and ultimately the participants) and even to recover fees previously paid that were in excess of that which was reasonable.

## STEP TWO: We Are Fiduciaries –We’re Responsible for Each Other

Another of the important functions of a plan fiduciary is to engage the services of others, who may as well be fiduciaries, to perform services on behalf of the plan. Many of these will be employees of the plan sponsor itself, while others, such as recordkeeping service providers, investment advisors and managers, and the trustee and custodian of plan assets, will be independent. The DOL has quite forcefully argued, in an amicus brief filed in litigation involving former executives of Enron, that this power to appoint other fiduciaries not only confers on the person or entity making the appointment fiduciary status, it imposes a continuing duty of oversight with respect to those appointed “in such a manner as may be reasonably expected to ensure that their performance has been in compliance with the terms of the plan and statutory standards, and satisfied the needs of the plan.”<sup>6</sup> Many commentators have remarked that this is a departure from conventional thinking for the DOL and is an overbroad attempt to hold very public “C-level” people (e.g., CEO, CFO, and COO) accountable to plan participants. However, ERISA clearly provides that one of the main obligations of a fiduciary is to function as a “prudent expert” with respect to decisions made concerning the plan. It would be hard to conceive of a scenario where a “prudent expert” engages the service of another to function as a fiduciary and then neglects to monitor that individual to ensure that the functions are being properly performed. Failure to do so would not make you liable for the breaches of fiduciary duties of your subordinate, but rather would be a breach of your own fiduciary duty of functioning as a prudent expert.

## Co-Fiduciary Liability

You may also be directly liable for another fiduciary’s breach of their duties under ERISA-based “co-fiduciary liability.” Philosophically, ERISA was designed to be self-enforcing – first, by empowering participants and their beneficiaries through knowledge (gleaned from plan documents, Summary Plan Descriptions, Summary Annual Reports, and various other tidbits of information that participants are entitled to) and having the right to sue in order to enforce their rights to benefits; and second, by making all fiduciaries liable for all other fiduciaries, encouraging them to be ever-vigilant watchdogs over all plan matters, and all those whose decisions affect plan matters. Section 405 of ERISA specifically provides that a fiduciary is liable for another fiduciary’s breach of duty if the fiduciary:

- knowingly participates in or knowingly acts to conceal a breach of another fiduciary
- enables another fiduciary to breach a duty by failing in his or her own responsibilities
- has knowledge of the breach of a duty by another fiduciary and doesn’t take reasonable steps to remedy the breach

This latter provision has been held to require a fiduciary to take legal action against the breaching fiduciary if that was reasonably necessary to cure the breach and obtain any restitution due to the plan.

Multiple trustees, each charged with responsibility for management of trust assets, must use reasonable care to prevent other co-trustees from committing breaches of fiduciary duty unless the trust agreement authorizes a specific division of responsibilities or of assets under each trustee’s responsibility.

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ties in which case each trustee is only responsible for that which has been delegated to them. Nonetheless, co-trustees would still have co-fiduciary liability if they have actual knowledge of a breach, enable a breach, or fail to take reasonable steps to remedy the breach of another.

participants (and their beneficiaries) and does this decision further the exclusive purpose of providing benefits to them?” Nothing in ERISA requires that your decisions be made to maximize the benefits to participants, but rather that in your fiduciary decision making process, you act consistently with the sole purpose of the plan, which is

For example, if a plan sponsor selects its local lending bank to be the plan’s recordkeeper and trustee, it does so as a fiduciary. If the decision to place the plan with the lender is motivated, even in part, on the belief that aggregating more business with the bank will lower corporate fees on other bank services or help in obtaining a loan, then the plan sponsor is using the plan for a purpose other than providing benefits to the participants and their beneficiaries. In this case, the plan sponsor, as a fiduciary, has violated the exclusive benefit rule and would be in breach of its primary fiduciary obligation.

The purpose of the exclusive benefit rule is to ensure that retirement plans and the assets accumulated in their trusts are never, ever, ever used for corporate or personal use by a fiduciary...

### STEP THREE: Understanding the Standards: Exclusivity – Prudence – Diversification – Documents

By now, it should be apparent that as a fiduciary you are responsible for every fiduciary function you perform and many fiduciary functions that other fiduciaries perform, so it’s necessary to understand what responsibilities fiduciaries have. ERISA makes this easy, as it only prescribes four obligations that fiduciaries must perform.

#### *The “Golden Rule”*

**First, every fiduciary must operate to administer the plan for the exclusive purpose of providing benefits to participants and their beneficiaries,** except that a fiduciary may use plan assets to defray the reasonable expenses of administering the plan.<sup>7</sup> This rule, generally called the “exclusive benefit rule,” is the “golden rule” of being a plan fiduciary. It doesn’t just mandate concern for the participants but rather, exclusive concern for the purpose of providing benefits to them.

The exclusive benefit rule in its most fundamental form requires that before you exercise your fiduciary discretion you ask, “How will this impact the par-

to provide the benefits promised under the plan, consistent with the other fiduciary duties, and tax code rules applicable to qualified retirement plans.<sup>8</sup> The purpose of the exclusive benefit rule is to ensure that retirement plans and the assets accumulated in their trusts are never, ever, ever used for corporate or personal use by a fiduciary and remain inviolately secure to provide benefits to participants. As discussed above, the plan sponsor wears many hats in the decisions to have a retirement plan, its design and implementation, and further, in its operation and administration. When the plan sponsor is wearing the settlor hat, it may act without consideration of ERISA – but still consistent with other laws – and not be concerned with the impact of its decisions on the plan and its participants. Indeed, many settlor decisions, such as reducing or eliminating company matching contributions into a 401(k) plan, affect the participants, but they are not fidu-

#### *Which Hat When?*

Some decisions a plan sponsor makes may have both settlor and fiduciary implications and the plan sponsor needs to be able to put on the fiduciary hat, when appropriate, to avoid violating the exclusive benefit rule. Decisions concerning investments in company stock or other securities are a case in point. The initial decision to use company stock as an investment in a retirement plan generally is a settlor decision based on the plan sponsor’s desire as an employer to reap the benefits of having employees having a stake in the financial performance of the company or possibly to help protect the company from unwanted overtures from an acquisitive competitor. Many other reasons may form the basis of a decision to include company stock as an investment in a retirement plan, all of which are generally unrelated to the purpose of having a retirement plan. Nonetheless, the decision on what investments

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ciary decisions and need not abide by the exclusive benefit rule. Other decisions made by the plan sponsor, however, may have exclusive benefit rule implications – even decisions that don’t appear to have any impact on participant benefits.

a plan will have is a purely fiduciary one. So while a plan sponsor (“settlor”) may make a decision to offer company stock within a retirement plan, the plan sponsor (“fiduciary”) needs to make a determination, independent of corporate concerns, that inclusion of compa-

ny stock is consistent with the exclusive benefit rule. In addition, other fiduciary obligations, including the prudence rule, will have a bearing on the soundness of having company stock as an investment and need to be considered as well. These will be discussed shortly.

### *Reasons for Reasonableness*

As described above, one of the most important aspects of the exclusive benefit rule a fiduciary must deal with is the impact of fees on participant account balances and ultimately, their benefits. ERISA allows the use of plan assets to defray only the “reasonable expenses” of administering the plan. Unfortunately, what is “reasonable” is dependent on the facts and circumstances of each plan’s operation. ERISA does not mandate minimizing fees, i.e., cutting costs to the bare minimum, but rather makes fiduciaries determine whether the value received for the fees paid is reasonable. This requires that plan fiduciaries:

- understand exactly what fees are being assessed against the plan
- know where those fees are going, e.g., how much is retained by an investment management company for operation of the mutual funds in which the plan invests; how much is being paid to a broker or other advisor for serving as a consultant to the plan sponsor; how much is being paid to the recordkeeper for operational expenses, educational services, and other services being provided
- understand if the amount each entity receives is a reasonable amount, considering the value the plan and its participants are receiving

Care must be taken to ensure that moneys removed from the plan to pay expenses are being used to pay legitimate expenses of the plan. Clearly, record-keeping and compliance services are a necessary expense for plan operation. The same would be true for educational expenses incurred for teaching participants about the fundamentals of plan investing and preparing for retirement. However, it could be argued that use of

plan assets to pay for educational service that teach participants how to create family budgets, perform rudimentary lifestyle or financial planning, or even to distinguish between stock and bond selection techniques when the plan only offers mutual fund investments, is not consistent with the exclusive purpose

## The key is to understand the issue, evaluate it, and apply a proper fiduciary process to arrive at a conclusion...

of the plan. Care should be taken when approving the payment of expenses from plan assets or even when using vendor provided service paid indirectly through the use of plan assets, to ensure that the service provided furthers the aim of providing benefits from the plan. Many services may be argued as being consistent with the exclusive benefit rule or inconsistent with it, depending on your particular perspective. The key is to understand the issue, evaluate it, and apply a proper fiduciary process to arrive at a conclusion as to the necessity of a service paid for by the plan and to maintain appropriate documents in support of that conclusion.

### *Prudence = Process + Approach*

**Second, a fiduciary must operate the plan “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”** This is generally referred to as the “prudent expert” standard applicable to fiduciaries engaged in managing retirement plans. The common law of trusts has long

imposed a “prudent man” standard on fiduciaries of non-ERISA trusts, which generally required that a fiduciary function with the care, skill, prudence and diligence that a prudent man would use in like circumstance. ERISA added the proviso that the prudent man do the same as one “familiar with such mat-

ters,” thereby imposing the higher “expert” standard on prudence for ERISA fiduciaries. While this doesn’t require that every fiduciary become an expert with respect to all of the disciplines needed to effectively administer a plan, it does require each fiduciary to adopt the perspective and methods that an expert would, or to hire appropriate experts to handle plan administration.

Experts take methodical approaches. They investigate, performing a due diligence of all salient materials and facts. They document every step of their process. They consider every aspect of the decision and the probable outcomes of alternative decisions. They follow the same process every time they have to

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make a similar decision unless they’ve come up with a better process, which they will use consistently in the future. They make decisions, even when they feel that they would like more time or more information, when not making a decision would be worse. They review their decisions, learning how to better the process and improve the outcomes, and to make certain that subsequent facts brought to light don’t require that they revise previous decisions. If necessary, they revise previous decisions. Finally, they aren’t afraid to admit that a decision they made had unintended

consequences or was simply wrong, but they make future decisions based on the circumstances as they exist and strive to correct those wrongs going forward.

## What is important here is that the plan fiduciary have a good understanding of the investment savvy of their participants...

### *Documentation: Just Record It*

Prudence is a process, not an outcome. The best defense against a challenge of imprudence is to have a documented process – evidence that the process was well thought out, periodically reviewed and modified, and that the decision was made consistent with that process. The key is to document everything appropriate to that end. Many times people are afraid to document, for fear that they’ve created a paper trail that could be used against them. Proper documentation does nothing but provide evidence of the Truth – with a capital “T.” If the Truth is bothersome, then perhaps you should review the process, because it probably isn’t prudent. The lack of documentation itself is evidence of the Truth, only you won’t be happy with the inference that a plaintiff’s attorney will draw from it.

Methodical documentation, indeed, is part of being a prudent fiduciary. Having documentation not only shows that you’ve followed the process, but provides the information necessary to review and modify the process, when necessary. Documentation should probably be more than “minutes” of a meeting indicating that “a discussion was had concerning...” and “a decision was made to...”. Rather, the notes should indicate that the participants engaged in a full and open fiduciary discourse, with details of comments and concerns enumerated, including those that show dissent, discussion, and resolution. “John raised the issue that ...” and “Sally argued the distribution should be granted because ...” are good first steps. When followed by, “The at-

tendees then agreed that the best course of action is... because...”, the documentation has some “meat.” People question whether it would be best to simply record the committee meetings and pre-

serve transcripts of their proceedings. The answer is, if the act of recording does not interfere with the discourse (by creating some fear or stage-fright in the minds of the participants), and appropriately demonstrates that the right process was followed with all relevant information, a recording may be a good option. What is important is to preserve a sufficient record to demonstrate the completeness of the discussion, evidencing the facts considered, the process undertaken, and the rationale for the results reached. That would be the best documentation to evidence an appropriate fiduciary process, and the seriousness with which the participants took their roles.

## ERISA does not mandate that plan asset managers always select the “best” investments, but rather that they invest “prudently,” in a manner, through diversification, that minimizes the potential for devastating losses.

### *Diversification*

**Third, a fiduciary must manage plan assets by diversifying the investments so as to minimize the risks of large losses, unless it is clearly not prudent to do so under the current circumstances.**<sup>10</sup> Managing plan assets prudently is at the heart of plan administration and fundamental to the ERISA precept that a plan is to exclusively provide benefits to plan participants and beneficiaries. ERISA does not mandate that plan asset managers always select the “best” investments, but rather that they invest “prudently,” in a manner,

through diversification, that minimizes the potential for devastating losses. Under regulations issued under an optional safe harbor provided in §404(c) of ERISA, which applies to investment fund selection in participant-directed defined contribution plans, the DOL indicates that it is always the responsibility of plan fiduciaries to select a diverse group of investments, each of which is diversified, with materially different risk and return characteristics, which, when taken as a whole, allow participants to structure a portfolio with risk and return characteristics within the normal range of risk and return characteristics for participants of that type. Whew! Such a task for fiduciaries to undertake! When broken down, though, the DOL’s pronouncement indicates a framework fiduciaries can implement to be “prudent” in the investment selection process.

Start with a “diverse group” of investments, which in the context of a participant-directed plan, means a variety of funds from which participants select. Variety in this context doesn’t mean numerous, but rather, distinct. Having investment funds that stick to specific

and distinct investing styles produces a diverse group. Further, each of the funds themselves must be diversified, which generally means that the funds must hold a diverse group of underlying investment securities. Mutual funds would be a prime example of this, as would bank collective trusts, as through the common investing “power” of a large amount of assets, the managers of each can buy many different securities. Arguably, a single issuer guaranteed investment contract, commonly referred to as a “GIC”, would not be diversified, because its return and the “guarantee” are based on the success (or failure) of a single insurance company. Pools of

## SHOULD A BROKERAGE ACCOUNT OPTION BE INCLUDED IN YOUR PLAN?

Deciding whether to include a brokerage option or not is a fiduciary decision. There are two fundamental questions a fiduciary should ask in determining whether a brokerage option is prudent.

**First, “Is a brokerage option necessary to fulfill the investment needs of some, if not all, of my participants?”**

Every individual has differing expectations, investment savvy, risk tolerance, and interest in managing their financial affairs. Many organizations have diverse groups of employees, with many being content with investing in mutual funds and others requiring more investment options to fulfill their financial goals. In this case, it may be prudent to consider offering a brokerage option which would allow those with appropriate needs to select investments outside of the confines of the funds offered in the plan.

**Second, “Can my participants be educated on the proper use of a brokerage window in the plan so that those who are unwilling or unable to manage their assets will opt not to use the brokerage option?”**

Because of tax-law-based non-discrimination constraints, a brokerage option, if included in the plan, must be available to all participants, not just those who may be savvy enough for its prudent use. The key to successfully integrating a brokerage option into a plan is to ensure that it is used by those who have the wherewithal to evaluate individual investment options and can use the brokerage option to create a portfolio with characteristics different from that which could be created from a selection of the funds in the plan.

Including a brokerage option within a plan does not relieve the plan sponsor from the fiduciary obligation of having an appropriate investment fund line-up without the brokerage option for the benefit of those who choose not to use the brokerage option. Indeed, the DOL has indicated that a “brokerage only” plan might not satisfy the requirements of ERISA §404(c) and the plan sponsor may be liable for the investment mistakes of participants given no “404(c)-compliant” investment options.

GICs, or synthetic GICs with protection from multiple issuing insurers, would be more diversified.

Each of the funds must have materially different risk and return characteristics from the others. This requirement functions to ensure that a prudent fiduciary will have a range of investment options from “conservative” to “aggressive” (with commensurate return potentials) that allow participants to build portfolios appropriate for them, considering their individual risk tolerance and investing time horizon. What is important here is that the plan fiduciary have a good understanding of the investment savvy of their participants and make determinations of what is right for them. It is a careful balancing act that a fiduciary must undertake, between providing what the participants believe is appropriate for them and providing what a prudent fiduciary believes is appropriate, which many times are very different positions.

### *Investment Policy Statement*

ERISA mandates that fiduciaries making investment decisions follow a written investment policy statement (“IPS”), which lays out the criteria the prudent fiduciary would use in investment fund selection and retention, and the process for removal and replacement of funds that no longer meet the criteria.<sup>11</sup> Surprisingly, many plans do not operate with a written IPS, and some plans have a written IPS but don’t follow it. Having a documented process and not following it is a per se breach of a fiduciary duty. Having an IPS and following it is the best protection against challenges in investment fund selection. Keep in mind that an IPS is a guide and does not mandate certain outcomes. A prudent fiduciary should have sufficient flexibility to consider all factors in a dynamic investment universe, most of which could not be anticipated and reduced to rigid rules. Furthermore, criteria so strict as to cause investment fund changes based on strictly objective criteria, such as a fund not remaining within the top decile of its peer group, would almost certainly require fund

changes in rapid-fire succession and be wholly unworkable. Investment professionals develop disciplined, but not necessarily rigid, approaches to decision making and use as much art as science in selecting investment funds. Clearly, in the case of investment selection, if a plan fiduciary fails to have the knowledge or talent to be a successful prudent expert, the fiduciary should consider hiring those who are able to fulfill these obligations.

### *Company Stock*

Company stock in a retirement plan is a point of concern for plan fiduciaries. Deciding to include company stock as an investment in a plan is both a settlor function and a fiduciary one. Generally, corporate decision making is involved in including company stock in a plan. However, the fiduciaries of a plan must determine initially that investing plan assets in company stock is prudent and that retention of company stock is appropriate considering all of their mandates. Many believe that ERISA provides an exemption for company stock in plans and this is partially true. ERISA exempts “qualified employer securities” from the diversification requirement contained in §404(a)(1)(C), and IRC §4975 defines an employee stock ownership plan (ESOP) as a special type of qualified plan that invests primarily in employer securities, implying authorization for acquiring and retaining company stock. However, the “exclusive benefit” and “prudent expert” rules *always* apply to ERISA-covered plans, even those complying with the definition of an ESOP or exempt from the diversification rules. Contained in your IPS should be provisions for evaluating company stock, using appropriate criteria for an undiversified investment, and for continually evaluating company stock in varying market conditions. At a minimum, fiduciaries should evaluate the company’s fundamentals versus

its peers, marketability of its securities (float, volume, exchange and market maker capabilities), and the impact of plan ownership and participant trading activity on the market for company shares. Fundamentally, a decision needs to be made that company stock is an appropriate investment for the participants, consistent with the goal of the retirement plan, of providing part of a financially secure retirement, and not merely a corporate tool to achieve settlor goals.

### *Plan Documents – Fiduciary Roadmaps*

**Fourth, and finally, a fiduciary must adhere to the terms of the plan documents, unless to do so would be a violation of one of the other fiduciary obligations.<sup>12</sup> ERISA requires all plans to operate with a written document.<sup>13</sup>** The plan document is the roadmap. It defines the type and to some extent, the amount of benefits to be received, the form in which those benefits may come, the time benefits are payable, and criteria (eligibility, vesting, etc.) for receiving those benefits. It also empowers the participants to enforce their rights – by being evidence of what they are entitled to, which can then be enforced through DOL action or litigation. Fiduciaries are well advised to be familiar with all

**Fundamentally, a decision needs to be made that company stock is an appropriate investment for the participants, consistent with the goal of the retirement plan, of providing part of a financially secure retirement...**

of the provisions of the plan and to refer to the documents frequently to refresh their memories as they make plan decisions.

The one exception ERISA provides to abiding by the written plan document rule is that a fiduciary must ignore the plan’s provisions if to comply with them would be a breach of any of the other fiduciary obligations imposed on them, including the “exclusive benefit”

and “prudent expert” rules. For example (again!), a particular trouble spot concerns company stock. Many plan documents (still!) provide that employer contributions, particularly employer matching contributions, are to be invested in company stock and must remain invested in the company stock fund until, for example, a participant attains a specified age. If it becomes imprudent, as result of financial troubles at the company, market turmoil, or for whatever reason the fiduciary determines to be important enough, for the trust to continue holding the company stock, the fiduciaries are faced with a dilemma of abiding by the terms of plan documents or being prudent experts and liquidating the securities. ERISA clearly indicates that the fiduciary should, in this case, ignore the documents and be the prudent expert, by explicitly saying that the requirement to abide by the plan document is contingent on the fiduciary not breaching the other fiduciary duties.

Making the decision to act contrary to the plan document is clearly a drastic step to take, and the same care should be taken in making that decision as in making other fiduciary decisions. That is, thoroughly investigate the facts, explore alternatives, apply appropriate criteria, and act prudently. Acting prudently may mean acting unilaterally or acting in concert with other fiduciaries. Clearly, if time permits, consideration should be given to amending the plan, (if the plan sponsor wearing its “settlor” hat is in agreement) to eliminate the conflict, but proceeding in conformity with the other fiduciary obligations without an amendment, for the right reasons, may be required. As always, a prudent fiduciary would document all relevant facts and circumstances leading to the conclusion to ignore the plan provisions and would only do that which was minimally necessary to comply with the other ERISA obligations.

## PART II

# Moving Towards Being a Successful Fiduciary: How to Limit Your Fiduciary Liability

Understanding the role of a fiduciary, as discussed in Part I, is essential to truly appreciate the depth and breadth of responsibilities and the significance of each of the obligations a fiduciary must fulfill. In other words, Part I describes those things which give rise to fiduciary risk. Part II provides some guidance on what steps a fiduciary can undertake, not to minimize the risk, but rather to ensure the fiduciary is fulfilling those obligations properly and not incurring liability in the first place. This discussion is by no means exhaustive and certainly there is no guarantee that by doing these things you won't be sued, or worse, won't lose if you are, but these are general steps that are common among successful fiduciaries and reduce your risk of liability. Fiduciaries should remind themselves that there is no substitute for sound judgment. Doing the right thing, from the right perspective, with the right frame of mind, is core to being a good fiduciary.

### STEP FOUR: Talent Management: The Right Skills in the Right Roles

# 4

In order to limit your potential fiduciary liability, you must first understand what fiduciary functions need to be performed, what functions are being performed, and who is performing them. To be protected, a fiduciary must understand what the scope of the job is and determine that every aspect of being a fiduciary has been covered by competent personnel. Scoping out the fiduciary “project” is the first step to developing a roadmap for ensuring the prudent execution of all of the fiduciary obligations imposed by ERISA. A critical first step is to determine if current personnel have the requisite skills to accomplish all of the fiduciary tasks and fulfill the ERISA mandates. Understanding the areas of expertise needed, the talent available to fill them, and the prospects of developing internal talent versus engaging others would itself be a prudent process evidencing fulfillment of the role of a fiduciary.

Since functioning as a fiduciary is dynamic, documenting all of the various tasks to be performed by fiduciaries would be impossible. However, as a starting point, consider the following

general questions that inquiring fiduciary minds should find the answers for:

- **Who is responsible for maintaining the plan documents?**

Plan documents must be kept up-to-date based on current ERISA and tax law, as well as changes in the regulatory environment. In addition, various other parts of the plan document set must be reviewed regularly, revised as appropriate, with some needing to be disseminated to participants on a regular basis (such as the Summary Annual Report) or on request (including the written plan, Forms 5500, Summary Plan Description, and others).

Also, any form of employee communication concerning the plan should be reviewed for accuracy and consistency with the terms of the plan. Some information needs to be distributed to participants, while other information may be useful to employees, but not required. Generally, plan terms supersede other forms of communications; however, in many cases, inaccurate or inconsistent employee communications have been held to define the terms of the plan from the participant's perspective and plan sponsors have had to alter the terms of their plans, albeit temporarily, to match that which the communications material provided.

Good, timely, accurate communications is both a fiduciary obligation and prudent protection for the plan sponsor who uses it to set appropriate expectations for participants.

- **Who monitors the process and approves, if necessary, for money-in and money-out transactions?**

Nothing is more central to the operation of a plan than making contributions into the trust and providing distributions of benefits from the trust. Clearly, the handling of money transactions should be done with appropriate care. The process should be defined to ensure contributions are made on a timely basis, invested on a timely basis, and properly allocated to participant accounts and that accurate and *timely* distributions are made to participants entitled to receive them. Plan sponsors often rely on service providers to implement processes for these types of transactions. Plan fiduciaries need to be satisfied that the process is consistent with the terms of their plans (i.e., spousal consent is obtained for money-out transactions if the plan provides for certain annuity types of benefits) and that the service provider is providing accurate calculations of the amounts involved. Nothing can give rise to liability faster than delayed contributions<sup>14</sup> or improper investments or when a distribution is delayed or the amount is disput-

ed. Participants' trust in the smooth operation of a plan must be earned, especially where their money is concerned. Errors happen, but prudent fiduciaries continually examine the process and make changes where necessary to minimize those errors and maximize the speed with which corrections occur, while keeping all affected parties apprised along the way.

Participant desires need not translate into fiduciary action, but may provide greater insight into participants' psyches, identify participant needs, and help fiduciaries to refine their decisions.

- **Which fiduciary or fiduciaries are primarily responsible for managing the plan's investments (or at least selecting and monitoring the investment funds that will be offered to the plan participants) and do they have the requisite skills to be a "prudent experts" in that field?**

Hindsight being what it is, when an investment loses value, plan participants will question fund choices and often suggest an alternative that is the "hot" fund or flavor of the day. This is clearly one area where the plan sponsor should consider hiring the expertise necessary.

In the event your service provider performs investment selection or monitoring services, you should examine those services and independently determine whether the service provider is a fiduciary with respect to plan investments and whether the plan sponsor is protected by the "registered investment advisor (RIA)" exception to co-fiduciary liability. Nonetheless, plan fiduciaries need to monitor the activities of the RIA, whether it be the plan's service provider or an independent, to determine if the appropriate expertise exists, that the plan benefits from the services of the RIA, and that the plan is receiving appropriate value for the expenses incurred (assuming the plan is paying directly or indirectly

anything to the RIA).

- **What mechanism exists to understand participant level issues, evaluate concerns, and escalate them for appropriate resolution?**

In many cases plan fiduciaries take an "I know what's best for my employees and my plan" approach when it comes to the plan and participants. While there is some truth that a pru-

dent fiduciary will do what's best for participants rather than do what they want, sometimes it is necessary to understand what participants want in order to understand what they need. Fiduciaries need to ask themselves:

Do participants understand the plan?

Are the communications geared towards the participants' demographics? Are they understandable, too simple or complex, related to the typical participants' experiences, and appropriate for my employees?

Carefully scoping out the extent of fiduciary responsibilities and ensuring that the right people are doing the right things is the best protection against inadvertent lapses in fulfilling important fiduciary obligations.

Do the participants need investment education, advice, pre-mix lifestyle fund options, or would they be better off with professionally managed investments?

Participant desires need not translate into fiduciary action, but may provide greater insight into participants' psyches, identify participant

needs, and help fiduciaries to refine their decisions and decision making process to better provide benefits to participants.

As a side benefit, participants who have realistic expectations and understand how the plan works are more likely to have trust in those who operate the plan and consequently are less likely to stir up trouble (or even to litigate).

- **What process is in place to make decisions and what process is in place to review and modify the decision making process?**

In most cases, plan sponsors set up a retirement plan committee to function as the decision making body and fiduciary for the plan, which then raises the question of, "Who are the right people to be on that committee?". There is no pat answer, except to say that each of the members of the committee is a fiduciary and each of them has co-fiduciary liability for each of the others. Hence, the people on the committee should be those who can fulfill the obligations imposed on them by ERISA and bring something to the committee which improves its collective capabilities as a fiduciary.

Someone adept at investment issues, for example, would be an appropri-

ate member of the committee, as would be one who understands the regulatory issues involved in administering a plan. Individuals who are skilled at analyzing issues and synthesizing information may be appropriate. People need not be on the committee by virtue of their titles or positions.

- Should a CEO or CFO serve on a fiduciary committee for the plan?

Prudence would indicate only if they brought a specific skill or trait to the committee which would improve the process or the decisions. Indeed, it may be argued that such people should not be on the committee. Members of the committee as fiduciaries have an obligation to the committee, each other, and the plan, to be open and honest and to disclose all pertinent information they possess about a matter of import to the plan. This would include confidential information they obtained in their “real” jobs that is unrelated to their functions as a fiduciaries on the committee. A CEO who knows that an important customer is about to be lost with a commensurate impact on the company’s stock price would be obligated to disclose that information when deciding whether to continue to hold

- Should members of the rank and file workforce be represented on the committee?

The answer is, of course, if they bring a skill or trait to the committee that would improve its decision making process and outcomes. Many times plan sponsors want a couple of rank and file employees on the committee to secure buy-in of the committee’s decisions and lend some credibility to the otherwise closed-door decision making process. Unfortunately, unless the individuals add value to the process, their mere presence may hinder that full and fair fiduciary discourse needed to arrive at well reasoned decisions. If obtaining buy-in is an important objective of the plan sponsor, it should consider forming an ad-hoc advisory board comprised of appropriate individuals to make non-binding recommendations concerning salient matters of plan administration and even plan design.

Each of the members of the committee is a fiduciary and each of them has co-fiduciary liability for each of the others.

company stock in a retirement plan. Arguably, the DOL’s position is that this information should be disclosed regardless of whether the executive with the knowledge is a member of the fiduciary committee, under the theory that the executive has the power to hire and fire the committee members and thus is a fiduciary with respect to the plan charged with that responsibility. Others dispute the DOL’s interpretation and cite competing laws, most notably securities laws, which often bar certain “insiders” from disclosing material information not yet made available to the general investing public. Nonetheless, having such individuals on the committee would clearly present a conflict and may not be worth the potential exposure.

By keeping this ad-hoc advisory board out of the fiduciary realm and more in the settlor realm, the plan sponsor can deal with the recommendations in light of corporate concerns rather than fiduciary ones and perhaps provide another communication channel to employees or participants to set expectations, receive feedback, and consider alternatives, without burdening the fiduciary committee with extraneous issues unrelated to their primary functions.

Carefully scoping out the extent of fiduciary responsibilities and ensuring that the right people are doing the right things is the best protection against inadvertent lapses in fulfilling important fiduciary obligations.

## STEP FIVE: It’s All About Process



Process, process, process.... ERISA sets a process-based standard for fiduciaries. As noted earlier, a prudent expert is one that uses a well thought out process for arriving at well reasoned conclusions. It is through the scrupulous following of an appropriate process that disciplines the expert to quality decision making. So then, what makes for an appropriate process? Again, the appropriateness of the process will be dependent on the facts and circumstances of each case; however, there are several characteristics which all appropriate processes share:

### *Process Success Factors*

**The process should be designed to filter out the extraneous and focus on that which is truly important to the ultimate decision.** The hallmark of an effective process is the focus placed on the core decisions and the inputs required to make the decisions. For example, in selecting an appropriate investment fund for inclusion in a participant-directed 401(k) plan, it would be essential to explore things such as manager tenure, portfolio turnover, style specificity and drift, expense ratios, return, alpha, beta, and the like. It probably wouldn’t be important to consider the portfolio manager’s hobbies, marital status or other extraneous information. The fiduciary process, through the definition of criteria essential for making the decision, would exclude or rather, not even consider including, the latter. In order to make this happen, the process needs to be defined to:

- identify what is the salient information to review prior to making a decision
- provide a framework for obtaining reliable information consistently
- have a disciplined approach to scrubbing the information

- provide alternative avenues of analysis when information is lacking or unavailable, including deferring a decision until the information becomes available.

Of paramount importance in this regard is having the ability and authority to separate settlor concerns from the fiduciary decision making process. To be effective, the decisions a fiduciary arrives at need only be based on the information essential to carry out the ERISA mandates. Should a fiduciary decision have corporate impact, a corporate decision needs to be made as well, but that must be made independent of the fiduciary decision.

**The process requires a rigorous investigation of all facts relevant to the decision and allows for a weighing of possible outcomes based on those facts and varying assumptions.** Not only must the right information be obtained prior to making a decision, the right evaluation of that information must occur.

Because we live in an imperfect world, we won't always have 100% of the information we would like to have prior to making a decision so we must also make certain educated assumptions in order to proceed. A truly well thought out decision making process will ascertain which information is crucial for decision making, which is helpful but not required, which forms the basis for educated interpolation, and which adds weight or supplements other information.

Having a formula, which admittedly may be more art than science, allows the fiduciaries to synthesize a prudent conclusion. As important is the ability to replicate the decision making process, arriving at similar conclusions with similar facts, and being able to

distinguish disparate outcomes on the basis of salient disparate inputs.

In other words, when you reach a different conclusion for similar but not identical situations, you had better be able to justify the different results on the basis of those facts which are not similar. While there is no substitute

## Not only must the right information be obtained prior to making a decision, the right evaluation of that information must occur.

for sound fiduciary judgment, the goal here is to remove as much discretion from the decision making process as possible. Have facts A, B, and C, then the decision will be X.

Have facts A, B and D, and the decision will be Y. The fiduciary discretion is involved in defining the process and identifying that a new fact warrants a sufficiently different outcome. Once the process is formulated, the fiduciaries can concentrate on refining the inputs and refining the process itself.

The process itself requires a continuing examination of the process and a review of all of the outcomes in order to continually improve the process and

## The hallmark of an effective process is the focus placed on the core decisions and the inputs required to make the decisions.

to ensure changed outcomes when facts or assumptions have changed.

Successful fiduciaries are not afraid to admit that an incorrect decision was made, but they:

- examine why the decision was incorrectly made
- determine whether the process has a systemic flaw
- reevaluate the criteria for determining important inputs to the process

- take whatever corrective action is required to rectify the situation. In many cases, individuals are reluctant to review and revise past decisions, fearing that to do so would imply a failure in the first place.

By following a predetermined course of conduct, i.e., following the "process" and utilizing the best information available (also predetermined), there is a significant reduction in the risk of failure. Information is dynamic and must

be taken in context. Simply put, things change. A successful fiduciary changes with the times, recognizing that new information may become available which would alter past decisions had it been known, and may alter the process of making decisions in the future (e.g., maybe the decision maker should wait an additional week or two when certain types of information will be available that could affect the decision). You cannot apply recently obtained information retroactively to all prior decisions, but where the context warrants, a good fiduciary would change prior decisions and apply a new process going forward.

Prudence is a process and provided the process is consistent with the mandates that a plan be operated exclusively to provide benefits

to participants, avoiding undue investment risk, and consistent with the terms of the written plan documents and documented processes, fiduciaries will be well protected.

## STEP SIX: Continuous Improvement – The Science of Change

The state of the art in fiduciary science is evolving. Recent corporate scandals have brought a new awareness of fiduciary obligations to us and to many plan participants. The reality of the situation is, however, that the definition of an ERISA fiduciary and the obligations placed on them has not changed since ERISA was signed into law in 1974. What has changed is the world in which we must apply those rules. Congress, through a combination of foresight and luck, crafted legislation that provided a broad framework appropriate in many varied circumstances. Congress couldn't foresee Enron, but it could foresee situations in which corporate concerns would run roughshod over fiduciary ones and hence put in place absolutes that mandate (with stiff penalties) principled adherence. There is no mandate that employers sponsor retirement plans. Companies do so for purely corporate reasons, which can include paternalism. What has been mandated is that if an employer makes promises to provide for the retirement of its workers, it must follow the precepts of ERISA in order to ensure, subject to market forces, that those promises are kept.

### *Bad Things Can Happen to People Who Don't Follow the Rules*

What are the penalties for malfeasance as a fiduciary? They can be severe.

**First, any fiduciary that breaches a duty is personally liable to make good to the plan any losses it suffered as a result of the breach.**<sup>15</sup> Making good to the plan losses is not as simple as restoring any actual losses realized by the plan, but rather placing the plan in the position it would have been had the breach not occurred. In other words, making good any losses means restor-

ing any profits the plan would have made, but for the breach. So, if a fiduciary "borrowed" funds from the plan to personally invest in a hot stock, reaping a 100% windfall on the investment, the breaching fiduciary would have to restore to the plan the amount borrowed, plus an amount equal to what the plan would have earned on the funds had the fiduciary not borrowed the funds. The amount of earnings to be restored to the plan could be measured in many ways, including using the profits made by the breaching fiduciary as the yardstick, on the theory that had the fiduciary not borrowed the money and usurped the opportunity, the plan could have invested in the hot stock, reaping the 100% return on its investment.

**Second, the breaching fiduciary must disgorge to the plan any profits realized through the use of plan assets.** In

Any fiduciary that breaches a duty is personally liable to make good to the plan any losses it suffered as a result of the breach.

the example above, the profit realized by the breaching fiduciary through the use of plan assets is 100%, which would have to be restored to the trust. Keep in mind this disgorgement of profits to the plan is in addition to the restoration of losses, including lost profits, that the breaching fiduciary must make to the plan. So in the case of our fiduciary, the amount that he or she could conceivably have to turn over to the plan would be the sum of:

- the amount originally borrowed from the plan, in violation of the fiduciary duty to use plan assets "exclusively" to provide benefit to participants (or, 100% of the principal used)
- the amount of profit the plan would have received had the breach not occurred, which could be measured by the amount of profit the breaching fiduciary actually made on the investment (in our example, a 100% return)

- the profit actually received from the misuse of plan assets (a 100% return, for a grand total in our example of 300% of the amount originally borrowed).

As you can see, the financial penalties for a breach are severe, but we are not yet finished. If the breach involved a "prohibited transaction",<sup>16</sup> the person involved in the prohibited transaction would also be liable for an excise tax equal to 15% of the amount involved, escalating to an excise tax of 100% in the event the prohibited transaction is not "unwound" during the same "taxable period", generally the plan year. The excise tax is cumulative, and for each plan year that the prohibited transaction remains uncorrected, a new excise tax is imposed.

**Third, a breaching fiduciary is subject to a statutory penalty equal to 20% of**

**the amounts recovered in a civil action by the Department of Labor.**<sup>17</sup> Under ERISA, the Secretary of the DOL may bring a civil action against a fiduciary to remedy a breach of any of the obligations imposed on them, and if successful, the Secretary shall impose an addition 20% "penalty" against the fiduciary of any amounts recovered.

**Fourth, a breaching fiduciary is subject to any "other" equitable or remedial relief a court may deem appropriate, including removal as a fiduciary with respect to the plan, and being permanently barred from having anything to do with ERISA covered plans in the future.** In some cases, courts have used this provision to ban service providers from continuing in business and have removed employers as fiduciaries from having anything to do with their own plan, instead turning the role of "Plan Administrator" over to an independent party.

**Finally, in exceptionally egregious cases, breaching fiduciaries can be criminally prosecuted for misusing employee benefit plan funds<sup>18</sup> and may receive penalties of up to \$10,000 per occurrence and incarceration of up to five years.**

## SUMMARY

The purpose of this exercise is not to scare ERISA fiduciaries, but rather to impress upon all fiduciaries the seriousness of the undertaking of being a fiduciary. Those who approach the task with an appreciation of their purpose in fulfilling the noble pursuit of helping employees to achieve better retirements and an understanding of the penalties that will be imposed on those who fail, will strive to be the best fiduciaries they can and continually improve in that regard.

If you've read this guide, most likely you are a fiduciary under ERISA and your day-to-day responsibilities involve making discretionary decisions impacting plans and their participants. It is a tremendous responsibility. Only through an understanding of the mandates ERISA imposes on fiduciaries and an appreciation of the perspective required, particularly from the "exclusive benefit rule" vantage point, can a fiduciary perform prudently and consistent with a prudent process. To paraphrase an oft-quoted axiom, the best defense fiduciaries can mount is to aggressively take the offense in performing their functions to the best of their ability. Worry less about minimizing risk and more about maximizing performance and the risk will diminish.

Schwab's client service team is available to help you navigate your fiduciary responsibilities. Let us know how we can assist you and your committee.

Contact your Schwab representative or call Michael Olah at 888-444-4015.

You can also visit:  
[www.scrs.schwab.com](http://www.scrs.schwab.com)



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Michael has extensive experience in all matters pertaining to retirement plan design, documentation, administrative processes and procedures, and compliance and fiduciary concerns. In connection with fiduciary issues, Michael is instrumental in working with clients to establish processes and procedures for establishing prudent fiduciary processes, and monitoring decision making, and working with others to ensure appropriate processes for investment selection.

He also works as a resource for client's benefits and investment committees in setting policy with respect to plan design, administration and funding.

Michael received his law degree from the University of Akron in 1985, and his LLM (Taxation/Benefits) from Case Western Reserve University in 1995, and has practiced in law firms in northeastern Ohio and Virginia. Prior to joining Schwab, Michael was Director of ERISA Services for a mutual fund company, and previously Trust and Fiduciary Counsel for a large midwestern-based national bank. Michael has extensive experience in the industry, and teaches employee benefits law and related issues in the Certified Employee Benefits Specialists (CEBS) program, and benefits courses in various Paralegal Studies curricula. He has also been active in various local, regional and national employee benefit professional organizations, including the Midwest Benefits Conference, WEB (Working in Employee Benefits), International Foundation of Employee Benefit Plans, and the American Bar Association Joint Committee on Employee Benefits, and is frequently a speaker on various topics before these, and other professional organizations and conferences.

## Footnotes

- <sup>1</sup> ERISA, §3(16)(A).
- <sup>2</sup> Specifically §§401(a)(4) and 410(b) of the Internal Revenue Code of 1986, as amended relating to general prohibitions against discrimination in benefits, rights and features under a plan; and §§401(k) and 401(m) of the Code which provide certain non-discrimination rules applicable to salary deferral contributions and total contributions made to "401(k)" plans.
- <sup>3</sup> ERISA defines as a fiduciary an investment advisor who "renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so." ERISA Section 3(21)(A).
- <sup>4</sup> DOL Reg. §2510.3-101.
- <sup>5</sup> Many "general account" products have "guaranteed" returns measured by the return achieved on a specific pool of assets, or index, but generally the "guarantee" comes solely as an unsecured promise of the insurance company itself, and on the insolvency of the insurance company, the owner of a "general account" contract would have no specific claim to any individual assets of the insurance company, and would receive only a pro-rata share of the net general assets.
- <sup>6</sup> DOL amicus brief, *Tittle v. Enron Corp.*, Civil Action No. H-01-3913, U.S. District Court for the Southern District of Texas, p. 8, citing 29 C.F.R. §2509.75-8.
- <sup>7</sup> ERISA, §404(a)(1)(A).
- <sup>8</sup> Some of which, such as the provisions in Internal Revenue Code §402(g) which limit the total amount that can be deferred into a "401(k) plan," actually work to limit the benefits participants may receive under the plan.
- <sup>9</sup> ERISA §404(a)(1)(B).
- <sup>10</sup> ERISA §404(a)(1)(C).
- <sup>11</sup> See generally, DOL Interpretive Bulletin 94-2.
- <sup>12</sup> ERISA §404(a)(1)(D).
- <sup>13</sup> ERISA §402(a)(1).
- <sup>14</sup> The DOL has issued guidance indicating that for salary deferrals in a 401(k) plan, contributions must be made as soon as practicable, but in no event later than the 15th business day of the month following the month the deferral was made. The DOL's position is clear that "as soon as practicable" means just that and that anything longer than several days to a week after payday is suspect.
- <sup>15</sup> ERISA §409(a).
- <sup>16</sup> Both ERISA (§406) and the Internal Revenue Code ("IRC") (§4975) define certain transactions between a plan and a Party in Interest (ERISA) or a Disqualified Person (IRC) as being prohibited as a result of the potential for a conflict of interest to exist. Parties in Interest and Disqualified Persons are those in a position whose dealings with the plan may be less than arms length. For example, the employer, officers and employees, service providers, and certain relatives of some of these are Disqualified Persons (and Parties in Interest) and may not lend, borrow, sell, lease or otherwise exchange property with the plan, unless an exemption to the prohibited transaction rules exist.
- <sup>17</sup> ERISA, Section 502(l)(1).
- <sup>18</sup> 18 U.S.C. §664.

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