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Outsourcing Fiduciary Responsibility

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Today's Topics

- I. Fiduciary Overview
- II. Spectrum of Outsourcing
 - A. Effective Delegation vs. Ineffective Delegation
 - B. Allocation of Responsibility Amongst Fiduciaries
 - C. Use of Fiduciary Consultants
 - D. Retention of Investment Managers (plan assets vs. non-plan assets)
 - E. Designating Third Parties as Sole Named Fiduciaries
- III. Use of Independent Fiduciaries to Resolve Conflicts
 - A. Why Are Independent Fiduciaries Necessary?
 - B. Frequent Situations
 - C. Practical Considerations

I. Fiduciary Overview

- Who is a fiduciary?
- What are a fiduciary's duties?
- Duties of appointing fiduciaries

Who Is a Fiduciary?

- Functional test – a person is a fiduciary to the extent he or she:
 - exercises any authority or control respecting management or disposition of plan assets
 - renders investment advice for compensation with respect to plan assets
 - has any discretionary authority or discretionary responsibility for plan administration

Who Is a Fiduciary?

- A person becomes a fiduciary by:
 - being formally designated as a fiduciary
 - functioning as a de facto fiduciary
 - appointing other fiduciaries
 - default – if a plan administrator is not named, the plan sponsor (usually the employer) is considered to be the plan administrator

What Are a Fiduciary's Duties?

- The exclusive purpose rule
- Avoidance of prohibited transactions
- The prudent-man standard – process is key
- Diversification
- Following the terms of the plan

What Are a Fiduciary's Duties?

- Allocation of fiduciary responsibility for investment management
 - Trustee (default rule)
 - Named fiduciary (trustee responsible for following named fiduciary's "proper" directions)
 - Investment manager appointed by named fiduciary (trustee relieved of investment management responsibility)

Appointing and Monitoring

- Under ERISA, whoever appoints a fiduciary also has a limited fiduciary duty that includes:
 - being prudent in deciding whom to appoint
 - prudently monitoring the performance of the appointed fiduciary

Appointing and Monitoring

- In a number of lawsuits, the attorneys representing groups of employees and retirees have tried to use the duty to appoint and monitor as a basis for holding directors, officers and other executives responsible for the investment decisions of the fiduciaries they appoint
- The Department of Labor (DOL) has supported some of these lawsuits – e.g., Enron

Practical Suggestions to Reduce Litigation Risk

- Carefully evaluate fiduciary candidates and document selection process
- Ensure that candidates' qualifications are consistent with duties
- Provide training to fiduciaries

Practical Suggestions to Reduce Litigation Risk

- Receive and review periodic reports from appointed fiduciaries
 - Performance
 - Fees and costs
 - Significant events
- Document monitoring of appointed fiduciaries

Practical Suggestions to Reduce Litigation Risk

- Confirm compliance with investment policy statements
- Seek independent expert advice
- Replace non-performing fiduciaries
- Consider obtaining fiduciary insurance coverage

Spectrum of Outsourcing

- Effective Delegation vs. Ineffective Delegation
 - Effective Delegation = complete transfer of responsibility to another entity or person
 - *Selection and monitoring of the delegatee is the key*
 - Ineffective Delegation = responsibility remains with the delegator
 - *The level of monitoring and responsibility is generally higher with an ineffective delegation because the delegator is responsible for not only the selection of the delegatee but all of the underlying decisions made by the delegatee*
- Establish a clear procedure to ensure the appointment falls into the appropriate category

Spectrum of Outsourcing

- Allocation of Fiduciary Responsibility
 - Plan document may allocate fiduciary responsibility among different people
 - Plan document may establish a procedure to allow fiduciaries to allocate among themselves fiduciary responsibility (other than “trustee responsibility”)
 - Fiduciaries can still be liable for allocated duties if:
 - *They were involved in the allocation and such allocation was imprudent*
 - *They continued the allocation when it was known to be imprudent*
 - *They knowingly participated in, or enabled, another’s breach*

Spectrum of Outsourcing

- Use of Consultants
 - Consultants may become fiduciaries under ERISA
 - *DOL regulation (which may be revised) outlines five-part test to determine when an investment consultant becomes a fiduciary under ERISA*
 - *Case law has indicated that could become a fiduciary where named fiduciary routinely follows advice*
 - Even though consultants will not have discretionary authority and will only make recommendations, they often serve in a fiduciary capacity
 - A named fiduciary generally still has responsibility for investment decisions it makes even if based on consultant's advice

Spectrum of Outsourcing

- Retention of Investment Managers
 - Is the manager holding “plan assets”?
 - If yes
 - Manager will be a fiduciary
 - If an “investment manager” under 3(38) of ERISA and acknowledges fiduciary status, then there will be an effective delegation and the named fiduciary responsible for appointment will generally not be responsible for underlying investment decisions made by the manager
 - An “investment manager” is:
 - » A bank
 - » A registered investment advisor
 - » A qualified insurance company
 - Only a “named fiduciary” may appoint an investment manager under ERISA

Spectrum of Outsourcing

- Retention of Investment Managers
 - Is the manager holding “plan assets”?
 - *If no*
 - Manager will generally not be a fiduciary
 - Appointing fiduciary responsible only for the selection and monitoring of the manager/fund, but not responsible for underlying investment decisions
 - Manager does not need to qualify as an “investment manager” for the delegation to be effective
 - *DOL Plan asset regulation*
 - Investments in another entity are plan assets unless subject to an exception
 - » 25% test
 - » Operating companies
 - » RICs
 - » Publicly traded companies

Spectrum of Outsourcing

- Designating Third Parties as Named Fiduciaries
 - Some managers are now offering a new product where they attempt to serve as “sole” investment fiduciary
 - *Manager is appointed as named fiduciary*
 - By plan sponsor
 - In plan documents
 - *Arguably relieves all employer-related individuals from fiduciary responsibility*
 - *Could still be a residual fiduciary duty to monitor*

Use of Independent Fiduciaries to Resolve Conflicts

- Why are Independent Fiduciaries Necessary?
 - The independent fiduciary serves to replace fiduciaries that would otherwise be insiders when conflicts of interest arise that would make it too risky for them to make decisions regarding plan assets, solely in the interests of the plan's participants. The use of an independent fiduciary can eliminate these conflicts and potential liabilities
 - The DOL developed a body of regulatory law regarding independent fiduciaries in granting exemptions from the prohibited transaction provisions of ERISA (406 and 407).
 - The DOL has often required as one condition that the conflicted party “step out of its fiduciary shoes” and insert an objective, qualified special purpose fiduciary to act on behalf of the plan.
 - The role of a fiduciary is to be responsible solely to the participants and the beneficiaries of the plan it serves – and the use of an independent fiduciary makes this requirement more feasible and realistic.

Use of Independent Fiduciaries to Resolve Conflicts

- Frequent Situations
 - Employer Stock in Plans
 - *Stock Drops*
 - *Ongoing management of stock or stock funds*
 - *Bankruptcies*
 - *Rescission offers*
 - *Tender offers*
 - *Spin-offs*
 - Employer Contributions
 - *In kind contributions*
 - *Sale/lease backs*
 - *Withdrawal liability actions*
 - Transactions with the Plan Sponsor
 - *Sales of property*
 - *Provision of services*

Use of Independent Fiduciaries to Resolve Conflicts

- Practical Considerations:
 - Must carefully define the independent fiduciary's exact role. This includes specifying what the fiduciary's functions and liabilities are and are not.
 - Specify whether the independent fiduciary is only providing advice or whether it becomes the decision maker.
 - Even if the independent fiduciary becomes the decision maker the contract should outline its exact status.
 - Whether and to what extent the independent fiduciary is free to employ other professional advisers to assist and at what cost.
 - Will the independent fiduciary be responsible for providing reports to the named fiduciary?
 - The nature of any indemnification in favor of the independent fiduciary and what entity provides it.
 - The DOL has issued a Class Exemption to the prohibited transaction rules that requires an independent fiduciary to act for the plan in giving a release to plan fiduciaries as part of a litigation settlement.

Questions?

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