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Introduction to Fiduciary Responsibility

Fiduciary Responsibility: Why is it "Hot?"?

Ever since the Enron and WorldCom debacles, Fiduciary Responsibility has been the hot topic of the benefits/ ERISA world. Both the Department of Labor (DOL) and the Employee Benefits Security Administration (EBSA) have been focusing their efforts on ensuring that plan fiduciaries act in strict compliance with their legal responsibilities.

The DOL has been on an intensive fiduciary education campaign (1*), while EBSA has been stepping up its enforcement of fiduciary requirements under the Employee Retirement Income Security Act (ERISA.) In fiscal year 2011 alone, EBSA closed 3,472 civil investigations with 75.29% of those resulting in monetary damages or other corrective action imposed upon plan fiduciaries. It also closed 302 criminal investigations which led to the indictments of 129 individuals. The total monetary impact of these enforcement actions for FY 2011 was $1.38 Billion. (2*)

Fiduciary Responsibility: What's Changed?

Until 2008, ERISA permitted plan participants to sue their employers and other plan sponsors for breaches of their fiduciary responsibilities only as part of a class action lawsuit. The relief available to these plan participant plaintiffs was restitution for any losses incurred by the plan itself, but nothing for losses suffered by the individual plan participants themselves. (3*) Given the expense of conducting class action suits, these lawsuits necessarily targeted very large retirement plans with hundreds of millions in assets. (4*)

However, in 2008 all of this changed. The Supreme Court decided in ***LaRue vs. DeWolfe*** that individual employees can now sue their employers for breaches of fiduciary responsibility with the objective of receiving damages for their own personal losses. This pertains to large plans, small plans, and any plans in between. *LaRue vs. DeWolfe* has opened the door for any employee with a grievance to initiate his or her own individual ERISA suit.

It also opens the door for plaintiff's attorneys to recruit plan participants as clients. Just as today we see commercials asking if we've been hurt in an accident, suffered medical misconduct, or contracted a disease from tobacco or asbestos, tomorrow we will probably be confronted by commercial ads asking: "**Do You have Enough Money to Retire?**"

Who is a Fiduciary?

Are you a fiduciary, and why is fiduciary responsibility such an issue?

Every 401(k) plan has at least one named trustee who holds the fiduciary responsibility to operate the plan in a prudent manner. But the trustee is rarely the only fiduciary for the plan. There are usually a number of individuals who act in a fiduciary capacity with respect to a plan. Some are specifically named in the plan document; some are not.

There are two types of fiduciaries: (1) *Named Fiduciaries* --- those that are specifically named in the plan document or otherwise by the plan sponsor according to procedure established in the plan document, and (2) *Functional (or Deemed) Fiduciaries* --- those who act in a fiduciary capacity based on their job duties or responsibilities with respect to a plan. Individuals serving on investment committees, selecting service providers to a plan, and/or having any discretionary authority over a plan are typically considered to be Functional Fiduciaries.

Since fiduciary status may be based on a person's duties and conduct rather than his or her title or official position with respect to a plan, it is possible to be a fiduciary without being aware of it.

Given the nature of their duties, the following positions are generally assumed to have at least Functional Fiduciary status: CEO, CFO, HR Director, Controller, Business Owner, Managing Partner, and Office Manager.

Fiduciary responsibility carries personal liability! There is no "corporate veil" to protect a fiduciary. ERISA 409(a) states "any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed by this sub-chapter shall be personally liable to make good to such plan any losses to the plan resulting from each such breach….." (5*)

Any employee --- regardless of title or official capacity --- who either (1) chooses, or is involved in the decision process of choosing, a 401(k) provider or the investment options that will be offered in the 401(k) plan and/or (2) has any effect on changes made to the plan itself has fiduciary responsibility…. and therefore potential personal liability!

Think of it this way: Your 401(k) assets cannot be taken from you by creditors or as a result of a judgment if you've been sued in court. There are two, and only two, circumstances in which your 401(k) assets can be taken from you involuntarily: Through a divorce proceeding and if you are found liable in a fiduciary breach lawsuit!

What is Fiduciary Responsibility?

Fiduciary obligations are among the "highest known to the law." The fiduciary must discharge his or her duties "with the care, skill, prudence, and diligence that a prudent person 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." A fiduciary must act for the exclusive purpose of providing retirement benefits, and all decisions regarding the plan must be made with the best interests of the participants and beneficiaries in mind.

While fiduciary responsibility carries many duties, the following are some of the most basic:

1. Acting solely in the interest of plan participants and their beneficiaries and with the exclusive purpose of providing benefits to them. (*Exclusive Benefit Rule*)

2. Carrying out his or her duties **prudently**. (*Prudent Person Rule 6**)

3. Following the plan documents (unless inconsistent with ERISA.)

4. Diversifying plan investments. (7*)

5. Paying only **reasonable** plan expenses. (8*)

6. Avoiding conflicts of interest. Fiduciaries may not engage in transactions on behalf of the plan that benefit parties related to the plan, such as other fiduciaries, services providers, or the plan sponsor. (*Prohibited Transactions*)

What We've Found

Over the years, we've encountered plans and fiduciaries that have violated each one of these basic duties. A few examples of what we've found include:

1) A Chief Financial Officer who would not even discuss the possibility of a having a fiduciary assessment performed because his company's 401 (k) provider was the bank with which the company had its lending relationship. *(*This constitutes two (2) violations --- *Violation of the Exclusive Benefit Rule* and *Conflict of Interest.)*

2) Half of the investment options in the above plan had underperformed their benchmarks and peers for both the 3 and 5 year periods. *(*Violation of *Prudent Person Rule.)*

3) After asking its broker multiple times to explain all the fees relative to its plan, one company informed us they were sure they were paying a total of $7,700 in annual fees. Piedmont uncovered that they were in fact paying $22,000 annually --- $14,000 of the fees were "hard to find." (9*)

4) An HR manager, who did not know what an Investment Policy Statement was, informed us that she was confident she had no fiduciary concerns whatsoever because the broker (a non-fiduciary) who sold the plan had told her so. (10*)

Fiduciary duties are often counter-intuitive, and sometimes seem to contradict common sense. For example, very few fiduciaries realize that unless a plan is in compliance with

ERISA Rule 404(c), they retain liability for all investment decisions made, including decisions by the plan participants themselves. Imagine being held responsible for the losses of a 60-something aged employee who in January 2000 invested 100% of his or her portfolio in a then seemingly unbeatable technology fund! (11*)

It is important to note that not all fiduciary duties derive directly from ERISA. For example, ERISA mandates that plan sponsors adhere to a "prudent process" in operating their 401(k) plans, but does not explain what such a process entails. Prudent investment processes have developed over time through other laws, such as the Uniformed Prudent Investors Act (UPIA,) Uniform Management of Public Employees Retirement Systems Act (UMPERSA), as well as through case law.

It is from the UPIA we learn that the Investment Policy Statement (IPS) is the most important fiduciary task in developing and maintaining a "prudent process." An IPS defines the roles and responsibilities of the investment committee, clearly defines a prudent process, and provides a paper trail as evidence of that prudent investment process.

It's Not What You Do; It's What You Don't Do

Many believe that breach of a fiduciary duty is necessarily a malicious or criminal act. However, most fiduciary breaches result from the omission, not the commission, of an act. According to Fred Reish, a nationally recognized ERISA attorney, **"**Fiduciaries are not sued for what they do; instead they are sued for what they do not do."

Many of the current fiduciary breach lawsuits are based upon fiduciaries failing to do one or more of the following: (1) understanding and being fully aware of all the fees being charged to the plan, (2) understanding the compensation being received by any interested party to the plan, (3) ensuring that the fees and compensation paid to service providers are reasonable relative to the services being provided, and/or (4) conducting due diligence and monitoring the performance of the investment options in the plan.

Fiduciary Paradox

Given the first three requirements listed in the paragraph above, and given that a fiduciary can be held personally liable for not fulfilling these requirements, one might find it absurd that a non-fiduciary service provider is under no obligation to disclose this information.

While some service providers hide this information within hundreds of pages written in "legalese," one nationally recognized service provider responded to a fiduciary's inquiry that this information was "proprietary information" that they had no obligation nor desire to provide. (*12)

So what is the non-professional fiduciary to do? The answer is clearly stated under the law and has been reinforced in case law:

> "Unless they possess the necessary expertise to evaluate such factors, fiduciaries would need to obtain the advice of a qualified, independent expert."
>
> ***DOL Reg. § 2509.95-1(c)(6)***

> "…where the trustees lack the requisite knowledge, experience and expertise to make the necessary decisions with respect to investments, their fiduciary obligations require them to hire independent professional advisors."
>
> ***Liss v. Smith, 991 F.Supp. 278, 297 (S.D.N.Y.*** **1998)**

Any fiduciary not fully aware of their responsibilities and the issues raised so far, would be well served by speaking with an independent fiduciary.

Additional questions with which a knowledgeable fiduciary ought to be comfortable are:

- Are your Sub-TA fees used to offset plan admin expenses?
- Does your plan advisor assume fiduciary responsibility with you in writing?
- Have you calculated the Retirement Income Replacement Ratio for your plan?
- Are you utilizing an ERISA 3(38) fiduciary to transfer your fiduciary risk?
- Are you using Rule 404c to limit your fiduciary responsibility?
- Are you aware of all the direct & indirect fees being charged to your plan?
- Are your plan fees "reasonable" compared to the services provided?
- Are you aware that fiduciary responsibility carries a personal liability?
- Do you apply the Exclusive Benefit Rule when making plan decisions?
- Are you aware of all compensation being received by parties of interest to your plan?
- What have you done to protect your plan from LaRue v. DeWolfe?
- What effect do "transaction costs" have on your plan?
- Does your IPS determine when to replace an investment option?

Notes:

1* http://www.dol.gov/ebsa/fiduciaryeducation.html

2* http://www.dol.gov/ebsa/newsroom/fsFYagencyresults.html

A fiduciary is responsible for prudent management of the investment process, not for investment results. Fiduciary liability is dependent upon the process undertaken, not the performance achieved. **"Losses" are not necessarily due to the volatility of the market or a particular investment option; assets lost to unreasonable fees and/or compensation can also constitute losses. Hence, a fiduciary can be held responsible for selecting and/or maintaining an imprudent investment option within the plan.**

For example:

- Assume that you are an employee with 35 years until retirement and a current 401(k) account balance of $25,000. If returns on investments in your account over the next 35 years average 7 percent and fees and expenses reduce your average returns by 0.5 percent, your account balance will grow to $227,000 at retirement, even if there are no further contributions to your account.
- If fees and expenses are 1.5 percent, however, your account balance will grow to only $163,000.
- The 1 percent difference in fees and expenses would reduce your account balance at retirement by 28 percent.

Look at 401(k) Plan Fees, DOL, Employee Benefits Security Administration

4* http://www.erisafraud.com/Default.aspx?tabid=1025 and

http//www.groom.com/assets/attachments/401_k_%20Fee%20Litigation%20Outline%2010.21.09.pdf

- In Braden v Wal-Mart Stores, Inc, the Eighth Circuit Court of Appeals ***recently reversed a district court's judgment dismissing a punative class action brought by a 401(k) plan participant who*** alleged that Wal-Mart, the plan's sponsor and administrator, and various executives involved in the management of the plan breached fiduciary duties imposed by ERISA. ***The plaintiff challenged the defendants' process of and motivations in selecting the mutual funds for inclusion in the plan, claiming that the funds charged unjustifiably high fees and that revenue sharing payments constituted improper kickbacks to the plan's trustee.***

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5* The DOL can also assess a civil penalty against a fiduciary who breached its duty or

any person who knowingly participated in a breach in the amount of 20% of the amount recovered in a settlement with the DOL or awarded in a civil suit.

ERISA § 502(l)

6* **Prudence**

An example of acting prudently is offering investment options that are at least average relative to their index and peers. To include an investment option that has consistently (3 -5 years) underperformed its peers and/or its index is blatantly imprudent.

*7** **Diversification**

A fiduciary must offer a diversified selection of investment options. However, usually because a funds' name doesn't include what type of fund it is, we often find a dozen different funds with several of them being too similar. For example, these four funds all fall into the Large Blend category so having these four provides no meaningful diversification: Vanguard S&P 500 Index, Aim Basic Value, Alliance Bernstein Wealth Appreciation Strategies, and the Jennison Dryden 20/20 Focus fund Meanwhile a plan that has multiple funds occupying the same category often have no fund in another category, such as small-cap or international.

*8** **Fees & Compensation**

Fiduciaries have an obligation to "assure that the compensation paid directly or indirectly by [a plan to a service provider] is reasonable**, taking into account the services provided to the plan as well as any other fees or compensation received by [the service provider] in connection with the investment of plan assets**. The responsible plan fiduciaries therefore must obtain sufficient information regarding any fees or other compensation that [the service provider] receives with respect to the plans investments….to make an informed decision whether the [service providers] compensation for services is no more than reasonable."

DOL - Frost (97-15A) and Aetna (97-16A)

9* **Revenue Sharing**

Few plan sponsors realize that most 401k plan expenses are not paid with hard dollars, but rather through subsidies taken from the mutual funds. These subsidies are commonly known as "sub-TA fees" and "12b-1 fees" which are buried within the fund's expense ratio. 12b-1 fees generally pay an advisor or salesperson and range between 25 basis points (bps) and 100 bps. Sub-TA fees are supposed to offset the administration of the plan, be paid to an administrator, and generally range 15 and 50 bps.

10* Not having a written IPS is often the first indication of fiduciary vulnerability.

11* **Rule 404c**

"What does 404(c) protect against? In a nutshell, it offers a shield against imprudent participant investment decisions. As an example, consider a 25-year-old who decides to put his account in the money market fund—and keeps it there for 40 years. Or a 65-year-old who invests his entire account in an aggressive growth fund and loses significant amounts in a bear market. In a 404(c) plan, the fiduciaries will not be legally responsible for the imprudence of those decisions." Fred Reish

*12** **Disclosure**

While assessing one group annuity based plan, we reviewed three plan level documents totaling 102 pages, and then 4 documents totaling an average of 400 pages for each of 15 investment options!

Additional Compensation to Salesperson's firm (ABC Firm):

- ***Assets Under Management***: *ABC Firm receives payments of* ***up to*** *0.06% on all assets, attributable to your plan. These payments* ***may be*** *referred to as "revenue sharing"* ***under some*** *circumstances. The payments are made by the XYZ Company to ABC Firm. Your Financial Advisor does not receive any part of these payments.*

- ***New Purchases:*** *ABC Firm receives payments of* ***up to*** *0.15% on new asset purchases made by the plan. These payments* ***may be*** *referred to as "revenue sharing"* ***under some*** *circumstances. The payments are made by the XYZ Company to ABC Firm. Your Financial Advisor does not receive any part of these payments. Amounts payable by XYZ Company to ABC Firm by do not result in an additional direct charge to your Plan or to the products,* ***except to the extent*** *XYZ Company applies an asset charge* ***or other*** *charge* ***and*** *pays compensation to ABC Firm from it's general revenues.*