



*Association of
Public
Pension
Fund
Auditors*

Fiduciary Responsibility

Ian Lanoff

GROOM LAW GROUP

www.groom.com

November 7, 2005

Trust Law Evolution

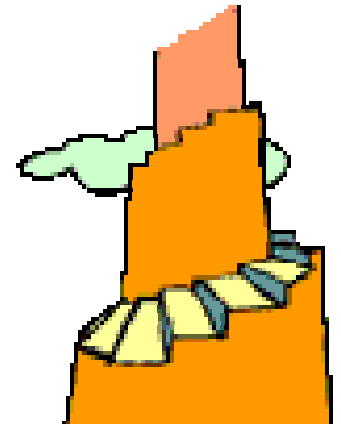
- Old English law recognized trusts
- Family trusts have existed for centuries
- Pension funds emerged in the 1900s
- In 1974, ERISA codified trust law applicable to private pension plans

Public plans – *not* subject to ERISA

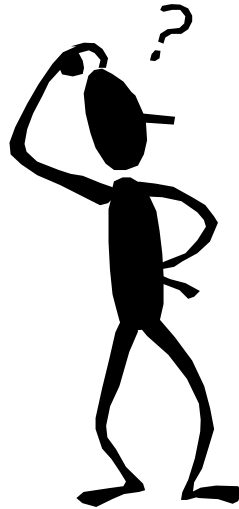
- But ERISA is extremely influential
- Public plan laws are modeled after ERISA:
 - Most impose duties of prudence and loyalty
 - Many have fiduciary conflict provisions
 - Many have party in interest rules
- Public plans trustees look to ERISA for guidance
- ERISA provides a model for *best practices*

Today's Roadmap

1. Who is a fiduciary?
2. The 4 primary fiduciary duties
3. Procedural prudence
4. ETIs
5. Fiduciary misconduct (*i.e.*, conflicts)
6. Co-fiduciary liability
7. Party in interest violations
8. Prohibited transactions under the IRC
9. Plan expenses
10. What can internal auditors do?



Who is a fiduciary?



Why is it important to know if you are a fiduciary?

- Fiduciaries must satisfy the "*highest standard of conduct known to law*"
- Fiduciaries who violate those standards may become personally liable



Definition of *fiduciary*

- ERISA has a “functional” definition:
 - You are a fiduciary if your job involves a “fiduciary function” (regardless of what is in your job description)
 - Even if your job does not involve a fiduciary function, you are a fiduciary if take on a fiduciary function (*i.e.*, act outside your job)
 - Ministerial acts are not fiduciary functions
- Applicable state law may be different

What is a fiduciary function?

- If you exercise discretionary authority or control with respect to management of the plan or the assets of the plan
or
- If you actually have discretionary authority or responsibility for plan administration
or
- If you provide investment advice for a fee

Can an Internal Auditor be a Fiduciary?

- Does the ERISA model apply?
- Do you hire and fire plan service providers?
- Do you buy products from vendors?
- Do you have discretionary authority or responsibility for plan administration?
- You could be a fiduciary with respect to some parts of your job, but not others...

Can Fiduciary Duties be Delegated to You?

- Generally, fiduciaries can delegate fiduciary responsibilities
- But the ultimate responsibility (liability) remains with the fiduciary
 - For example, if the trustees delegate the contracting function to internal audit, you may *share* the fiduciary responsibility (liability) with the trustees
 - ERISA permits delegation to investment managers
- Fiduciaries have a duty to monitor delegees (including investment managers) and replace them if appropriate

What if you are not a fiduciary?

- Even if you are not a fiduciary, the trustees on the board are fiduciaries
- And your plan's executive director (and other officers) also may be fiduciaries
- Therefore, if you are not a fiduciary – good news – you might not risk personal liability
- But others could be personally liable for a fiduciary breach if you perform poorly

4 Primary Fiduciary Duties

- Duty to act prudently
- Duty of loyalty
- Duty to diversify investments
- Duty to follow plan documents

Cornerstone: Duty to act prudently



Duty to Act Prudently

Must act with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims

- Pure heart and empty head does not work
 - Good faith is not enough

Public Plans = the *least* fiduciary latitude

Public Plans

Prudent Expert/Public Scrutiny

Corporate & Union ERISA Plans

ERISA Prudent Expert

Not for Profit Organizations

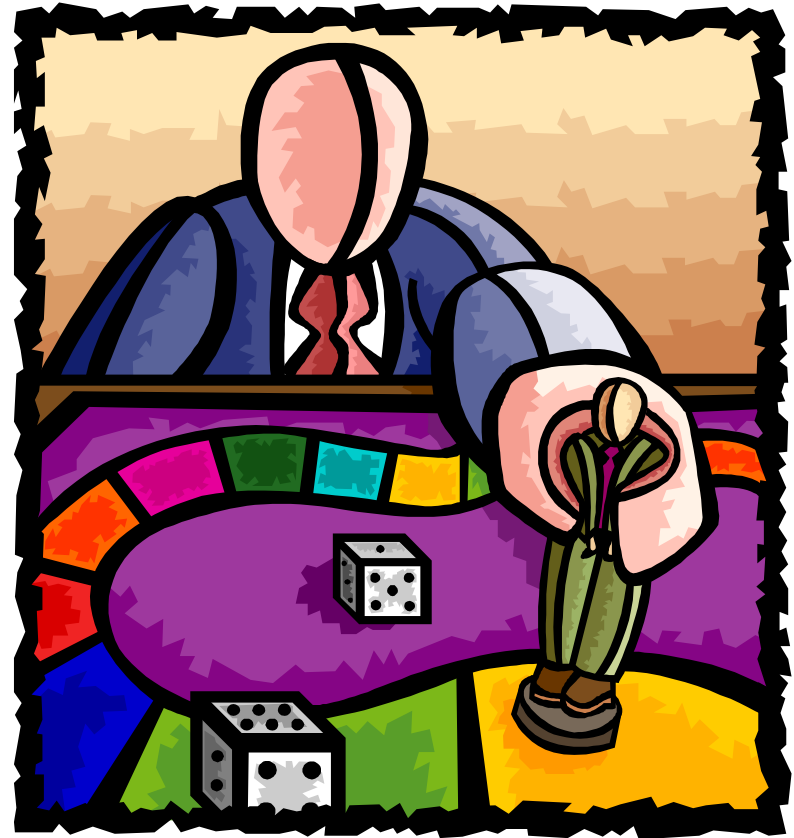
Prudent Person

Corporate Board of Directors

Business Judgment Rule

Procedural Prudence

- No guarantee of success required
- A prudent process is more important than a good outcome
- Prudence is judged at the time the transaction is entered – not in hindsight



Six Elements of a *Prudent Procedure*

1. Determine what information is needed to make the decision
2. Gather that information from competent, unbiased sources
3. Give it due consideration
4. Consult experts as appropriate regarding each of the foregoing elements
5. Make the decision taking into account the information gathered and advice obtained
6. Document the decision and reasons for making it – particularly carefully if the decision is contrary to the expert advice obtained

Duty to Diversify

Requires the Board (or other investment fiduciary) to diversify investments so as to minimize the risk of large losses



Duty of Loyalty



Duty of Loyalty

- Fiduciaries must discharge their duties solely in the interests of participants and beneficiaries
- For the exclusive purposes of:
 - providing benefits to participants/beneficiaries
 - defraying reasonable administrative expenses

Solely in the Interests

- Fiduciaries have no duty of loyalty to –
 - the legislature
 - to taxpayers
 - to the union who appointed him or her
 - to the governor who appointed him or her
 - to contributing employers

Solely in the Interests

- While performing trust business, fiduciaries may wear only one hat – that is act "solely in the interests" of participants and beneficiaries
- When performing trust business, fiduciaries may not also wear a second hat as, for example, a representative for the union or employer



Economically-targeted investments



- Sometimes called *social investing*
- Does it violate the duty of loyalty?
- Or prudence?
- All-else-is-equal test ...

Corporate Governance

- A fiduciary who fails to vote or cast a vote without considering the impact of the question, or votes blindly with management, would appear to violate his or her duty to prudently monitor plan assets
- The emergence of "Shareholder Activism"

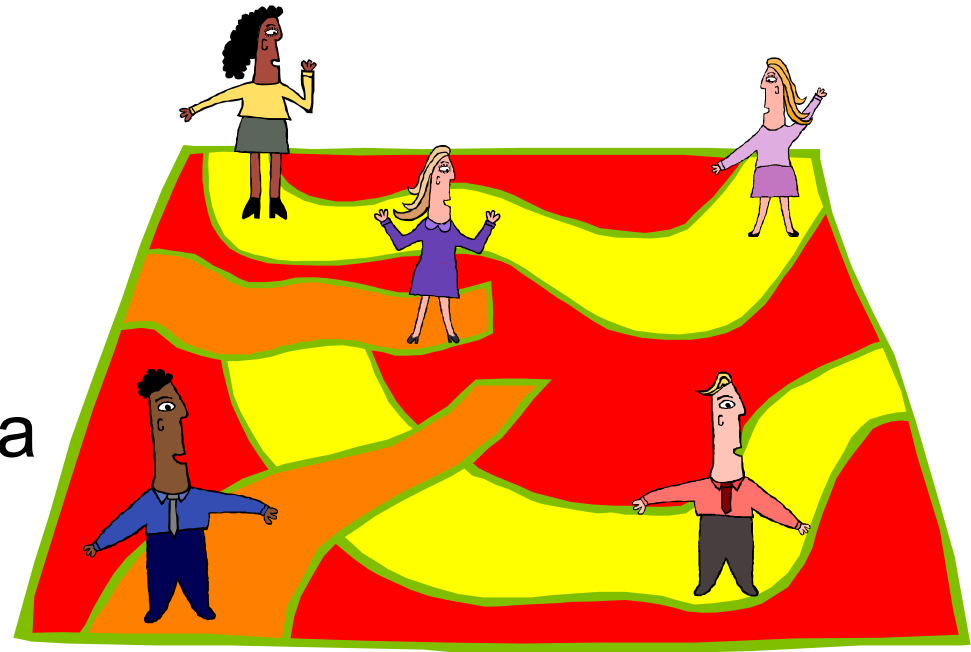


Does "loyalty" mean all participants must be treated the same?

- Generally, in processing claims, similarly-situated participants and beneficiaries must be treated similarly
- What about plan design issues?
 - Is it a fiduciary breach to design a health plan that provides better benefits to some groups?
 - This might be a "settlor" function – not a fiduciary decision
 - Even if a fiduciary decision, generally, it is not required to provide the same benefits to all

The duty of loyalty includes the duty not to mislead participants

- Fiduciaries must communicate material facts affecting the interests of beneficiaries
- This duty exists when a beneficiary asks fiduciaries for information, and even when he or she does not



Duty to follow plan documents

- To the extent consistent with law
- Current *hot topic* for corporate plans:
 - If plan documents require fiduciaries to invest in company stock, would the duty of prudence *ever* require investment fiduciaries to override that requirement?
 - If yes, *when*?



Protection From Liability

- Rely on experts (not always)
- Procedural prudence (might be a safe harbor)
- Government or sovereign immunity (probably not)
- Fiduciary liability insurance (to a limited extent, may be covered under the plan's policy)

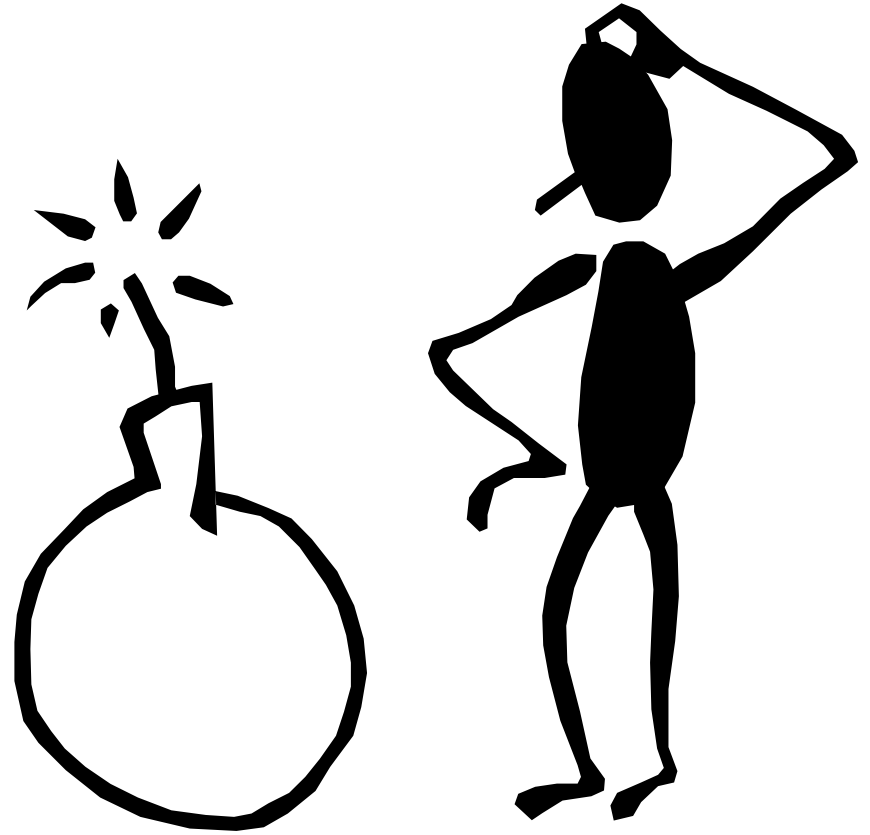
Co-fiduciary liability

- You are your brother's keeper
- You will have co-fiduciary liability if:
 - you know of another fiduciary's breach and do nothing
 - If your failure to perform your own fiduciary duties (e.g., fail to monitor others) enables another fiduciary to breach his or her duties
- Resigning, without more, is not a solution



Misuse of Fiduciary Authority

- 3 ways:
 - Own interest (also called fiduciary self-dealing)
 - Adverse party conflicts of interest
 - "Kick-backs"



Fiduciary Self-Dealing

- A fiduciary cannot act in a transaction if the fiduciary has a self-interest (e.g., hiring a relative's firm to be a service provider)



Adverse Party Conflicts of Interest

- A fiduciary cannot represent a party with an adverse interest, even if he or she receives no personal gain
- Trustees of two plans who negotiated a loan between the plans engaged in an unlawful transaction because the interests of borrowers and lenders are always adverse

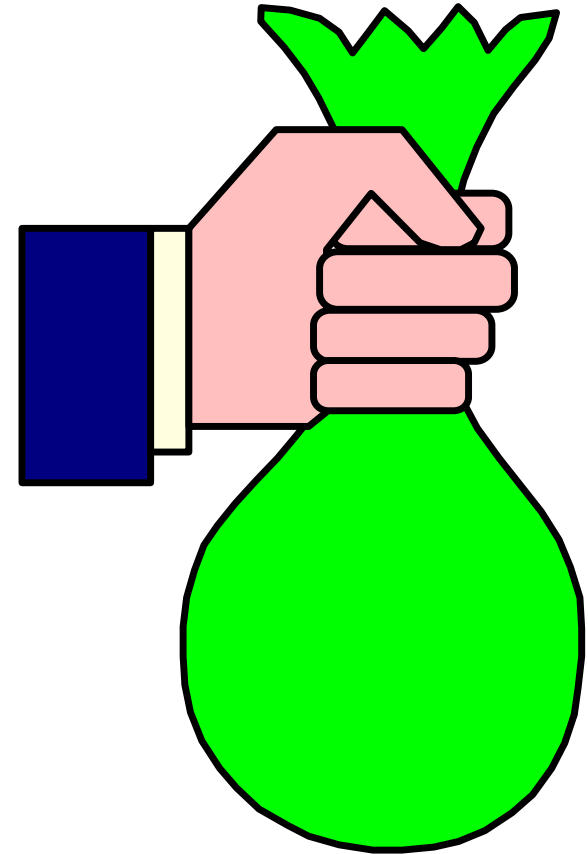
5 Elements of a *Kickback*?

1. A "fiduciary"
2. must receive "consideration"
3. from a party "dealing with" the plan
4. for the fiduciary's "own personal account"
5. "in connection with" a plan transaction.



Kickbacks

- A fiduciary charged with violating the anti-kickback rule must prove by "clear and convincing evidence" that compensation he or she received was for some service other than a transaction involving the plan

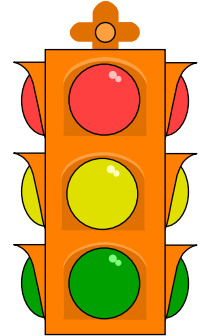


Who goes
to the
dark side?



Resolving Fiduciary Conflicts

- Avoid if possible
- Disclose and recuse if unavoidable
 - Very technical, tenuous conflicts may be okay
 - Recusal means absence from *all* consideration
- No way to resolve a kick-back
 - Disclosure and recusal are not a remedy for kick-backs



Party in Interest Prohibitions

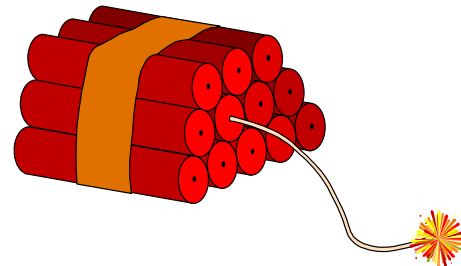
- *Per se* violations
- Covers most *non-exempt* transactions between the Trust and parties in interest:
 - Sales; exchanges; leases; loans; furnishing of goods, services, or facilities; use of plan assets
- Parties in interest include:
 - Employers, union, participants, trustees and fiduciaries, service providers (e.g., lawyers, actuaries, investment managers)
 - A broad ranges of affiliates of the foregoing

Exemptions for Transactions Involving Parties in Interest

- ERISA has many exemptions:
 - Common exemption is for reasonable contracts for appropriate services needed to operate the Plan and Trust
 - QPAM exemption: Covers independent investment managers of a certain size
 - Many other exemptions
- State law may be different
 - May set an *arm's length* standard

Prohibited Transactions under the Internal Revenue Code

- Section 503 of the Code
- This does apply to tax-qualified *governmental* pension plans
 - Many of the rules are similar to ERISA's fiduciary misconduct and party in interest prohibitions
- Penalty for violating these rules:
 - Loss of tax exempt status



Plan Expenses



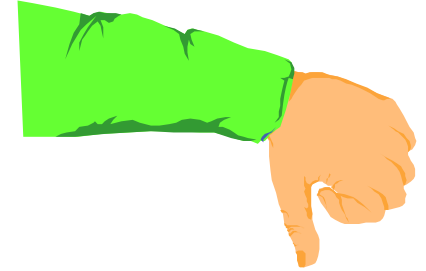
What is a reasonable administrative expense?

- Is it for appropriate plan services?
- Is it permitted under the rules governing the plan?
- Is it reasonable in amount?
- Is it a "fiduciary" & not a "settlor" expense?
 - A union or employer trustee cannot charge expenses related to his or her other position

Appropriate Services

- Generally, any cost incurred by fiduciaries can be paid from plan assets
- For example
 - Plan administration expenses, recordkeeping, participant communications, actuarial and accounting fees, claims processing fees
 - Fees for trust and custodial services
 - Investment expenses

Not Appropriate Services



- Services benefiting the employer or union
- Services to a different plan
- Services not reasonably necessary to carry out plan administrative, investment and operational requirements
- Arrangements involving self-dealing, conflicts of interest or kickbacks

Reasonable in Amount

- Reasonableness must be determined in light of the services rendered
 - As would ordinarily be paid for like services by like enterprises under like circumstances
 - Within the range of compensation to others in the same industry or occupation for similar services
- Reasonableness is measured at the time the contract is entered
 - Not at the time the contract is questioned



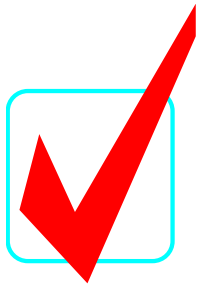


What can internal auditors do?

Procedures?

Do your plan fiduciaries follow prudent *procedures* when making decisions?





Internal policies?

1. Do you have a policy designed to identify and avoid:
 - *fiduciary conflicts?*
 - *prohibited transactions?*
 - *party in interest violations?*
2. Have you listed primary parties in interest?
3. Written benefit claims procedures?
4. Travel and expense policy?
5. Records retention policy?

External policies?

Monitoring outside fiduciaries?

- Do you ask outside investment managers (or other outside fiduciaries) to provide you with copies of *their* policies to avoid fiduciary conflicts and other prohibited transactions?
- Is requesting policies from outside fiduciaries part of the duty to monitor?

Fiduciary Compliance Audit?

- Many corporate plans retain outside firms to undertake a *fiduciary* compliance audit
- Would that be appropriate for your plan?

What can organizations do to strengthen and improve fiduciary understanding?

What can internal auditors do to help foster a greater sense of fiduciary responsibility?

What do professional standards
require?



*Association of
Public
Pension
Fund
Auditors*

GROOM LAW GROUP