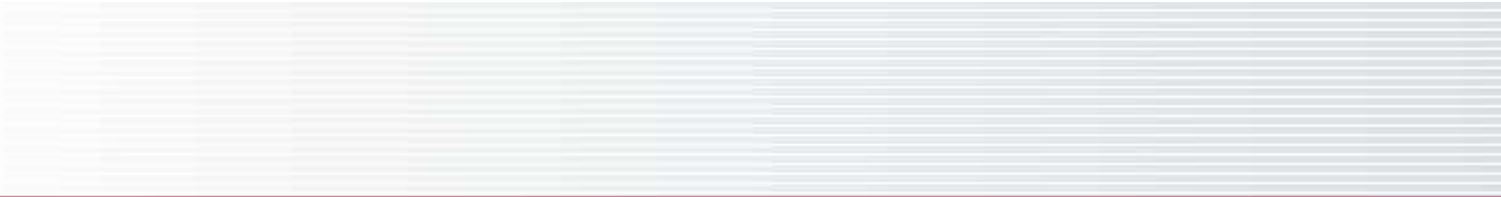


“By year end [2008], investors of all stripes were bloodied and confused, much as if they were small birds who had strayed into a badminton game.”

Warren E. Buffet, Chairman of the Board
Berkshire Hathaway, Inc., February 27, 2009



“It is difficult for an empty sack to stand upright.”

Ben Franklin

“Come on, be honest: you never really understood most of this stuff.”

Anna Quindlen

Newsweek, March 30, 2009

“History does not repeat itself. But sometimes it does hum a familiar tune.”

Michael Kazin

Newsweek, March 30, 2009

General Sources of Fiduciary Standards

- ❑ Internal Revenue Code
- ❑ Trust Law
- ❑ UMPERSA
- ❑ ERISA
- ❑ Other Federal Laws
- ❑ State and Local

Fiduciary Standards – Internal Revenue Code

Exclusive Benefit Rule

- "Under the trust instrument it [must be] impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries."

- Internal Revenue Code, § 401(a)(2)

Fiduciary Standards – Internal Revenue Code *(Cont'd)*

Prohibited Transactions

- A qualified plan is prohibited from participating in any transaction in which it –
 - “(1) lends any part of its income or corpus, without receipt of adequate security and a reasonable rate of interest, to;
 - (2) pays any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered, to’
 - (3) makes any part of its services available on a preferential basis to;

Fiduciary Standards – Internal Revenue Code *(Cont'd)*

Prohibited Transactions *(cont'd)*

(4) makes any substantial purchase of securities or any other property, for more than adequate consideration in money or money's worth, from;

(5) sells any substantial part of its securities or other property, for less than an adequate consideration in money or money's worth, to; or

(6) engages in any other transaction which results in a substantial diversion of its income or corpus to;

the creator [of or] a person who has made a substantial contribution to [the trust]....”

- Internal Revenue Code, § 503(b)

Fiduciary Standards – Trust Law

Prudent Investor

- "The trustee is under a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust."

- Restatement (Third) of Trusts, § 227

Fiduciary Standards – Trust Law *(Cont'd)*

Fiduciary Duties

- ❑ A trustee or fiduciary must observe four duties in administering a trust:
 - Duty of Care and Skill
 - Duty of Caution (Diligence)
 - Duty of Diversity
 - Duty of Loyalty

Restatement of Trusts – Duty of Care and Skill

- The trustee must exercise reasonable effort and diligence in making and monitoring investments for the trust, with attention to the trust's objectives. The trustee has a related duty of care to keep informed of rights and opportunities associated with those investments.
 - The formulation and the implementation of an appropriate investment strategy, with investments to be selected and reviewed in a manner which is appropriate to that strategy.

Restatement of Trusts – Duty of Care and Skill *(Cont'd)*

- o Relevant information about the circumstances and requirements of the trust and its beneficiaries (e.g., an asset/liability study), the contents and resources of the trust, and the consideration of how the risk and return of available investment alternatives match up with the investment goals of the trust.
- o Securing and considering the advice of experts on a reasonable basis. It is ordinarily satisfactory that this information and advice be obtained from sources on which prudent fiduciaries in the community customarily rely. This can include fiduciary counsel, tax counsel, accounting advice, among others.

Restatement of Trusts – Duty of Caution

- The trustee must exercise the caution of a prudent investor managing similar funds for similar purposes and in similar circumstances.
 - Attention both to safety of the capital and to securing a reasonable return
 - Prudently manage and assess risk

Restatement of Trusts – Duty to Diversify

- A central feature of such prudence is the reduction of uncompensated risk through diversification.
 - The trustee must monitor and review investment performance and the process of investing funds.

Restatement of Trusts – Duty of Loyalty

- The trustee must conform to "fundamental fiduciary duties of loyalty (§ 170) and impartiality (§ 183)."
 - Adherence to the duty of loyalty should prohibit all transactions posing conflicts of interest.
 - Personal Interest
 - Conflicting interests of beneficiaries
 - Multiple trusts

Fiduciary Standards – UMPERSA

Fiduciary Duties

- ❑ A trustee or other fiduciary shall discharge duties with respect to a retirement system:
 - Solely in the interest of the participants and beneficiaries
 - For the exclusive purpose of providing benefits to participants and beneficiaries and paying reasonable expenses of administering the system

Fiduciary Standards – UMPERSA *(Cont'd)*

- o With the care, skill, and caution under the circumstances then prevailing which a prudent person acting in a like capacity and familiar with those matters would use in the conduct of an activity of like character and purpose
- o Impartially, taking into account any differing interests and participants and beneficiaries

Fiduciary Standards – UMPERSA *(Cont'd)*

- o Incurring only costs that are appropriate and reasonable
- o In accordance with a good-faith interpretation of the law governing the retirement program and system

- UMPERSA, § 7

Fiduciary Standards – UMPERSA *(Cont'd)*

- A trustee must set aside the interests of the appointing authority.
 - "It is as improper for a fiduciary to take actions for the purpose of benefiting a third person as it is for a fiduciary to act in its own interest. In the retirement system setting, it is important to note that this duty includes the obligation to set aside the interests of the party that appoints a trustee or fiduciary. A trustee, for example, must act solely in the interests of participants and beneficiaries and set aside any interest of a party responsible for the trustee's appointment, such as an employer or union."

- UMPERSA Comments on § 7

Fiduciary Standards – UMPERSA *(Cont'd)*

- o The power of a trustee to delegate investment and management functions is affirmed, clarified, and subjected to safeguards.

- UMPERSA, § 6.

Goal – Fiduciary Independence

- UMPERSA "is intended to ensure that retirement system trustees have a level of independence sufficient to permit them to perform their duties and to do so effectively and efficiently. Trustees are different from other state actors because they are subject to an extensive and stringent set of fiduciary obligations to retirement system participants and beneficiaries. These obligations both require and justify some level of trustee independence."

- UMPERSA Comments on § 5.

Fiduciary Standards – ERISA

Exclusive Benefit and Prudent Person

- "A fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and –
 - For the exclusive purpose of:
 - Providing benefits to participants and their beneficiaries
 - Defraying reasonable expenses of administering the plan

Fiduciary Standards – ERISA *(Cont'd)*

- o 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
- o By diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so
- o In accordance with the documents and instruments governing the plan"

- ERISA § 404(a)(1)

Fiduciary Standards – ERISA *(Cont'd)*

- ❑ Summary of Fundamental ERISA Standards:
 - Written employee benefit plan document
 - "Provide for one or more named fiduciaries who jointly or severally shall have authority to control and manage the operation of the plan"
 - If more than one named fiduciary, fiduciary responsibilities may be allocated among those fiduciaries.
 - Named trustees may designate other persons to carry out fiduciary responsibilities.

State Law Sources of Fiduciary Standards

- ❑ Constitution
- ❑ Statutes
 - Uniform Laws
 - Plan Document
- ❑ Case Law
- ❑ Administrative Rules

Applying These Fiduciary Standards

- ❑ Who is a fiduciary?
- ❑ What are the obligations of a fiduciary?
- ❑ What is prudence?
- ❑ Can duties be delegated?
- ❑ Can exposure be limited or managed?
- ❑ New challenges

Who is a Fiduciary?

- ❑ Anyone can be a fiduciary.
- ❑ You are a fiduciary to the extent you:
 - Exercise any authority or control over plan management or plan assets
 - Render investment advice to the plan for direct or indirect compensation
 - Have discretionary authority or responsibility for plan administration

Who is a Fiduciary? *(Cont'd)*

- Typical Fiduciary Activities:
 - Appointing other plan fiduciaries
 - Delegating responsibilities to other fiduciaries
 - Selecting/monitoring plan investment vehicles
 - Acquiring/disposing of plan assets
 - Interpreting plan provisions
 - Making decisions under the plan
 - Being an officer – sometimes

What are the Obligations of a Fiduciary?

- ❑ To act in accordance with the written plan documents and governing law (Tax Code, Other Federal Law, State Law)
 - Benefits must be paid in strict accordance with plan provisions
 - Benefits must be paid in strict accordance with governing law
- ❑ To act solely in the interests of plan participants and beneficiaries

What are the Obligations of a Fiduciary? *(Cont'd)*

- Practical impact on Trustees:
 - Sole focus must be performing duties for the exclusive benefit of members and beneficiaries
 - Act as a fiduciary for all members of the system – retirees, actives, inactives and beneficiaries
 - Set aside pre-conceived notions and work from the facts and from statutes, rules, Board policies and procedures
 - Conduct periodic actuarial valuations
 - The plan must be administered as written

What are the Obligations of a Fiduciary?

- Practical impact on Trustees: *(Cont'd)*
 - Understand fiduciary responsibility – good governance requires that each fiduciary understands their duties and the duties of their co-fiduciaries
 - Where there are multiple responsibilities and multiple plans – Trustees must understand impact on each plan

What are the Obligations of a Fiduciary? *(Cont'd)*

- ❑ Practical impact on Trustees: *(Cont'd)*
 - Avoid conflict of interest
 - Consider "gift policy"
 - Comply with all ethics standards
 - Monitor costs but make sure budget is reasonable to get the job done

What are the Obligations of a Fiduciary? *(Cont'd)*

- Practical impact on Trustees: *(Cont'd)*
 - Make sure to keep up-to-date with law changes
 - Trustees must be aware of the entire legal context, including other federal laws:
 - HIPAA
 - ADEA
 - ADA
 - Confidentiality – Federal law issues

What are the Obligations of a Fiduciary? *(Cont'd)*

- Practical impact on Trustees: *(Cont'd)*
 - Represent plan participants and beneficiaries with policy makers within Board Policy

What are the Obligations of a Fiduciary? *(Cont'd)*

- Practical impact on Staff:
 - Administer the plan as it is
 - If something really isn't working, let the appropriate party know
 - Confidentiality – Federal law issues
 - Make sure system is getting a "good value" from your services
 - Work effectively and efficiently

What are the Obligations of a Fiduciary? *(Cont'd)*

- Practical impact on Staff: *(Cont'd)*
 - Make sure to keep up-to-date with law changes
 - Make sure to keep up-to-date on changes in Board and office procedures and processes
 - Be sure to get correct information about members, beneficiaries, retirees
 - Develop process and procedures to avoid, find and correct errors

Fiduciary Issues – Defined Contribution Plans

- ❑ Selection of a diversified range of investment options.
- ❑ Selection of a default option.
- ❑ Generally, a statement of investment policy is a written statement that provides fiduciaries with guidelines or restrictions concerning various types or categories of investment management decisions.

What is the "Prudent Expert" Standard?

- ❑ A fiduciary must act:
 - With the care, skill, prudence, and diligence
 - Under the circumstances then prevailing
 - That a prudent person acting in a like capacity (expert)
 - And familiar with such matters
 - Would use in the conduct of an enterprise of a like character with like aims

"Procedural Prudence"

- Prudence requirements generally are satisfied if:
 - The fiduciary making an investment or engaging in any course of action has given appropriate consideration to those facts and circumstances that, given the scope of the fiduciary's duties, the fiduciary knows or should know are relevant, and
 - The fiduciary acts accordingly.

"Procedural Prudence" *(Cont'd)*

- ❑ The emphasis under ERISA is on process more than on the best possible result.
- ❑ The courts have held that the test of prudence is one of conduct and process, and not a test of the result. For example, the focus of an investment inquiry is how the fiduciary acted in his selection of the investment, and not whether an investment succeeded or failed.

"Procedural Prudence" *(Cont'd)*

- ❑ Among other things, a fiduciary must:
 - Establish a prudent process for selecting service providers
 - Ensure that fees paid to service providers and other expenses of the plan are reasonable in light of the level and quality of services provided
 - Monitor service providers once selected to see that they continue to be appropriate choices

"Procedural Prudence" *(Cont'd)*

- Practical impact on Trustees:
 - Good Board governance is the key -
 - Written policies
 - Clear understanding of roles
 - Adherence to policies

"Procedural Prudence" *(Cont'd)*

- Practical impact on Staff:
 - Do things "By the Book"
 - But – raise concerns

Prohibited Transactions

- ❑ A fiduciary may not:
 - Deal with plan assets in his own interest
 - Act in a transaction with a "party in interest" if adverse to the interests of plan participants
 - Receive any consideration for his personal account from any party in connection with a transaction involving the plan

Prohibited Transactions *(Cont'd)*

- A clear conflict of interest policy is needed.
 - A gift policy can be part of this

Can You Delegate These Duties?

- ❑ Trust Law contemplates that others will assist you
 - Authorizes you to retain professional advisors
 - Can pay reasonable expenses from the plan assets
- ❑ Trust Law allows you to delegate duties
 - Transfer of fiduciary duty to third party

How Do You Delegate Your Duties?

- ❑ In order to delegate your fiduciary responsibilities you must:
 - Have plan documents that set forth a procedure authorizing you to do so
 - Act in accordance with fiduciary duties in selecting the third party and monitoring his or her activities/performance
 - Additional rules apply for investment managers
 - Make sure contracts and agreements specify fiduciary responsibility

How Do You Delegate Your Duties?

- o As to a defined contribution plan – provide reasonable information to allow participants to direct investments for their accounts

Example – Prudent Delegation

- ❑ "Prudent delegation requires informed, careful evaluation of potential managers for the venture capital program and to monitor their performance of their duties. It also requires that the trustees have or obtain the capacity to develop appropriate working arrangements and to negotiate an appropriate contract with an individual or firm selected for the managerial role."

- Restatement (Third) of Trust, Section 227, Comment j.

What are the Legal Standards for Delegation?

- A trustee has a duty personally to perform the responsibilities of trustee except as a prudent person might delegate those responsibilities to others. In deciding whether, to whom and in what manner to delegate fiduciary authority in the administration of a trust, and thereafter in supervising agents, the trustee is under a duty to the beneficiaries to exercise fiduciary discretion and to act as a prudent person would act in similar circumstances.

- Restatement of Trusts, § 171. Duty with Respect to Delegation.

What About Professional Advice?

- ❑ Reliance on professional advice:
 - You remain responsible for the fiduciary duty in question;
 - The advisor does not necessarily become a fiduciary.
- ❑ But, the fact that you have consulted with advisors helps demonstrate that you have met your duties.
 - Even if you lack expertise or have a potential conflict-of-interest;
 - So long as your reliance is reasonable.

What About Professional Advice? *(Cont'd)*

- ❑ Commentators advise that a fiduciary must seek independent advice when the fiduciary lacks necessary expertise, but the fiduciary must exercise independent judgment after reviewing and analyzing the expert's recommendation.
 - Courts will look at whether a fiduciary had documentation and took the time for proper reflection and discussion.

Managing Risk

- ❑ Manage governance risk: the risk that the fiduciaries will (intentionally or unintentionally) through management actions or lack of action create underperformance. Underperformance include:
 - o Poor member services
 - o Poor communications
 - o Ethical problems and issues

Managing Risk *(Cont'd)*

- o Inconsistency in plan administration
- o Misunderstanding of fiduciary roles
- Create a clear organization structure
- Provide for independent oversight (checks and balances)

Managing Risk *(Cont'd)*

- ❑ Establish good hiring practices, conduct evaluation, and maintain appropriate working environment
- ❑ Provide adequate initial and continuing education resources

Managing Risk *(Cont'd)*

- ❑ Manage risk of operational failure in internal operations
 - Design to avoid breakdown in systems, procedures, personnel or process
 - Conduct periodic independent audits
 - Conduct periodic internal reviews
 - Segregate internal duties and periodically review for "drift" in responsibilities

Managing Risk *(Cont'd)*

- o Create and maintain continuity or contingency plans for internal management and operating systems
 - regular back-ups
 - off-site storage
 - back-up communication links
 - disaster recovery

The "New" Fiduciary Standards

- ❑ Growing out of corporate scandals, there's a new set of fiduciary standards emerging:
 - Duty not to mislead designated fiduciaries by silence or inaction by the designating fiduciary.
- ❑ Duty to monitor the "actions" of designated fiduciaries on a continuous basis, not just periodically.
- ❑ Duty to insure that the designated fiduciaries have "accurate information," especially when the co-fiduciary has special knowledge not readily available to the designated fiduciary.

What's a Fiduciary To Do?

- ❑ Act in accordance with trust objectives
- ❑ Act in accordance with the plan document
- ❑ Act in accordance with written policies
- ❑ Appropriately and knowledgeably delegate duties
- ❑ Retain and rely on expert opinion
- ❑ Monitor and verify
- ❑ Operate for the exclusive benefit of beneficiaries



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