Chapter 35

Specific Corporate Compliance Challenges by Practice Area: ERISA

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PART I: OVERVIEW

§ 35.01 Introduction to ERISA

Imagine that it is late in the day on December 11, 2008. You recently became a fiduciary of a publicly-traded company's pension plan and have just learned that Bernard Madoff, the founder and chairman of Bernard L. Madoff Investment Securities LLC ("BLMIS") and the former chairman of the NASDAQ stock exchange, has been arrested for operating a giant "Ponzi scheme" allegedly defrauding thousands of customers to the tune of billions of dollars. You initially thank your lucky stars that you had none of your own money invested with Mr. Madoff's firm but suddenly terror grips you. The pension plan for which you serve as a fiduciary might have had money invested with BLMIS (either directly or through a feeder fund). Questions begin to race through your mind. Was money invested with BLMIS? If so, how much money was invested, when was the money invested, who made the decision to invest, and are you subject to a lawsuit, either by the government or the plaintiff's bar?

Core Statute: Although the above-described scenario implicates a number of legal areas—including securities law, bankruptcy law, and insurance law—it may also implicate the federal statute known as the Employee Retirement Income Security Act of 1974 ("ERISA"), 29 U.S.C. §§ 1001–1461. Congress enacted ERISA in response to the Studebaker Company's shut down of its South Bend, Indiana plant in December 1963—which left thousands of employees without any retirement savings—to help avert (or minimize) similar occurrences. The primary purpose of ERISA is to protect interstate commerce and the retirement and other employee benefits of plan participants and beneficiaries by providing for disclosure and reporting to participants and beneficiaries, establishing standards of conduct, responsibility, and obligations for fiduciaries, and by providing for remedies, sanctions and ready access to the federal courts. *See* ERISA, § 2, 29 U.S.C. § 1001. Among other things, ERISA, its regulations, and case law interpreting the statute and its regulations, describe the special, heightened duties (known as "fiduciary duties") owed by those entrusted with protecting such benefits (known as "fiduciaries"). *See Massachusetts Mutual Life Insurance Co. v. Russell*, 473 U.S. 134 (1985) (discussing ERISA's legislative history). Further, the Employee Benefits Security Administration ("EBSA"), an agency of the United States Department of Labor ("DOL"), is charged with enforcing ERISA and ensuring that businesses and individuals are in compliance with the law and its regulations. Currently, EBSA is entrusted with protecting 150 million Americans having retirement accounts totally $6.5 trillion. *See OIG Report*, "EBSA Needs to Provide Additional Guidance and Oversight to ERISA Plans Holding Hard-to-Value Alternative Investments," at

http://www.oig.dol.gov/public/reports/oa/2013/09-13-001-12-121.pdf.

In this Part I, we provide an introduction to ERISA to help you understand its applicability. In Part II, we discuss ERISA's fiduciary duties and prohibited transactions, and outline best practices for fiduciary compliance. In Part III, we discuss ERISA litigation and risk management, and in Part IV we discuss ERISA reporting and disclosure requirements. An understanding of these issues will help companies and their fiduciaries stay in compliance with ERISA and avoid potential liability. For further information, we recommend the DOL's website, www.dol.gov/ebsa/, which contains additional information to help businesses and individuals comply with the law. Additional resources are also contained at the end of this Chapter.

§ 35.02 What is an ERISA Plan?

ERISA defines an employee pension benefit plan or pension plan as any plan, fund, or program which is established or maintained by an employer to provide retirement income to employees or results in employees deferring income for a period extending to termination of employment and beyond. ERISA § 3(2), 29 U.S.C. § 1002(2). There are two types of ERISA pension plans: (i) "defined benefit plans" and (ii) "individual account plans" (which are often also called "defined contribution plans"). Defined benefit plans provide employees with a fixed amount at retirement based on a certain formula and factors including compensation, age, and the length of service of the individual who is a "participant" in the plan. *See* ERISA § 3(35), 29 U.S.C. 1002(35). The risk of loss in these plans (for example, loss as a result of a fraudulent ponzi scheme) remains with the employer. By contrast, an "individual account plan" is defined as "a pension plan which provides for an individual account for each participant and for benefits based solely upon the amount contributed to the participant's account, and any income, expenses, gains and losses." ERISA § 3(34), 29 U.S.C. § 1002(34). In individual account plans, some risk of loss shifts over to the individual participants. ERISA requires that the benefits, requirements, and other characteristics of such pension plans be in writing and described in "plan documents," which may consist of one or more documents.

Pension plans are generally designed to encourage employees to save for their retirement and other long-term goals. The defined contribution plans permit employees to defer a percentage of their salary on a pre-tax basis and permit the employer to make a contribution (known as a "matching contribution"). *See Harzewski v. Guidant Corp.*, 489 F.3d 799 (7th Cir. 2007) (stating that an employee's retirement is the eventual value of her account based on contributions made by the employer and/or the employee). In addition, sometimes the "plan sponsor"—the entity that establishes the pension plan—makes discretionary "basic" contributions to participants' accounts. In contrast to traditional defined benefit pension plans, participants alone shoulder the investment risk in defined contribution plans. *See Hirt v. Equitable*, 533 F.3d 102, 105 (2d Cir. 2008) (explaining that defined benefit plans differ from defined contribution plans with respect to who bears the investment risk; defined benefit plans guarantee a specific benefit without regard to market performances, whereas in defined contribu-

tion plans the employee bears investment risks); *Register v. PNC*, 477 F.3d 56, 61-62 (3rd Cir. 2007) (same).

Participants in defined contribution plans are typically given several different investment options in which to invest their contributions and any employer matching contributions, including in the employer's stock fund ("Stock Fund"). Some plans provide that up to 100% of its assets may be invested in the Stock Fund and sometimes there are restrictions on a participant's ability to transfer her money in and out of a Stock Fund. Moreover, some plans require its fiduciaries to invest in a Stock Fund only upon a participant's directions.

One popular type of defined contribution plan worth noting is an employee stock ownership plan ("ESOP"). Under ERISA, fiduciaries are generally required to "diversify" the investments of the plan. *See* ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C). By contrast, ESOP fiduciaries receive a waiver from this requirement with respect to investments in the employer's securities. *See* ERISA § 404(a)(2), 29 U.S.C. § 1104(a)(2).

Trap: ESOPs must be "designed to invest primarily in employer stock." *See* ERISA § 407(d)(6), 29 U.S.C. § 1107(d)(6). This requirement has not yet been interpreted by the IRS or the courts, but the phrase implies that in order for a plan, or a portion thereof, to qualify as an ESOP it must invest or hold the majority of its plan assets in employer securities. A DOL Advisory Opinion [83-6 (Jan. 24, 1983)] states that there is no fixed, quantitative standard for the "primarily invested" requirement and that the applicable requirements are flexible and vary according to the facts and circumstances. In light of this ambiguity, employers should be careful when designing an ESOP. As a result of the Pension Protection Act of 2006, participants are permitted to transfer their shares in employer stock in exchange for shares of equivalent value in other investment options offered by their plan. Pension Protection Act, § 901(b) (adding Internal Revenue Code § 401(a)(35) and ERISA 204(j)).

ERISA not only covers pension plans, but also "welfare benefit plans," which includes any plan, fund, or program established or maintained by an employer or by an employee organization, or by both, to the extent that such plan, fund, or program provides for its participants or their beneficiaries medical, surgical, or hospital care or benefits, or benefits in the event of sickness, accident, disability, death or unemployment, or vacation benefits, apprenticeship or other training programs, or day care centers, scholarship funds, or prepaid legal services, or any benefit described in the Labor Management Relations Act of 1947, § 302(c) (other than pensions on retirement or death, and insurance to provide such pensions). *See* ERISA § 3(1), 29 U.S.C. § 1002(1). Welfare benefit plans also must be operated in accordance with the fiduciary duties detailed below.

Further in connection with health care plans, ERISA has been amended by the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA") and the Health

Insurance Portability and Accountability Act of 1996 ("HIPAA"). While welfare benefit plans and their related statutes involve issues that are beyond the scope of this chapter, recent regulation warrants mention. The Patient Protection and Affordable Care Act of 2010 directs the Departments of Labor, Health and Human Services, and the Treasury to develop standards for use by group health plans and health insurance issuers in providing a summary of benefits and coverage (SBC) to participants. Pursuant to the legislation, the Departments issued final regulations regarding SBC standards. *See* 80 Fed. Reg. 34299 (June 16, 2015). The regulations require health insurance issuers offering group health insurance to provide an SBA to a group health plan or its sponsor upon an application by the plan for health coverage. The regulations similarly require group health plans (including plan administrators) and insurance issuers to provide an SBC to participants and beneficiaries. An entity tasked with providing an SBC to an individual may contract with third parties to provide the SBC on the entity's behalf so long as the entity: (i) monitors performance under the contract, (ii) corrects noncompliance where feasible, and (iii) communicates with participants and beneficiaries affected by noncompliance. These final regulations became effective on August 17, 2015.

§ 35.03 Is Your Plan Covered by ERISA?

How do you know whether your employee benefits plan is governed by ERISA? Essentially, "[i]f it Talks Like a Duck . . . and Walks Like a Duck . . . It is . . ." *possibly* an ERISA plan. *Donovan v. Mercer*, 747 F.2d 304, 305 (5th Cir. 1984). Indeed, while most such plans are governed by ERISA, not every retirement or benefits plan is covered. For example, ERISA Section 4(b) specifically exempts from ERISA certain plans sponsored by governments, churches, and certain tax-exempt entities. 29 U.S.C. § 1003. The DOL has provided guidance as to what is a covered plan. *See* 29 C.F.R. § 2510.3-2(f). The primary focus of the DOL guidance is the degree to which the employer is involved in establishing and/or managing a plan. For example, the selection of service providers could be considered employer involvement, subjecting a plan to ERISA's requirements. Other actions by the employer, such as making contributions to the plan or negotiating special features with a service provider, could also make an arrangement subject to ERISA. *See DOL's Field Assistance Bulletin 2007-2—Is Your Plan Subject to ERISA?*

§ 35.04 Who is a Fiduciary?

A person is an ERISA "fiduciary":

> [w]ith respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he 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, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan . . . .

ERISA § 3(21), 29 U.S.C. § 1002(21)(A).

Plan documents must designate a "named fiduciary" who has the authority to control

and manage the operations of the plan. ERISA § 402(a)(1), 29 U.S.C. § 1102(a)(1). ERISA defines a "named fiduciary" as "a fiduciary who is named in the plan instrument, or who, pursuant to a procedure specified in the plan, is identified as a fiduciary (A) by a person who is an employer or employee organization with respect to the plan or (B) by such an employer and such an employee organization acting jointly." ERISA § 402(a)(2), 29 U.S.C. § 1102(a)(2).

§ 35.05 De Facto Fiduciary

The United States Supreme Court has articulated a functional test to determine whether an individual is a fiduciary, focusing not on the individual's formal designation, but rather on the person's actions or authority. *Mertens v. Hewitt Associates*, 508 U.S. 248, 262 (1993); *Hancock v. Harris Trust,* 510 U.S. 86, 95–96 (1993) (although ERISA's fiduciary provisions "are not mellifluous" (i.e., smooth and flowing), when "read as a whole," it is clear that "Congress commodiously imposed fiduciary standards on persons whose actions affect" a participant's retirement) (emphasis added). Accordingly, if a person exercises or has any discretionary authority or control over plan administration or assets, that person may be deemed to be an ERISA *de facto* fiduciary. This test is fact-intensive and, consistent with the goals of ERISA, is to be construed broadly. *See In re Pfizer ERISA Litigation,* 2009 U.S. Dist. LEXIS 22637 (S.D.N.Y. Mar. 20, 2009); *Feigenbaum v. Summit Health Administrators, Inc.,* 2008 U.S. Dist. LEXIS 45396 (D.N.J. June 9, 2008) (a determination on fiduciary status does not hinge on formal designation, but rather upon the functional test).

Warning: Appointing and removing plan fiduciaries are fiduciary functions. *Harris v. Koenig,* 602 F. Supp. 2d 39, 60 (D.D.C. 2009) ("The power to appoint and remove trustees carries with it the concomitant duty to monitor those trustees performance.")(*citing Liss v. Smith*, 991 F. Supp. 278, 311 (S.D.N.Y. 1998)). Having the power to appoint and remove gives rise to the duty to monitor. *See Ford Motor Company ERISA Litigation*, 590 F. Supp. 2d 883 (E.D. Mich. 2008). Accordingly, it is important for such persons (who are themselves fiduciaries) to monitor their fiduciary appointments.

Note that fiduciaries will *only* be a fiduciary with respect to those powers delegated to them. *Brant v. Grounds*, 687 F.2d 895, 897 (7th Cir. 1982) (bank that provided investment advice to a plan was fiduciary only with respect to such advice) (emphasis added). Thus, if a claim is brought against directors and/or officers ("D&Os") in connection with the loss of plan assets as a result of imprudent investments, and those D&Os only had the power to appoint other fiduciaries, the D&Os would likely be shielded from liability unless it can be established that a failure to monitor the appointees was the cause of the loss to the plan.

§ 35.06 Directors and Officers as Fiduciaries

As mentioned above, D&Os—who generally only have the power to select and

remove others who administer the plan—would be found to be fiduciaries under ERISA only with respect to such appointments. Further, DOL regulations provide that D&Os are fiduciaries under ERISA only to the extent that they have responsibility for the appointment and/or retention of other ERISA fiduciaries. 29 C.F.R. 2509.75-8 (2007).

Certain courts have held that D&Os are not ERISA fiduciaries in the absence of express individual authority for plan administration. For example, in *Confer v. Custom Eng'g Co.*, 952 F.2d 34 (3d Cir. 1991), where the plan document named the corporation as the named fiduciary of the plan, the court explained that "the officers who exercise discretion on behalf of that corporation are not fiduciaries . . . unless it can be shown that these officers have *individual* discretionary roles as to plan administration." *Id.* at 37. As such, if a corporation delegated some of its fiduciary responsibilities to an officer or designated the officer as the plan administrator, fiduciary status would be found.

By contrast, at least two Circuits have rejected the above analysis, holding instead that ERISA and its policy support a broader, functional fiduciary test and rejecting any attempt to limit the liability of D&Os who function as fiduciaries. *Kayes v. Pacific Lumber Company,* 51 F.3d 1449, 1461 (9th Cir. 1995); *Musmeci v. Schwegmann Giant Super Markets, Inc.,* 332 F.3d 339 (5th Cir. 2003) (using the same functional approach as *Kayes*); *see also Briscoe v. Fine*, 444 F.3d 478, 487 (6th Cir. 2006) (stating that the primary difference between *Confer* and *Kayes* is that *Confer* appears to begin with a rebuttable presumption against D&O fiduciary liability, whereas *Kayes* starts with no initial presumption)

The weight of authority appears to reject a per se rule of non-ERISA fiduciary liability for D&Os where the corporation alone is identified as the named fiduciary. Courts outside the Third Circuit appear to reject the *Confer* rationale and instead hold that D&Os could be ERISA fiduciaries if they have or exercise discretionary authority or control over the administration or assets of the plan, regardless of whether they are acting in an individual or corporate capacity.

§ 35.07 The "Two Hats" Doctrine

The "two hats" doctrine provides that when an individual is acting in a corporate capacity on behalf of the company, ERISA's fiduciary duties are not implicated. *See Pegram v. Herdrich,* 530 U.S. 211, 225–226 (2000) (employer can switch between wearing its "fiduciary" and "employer" hats). An individual may be acting in a corporate capacity—performing a "settlor" function—by adopting, amending, or terminating a plan. *See In re Ullico Inc. Litigation,* 605 F. Supp. 2d 210 (D.D.C. Mar. 31, 2009) (citing to Supreme Court precedent). Accordingly, to trigger an individual's fiduciary duties, an individual must have been acting in a fiduciary capacity and not a corporate one. *See In re Citigroup ERISA Litigation*, 2009 U.S. Dist. LEXIS 78055 (S.D.N.Y. Aug. 31, 2009)(holding that the defendants were not acting in a fiduciary capacity with respect to offering employer stock as an investment option because they had no discretion under the plan document to eliminate the employer stock fund as an investment option). The Supreme Court has acknowledged this doctrine and has found

that an individual may not be wearing both hats at the same time. *Varity Corp. v. Howe*, 516 U.S. 489 (1996).

§ 35.08 Benefits Committee

"Best practices" dictate that employers who sponsor a benefits plan should establish a "benefits committee" to govern and administer the plan in accordance with ERISA. A benefits committee must be carefully comprised of experts within the company and should contain at least two subcommittees—the investment committee and the administrative committee. The benefit committee's "Charter" should be designed to describe all the duties and responsibilities of the committees. The plan documents and investment policy statements should be reviewed to ensure the Charter is accurate. At a minimum, the Charter should detail the following:

— The Committee's Purpose (to ensure the plan's purpose (as detailed in the plan document) is met and in compliance with ERISA)

— Membership (which should de detailed by title, e.g., VP of Finance, with qualifications that include ERISA fiduciary duties and responsibilities).

— Authority and Responsibilities (including such information as the timing of review of the Charter; evaluation and approval of matters necessary to satisfy ERISA's fiduciary obligations; providing ERISA compliance report to the company's Board of Directors at least semi-annually; providing recommendations to the Board of Directors; evaluation, selection, retention, appointment, or termination of all the plan's service providers; decision making authority with respect to plan administration, design and policy; and investment review).

— ERISA Compliance (setting forth ERISA's fiduciary requirements as described below).

— Operations of the Committee (when and how meetings of the committee are conducted). Minutes should be taken at all fiduciary committee meetings.

— Authority of the Charter (for example, if there are conflicts between the plan and the charter, the terms of the charter should govern).

§ 35.09 Administrative and Investment Sub-Committees

Benefits committees should be broken into at least two subcommittees, one for investment and the other for administration. The Chief Financial Officer and Treasurer usually are members of the Investment Committee, while the executives in charge of Human Resources, Compensation and Benefits, Legal, and Operations usually serve on the Administrative Committee.

§ 35.10 Meeting with the Board of Directors

As provided in the Charter, the benefits committee should meet with the Board of Directors semi-annually. In addition, the Charter should provide the benefits committee with the discretion to hold a special meeting with the Board. At the meeting, aside from certain plan-related business decisions (referred to as "settlor functions") such as establishing the benefit plan, adopting plan documents and amendments, or whether to terminate a plan, the Board should receive a report regarding the fiduciaries' actions

for the past year in order to review their performance.

§ 35.11 Best Practices for the Board of Directors: Appointment and Monitoring of Fiduciaries

The Board of Directors is responsible for appointing and monitoring fiduciaries, which requires that delegation of authority be done prudently. With respect to the appointment process, the Board of Directors should, with counsel, engage in a thorough process as to the selection of fiduciaries, which process should include assessing the potential fiduciaries' experience and qualifications. This process should be documented clearly and in detail.

With respect to the monitoring of plan fiduciaries, the Board of Directors should be provided with a report by a third party of all the major fiduciary decisions that have been made in order to assist them in making a determination as to whether the fiduciaries are performing their responsibilities as required by ERISA. This process should also be described in the minutes and, if done properly, should help to insolate the Board of Directors from claims of breach of fiduciary duty for failure to monitor the plan's fiduciaries.

If the Board of Directors desires, they may eliminate the duty to appoint and monitor fiduciaries by delegating the authority to perform this function to certain company executives or officials. Alternatively, the plan document can be amended to automatically appoint fiduciaries by their title and function within the company (e.g., "the benefits committee shall be comprised of the Chief Financial Officer, the Treasurer, and the Vice President of Human Resources").

§ 35.12 Service Providers as Fiduciaries

The DOL has proposed a rule that, upon adoption, would deem a person to be a fiduciary of an employee benefit plan under ERISA as a result of giving investment advice to a plan or its participants or beneficiaries. *See* 80 Fed. Reg. 21928 (Apr. 20, 2015). The proposal also applies to the definition of a fiduciary of a plan under Section 4975 of the Internal Revenue Code. The proposal treats persons who provide investment advice or recommendations to an employee benefit plan, plan fiduciary, plan participant or beneficiary, Individual Retirement Account (IRA), or IRA owner as fiduciaries.

The proposal's definition of fiduciary includes a wider array of advice relationships than preexisting ERISA regulations, which would be replaced upon adoption. More specifically, the types of advice that fall into the proposal's definition of fiduciary investment advice include: (i) investment recommendations, (ii) investment management recommendations, (iii) appraisals of investments, and (iv) recommendations of persons to provide investment advice for a fee or to manage plan assets. Persons who provide such advice are fiduciaries if they either represent that they are acting as a fiduciary under ERISA or provide the advice pursuant to an agreement.

The proposal includes carve-outs for persons who do not hold themselves out to be acting as ERISA fiduciaries. Subject to certain conditions, these carve-outs cover: (i) a counter-party's statements or recommendations made to a large plan investor in an

arm's length transaction, (ii) offers or recommendations to ERISA plan fiduciaries to enter into a swap that is regulated under the Securities Exchange Act or the Commodity Exchange Act, (iii) an ERISA plan employee's statements or recommendations provided to a plan fiduciary so long as the employee receives no fee beyond his or her normal compensation, (iv) marketing a platform or investment alternatives to be selected by a plan fiduciary for an ERISA participant-directed individual plan, (v) the identification of investment alternatives that meet objective criteria specified by an ERISA plan fiduciary or the provision of objective financial data to such fiduciary, (vi) the provision of an appraisal, fairness opinion or a statement of value to an ESOP regarding employer securities, to a collective investment vehicle holding plan assets, or to a plan for meeting reporting and disclosure requirements, and (vii) information and materials that constitute "investment education" or "retirement education."

PART II: ANALYSIS

§ 35.13 Fiduciary Duties

When one hears the words "fiduciary duty," one is reminded of Judge Cardozo's oft-cited description of that duty: "[a] [fiduciary] is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior." *Meinhard v. Salmon*, 249 N.Y. 458 (1928). Under ERISA, fiduciaries are required to: (i) act for the "exclusive purpose" of the plan, (ii) act with "prudence," (iii) "diversify" plan investments, and (iv) act in accordance with the "terms of the plan."

§ 35.14 The Exclusive Purpose Rule

Under the "exclusive purpose" rule, plan assets must be used only: (i) to pay plan benefits, and (ii) to pay plan expenses that are reasonable and relate only to plan activities. ERISA § 404(a), 29 U.S.C. § 1104(a). Where fiduciaries follow the express terms of the plan, there should be no violation of the exclusive purpose rule as long as those terms are in accordance with ERISA. On the other hand, were a named fiduciary to personally profit from his service as a fiduciary at the expense of a plan—by, for example, controlling a service provider that overcharges the plan for services for his own pecuniary interest—a court would most likely remove that fiduciary or force him to resign.

This duty requires that fiduciaries, at a minimum, engage in a scrupulous independent investigation of their options to insure that they act in the best interests of the plan participants and beneficiaries. *See Donovan v. Bierwirth*, 538 F. Supp. 463, 470 (E.D.N.Y. 1981), *aff'd as modified,* 680 F.d 263, 272 (2d Cir.), *cert. denied,* 459 U.S. 1069 (1982). Accordingly, there are certain circumstances that require a fiduciary to recuse himself from a particular transaction due to a conflict of interest. Recusal, under the DOL's interpretation, means to abstain from any consideration of the transaction at issue and refrain from exercising any authority, control, or responsibility with respect to the transaction at issue. However, a fiduciary who recuses himself will still have the duty to disclose to the plan material information in his possession with respect to the particular transaction. *See Barry v. Iron Workers*, 404 F. Supp. 2d 145 (D.D.C. 2005).

In explaining this duty, the DOL uses the example of where a trustee of a plan also serves as the president of a bank that is proposing to provide administrative services to the plan for a fee. The DOL regulations state that no ERISA Section 406 violation occurs if the trustee/president "absents himself from all consideration of [the Bank's] proposal and does not otherwise exercise any of the authority, control or responsibility which makes the trustee/president a fiduciary to cause the plan to retain [the Bank]." 29 C.F.R. 2550.408b-2(f)(7). The DOL has issued several advisory opinions and information letters concerning this issue and, from time to time, has granted exemptions to permit the provision of services to the plan by an entity related to a fiduciary where the conflicted fiduciary has recused himself from the decision.

§ 35.15 Prudence

Above all else, an ERISA fiduciary is required to act with the "care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in like capacity and familiar with such matters would use in the conduct of an enterprise of like character with like aims." ERISA 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B). A court faced with the issue of whether a fiduciary has acted with prudence will consider what a comparable fiduciary would have done under similar circumstances. Prudence is not measured in hindsight, whether it accrues to the fiduciary's detriment or benefit. *DiFelice v. U.S. Airways, Inc.*, 497 F.3d 410, 424 (4th Cir. 2007); *Steinman v. Hicks*, 252 F. Supp. 2d 746, 759 (7th Cir. 2003) (citing Judge Scalia as stating "'I know of no case in which the trustee who has happened—through prayer, astrology or just blind luck—to make (or hold) objectively prudent investments (e.g., an investment in a highly regarded 'blue chip' stock) has been held liable for losses from those investments because of his failure to investigate and evaluate beforehand.'") The test is not what resulted, but what actions/process did the fiduciary undertake at the time. *DiFelice, supra*; *Bunch v. W.R. Grace*, 555 F.3d 1 (1st Cir. 2009) (prudence requires considering the "totality of the circumstances").

Several courts in ERISA cases have adopted the "modern portfolio theory," ("MPT") which "teaches that an investment in a risky security as part of a diversified portfolio is, in fact, an appropriate means to increase return while minimizing risk." *DiFelice, supra*, 497 F.3d at 423. The prudence of investments or classes of investments must be reviewed individually and the plan fiduciary must prudently select and continuously monitor each investment option available in a plan. *Id*; *see also* José Martin Jara, What Is the correct Standard of Prudence in Employer Stock Cases, in NEW YORK UNIVERSITY REVIEW OF EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION § 1B.03, at 1B-29–1B-38 (Alvin D. Lurie ed., 2012) (discussing the MPT in greater detail, criticisms of the MPT, and alternative strategies).

The Supreme Court held that plan fiduciaries have a continuing obligation to monitor investments in a plan under § 401(k) of the Internal Revenue Code. In *Tibble v. Edison Int'l*, 135 S. Ct. 1823, 191 L. Ed. 2d 795 (2015), the Court held that a plan fiduciary must exercise prudence while selecting plan investments at the outset and while monitoring those investments over time. Beneficiaries of Edison International's 401(k) plan filed a claim against the employer alleging breach of fiduciary duty. Specifically, the plaintiffs alleged that the fiduciaries breached their duty by offering mutual funds with higher administrative costs than available lower-cost alternatives. The initial decision to offer some of the mutual funds referenced in the complaint occurred over six years prior to the plaintiffs' filing. The Ninth Circuit Court of Appeals denied the beneficiaries' claims, holding that ERISA bars claims based on funds that were first offered more than six years prior to filing. *See Tibble v. Edison Int'l*, 729 F.3d 1110 (9th Cir. 2013). The Supreme Court reversed the decision, asserting that the fiduciaries have a continuing duty to monitor trust investments and remove imprudent ones. When a fiduciary has breached his or her duty by failing to properly monitor investments and remove imprudent ones, a plaintiff may file a claim for breach of duty so long as the alleged breach of the continuing duty occurred within

six years of suit. *See Tibble*, 135 S. Ct. at 1828–29. However, the Court left the task of defining the scope of this continuing duty to the Ninth Circuit.

On remand, the Ninth Circuit held that the beneficiaries had forfeited their ongoing duty to monitor argument by failing to raise it before the district court or the Ninth Circuit. *See Tibble v. Edison Int'l,* 820 F.3d 1041 (9th Cir. 2016). The beneficiaries argued that their failure to raise the ongoing duty to monitor argument was due to the district court prohibiting them from doing so. The Ninth Circuit determined that the district court barred the beneficiaries from arguing about the initial decision to include the mutual funds but did not bar them from making a separate argument that the fiduciaries owed a continuing duty to monitor said funds. *Id.* at 1046-48. However, this decision was subsequently vacated and the case was granted a rehearing en banc. *See Tibble v. Edison Int'l,* 831 F.3d 1262 (9th Cir. 2016).

§ 35.16 Diversify Investments

An ERISA fiduciary also has the duty to diversify the plan's investments to minimize the risk of loss. ERISA 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C). However, investments need not be diversified when (i) it is clearly prudent not to do so, (ii) ownership of employer stock is a principal purpose of the plan, and when (iii) participants direct the investment of their own accounts. *See Nelson v. Hodowal,* 512 F.3d 347, 351 (7th Cir. 2008) ("Diversification is valuable even when each security is accurately priced by the stock market."); *Summers v. State Street,* 453 F.3d 404, 409 (7th Cir. 2006) (diversification is part of the overall duty of prudence, unless directed pursuant to an ESOP to invest in employer stock).

While ERISA generally imposes duties of care, skill, prudence, diligence and diversification upon plan fiduciaries, it exempts fiduciaries from overseeing employer stock plans or investment options from any duty to diversity such investments:

> In the case of an eligible individual account plan (as defined in Section 1107(d)(3) of this title), the diversification requirement of paragraph (1)(C) and the prudence requirement (only to the extent that it requires diversification) of paragraph (1)(B) is not violated by acquisition or holding of qualifying employer securities (as defined in Section 1107(d)(4) and (5) of this title.

29 U.S.C. § 1104(a)(2); *see Steinman v. Hicks*, 352 F.3d 1101, 1103 (7th Cir. 2003) ("Congress believing employees' ownership of their employer's stock a worthy goal, has encouraged the creation of ESOPS both by giving tax breaks and by waiving the duty ordinarily imposed on trustees by modern trust law (including ERISA . . .) to diversity the assets of a pension plan.")

§ 35.17 The Terms of the Plan

Fiduciaries are required under ERISA to act "in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with [ERISA]." ERISA 404(a)(1)(D), 29 U.S.C. § 1104(a)(1)(D). A fiduciary cannot be found liable for a breach of fiduciary duty if she follows the terms of the plan documents—again, assuming those documents are consistent with ERISA. *See Tatum v. RJR Reynolds Tobacco Co.*, 392 F.3d 636 (4th Cir. 2004) (plaintiff and

the Secretary of Labor (as amicus curie) argued that the plan fiduciaries, in divesting employer stock, had a duty to ignore the plan document if it was imprudent to sell). RJR Reynolds has since unsuccessfully petitioned the Supreme Court for certiorari. *See Tatum v. RJR Pension Inv. Comm.*, 761 F.3d 346 (4th Cir. 2014), *cert. denied*, 135 S. Ct. 2887 (2015).

When the terms of the plan require investment in employer stock, certain courts view this duty in conflict with ERISA's prudence and diversification requirements. In this regard, courts have acknowledged that there may be a time when a fiduciary must not follow the terms of the plan because investment in employer stock has become imprudent. *See Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995). On the other hand, courts have held that a fiduciary's decision to purchase or hold employer stock is exempt from the duty to diversify and related duty of prudence. *See Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243, 248 (5th Cir. 2008); *Wright v. Oregon Metallurgical Corp.*, 360 F.3d 1090, 1097 (9th Cir. 2004).

§ 35.18 Prohibited Transactions

ERISA defines certain transactions between a plan and a party in interest as "prohibited transactions." *See* ERISA § 3(14) and § 406(a), 29 U.S.C. § 1002(14) and § 1106(a). (A "party in interest" is defined as, to name a few, "a fiduciary . . . counsel, or employee of [an] employee benefit plan," "a person providing services to such plan," or an "employer . . . whose employees are covered by such plan. ERISA § 3(14)(A), (B), (C), 29 U.S.C. § 1002(14)(A),(B),(C)). Specifically, ERISA provides that a fiduciary must not allow a plan to enter into a transaction with a party in interest that will constitute a direct or indirect: (i) sale or exchange, or leasing of any property; (ii) lending of money or extension of credit; (iii) furnishing goods, services, or facilities; (iv) transfer or use of any assets of the plan; or (v) acquisition of employer security or employer real property. *See Dupree v. The Prudential Insurance Company of America,* 2007 U.S. Dist. LEXIS 57857 (S.D. Fla. Aug. 10, 2007) (discussing several prohibited transaction exemptions at great length).

For example, any arrangement for services between a plan and a service provider is a prohibited transaction under the rule that a fiduciary must prevent a plan from engaging in a transaction which he knows constitutes the furnishing of services or a transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan. ERISA 406(a)(1)(C),(D), 29 U.S.C. § 1106(a)(1)(C),(D). Given these definitions, it is difficult to understand how a plan can operate if a "prohibited transaction" is a transaction between the plan and its services providers. Fortunately, there are statutory and class exemptions that clarify the situation. *See, e.g.*, ERISA § 408(b)(2), 29 U.S.C. § 1108(b)(2) (exempting contracts with service providers if certain conditions are met, as discussed below). *See Dupree*, *supra*, 2007 U.S. Dist. LEXIS 57857 (discussing the applicability of ERISA § 408(b)(2) with respect to payment of investment management fees for investments in single client accounts).

ERISA also defines certain transactions between the plan and fiduciaries as "prohibited transactions." *See* ERISA § 406(b), 29 U.S.C. § 1106(b) (prohibiting fiduciaries from engaging in conflicts of interest). Specifically, as set forth in ERISA Section 406, a fiduciary cannot deal with the assets of the plan for his own interest,

may not participate on behalf of a party in a transaction whose interests are adverse to the interests of the plan or the plan's participants and beneficiaries, and cannot receive any kick-backs.

§ 35.19 Statutory and Class Exemptions

A major exemption from the prohibition against certain arrangements between plans and service providers is provided by ERISA Section 408(b)(2), which requires the following: (i) that the contract or arrangement is reasonable, (ii) the services are necessary for the establishment or operation of the plan; and (iii) no more than reasonable compensation is paid for the services. *See* 29 U.S.C. § 1108(b)(2); 29 C.F.R. 2550.408b-2(b)(c) and 2550.408c-2. Accordingly, if these requirements are met, then the transaction may properly occur.

In 2012, the DOL's regulations became effective on when a contract or arrangement is "reasonable" under ERISA Section 408(b)(2). *See* 77 Fed. Reg. 5632 (Feb. 3, 2012). These regulations require certain service providers to pension plans to disclose detailed information about their compensation and any potential conflicts of interest. Specifically, the regulation requires disclosure from service providers expected to receive at least $1,000 in, direct or indirect, compensation for services to a covered plan. *Id.*

In addition to the statutory exemptions, the DOL has the authority to grant class and individual exemptions, certain of which specifically relate to financial-type transactions. One of the more popular class exemptions is Prohibited Transaction Exemption (PTE) 84-14. *See* 70 Fed. Reg. 49305 (Aug. 23, 2005). It permits transactions between an investment fund managed by a qualified professional asset manager (QPAM) and a party in interest with respect to a plan participating in the fund. The asset manager must meet certain equity capital or net worth requirements to qualify as a QPAM under the exemption. The fiduciary must ensure that the asset manager qualifies as a QPAM.

In a final rule issued in 2016, the DOL expanded who is a fiduciary under ERISA by reason of providing investment advice and promulgated a new exemption to allow certain methods of compensation for retirement investment advisors. *See* 81 Fed. Reg. 20946 (Apr. 8, 2016). The regulation requires that those who give investment advice to IRAs and retirement plans become fiduciaries and abide by the fiduciary standard. The intention of the regulation is to protect investors by preventing advisors and institutions from receiving compensation that is inconsistent with the best interests of the investors.

The DOL espoused a new exemption—The Best Interest Contract Exemption (BICE)—which permits those who provide investment advice for variable compensation to continue doing so without incurring penalties under ERISA and IRS rules. The BICE requires that there be a contract between those who provide advice for variable compensation and the investor. The contract only applies to IRAs and non-ERISA retirement plans and it contains a number of warranty requirements. The BICE also requires that advisors receiving variable compensation make numerous disclosures when providing retirement investment advice. These disclosures include website disclosures, contract disclosures, and point-of-sale disclosures.

Level-fee fiduciaries have to meet fewer requirements in order to receive compensation under the BICE. Advisors who provide their services for a level fee are not required to have a contract with their investors and have fewer disclosure requirements than advisors receiving variable compensation. However, the exemption is more narrowly applied in the case of level-fee fiduciaries. The fiduciary's fees, as well as those of the supervising firm and its affiliates, must be level. The BICE does not permit third-party payments.

§ 35.20 Individual Exemptions

In addition to the foregoing, should a particular transaction not meet a statutory or class exemption, an application for individual relief may be made to the Office of Exemptions of the, EBSA, DOL. In order to grant an exemption, the DOL must find that the exemption is administratively feasible, in the interests of the plan and of its participants and beneficiaries, and protective of the rights of participants and beneficiaries of the plan.

An example of an individual exemption has involved "Auction Rate Securities," which are debt instruments or preferred stock with an interest rate or dividend that is reset at specified intervals through a Dutch auction process. *See* 79 Fed. Reg. 43069 (July 24, 2014). With respect to transactions involving ERISA Title I plans, the DOL has granted exemptions to permit (i) the sale or exchange of an Auction Rate Security by a plan to the Sponsor of such plan, or (ii) a lending of money or other extension of credit to a plan in connection with the plan's holding of an Auction Rate Security from a securities firm or any of its current or future affiliates or subsidiaries or other introducing brokers or clearing brokers, where the loan is repaid in accordance with its terms and guaranteed by the Plan Sponsor. *Id.*

§ 35.21 Personal Liability and Civil Actions

ERISA Section 409(a) exposes fiduciaries to personal liability for their breaches of fiduciary duty:

> Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries . . . shall be personally liable to make good to such plan any losses to the plan resulting from each such breach . . . .

29 U.S.C. § 1109(a).

To prove a breach of fiduciary duty, a plaintiff must establish that the defendant: (i) was a fiduciary; (ii) was acting in the capacity of a fiduciary; and (iii) acted in breach of his duties. *See Silverman v. Mutual Benefit Life Insurance Co.*, 941 F. Supp. 1327 (E.D.N.Y. 1996). Moreover, ERISA Section 502 allows only participants, beneficiaries, and fiduciaries to bring an action for violations of ERISA. 29 U.S.C. § 1102.

§ 35.22 Best Practices for Fiduciary Compliance

The best practices for fiduciary compliance include three important procedures. These procedures are using due diligence to review the plan documents, policies and procedures; carefully selecting and regularly monitoring service providers; and providing formal and continuous fiduciary training to all plan fiduciaries.

[1] Review of Plan Documents, Policies, and Procedures

A starting point for complying with ERISA's fiduciary requirements is to review the plan's governing documents. Certainly upon appointment as a fiduciary, or as soon thereafter as possible, the plan document and summary plan description ("SPD") should be reviewed and a determination should be made as to whether the plan is being operated in compliance with those documents. A determination should also be made as to whether the plan document or SPD need to be amended.

With respect to plan investments, the fiduciaries must first ascertain whether the plan has an investment policy statement ("IPS") and guidelines and, if the plan has no such statement, the fiduciaries should adopt one. If an IPS is in place, it should be reviewed in light of current economic conditions. In 1994, the DOL issued Interpretive Bulletin 94-2 encouraging plan fiduciaries to adopt written statements of investment policy. Interpretive Bulletin 94-2 also states that compliance with ERISA's prudence requirement requires maintenance of proper documentation of the activities of the investment manager and of the named fiduciaries of the plan in monitoring the investment manager.

Warning: Fiduciaries remain personally liable if they select or retain an investment manager or consultant when it is not prudent to do so. *See California Ironworkers Field Pension Trust v. Loomis Sayles in Co.*, 259 F.3d 1036 (9th Cir. 2001); *Lowen v. Tower Asset Management, Inc.*, 829 F.2d 1209 (2d Cir. 1987).

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[2] Contracting with Service Providers and Monitoring

When selecting and monitoring service providers, ERISA requires that a fiduciary have sufficient information to make informed decisions about the services, costs, and qualifications of the service provider. *See, e.g.*, Field Assistance Bulletin 2002-3 (November 5, 2002) and Advisory Opinions 97-16A (May 22, 1997) and 97-15A (May 22, 1997); *see also Abbott v. Lockheed Martin Corp.*, 2009 U.S. Dist. LEXIS 26878 (S.D. Ill. Mar. 31, 2009).

The DOL has further stated that a fiduciary must consider the proposed compensation or fees, the service provider's qualifications, and the quality of services being retained. In this regard, a fiduciary should not consider the compensation or fees to the exclusion of other factors. Thus, a fiduciary is not required to select the lowest-cost service provider, as long as the compensation or fees paid to the service provider are reasonable in light of the particular facts and circumstances. Furthermore, this analysis and review of the service provider should be done on a periodic basis and note that reliance on the advice of consultants in terms of reviewing a service provider is not a complete defense. *See George v. Kraft Foods Global, Inc.*, 641 F.3d 786, 799–800 (7th Cir. 2011) ("Although the fact that defendants engaged consultants and relied on their advice with respect to [the record keeper]'s fee is certainly evidence of prudence, it is not sufficient to entitle defendants to judgment as a matter of law.") (citing to *Keach v. U.S. Trust Co.*, 419 F.3d 626, 636–37 (7th Cir. 2005) (stating that relying on advice

from outside consultant "is not a complete defense against a charge of imprudence")); *Howard v. Shay*, 100 F.3d 1484, 1489 (9th Cir. 1996) (same); *Donovan v. Cunningham*, 716 F.2d 1455, 1474 (5th Cir. 1983) (stating that "[a]n independent appraisal is not a magic wand that fiduciaries may simply waive over a transaction to ensure that their responsibilities are fulfilled"); *Donovan v. Bierwirth*, 680 F.2d 263, 272 (2d Cir. 1982) (stating that soliciting outside advice does not operate as a "complete whitewash" which, without more, satisfies ERISA's prudence requirement).

In 2005, the Securities and Exchange Commission ("SEC") and the DOL issued a document entitled "Selecting and Monitoring Pension Consultants—Tips for Plan Fiduciaries," which includes a model questionnaire to be sent to proposed service providers. The questionnaire was designed to solicit more information about conflicts of interest and includes the following questions:

— If you are hired, will you acknowledge in writing that you have a fiduciary obligation as the plan's investment advisor while providing the consulting services being sought?

— Do you consider yourself a fiduciary under ERISA with respect to recommendations you provide the plan?

Of course, after a service provider is hired, at some point the fiduciaries may decide to change service providers. Fiduciaries have a duty to continue to monitor service providers and, if the fiduciaries subsequently discover that the services are below expectations or that the provider is overcharging the plan, the fiduciaries would not only be justified in changing the service provider at that time but arguably would be required to do so or be in breach of their own fiduciary duties.

With respect to "Ponzi" schemes, a fiduciary may be held liable for causing losses to a plan by failing to take precautionary steps to limit a service provider's ability to embezzle assets from the plan. *See Chao v. Merino,* 452 F.3d 174 (2d Cir. 2006) (fiduciary was aware that service provider had previously embezzled funds). The DOL's Office of Inspector General ("OIG") has concluded that further oversight and adequate assurances are required to ensure fiduciaries are meeting their duties in connection with investments in hard-to-value alternative investments to avoid such Ponzi schemes. *See OIG Report at 18–19*, http://www.oig.dol.gov/public/reports/oa/2013/09-13-001-12-121.pdf. OIG specifically opined that

> "plan management need[s] to establish an accounting and financial reporting process for determining the fair value measurements and disclosures, select appropriate valuation methods, identify and adequately support any significant assumptions used, prepare the valuation, and ensure that the presentation and disclosure of the fair value measurements are in accordance with the [Generally Accepted Accounting Principles]." *Id.* at 15.

Should you find yourself in the unfortunate circumstance of being swindled, the events relating to Bernard Madoff and investments with BLMIS prompted the DOL to provide guidance on what to do if plan assets were invested in the Ponzi scheme. The DOL advised that fiduciaries shall take the following steps: (1) request disclosures from investment managers, fund managers, and other investment intermediaries

regarding the plan's potential exposure to investments at risk; (2) seek advice regarding the likelihood of losses; (3) make appropriate disclosures to other plan fiduciaries and the participants and beneficiaries; and (4) consider whether the plan has a claim that will reasonably lead to recovery of [Ponzi scheme]-related losses. *See Statement of EBSA—"Duties of fiduciaries in Light of recent Events Regarding Bernard L. Madoff investment Securities LLC"* found at http://www.dol.gov/ebsa/pdf/madoffguidance.pdf.

Fiduciaries are also required to know all of the expenses that are being paid by the plan, directly or indirectly, and to determine if they are reasonable (i.e., whether the expense is competitive in the marketplace and whether the plan and its participants receive value commensurate to the cost). 29 U.S.C. §§ 404(a)(1)(A)(ii), 406(a) (1) (C), and 408(b) (2). Fiduciaries are not required to choose the least expensive services," . . . 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." *See* www.dol.gov ("A Look at 401(k) Plan Fees"). Fiduciaries should be provided with written disclosure of all compensation and other payments, direct or indirect, related to the investments being recommended.

In 1996, the Advisory Council to the DOL's Working Group on Service Providers drafted representative types of questions to which fiduciaries should seek answers to satisfy their obligations as fiduciaries under ERISA. We believe these questions provide reasonable guidance to help fiduciaries comply with their obligations under ERISA and we have, therefore, included them in the Appendix to this Chapter.

[3] Fiduciary Training

Plan fiduciaries should have formal and continuous fiduciary training. In fact, during DOL investigations, when government officials interview plan fiduciaries, one question that is guaranteed to be asked is whether the fiduciary can describe what she thinks are her fiduciary duties under ERISA.

Additionally, fiduciary training is extremely useful given that ERISA, a complicated law to begin with, is constantly evolving and that litigation in this area is at an all time high. The ability to detect issues and know when to consult with trusted advisors is critical. Detecting fiduciary issues early can help prevent lawsuits and government investigations. In addition, with counsel, a breach may be detected and corrected thorough the DOL's Voluntary Fiduciary Correction Program or the Delinquent Filer's Voluntary Correction Program.

Accordingly, fiduciaries should be aware of EBSA's interactive website—the "ERISA Fiduciary Advisor"—created to increase the awareness and understanding of basic fiduciary responsibility in managing a retirement plan. *See* http://www.dol.gov/elaws/ERISAFiduciary.htm. Subsequent and ongoing fiduciary training is also advisable and can be structured so as to increase the scope and complexity of the topics covered including, but not limited to, the following: the roles of the sponsor, administrator, management, and service providers; the basics of trust law; effective decision making; basic administrative operations and processes; distribution issues; asset classes and their characteristics; historical risk and returns; investment tolerance;

diversification and asset allocation; and performance measurement.

Fiduciaries should also be aware of the IRS Employee Plans Compliance Resolution System (EPCRS). The system provides guidance to fiduciaries in the event of an error made in the process of plan maintenance. The EPCRS also offers useful guidance on how to avoid the consequences of plan disqualification. Disqualification affects employees, employers, and the plan's trust. For employees, the major consequence of disqualification is the requirement to include in income any employer contributions made to the trust for his or her benefit in the calendar years the plan is disqualified. For employers, disqualification results in limited tax deductions. Disqualification may result in the plan's trust losing its tax-exempt status and becoming a nonexempt trust. A disqualified plan also results in the trust owing income taxes on earnings.

There are three ways to correct mistakes under the EPCRS in order to avoid disqualification: (i) Self-Correction Program, (ii) Voluntary Correction Program, and (iii) Audit Closing Agreement Program. The Self-Correction Program permits a plan sponsor to correct plain failures without contacting the IRS or paying a fee. The failures that may be corrected through this program are limited to operational issues, that is failure to follow the terms of the plan. The program is not available for problems with the plan document, such as the failure to keep it current in regards to changes in the law. A qualified plan sponsor may correct failures within two years of the end of the plan year in which the failures occurred.

The Voluntary Correction Programs requires a plan sponsor to make a submission to the IRS that: (i) includes completed application and fee compliance forms, (ii) identifies the mistakes, (iii) proposes corrections using the general principles provided in the revenue procedures, (iv) proposes changes to ensure that mistakes do not recur, (v) pays a compliance fee, and (vi) may include electronic pre-formatted model documents and acknowledgement letters. After conducting a review, the IRS will issue a statement detailing mistakes identified by the plan sponsor and the correction methods approved by the IRS. The plan sponsor then has 150 days to correct the identified mistakes. While the IRS processes the submission, employee plans may not be audited, except under certain circumstances.

The Audit Closing Agreement Program requires that when the plan sponsor or plan is under audit, the sponsor: (i) enters into a closing agreement with the IRS, (ii) makes the necessary corrections prior to entering into the agreement, and (iii) pays a sanction negotiated with the IRS.

The IRS has modified the EPCRS in its promulgation of Rev. Proc. 2015-27, 2015-16 I.R.B. 914. These changes are meant to improve various aspects of the EPCRS, such as reducing the Voluntary Correction Program compliance fees and clarifying correction rules for overpayments made to participants. Other changes include a new acknowledgement letter form and other model document changes, miscellaneous modifications to correction rules and revision of citations and cross references, and modifications to the Self-Correction Program for IRC 415(c) failures.

The IRS has also modified the EPCRS through Rev. Proc. 2015-28, 2015-16 I.R.B. 920. The modifications provide new safe harbor correction methods and an alternative

method for calculating Earnings for Employee Elective Deferral Failures under 401(k) and 403(b) plans.

PART III: ERISA LITIGATION AND RISK MANAGEMENT

§ 35.23 Common Claims

The following in a non-exhaustive list of the type of ERISA cases being filed, many of which are being filed as class actions: (i) "stock drop" cases (alleging that employer stock is an imprudent investment option and/or inadequate disclosure concerning the employer's financials, as discussed in detail below), (ii) fee cases (alleging that it was imprudent for the fiduciaries to select certain funds because the fees were too high), (iii) merger and acquisition cases (alleging that participants lost benefits as a result of a merger or acquisition), (iv) early retirement benefits cases (alleging that participants were misled into accepting early retirement and received fewer benefits as a result), (v) cash balance cases (alleging that the participant's benefit decreased when his account was transferred from a traditional plan to a cash balance plan), (vi) discrimination/ retaliation cases (alleging that the participant was retaliated against for claiming benefits), (vii) retiree health benefits cases (alleging that the participant did not received the promised health benefits), and (viii) cases alleging that fiduciaries engaged in prohibited transactions, had a conflict of interest, and/or breached their fiduciary duties.

§ 35.24 Settlements

ERISA litigation is at an all time high and plaintiff's counsel have become more sophisticated in pleading violations of ERISA. Over the past decade settlements in cases involving the investment of employer stock as an investment option within the 401(k) plan have alone totaled over a billion dollars. José Martin Jara, *What Is the Correct Standard of Prudence in Employer Stock Cases*, 45 J. Marshall L. Rev. 541 (2012), *reprinted at* NEW YORK UNIVERSITY REVIEW OF EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION § 1B.01, AT 1B-5–1B-6 (Alvin D. Lurie ed., 2012). Furthermore, through investigations conducted by the DOL in enforcing ERISA, the total recoveries for fiscal year 2015 totaled $696.3 million. *See* DOL Fiscal Year 2015 Fact Sheet, *available at* https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/ebsa-monetary-results.pdf. Some recent notable settlements include Boeing's $57 million settlement of a suit brought by a class of plaintiffs alleging excessive fees and 401(k) mismanagement in violation of fiduciary duties under ERISA. *See Spano v. Boeing Co.*, No. 06-cv-743-NJR-DGW (S.D. Ill. Nov. 5, 2015). Novant Health settled a similar class action for $37.95 million, in addition to owing the plaintiffs affirmative relief of $69 million. *See Kruger v. Novant Health, Inc.*, No. 1:14-cv-00208 (M.D.N.C. Nov. 9, 2015). Lockheed Martin Corp. was also involved in a suit alleging that the company was passing on excessive fees to its employees in its management of 401(k) plans. *See Abbott v. Lockheed Martin Corp.*, No. 3:06-cv-701 (S.D. Ill. July 20, 2015). In that case, the defense contractor settled the allegations for $62 million.

A decision to settle a case on behalf of a plan is a fiduciary act subject to all of the fiduciary duties and responsibilities under ERISA. PTE 2003-39 68 FR 75632, 75635.

It is important for fiduciaries to engage in prudent processes, and document such processes, in reaching a decision as to whether or not to sue or whether to settle a claim on behalf of a plan. 29 U.S.C. § 1104.

Settlements authorized by fiduciaries must be reasonable, in light of the plan's likelihood of full recovery, the risks and costs of litigation, and the value of claims foregone. Such settlements must be no less favorable to the plan than comparable arm's-length terms and conditions that would have been agreed to by unrelated parties in similar circumstances. In addition, the transaction must not be part of an agreement, arrangement or understanding designed to benefit a party in interest. PTE 2003-39, Application No. D-11100, in 68 Fed. Reg. 75632, 75635 (Dec. 31, 2003). How these factors are weighed by fiduciaries will differ, depending on the type of case, but will always require a prudent decision-making process, given the facts and circumstances of the particular situation. PTE 2003-39; 68 FR 75632, 75636.

When plan fiduciaries enter into settlement agreements on behalf of plans which are suing such entities as the employer or an investment provider, those entities are normally "parties in interest" (*i.e.*, related to the plan under ERISA and DOL regulations). It is the DOL's view that a potential claim or "chose in action" is a type of property and that a plan's release of its claim against such party in interest may constitute a prohibited sale or exchange with the plan, as well as a prohibited transfer or use of plan assets for the benefit of a party in interest. *See* DOL Opinion Letter 95-26A. On the other hand, there are many situations in which a plan settles litigation which may not give rise to a prohibited transaction or may otherwise be covered by an existing statutory or administrative exemption. For example, settlement with a service provider of a dispute related to the provision of services or incidental goods to the plan that is otherwise exempt under ERISA 408(b)(2) would not be considered a prohibited transaction by the DOL. *See* DOL Opinion Letter, 95-26A.

One court examined the issue of whether an administrator of a self-insured health plan breached his fiduciary duty by failing to bring suit against the employer for failure to pay claims. *Herman v. Mercantile Bank NA*, 137 F.3d 584 (8th Cir. 1998), *as amended*, 1988 US App. LEXIS 7496 (8th Cir. 1988). The court held that in order to find that a fiduciary breached its duty for failure to pursue a lawsuit, the court must find that the lawsuit would be successful and advantage the beneficiaries of the plan. The court also took into consideration the length of time it would take for the lawsuit to benefit the plan. *Id.* at 587.

With respect to the DOL's view that the exemption provided in Section 408(b)(2) may cover an exchange of property made solely to resolve claims arising out of the performance of an underlying service arrangement, the DOL notes that this exemption would *only* apply if:

> (1) the underlying service arrangement giving rise to the party in interest relationship is exempt under Section 408(b)(2) and the underlying arrangement continues to meet the requirements of Section 408(b)(2), after taking into account—
>
> (a) the settlement itself,

(b) the alleged conduct of the service provider which gave rise to the claim, and

(c) the following additional factors where the nature of the alleged conduct makes their consideration appropriate—

(i) the service provider's ability to provide adequate assurances that the alleged conduct which gave raise to the claims and similar conduct will not occur in the future, *including, where relevant, the service provider's willingness to acknowledge intentional wrongdoing or negligence*, and

(ii) the plan fiduciaries' ability to guard against the opportunities for any future abuse that may be inherent in the party in interest relationships between the settling parties and the plan;

(2) the party in interest relationship arises solely from service arrangements that are exempt under Section 408(b)(2); and

(3) the settlement is a reasonable arrangement from the point of view of the plan in that the plan fiduciaries have prudently determined that the plan will receive payment in the settlement that is at least equal to the value of the plan's claims considering the risks of litigation. DOL Advisory Opinion 95-25A.

§ 35.25 Fidelity Bond

ERISA generally requires every person who "handles" plan assets to be bonded, i.e., those who, with respect to plan assets, have the authority to sign checks, endorse instruments, or disburse funds. The purpose of the bond is to protect against misappropriation by persons handling plan assets and, generally, the amount required must not be less than 10% of the funds handled. ERISA § 412, 29 U.S.C. § 1112. Under 29 CFR § 2580.412-11, the bond must insure those who handle funds, from the first dollar of loss up to the maximum amount that can be purchased with plan assets is $500,000 per plan. In the case of a plan with employer securities, the maximum amount that can be purchased with plan assets is $1,000,000. *See* Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (2006). Additional bonding above the $500,000 or $1,000,000 can be purchased using other assets not coming from the plan such as assets of the plan sponsor.

The fidelity bond may not have a deductible, as in a fiduciary liability policy. However, based on the DOL regulation and guidance, fidelity bonds can have a deductible but only after exhausting the required maximum amount (i.e., the $500,000 or $1,000,000 amount, whichever is applicable). *See* 29 CFR § 2580.412-11 and *DOL Field Assistance Bulletin No. 2008-04—Guidance Regarding ERISA Fidelity Bonding Requirements.*

Cyber-related threats are a growing concern for retirement plan fiduciaries. Plan participants entrust fiduciaries with a volume of personal information, and it is prudent for fiduciaries to consider and react to cyber risks and the threats they pose to plan participants. Although much of this personal information may be handled by record keepers and third-party administrators, fiduciaries may still be held liable for cyber-attacks on plans and their participants. Fiduciaries have options to mitigate the risks of cyber threats to their investors. While traditional commercial general liability

and property insurance may provide some protection, plan sponsors and administrators should consider obtaining cyber and privacy insurance to fill any potential gaps. The Support Anti-Terrorism by Fostering Effective Technologies (SAFETY) Act of 2002 might also provide protection to plan sponsors and administrators. *See* 6 USC 441-444. Plan sponsors and administrators can have their cyber security policies SAFETY Act approved and require that third-party administrators hold SAFETY Act approved protections. Obtaining SAFETY Act approved protections can provide presumptive evidence that cyber security programs are reasonable and that sponsors and administrators exercised their fiduciary duties.

§ 35.26 Fiduciary Liability Insurance

Obtaining fiduciary liability insurance—and at the proper amounts (a "tower" of insurance)—is a major risk management tool that ERISA fiduciaries must consider. These policies provide Directors and Officers type insurance coverage, in that they protect directors, officers, and executives from allegations of breach of fiduciary duty under ERISA. In addition, these policies provide protection in connection with administrative errors and omissions in the day-to-day operation of a plan.

ERISA § 410 (29 U.S.C. § 1110) provides, in part, that a plan can purchase insurance for its fiduciaries or for itself to cover liability or losses occurring by reason of the act or omission of a fiduciary, if such insurance permits recourse by the insurer against the fiduciary in the case of a breach of fiduciary obligation by such fiduciary.

Understanding how these policies are triggered is crucial to understanding whether the plan and its fiduciaries will be adequately protected. The typical fiduciary policy provides the following terms and conditions, which should be thoroughly analyzed at least no later than the moment an allegation of misconduct or breach of duty is made against a fiduciary.

- Insuring Clause

The insuring clause provides, in part, that the Insurer shall pay all sums it becomes legally obligated to pay as damages on account of any claims made during the Policy Period as a result of any actual or alleged breach of fiduciary duty committed by any Insured.

- Defense Costs Coverage

These policies usually permit the Insured to select counsel from a list of approved law firms and require that the Insurer pay for defense fees and costs after the retention/deductible has been satisfied.

⊠ **Strategic Point:** Prior to deciding which insurance company to buy coverage from, it is important to find out which law firms are approved by the insurance companies being considered. If a particular firm is preferred by the plan and its fiduciaries and it is not on an insurance company's "approved" list, the fiduciaries may attempt to negotiate the addition of that law firm through a special endorsement to the Policy.

• Definition of "Claim": may include a written demand for monetary or non-monetary relief; civil, criminal or arbitration proceeding commenced by service of a complaint, return of an indictment or receipt or filing of a notice of charges; formal agency or regulatory proceeding; or an informal or fact finding investigation.

• Definition of "Insured": may include any "Natural Person Insured," which are past, present or future directors, officers, and/or employees of the sponsoring organization in their capacity as fiduciaries, administrators or trustees of a covered plan, any plan, or the sponsor organization.

• Definition of "Wrongful Act": may include a violation of any of the responsibilities, obligations or duties imposed upon fiduciaries by ERISA or similar law; any matter claimed against an Insured solely by reason of his, her or its status as a fiduciary; any act, error or omission solely in the performance of counseling employees, participants and beneficiaries, providing interpretations, handling records, and activities affecting enrollment, termination or cancellation of employees, participants and beneficiaries.

• Definition of "Loss": may include, damages, judgments, settlements and defense costs; certain civil penalties (ERISA § 502(l), (i), or (c) penalties); certain penalties under the IRS or DOL amnesty programs. Excluded from the definition of loss are: other penalties, taxes, uninsurable matters, benefits

• Exclusions: Some of the more common exclusions under these policies are: dishonesty or personal profit by insured; knowing or willful (or reckless) violation of any statute, rule, or law; criminal or deliberate acts; claims or notice of circumstance reported to prior insurers; pending or prior litigation or investigations; failure to collect contributions owed to a plan; failure to fund a plan in accordance with ERISA; failure to procure, maintain, or renew adequate insurance; failure to comply with workers' compensation, unemployment, social security and similar laws; bodily injury/property damage; discrimination (except in violation of ERISA); and Insured versus Insured.

§ 35.27 Indemnification

In addition to fiduciary liability insurance, an employer (i.e., the plan sponsor) may want to provide indemnification to its officers and executives who are designated fiduciaries of the company's retirement plans. However, the decision to do so requires that the agreement be carefully drafted since its validity and enforcement will rest on the language and interpretation of the agreement. *See generally, Flood v. Clearone Communs., Inc.,* 618 F.3d 1110 (10th Cir. 2010) (the Tenth Circuit acknowledged that invoking a contractual condition to an indemnification agreement required good faith, but stated that "good faith isn't susceptible to mathematical proof.").

ERISA Section 410 provides that: "[a]ny provision in an agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation, or duty under this part shall be void as against public policy." The DOL ruled that this section would void any arrangement that provides for indemnification of a fiduciary by the retirement plan itself, because the plan will not have any recourse against the fiduciary. *See* 29 C.F.R. Section 2509.75-4. However, the DOL stated that Section 410 would allow an employer to indemnify a fiduciary. *Id.*

The following are required under any ERISA indemnification agreement:

- The agreement specifically must exclude indemnification if the fiduciary is found to have breached his or her fiduciary duties; and
- The agreement expressly states that the fiduciary if advanced fees to defend a breach of fiduciary duty claim and later found to be in breach, he or she must reimburse the employer the fee advanced.

See Harris v. Greatbanc Trust Co., 2013 U.S. Dist. LEXIS 43888 (Mar. 15, 2013).

Other considerations in indemnifying fiduciaries are:

- Whether the fiduciary should pay for his or her defense and if found not guilty of a fiduciary breach, then the employer will reimburse the fiduciary for the costs of defending the lawsuit; or
- Whether the employer will advance fees to fund the litigation prior to a final determination (*See Moore v. Williams*, 902 F. Supp. 957 (N.D. Iowa 1995) (court upholding an ERISA indemnification agreement which provided for the advancement of fees).

§ 35.28 Employer Securities and Stock Drop Cases

Increasingly, companies are being named as defendants by plaintiffs' counsel in what are known as employer or company "stock drop" class action lawsuits. These lawsuits—which tend to allege violations of both the federal securities laws and ERISA—continue to be filed in part because participants are still investing a large percentage of their retirement savings in employer stock, despite the well publicized losses in retirement savings accounts held in the Enron and Worldcom plans.

Indeed, as discussed above, ERISA specifically authorizes and promotes such employee ownership mechanisms. An employer may sponsor an ESOP consisting exclusively or primarily of employer stock, and the plan fiduciaries are relieved of the ordinary requirement of diversification. Similarly, there is no diversification requirement with respect to plan investments in qualified employer securities in a 401(k) plan offering a number of other investment options and allowing participants to direct and change their own investments in them. *See* 29 U.S.C. §§ 1104(a)(2) and 1107(a)(2).

Over the past few years there has been an explosion of ERISA fiduciary litigation in response to adverse corporate news, and it is likely to increase given the current economic climate. The cases arise in a number of different circumstances—from the alleged fraud and insider self-dealing of the Enron executives to cases where the company simply suffers a decline in stock value due to business and market conditions. A leading plaintiff's firm maintains a website, www.erisafraud.com, identifying companies it has sued or is suing, as well as others under investigation.

In virtually all of these cases, the plaintiff makes two sets of allegations. First, the plaintiffs allege that those responsible for overseeing the ESOP or the investment options in a 401(k) plan failed in their fiduciary obligation under ERISA to diligently evaluate whether company stock was a prudent investment for the plan. Second, in most of the cases, plaintiffs allege, much like in a securities case, that corporate

insiders failed to disclose material adverse information about the company, thereby permitting the plan and its participants to acquire stock at "artificially inflated prices."

In a "game changing" stock drop case, the Supreme Court ruled in 2014 that "the law does not create a special presumption favoring ESOP fiduciaries. Rather, the same standard of prudence applies to all ERISA fiduciaries, including ESOP fiduciaries, except that an ESOP fiduciary is under no duty to diversify the ESOP's holdings." *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459, 2467, 189 L. Ed. 2d 457, 468 (2014). The Court held that ESOP fiduciaries are not required to act based on inside information that violates securities laws. The holding also requires lower courts to consider how obligations under ERISA to refrain from certain actions may conflict with insider trading and disclosure laws.

While the previous presumption of prudence for ESOP fiduciaries is gone, not all is lost. The Court held that courts must consider the consequences of stopping purchases and disclosing information in order to analyze whether such actions would cause more harm than good. Fiduciaries may rely on the market price of publicly traded stock as an estimate of the stock's value when evaluating the prudence of investing a plan in company stock. The Court held that "allegations that a fiduciary should have recognized from publicly available information alone that the market was over- or undervaluing the stock are implausible as a general rule, at least in the absence of special circumstances." *Id.* at 2471. Fiduciaries are not required to "perform an action—such as divesting the fund's holdings of the employer's stock on the basis of inside information—that would violate the securities laws." *Id.* at 2472. "To state a claim for breach of the duty of prudence on the basis of inside information, a plaintiff must plausibly allege an alternative action that the defendant could have taken that would have been consistent with the securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it." *Id.*

Courts have extended this requirement to closely held corporations as well. *See Hill v. Hill Bros. Constr. Co.*, 2016 U.S. Dist. LEXIS 40225 (N.D. Miss. Mar. 28, 2016). For the first time, a district court applied the *Fifth Third* pleading standard to an employer stock drop claim regarding plans sponsored by closely held corporations. The court noted that, in *Fifth Third*, the Supreme Court did not outline situations that are specifically relevant for closely held corporations. *Id.* at 16. However, the court determined that this did not "necessarily preclude the application of the alternative action pleading standard to closely-held entities." *Id.* The court went on to apply the standard to the plaintiffs' claims. The court held that "in order to state a claim for breach of the fiduciary duty of prudence, the Plaintiffs must plausibly allege an alternative action that the Defendants could have taken consistent with securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than help it." *Id.* at 20. The court dismissed the case for two reasons. First, the court determined that the plaintiffs had not "pled an alternative action the fiduciaries could have taken that a prudent fiduciary in the same situation would not have viewed as more likely to harm the fund than to help it." *Id.* at 26. Second, the plaintiffs "failed to plead a causal connection between the alleged breach

of the duty of prudence and the losses that occurred." *Id.* at 26–27.

§ 35.29 Typical Impediments to Recovery

Case law suggests that there are certain impediments to succeeding on a claim for breach of fiduciary duty based on alleged imprudence in offering employer stock in an Eligible Individual Account Plan ("EIAP") or ESOP, or in failing to disclose adverse information about the company. Certain Circuits have not ruled directly on the issue of whether a fiduciary has an affirmative duty to disclose nonpublic corporate developments that might affect the value of the employer stock to plan participants. However, the Second Circuit has held recently that this requirement is not one of the disclosure requirements explicitly provided under ERISA, and that it would be inappropriate to infer such a duty from the general fiduciary provisions of ERISA (duty of loyalty and prudence). *See Gray v. Citigroup Inc. (In re Citigroup ERISA Litig.)*, 662 F.3d 128 (2d Cir. 2011), *cert. denied*, 184 L. Ed. 2d 296 (2012).

§ 35.30 The Presumption of Prudence

In light of ERISA's express exemption of EIAPs and ESOPs from the requirements of diversification, it was previously unclear whether a fiduciary may ever be held liable for losses in company stock investments in an EIAP or ESOP. *Wright v. Oregon Metallurgic Corp.*, 360 F.3d 1090, 1097–98 (9th Cir. 2004). Although a number of appellate courts had held that liability can attach, they were nonetheless in agreement that company stock investments were to be deemed presumptively prudent. *Kuper v. Iovenko*, 66 F.3d 1447 (6th Cir. 1995); *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995). Under these cases, to rebut the presumption of prudence required that "the plaintiff must show that the ERISA fiduciary could not have believed reasonably that continued adherence to the [plan's terms] was in keeping with the settl[o]r's expectations of how a prudent trustee would operate." *Moench*, 662 F.3d at 571.

These cases also suggested that the presumption of prudence may be overcome only by showing that fiduciaries knew of events calling into serious question the viability of the company and the prospects that there would be any long-term value in the employer stock. *See, e.g., Moench*, 62 F.3d at 572 (presumption may be overcome where fiduciaries know that company's financial situation "is seriously deteriorating and there is a genuine risk of insider self-dealing."). A number of courts had resisted any hard-and-fast pronouncements about the particular circumstances in which the presumption may be overcome, but they had done so principally because the cases have been before them on motions to dismiss, without any developed factual record. *See, e.g., Lalonde v. Textron, Inc.*, 369 F.3d 1 (1st Cir. 2004). However, not every Circuit had adopted the *Moench* presumption and those Circuits that did adopt the presumption were not clear as to what stage of the litigation the presumption applies. *See*, José Martin Jara, *What Is the correct Standard of Prudence in Employer Stock Cases*, in NEW YORK UNIVERSITY REVIEW OF EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION § 1B.04–§ 1B.04, at 1B-39–1B-61 (Alvin D. Lurie ed., 2012) (discussing the presumption and the conflict among the Circuits).

The Supreme Court has since eliminated the presumption of prudence for ESOP fiduciaries, effectively abrogating the aforementioned cases in this subsection. In *Fifth*

Third Bancorp v. Dudenhoeffer, 134 S. Ct. 2459, 189 L. Ed. 2d 457 (2014), former employees and retirement plan participants filed a class action suit claiming that their employer's plan fiduciaries had breached their duty of prudence in violation of ERISA. The ESOP fiduciaries had invested in the employer's stock, and prices of said stock plummeted over a two-year period. The employees claimed that the stock was overpriced, the investment was overly risky based on public, and insider information available to the fiduciaries, and the fiduciaries should have taken action in response to such a risky investment. The Sixth Circuit had concluded that the ESOP fiduciaries were entitled to a presumption of prudence. However, the Supreme Court reversed and remanded, holding that no such special presumption is due to ESOP fiduciaries. The Court also held that only one difference exists between ESOP and other ERISA fiduciaries, the difference being that ESOP fiduciaries are not liable for losses that result from a failure to diversify assets.

Furthermore, the Court stated that, in the absence of special circumstances, allegations that a prudent fiduciary acting on publicly available information should have recognized that the market improperly valued stock are "implausible as a general rule." *Id.* at 2471. In instances concerning acts based on inside information, the Court imposed on plaintiffs the requirement to "plausibly allege an alternative action that the defendant could have taken that would have been consistent with the securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it." *Id.* at 2472. Although the presumption of prudence is gone, the case offers at best a mixed victory for plaintiffs. Absent insider information, opportunities to assert viable claims will depend on a plaintiff's ability to plead special circumstances. In cases involving insider information, the Court has instructed lower courts to consider how the fiduciary's actions are consistent with federal securities laws. Lower courts must also consider how alternative courses of action could have done more harm than good to the fund.

§ 35.31 The Requirement of Causation

The language of ERISA Section 409(a), permitting recovery from a fiduciary of losses, specifically requires that such losses *result from* a breach of his or her fiduciary responsibilities, requiring as a condition for imposing monetary liability that the breach alleged be the proximate cause of a loss to the plan. Several courts have applied the loss causation standard in securities fraud cases set forth by the Supreme Court in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005), to ERISA cases. *See In re Boston Scientific Corporation ERISA Litigation*, 254 F.R.D. 24 (D. Mass. 2008); *Bendaoud v. Hodgson,* 578 F. Supp. 2d 257 (D. Mass. 2008); *but see In re Cardinal Health Inc. ERISA Litigation,* 424 F. Supp. 2d 1002 (S.D. Ohio 2006) (holding that *Dura's* loss causation requirements applicable in cases of securities fraud does not apply in the context of ERISA claim for breach of fiduciary duty based on material misrepresentation and/or failure to disclose material information). In *Dura*, the Supreme Court held that to recover for securities fraud based on an allegation that the plaintiff purchased stock whose price was "artificially inflated" by misrepresentation, the plaintiff must be able to link the misrepresentation to a drop in the stock price after purchase.

The causation requirement is important in ERISA stock drop cases. Loss must be measured starting from the time of the alleged breach. Further, the measure of recovery will depend on what the court determines a prudent and loyal fiduciary should have done, and that the defendants did not do, at a particular point in time. If the prudent action was to have closed a stock fund to new investments at a particular time, subsequent losses on holdings in the fund as of that date would not be recoverable because that loss is not attributable to the breach. As noted above, losses based on fraud type theories of fiduciary breach are similarly limited.

The only case where losses on the existing holdings in company stock would be found to have "resulted from" a breach of fiduciary duty is where the breach was in the failure to liquidate existing holdings of company stock. However, this would be difficult to prove as the presumption of prudence would apply Furthermore, usually employer stock funds are established in accordance with the plan documents (such as ESOPs), which may additionally provide that the participants, rather than the fiduciaries, are entitled to direct their own investments. Thus, liability pre-supposes that the fiduciary should have overridden the plan's clear terms. Fiduciaries who override plan terms in that fashion may well be violating ERISA, and could be subject to liability for such action. *See Tatum v. RJR Reynolds Tobacco Co.*, 392 F.3d 636 (4th Cir. 2004).

§ 35.32 Best Practices: Risk Management Against Employer Stock Drop Cases

Defending and ultimately resolving an employer stock drop class action lawsuit can be quite costly. Furthermore, these cases are disruptive to the company's business as, more often than not, the company's directors and officers are named in the lawsuit. In this regard, fiduciaries and plan sponsors should make an assessment as to whether the employer stock fund is a viable and appropriate investment. This would entail an analysis of the employer stock itself as well as how it mixes in with the entire investment portfolio.

After reviewing the employer stock fund, fiduciaries should implement separate and specifically tailored procedures for managing the fund. Fiduciaries should also be aware that directed trustees have a duty to investigate if they notice a "red flag" of misconduct. *See Pugh v. Tribune*, 521 F.3d 686, 699 (7th Cir. 2008). In addition, should a fiduciary find that he or she is in a conflict, he or she may then make a determination as to whether an independent fiduciary should be retained to temporarily manage the fund.

Fiduciaries who retain an independent fiduciary must consider the same factors used when retaining any other service provider. It should be clear that the independent fiduciary is to opine on the viability of the employer stock and execute its autonomous determination as to whether to retain or sell the employer stock. *See Bunch v. W.R. Grace & Co.*, 555 F.3d 1 (1st Cir. 2009).

The language in the plan document must be reviewed carefully. Some courts had previously held that plans that mandate the investment in employer stock lessen the likelihood of an abuse of discretion on the part of the plan's fiduciaries. *See Gray v.*

Citigroup Inc. (In re Citigroup ERISA Litig.), 662 F.3d 128, 138 (2d Cir. 2011), *cert. denied*, 184 L. Ed. 2d 296 (2012) We endorse the "guiding principle" recognized in Quan that judicial scrutiny should increase with the degree of discretion a plan gives its fiduciaries to invest. *See Quan*, 623 F.3d at 883 (citing *Kirschbaum*, 526 F.3d at 255 & n.9). However, the Supreme Court has rejected this notion along with the presumption of prudence for fiduciaries managing plans that mandate investment in employer stock. *See Fifth Third Bancorp*, 134 S. Ct. at 2467.

Employers will rightfully lament the loss of the presumption of prudence. The presumption had previously been a helpful and cost-saving litigation tool for fiduciaries defending stock drop claims. Notwithstanding the Court's rejection of the presumption, the *Fifth Third Bancorp* decision heightened the pleading standard plaintiffs must meet to make a viable claim. When asserting claims based on a fiduciary's possession of non-public information, a plaintiff must be capable of showing alternatives the fiduciary legally could have taken to avoid losses. *Id.* at 2472. A plaintiff must also show that a similarly situated fiduciary acting prudently could not have believed such alternatives would be more likely to harm the plan. *Id.* Fiduciaries may rely on the public market as an estimate of the stock's value for claims based on public information. *Id* at 2471.

Plan fiduciaries must continue to review investments in company stock, and this may involve reexamining the purpose of company stock in the plan. Fiduciaries should formally review the company stock option during committee meetings, and determinations of prudence should be documented in the meeting minutes. *See id.*

After this process, the fiduciaries need to decide what, if any, communications should be made to the plan participants. Under ERISA, fiduciaries must disclose material facts regarding the risks attendant to an employer stock fund. *See*, *Anweiler v. American Electric Power Service Corp.*, 3 F.3d 986, 991–992 (7th Cir. 1993).

Lastly, fiduciary liability insurance should be obtained (or, if already obtained, reviewed) to ensure that the plan and its fiduciaries are adequately protected against loss.

§ 35.33 Plan Fees and Expenses

Since 2006, there has been an increased focus by plaintiff's lawyers, the DOL, and Congress on fee arrangements for 401(k) plans, leading to a flurry of litigation and proposed regulatory and legislative activity. Numerous class action lawsuits involving Fortune 100 companies, privately held companies, and even higher education institutions, have been filed which include allegations of excessive fees and expenses and failure to provide sufficient investment information to inform participants.

In addition to the DOL regulations discussed earlier requiring service providers to disclose direct or indirect compensation to plan fiduciaries, the DOL has also issued regulations requiring plan fiduciaries to issue enhanced disclosures to participants in participant-directed accounts. *See* 75 Fed. Reg. 64910 (Oct. 20, 2010). The purpose of these additional disclosures is to provide plan participants with sufficient information regarding fees and expenses and the designated investments options under the plan to make informed decisions with regard to the management of their accounts. *Id.* Further,

to improve fee disclosure by plans, the DOL has revised the Form 5500 Annual Report/Report of Employee Benefit Plan (discussed below), including Schedule C.

⊠ **Strategic Point:** Fiduciaries need to review the plan's current contracts and arrangements with its service providers to ensure that they are reasonable as required by ERISA Section 408(b)(2). When reviewing these plan documents, fiduciaries should follow the DOL regulations on fees as well as any recent case law. Note that, ERISA Section 408(b)(2) is a statutory exemption from the prohibited transaction provisions under ERISA. In this regard, failure to meet the requirements under ERISA Section 408(b)(2) would mean that the fiduciaries engaged in a prohibited transaction with the service provider and would be exposed to liability and excise taxes.

Although the claims and allegations in fee litigation cases vary, some common claims include the following:

- fees are too high compared to the fees of comparable funds;
- failure to take into account revenue-sharing fees paid to record keepers and other third parties by mutual fund managers;
- offering mutual funds instead of lower cost separate accounts;
- offering more actively managed funds instead of index funds;
- offering retail class mutual funds instead of institutional class funds;
- conflicts of interest and prohibited transactions; and
- inadequate disclosures.

In one of the earlier "fee" cases, the Seventh Circuit upheld the district court's finding that there was no violation of ERISA by Deere and Fidelity for failure to disclose revenue sharing arrangements that existed between Fidelity Trust and Fidelity Research, since the arrangement violated no statute or regulation. *Hecker v. Deere & Company*, 556 F.3d 575 (7th Cir. 2009). The court stated that the participants were informed about the total fees imposed by the various mutual funds and were free to direct their investments to lower cost funds if they chose to do so, *Id.* at 585, and concluded that no breach of fiduciary duty occurred in the selection of the investment options. In fact, the Seventh Circuit even questioned "whether Deere's decision to restrict the direct investment choices in its Plans to Fidelity Research funds is even a decision within Deere's fiduciaries duties." *Id.* at 586.

While the *Deere* case is noteworthy, the SEC has stated that revenue sharing arrangements "not only pose potential conflicts of interest, but may also have the indirect effect of reducing investors' returns by increasing the distribution-related costs incurred by a fund." 69 Fed. Reg. 6438, 6441 n. 21 (Feb. 10, 2004). Thus, an ERISA fiduciary would be required to disclose such fee arrangements to plan participants because such arrangements present a potential conflict of interest and would likely

have a direct effect on a participant's account.

A success for the defense bar, *George v. Kraft Foods Global, Inc.*, resulted in a win for defendants who faced excessive fee claims brought on behalf of participants of a Kraft sponsored 401(k) plan. *See George v. Kraft Foods Global, Inc.*, 684 F. Supp. 2d 992 (N.D. Ill. Jan. 27, 2010). The district court dismissed the class action suit on a motion for summary judgment. The court held that the fiduciaries did not breach their duties in setting and monitoring the plan's recordkeeping fees, nor had they failed to make the required disclosures. The court found that Kraft had fulfilled its duty by regularly reviewing and negotiating the contract with the plan's record keeper. Plaintiffs argued that the only prudent means of determining the reasonableness of the fees was through a competitive request for proposal process, and alleged that defendants had failed to engage in this process in its renegotiations with the record keeper. The court also determined that Kraft had appropriately disclosed the fees paid to the record keeper. Relying on *Hecker v. Deere*, the court held that it was sufficient for the fiduciaries to disclose the total fees for the funds, which included recordkeeping fees, through communications like quarterly statements, fund fact sheets, and summary plan descriptions. *See Hecker v. Deere & Co.*, 556 F.3d 575 (7th Cir. 2009).

While the law is still in a state of flux with respect to fees, it is an area that plan fiduciaries should have at the top of their list of areas to focus on and address. Recent excessive or improper fee cases have exposed plan sponsors to millions of dollars in liability. *See Tussey v. ABB, Inc.*, 2012 U.S. Dist. LEXIS 45240 (W.D. Mo. Mar. 31, 2012) (court issued judgment in the amount of $37 million, in part, for failing to monitor costs and failing to leverage its bargaining power to lower fees); *Beesley v. International Paper*, No. 3:06-CV-00703 (USDC S.D. Ill 2013) (proposed class settlement of $30 million submitted to the court for approval on October 1, 2013).

Aside from fees charged by investment vehicles, there are other fees that must be reviewed. For example, labor expenses may be paid from plan assets. *See* DOL Advisory Opinion 89-09A (June 13, 1989) (advising corporation that provided administrative and other services to the employee benefit plans it sponsored that employees should maintain time sheets of all hours worked separated by plan for which work was done). In *Dole v. Formica*, 1991 U.S. Dist. LEXIS 19743, *6-*8 (N.D. Ohio Sept. 30, 1991), the trustees of a Union pension fund arranged for business agents of the Union to provide administrative services to the fund in exchange for compensation from the fund based on a percentage of fund contributions. The court found that this was a transaction between the plans and a party-in-interest under Section 406(a)(1)(C), but that the "arrangement is not a per se violation of ERISA." *Id.* at *22–*23. Relying on Section 408(b)(2)'s exemption for reasonable compensation, the court determined that the fee arrangement was reasonable when first implemented because it was based on the time the Union agents actually spent on servicing the funds, as determined by a study conducted by the fund trustees. *Id.* at *23. However, the trustees did not review the arrangement for over ten years and it had become unreasonable. *Id.* Ultimately, the court recognized that "the Union was an acceptable, or even a preferable service provider" but held that the trustees acted "unreasonably in paying a straight percentage of the contributions as compensation for

services when the services rendered are undocumented." *Id.* at *26.

In addition, the court found that the trustees could not properly review the arrangement because of the "lack of record-keeping" by the Union agents. *Id.*; *see also id.* at *8 ("The business agents kept no records or documentation identifying or describing the services they provided to the Fund or the amount of time spent on such services."). The court further found that the trustees could have demonstrated that the funds paid reasonable compensation by "showing the cost to the Funds if these services were provided by others." *Id.* at *25. *See also Donovan v. Dillingham*, 1984 U.S. Dist. LEXIS 20546, at *7 (N.D. Ga. Jan. 10, 1984) (finding prohibited transaction with party-in-interest where plan trustees employed wholly owned corporation as administrator of trust and instead of specifying amount of compensation, paid the corporation the "excess amount of contributions remaining after the insurance premiums had been purchased").

In *Tibble v. Edison International*, the Supreme Court held that there is a continuing duty to periodically monitor plan investments, regardless of whether the investment was selected outside the six-year statute of limitations period. *See Tibble v. Edison International*, 135 S.Ct. 1823 (2015). The Court, among other things, focused on the issue of selecting retail instead of institutional share classes. The plaintiffs claimed that defendants acted imprudently by investing in retail share classes rather than the institutional share classes that were offered by the mutual funds. Both the retail and institutional share classes were available at the time of the initial investment decision. The only difference between the two was that the retail shares charged higher fees. The district court granted summary judgment in favor of the fiduciaries with respect to all but six mutual funds. *See Tibble v. Edison Int'l, et al.*, 639 F. Supp. 2d 1074 (C.D. Cal. 2009), *supplemental opinion at* 639 F. Supp. 2d 1122 (C.D. Cal. 2009). For three of these funds, the court found that the defendants had failed to consider the different share classes for certain funds. This failure to consider and investigate certain institutional share classes was a breach of the fiduciary duty of prudence. On appeal, the Ninth Circuit held that the fiduciaries had not breached their duty of prudence by offering the mutual funds and also rejected a rule that only institutional class mutual funds are prudent. *See Tibble v. Edison Int'l*, 729 F.3d 1110 (9th Cir. 2013).

The number of fee litigation cases is increasing. In 2015, three cases in total settled for over $220 million and over $80 million in attorney's fees. *See Haddock v. Nationwide Life Ins. Co.*, No. 01-cv-1552 , slip op. at 2 (D. Conn. Mar. 26. 2015), ECF No. 597-1 (Plaintiffs' Unopposed Memorandum in Support of Final Approval of Class Action Settlement); *Haddock v. Nationwide Life Ins. Co.*, No. 01-cv-1552, slip op. (D. Conn. Apr. 9. 2015), ECF No. 601, (Final Order Approving Settlement); *Abbott v. Lockheed Martin Corp.*, No. 3:06-cv-701 (S.D. Ill. July 2, 2015), ECF No. 520 (plaintiffs' memorandum in support of joint motion for settlement); *Abbott v. Lockheed Martin Corp.*, No. 3:06-cv-701 (S.D. Ill. July 20, 2015), ECF No. 526 (final order approving settlement); *Krueger v. Ameriprise Fin. Inc.*, No. 11-cv-2781, slip op. at 1-2 (D. Minn. July 13, 2015), ECF No. 624, (Final Order Approving Settlement); *Krueger v. Ameriprise Fin. Inc.*, No. 11-cv-2781, slip op. at 1-2 (D. Minn. July 13, 2015), ECF No. 623 (Order Granting Motion for Attorneys' Fees). The plaintiffs in these cases

were successful in receiving the large awards despite losing on a number of their claims.

Current trends in fee litigation cases show plaintiffs bringing claims against 401(k) plans offering low-cost funds. Plaintiffs have brought claims against 401(k) plans offering Stable Value Funds and Vanguard investment options. In *Bell v. Anthem Inc.*, plaintiffs alleged that the 401(k) plan failed to leverage its bargaining power to demand lower cost investment options. A number of the alleged high-cost funds at issue were Vanguard mutual funds, which charged the Anthem plan a significantly lower fee compared to industry averages for other investment options. This case is significant because Vanguard funds have historically been promoted by plaintiffs' counsel as having relatively lower index-based fees. *See* Amended Complaint, *Bell v. Anthem Inc.*, No. 1:15-cv-02062 (S.D. Ind. Mar. 16, 2016), ECF No. 23.

A similar case has been filed against the fiduciaries of Chevron's 401(k) plan. *See* Complaint, *White v. Chevron Corp.*, No. 4:16-cv-00793 (N.D. Cal. Feb. 17, 2016), ECF No. 1. Plaintiffs alleged that the fiduciaries breached their fiduciary duty by not offering a stable value fund and by instead offering lower-cost Vanguard funds and a Vanguard money market fund. They also took issue with Chevron's inclusion of certain Vanguard mutual funds. On that point, the plaintiffs alleged that there were identical Vanguard funds with lower-cost share classes available.

In contrast with the plaintiffs in Chevron, the plaintiffs in *Ellis v. Fidelity Management* took issue with Fidelity's provision of a stable value fund. *See* Complaint, *Ellis v. Fidelity Management Trust Co.*, No. 1:15-cv-14128 (D. Mass. Dec. 11, 2015), ECF No. 1. Plaintiffs alleged that the stable value fund offered by Fidelity as an investment option in the Barnes & Noble 401(k) plan performed poorly due to Fidelity's investment strategy. They argued that Fidelity should have invested less in shorter average duration securities and more in longer duration bonds. Fidelity adopted its strategy of investing in shorter duration securities after complaints that its previous strategy was too aggressive. Plaintiffs also alleged that Fidelity charged excessive fees and permitted contract providers to charge excessive fees.

In *Pledger v. Reliance*, plaintiffs took issue with the trustee of Insperity's 401(k) plan for offering money market funds instead of stable value funds. *See* Amended Complaint, *Pledger v. Reliance Trust Co.*, No. 1:15-cv-04444 (N.D. Ga. Apr. 15, 2016), ECF No. 37. Plaintiffs alleged that the money market funds did not keep pace with inflation, and the failure to offer alternative stable value funds was a breach of fiduciary duty. Plaintiffs made this claim even though Reliance ultimately added a stable value fund option to the plan in 2014. Plaintiffs claim that this fund was not well established and was underperforming.

In conclusion, a review must be made of all the investment options in the plan. Plaintiffs are no longer just attacking the fund with the greatest loss in value or highest in fees, but the investment option's overall purpose within the entire plan's portfolio. Plan sponsors should review their current investment options and ensure they meet the guidelines as set forth in the Investment Policy Statement. Lastly, these discussions

among plan fiduciaries must be documented and stored.

(Text continued on page 35-33)

PART IV: REPORTING AND DISCLOSURE

§ 35.34 Form 5500 and Audited Financials

Pursuant to the DOL's annual reporting requirements, plans must make on Schedule C of Form 5500. *See* 72 Fed. Reg. 64710 (Nov. 16, 2007). Effective for 2009 plan year filings, the new Schedule C requires plans to report service providers who receive $5,000 or more in compensation during the plan year, and to report direct compensation paid to service providers in a line item separate from indirect compensation received by service providers from sources other than plan or plan sponsor. 72 Fed. Reg. 64712 (Nov. 16, 2007).

Service providers whose compensation is limited to "eligible indirect compensation" (i.e, certain specified types of common investment related fees) must provide the plan administrator with written disclosures of (i) the existence of indirect compensation, (ii) the services provided or the purpose of the indirect compensation, (iii) the amount or a description of the formula used to calculate the compensation, and (iv) the identity of the parties paying and receiving the compensation. *Id.*

If a service provider fails or refuses to provide such necessary compensation disclosures, the plan administrator must specifically identify the service provider on the revised Schedule C.

The DOL believes that these revisions will assist plan administrators in monitoring compensation arrangements, better understand the impact of fees, and better evaluate the value of the services retained, and that plan administrators will now have the ability to negotiate fair prices for necessary plan services. 72 Fed Reg. 64719 (Nov. 16, 2007).

ERISA has comprehensive and extensive reporting and disclosure requirements, depending on the type of plan. The following reflects some of the major requirements.

A DOL review of 400 Form 5500 plan audits found 39% had major deficiencies in auditing standards. Concerned with audit quality, the DOL has provided recommendations to address enforcement, legislation and regulation, and outreach. More specifically, the DOL intends to focus more of their resources on firms with smaller employee plan audit practices that undertake audits of plans with large amounts of assets. The DOL also recommends eliminating ERISA's limited scope audit exemption, which permits auditors to avoid auditing investment information prepared and certified by banks, and changing the qualification requirements for certified professional accountants (CPAs). Lastly, the DOL intends to provide training and licensing support for CPAs who perform plan audits.

§ 35.35 Summary Plan Description/ Summary of Material Modifications

The Summary Plan Description (the "SPD") is the main document for informing participants and beneficiaries about the plan and how it works. The DOL requires that the SPD be written in a manner that can be understood by the average participant and have sufficient details so participants can assess their benefits, rights and obligations under the plan. The DOL has prescribed certain requirements for style, format and

content of the SPD. *See* 29 C.F.R. § 2520.102-2 and 2520.102-3.

The SPD must be distributed to participants automatically within 90 days of being covered under the plan and to beneficiaries within 90 days of receiving benefits. Should there be any changes to the plan, an updated SPD must be distributed every 5 years.

Usually when a plan is amended, a Summary of Material Modifications (the "SMM") must be issued to participants and beneficiaries describing the material modifications to the plan and changes to the SPD. The SMM must be distributed to participants and beneficiaries no later than after the end of the plan year in which the change was made.

§ 35.36 Summary Annual Report

The Summary Annual Report (the "SAR") is a short report giving a basic summary of the Form 5500. Again, the DOL requires that the SAR be in a certain format. *See* 29 C.F.R. § 2520.104b-10(d). The SAR must be distributed to participants and beneficiaries within 9 months after the end of the plan year, or 2 months after the due date for filing the Form 5500.

Note that the SAR is not required for defined benefit plans beginning after December 31, 2007, because such information is now provided in the annual funding notice.

§ 35.37 Pension Benefit Statement

The Pension Benefits Statement (the "PBS") provides the total benefits and total nonforfeitable pension benefits, if any, which have accrued, or the earliest date in which they become nonforfeitable.

The PBS for a 401(k) type plan must provide the value of each investment to which assets in the individual account have been allocated. The PBS for individual account plans, providing for participant direction, must include the following explanations: any limitations or restrictions on directing investments; the importance of a well-balanced and diversified portfolio (which includes a statement of the risk of holding more than 20% of a portfolio in employer securities); and a notice directing participants to the DOL's website for further information on investing and diversification.

The PBS must be issued quarterly for participant directed account plans and annually for non-participant directed plans. For defined benefit plans, the PBS must be issued once every 3 years or at least once a year if the administrator provides notice of the availability of the PBS and ways to obtain it.

§ 35.38 Conclusion

As should be apparent from the foregoing discussion, complying with ERISA and its regulations is no easy task given the complexity of the statute and the fact that the law continues to develop at a rapid pace as a result of a number of factors. A fiduciary's task is made that much more difficult given that the issue of whether a person has breached fiduciary duties is extremely fact-intensive and may vary depending on the particular circuit within which the case is brought. It is thus often difficult to predict

whether a particular course of action will shield the fiduciary from liability or make the fiduciary an easy target for the government or plaintiff's bar.

Notwithstanding these challenges, this Chapter has attempted to provide an overview of the basic requirements of ERISA and concrete steps that companies and their fiduciaries should take in order to remain compliant and to avoid liability. Whether the task involves establishing a benefits committee, selecting a service provider, monitoring other fiduciaries, or selecting or monitoring investments, the key to ERISA compliance is to, at all times, act in accordance with the fiduciary duties outlined above, i.e., (i) act for the "exclusive purpose" of the plan, (ii) act with "prudence," (iii) use "diversification" with respect to plan investments (unless exempted, as discussed), and (iv) act in accordance with the "terms of the plan."

PART V: PRACTICE RESOURCES

§ 35.39 Research References

- Report of the Working Group on Guidance in Selecting and Monitoring Service Providers, dated November 13, 1996, found at http://www.dol.gov/ebsa/publications/srvpro.htm.

Report of the Working Group on Guidance in Selecting and Monitoring Service Providers

November 13, 1996

The Working Group on Guidance in Selecting and Monitoring Service providers presents its interim report and recommendations to the 1996 ERISA Advisory Council.

I. THE WORKING GROUP'S PURPOSE AND SCOPE

The 1996 Advisory Council on Employee Welfare and Pension Benefit Plans created a Working Group on Guidance in Selecting and Monitoring Service Providers. The Working Group was charged with studying and making recommendations concerning the need for, appropriateness and form of guidance to plan sponsors and fiduciaries in the Selection and Monitoring of Service Providers.

The 1996 Working Group determined that its study would focus on welfare plans as well as pension plans. The Working Group also determined that its study should take place over the course of two years. After reviewing the universe of common service providers (see below), the Working Group concluded that, unless it focused its inquiry, the large variety of service providers would preclude a thorough evaluation of this topic.

The Working Group concluded that, the first year, the study would focus primarily on pension plans with an emphasis on the selection and monitoring of investment managers, investment consultants and bundled service arrangements for small 401(k) plans. The Working Group chose this approach based on testimony that the decisions involving investment management were likely to have the most significant impact on plan participants. The Working Group recommends that this study continue for a second year, to focus primarily on service providers to welfare plans.

The Working Group decided to review general principles and industry practices in the selection and monitoring of service providers that could be determined from the specific areas studied. Preliminary conclusions and recommendations would be reported after the first year and modified, as appropriate, after the second year of the study.

The need for discussion on this topic was reinforced by the work of the 1995 Advisory Council's Working Group on Real Estate Investments. Among its recommendations, the 1995 Real Estate Working Group recommended:

The Department of Labor should explore the feasibility of developing and disseminating a publication which simply details the duties of fiduciaries as they relate to plan investments in real estate.

Further study of the issues of plans with less access to sophisticated real estate expertise is warranted.

These recommendations were based on testimony before the 1995 Real Estate Investment Working Group that Trustee Guidance and education was necessary so that trustees better understand their potential liability, especially trustees of small and medium sized trusts.

II. WORKING GROUP PROCEEDINGS

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- For Retirement Plans
- For Small Employers

■ Reporting and Filing
■ Webcasts

The Working Group received oral and written testimony at a series of public hearings. The Working Group also received and discussed research and material from public sources that related to the topic of study.

At the meeting on May 7, 1996, the Working Group discussed the various types of service providers that might be retained by both pension and welfare plans (see page 1). The Working Group acknowledged that different selection and/or monitoring procedures might be appropriate for different types and sizes of plans and with respect to different types of service providers. However, the Working Group determined that it would attempt to identify general principles that apply to the selection and monitoring of various service providers by different types of plans.

The Working Group decided to look at the practices and problems with specific providers and industries. From both the industry practices and the gaps in those practices, the Working Group would provide suggestions both with respect to those areas in which guidance would be helpful and the nature of the guidance. The Working Group would also attempt to identify sources of information for fiduciaries concerning the practices and/or qualifications of specific service providers.

At the hearing on June 18, 1996, Marc Machiz, Associate Solicitor of Labor, Plan Benefit Security Division, reviewed the cases brought by the Department of Labor concerning fiduciary misconduct in the selection and monitoring of service providers. Jack Marco, Marco Consulting, testified concerning practices of both investment managers and investment consultants.

At the hearing on July 16, 1996, the Working Group heard testimony concerning the procedures for selection and monitoring of investment managers and codes of conduct from the perspective of corporate plans, public plans and foundations. The witnesses were Joseph P. Craven of Putnam Investment Company and Carter F. Wolfe from the Howard Hughes Endowment. Barry Mendelson, Senior Special Counsel in the Investment Management Division of the Securities and Exchange Commission, testified concerning procedures, practices and information sources to aid fiduciaries in the selection and monitoring of mutual funds and investment advisors.

The hearing on September 10, 1996, focused on issues and procedures with respect to bundled service arrangements, including investment management services, often provided to small 401(k) plans. The Working Group heard testimony from Leonard P. Larrabee, III Assistant General Counsel, the Dreyfus Corporation, representing the Pension Committee of the Investment Company Institute and from Edmond F. Ryan, Senior Vice President, Defined Contributions Operations Department for Massachusetts Mutual Life Insurance Company.

At its meeting on October 9, 1996, the Working Group discussed the testimony and written material received and the Working Group's preliminary conclusions.

The Working Group held a public teleconference on November 4, 1996, to discuss its draft report.

A list of the Exhibits and written material received can be found in Sections IV and V. A summary of the oral testimony can be found in Section VI.

III. FINDINGS AND RECOMMENDATIONS: PENSION PLANS

The testimony and case law concerning service providers indicate that some form of easily accessible educational material would be useful for both large and small plans. Not only are plan fiduciaries faced with the substantial requirements of due diligence in the selection and monitoring of service providers, but in the case of investment managers, fiduciaries also face the difficult task of understanding and evaluating the risk in the underlying investment proposed by the provider.

Many of the problems with respect to service providers arise because the responsible plan fiduciary either does not understand his role and responsibility in the selection and monitoring of service providers or exercises poor judgment because he does not have experience or an appropriate source of information concerning legal requirements and industry practices. The Working Group heard testimony that many of the cases also involve an element of self-dealing.

Although the case law indicates that a large portion of the cases involve small to medium sized plans and Taft-Hartley plans, the misunderstandings and poor judgment based on lack of information also affect larger plans. However, in the case of single employer defined benefit plans where the sponsor is ultimately responsible for funding the plan benefits, or where plan assets are not at issue, the financial consequence of poor selection and monitoring of service providers tends to fall on the sponsor. In many such cases, it appears that problems with service providers are borne directly by the plan sponsor.

Therefore, the Working Group concludes that educational information would be useful to fiduciaries of plans of all sizes but would particularly benefit fiduciaries of small and medium size plans.

The Working Group acknowledges the concern expressed by Marc Machiz in his testimony that any form of guidance carries with it both the promise of improving practice among the weaker segments of the industry as well as the danger of inducing undue complacency if the Guidance is too formulated, sets too low a standard or is insensitive to the wide variations and circumstances that plan fiduciaries face. However, the Working Group concludes that information could be developed for fiduciaries based on clearly defined general principles of fiduciary conduct and industry practices that would serve as a resource to the industry and not provide a refuge for those who would willfully disregard their responsibilities. The majority of the Working Group does not believe that new legislation or regulation is required.

Educational material is needed and is appropriate for both small and large plans in the form of sponsor and fiduciary education. However, educational material will be most useful to small and midsize plans. While educational material will not change the behavior of those who would act in their own self interest and/or with deliberate disregard of their fiduciary obligations, it can still have an impact to discourage such activity by equipping others to recognize and object to improper conduct.

The Working Group collected a wealth of valuable information on this topic. This information has been categorized by subject in Sections IV and V of this report. The oral testimony of witnesses has been summarized in Section VI. In order to make this information more accessible, the Working Group recommends that the Department of Labor develop and disseminate educational materials to plan sponsors, participants and service providers that include the following information:

A plain language description of the duties of fiduciaries with respect to selection and monitoring of various kinds of plan service providers, including the Department's views on the importance of maintaining a written record of the due diligence process and of disclosing potential conflicts to plan participants (see Sections IV and V).

An explanation of the legal effect of a plan fiduciary's delegation of responsibilities to various service providers including the ongoing duty to monitor and evaluate the performance of the service providers selected by the fiduciary (see Section IV).

An explanation of the ability of a fiduciary to rely on the advice of service providers (see Section IV).

Examples of questions a fiduciary should ask or procedures a fiduciary should follow in connection with the selection and monitoring of service providers (see Section V).

Sources of information concerning various types of service providers (see Section IV).

The Working Group also recommends that the 1997 ERISA Advisory Council continue the work on this topic with a focus on service providers to welfare plans.

IV. EXHIBITS AND WRITTEN MATERIAL RECEIVED

A. Selection and Monitoring Criteria

Procedures for Selecting Investment Managers Appendix A to consent decree in Arizona State Carpenters Pension Trust Fund, et al. v. Miller, et al.

Procedures for Monitoring Investment Managers Appendix B to consent decree in Arizona State Carpenters Pension Trust Fund, et al. v. Miller, et al.

Department of Labor Regulation 29 CFR § 2550.404a-1 Investment Duties, and the preamble thereto, 42 FR 54122.

Letter from Olena Berg, Assistant Secretary for Pension and Welfare Benefits Administration, to Honorable Eugene A. Ludwig, Comptroller of the Currency, concerning the Department of Labor's views with respect to the utilization of derivatives in the portfolio of pension plans subject to the Employee Retirement Income Security Act.

Labor Department Interpretive Bulletin No. 94-2 Relating to Written Statements of Investment Policy, Including Proxy Voting Policy or Guidelines, 29 CFR 2509.94-2.

Labor Department Interpretive Bulletin No. 95-1 on Plan Selection of Annuity Provider, 29 CFR 2509.95-1.

Labor Department Interpretive Bulletin No. 96-1 Relating to Investment Education, 29 CFR 2509.96-1.

B. Cases on Fiduciary Responsibility and Liability for the Selection and Monitoring of Service Providers; Fiduciaries' Reliance on Service Providers:

- Donovan v. Mazola, 716 F.2d 1226 (9th Cir. 1983)
- Donovan v. Tricario, 5 EBC 2057 (SD Fla. 1984)
- Brock v. Robbins, 830 F.2d 640 (7th Cir. 1987)
- Benvenuto v. Schneider, 678 F. Supp. 51 (ED NY 1988)
- McLaughlin v. Bendersky, 705 F. Supp. 417 (ED IL 1989)
- Morgan v. Independent Drivers Association, 15 EBC 2515 (10th Cir. 1992)
- In Re: Unisys Savings Plan Litigation, 74 F.3d 420 (3rd Cir. 1996)
- Glaziers and Glassworkers Local 252 Annuity Fund v. Newbridge Securities, Inc., 20 EBC 1697 (3rd Cir. 1996)

C. Conflicts of Interest and Compensation

Code of Ethics and Standards of Professional Conduct for financial analysts, Association for Investment Management and Research (AIMR).

Investment Management Consultants Association (IMCA) Standards and Practices for the Professional Investment Management Consultant, received Nov. 1, 1996.

"Firm Views on Soft Dollars," Institutional Investor

Investment Manager Questionnaire, The Marco Consulting Group

Contract language concerning other compensation, The Marco Consulting Group

Eugene B. Burroughs, "Checklist of Elements for Inclusion in Investment Policy Statement," Investment Policy Guidebook for Trustees, International Foundation of Employee Benefit Plans, Brookfield, WI, 1995.

Presentation of Joseph P. Craven, Outline and Exhibits:

Summary of MASTERS' Investment Policies and Procedures

Request for Proposal for Investment Management Services, The Commonwealth of Massachusetts

Disclosure Statement, The Commonwealth of Massachusetts

Massachusetts State Teachers' and Employees' Retirement Systems Trust, Manager Search, Manager Analysis

Howard Hughes Medical Institute, Standard Operating Policy and Procedure Manual, Conflict of Interest Policy

Written Testimony of Barry Mendelson including Article on "How to Find a Qualified Financial Planner."

D. Information and protection available from the Securities and Exchange Commission:

"Invest Wisely: Advice from Your Securities Industry Regulators," Securities and Exchange Commission, 1994.

"Ask Questions - Questions You Should Ask About Your Investments...and What To Do If You Run Into Problems", Securities and Exchange Commission

"Invest Wisely: An Introduction to Mutual Funds," Securities and Exchange Commission, 1994

"What Every Investor Should Know," Securities and Exchange Commission, 1995

"Investor Fraud and Abuse Travel to Cyberspace," Investor Beware, Securities and Exchange Commission, 1996

"Consumers' Financial Guide," Securities and Exchange Commission, 1994

"How To Avoid Ponzi and Pyramid Schemes," Securities and Exchange Commission

"Information For Investors," Collection of Fact Sheets from the Securities and Exchange Commission

V. EXAMPLES OF QUESTIONS A FIDUCIARY SHOULD ASK.

The following are examples of questions which fiduciaries may consider in hiring and monitoring the performance of a service provider. Given the wide range of plan needs, it is impossible to provide a complete list of questions which will be applicable to all plans and all circumstances. Nevertheless, the Working Group believes that the following are representative of the types of questions to which fiduciaries should seek answers to satisfy their obligations as fiduciaries under ERISA.

A. ISSUES FOR FIDUCIARIES WHO ARE HIRING A SERVICE PROVIDER

What service or expertise does the plan need? Is the service or expertise necessary and/or appropriate for the functioning of the plan?

Does this service provider propose to provide the service that is necessary or appropriate for the plan?

Does this service provider have the objective qualifications to properly provide the service that is necessary and/or appropriate for the plan? Generally, the fiduciary should seek the following information that will vary with the type of service provider being retained:

- business structure of the candidate
- size of staff
- identification of individual who will handle the plan's account
- education
- professional certifications
- relevant training
- relevant experience
- performance record
- references
- professional registrations, if applicable
- technical capabilities
- financial condition and capitalization
- insurance/bonding
- enforcement actions; litigation
- termination by other clients and the reasons

4. Are the service provider's fees reasonable when compared to industry standards in view of the services to be performed, the provider's qualifications and the scope of the service provider's responsibility?

5. Does the plan have a conflict of interest policy that governs business and personal relationships between fiduciaries and service providers and among service providers? Does the plan require disclosure of relationships, compensation and gifts between fiduciaries

and service providers and among service providers?

6. Does a written agreement document the services to be performed and the related costs?

B. ADDITIONAL ISSUES WHEN HIRING AN INVESTMENT MANAGER

1. Does the Plan have a Statement of Investment Policy? Some or all of the following issues may be addressed by a Statement of Investment Policy:

(See Department of Labor Interpretive Bulletin 94-2.)

Evaluation of the specific needs of the plan and its participants

Statement of investment objectives and goals

Standards of investment performance/benchmarks

Classes of investment authorized

Styles of investment authorized

Diversification of portfolio among classes of investment, among investment styles and within classes of investment

Restrictions on investments

Directed brokerage

Proxy voting

Standards for reports by investment managers and investment consultants on performance, commission activity, turnover, proxy voting, compliance with investment guidelines.

Policies and procedures for the hiring of an investment manager

Disclosure of actual and potential conflicts of interest

2. What is the position to be filled? Why is the Plan hiring an additional investment manager? Is the Plan replacing a terminated manager with a manager of the same investment style or hiring an additional manager with a different investment style? Is the hiring of this manager consistent with the Statement of Investment Policy?

3. Does the Investment Manager have the objective qualifications for the position being filled? (See questions concerning qualifications above.) Does the candidate qualify as an investment manager pursuant to ERISA section 3(38)?

4. How does the investment manager manage money? What is the manager's performance record and how does the manager achieve his performance? What are the risks of the investment manager's style and strategy compared to other styles and strategies? Do you understand what the manager does and the risks involved? Is this risk level acceptable in view of the return? How do this manager's investment style and strategy fit into the portfolio as a whole? (See Department of Labor Regulation 29 CFR § 2550.404a-1 Investment Duties and Letter from Olena Berg, Assistant Secretary for Pension and Welfare Benefits Administration, to Honorable Eugene A. Ludwig, Comptroller of the Currency concerning the Department of Labor's views with respect to the utilization

of derivatives in the portfolio of pension plans subject to the Employee Retirement Income Security Act.)

5. How does the investment manager measure and report performance? Does the process ensure objective reporting?

6. Is the investment manager a qualified professional asset manager? What is the investment manager's process to comply with the prohibited transactions provisions of ERISA?

7. What is the investment manager's process to insure compliance with the plan's investment policy and guidelines?

8. What is the investment manager's record with respect to turnover of personnel?

9. Has the manager's investment style been consistent?

10. Has the investment manager been terminated by plan clients within a relevant time period and why?

11. Has the ownership of the investment manager changed within a relevant time period and how will this affect the ability of the manager to perform the services needed by the plan?

12. What are the investment manager's fees? Are the fees reasonable in comparison with industry standards for the type and size of the investment portfolio? Does the fee structure encourage undue risk taking by the investment manager?

13. Does the investment manager have a personal or business relationship with any of the plan fiduciaries, or with another service provider recommending the investment manager? If a relationship does exist, how does it impact on the evaluation of the objective qualifications of the investment manager and the recommendation?

14. If the plan has adopted a directed brokerage arrangement with a broker affiliated with the plan's investment consultant, how does the investment manager determine when to use broker affiliated with the investment consultant? What are the per share transaction costs?

15. Does the investment manager have insurance which would permit recovery by the plan in the event of a breach of fiduciary duty by the investment manager? What is the amount of the insurance? Who is the insurance carrier?

C. ADDITIONAL ISSUES WHEN HIRING AN INVESTMENT CONSULTANT

What is the role of the investment consultant? Are the investment consultant's duties clearly stated in the Statement of Investment Policy and/or the contract with the Investment Consultant?

Does the Investment Consultant:

Monitor and advise concerning asset allocation

Monitor and advise concerning riskiness of investment strategies, styles and individual investment managers Monitor and advise concerning the performance and riskiness of

investments under the direct investment control of the fiduciaries

Monitor and advise concerning the compliance of the investment managers and direct investments with the Statement of Investment Policy and Investment Guidelines

Accept fiduciary responsibility in writing for all or some of the services it performs? Does the contract state specifically for which services the consultant accepts fiduciary responsibility?

3. Is the investment consultant's fee reasonable when compared to industry standards in view of the services to be performed and the scope of the consultant's fiduciary responsibility?

4. What are the investment consultant's performance measurement process and techniques including the performance data base used to evaluate the investment manager's performance? Do you understand the process? Are these processes and techniques appropriate?

5. Does the investment consultant have a personal or business relationship with any of the plan fiduciaries, or with one or more investment managers? Does the consultant receive compensation from investment managers either through the sale of services or through directed brokerage arrangements? If a relationship does exist, how does it impact on the evaluation of the consultant's recommendation of the investment manager?

6. What investment managers were recommended by the investment consultant in recent searches for other clients?

7. Does the investment consultant have insurance which would permit recovery by the plan in the event of a breach of fiduciary duty by the investment consultant? What is the amount of the insurance? Who is the insurance carrier?

D. ADDITIONAL ISSUES WHEN HIRING A BUNDLED SERVICE PROVIDER

Is the bundled service provider financially stable and committed to the defined contribution business for the long term?

What is the bundled service provider's track record for delivering accurate and timely record keeping, and other administrative services, and insuring regulatory compliance?

Does the bundled service provider offer a wide range of investment options that will allow participants to make appropriate asset allocation decisions and achieve their investment objectives?

Has the bundled service provider demonstrated the ability to generate superior investment performance over time?

Does the bundled service provider have the administrative capability to provide assistance with employee enrollment, investment education and ongoing plan communication?

Does the bundled service provider have knowledgeable and dependable service representatives available to consult with plan participants?

Has the plan sponsor been provided with advance written disclosure indicating the expenses and commissions, if any, that the bundled service provider will receive?

Are the bundled service provider's expenses reasonable in relation to the level of services provided?

Has the plan sponsor received sufficient information to make a true comparison of the

services provided by the various bundled service arrangements available to select from?

What procedures or mechanisms are in place to assure that any mistakes that may be made by the bundled service provider will be disclosed to the plan sponsor and corrected?

Does the plan sponsor understand its role in monitoring the bundled service provider?

Has the bundled service provider disclosed in writing the capacity in which it is acting, and has the plan fiduciary acknowledged its understanding of this role?

Has the bundled service provider disclosed any potential conflicts of interests?

E. ADDITIONAL ISSUES IN MONITORING SERVICE PROVIDERS

Who is responsible for monitoring the service provider?

What is the process to monitor the service provider?

Are written reports provided by the service provider? With What frequency are the written reports provided?

Do the written reports describe the performance of the service provider as compared to the applicable written guidelines and/or contract?

Do the written reports provide sufficient information to adequately evaluate the performance of the service provider compared to benchmarks or industry standards?

Is there a process in place to either: (a) correct any non-conformance with guidelines/contract, benchmarks or industry standards; or (b) to terminate the service provider and retain a successor?

Has the responsibility for monitoring a service provider been delegated to an individual or another service provider?

If the responsibility to monitor a service provider has been delegated, has the individual or service provider to whom the delegation has been made accepted fiduciary responsibility in writing for the monitoring?

VI. SUMMARY OF TESTIMONY RECEIVED

Meeting of June 18, 1996

Testimony of Mr. Marc Machiz,

Associate Solicitor of Labor,

Plan Benefits Security Division

Mr. Machiz opened his testimony by saying that the perspective that he brought to the group's discussion was based upon his review of investigations and supervision of enforcement litigation. He stated that if he had to pick one part of the service provider universe where improper selection and lack of monitoring had the potential for causing the most harm to plans, it would be investment managers. He felt this because of the investment managers' direct control of plan assets.

Mr. Machiz went on to make the important point that not only are plan fiduciaries faced with the requirement of diligence in the selection and monitoring of providers, but that

they also had the difficult task of understanding and evaluating the question of risk in the underlying investments proposed by the provider. In his view, in many cases, fiduciaries do not adequately understand and evaluate the investment risk. As examples of this last point, he cited the Arizona State Carpenters case and Lowen v. Tower Asset Management.

In evaluating an investment manager's performance, it is fairly simple to calculate the rate of return. It is more difficult to measure and appreciate the amount of risk involved in achieving that return. Trustees must also understand the investment manager's fee arrangements both in terms of ultimate cost to the plan and in terms of any incentive the fee arrangement gives the investment manager to take inappropriate risk.

Mr. Machiz made the point that a written statement of investment policy can be a useful tool in the selecting and monitoring of investment managers. He pointed out that in 1994 the Department had issued Interpretive Bulletin 94-2 that explained the use of such a statement and encouraged plan fiduciaries to adopt written statements of investment policy.

Interpretive Bulletin 94-2 also states that compliance with ERISA's prudence requirement requires maintenance of proper documentation of the activities of the Investment Manager and of the named fiduciary of the plan in monitoring the investment manager.

Mr. Machiz stated the Department's concern that trustees be aware, not just of the rate of return of an investment, but also the types of risks inherent in the rate. A greater risk should be rewarded with greater return. Some investments require a much higher degree of financial sophistication and expertise to understand the nature of the risks and potential returns. He said that the Department's concern concerning fiduciaries' awareness of risk could be seen in the Letter of Guidance released with the Comptroller of the Currency, Statement on Derivatives, March 28, 1996.

Concerning the focus of the Working Group, Mr. Machiz cautioned that the prospect of official guidance carries with it the promise of improving practice among the weaker segments of the industry as well as the danger of inducing undue complacency if the guidance is too formulated, sets too low a standard, or is insensitive to the wide variations and circumstances that plan fiduciaries face. He said that the Department would rely on the Council's wide practice experience to instruct them on the value and risks of proceeding with guidance.

Mr. Machiz noted that if you looked at the full range of the Department of Labor's litigation, there are a tremendous number of cases involving small to medium-sized plans. The small plans' cases usually had a self-dealing tinge to them and there was not really a selection and monitoring service provider aspect to them.

He also noted that a significant portion of the cases about selection and monitoring service providers involve Taft-Hartley plans. He noted, however, that the reasons for this probably having nothing to do with where the service provider problems arise. In the case of single employer defined benefit plans, sponsors are ultimately responsible for funding the benefits regardless of the performance of the investment manager and other service providers. The sponsor must pay the money to fund the plan sooner or later. If the sponsor discovers a problem, he simply fires the investment manager or other service provider.

Mr. Machiz commented that investment manager's sales pitches to trustees generally included little discussion regarding risk and this was usually confined to a few sentences in which the trustees were assured that the manager had figured out how to out-perform the market while taking risks less than the market at large. When we look at the cases, we see fiduciaries who have a service provider -- either an investment consultant or the investment manager -- who is giving the fiduciaries updates on how the plan is performing but really no assessment of the underlying risk of the portfolio. Another issue for trustees is whether the consultant hired to do performance tracking has been hired to perform the

right service for the plan. Will the performance consultant give an assessment of the risks in the portfolio and not just performance numbers.

In response to a question, Mr. Machiz responded that the theme of overpayment for services showed up in a number of the Department's cases. Overpaying for services by either not doing competitive bidding or taking other steps to ascertain the correct price for services shows up often in welfare plan cases. In investment cases the issue is usually not the fee but the way services were provided. His sense is that fees for investment managers tend to be fairly competitive. In the Department's cases, the investment managers got their profit on the other end by investing in investments in which they owned an interest. Once an investment manager has discretion over the plan assets, the potential for making himself wealthy comes not so much from charging a few extra basis points for management but from abusing the power that's been given to him, whereas with a welfare plan's contract administrator oftentimes the price at which services are provided is the abuse itself. In the case of other service providers, the pricing is really a different problem than the quality issues that are the focus of investment manager cases.

Mr. Machiz said that his feeling is that service provider abuse cases are the result of ignorance and with plan fiduciaries being "too cozy" with service providers. A formal process for selecting and monitoring makes it more difficult to rely on inappropriate factors. However, he stated his view that there is virtually no process that with enough will and ingenuity can't be fixed. However, to the extent problems are the result of ignorance and not the fact that the decision makers are "ethically challenged," guidance and education can attempt to address this.

Mr. Machiz also discussed other potential areas of service provider abuse. He discussed the selling of insurance to the plan by the administrator and inadequate disclosure of commission income. He also mentioned the potential for conflict of interest when the investment performance monitors are also in the brokerage business. How much does the brokerage income influence whom they recommend? It is something that the Trustees need to be aware of and question.

Mr. Machiz agreed that one of the more difficult issues facing trustees in retaining service providers was to always be sure that the scope of the engagement was appropriate for the type of advice that needed to be given. It's a serious problem, particularly when the plan fiduciary is not an expert in the particular area (that is why the fiduciary is, in fact, hiring the service provider in the first place). Fiduciaries need to know enough to ask the right questions and to enter into an agreement with the service provider where the scope of the engagement is appropriate. If the scope is too broad, the plan may overpay. On the other hand, if the scope is too narrow it may not accomplish the goal the fiduciary set out to accomplish by retaining the service provider in the first place. Mr. Machiz agreed with these points and again noted the importance of a formal written statement of investment policy.

However, Mr. Machiz noted in response to questions concerning investment guidelines that neither the statute nor regulations required them. In addition, the specificity of the Guidelines affected their utility in limiting investment managers and managing investment risk. He looked to the Working Group for recommendations concerning investment guidelines.

In response to questions regarding whether accountants could become more useful in highlighting investment problems before they became serious, Mr. Machiz said that in his experience, if you try to talk to accountants about issues of prudent investing, they tell you that this is not their area of expertise and that you are looking at the wrong service provider.

In response to a question about counsel's role, Mr. Machiz said that he believed that counsel's role was a very delicate role. He said that he believed that counsel had a responsibility to advise the named fiduciary who was making the decisions about the need

to put procedures in place to make sure that there is appreciation of risk. He pointed out that counsel should advise that there be adequate processes in place so that if the fiduciary is ever questioned about why did they hire this manager, why did they conclude that this manager should continue to be retained, that it can be adequately justified.

In response to a question about the possibility of having portfolios under Department guidelines, Mr. Machiz responded that there already exist a Department prudence regulation which people tend to forget about. He pointed out that it talks in terms of taking into account the risks and returns in the context of the entire portfolio. The regulation suggests that we're not going to tell you that there's any kind of investment that is absolutely forbidden, but you have to consider that investment in terms of its function in the portfolio. The Department has been very sensitive to not limiting the investments from which fiduciaries could choose. However, if there is a type of investment for which no one really understands the risk characteristics, the prudent thing might be for the fiduciary to wait until the risk characteristics of the investment are understood.

Mr. Machiz noted that the Exhibits on Selecting and Monitoring Service Providers that were part of the consent order in the Arizona Carpenters Case were negotiated by the Department of Labor in the specific context of that litigation. They did not go through a general policy review since there was not concern for universal applicability. Therefore, they should be looked at as potentially instructive but not as any kind of final and definitive view of the Department on what trustees should be doing.

Testimony of Mr. Jack Marco,

Marco Consulting Company

Chicago, Illinois

Mr. Marco stated that he had been an investment consultant for about 19 years. He said that his company helps trustees establish investment guidelines, hire money managers, evaluate performance, vote proxies. The company does not actually manage money for the trustees.

He pointed out that even with Association for Investment Management Research (AIMR) standards that have been published about the way money managers should present numbers, this still does not prevent some people from displaying numbers in a way that makes them look good. It makes them look better than they really are. For example, he recently evaluated a money manager who claimed that he had beaten the index over a period of time. However, the time periods listed ended in March. When he evaluated their numbers on an annual basis, they had failed to beat the index in seven out of ten years. The AIMR standards do not prevent this type of manipulation.

He also pointed out that in hiring a money manager, a plan should be wary about working from a published list of top performers or trade publications. He gave an example of investment manager who was on the top of a list but when Mr. Marco investigated, he found that this investment manager was a small bank, had only a small amount under management and had one good year. In another case, an investment manager who was on probation with Mr. Marco's client for his poor performance was rated highly by a publication. When he called the manager he was told that the publication was given the performance of a very specialized investment product they offer and which is very different from the investment product they provide most of their clients. However, this distinction was not noted in the publication.

He noted that fiduciaries of large plans can be unsophisticated with respect to investments. They may be just as easily misled by information as their small plan counterpart since they are not in the investment business. In addition, in the case of larger plans, egos may get in the way of seeking expert information.

Mr. Marco pointed out that his firm regularly monitors the performance of hundreds of money managers. However, in the case of a new manager, his firm has a 15-page questionnaire that they have the money manager fill out about the money manager. They asked for performance information from the inception of the money management form. He pointed out that it was important that his company get raw information regarding the money manager's performance and not composites put together by some marketing person at the money management firm. It is the job of the marketing person to create a composite that makes the money manager look good. His company then does a proper analysis of the numbers including analysis of the individual accounts managed to note variations in performance.

Mr. Marco said that other important things to look for when hiring a money manager are turnover of personnel in the firm, turnover of clients, style changes, ownership changes and litigation.

He noted that it was very difficult for fiduciaries, who are not in the investment business, to know what questions to ask, get all of the relevant information and evaluate it. Therefore, he feels that fiduciaries should go to a professional to help them select investment managers because it is a very difficult process to do correctly on their own.

However, Mr. Marco suggested that his own field, investment counseling, had some problems of its own. He pointed out that they were totally unregulated and unsupervised by anybody. He suggested that if an investment consultant was receiving a fee from a money manager, and that money manager is hired, that is a problem. He did not suggest regulation, but suggested that some sort of required disclosure to clients be required.

Mr. Marco explained that for an investment manager to get a new account is tremendously profitable. They really do not have to do much additional work to service a new account except prepare a report and attend some meetings. They do not have to do more research; they just buy bigger blocks of securities. Since it is so profitable to add clients, investment managers will do almost anything to get new business, including trying to influence the people who advise the fiduciaries in their decisions -- the investment consultants. Therefore, he feels that if an investment consultant has some connection to a money manager or is receiving some compensation from a money manager, the consultant's advice should be suspect. He suggested that if a fiduciary hires a consultant with some connection to a money manager, that the fiduciary may want to stipulate at the beginning of the process that the related firm may not be considered to be hired.

Mr. Marco stated his opinion that one of the biggest problems in the industry is investment consultants doing business with money managers -- selling services, doing brokerage, anything that involves compensation. In this situation, the consultant has two employers -- they are working for the fiduciaries and they are working for the money manager that they are supposed to be evaluating or recommending. Mr. Marco felt that fiduciaries should inquire of their consultants concerning compensation from money managers. He feels consultants should be required to disclose what revenue they receive from money managers. Fiduciaries can then make up their minds concerning the objectivity of the consultant's recommendations.

In response to a question, Mr. Marco acknowledged that for very small plans, under $10 million, it was usually cost prohibitive for them to go hire a consultant. He thought that these plans should stick with pooled funds where they would be much better off since the performance numbers are more reliable. However, Mr. Marco noted that fiduciaries can end up investing in inappropriate pooled investment vehicles.

In response to a question, Mr. Marco pointed out that unless a consultant claimed to be an investment advisor or a licensed broker, there were no regulations. Investment Advisors are regulated under the Investment Advisory Act.

When asked if there were a self-regulating organization for investment consultants, Mr.

Marco said there was one called the Investment Management Consultants Association (IMCA). Upon investigation, he found the organization to be loaded with broker consultants. When he talked with them about joining, he said that he would join if the organization would simply say you cannot do business with the other side. Let consultants be consultants and not sell services to money managers. He felt this would totally wipe out their membership.

Mr. Wood asked if Mr. Marco thought some sort of disclosure for plan sponsors or fiduciaries might not be a good idea. Perhaps an annual statement that they receive no compensation or any benefit, side benefits from any relationship they have with either investment managers, custodians, consultants, or service providers. He wondered if this might be particularly good for the ethically challenged. Mr. Marco said that he did not think that it would hurt, however, anybody that's going to do that has a much bigger problem than just hiring a manager.

In response to a question concerning the questions he would ask if hiring an investment consultant, Mr. Marco stated that he would ask about experience and qualifications, potential conflicts of interest -- what businesses is the consultant in besides consulting -- technical capabilities, measurement techniques -- what kind of data bases are used for performance, communications and references.

In response to a question, Mr. Marco stated that contracts with consultants should require them to acknowledge fiduciary responsibility. Many consultants will not sign anything that says they are a fiduciary.

Meeting of July 16, 1996

Joseph P. Craven,

Senior Vice President

Putnam Investments

Boston, Massachusetts

Based on his prior experience, Mr. Craven stated the ultimate goal for plan sponsors and trustees in selecting and monitoring investment managers is to have in place formalized written decision-making policies and procedures. Investment policies and procedures should be (1) consistent with the fiduciary responsibilities of plan sponsors/trustees, staff and investment consultants; and (2) give plan sponsors/trustees the best opportunity to select and retain investment managers who will serve the long- term needs of the plan and its participants.

In hiring investment managers, Mr. Craven stressed the importance of trustees observing five criteria. The first criterion is for plan sponsors/trustees to have a working knowledge of the specific needs of the plan and its participants. Plan needs include determining investment goals, risk tolerances, staffing levels and conducting investment manager oversight. Needs of the plan will determine its investment structure and asset allocation. A plan's asset allocation should determine types of investment managers evaluated for hire.

The second important criterion is for all policies and procedures involved in the hiring of investment managers be put in writing. Unless policies and procedures are written, there will always exist substantial opportunity for misunderstanding. Written procedures should be specific to plan's individual needs, and utilize a format clearly understood by all plan sponsors/trustees. Plans should consider utilizing a request for proposal (RFP) format to make the selection process as fair as possible. All selection criteria for hiring managers should be determined before a search is initiated.

The third criterion is for plan sponsors and trustees to gather as much information as possible to help them make informed decisions. Trustees can utilize consultant databases and other reference sources to evaluate managers performance numbers. All client and professional references should be carefully screened and critically analyzed.

The fourth criterion is to require full disclosure of all potential conflicts of interest between investment managers and plan sponsors/trustees, staff, and investment consultants. Investment manager candidates should complete a disclosure statement revealing all financial relationships between their firm and all other parties doing business with the pension plan. The fifth criterion is to carefully evaluate information provided by investment managers before making a selection. Each step in the selection process should be carefully documented in writing should it be needed for later reference.

Mr. Craven testified that monitoring investment managers is as much a fiduciary duty for plan sponsors/trustees as selecting them. He recommended that plan sponsors/trustees consider four important points in the monitoring process. The first point is every pension plan should have clear and understandable written investment guidelines applicable to each class of investment managers. The guidelines should clearly state all restrictions and limitations placed on each class of investment managers.

The second important point is that investment managers' compliance with investment guidelines be closely monitored by either internal staff or an investment consultant. Investment managers failing to stay within established guidelines should be dealt with immediately. Mr. Craven's third point covered the different types of due diligence required over different time periods. Investment manager compliance with written guidelines should be evaluated at least quarterly, while investment managers performance against peers can be performed on a less frequent basis.

The difficulty of investment manager oversight and compliance was the last point made by Mr. Craven. Plan sponsors/trustees should have either adequate internal staff or an investment consultant to closely monitor investment managers. Mr. Craven suggested smaller pension plans need fewer managers and should utilize less complex asset allocation. Software packages are now commercially available to help plan sponsors/trustees monitor investment managers' compliance. Software packages may be an attractive alternative for plan sponsors/trustees who are unable to afford hiring internal staff or an investment consultant.

In closing, Mr. Craven stated plan sponsors/trustees must remember they are dealing with funds belonging to plan participants and not their own money. Consequently, plan sponsors/trustees must sometimes pass up appealing investment opportunities not meeting long-term needs of the pension plan.

Carter F. Wolfe

Howard Hughes Endowment

In selecting investment managers, Mr. Wolfe stated it was critical for plan sponsors/trustees to establish clear investment guidelines as a first step. In drafting investment guidelines, plan sponsors/trustees should consider three important points. The three points are: (1) choosing the relevant index for each class of investment manager; (2) determining the amount investment managers are expected to exceed their index; and (3) determining how much risk plan sponsors/trustees are willing to tolerate in order for managers to exceed their indexes.

In choosing the types of managers to be hired, plan sponsors/trustees can utilize either individually managed accounts, commingled funds, or mutual funds. Smaller plans have difficulty justifying individually managed accounts because of the higher management fees and are better off selecting commingled funds or mutual funds. In addition, plan sponsors/trustees may choose between active and passive management styles by

managers. Mr. Wolfe's recommendation was small and medium-size plans should utilize passively managed index funds to invest plan assets. Index fund management fees are lower than their actively managed counterparts. Because of lower management fees, index fund managers cannot afford to market and entertain plan sponsors/trustees.

Plan sponsors and trustees cannot depend solely on investment managers' historical performance in selecting managers. Mr. Wolfe discussed a Cambridge Associates chart showing how investment market conditions change and how few investment managers maintain performance at highest levels due to changing market conditions. First-quartile performing managers in the first five-year period may easily be performing at third-quartile levels in the second five-year period and vice versa.

Mr. Wolfe stated plan sponsors/trustees should remember the three "Ps" of investment manager selection. The three "Ps" are (1) philosophy of the firm; (2) people qualifications; and (3) performance numbers. Plan sponsors/trustees should evaluate an investment management firm's philosophy for a good fit with the plan's asset allocation. A key question for plan sponsors/trustees to ask is: Has the firm's investment philosophy stayed consistent over time. People qualifications include researching key staff members backgrounds and qualifications. Plan sponsors/trustees should inquire into: How much turnover is there among key staff members? How is the firm owned? Are compensation packages in place to retain key staff members? Who are the firm's clients and how long have they been associated with the investment management firm?

Once investment managers are selected, plan sponsors/trustees must decide how to compensate the investment managers for their services. There are two types of investment manager fees, fixed and performance-based fees. Performance-based fees are much more complex and difficult to calculate. Consequently, performance fees are not as widely used as fixed fees. Another difficulty for plan sponsors/trustees in negotiating fees is the difficulty getting industry-wide comparable data on investment management fees.

Mr. Wolfe advised plan sponsors/trustees to concentrate in three areas to effectively monitor investment managers. First, plan sponsors/trustees should ensure investment managers are complying with written investment guidelines and terms of their individual contracts. The second area was monitoring turnover of key personnel within the investment management firm. Effective due diligence was the third area mentioned by Mr. Wolfe and should involve at least one on-site visit to each investment manager annually.

On the subject of investment consultants, Mr. Wolfe recommended plan sponsors/trustees not let investment consultants pass their account to a junior consultant who has less experience. When selecting an investment consultant, plan sponsors and trustees should interview all clients furnished as references.

Lastly, Mr. Wolfe said he was unfamiliar with the practice of investment consultants selling informational products to investment managers.

Barry Mendelson,

Senior Special Counsel in the Investment Management Division

Securities and Exchange Commission

When selecting a mutual fund, a Plan sponsor should consult a number of sources. First, the sponsor should thoroughly review the Fund's prospectus. The prospectus contains information about the mutual fund's investment objectives, risk profile, fees and expenses and past performance. In addition, plan sponsors should consult a fund's statement of additional information or SAI that contains more detailed information about the mutual fund than is found in the prospectus. An SAI is available from a mutual fund upon request.

Plan sponsors can obtain even more information about a mutual fund by reviewing its

most recent annual and semi-annual reports to shareholders. These reports list all of the fund's portfolio holdings and give past performance information. The itemization of a mutual fund's portfolio holdings gives valuable insight into the fund manager's strategy and philosophy.

In addition, plan sponsors should consult third-party source material. For example, Morningstar publishes reports covering approximately 3000 stock and bond funds. More importantly, the reports contain an analyst's discussion of the fund and a risk analysis of the fund's portfolio using Morningstar's risk rating system that has become the standard in the industry. In addition to Morningstar, Lipper Analytical Services also publishes reports that track fund performance and fees.

Fund sponsors should consider visiting the offices of the mutual fund. Speaking with the portfolio manager can lead to insights into the fund's investment strategies. Sponsors should also speak to the mutual fund's administrative personnel to find out what special services that fund may be able to provide to the plan.

A plan sponsor should also carefully review the risks associated with investment in a mutual fund. As part of a general review of mutual fund disclosure requirements, the SEC is examining what can be done to improve the discussion in the prospectus of risk and allow investors to gauge more accurately a fund's overall risk profile.

Sponsors should pay particular attention to information about sales charges and operating expense. Expense is particularly important because every basis point of expense lowers the fund's return.

Sponsors should check to see how long the current fund manager has held his or her position.

Plan sponsors often select investment advisory firms to be responsible for investing some or all of the plan's assets. Generally, a firm or individual that provides investment advice for a fee must register with the SEC and comply with the Investment Advisors Act. A fundamental element of the Investment Advisors Act is that the investment advisor owes its clients a fiduciary duty and, therefore, must act solely in their best interests. It is integral to this fiduciary duty to require full and fair disclosure of all material information. Therefore, the Investment Advisers Act requires and advisor to furnish each prospective client with a written disclosure statement containing: the types of advisory services, the fees its charges, the types of securities with respect to which the firm provides advice, the methods of investment analysis used by the firm, any affiliations with other securities professionals, whether the firm makes securities transactions for advisory clients, a current financial statement, the educational and business background of the key employees and any legal action taken against the firm's employees.

Mr. Mendelson noted that the law does not require any educational or business standards in order to register as an investment advisor. Anyone can register so long as they disclose the required information. Therefore, plans sponsors must carefully check the credentials of an advisor before hiring him or her. For this reason, sponsors may want to hire an advisor who has been certified or accredited by a private organization.

Since information in an advisor's disclosure brochure is very general in nature, sponsors must obtain specific information about how the advisor intends to invest the plans' assets and the fees it will charge. Sponsors should ask not only about the advisor's direct compensation but also about indirect compensation such as soft dollar arrangements and compensation to affiliated broker dealers. Sponsors should also ask for past performance information and references.

Plan sponsors may engage the services of an investment consultant to assist in the selection of mutual funds for the plan. Depending on the services it provides an investment consultant may be required to register as an investment advisor. In any event,

sponsors should ask whether the Investment consultant or anyone affiliated with the consultant will receive any remuneration of any kind other than the fee paid by the plan as a result of the consulting arrangement.

Many of the same sources of information consulted before selecting an investment fund or advisor should be consulted to monitor the fund or advisor after selection. These should be reviewed to determine how the fund has performed compared to the market generally.

The investment advisor is required to notify clients of any material change in the advisory relationship. Finally, the sponsor should arrange with periodic meetings with the advisor to discuss the management of the plan's assets.

Mr. Mendelson noted that the mutual funds were only required to report their holdings twice a year but that fiduciaries may wish to check on the fund's portfolio on a more frequent basis.

Under the securities laws, investment consultants who provide advice concerning particular investments are required to register. If a fiduciary wants to protect the plan he or she can insist that the consultant be registered. He felt it was more important for the fiduciary to find out about the consultant's credentials, get references and find out if the consultant is receiving compensation from any source other then the pension plan.

Mr. Mendelson stated that under the Investment Advisors Act of 1940 any one who gives personalized investment advice for compensation is an investment advisor under the act.

With respect to fees for mutual funds, Mr. Mendelson comments that many funds will waive the load for pension plan investments or plan investments over a particular amount. Therefore, there is no need for a plan to pay a load since there is a universe of funds out there that will make the same investment management services available without a load.

Mr. Mendelson noted that the SEC could examine an investment advisor who fails to disclose a conflict of interest.

Mr. Mendelson discussed in general terms the current proposals of the SEC to require better disclosure of the risk of an investment fund. The change would be in the nature of disclosure with respect to the current portfolio rather than with respect to potential investments.

Mr. Mendelson commented that a similar disclosure project was not needed for investment advisors because they were fiduciaries under ERISA and, therefore, had an obligation to recommend only investments that are suitable for their clients. A decision of the United States Supreme Court from the 1960s--SEC v Capital Gains Bureau, Inc.-- states expressly that anyone who is registered as an investment advisor is a fiduciary.

Meeting of September 10, 1996

Edmond F. Ryan

Senior Vice President, Pension Management

Massachusetts Mutual Life Insurance Company

Mr. Ryan prefaced his remarks by stating that he is familiar with the range of bundled products offered by the service provider community to 401(k) plans as a result of his twenty-three years of experience within the pension industry. His comments focused on the bundled product offered by MassMutual in the small employer market place, which is fairly representative of bundled products offered by the insurance industry.

Mr. Ryan made the important point that although the legal standards for selecting service providers does not vary depending upon whether a 401(k) plan is small or large, what makes sense does vary. The fixed cost of establishing and maintaining a plan is a far more significant issue for a small employer. Additionally, the administrative burden and complexity of maintaining a 401(k) plan is a bigger issue for small employers. While large employers often have fully staffed Human Resources and Treasury Departments, and many even have internal investment units, small employers rarely have this expertise in house. Consequently, they need a higher level of guidance and assistance.

Claims by small businesses that they do not maintain retirement plans because they are too costly and complicated are made manifestly clear when one looks at coverage rates relative to plan size. The Department of Labor estimates that almost one half of private sector workers--51 million people--do not have retirement plans. While over 80% of large companies with over 1000 employees offer plans; less than 25% of small companies, which are defined as having fewer than 100 employees offer plans.

According to Mr. Ryan, the bundled service provider approach provides small employers with a response to both the cost and complexity hurdles to plan coverage. A bundled product can provide an employer that sponsors a small plan with an array of valuable plan features previously available only to large plans, all at a reasonable cost. The bundled approach also prevents any gaps or overlaps in service that might otherwise result when multiple service providers are involved. While it makes sense for large employers to have multiple service providers, the bundled approach makes sense for small employers and provides them with a realistic opportunity to provide important retirement benefit to their workers.

Mr. Ryan noted that providing services to the defined contribution market is a very competitive business. Since 1982, when there were only a handful of competitors in the full service 401(k) market place, more and more service providers, including insurance companies, banks, third party administrators and employee benefit consultants, have entered the highly concentrated 401(k) provider market place. Several years ago mutual funds began to focus on the burgeoning 401(k) market as well. This ever increasing competition, coupled with advances in technology and a movement toward more wide spread benefits outsourcing have forced the leading companies to upgrade the quality of their bundled services without increasing fees. Service providers have enhanced their technological capabilities and resources and can now provide daily valued funds, daily valuation participant record keeping systems, 800 telephone numbers for participants to access account information and online employer access to plan and participant information. These technological innovations in plan administration and record keeping allow bundled service providers to respond to the demand for more comprehensive and integrated outsourcing of benefit plan administration.

On the investment side, providers need an array of funds covering the entire risk-return spectrum. Mr. Ryan noted that the Department of Labor's promulgation of Regulation §404(c) accelerated this trend by encouraging employee-directed defined contribution plans to offer a broad range of investment alternatives. When the Department published its regulation in 1992, it insisted on a minimum of three covariant funds. Today, a typical bundled 401(k) client has up to eight funds. Greater investment choice and opportunity for diversification have produced a need for more and better investment education tools and counseling for plan participants. Mr. Ryan commended the Department for its recent release of Interpretive Bulletin 96-1, which will encourage employers to provide additional financial educational materials without incurring the risk of becoming a fiduciary under ERISA.

Market data demonstrates that plan sponsors across all segments of the 401(k) market increasingly prefer these reasonably priced bundled products, Mr. Ryan noted. For example, a recent study found that the number of large defined contribution plans, (those with more than 1,000 participants,) using a single vendor for plan services increased to 59% in 1995 from 37% in 1989. Mid-size plans dramatically increased their use of bundled service to 62% in 1995 from 46% in 1989. The move toward bundled services

was also dramatic among small plans, which increased single vendor usage to 70% in 1995 from 62% in 1989.

Mr. Ryan stated that, in his experience, plan sponsors who purchase a bundled package of investments and administrative services have seven essential expectations. The first essential client expectation of a bundled service provider is financial stability, with a commitment to the defined contribution business for the long term. Studies confirm that prospective purchasers of a full service product rate financial stability as the single most important vendor selection criteria. This is reasonable since retirement plans by their very nature represent a long term financial commitment by employers to their employees. Therefore, prudent plan sponsors should inquire about the financial stability and experience of the service provider, and this is information the service provider should readily disclose.

The second essential expectation is timely and accurate compliance and record keeping services that reduce the plan sponsor's work load and save time and money. Mr. Ryan testified that an essential ingredient of any successful defined contribution program is the strength and flexibility of its administrative service capabilities. The track record of a vendor's ability to deliver the basics, accurate and timely record keeping, regulatory compliance and other administrative services, should be an absolutely crucial consideration for a plan sponsor when selecting a full service product.

A quality provider recognizes that small employers most often lack fully staffed human resource and benefit areas to manage their 401(k) plans, and strive to provide a competitive, state-of-the-art array of services in order to minimize the administrative burdens placed on the employer. The following services are now the rule for most 401(k) bundled products: (1) A daily valuation record keeping system should be able to process all withdrawals, including hardships, terminations, and retirements, as well as participant loans, and have the capacity to ensure that participant records always total to plan level records for all investment funds. (2) The record keeper should withhold federal and state income taxes from distributions made to participants and beneficiaries, and prepare IRS tax information forms. (3) Current information should be routinely available via an interactive voice response system. Through these systems participants can access account information using a toll free 800 telephone number and obtain information that is updated on a daily basis. (4) Comprehensive participant loan services should be available to assist the plan sponsor in the day-to-day administration of loans. (5) Detailed, yet easy to understand, reports should be made available to the plan sponsor summarizing the plan related activity that has occurred. (6) To ensure that participants know how their contributions are being invested and how their investments are performing, written participant account balance statements should be provided to participants on as frequently as a quarterly basis.

The third essential expectation is an investment manager which has demonstrated the ability to generate superior investment performance over time and which offers a wide range of investment options that will achieve plan participants' investment objectives. Plan sponsors demand that the investment options available under a bundled product be diverse and produce competitive rates of return, because employees' ultimate retirement benefits will be based on investment performance.

Mr. Ryan noted that one of the great challenges facing plan sponsors is getting participants to make rational investment decisions for retirement. Many Americans make little or no provision for their retirement security during their working years. Even those that have made the crucial decision to begin investing for retirement often select overly conservative investments that weaken their retirement security because of low rates of return or are inconsistent with their investment objectives and risk profiles. This is especially true in today's 401(k) environment, where more and more plans allow participants, rather than plan fiduciaries, to make their own investment selections. Consequently, a bundled service provider must provide education and assistance to participants planning for retirement and making asset allocation decisions.

The fourth essential bundled 401(k) client expectation is an administrator that assists with employee enrollment, investment education and ongoing plan communication. To achieve maximum value and high levels of participation, the plan must be recognized, understood and appreciated by employees. Small employers, who typically do not have a sophisticated human resource organization, rely heavily on the employee communication services provided under a bundled product to achieve that potential by assisting in the development of an effective employee communication program. An effective employee communication program should include the basics on investment education, and provide participants with a means for assessing their risk tolerance as well as designing alternative asset allocation strategies which provide them flexibility to meet individual return objectives and risk tolerance.

Investment education and retirement planning information for employees can take the form of written material, video tapes, computer software, and periodic group education sessions as well as one-on-one conversations with pension professionals. Mr. Ryan noted that because retirement planning concepts and terminology may be complicated for some employees, educational materials should be designed to appeal to all levels of investment sophistication in accordance with Interpretive Bulletin 96-1

The fifth essential client expectation is an administrator that helps interpret the laws and regulations and keeps their plan in compliance as the legal environment changes. Compliance with government regulations is paramount to a 401(k) plan's existence and plan design and ongoing regulatory compliance are critical parts of a bundled program. Most bundled service programs include prototype plan documents. They are flexible, comply in form with IRS regulations, and economic to use since they save the plan sponsor time and money on qualification filings and ongoing compliance. A typical bundled service program assists plan sponsors in drafting Summary Plan Descriptions, completing Form 5500s and keeping their plans in compliance with the operational requirements of the Internal Revenue Code through testing services.

The sixth essential bundled 401(k) client expectation is a consultant that provides personal attention from people who are knowledgeable and dependable. The ability for participants in plans sponsored by small employers to speak with a knowledgeable and dependable service representative is vital to ensuring plan sponsor satisfaction. A voice response system can be combined with personal assistance from customer service representatives to help keep participants informed about the plan and their accounts.

Mr. Ryan noted that while it is obvious that small plan sponsors who select a bundled product receive a level of services that was previously available only to the largest plans because of cost concerns, the services are valuable only if they are provided accurately and on a timely basis. A bundled program should operate with documented service standards and deliver service on time, accurately, and to specifications. The bundled service provider should establish stringent internal measurement goals and seek constant improvement.

The seventh essential bundled 401(k) client expectation is that expenses must be reasonable in relation to the level of services provided. A key consideration for the plan sponsor is the method for the payment of expenses. They can be paid by the plan sponsor, withdrawn from participants' accounts, shared by both the plan sponsor and the participant or paid from forfeitures. Most plans across all market segments provide for cost sharing by the plan participants and the sponsor company. All expenses should be fully disclosed to the plan sponsor in writing. Mr. Ryan brought to the Council's attention an article that appeared in the April 1996 edition of CFO entitled, Facing Up To Total Plan Cost. The article suggests there is a wide disparity in costs of bundled 401(k) service provider packages.

Mr. Ryan concluded his testimony by stating that he views the role of the bundled service provider as part business-part social engineer. Such organizations exist only because they can offer quality services at a reasonable cost and meet their profit objectives. He noted that he also takes pride in the fact that bundled service providers, like MassMutual, are

the only reason small companies are able to offer 401(k) retirement plans to hundreds of thousands of employees.

Leonard P. Larrabee, III

Senior Counsel

The Dreyfus Corporation

Mr. Larrabee, an attorney with the Dreyfus Corp. spoke on behalf of the Investment Company Institute (ICI), and was accompanied by Catherine L. Heron, Vice President and Senior Counsel, and Russell Gaylor, Assistant Counsel, who coordinate pension activity at the ICI. Mr. Larrabee began his testimony by stating his definition of a bundled service arrangement. Such an arrangement is an integrated package of administrative and investment services from affiliated or unaffiliated entities that is offered to the defined contribution market as a single product. That definition covers a variety of programs. The most basic one would involve an integrated package of administrative and investment services offered by a single financial institution. Mr. Larrabee made the point that, in the last five years, strategic alliance programs have been developed as an alternative to traditional bundled arrangements. The difference is that instead of having one financial institution offering investment and administrative services as a coordinated, integrated product, two or more institutions band together to provide a complete package of administrative and investment services as a coordinated, integrated product.

Mr. Larrabee next stated that the distinction between an alliance program and the traditional bundled service arrangement has become blurred in that it is becoming more and more common for a financial institution that offers a traditional, "one stop shopping," product to open up its program to include outside funds within its own bundled program.

The bulk of Mr. Larrabee's prepared remarks were devoted to the types of services a plan and its participants receive when a plan sponsor decides to purchase a bundled package of services. They can potentially receive every type of service involved in the daily operation of a defined contribution plan such as investment products, trustee services, record keeping services, communication and educational materials, telephone voice response systems, and plan documentation and compliance services. In essence, a plan sponsor could contract with a bundled service provider to have all of its defined contribution needs addressed.

Mr. Larrabee next discussed the issue of selecting service providers and specifically addressed the concern that participants' interests may be compromised by a plan sponsor's desire for the administrative convenience afforded by bundled service arrangements. Mr. Larrabee felt such criticism is unfair, and made the point that the same types of processes and procedures that are followed in the unbundled context carry over to the bundled service arrangement. With respect to investment options, Mr. Larrabee stated that due to the large number of bundled service providers to select from, if a particular service provider does not offer competitive investment products, it will not survive.

According to Mr. Larrabee, participants' interests are served by the number of "participant friendly" features available in a bundled service arrangement, such as daily valuation of participant account balances coupled with the ability to make daily transactions. Mr. Larrabee noted that studies have shown that the ability of participants to trade on a daily basis actually leads to better investment decisions on the part of participants who tend to focus on investing for the long-term without having to worry about market volatility over the short-term. He also stated that the ability to make frequent transactions in a bundled arrangement leads to better allocation decisions by participants.

Investment education is another participant friendly service typically found in a bundled service arrangement. Mr. Larrabee noted that financial institutions and their personnel are

experts in investment matters. Many of the innovative educational materials developed for participants in defined contribution plans evolved from the bundled service type of arrangement. In a bundled service arrangement, investment education materials are coordinated and targeted to the particular investment options available under the plan. Such materials are more effective in terms of educating employees and influencing their behavior than generic materials that may be used in an unbundled situation.

Mr. Larrabee made the point both in his testimony and in a question posed to him later that in a bundled arrangement the parties available to answer participant questions about investments available under the plan are registered representatives of the service provider. They are licensed and trained to answer any and all questions relating to securities and other investments available to plan participants. This is typically not the case in an unbundled arrangement where the answers to participant questions may be more scripted and less informative.

Mr. Larrabee concluded his remarks by stating that the reason bundled service arrangements -- whether they are in the form of the traditional one stop shopping arrangement or an alliance program -- are so popular and will continue to be so popular is that they are very responsive to the interests of the key players in a defined contribution plan, the plan participants.

In response to questions about the cost differential of bundled versus unbundled arrangements, Mr. Larrabee stated that he believes a plan sponsor tends to receive a better net price on a bundled arrangement, and that on a per participant basis, a bundled arrangement is more economical.

Custody and money management are handled by independent entities in a typical unbundled arrangement, and provide important cross-checks in the reconciliation of plan assets. Mr. Larrabee was asked to what extent do bundled service arrangements dilute this protection, and whether errors would be less likely to be reported to plan sponsors in a bundled arrangement. Mr. Larrabee responded that reconciliation procedures do take place in bundled arrangements, and that the potential for errors going unreported and uncorrected is not any greater or lesser in either arrangement. He and Ms. Heron stated that mutual funds, like banks and insurers, are highly regulated entities. They are regulated at both the federal and state level. There is no indication that the regulatory regimes are inadequate to deal with any mistakes or problems that arise, including any conflicts of interests between affiliated entities. Plan sponsors and participants receive numerous reports and statements. A mistake could potentially be found by a regulator, an auditor, a plan sponsor, a plan participant or by the service provider itself. Financial institutions take responsibility for the errors that they make. When mistakes occur, they are corrected so that participants are put in the position they would have enjoyed if the transactions were processed correctly when initiated.

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