Investments: A Fiduciary Primer

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Who Are Investment Fiduciaries?

- *Trustees* are fiduciaries under ERISA 3(21) because they have discretionary management over plan assets.
- Trustees may delegate certain investment responsibilities to investment managers, *but* they retain overall responsibility for the investment program.

Who Are Investment Fiduciaries?

- *Consultants* are fiduciaries under ERISA 3(21) because they provide investment advice for a fee.
  - Prepare statement of investment policy (SOIP).
  - Screen/recommend investment managers.
  - Monitor investment managers.

Who Are Investment Fiduciaries?

- *Managers* are fiduciaries under ERISA 3(38) if a plan delegates to them buy/sell decisions.
  - Hiring, delegation to, and retention of investment managers is typically at the recommendation of the consultant.
  - This is where the Outsourced Chief Investment Officer (OCIO) model really lies, since OCIO consultants often recommend their companies' own investment vehicles.

Who Are Investment Fiduciaries?

- *Non-fiduciaries*
  - Mutual fund managers
  - Private placement managers

U.S. Department of Labor Guidance on Investments

- There are five fiduciary duties under Title I, Part 4 of ERISA.

U.S. Department of Labor Guidance on Investments

- The first fiduciary duty is the *Duty of Loyalty*.
- The duty of loyalty requires fiduciaries to act at all times in the best interests of participants and beneficiaries, and to spend plan assets only on benefits and reasonable administrative expenses.

U.S. Department of Labor Guidance on Investments

- DOL calls a per se breach of the duty of loyalty a *prohibited transaction*.
- Examples of prohibited transactions would be paying an investment professional unreasonable compensation, or getting kickbacks from an investment professional.

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- The second fiduciary duty is the *Duty of Prudence*.
- The duty of prudence requires fiduciaries to act as prudent *experts* would under all the facts and circumstances.
- If fiduciaries lack the expertise themselves, they must retain experts to advise them.

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- Hiring and following investment experts, however, does *not* automatically fulfill a fiduciary's duty of prudence.
- The fiduciary must still diligently attend to the investment program by being an active skeptic of the advice he/she receives.
- There is no substitute for a fiduciary's own common sense, experience, and judgment.

U.S. Department of Labor Guidance on Investments

- The third fiduciary duty is the *Duty of Diversify Investments* so as to avoid the risk of large losses, unless it would be imprudent to do so.

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- The fourth fiduciary duty is the *Duty of Follow Plan Documents*, unless it would be illegal to do so.
- Remember the statement of investment policy (SOIP) we spoke about earlier? It is a plan document which fiduciaries must follow (or amend if they make changes).

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- The fifth fiduciary duty is the *Duty to ensure Co-fiduciaries are fulfilling their duties*.
- That means that a fiduciary cannot participate in, enable through inaction, or ignore a co-fiduciary's breaches.

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- An example of where one fiduciary can be held liable for a co-fiduciary's breach is if by failing to attend meetings, a fiduciary does not stop a conflicted co-fiduciary from voting for an investment manager.

First Set of Questions to Ask About Investments

- One way that a fiduciary can fulfill his/her fiduciary duties is by asking how a given investment has satisfied the five fiduciary duties we have covered.

First Set of Questions to Ask About Investments

- Does the investment advance the best interests of participants and beneficiaries, and at a reasonable cost?

First Set of Questions to Ask About Investments

- Has the plan followed a prudent process in selecting/monitoring the investment, seeking advice from experts when necessary?

First Set of Questions to Ask About Investments

- Does the investment diversify the plan's portfolio?

First Set of Questions to Ask About Investments

- Does the investment fit the plan’s governing documents, most importantly its statement of investment policy (SOIP)?

First Set of Questions to Ask About Investments

- And has the selection/retention/disposal of an investment been free of any potential fiduciary breaches, such as self-dealing by one or more fiduciaries?

Second Set of Questions to Ask About Investments

- A second way to approach fulfilling one's fiduciary duties towards investments is to answer these eight questions, in alphabetical order.

Second Set of Questions to Ask About Investments

- How does this investment fit into the plan's *asset allocation*?

Second Set of Questions to Ask About Investments

- Is this investment free of potential *conflicts of interest*?
- If not, what are they, and are they manageable or disqualifying?

Second Set of Questions to Ask About Investments

- How much does this investment *cost*?

Second Set of Questions to Ask About Investments

- What is this investment's *liquidity*?

Second Set of Questions to Ask About Investments

- What has this investment's *performance* been compared to its peers and against other alternatives?

Second Set of Questions to Ask About Investments

- What are the *risks* posed by this investment?

Second Set of Questions to Ask About Investments

- What is the *standard of care* the investment manager must fulfill?

Second Set of Questions to Ask About Investments

- What is the *valuation* process for the investment?

Second Set of Questions to Ask About Investments

- If a fiduciary understands his/her plan's *asset allocation,* an investment's potential *conflicts,* an investment's *cost,* an investment's *liquidity,* an investment's *performance,* an investment's *risks,* an investment manager's *standard of care,* and an investment's *valuation* process, then he/she can make legally defensible decisions about any particular investment.

Key Takeaways

- Trustees, consultants, and managers are all fiduciaries, *unless* the consultant recommends, and the trustees choose, a non-fiduciary manager. Then only the trustees and consultant act as fiduciaries.

Key Takeaways

- Fiduciaries need to fulfill all five of their fiduciary duties under ERISA when it comes to investments:
  - *Loyalty*
  - *Prudence*
  - *Diversification*
  - Adherence to *plan documents*
  - Absence of *co-fiduciary breaches*

Key Takeaways

- Fiduciaries can fulfill their fiduciary duties with respect to a plan's investment program by asking how an investment decision satisfies all of these five duties and/or understanding how a particular investment measures up with respect to *asset allocation*, *conflicts of interest*, *costs*, *liquidity*, *performance*, *risks*, the *standard of care*, and *valuation*.

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