

Selecting and Monitoring Investment Professionals

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ERISA imposes a wide variety of technical and, in some cases, extremely complex rules with which employee benefit plan fiduciaries must comply when investing ERISA plan assets. These rules are applicable to all plan fiduciaries responsible for effectuating or monitoring ERISA plan assets including, among others, boards of trustees of collectively bargained plans, boards of directors of corporations sponsoring ERISA-covered plans and plan administrators, as well as investment managers, investment consultants, broker-dealers, banks, custodians and similar financial institutions. If you are one of those above, it behooves you to obtain at least a rudimentary understanding of ERISA's fiduciary responsibility rules, burgeoning regulations and evolving unique case law. This article addresses salient legal issues confronting plan fiduciaries today in connection with the investment of employee benefit plan assets.

The proper treatment of this subject would probably merit an article of several hundred pages. However, in order to be charitable to your sight and psyche, we have endeavored to boil down only the essentials. Obviously, this article represents only a brief summary of the issues at hand and, therefore, we would urge you to consult with legal counsel that specializes in ERISA with respect to any specific issues or problems that you encounter in this field. Happy reading!

The Fiduciary's Role in Today's Political and Economic World

The Opportunity and Danger of the Moment

The world of employee benefit plan funding and finance is currently a world of risk. The past several years have engendered massive economic losses, as well as a reduced level of confidence in the financial system and in those who manage it. The fact that participants bear the risk of invest-

ment losses—especially under defined contribution plans, such as 401(k) plans—is a new and very disturbing concept for many.

Thus, it is more critical than ever today for ERISA plan fiduciaries to keep abreast of economic and legal developments and, most importantly, to proactively anticipate situations that may pose substantial risks as well as those that present opportunities—especially issues such as investment manager selection, fiduciary liability, participant education and investment diversification.

Employee benefit plan trustees are being held accountable to increasingly strict standards. The Sarbanes-Oxley Act, signed into law on July 30, 2002, imposed increased sanctions and criminal violations of ERISA. The new law also tightened the restrictions on 401(k) blackout periods, requiring advance notice to participants of times that they will be unable to make any changes to their investments and limiting insider trading.

In addition, premiums for “fiduciary

liability” and other insurance for officers, directors, trustees and other plan fiduciaries are rising precipitously. In the past years since 9/11, premium rates have increased on average from 20% to as much as 80%. Insurance companies are also refusing to renew coverage for some companies—particularly those that invest a significant percentage of their employee benefit plan's assets in company securities.

Delegation of Plan Manager Selection

The search for the best individuals to manage employee benefit plan assets is one of the most important tasks a plan fiduciary can undertake. Conventional wisdom says only one in four professional fund managers ever outperforms the index. The search is further complicated by the nation's recent tide of corporate scandals that occurred in the early part of this decade.

Some experts even argue that ERISA, now 30 years old, is due for a significant overhaul that would shift the major responsibilities for the design and maintenance of retirement

plans to nonemployer, independent entities (e.g., insurers, banks or other organizations). Under such a scenario, employers would no longer serve as plan sponsors and fiduciary responsibilities would be fully assumed by the external vendors, who would also handle participant claims and disputes over benefits.

New Directions in Investment Strategies

Funds are under increasing pressure to boost returns in order to pay benefits. In this context, investment professionals are placing increased emphasis on private equity, hedge funds, venture capital and other “alternative” forms of investments.

Hedge funds are a booming asset class, currently attracting record cash flows. Up to 50% of equity trading revenues at an investment bank may be generated by hedge fund activity. Consequently, many institutional investors are seeking to educate themselves about hedge funds and trying to determine how a hedge fund strategy would fit in with their overall portfolios.

One of the most attractive benefits of a hedge fund—especially a hedge fund of funds—is that it offers low correlation to more traditional investments such as stocks. *Low correlation* means increased diversification and increased protection from downside risks. There is also an argument that loosely regulated hedge fund investment pools are better equipped to boost returns in a volatile market environment. However, one of the concerns is with the unregulated nature of the hedge fund sector. The Securities and Exchange Commission (SEC) has suggested subjecting hedge funds to regular inspections and compelling the funds to provide more information about their operations to investors and regulators.

An equally significant question relating to issues in investment of plan assets today is whether and how much to invest in company stock. The Enron collapse led to increased scrutiny on the holding of employer stock in employee retirement plans. As of December 31, 2000, Enron stock constituted 62% of the assets in Enron’s 401(k) plan.

Particularly in defined contribution plans, employer stock often constitutes a significant percentage of the assets held. Some companies voluntarily limit the amount of employer stock held, but most do not. The aggregate percentage of 401(k) assets in company stock is 19% and has stayed constant over the past five years.

General Fiduciary Issues for Investments of Plan Assets

Basic ERISA Fiduciary Rules

The cornerstone of ERISA’s fiduciary responsibility provisions is set forth in Section 404(a)(1) of ERISA, which provides that a fiduciary of an employee benefit plan shall discharge its investment duties with respect to such plan:

- For the exclusive purpose of . . . providing benefits to participants and beneficiaries
- With the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims
- By diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so
- In accordance with the documents and instruments governing the plan.

Definition of Fiduciary

The term *fiduciary* is broadly defined in ERISA as any person who

- Exercises any discretionary authority or discretionary control regarding management of the plan
- Exercises any authority or control (discretionary or otherwise) regarding management or disposition of its assets
- Renders investment advice regarding plan assets for a fee or other compensation, whether direct or indirect, or has any authority or responsibility to do so, or
- Has any discretionary authority or discretionary responsibility in the administration of such plan.

ERISA §3(21)(A).

See *Thomas, Head & Greisen Employees Trust v. Buster*, 24 F.3d 1114, 1117 (9th Cir. 1994) (“The definition of fiduciary under ERISA should be liberally construed.”), *cert. denied*, 513 U.S. 1127 (1995); *Blatt v. Marshall & Lassman*, 812 F.2d 810, 812 (2d Cir. 1987) (fiduciary status “must be determined by focusing on the function performed, rather than on the title held”); *Stein v. Smith*, 270 F.Supp. 2d 157, 165 (D.Mass. 2003) (“Under ERISA, a person . . . can be a fiduciary by virtue of being either named as such or by acting in a fiduciary capacity with regard to an ERISA plan”).

This definition encompasses, among others, plan trustees, plan administrators, employers, members of an employer’s board of directors, the members of an employer’s plan investment or administration committees, investment managers and each person who selects, appoints, supervises or monitors such individuals. See, e.g., *Martin v. Harline*, 15 Employee Benefits Cas. (BNA) 1138 (D.Utah 1992) (member of employer’s board of directors was a fiduciary because he had discretion to act with respect to employer’s employee stock ownership plan (ESOP) and, thus, was jointly and severally liable for any losses resulting from fiduciary breach).

The absence of a formal appointment as a fiduciary will not necessarily enable a person to avoid fiduciary liability under ERISA. See *Donovan v. Mercer*, 747 F.2d 304 (5th Cir. 1984) (formal appointment is not a prerequisite to fiduciary liability).

Officials of the company sponsoring an ERISA plan are fiduciaries to the extent that they retain authority for the selection and retention of plan fiduciaries because, to that extent, they have retained discretionary authority or control respecting management of the plan. 29 C.F.R. §2509.75-8 at D-4. See *Newton v. Van Otterloo*, 756 F.Supp. 1121, 1132 (N.D.Ind. 1991) (power to appoint and remove fiduciaries makes company’s board of directors fiduciaries). However, a plan sponsor does not become a fiduciary solely as a result of the establishment, amendment or termination of a plan. These “settlor” functions are not subject to the ERISA fiduciary rules. See *Walling v.*

Brady, 125 F.3d 114 (3d Cir. 1997); *Pay-onk v. HMW Indus.*, 883 F.2d 221, 225 (3d Cir. 1989).

The Prudence Standard

The standard for prudence depends on the circumstances. "The scope of the fiduciary's duty of prudence is . . . limited to those factors and circumstances that a prudent person having similar duties and familiar with such matters would consider relevant, whether the context is one of plan investments or otherwise." 44 *Fed. Reg.* 37,222-23 (July 20, 1979) (DOL release accompanying DOL Reg. §2550.404a-1(b)).

The courts generally have held that "ERISA's prudence standard 'is not that of a prudent lay person but rather that of a prudent fiduciary with experience dealing with a similar enterprise.'" *Whitfield v. Cohen*, 682 F.Supp. 188, 194 (S.D.N.Y. 1988) (quoting *Marshall v. Snyder*, 1 Employee Benefits Cas. (BNA) 1878, 1886 (E.D.N.Y. 1979)).

The Department of Labor (DOL), the courts and commentators have distinguished between two types of prudence—substantive and procedural. The former refers to the merits of the decision made by the fiduciary; the latter addresses the process through which the fiduciary reaches his or her decision. As long as there is no conflict of interest that would impair the fiduciary's exercise of independent judgment, a fiduciary that considers the appropriate substantive factors (*substantive prudence*) and does so using proper procedures (*procedural prudence*) will satisfy the prudence requirement, in most cases, even if the decision later leads to investment losses. *Katsaros v. Cody*, 744 F.2d 270, 279 (2d Cir.), *cert. denied sub nom. Cody v. Donovan*, 469 U.S. 1072 (1984); see also *California Ironworkers Field Pension Trust v. Loomis Sayles & Co.*, 259 F.3d 1036, 1043 (9th Cir. 2001) ("When applying the prudence rule, the primary question is whether the fiduciaries, 'at the time they engaged in the challenged transactions, employed the appropriate methods to investigate the merits of the investment and to structure the investment.'" (quoting *Donovan v. Mazzola*, 716 F.2d 1226, 1232 (9th Cir. 1983))); *Tittle v. Enron Corp.*, 284 F.Supp. 2d 511, 548 (S.D.Tex.

2003) ("the standard of the prudent man is an objective standard, and good faith is not a defense to a claim of imprudence").

Fiduciary Liability

ERISA imposes personal liability on plan fiduciaries who, by breaching their fiduciary duties, cause plans for which they are responsible to incur losses. ERISA §409. That section of ERISA provides that a fiduciary who breaches any of the responsibilities, obligations or duties imposed upon him/her as a fiduciary shall be:

1. Personally liable to reimburse the plan for any losses resulting from each breach
2. Subject to the possible imposition by the U.S. Secretary of Labor of an additional 20% penalty on the amount involved, ERISA §502(l)
3. Responsible for restoring to the plan any profits made through use of plan assets
4. Subject to such other equitable or remedial relief as a court may deem appropriate, such as liability for claimant's attorney fees and removal from his/her fiduciary position.

See ERISA §411; see also *Martin v. Feilen*, 965 F.2d 660 (8th Cir. 1992), *cert. denied*, 113 S.Ct. 979 (1993); *Tittle v. Enron Corp.*, 284 F.Supp. 2d 511 (S.D. Tex. 2003) (named fiduciaries, and those who assume fiduciary duty through their actions, are equally subject to liability); *Oscar A. Samos, M.D., Inc. v. Dean Witter Reynolds, Inc.*, 772 F.Supp. 715 (D.R.I. 1991); cf. *Tittle v. Enron Corp.*, 284 F.Supp. 2d 511 (S.D.Tex. 2003) (service providers and employers of plan participants, although not fiduciaries, may be liable for equitable relief if they knowingly assist in a fiduciary's breach).

"Losses" to the Plan From Breach of Fiduciary Duty

Courts have adopted a "but for" approach to assessing money damages for breaches of fiduciary duty. Liability is imposed in the amount that would restore the plan to the position it would have been in "but for" the breach. *California Ironworkers Field Pension Trust v. Loomis Sayles & Co.*, 259 F.3d 1036,

1046 (9th Cir. 2001) (holding that "even if losses attributable to the breach are more than balanced by gains resulting from appropriate investments, the plan beneficiaries are entitled to 'the greater profits the Plan might have earned if the Trustees had invested in other plan assets' rather than the impermissible assets") (quoting *Donovan v. Bierwirth*, 754 F.2d 1049, 1056 (2d Cir. 1985)) (measure of loss requires a comparison of what plan actually earned with what it would have earned had the funds been available for other purposes).

Hence, even if an improper decision results in a positive investment return, damages will nevertheless be assessed if a prudent decision would have resulted in an even greater return. See *Dardaganis v. Grace Capital, Inc.*, 889 F.2d 1237 (2d Cir. 1989).

Co-Fiduciary Responsibilities

Section 405(a) of ERISA provides that a plan fiduciary shall be liable for a breach of fiduciary responsibility of another fiduciary with respect to the same plan if he/she:

- (a) Participates knowingly in, or knowingly undertakes to conceal, an act or omission of such other fiduciary, knowing such act or omission to be a breach of fiduciary responsibility;
- (b) By failing to fulfill his/her own fiduciary responsibilities, has enabled the other fiduciary to commit such breach; or
- (c) Has knowledge of a breach by such other fiduciary and fails to make reasonable efforts under the circumstances to remedy the breach.

See *Fink v. Nat'l Sav. & Trust Co.*, 772 F.2d 951, 958 (D.C.Cir. 1985).

If a fiduciary does not possess knowledge of his or her participation in, or concealment of, a breach of fiduciary duty, the fiduciary lacking such knowledge will not necessarily be liable for the acts or omissions of another fiduciary. See *Davidson v. Cook*, 567 F.Supp. 225 (E.D.Va. 1983), *aff'd*, 734 F.2d 10 (4th Cir.), *cert. denied sub nom. Accardi v. McGuire, Woods and Battle*, 469 U.S. 899 (1984).

Every fiduciary must exercise prudence to prevent his/her co-fiduciaries from committing a breach of fiduciary

responsibility, and must jointly manage and control plan assets unless specific duties have been allocated among them. ERISA §405(b)(1)(A), (B).

In the absence of conduct that falls within Section 405(a), however, the liability of a fiduciary that is not a “named fiduciary” is generally limited to the functions he or she performs with respect to the plan, and he or she will not be personally liable for all phases of the management and administration of the plan. 29 C.F.R. §2509.75-8 at FR-16.

Delegation of Fiduciary Responsibilities—General Rule

Plan documents may provide for the allocation of responsibilities among named fiduciaries, and may authorize named fiduciaries to delegate nontrustee fiduciary responsibilities to others. However, “trustee responsibilities” relating to the management or control of plan assets may not be allocated unless such authority is delegated to an investment manager. ERISA §405(c)(1).

For example, if an employer prudently allocates fiduciary responsibilities among named fiduciaries according to plan procedures, the employer will not be liable for the acts and omissions of other named fiduciaries, except as provided in ERISA’s co-fiduciary rules. 29 C.F.R. §2509.75-8 at FR-13. Similarly, named fiduciaries will not be liable for the acts and omissions of a person who is not a named fiduciary in carrying out the responsibilities delegated to such person (29 C.F.R. §2509.75-8 at FR-14) provided, of course, that the named fiduciary prudently selects and monitors the actions of such individual.

Delegation of Fiduciary Responsibilities—To an Investment Manager

If an ERISA-qualified investment manager has been prudently appointed, neither the employer sponsoring the plan nor any other plan fiduciary will be liable for the acts or omissions of the investment manager or otherwise responsible for the investment of plan assets under the management of the investment manager, unless the appointment itself is

imprudent; or the fiduciary fails to prudently monitor, and take affirmative action with respect to, the conduct of the appointee. ERISA §405(d)(1).

Section 3(38) of ERISA provides that the following entities will qualify as an “investment manager” under ERISA, provided that the entity has acknowledged in writing that it is a fiduciary with respect to the plan:

- (a) An investment adviser registered under the Investment Advisers Act of 1940
- (b) A bank, as defined in the Investment Advisers Act of 1940
- (c) An insurance company qualified under the laws of more than one state to manage, acquire or dispose of plan assets.

The Investment Product—General Legal Considerations **The Fiduciary’s Independent Investigation**

One of the hallmarks of prudence under ERISA is whether the fiduciary undertook a thorough and complete investigation before embarking on a particular course of investment action. *Harley v. Minnesota Mining and Mfg. Co.*, 42 F.Supp. 2d 898, 906 (D.Minn. 1999) (“Under this standard, a fiduciary is obligated to undertake an independent investigation of the merits of an investment and to use appropriate, prudent methods in conducting the investigation.”), *cert. denied*, 537 U.S. 1106 (2003); *Fink v. Nat’l Sav. & Trust Co.*, 772 F.2d 951, 957 (D.C.Cir. 1985) (“A fiduciary’s independent investigation of the merits of a particular investment is at the heart of the prudent person standard.”)

If a fiduciary has failed to undertake the appropriate investigation before making an investment decision, the question is “whether, considering the facts that an adequate and thorough investigation would have revealed, the investment was objectively imprudent.” *Whitfield v. Cohen*, 682 F.Supp. 188, 195 (S.D.N.Y. 1988).

A fiduciary’s duties with respect to plan investments do not end after he/she has selected the investment options. Fiduciaries should monitor investments with reasonable diligence and, if necessary, dispose of improper

investments. *Hunt v. Magnell*, 758 F.Supp. 1292 (D.Minn. 1991); *Harley v. Minnesota Mining and Mfg. Co.*, 42 F.Supp. 2d 898, 906 (D.Minn. 1999) (“Once the investment is made, a fiduciary has an ongoing duty to monitor investments with reasonable diligence and remove plan assets from an investment that is improper.”), *cert. denied*, 537 U.S. 1106.

Considerations When Investing Plan Assets

The following factors, among others, should be considered with respect to the investment of the plan assets:

- Whether the particular investment or investment course of action is reasonably designed, as part of the portfolio, to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action
- The composition of the portfolio with regard to diversification
- The liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan
- The projected return of the portfolio relative to the funding objectives of the plan.

29 C.F.R. §2550.404a-1(b).

Fiduciaries should establish prudent investment objectives and strategies, including identification of the financial needs of the plan and preparation of a written statement describing the investment objectives of the plan. In establishing plan objectives, the following factors (among others) should be considered:

- Nature of the plan
- Purpose of the plan and the employer’s aim in offering the plan, taking into account the age, income levels and investment needs of participants
- Plan funding characteristics and funding provisions
- Plan size
- Plan liquidity requirements
- Acceptable risk-return ratios.

Statements of Investment Policy

According to DOL, a named fiduciary’s authority to issue statements of

investment policy to investment managers is inherent in the named fiduciary's authority, under the terms of the plan, to appoint investment managers. DOL Interpretive Bulletin 94-2 (July 29, 1994); ERISA §402(c)(3). A *statement of investment policy* is a written statement that provides the plan fiduciaries responsible for plan investments with guidelines and general instructions concerning various types or categories of investment management decisions, which may include restrictions on the types of investments (e.g., no foreign securities or venture capital issues); asset allocation requirements (i.e., limiting plan investments in equities to a specific percentage of the portfolio); minimum bond quality grades (e.g., no more than 25% of the total fixed income portfolio should be invested in bonds rated less than "A"); and proxy voting decisions (e.g., criteria regarding the support of or opposition to recurring issues, such as proposals to create a classified board of directors), etc.

ERISA does not specifically require that plan fiduciaries prepare statements of investment policy. DOL, however, believes that such statements serve a legitimate purpose in many plans by helping assure that the investments are made in a prudent and rational manner and are designed to further the purposes of the plan and its funding. DOL Interpretive Bulletin 94-2 (July 29, 1994); see also *Liss v. Smith*, 991 F.Supp. 278, 296 (S.D.N.Y. 1998) ("[t]he maintenance by an employee benefit plan of a statement of investment policy designed to further the purposes of the plan and its funding policy is consistent with the fiduciary obligations set forth in ERISA").

If a plan has a statement of investment policy, it would be advisable for it to contain a statement of proxy voting policy since such statements may increase the likelihood that proxy voting decisions will be consistent with other aspects of the investment policy. In addition, if a plan has many investment managers, a written proxy voting policy may also prevent the investment managers from taking conflicting positions on a given issue. *Id.*

According to DOL, a named fiduciary's determination of the terms of a

statement of investment policy represents an exercise of fiduciary responsibility. Such statements need to take into account factors such as the plan's funding policy and its liquidity needs as well as issues of prudence, diversification and other fiduciary requirements.

Prudent Investment Strategies and Decisions

The general standard for determining whether a fiduciary acted prudently in designing investment strategies and making investment decisions is whether it:

- Employed proper methods to investigate, evaluate and structure the investment
- Acted in a manner as would others who have a capacity and familiarity with such matters
- Exercised independent judgment when making investment decisions.

Jones v. O'Higgins, 11 Employee Benefits Cas. (BNA) 1660, 1667 (N.D. N.Y. 1989).

Fiduciaries should be able to establish that, in effecting such decisions, they:

- Conducted an impartial study of the advantages and disadvantages of the particular transaction
- Exercised due diligence in researching all aspects of the transaction
- Utilized acceptable standards in retaining qualified experts and consultants
- Relied on complete and up-to-date information.

Moreover, a fiduciary's conduct in investigating the merits of a transaction must satisfy prevailing industry standards. Compare *Jones v. O'Higgins*, 11 Employee Benefits Cas. (BNA) 1660, 1668 (N.D.N.Y. 1989) ("To find the defendant liable, this court would have to be provided with evidence that [the defendant] acted imprudently within the standards of the investment industry") with *GIW Indus., Inc. v. Trevor; Stewart, Burton & Jacobsen, Inc.*, 10 Employee Benefits Cas. (BNA) 2290, 2304 n.23 (S.D.Ga. 1989) ("While [investment management industry] custom and practice enter into an evaluation of prudence, the particular

obligations of a fiduciary under ERISA are not controlled by the investment management industry but by statute"), *aff'd*, 895 F.2d 729 (11th Cir. 1990).

The legislative history accompanying ERISA reflects that the expertise required of a plan fiduciary will vary with the size and scope of the plan. Individuals managing larger plans with enormous assets will be required to exercise a more professional approach to investment management than individuals administering small plans with a limited portfolio.

Retention of an Expert

The courts have recognized that not all plan fiduciaries can be expert in all phases of employee benefit plan investments and administration, nor can they have knowledge in the entire range of activities integral to the operation of a plan. ERISA §§402(c)(2) and (3). Therefore, a fiduciary has an affirmative duty to seek the advice and counsel of independent experts when his/her own ability is insufficient under the circumstances. *Katsaros v. Cody*, 744 F.2d 270, 279 (2d Cir.), *cert. denied sub nom. Cody v. Donovan*, 469 U.S. 1072 (1984).

Fiduciaries are responsible for determining whether the consultants they retain have qualifications in the subject area of the transaction. The advice of experts should set forth the benefits and risks of a particular transaction in a form that is comprehensible and should provide sufficient analysis and grounds for making informed decisions.

However, an independent appraisal from an expert will not satisfy a fiduciary's duty to act prudently, if the information provided to the consultants by the fiduciaries is inaccurate or based on erroneous assumptions. Indeed, while fiduciaries have a duty to seek independent advice where they lack the requisite education, experience and skill, they nevertheless must make their own decision based on that advice. *Whitfield v. Cohen*, 682 F.Supp. 188, 194-195 (S.D.N.Y. 1988); see also *Donovan v. Cunningham*, 716 F.2d 1455, 1474 (5th Cir. 1983) ("An independent appraisal is not a magic wand that fiduciaries may simply wave over a transaction to ensure that their re-

sponsibilities are fulfilled. . . . ERISA fiduciaries . . . are entitled to rely on the expertise of others . . . [, but] are responsible for ensuring that information is complete and up-to-date.”), *cert. denied*, 467 U.S. 1251 (1984).

Reliance on limited or inaccurate information will not relieve plan fiduciaries of the duty to independently investigate the advantages and disadvantages of a particular investment. See *In re Unisys Savings Plan Litig.*, 74 F.3d 420 (3d Cir. 1996) (it is a breach of ERISA's prudence standard if a plan administrator, without conducting an independent investigation, passively accepts a consultant's positive appraisal of a debt investment in a corporation that subsequently becomes bankrupt), *cert. denied*, 117 S.Ct. 56 (1996); *Chao v. Hall Holding Co., Inc.*, 285 F.3d 415, 430 (6th Cir. 2002) (“The fiduciary must (i) investigate the expert's qualifications . . . (ii) provide the expert with complete and accurate information . . . and (iii) ensure that reliance on the expert's advice is reasonably justified under the circumstances.”) (quoting and adopting the standard for fiduciary reliance on experts outlined in *Howard v. Shay*, 100 F.3d 1484, 1489 (9th Cir. 1996), *cert. denied*, 520 U.S. 1237 (1997)), *cert. denied*, 537 U.S. 1168 (2003).

Diversification of Plan Investments

A fiduciary involved in plan investments must diversify such investments so as to minimize the risk of large losses, unless it is clearly prudent not to do so under the circumstances. Plans should embody investments that provide diversification among different asset classes and within asset classes. See *Marshall v. Teamster Local 282 Pension Trust Fund*, 458 F.Supp. 986 (E.D.N.Y. 1978) (a concentration of 36% of the plan's assets in one form of investment is a violation of ERISA §404(a)(1)(C)). But see *Matassarini v. Lynch*, 174 F.3d 549 (5th Cir. 1999) (no breach of diversification rule where the failure to diversify account did not expose it to the risk of large losses), *cert. denied*, 528 U.S. 1116 (2000); *Metzler v. Graham*, 112 F.3d 207 (5th Cir. 1997) (no breach where 63% of the plan's assets were invested in one parcel of real property because, given the value of the real es-

tate and the purchase price paid, at no relevant time was there a “risk of large loss”); *In re Unisys Savings Plan Litig.*, 173 F.3d 145 (3d Cir. 1995) (employer found not to have breached fiduciary duty to diversify by investing 20% of fund's assets in guaranteed income contracts issued by an insurance company that went into receivership, since plaintiff failed to show that the fund suffered large losses as a result of the failure to diversify).

In devising an appropriate diversification policy for plan investments, fiduciaries should at least consider the following factors:

- The purpose of the plan
- The total amount of plan assets
- Overall financial and industrial conditions
- The types of plan investments (whether common or preferred stock, fixed income securities, governmental obligations, commercial paper, certificates of deposit, bankers' acceptances, mortgages or other forms of investments in real property, etc.)
- Geographic and industrial distribution
- The maturity dates of the various investments.

No. 1280, 93d Cong., 2d Sess. (1974), reprinted in 1974 U.S.C.A.N. 5038, at 5084-85.

While there is no specific formula against which to test diversification, fiduciaries should be wary of disproportionately heavy investments in:

- Security of a single issuer
- Securities dependent upon the success of a single enterprise
- Securities dependent upon conditions in one locality
- Stock of corporations engaged in one industry
- Mortgages concentrated in one geographical location
- Mortgages on one particular class of property.

Selection of an Investment Manager

Among other issues, ERISA's test of prudence focuses on a plan fiduciary's conduct in investigating, evaluating, selecting and monitoring an appropriate investment manager for investing

plan assets. See also discussion earlier in this paper.

The fiduciary responsible for appointing the investment manager must exercise prudence in selecting the manager. In this regard due consideration should be given to:

- The manager's ability to effectively manage the type of fund involved
- Whether the manager's organization and investment philosophies are consistent with the needs of the plan
- Whether the manager has performed well in managing similar investments for plans
- The manager's track record for meeting the stated objectives of plans he/she has managed.

Manager Experience, Qualifications and Investment Approach

The following is a suggested checklist of items that should be reviewed when selecting an investment manager for plan assets:

- ☐ The plan fiduciaries should identify a range of candidates whose expertise is consistent with the proposed investment guidelines or investment style identified for the investment manager position in question and document the process by which such candidates are selected, and the plan fiduciaries should interview other investment managers (to serve as a basis of comparison for one another).
- ☐ The plan fiduciaries should solicit the following information from each potential candidate:
 - A description of the precise services the manager is prepared to offer
 - A history of the manager's experience in the investment management business, including the total amount of assets under its control
 - A statement of the manager's investment approach or philosophy, and whether the manager has any internal investment guidelines
 - The number of retirement plan accounts and other accounts under the manager's

- management and their total current fair market value
- A detailed schedule of investment management fees
- A description of the manager's current staffing, and details as to the general experience and educational qualifications of the individuals who would be primarily responsible for the plan's account
- The name of any individuals who would be actively involved in handling the pension plan's account and details as to their experience and education
- A statement as to whether members of the staff would be available to meet with the plan fiduciaries on a regular basis
- A description of how policy is established by the manager and how it will be implemented
- A summary of any investment policy the manager recommended for pension plan assets placed under its management
- A tabulation of the time-weighted annual rates of total investment return on the combined results of all retirement plan equity portfolios under management for each of the previous five to ten years, and cumulatively for that period
- The dollar amount of the manager's fiduciary liability insurance and fidelity bond policies
- Any current or past litigation involving claims against the manager or any of its principals or investment professionals, and whether the manager or any of its principals or professionals has ever been held to be in violation of any federal or state laws
- Whether the manager, or any of its principals, has ever undergone bankruptcy, liquidation, reorganization, or similar proceedings; has had its registration or license re-

- voked or activities restricted; has ever been sued by a client or SEC; or has ever been denied fiduciary liability or fidelity insurance
 - Whether the manager is registered with SEC under the Investment Advisers Act of 1940, and the date of initial registration
 - Whether the manager is affiliated (or has any business relationship) with the broker-dealer it uses that could affect its investment decisions
 - Financial information relating to the manager, including its most recent balance sheet
 - The manager's policy with respect to the voting of proxies appurtenant to investment securities
 - A description of the manager's business structure, principal owners and affiliates
 - The procedure to be employed by the manager to comply with ERISA's prohibited transaction restrictions and whether the investment manager is a qualified professional asset manager.
- In addition to interviewing representatives of the investment manager (including the individuals who will be primarily responsible for managing the portfolio), the plan fiduciaries should evaluate the manager's qualifications by:
- Examining the manager's experience in the particular area of investments under consideration, as well as its experience with other ERISA plan assets by determining that the manager is widely known and well respected (as is the case with a major financial institution); securing and calling existing client references; seeking the advice of a knowledgeable professional third-party consultant; and/or utilizing the Internet as a resource for gathering information regarding the manager
 - Evaluating the record of the

manager's past performance with investments of the type contemplated, and reviewing a sample portfolio managed by the manager for a similarly situated client

- Evaluating the credentials and performance of the principals of the manager
- Inquiring of the Secretary of Labor and SEC as to whether any enforcement (or similar) actions have been initiated during the previous five to ten years with respect to the manager, or any of its principals or investment professionals.

Communication of Plan's Investment Objectives

Preliminarily, the plan fiduciaries responsible for the investment of plan assets, or their authorized representatives, should identify an investment style for that portion of the plan assets to be committed to the investment manager for the plan. Once an investment style has been selected, the fiduciary responsible for appointing the manager should establish a clear understanding with the manager as to:

- Rate of return sought through management of the plan assets
- Level of acceptable risk tolerance and diversification latitude
- Scope of the manager's discretion to acquire and maintain particular forms of assets and to determine the amounts of each type of asset
- Time frame for measuring performance
- Procedures to be used in monitoring and evaluating the performance of the manager
- A clearly defined list of investment restrictions; for example, venture capital investments, bond quality grades, uncovered options, short sales, futures contracts, restricted stock or private placements (with the possible exception of Section 144A securities), margin transactions (or any other borrowing of money) and volatile "derivative" instruments.

The foregoing is not an exhaustive list and, depending on the particular characteristics of the portfolio, some

(or all) of the foregoing types of investments may, under certain circumstances, be appropriate.

Investment Management Agreement

Plan fiduciaries must have legal counsel analyze the investment management agreement, offering memorandum, subscription agreement or other documents that set forth the terms of the relationship between the plan and the investment manager.

The agreement should be terminable by the plan fiduciaries on little or no advance notice (i.e., under most circumstances, not more than 30 days), with any fees paid in advance to the manager prorated to the date of termination. Among other features, the agreement should also provide representations that the manager:

- Is an investment adviser registered with SEC
- Is an investment manager within the meaning of ERISA Section 3(38)
- Acknowledges being a fiduciary (within the meaning of Section 3(21)(A) of ERISA) with respect to the plan's assets under investment
- Has obtained a bond in accordance with ERISA Section 412
- Maintains fiduciary liability insurance that specifically covers breaches of fiduciary duty under ERISA in a sufficient amount determined by the plan fiduciaries (the question of whether fiduciary liability insurance should be required at all may depend on the manager's size, stature, background and experience)
- Has made all necessary filings and obtained all requisite approvals from all relevant government agencies
- Will maintain the indicia of ownership of the plan's assets in the United States, or otherwise comply with the requirements of ERISA Section 404(b)
- Has obtained the appropriate authorization to execute the agreement
- Will indemnify the plan fiduciaries from any damages arising out of a breach by the manager of its agreement and/or its investment management duties (a reciprocal indemnity, from plan fiduciaries to

manager, should be avoided wherever possible)

- Will promptly advise the plan fiduciaries of any change in the ownership or management of the manager
- May not assign the agreement to a third party without the advance written consent of the plan fiduciaries
- Shall not effect any transaction that directly or indirectly will cause the plan (or any fiduciary thereof) to enter into a prohibited transaction under Section 406-408 of ERISA or Section 4975(c) of the Code (including any broker/dealer transactions with an affiliate of the manager, which is not the subject of a prohibited transaction exemption)
- Agrees that each of the foregoing representations are to be "continuing" in nature.

If fees are to be paid to the investment manager directly from plan assets (rather than from the employer), the plan fiduciaries have a duty to ascertain the reasonableness of the fees to be paid in relation to the amount of plan assets to be invested with the investment manager, in comparison to fees charged by comparable advisers.

Monitoring the Investment Manager

Fiduciary Duty to Monitor

The U.S. Department of Labor has described a fiduciary's duty to monitor the actions of those individuals to whom employee benefit plan fiduciary responsibilities have been delegated as follows:

At reasonable intervals the performance of trustees and other fiduciaries should be reviewed by the appointing fiduciary in such manner as may be reasonably expected to ensure that their performance has been in compliance with the terms of the plan and statutory standards, and satisfies the needs of the plan. No single procedure will be appropriate in all cases; the procedure adopted may vary in accordance with the nature of the plan and other facts and circumstances

relevant to the choice of the procedure.

ERISA Interpretive Bulletin 75-5, FR-17 (June 25, 1975); 29 C.F.R. §2509.75-8 (1975). See *Tittle v. Enron Corp.*, 284 F.Supp. 2d 511, 553 n.59 (S.D.Tex. 2003) ("the exercise of power to appoint, retain and remove persons for fiduciary positions triggers fiduciary duties to monitor the appointees"); *Saxton v. Cent. Pa. Teamsters Pension Fund*, 2003 U.S. Dist. LEXIS 23983 (E.D.Pa. 2003) (ignorance of mismanagement by investment managers was not a defense to a breach of fiduciary duty since appropriate monitoring would have alerted the fund administrators of the situation and imposed on them the responsibility to take corrective action); *Whitfield v. Cohen*, 682 F.Supp. 188, 196 (S.D.N.Y. 1988) ("fiduciary must ascertain within a reasonable time whether an agent to whom he has delegated a trust power is properly carrying out his responsibilities").

Insofar as the plan fiduciaries are able to review the investment reports of an independent custodian responsible for valuing fund assets and reporting all investment transactions, a layer of precaution is added to the monitoring process.

Nondelegable Fiduciary Responsibilities

The delegation of fiduciary responsibilities does not relieve the delegating fiduciary of the duty to monitor periodically the performance of the individuals to whom such responsibilities have been delegated so as to:

- Ensure adherence to the plan's objectives and funding policy
 - Determine whether the original plan investment objectives, and the objectives set forth in any investment guidelines, are being achieved
 - Determine whether modifications in underlying plan objectives or investment strategies are warranted.
- At the very least, the delegating fiduciary should prudently:
- Implement systematic procedures for the supervision of fiduciaries to whom responsibilities have been delegated
 - Conduct periodic performance evaluations with respect to such fi-

duciaries, including any investment managers who have been appointed

- Require periodic reports of each investment manager's progress in implementing the plan's investment strategy, including reports to establish that the funding posture of the plan is sound.

Periodic Reports of Plan Investments

In the investment context, once the plan fiduciaries have selected an investment manager, they have a duty to ensure that the manager prepares periodic accounting and reports (at least quarterly) of the plan's investments and to promptly review such accounting and reports. The minimal content of such accounting should include:

- The fair market and book value of the investments (where an investment consists of securities not regularly traded on a national securities exchange, a detailed description of the financial condition of the issuer of such securities, including applicable financial statements, should be provided)
- A calculation of the investment income, capital appreciation or depreciation (both realized and unrealized), and investment return for the period in question (it probably also would be useful to have the investment return computed on a quarterly, annual, and from-inception basis)
- A list of the proxies appurtenant to the investment account and detailed information as to the manner in which such proxies were voted by the manager and the precise reasons for each vote
- A breakdown of all fees (from whatever sources) received by the investment manager in connection with the investment of trust assets, including brokerage commissions.

Monitoring Investments and the Investment Manager's Performance

As noted above, plan fiduciaries also have a duty to periodically monitor the investments made by, and the overall performance of, the investment manager. This duty should be satisfied

by initiating at least the following actions.

Fiduciaries should periodically review (at least quarterly, or more often if needed) the accounting and reports provided by the investment manager for the purpose of confirming:

- The adequacy of their content
- The investment manager's performance during the period
- The accuracy of the asset valuation method
- Whether the investment manager has managed the portfolio consistent with any investment guidelines and the investment manager's stated investment philosophy and style, and for the purpose of generally comparing them in material respects with information provided by the plan's custodian including the custodian's statement of transactions
- The rate of return earned by the investment manager during the period in question on an overall basis, and by asset class and, where investments are in more than one sector, by sector
- Whether that rate is reasonable (as an absolute number, and when compared to other comparable investment managers appropriate indices or benchmarks) and, if not, whether the continued retention of the investment manager is prudent.

Fiduciaries should also meet with the investment manager periodically (at least annually) to review the status and performance of the plan's investments, as well as to review the investment manager's performance and any significant changes in its corporate or capital structure, investment style, brokerage affiliation or practices, investment process or professional staff. Fiduciaries must review periodically (at least annually) the voting procedure pursuant to which the investment manager votes proxies, in addition to the manner in which proxies were voted in specific situations.

Also to be reviewed periodically are the investment manager's practices regarding brokerage and trading, including brokerage costs, use of soft dollars, quality of securities, execution and portfolio turnover.

At least annually, fiduciaries should

establish and review the procedures for communicating information regarding investments and investment managers among the trustees, the plan's staff and the plan's service providers (including but not limited to the plan's attorneys, actuaries and custodial trustees). They should also verify, at least quarterly, the accuracy of the fee computation.

Fiduciaries must also terminate the investment manager's services, as soon as prudently possible, or immediately, if its performance is unsatisfactory, and retain an independent investment consulting or monitoring firm to do all or a portion of the foregoing.

Proxy Voting

Shareholders of companies are provided the right to vote on certain corporate issues. The voting procedure in connection with this right is referred to as the voting of proxies or proxy voting.

Fiduciary Issues

DOL has stated that the fiduciary act of managing plan assets includes the voting of proxies appurtenant to the shares of stock owned by the plan. See DOL letter to Helmut Fandl, Chairman of Retirement Board of Avon Products, Inc. (Feb. 23, 1988).

Plan fiduciaries have the exclusive authority and responsibility for voting proxies, unless the plan has delegated to an investment manager the authority to manage, acquire or dispose of the plan's assets. In most cases, fiduciaries have taken the opportunity to delegate this responsibility to managers.

If the plan has appointed an investment manager, he/she has a fiduciary duty to vote proxies, unless the plan document permits the trustee or other fiduciary to vote proxies and the investment management agreement expressly precludes the investment manager from voting proxies. See DOL letter to Robert A.G. Monks, Institutional Shareholders Services, Inc. (Jan. 23, 1990). However, other than monitoring the voting of such proxies, plan fiduciaries will be relieved of liability for the improper exercise of proxies by the plan's investment managers.

DOL Interpretive Bulletin 94-2 (July 29, 1994) confirms the approach outlined in the DOL letters to Robert A.G. Monks and Helmuth Fandl, discussed above, and clarifies that, when delegating investment management authority to an investment manager, the named fiduciary may reserve the right to direct a trustee regarding the voting of proxies relating to specified shares of stock or issues. It may also reserve the right to another named fiduciary if the plan provides for procedures for allocating fiduciary responsibilities among named fiduciaries.

DOL has stated that the decision to tender shares of stock in a tender offer is a fiduciary act. However, there is not an automatic requirement that fiduciaries must accept a tender offer when the offer represents a premium over the prevailing market price.

Responsibilities

If the plan's fiduciaries do not appoint an investment manager, they have a fiduciary duty to vote proxies.

If an investment manager has been duly appointed, the investment manager has a duty to confirm that it has received the proper number of proxies, to vote the proxies, and to maintain accurate records. The plan fiduciaries have a duty to monitor the investment

manager's proxy voting procedures and to monitor the voting of specific proxies.

Other Actions to Consider

Carefully review plan documents and investment management agreements to ensure that the plan's fiduciaries are not precluded from delegating to an investment manager the authority to vote proxies. Negotiate investment management agreements with specific language delegating to the investment manager the fiduciary duty to vote proxies or specific language retaining the fiduciary duty to vote proxies.

Establish a monitoring and review procedure for proxy voting activity, and consider establishing an internal

proxy monitoring or corporate governing committees, or retaining an outside evaluator to help with this task.

Develop a specific set of investment manager guidelines for voting proxies. These guidelines should separate issues involved in proxy voting into established categories: routine matters, nonroutine matters, corporate governance matters and social issues.

When a named fiduciary reserves the right to vote employer securities and such right is not passed through to plan participants and beneficiaries (provided that pass-through voting is not legally required), fiduciaries should exercise caution in voting employer securities in order to avoid prohibited transactions under Section 406(b) of ERISA and conflicts of interest. **B&C**



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