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Getting Board Attention - Time to Take Fiduciary Inventory©

Roger Levy, LLM, AIFA®

In all the talk of increasing fiduciary risk associated with retirement plans, one finds little discussion of the role of corporate directors. However, this is an important topic. In public companies, independent directors must comprise the majority of the board under NYSE and NASDAQ rules and all directors are required to undergo board governance training and assessment. The problem is that outside directors are often in the dark about management of the company's retirement plan(s) and investments, and, in practice, little governance training extends to the fiduciary risks which retirement plans pose. This is a mistake. Risk management oversight is a board function and retirement plans pose important risks: personal liability, litigation risk and government enforcement activity.

Typically, directors owe their fiduciary duties of loyalty and care to the stockholders and their actions are judged against a presumption that they have acted on an informed basis, in good faith and in the honest belief that their action was in the best interests of the company. These are different from the duties owed by fiduciaries to the company's retirement plan under the *Employee Retirement Income Security Act of 1974* (ERISA). Under ERISA, fiduciaries owe their duties of loyalty and care exclusively to the plan participants and beneficiaries, and they are held to a "prudent expert" standard of care. Whether or not board members become fiduciaries to the company's retirement plan(s) – generally this occurs if the board is a named fiduciary in the plan document or if the board appoints the investment committee – it is important for the board to evaluate how retirement plan responsibilities are met. First, this is a natural progression of corporate governance and implementation of proper controls. Secondly, there may be fiduciary risk mitigation strategies available for consideration. However, for the board to evaluate risk and mitigation strategies, it must understand how fiduciary responsibilities respecting the company's retirement plan(s) are met and take inventory of the company's fiduciary resources. This will occur against a changing fiduciary landscape.

Post 2008 Fiduciary Landscape

The capital markets meltdown in 2008 had an immediate impact on long held views on investment management. Suddenly, asset classes became more closely correlated, putting into question Modern Portfolio Theory and traditional ideas of asset allocation and portfolio construction. At the same time, new and sometimes complicated investment products and strategies emerged leading some investment committees to become indecisive and subject to "fiduciary fatigue."

ERISA Regulation

In an effort to improve the retirement prospects of retirement plan participants, the Department of Labor (DOL) introduced new regulations under ERISA § 408b-2 and § 404a-5 to increase disclosures made to and by retirement plans, with particular focus on 401k plans. The former regulation requires disclosures by service providers of their services, compensation and fiduciary status and, equally important, it imposes an obligation on plan fiduciaries to evaluate those disclosures to determine that the arrangements are reasonable. A failure to do so may result in an ERISA prohibited transaction with potential penalties and other liabilities. The latter regulation requires 401k plans to make detailed disclosures to plan participants of administrative and investment related expenses and of investment performance. The regulation increases the scope of disclosures previously required to justify a claim of relief from fiduciary liability under ERISA § 404(c). Further, the regulation requires the disclosures as a fiduciary duty, effectively turning notions of fiduciary relief on their head.

Fiduciary Breach Litigation

The last five years or more have also seen an increase in fiduciary breach litigation, initially with inconsistent results. Household names such as United Technologies, Unisys, Deere, and IPC saw fiduciary breach claims against them dismissed, while others, such as General Dynamics, Kraft, Bechtel, Caterpillar and Wal-Mart reached settlements rather than risk higher costs and damage awards. Some more recent cases have survived motions for dismissal, leading to decisions which reaffirm fiduciary duties and include, in some cases, significant damage awards.

The ABB Decision

Consider the decision, now on appeal, in (*Tussey v. ABB, Inc.*, No. 2-06-CV-04305, 2010 U.S. Dist. LEXIS 45240 (W.D. Mo. Mar. 31, 2012), where the Court found that the ABB fiduciaries violated their ERISA fiduciary obligations to the plan when they: failed to monitor recordkeeping costs and negotiate rebates available to the plan; selected more expensive share classes when less expensive share classes were available; failed to abide by selection and monitoring criteria contained in the plan's investment policy statement when changing fund options in the plan's investment menu; and agreed to pay Fidelity higher than market costs for recordkeeping in order to subsidize corporate services provided by Fidelity to ABB.

The Edison Decision

More recently, the 401(k) decision in the 9th U.S. Circuit Court of Appeals on March 21, 2013 in *Glenn Tibble et al. vs. Edison International et al*. found that the company breached its fiduciary responsibilities in selecting retail-class shares in an investment fund by failing to investigate the availability of cheaper, institutional-class shares in the same fund.

The Lockheed Martin Appeal

This was followed by a decision in the appeal from the dismissal of the 2006 claim against Lockheed Martin. In *Abbott v. Lockheed Martin Corporation (N0. 12-3736)*, the Seventh Circuit Court of Appeals will now allow a trial on the facts of the plaintiff's claim that plan fiduciaries imprudently selected for inclusion in the investment menu a stable value fund where, rather than containing a mix of short- and intermediate-term investments, the fund invested in short-term money market funds that did not beat inflation sufficiently to provide a meaningful retirement asset. This is the first 401k decision where the conservative nature of an investment has been questioned for underperformance. Note that this case may be headed to the US Supreme Court.

Defined Benefit Plan Litigation – Weyerhaeuser

Litigation has also involved defined benefit plans. This is uncommon because investment outcomes don't generally impact retirement benefits which are effectively guaranteed. This was demonstrated recently in *Palmason v. Weyerhaeuser Co., W.D. Wash., No. 2:11-cv-00695-RSL, 8/23/13*, which involves claims that Weyerhaeuser had adopted imprudent investment policies and guidelines with regards to the total exposure/risk of the investment portfolio. A Motion to Dismiss resulted in dismissal of claims for monetary damages because the plaintiffs could not show that the alleged breaches created an appreciable risk that the defined benefits would not be paid. However, the court did allow claims for equitable injunctive relief to continue. Accordingly, the court will now hear claims that the plan fiduciaries failed to sufficiently diversify assets and that their investment policy did not exclusively benefit plan participants but served to increase Weyerhaeuser's net income and stock price for the benefit the company and senior executives.

DOL Enforcement and Other Action

In 2012, the DOL closed 3,566 civil investigations, with 2,570 (72.1%) resulting in monetary recovery of $1.27 billion or other corrective action. 318 criminal investigations were also closed, with 117 individuals being indicted and 78 resulting convictions or guilty pleas.

Further, as part of its investigation of retirement plans, the DOL is now likely to ask whether trustees and investment committees are receiving fiduciary training. Such enquiries are becoming widely reported by ERISA attorneys who represent plan sponsors.

Plan Sponsor and Investment Advisor Reaction

Regulatory action and fiduciary breach litigation have combined to drive some plan sponsors and investment advisors to consider alternative strategies for managing retirement plan investments and the fiduciary responsibility associated with that process. Typically, these involve outsourcing the responsibilities associated with the investment process.

Outsourcing Investment and Administration Functions

Investment advisors have generally played a consulting or non-discretionary advisory role in the investment process. In this capacity, advisors have provided asset allocation and portfolio construction recommendations and investment manager selection and replacement recommendations but the ultimate responsibility has lain with the investment committee to give final aproval. In this role, the investment advisors have acted as co-fiduciaries with investment committee members for ERISA purposes. Now advisors offer similar services but on a discretionary basis whereby they act independently of investment committee approval, thereby relegating investment committees to a purely oversight function. These services are sometimes referred to as "Outsourced CIO" "Implemented Consulting" or "Fiduciary Management". Such offering are intended to combat "fiduciary fatigue" by making the investment process more nimble with the added advantage of mitigating fiduciary risk.

Plan Design Changes

As a further means of insulating plan sponsors from fiduciary responsibility, a strategy finding currency in some quarters would have the plan document amended to identify a specified advisor as the "named fiduciary", thus removing the plan sponsor from the reach of ERISA's fiduciary regulation. The appointment of the advisor in this manner would be regarded, so the argument goes, as a "settlor" function where the courts give deference to employers in making "plan design" design decisions outside of the cloak of fiduciary responsibility.

Time to Take Fiduciary Inventory

As the foregoing discussion indicates, a company's retirement plan has become a more complex and risky proposition, particularly where 401(k) plans are involved. Against this background, the board must evaluate the adequacy of the resources which the company devotes to retirement plan management and determine what change, if any, should be made. The following summarizes a fiduciary evaluation strategy:

1. Analyze the composition and structure of the plan's investment committee, its familiarity with investment matters, the frequency of meetings, minute taking procedures and outcomes, as well as the committee's adherence to the plan's investment policy statement.

2. Determine the fiduciary knowledge base of investment committee members and the need for fiduciary training, whether on a one time or periodic basis.

3. Evaluate the effectiveness of the investment committee and the plan's service providers in conforming to best practices (e.g. evaluating service provider arrangements evaluation and benchmarking plan costs) and determine whether an independent assessment of such matters would strengthen the committee's effectiveness and provide comfort to the board, particularly outside directors, that a crucial part of the company's employee benefits program and a source of fiduciary liability is properly managed.

Taking fiduciary inventory represents prudent fiduciary oversight for the board of any plan sponsor company. For those contemplating a change in the manner in which retirement plan assets are managed, it is a necessary element in the decision process.

Roger Levy, LLM, AIFA®
Managing Director
Cambridge Fiduciary Services, LLC
CEFEX Analyst