On Being a Fiduciary: Minimizing Risk

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Who is a Fiduciary?

Under ERISA, an individual or firm becomes a fiduciary by performing investment tasks and accepting the responsibility that comes with performing those tasks. A thorough understanding of how to properly perform these duties using prudent tactics appropriate to managing and minimizing risk is essential to a fiduciary.

Fiduciary Functions

The first step toward minimizing fiduciary risk is to realize that the investment duties professionals perform automatically make them fiduciaries with significant potential liabilities in connection with their clients. ERISA changed the scope for fiduciaries of employee benefit plans by realizing that the complexity of plan operation and administration requires the delegation to many individuals to handle various parts of a plan. ERISA states that if you perform one function making you a fiduciary, you are a fiduciary, and the three general functions are:

Exercises discretionary authority in the management of a plan

Exercising discretionary authority in the management of a plan means you have discretionary decision-making authority and you exercise judgment in making those decisions. It also means you control the plan assets in terms of buy and sell decisions. It is important to understand the legal distinction between a Plan Administrator from a third party administrator such as the record keeper and those handling the daily operations of the plan.

The Plan Administrator is the plan sponsor and ultimately responsible for the plan; however, both groups are fiduciaries. In matters of designing the plan for different classifications of eligible employees, the Plan Administrator is then working as a "settlor" and the scope of these duties are outside the definition of fiduciary responsibilities.

For example, it would be appropriate for an investment committee of a firm to recommend changes in the plan design that would encourage participation in the plan, such as recommending life-cycle funds, which would be consistent with fiduciary functions, but it would just be a "settlor" function if the investment committee was asked to find ways to reduce costs associated with the plan operation or change the matching formula.

Receives payment for regularly providing investment advice

Anyone who provides investment advice to the plan or its participants on a regular basis for compensation (either direct or indirect) is termed a fiduciary. Indirect compensation is pay that is coming directly from the mutual fund investments through 12(b)-1 fees or other revenue sharing arrangements or through trading or brokerage commissions received by an advisor. A broker or consultant who regularly provides investment advice or quarterly monitoring would be a fiduciary if they receive compensation from any source.

A current misconception is that if a plan sponsor hires an investment advisor or consultant to select, monitor and advise on plan investments (whether they are directly managing the assets or not), then the plan sponsor is completely relieved of their fiduciary obligations. The plan sponsor has co-fiduciary responsibility with the outside investment advisor.

ERISA Section 405 states that a fiduciary is responsible for another fiduciary's breach of duty if the fiduciary participates or is aware of an act to conceal a breach of another fiduciary and does not take steps to correct it. In a recent court case, the broker for the plan, acting as an advisor, was also held responsible as a co-fiduciary for the illegal actions and fiduciary breach of another trustee. If there are many trustees of a plan, they must all take steps to prevent breaches of fiduciary duty.

Exercises any discretionary authority in the administration of a plan

A fiduciary has discretionary authority over the management of the plan and assets. A fiduciary is primarily responsible for dealing with daily decisions in the operation of the plan such as who is eligible to participate and interpreting plan documents.

The Plan Administrator is a fiduciary under this definition and one of the most important functions is to determine if the fees are reasonable. The Department of Labor has stated that any fees borne by the plan need to be acknowledged, evaluated and approved by the fiduciary. This means the Plan Administrator must have full knowledge of all the revenue received by the service providers, especially revenue sharing among all investment and service providers.

Most of the fees are visible in a plan and are revealed in the mutual fund prospectus, such as the expense ratio for the fund, or in the participant's summary statements, such as record keeping and transaction fees. Some can be buried in net return performance figures but a gross performance number should be supplied as well.

The main issue is who is receiving the fees and how do the participants benefit from these fees. A key question that all fiduciaries must ask is whether the mutual fund returns enough to warrant the manager fees paid. Peer manager comparisons, index funds and choosing less expensive funds can be a way to monitor this issue.

Fiduciary Responsibilities

Every fiduciary must operate to administrate the plan for the exclusive benefit of providing benefits to the participants. This philosophy is also known as the "Golden Rule". The fiduciary may use plan assets to defray reasonable plan administration expenses. This rule is in force to ensure that the plan assets are not used for corporate or personal use by the fiduciary.

The fiduciary must operate the plan "with the care, skill, prudence and diligence under the circumstances prevailing that a prudent man acting in a like capacity would use in the conduct of an enterprise of a like character and with like aims", also known as the "Prudent Expert Standard". A prudent process would include documentation and a clear record of all actions taken in regards to the plan. Having documentation proves that a clear process was followed and steps were taken and documented along the way. Documenting a committee meeting with a full discussion of each member's point of view is highly advised.

A fiduciary must also manage plan assets by diversifying the investments so as to minimize the risk of large losses, unless it is clearly not prudent to do so under the given circumstances.

ERISA does not specify that all investments have to be the "best" investments, but the fiduciary must invest prudently and offer investments across a broad universe with different asset classes, risk and return characteristics that allow a participant to diversify his holdings. This range of investments allows a participant to pick a conservative or aggressive portfolio based on his risk preferences and age.

ERISA requires all plans to operate with a written investment policy that displays the criteria for investment fund selection and retention.

Plan documents must be updated regularly based on current ERISA and tax laws and some parts must be sent to the participants on a regular basis (such as Summary Plan Documents) or on request (such as the written plan and Form 5500). Handling of plan distributions and contributions is critical because liabilities can arise if cash flows are delayed or a participant account balance is disputed.

There are penalties associated with fiduciaries that commit a breach of duty. For example, a fiduciary must make restitution on any losses the plan suffered if they "borrowed" money from the plan and then used it for a profit-making venture. They must replace the funds and any profits realized to the plan. Under ERISA, the Secretary of Labor may also impose an additional 20% penalty on any amounts recovered. The fiduciary may be permanently banned from overseeing any ERISA plans, be personally sued and face criminal charges.

Summary

Taking on the role of fiduciary is a serious matter and should not be taken lightly. A careful search for the right people who understand their fiduciary duties and perform to the fullest extent is the best way to ensure the success of a plan. A thorough understanding of the mandates ERISA imposes on fiduciaries is paramount to a fiduciary's willingness to take on the role to prudently and exclusively perform for the benefit of the participants.