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Legal Memoranda

To accompany the *Prudent Practices for
Investment Fiduciaries* handbook series

Legal Memorandums prepared by
Reish Luftman Reicher & Cohen

U.S. Edition

LEGAL MEMORANDA

For
Prudent Practices for Investment Fiduciaries
(U. S. Editions)

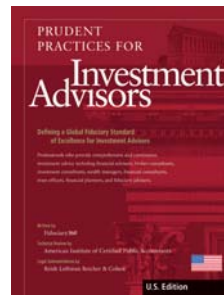
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To accompany the fiduciary handbooks:



***Prudent Practices for
Investment Stewards***



***Prudent Practices for
Investment Advisors***

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PRUDENT PRACTICES FOR INVESTMENT FIDUCIARIES

PRACTICE SA - 1.1

Investments are managed in accordance with all applicable laws, trust documents, and written investment policy statements (IPS).

ERISA Requirements

The Employee Retirement Income Security Act of 1974 (ERISA) requires that fiduciaries must follow its provisions, the provisions of the plan document, and the other documents and instruments governing the plan.

ERISA §402(a)(1) requires that plans be written.

Every employee benefit plan shall be established and maintained pursuant to a written instrument.

In addition to a written plan, ERISA requires that plan assets be held in a trust. [ERISA §403(a)] Furthermore, courts have held that the trust documents are part of the documents governing the plan. For example, in *Morse v. New York State Teamsters Conference Pension and Retirement Fund*, 580 F. Supp. 180 (W.D.N.Y. 1983), *aff'd*, 761 F.2d 115 (2d Cir. 1985), the court stated:

Concerning plaintiff's contention that the trustees have failed to act in accordance with the documents and instruments governing the plan, 29 U.S.C. § 1104(a)(1)(D), the Trust Agreement and the Plan constitute the "documents and instruments" with which the trustees are required to discharge their duties under this section of ERISA." [Morse at 186, citing Winpisinger v. Aurora Corp. of Illinois, 456 F. Supp. 559, 567 (N.D. Ohio 1978).]

ERISA §404(a)(1) provides:

Subject to sections 403(c) and (d), 4042, and 4044, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and ...

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this title and title IV.

The question of whether retirement plan investments must be managed in accordance with an investment policy statement (IPS) is more complicated. [Note: We use "investment policy statement" or "IPS" to mean a written document containing a plan's "investment policy" (or "IP")]. The first step is to determine if ERISA requires a written investment policy statement.

Practice SA - 1.1 (continued)

ERISA does not have a specific requirement that plan fiduciaries establish investment policy statements. However, DOL Reg. §2509.94-2(2) states that

[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 §404(a)(1)(A) and (B).

The referenced sections describe ERISA's general fiduciary requirements of loyalty and prudence.

While there is no explicit requirement that plan fiduciaries develop an investment policy statement, the general fiduciary responsibility rules require that the fiduciaries engage in a prudent process for the selection and monitoring of the investment alternatives and may, in certain cases, require that those procedures be reduced to writing. For example, in Interpretive Bulletin 94-2, the DOL stated that investment policy statements

serve a legitimate purpose in many plans by helping to ensure that investments are made in a rational manner and are designed to further the purposes of the plan and its funding policy.

This statement by the DOL echoes various requirements of ERISA, including the following:

1. The requirement of ERISA §402(b)(1) that “[e]very employee benefit plan ... provide a procedure for establishing and carrying out a funding policy and method consistent with the objectives of the plan and the requirements of [Title I].”
2. The requirement of ERISA §404(a)(1)(D) that the fiduciaries must discharge their duties “in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of [Title I] and Title IV.” This implies that documents needed to operate the plan must be reduced to writing. This is further supported by the DOL’s explanation in Interpretive Bulletin 94-2 that “Statements of investment policy ... would be part of the ‘documents and instruments governing the plan’ within the meaning of ERISA §404(a)(1)(D).” [29 C.F.R. §2509.94-2]
3. The requirement of ERISA §104(b)(4) that, upon request by the participants, plan administrators “furnish a copy of the latest updated summary plan description, [various other enumerated documents] and **other instruments under which the plan is established or operated.**” [Emphasis added] In order to furnish a copy of a document, it must be reduced to writing. One reading of this section is that the plan administrator is only required to furnish a document where it actually exists, but does not require that the plan create documents for purposes of operating a plan. Conversely, another plausible interpretation of this section, when coupled with the other sections noted above, is that significant plan policies and procedures must be written so that the participants have an opportunity to review those policies in order to understand the operation of the plan and determine if the fiduciaries are complying with the policies that can significantly impact the plan. (This reading is supported by Interpretive Bulletin 75-5 dealing with fiduciary responsibilities. In that Bulletin, the DOL states that “the purpose of the funding policy

Practice SA - 1.1 (continued)

requirement set forth in section 402(b)(1) is to enable plan participants and beneficiaries to ascertain that the plan has a funding policy that meets the requirements of [ERISA].” [29 C.F.R. §2509.75-5 FR-4]

4. The requirements, discussed in the Legal Memorandum for *Practice 3.2*, that the allocation of responsibilities among fiduciaries be in the plan document and that the acknowledgment of fiduciary status by an investment manager be in writing. [ERISA §§402(b)(2) and 3(38)(C)]

The preamble to the DOL’s 404(c) regulations, which states the affirmative requirement under ERISA that fiduciaries prudently select and monitor investments chosen for participant-directed plans, implies the requirement for an investment policy. It seems difficult, if not impossible, to monitor investments without the use of selected standards for measuring the performance and expenses of the investment options. This is confirmed in Interpretive Bulletin 94-2, in which the DOL stated:

It is the view of the Department that compliance with the duty to monitor necessitates proper documentation of the activities that are subject to monitoring.

Finally, in Interpretive Bulletin 94-2, the DOL explained the purpose of an investment policy statement:

As used in this interpretive bulletin, a statement of investment policy provides general instructions or guidelines to be applied in all applicable situations, such as identification of applicable classes or types of investments, limitations on investment categories as a percentage of the plan’s portfolio, or generally applicable guidelines regarding voting positions in proxy contests ... rather than specific instructions as to the purchase or sale of a specific investment at a specific time or specific instructions to vote specific plan proxies a certain way. [29 C.F.R. §2509.94-2, Interpretive Bulletin 94-2 – Written Statements of investment policy, including proxy voting policy or guidelines (July 29, 1994)]

The duty to monitor is a part of the investment policy of a plan. Further, the monitoring process to be used, the criteria for monitoring, and the actions to be taken as a result of the monitoring are part of the investment policy. Thus, it is clear that plan fiduciaries must develop at least the key elements of an investment policy. However, it is not clear that ERISA requires that the policy always must be reduced to writing.

In some cases, though, ERISA’s general fiduciary provisions require that the policy be reduced to writing. *Liss v. Smith*, 991 F. Supp. 278 (S.D.N.Y. 1998) held that:

ERISA does not have a specific requirement that a written investment policy be maintained by the trustee. I find, at least in this instance, that such a policy is necessary to ensure that the plan investments are performing adequately and meeting the ... needs of the Funds.

Practice SA - 1.1 (continued)

In referring to DOL Interpretive Bulletin 94-2, the court held:

While this regulation states only that a written investment plan is “consistent” with ERISA’s fiduciary duty requirements, in the circumstances here, absence of any plan constitutes a breach of fiduciary duty. [Liss at 296]

Therefore, an investment policy is required under ERISA (whether it is reduced to writing or not), and a written IPS may be required on a facts-and-circumstances basis as determined by the courts. **[IBP]** As a result of the uncertainty, and to adopt the best practices of the investment community, fiduciaries are well-advised to develop and memorialize investment policies.

The second step is to determine, if an IPS does exist, whether it is part of the documents governing the plan and therefore must be followed to avoid fiduciary breach. As noted above, in Interpretive Bulletin 94-2, the DOL states that:

Statements of investment policy ... would be part of the “documents and instruments governing the plan” within the meaning of ERISA §404(a)(1)(D). [29 C.F.R. §2509.94-2]

The appellate court in *Dardaganis v. Grace Capital, Inc.*, 889 F.2d 1237 (2d Cir. 1989) held that the fiduciary must follow the documents governing the plan assets. In this case, the defendant, GCI, entered into an investment management agreement with the trustees of Dardaganis to manage the assets of their retirement fund. The agreement stipulated a cap on the common stocks held in the fund. GCI repeatedly violated the terms of the agreement. In its earlier opinion, the district court in *Dardaganis* held, and it was later affirmed by the appellate court, that:

... by agreeing to become the Fund’s investment manager, Grace Capital assumed the obligation to manage the assets prudently and solely in the interest of plan participants. It also assumed the statutory obligation to manage the assets “in accordance with the documents and instruments governing the plan.” 29 U.S.C. §1104(a)(1)(D)[Dardaganis v. Grace Capital, Inc., 664 F. Supp. 105, 108 (S.D.N.Y. 1987)]

Citing from the district court’s opinion, the appellate court stated that “any violation of the terms of [the] Agreement constitutes a breach of Grace Capital’s fiduciary duty under §1104(a)(1)(D) and creates liability to the fund.” [Dardaganis at 1239]

Thus, case law has concluded that the phrase “documents and instruments governing the plan” of ERISA §404(a)(1)(D) includes investment management policies and agreements.

UPIA and UPMIFA Requirements

The Uniform Prudent Investor Act [UPIA] and Uniform Prudent Management of Institutional Funds Act [UPMIFA] require the assets of a trust be managed in accordance with statutory and trust provisions.

Practice SA - 1.1 (continued)

The UPIA explicitly requires the fiduciary to manage the assets in conformity with the terms of the trust and the provisions of the UPIA in §4, “Duties at Inception of Trusteeship.” This section states:

[w]ithin a reasonable time after receiving property, an institution shall make and carry out decisions concerning the retention or disposition of the property or to rebalance a portfolio, in order to bring the institutional fund into compliance with the purposes, terms, and distribution requirements of the institution as necessary to meet other circumstances of the institution and the requirements of this [act].

The UPMIFA contains a similar provision to the UPIA. Section 3(e)(5) of UPMIFA states:

[w]ithin a reasonable time after receiving property, an institution shall make and carry out decisions concerning the retention or disposition of the property or to rebalance a portfolio, in order to bring the institutional funds into compliance with the purposes, terms, distribution requirements of the institution and the requirements of this [Act].

The UPIA and UPMIFA do not explicitly require a written investment policy statement. Even so, UPIA §2 and UPMIFA §3 set out specific requirements that support modern investment practices. These Sections cover the standard of care; portfolio strategy; and risk and return objectives for investment management, and subsections (a) – (d) support an overall duty to monitor investments that applies to both investing and managing trust assets.

The fiduciary standard of care in UPIA §2(a) states:

A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution. [UPIA §2(a). See also, UPMIFA §3(b)]

One of the primary objectives of the UPIA is to establish that

the standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments.

Specifically, §2(b) provides:

A trustee’s investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.

Practice SA - 1.1 (continued)

A similar provision is contained in UPMIFA §3(e)(2). While the UPIA and UPMIFA do not have any specific requirements for an IPS, their provisions contemplate that a fiduciary will engage in a prudent process in managing a trust's assets. An investment policy is a part of that prudent process, since it covers issues such as the selection and review of investments, the use of advisors, and so on. **[IBP]** While there is not any additional guidance on whether the policy must be reduced to writing, we believe that, in a given case, a court may find that a fiduciary breached its duties by not documenting an investment policy - much as the *Liss* court did under ERISA.

MPERS Requirements

The general fiduciary duties are contained in §7 of the Uniform Management of Public Employee Retirement Systems Act [MPERS]. Subsection 7(6) requires that

[a]trustee or other fiduciary shall discharge duties with respect to a retirement system in accordance with a good-faith interpretation of the law governing the retirement program and system.

Section 4(a) of MPERS states the basic principle:

... all assets of a retirement system are held in trust.

Subsections (b) through (d) provide guidance on particular applications of the principle. Inherent in the requirement that a trust be established is a requirement that its terms be followed. The law would not mandate a meaningless act.

The MPERS Act also requires that the investments be managed in accordance with an investment policy statement.

A trustee with authority to invest and manage assets of a retirement system shall adopt a statement of investment objectives and policies for each retirement program or appropriate grouping of programs. The statement must include the desired rate of return on assets overall, the desired rates of return and acceptable levels of risk for each asset class, asset-allocation goals, guidelines for the delegation of authority, and information on the types of reports to be used to evaluate investment performance. At least annually, the trustee shall review the statement and change or reaffirm it. [MPERS §8(b)]

PRUDENT PRACTICES FOR INVESTMENT FIDUCIARIES

PRACTICE SA - 1.2

The roles and responsibilities of all involved parties (fiduciary and non-fiduciary) are defined, documented, and acknowledged.

ERISA Requirements

A fiduciary must act

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. [ERISA §404(a)(1)(B)]

The prudence standard is that of a hypothetical person who is “*familiar with such matters.*” As a result, the standard requires that a fiduciary for a retirement plan be familiar with the issues and responsibilities of the management of an enterprise that is worth investing for retirement benefits.

A fiduciary’s conduct is to be judged against a presumption of a high degree of knowledge.

The prudence standard charges fiduciaries with a high degree of knowledge. The standard measures the decisions of plan fiduciaries against the decisions that would be made by experienced investment advisers. [Joint Committee on Taxation, Overview of the Enforcement and Administration of the Employee Retirement Income Security Act of 1974, at 12 (JCX-16-90, June 6, 1990)]

Ignorance of the duties imposed on a fiduciary is no excuse. A fiduciary who is not aware that he is violating the fiduciary duties of ERISA is still liable for the violation. The ERISA standard of conduct is an objective one; good faith is not sufficient.

A trustee’s lack of familiarity with investments is no excuse: under an objective standard, trustees are to be judged according to the standards of others acting in a like capacity and familiar with such matters. [Marshall v. Glass/Metal Association and Glaziers and Glassworkers Pension Plan, 507 F. Supp. 378, 2 E.B.C. 1006 (D. Hawaii 1980). See also, Katsaros v. Cody, 744 F.2d 270, 279, 5 E.B.C. 1777 (2d Cir. 1984), cert. denied, 469 U.S. 1072, 105 S. Ct. 565, 83 L.Ed. 2d 506 (1984), where the trustees, who lacked familiarity with investments and were ill-equipped to evaluate the soundness of a proposed loan, were held liable for breach of fiduciary duty due to their failure to seek outside assistance to help them.]

Practice SA – 1.2 (continued)

Especially with regard to investing plan assets, a fiduciary must act as a prudent and knowledgeable person would under similar circumstances, taking into account all relevant factors as they appeared at the time of the investment decision, not in hindsight. This is generally referred to as the “*prudent expert rule*.” Said the court in *Marshall v. Snyder*, 1 E.B.C. 1878 (E.D.N.Y. 1979):

... the framers of §404(a)(1)(B) established a standard of conduct based on a measure of how a prudent man in a like capacity (administration of employee benefit plans) and familiar with such matters would act. Thus, ERISA’s prudence test is not that of a prudent lay person but rather that of a prudent fiduciary with experience dealing with a similar enterprise. [Marshall at 1886]

Under ERISA, the fiduciary is held to the so-called prudent expert rule even if he lacks the capabilities required to carry out his fiduciary responsibilities. Under these circumstances, he must engage experts who have the requisite skill, knowledge, and experience needed by the plan. [*Donovan v. Mazzola*, 716 F.2d 1226, 4 E.B.C. 1865 (9th Cir. 1983)] However, the fiduciary retains the ultimate responsibility for the decision.

A fiduciary’s independent investigation of the merits of a particular investment is at the heart of the prudent person standard. [Fink v. National Savings and Trust Company, 772 F.2d 951, 957, 6 E.B.C. 2269 (DC Cir. 1985)]

So by failing to make any independent investigation and evaluation of a potential plan investment, the fiduciary in *Fink* was held liable for breach of fiduciary obligations.

Fiduciary decisions will be scrutinized based on the care the fiduciary took in investigating the facts beforehand. In *Donovan*, the court stated that the test for prudence was

whether the individual trustees, 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. [Donovan at 1232]

The duty to investigate inherently presupposes an understanding of the fiduciary’s duties, and failure to be aware of one’s duties can constitute fiduciary breach under ERISA.

UPIA and UPMIFA Requirements

The UPIA and UPMIFA impose the obligation of prudence on trustees. UPIA states:

... [A] trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule set forth in this [Act]. [UPIA §1(a). See also, UPMIFA §3(b)].

Practice SA – 1.2 (continued)

The standards of care under the UPIA and UPMIFA are similar to that required by ERISA: to act as a prudent person would. As described in UPIA §2, the standard is that of a prudent investor similarly situated:

[a] trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill and caution. [UPIA §2(a); See also, UPMIFA 3(b)]

The trustee has a duty to monitor and investigate. As stated in UPIA §2(d):

A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets. [See also, UPMIFA §3(c)(2).]

The Comments to the Act note that “managing” includes monitoring, or the trustee’s continuing responsibility to oversee the suitability of investments already made as well as those that are new. Subsection (d) also describes the traditional fiduciary responsibility to examine information likely to have importance regarding the value or security of an investment.

MPERS Requirements

MPERS requires the fiduciary (*i.e.*, the trustee) to understand and be aware of its duties. The language of MPERS is virtually identical to the language of ERISA and the discussion earlier in this memorandum applies here as well.

General fiduciary duties under MPERS are enumerated in §7 and mirror the duties described in ERISA, sounding the well-recognized trust duties of loyalty and prudence:

A trustee or other fiduciary shall discharge duties with respect to a retirement system:

(1) Solely in the interests of plan participants and beneficiaries;

(2) For the exclusive purpose of providing benefits to participants and beneficiaries ...; and

(3) With the care, skill, and caution under the circumstances then prevailing which a prudent person acting in a like capacity and familiar with those matters would use in the conduct of an activity of like character and purpose [MPERS §7(1-3)]

Practice SA – 1.2 (continued)

What sets MPERS apart from ERISA is that these duties apply in the public retirement system setting. The Comments to §7 note that, in the public retirement system setting, the duty of loyalty includes the obligation to set aside the interests of the party that appoints a trustee or fiduciary. The trustee must act solely in the interests of participants and beneficiaries, and not in the interests of the union or employer responsible for the trustee's appointment. *See National Labor Relations Board v. Amax Coal Co.*, 453 U.S. 322, 101 S. Ct. 2789, 69 L.Ed. 2d 672 (1981), where the Supreme Court looked to the language and legislative history of §302(c)(5) of the Labor Management Relations Act, 29 U.S.C.S. §141 et seq. (as well as ERISA) and reasoned that:

[they] therefore demonstrate that an employee benefit fund trustee is a fiduciary whose duty to the trust beneficiaries must overcome any loyalty to the interest of the party that appointed him. [NLRB at 2796]

PRUDENT PRACTICES FOR INVESTMENT FIDUCIARIES

Practice SA - 1.3

Fiduciaries and parties in interest are not involved in self-dealing.

ERISA Requirements

Title I of the Employee Retirement Income Security Act of 1974 (ERISA) prohibits certain specified transactions between a plan and parties in interest. [ERISA §406(a)] A *party in interest* is a person or entity who is closely related to the plan as defined in ERISA §3(14) and includes, among others:

(A) any fiduciary (including but not limited to, any administrator, officer, trustee, or custodian), counsel, or employee of such employee benefit plan;

(B) a person providing services to such plan [ERISA §3(14)(A) and (B)]

Note: The ERISA Title I definition of a party in interest is similar to the Internal Revenue Code definition of “disqualified person” under IRC §4975. In addition to the remedies under ERISA, a disqualified person is subject to a tax on each prohibited transaction under IRC §4975.

The definition of a party in interest includes fiduciaries as well as other persons, but certain of the ERISA prohibitions are specifically directed at fiduciaries. The prohibited transactions for parties in interest are found in ERISA §406 and, in general, they cover the following transactions: engaging in sales, exchanges, or leases of property with the plan; lending money or extending credit to or from the plan; furnishing goods, services, or facilities to or from the plan; and the transfer of plan assets to, or use of plan assets by or for the benefit of, a party in interest. [ERISA § 406(a)]

In addition, ERISA §406(b) prohibits fiduciaries from engaging in acts of self-dealing:

A fiduciary with respect to a plan shall not –

(1) Deal with the assets of the plan in his own interest or for his own account;

(2) In his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, or

(3) Receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan. [ERISA §406(b)]

Practice SA - 1.3 (continued)

In one case, a court explained the rationale for these prohibited transaction rules:

In addition to the general fiduciary duties of loyalty and prudence, ERISA also regards specific types of transactions between a plan and related persons, known as “parties in interest,” as inherently susceptible to abuse. [Whitfield v. Tomasso, 682 F. Supp. 1287, 1301, 9 E.B.C. 2438 (E.D.N.Y. 1988)]

Furthermore, the court said:

In addition to the prohibitions of section 406(a), section 406(b), 29 U.S.C. §1106(b), prohibits plan fiduciaries from placing themselves in a conflict of interest situation where their loyalty to the plan may be divided. [Whitfield at 1301]

Some exemptions from the prohibitions of §406 are allowed, and exemptions come in several forms: statutory, regulatory, class, and private exemptions.

UPIA and UPMIFA Requirements

Unlike ERISA, UPIA and UPMIFA do not contain provisions that explicitly prohibit self-dealing. However, the Comments to several sections of the UPIA make it clear that the general fiduciary provisions prohibit self-dealing. Under the UPIA, as in ERISA §404(a)(1)(A), the trustee must

invest and manage the trust assets solely in the interest of beneficiaries. [UPIA §5]

According to the Comments to §5, this duty of loyalty is the most characteristic of trust law and requires the trustee (a fiduciary) to act exclusively for beneficiaries, as opposed to acting for the trustee’s own interest or that of third parties. [UPIA §5, Comments]

Similarly, the UPMIFA emphasizes donor intent. The Prefatory Note to the UPMIFA states:

UPMIFA improves the protection of donor intent with respect to expenditures from endowments. When a donor expresses intent clearly in a written gift instrument, the Act requires that the charity follow the donor’s instructions. When a donor’s intent is not so expressed, UPMIFA directs the charity to spend an amount that is prudent, consistent with the purposes of the fund, relevant economic factors, and the donor’s intent that the fund continue in perpetuity. This approach allows the charity to give effect to donor intent, protect its endowment, assure generational equity, and use the endowment to support the purposes for which the endowment was created.

Practice SA - 1.3 (continued)

The trustee's duty to abstain from self-dealing is discussed in the Comments to UPIA §2, which describes the trustee's standard of care and portfolio strategy. One of the modern investment practices described in UPIA §2(e) is the removal of restrictions on the kinds of investments the trustee may make.

A trustee may invest in any kind of property or type of investment consistent with the standards of this [Act] [UPIA §2(e)]

However, that general provision is limited by an example described in the Comments to §2 of the UPIA:

Were the trustee to invest in a second mortgage on a piece of real property owned by the trustee, the investment would be wrongful on account of the trustee's breach of the duty to abstain from self-dealing [UPIA §2, Comments]

Thus, the requirements of UPIA §§2 and 5 require the loyalty of the fiduciaries to the beneficiaries and prohibit self-dealing on the part of the trustee. Although the UPMIFA requires the protection of donor intent, it does not specifically prohibit self-dealing. However, self-dealing would appear to be inconsistent with using the endowment for the purpose it was intended for.

MPERS Requirements

MPERS requires trustees to act exclusively for the participants and beneficiaries, as opposed to acting for the fiduciaries' own interests or those of third parties.

A trustee or other fiduciary shall discharge duties with respect to a retirement system:

(1) Solely in the interest of the participants and beneficiaries; and

(2) For the exclusive purpose of providing benefits to participants and beneficiaries.... [MPERS §7(1) and (2)]

This general requirement that fiduciaries place the interests of the participants and beneficiaries above their own effectively places any self-dealing under great scrutiny and may, in effect, prohibit self-dealing. That is, it is difficult to imagine a situation in which a fiduciary engages in a transaction with a retirement system without placing its own interests equal to or ahead of the interests of the participants and beneficiaries. To avoid violations of the general fiduciary rules, fiduciaries should either avoid self-dealing or have an independent fiduciary negotiate on behalf of the retirement system.

MPERS does not contain a set of negative duties or prohibited transactions, as does ERISA §406, and according to the Comments in §7 there are several reasons for this omission: ERISA's prohibited transactions rules have necessitated a complex set of statutory exemptions and administrative waivers; the negative duties add little to the affirmative duties of MPERS; the negative duties duplicate state law protections; and MPERS requires disclosure of transactions between the retirement system and significant actors. [MPERS §7, Comments]

Practice SA - 1.3 (continued)

This last reason perhaps is the most important justification for the specific prohibition against self-dealing, for in MPERS §17(c)(12) and (13) the plan must include, in its annual disclosure of financial and actuarial status, the following details:

(12) A description of any material interest, other than the interest in the retirement program itself, held by any public employer participating in the system or any employee organization representing employees covered by the system in any material transaction with the system within the last three years or proposed to be effected;

(13) A description of any material interest held by any trustee, administrator, or employee who is a fiduciary with respect to the investment and management of assets in the system, and, if the fiduciary is an individual, by a related person of the beneficiary, in any material transaction with three system within the last three years or proposed to be effected.
[MPERS §17(c)(12) and (13)]

The requirement of the disclosure of information about self-dealing and conflicts reinforces the limitations on self-dealing between a retirement system and a fiduciary.

PRUDENT PRACTICES FOR INVESTMENT FIDUCIARIES

Practice SA - 1.4

Service agreements and contracts are in writing, and do not contain provisions that conflict with fiduciary standards of care.

ERISA Requirements

ERISA recognizes that a fiduciary, in discharging his duties, may need to seek assistance from other persons, such as investment advisors and managers, and may delegate certain responsibilities to them.

A fiduciary ... may employ one or more persons to render advice with regard to any responsibility such fiduciary has under the plan. [ERISA §402(c)(2)]

However, when hiring advisors or purchasing goods or services, ERISA's general fiduciary rules would require that the fiduciaries take reasonable steps to protect the plan from losses and misunderstandings. Thus, fiduciaries should reduce any agreement of substance to writing in order to define the scope of the parties' duties and responsibilities, to ensure that the plan is managed in accordance with the written documents that govern the plan, and to confirm that the parties have clear, mutual understandings of their roles in conducting plan business.

Under ERISA, investment managers are required to acknowledge in writing that they are a fiduciary with respect to a plan. [ERISA §3(38)(C)] Except for investment managers, however, there is nothing explicit in ERISA requiring a written service agreement or contract. But the fiduciary standards of ERISA imply that service agreements and contracts be reviewed carefully and therefore by extension suggest that they be in writing.

A written service agreement typically would also set forth the costs for these services, and could possibly avert a breach of fiduciary duty. A service provider is a "party in interest" under ERISA since the definition of "party in interest" includes "a person providing services to such a plan." [ERISA §3(14)(B)] For example, transferring plan assets directly or indirectly to a party in interest is a prohibited transaction under ERISA, but an exemption is allowed for

... contracting or making reasonable arrangements with a party in interest for office space or legal, accounting or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefore. [ERISA §408(b)(2)]

The fiduciary must discern if the fees paid for services are reasonable, and this would be difficult if not impossible without a written service agreement to review.

Practice SA - 1.4 (continued)

A written agreement also furnishes the plan fiduciary with a document for measuring and monitoring the service provider's activities. A failure to monitor can lead to breach of fiduciary duty under the general duties of ERISA §404(a)(1). In Interpretive Bulletin 94-2, the DOL expressed its view that:

... compliance with the duty to monitor necessitates proper documentation of the activities that are subject to monitoring. [DOL Reg. §2509.94-2, Interpretive Bulletin 94-2 – Written statements of investment policy (July 29, 1994)]

In at least one court case the court explained that:

... at the very least, trustees have an obligation to (i) determine the needs of a fund's participants, (ii) review the services provided and the fees charged by a number of different providers, and (iii) select the provider whose service level, quality and fees best match the fund's needs and financial situation. [In addition,] [t]rustees also have an ongoing obligation to monitor the fees charged and services provided by service providers with whom a fund has an agreement, to ensure that renewal of such agreements is in the best interest of the fund. [Liss v. Smith, 991 F. Supp. 278, 300 (S.D.N.Y. 1998), citing Whitfield v. Tomasso, 682 F. Supp. 1287, 1304, 9 E.B.C. 2438 (E.D.N.Y. 1988)]

UPIA and UPMIFA Requirements

The duties of loyalty and prudence also are fiduciary requirements under the UPIA and the UPMIFA. The UPIA states that:

A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries.
[UPIA §5]

A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.
[UPIA §2(a)]

Section 2 of the UPIA sets out standard of care requirements that support modern investment practice, including the duty to monitor investments.

The UPMIFA also contains the duties of loyalty and prudence. Section 3(b) of the UPMIFA states:

In addition to complying with the duty of loyalty imposed by law other than this [act], each person responsible for managing and investing an institutional fund shall manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.

Practice SA - 1.4 (continued)

The UPIA and the UPMIFA also favor the modern trend toward delegating duties, including investment and management functions. Section 9 of the UPIA states:

A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in ... establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust [UPIA §9(a)(2), similar to the delegation rule under ERISA §403(a)(2)].

The UPMIFA also includes a section on the delegation of management and investment functions. It states:

Subject to any specific limitation in law other than this [act], an institution may delegate to an external agent the management and investment of an institutional fund to the extent that an institution could prudently delegate under the circumstances. An institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances ...[UPMIFA §5(a)]

[IBP] Best practices also favor reducing the terms of the delegation to a writing since it would be difficult to establish the scope and terms of the delegation without a written agreement. This also would ensure that the trustee and the service provider have clear understandings of their roles and responsibilities.

The UPIA and the UPMIFA require the trustee and the institution to be prudent with beneficiaries' money and to minimize costs.

In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee. [UPIA §7. See also, UPMIFA §3(b) and (c)]

A written agreement, therefore, would provide a mechanism for monitoring costs and the scope of services.

MPERS Requirements

In the powers authorized to the trustee in §5 of MPERS, the trustee has the exclusive authority to

obtain by [employment or] contract the services necessary to exercise the trustee's powers and perform the trustee's duties including actuarial, auditing, custodial, investment, and legal services.... [MPERS §5(a)(2)]

Thus, a contract supports the best practice of outlining roles and responsibilities of the parties involved in administering the trust.

Practice SA - 1.4 (continued)

MPERS also follows the modern investment trend of permitting prudent delegation of the plan trustee's duties, here in the retirement system setting. [MPERS §6] MPERS also imposes the general fiduciary duties of prudence and loyalty [MPERS §7], which apply when duties are being delegated:

The trustee or administrator shall exercise reasonable care, skill, and caution in ... establishing the scope and terms of the delegation, consistent with the purposes and terms of the retirement program. [MPERS §6(b)(2)]

Therefore, in all cases the fiduciaries must define the scope and terms of the engagement. And in matters of substance, where a misunderstanding or conflict could result in a material loss or cost to the plan, prudence customarily would dictate that the provisions of the engagement be reduced to a detailed written agreement between the parties.

PRUDENT PRACTICES FOR INVESTMENT FIDUCIARIES

Practice SA - 1.5

Assets are within the jurisdiction of U.S. courts, and are protected from theft and embezzlement.

ERISA Requirements

Under ERISA,

except as authorized by the Secretary [of Labor] by regulation, no fiduciary may maintain the indicia of ownership of any assets of a plan outside the jurisdiction of the district courts of the United States. [ERISA §404(b) and DOL Reg. §2550.404b-1]

The rule requiring that plan assets be subject to federal court jurisdiction is to prevent fiduciaries from frustrating efforts to supervise their activities and to effect remedies for breach of trust. [H.R. Report No. 93-1280 (93rd Cong., 2d Sess., 1974), p. 306]

In addition, plans subject to ERISA also are required to maintain a fidelity bond, covering the plan fiduciaries and other persons who handle funds or other property of the plan.

Every fiduciary of an employee benefit plan and every person who handles funds or other property of such a plan ... shall be bonded as provided in this section [ERISA §412(a)]

The purpose of the bond is to ensure that the assets of the plan are protected against loss from acts of theft or embezzlement by persons having access to the assets.

Finally, under general trust law, upon which ERISA is based (*see, e.g., Varity Corporation v. Howe et al*, 516 U.S. 489, 496, 116 S. Ct. 1065, 134 L.Ed.2d 130 (1996): “*these fiduciary duties draw much of their content from the common law of trusts, the law that governed most benefit plans before ERISA’s enactment.*”), fiduciaries have the obvious duty to take prudent steps to safeguard the assets entrusted to them to ensure that those assets are available for the purposes of the trust.

UPIA and UPMIFA Requirements

The UPIA and the UPMIFA do not contain explicit requirements similar to those for plans subject to ERISA. However, by implication, to fulfill its fiduciary duty to invest and manage the trust assets for the exclusive benefit of the beneficiaries of a trust, the trustee would need to take prudent steps to protect the assets from theft and other reasonably foreseeable injury. [UPIA §5] That is, it would be a breach of fiduciary duty to fail to take ordinary and customary steps (such as bonding) to protect against losses due to theft or embezzlement.

Practice SA - 1.5 (continued)

[IBP] Further, the prudence requirements of UPIA §2(a) and UPMIFA §3(b) would reasonably require that the assets be maintained within the jurisdiction of the United States court system so that the appropriate courts would have jurisdiction to protect the participants and to enforce the UPIA provisions. Consistent with this premise, in UPIA §9 and UPMIFA §5(d), where the trustee or institution is given the ability to delegate investment and management functions to an agent, the agent submits to the jurisdiction of the courts of the particular state. The UPIA provides:

By accepting the delegation of a trust function from the trustee of a trust that is subject to the law of this State, an agent submits to the jurisdiction of the courts of this State. [UPIA §9(d)]

MPERS Requirements

MPERS also provides that the trustee may delegate certain functions so long as

[b]y accepting the delegation of a function from the trustee or administrator, an agent submits to the jurisdiction of the courts of this State. [MPERS §6(e)]

“State” is defined as one of the States of the United States, the District of Columbia, Puerto Rico, the United States Virgin Islands, or any territory or insular possession subject to the jurisdiction of the United States. [MPERS §2(21)]

Although under ERISA §412(a) a plan is required to maintain a surety bond as protection against losses, MPERS does not have that specific requirement. However, as described in MPERS §11,

*a retirement system **may** insure itself against liability or losses occurring because of a breach of duty under the Act by a trustee or other fiduciary. [Emphasis added] [MPERS §11(c)]*

The Comments to §11 state that the intent of §11(c) is to permit retirement systems to pursue a wide variety of arrangements for insuring against losses resulting from fiduciary violations including self-insurance, risk-retention groups, and commercial fiduciary liability insurance. [MPERS §11, Comments] **[IBP]** While this provision covers insurance and not fiduciary bonding, it highlights the statutory intent that fiduciaries take prudent steps to preserve and protect plan assets from risk.

[IBP] Further, as with the UPIA, the general prudence requirement of MPERS §7 would require that the fiduciaries take reasonable steps to protect the plan’s assets, which would ordinarily include bonding persons who have access to those assets and maintaining the assets in a manner subject to the jurisdiction of the U.S. courts and the enforcement of MPERS’ provisions. [MPERS §7]

PRUDENT PRACTICES FOR INVESTMENT FIDUCIARIES

Practice SA - 2.1

An investment time horizon has been identified.

ERISA Requirements

ERISA does not specifically address a requirement that fiduciaries identify an investment time horizon. Nevertheless, this is implicit in the fiduciary duties imposed by ERISA.

To fulfill its obligation to act prudently under ERISA §404(a)(1)(B), the fiduciary must give:

... appropriate consideration to those facts and circumstances that ... the fiduciary knows or should know are relevant to the particular investment or investment course of action involved [29 C.F.R. §2550.404a-1(b)(1)(A)]

According to the DOL, “appropriate consideration” includes the following:

A determination by the fiduciary that 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 the investment course of action ... [29 C.F.R. §2550.404a-1(b)(2)(A)(i)]

Thus, the fiduciary is required to establish policies for the plan that will address the likelihood of meeting the plan’s investment goals to enable it to provide benefits to the participants and avoid losses. One of the factors that must be considered in establishing these policies is the investment time horizon.

The DOL has recognized the significance of investment time horizons in its Interpretive Bulletin relating to participant investment education. [29 C.F.R. §2509.96-1] The DOL notes that, with the advent of participant directed plans,

[t]here has been an increasing recognition of the importance of providing participants and beneficiaries, whose investment decisions will directly affect their income at retirement, with information designed to assist them in making investment and retirement-related decisions appropriate to their particular situations. [Ibid.]

Practice SA – 2.1 (continued)

Among the information the DOL suggests may be relevant to a participant (which the plan sponsor may provide to participants without being deemed to give “investment advice” under ERISA) is the following:

Information and materials that inform a participant or beneficiary about: ... (v) determining investment time horizons.... [29 C.F.R. §2509.96-1(d)(2)]

At least one court also has recognized the importance of considering appropriate investment time horizons for the plan. In *Metzler v. Graham*, 112 F.3d 207 (5th Cir. 1997), the court considered the duty of a plan fiduciary to diversify unless it was clearly prudent not to do so. The court reasoned that although no statute or regulation specifies what constitutes “diversification,” ERISA’s legislative history provides some guidance:

*The degree of investment concentration that would violate this requirement to diversify cannot be stated as a fixed percentage, because a fiduciary must consider the facts and circumstances of each case. The factors to be considered include (1) the purpose of the plan; (2) the amount of the plan assets; (3) financial and industrial conditions; (4) the type of investment, whether mortgages, bonds, or shares of stock or otherwise; (5) distribution as to geographical location; (6) distribution as to industries; and (7) **the dates of maturity.** [Emphasis added] [*Metzler*, 112 F. 3d at 209, citing H.R. Rep. No. 1280, 93d Cong., 2d Sess. (1974)]*

The *Metzler* court faced the issue of whether the plan fiduciary, in investing 65% of the plan’s assets in one piece of real estate on which the plan received no return, had breached its duty to diversify. The court held that there was no breach since the plan, after purchasing the property, had sufficient cash remaining in the plan to cover projected plan payouts for the next 20 years. The Secretary of Labor had contended that the time horizon should not be a factor in evaluating whether the plan trustee had appropriately diversified to reduce the risk of large losses, since losses are not postponed until the investment is liquidated. The *Metzler* court disagreed, concluding that it was entirely appropriate for a fiduciary to consider the time horizon over which the plan will be required to pay out benefits in evaluating a given investment strategy. [*Metzler* at 210].

[IBP] Thus, while there is no explicit requirement in ERISA to establish a time horizon for the plan’s investments, both the DOL and the courts have recognized the necessity of an identified plan horizon for the appropriate investments, taking into account issues such as volatility and diversification.

UPIA and UPMIFA Requirements

The UPIA and the UPMIFA do not directly address the issue of identifying an investment time horizon, but they do require trustees and institutions to consider the issue by implication.

Practice SA – 2.1 (continued)

Section 2 of the UPIA identifies the standard of care, portfolio strategy, and risk and return objectives of the trust that the trustee must observe. The first requirement is that:

The trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other considerations of the trust. [UPIA §2(a). *See also*, UPMIFA § 3(b)]

Section 2 goes on to address the trustee's obligation to identify an investment strategy.

A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust. [UPIA §2(b). *See also*, UPMIFA § 3(e)(2)]

The remainder of Section 2 of the UPIA describes various factors the trustee should take into account in investing and managing the trust assets. The comments under Section 2 make clear the focus is on modern portfolio theory. For example:

Subsection (b) emphasizes the consolidated portfolio standard for evaluating investment decisions, and goes on to point out that Subsection (b) also sounds the main theme of modern investment practice, sensitivity to the risk/return curve.

When managing and investing an institutional fund, the UPMIFA requires the institution to consider:

the needs of the institution and the fund to make distributions and to preserve capital ...[UPMIFA §3(e)(1)(G)]

The UPMIFA also provides that:

In making a determination to appropriate or accumulate, the institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, and shall consider, if relevant, the following factors:

- (1) the duration and preservation of the endowment fund; [and]*
- (2) the purposes of the institution and the endowment fund...*[UPMIFA §4(a)(1-2)]

Practice SA – 2.1 (continued)

The Comments to Section 4 of the UPMIFA provides that the indefinite duration of the fund must be considered. It states:

When the institution considers the purposes and duration of the fund, the institution will give priority to the donor’s general intent that the fund be maintained permanently. Although the Act does not require that a specific amount be set aside as “principal,” the Act assumes that the charity will act to preserve “principal” (i.e., to maintain the purchasing power of the amounts contributed to the fund) while spending “income” (i.e. making a distribution each year that represents a reasonable spending rate, given investment performance and general economic conditions).

[IBP] Taken together, the requirements of Section 2 of the UPIA strongly suggest that the trust time horizon is important by requiring the trustee to focus on the purposes of the trust and by requiring the trustee to invest prudently, using an overall investment strategy that takes into account risk and return objectives. By considering the appropriate investment time horizon, the trust is more likely to meet its objectives and to minimize the risk that the volatility of the chosen investments will result in losses to the plan.

Similarly, the UPMIFA emphasizes that the institution balance the permanent nature of the fund with the need to fulfill the intent of the endowment.

MPERS Requirements

Section 8 of MPERS imposes duties on the trustee when investing and managing trust assets. Section 10 addresses the standards for evaluating the performance of fiduciaries. Section 10(b) states:

The trustee’s investment and management decisions must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the program or appropriate grouping of programs. [MPERS §10(b)]

The comments to this section explain the requirement in more detail:

Subsection (b) also sounds the main theme of modern investment practice, sensitivity to the risk/return curve. Returns correlate strongly with risk, but tolerance for risk may vary with the circumstances of the retirement program or appropriate grouping of programs. A program that has a large proportion of its participants and beneficiaries near and beyond retirement age may have a lower risk tolerance than a program that has a large proportion of young participants.

Practice SA – 2.1 (continued)

The example in the quoted language identifies the need for fiduciaries to focus on the relevant time horizon and to take that into account in developing the risk tolerance of the trust. This is seen in the emphasis on the “circumstances of the retirement program.” That is, the investment time horizon of the trust’s assets will affect whether the plan can meet its objective of providing retirement benefits, and how well it can minimize losses during a short time horizon by choosing investments that are less volatile.

The prudence of documenting the timing and distribution of cash flows, and the payment of liabilities:

ERISA Requirements

To provide benefits to participants, plan fiduciaries must ensure that sufficient assets are available to cover payments as they come due. Section 402(b) of ERISA requires every employee benefit plan to

... provide a procedure for establishing and carrying out a funding policy and method consistent with the objectives of the plan [ERISA §402(b)(1)]

DOL regulations under ERISA §404(a) direct plan fiduciaries, in fulfilling their investment duties, to take into consideration such factors as:

(ii) The liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and

(iii) The projected return of the portfolio relative to the funding objectives of the plan. [29 C.F.R. §2550.404a-1(b)(2)]

In Interpretive Bulletin 94-2, the DOL explained the rationale for the requirement for a funding policy:

The ERISA Conference Report indicates that the purpose of the requirement for a funding policy is to enable the plan fiduciaries to determine the plan’s short- and long-run financial needs, and communicate these requirements to the appropriate persons. For example, with a retirement plan it is expected that under this procedure, the persons who manage the plan will determine whether the plan has a short-run need for liquidity (e.g., to pay benefits) or whether liquidity is a long-run goal and investment growth is a more current need. This, in turn, is to be communicated to the persons responsible for investments so that investment policy can be appropriately coordinated with plan needs. [DOL Reg. §2509.94-2, Interpretive Bulletin 94-2 - Written statements of investment policy (July 29, 1994), citing from H.R. Report No. 93-1280, 93rd Cong. 2d Sess. at 297 (1974)]

Practice SA – 2.1 (continued)

The fiduciaries of the plan should document the funding policy and related investment practices in writing. By reducing the policies to writing, the fiduciaries will have taken appropriate steps to comply with ERISA's requirements, to prove their compliance and facilitate the implementation and administration of those policies. As explained by the DOL in an analogous situation (that is, the fiduciary responsibility to monitor investment-related decisions):

It is the view of the Department that compliance with the duty to monitor necessitates proper documentation of the activities that are subject to monitoring. Thus, the investment manager or other responsible fiduciary would be required to maintain accurate records as to proxy voting. Moreover, if the named fiduciary is to be able to carry out its responsibilities under ERISA §404(a) in determining whether the investment manager is fulfilling its fiduciary obligations in investing plan assets in a manner that justifies the continuation of the management appointment, the proxy voting records must enable the named fiduciary to review not only the investment manager's voting procedure with respect to plan-owned stock, but also to review the actions taken in individual proxy voting situations. [DOL Reg. §2509.94-2, Interpretive Bulletin 94-2 – Written statements of investment policy (July 29, 1994)]

UPIA and UPMIFA Requirements

The trustee under the UPIA and institution under the UPMIFA must ensure that the plan and fund have sufficient assets to pay bills and meet liabilities as they become due. Under the UPIA and the UPMIFA, the trustee or other applicable person is charged with the responsibility for investing and managing trust assets, subject to the prudent investor standard and exercising reasonable care, skill, and caution. [UPIA §2(a); UPMIFA §3]

According to the Comments to UPIA §1, the prudence standard had its origins in *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446 (1830), where trustees should

observe how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested. [Harvard at 461]

Any investment and management decisions made by the trustee must be evaluated as part of an overall investment strategy with risk/return objectives that reasonably suit the trust. [UPIA §2(b); UPMIFA §3(e)] The Comments to UPIA §2 describe how this section supports the theme of modern investment practice, sensitivity to the risk/return curve, with risk tolerance varying greatly with the purposes of the trust and the relevant circumstances of the beneficiaries. In making decisions about investing and managing trust assets, the trustee and institution must consider such factors as:

- (1) *General economic conditions;*
- (2) *The possible effect of inflation or deflation;*

Practice SA – 2.1 (continued)

(3) The expected tax consequences of investment decisions or strategies;

(4) The role that each investment or course of action plays within the overall trust portfolio.... [UPIA §2(c)(1 - 4). See also, UPMIFA §3(e)(1)]

In addition, the trustee must also consider the

(7) needs for liquidity, regularity of income, and preservation or appreciation of capital [UPIA §2(c)(7)]

Thus, as with ERISA, the trustee under the UPIA and institution under the UPMIFA must take into account the provisions of the trust and the needs of the beneficiaries or charity and match the investments with those “liabilities” and cash flow needs.

Also, by documenting the requirements for cash flow and liquidity, and the investment policies to satisfy those needs, the trustee or institution has documented its compliance with the legal requirements and has taken reasonable steps to implement and administer those decisions.

MPERS Requirements

Although MPERS, unlike ERISA, does not contain a separate requirement for a funding policy, the plan trustee, as part of its general fiduciary duties described in MPERS §7, still must ensure that the plan will be able to pay benefits:

A general fiduciary duty is for the trustee to discharge his duties:

(1) Solely in the interest of the participants and beneficiaries; and

(2) For the exclusive purpose of providing benefits to participants and beneficiaries and paying reasonable expenses of administering the system. [MPERS §7(1) and (2)]

In describing the trustee’s duties, MPERS also states that a trustee who has the authority to invest and manage assets must consider the same various factors that are delineated in Section 2 of the UPIA, including:

(A) General economic conditions;

(B) The possible effect of inflation or deflation;

(C) The role that each investment or course of action plays within the overall portfolio of the retirement program or appropriate grouping of programs;

(D) The expected total return from income, and preservation and appreciation of capital; and

(E) Needs for liquidity, regularity of income, and preservation or appreciation of capital. [MPERS §8(a)(1)(E)]

Practice SA – 2.1 (continued)

The documentation of the decisions necessary to satisfy these requirements facilitates their implementation and administration, and provides proof that the fiduciaries considered and reached conclusions on these requirements.

PRUDENT PRACTICES FOR INVESTMENT FIDUCIARIES

Practice SA - 2.2

A risk level has been identified.

ERISA Requirements

Historically, fiduciaries were governed by the common law of trusts, which required that the riskiness of each investment in a portfolio be measured in isolation. [*Laborers National Pension Fund v. Northern Trust Quantitative Advisors, Inc.*, 173 F.3d, 313, 23 E.B.C. 1001 (5th Cir.), cert. denied, 528 U.S. 967 (1999); see also *Chase v. Pevear*, 383 Mass. 350, 419, N.E. 2d 1358, 1366 (1981)] But in DOL Reg. §2550.404a-1, the DOL determined that ERISA redefined the investment duties of fiduciaries to require that:

... the fiduciary shall be required to act as a prudent investment manager under the modern portfolio theory [Laborers, 173 F. 3d, at 317]

Specifically, the fiduciary's investment duties under ERISA §404(a)(1)(B) are satisfied if the fiduciary:

Has given appropriate consideration to those facts and circumstances that ... the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties.... [29 C.F.R. §2550.404a-1(b)(1)(A)(i)]

The DOL explained its regulations that:

"appropriate consideration" shall include, but is not necessarily limited to:

*(A) determination by the fiduciary that 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 the investment course of action, and*

(B) consideration of the following factors as they relate to such portion of the portfolio:

(i) the composition of the portfolio with regard to diversification;

(ii) the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and

(iii) the projected return of the portfolio relative to the funding objectives of the plan. [Emphasis added] [29 C.F.R. §2550.404a-1(b)(2)]

Practice SA – 2.2 (continued)

The focus of the regulations is on structuring a portfolio that takes into account the relationship between risk and return, and on properly balancing that relationship in light of the objectives of the trust. That process requires that the levels of risk and reward must be identified and compared.

UPIA and UPMIFA Requirements

The UPIA and the UPMIFA set forth the standards a trustee must use in deciding on the trust's portfolio strategy, and risk and return objectives. They require that the trustee employ modern investment practices.

*A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy **having risk and return objectives reasonably suited to the trust.** [Emphasis added] [UPIA §2(b). See also, UPMIFA §3(e)(2)]*

According to the Comments section, UPIA §2(b) describes the main theme of modern investment practice, *i.e.*, sensitivity to the risk/return curve.

Returns correlate strongly with risk, but tolerance for risk varies greatly with the financial and other circumstances of the investor, or in the case of a trust, with the purposes of the trust and the relevant circumstances of the beneficiaries. [UPIA §2, Comments]

The Comments to UPIA §2 also state that:

[a]n investment that might be imprudent standing alone can become prudent if undertaken in sensible relation to other trust assets....

Subsection 2(c) of the UPIA describes some of the factors the trustee should consider in investing and managing trust assets. According to the Comments to §2, these factors

... commonly bear on risk/return preferences in fiduciary investing. [UPIA §2, Comments]

The factors include:

- (1) General economic conditions;*
- (2) The possible effect of inflation or deflation;*
- (3) The expected tax consequences of investment decisions or strategies;*
- (4) The role that each investment or course of action plays within the overall trust portfolio ...;*
- (5) The expected total return from income and the appreciation of capital;*

Practice SA – 2.2 (continued)

(6) Other resources of the beneficiaries; and

(7) The needs for liquidity, regularity of income, and preservation or appreciation of capital.... [UPIA §2(c)(1-7)]

As a result, the trustee needs to determine the trust’s purpose and objectives, and then develop an investment strategy to achieve the needed returns at an appropriate level of risk.

MPERS Requirements

Section 8 of MPERS describes the trustee’s duties in investing and managing assets of a retirement system. MPERS §8 includes the requirement that the trustee, who has investment and management authority, identify investment objectives and risk levels:

*A trustee with authority to invest and manage assets of a retirement system shall adopt a statement of investment objectives and policies for each retirement program or appropriate grouping of programs. The statement must include the desired rate of return on assets overall, the desired rates of return and **acceptable levels of risk** for each asset class, asset-allocation goals, guidelines for the delegation of authority, and information on the types of reports to be used to evaluate investment performance. [Emphasis added] [MPERS §8(b)]*

In the Comments to §8, the commentators discuss different types of investment risks and offer insight into the considerations the trustee should use in evaluating those risks. Risk is divided into the categories of “compensated” and “uncompensated” risk, with “compensated” risk having a higher expected rate of return in order to induce investors to bear the greater risk associated with the particular investment. Risk can be reduced by configuring the portfolio to include investments in a variety of industries and categories so that the risk in a diversified portfolio will be less than the average risk of the separate holdings. [MPERS §8, Comments]

Under MPERS, then, trustees are required to identify and evaluate the different risk levels of each investment in the portfolio to create an overall investment strategy for the plan.

PRUDENT PRACTICES FOR INVESTMENT FIDUCIARIES

Practice SA - 2.3

An expected, modeled return to meet investment objectives has been identified.

ERISA Requirements

Section 404(a) of ERISA imposes on fiduciaries an obligation to act prudently. Specifically, a fiduciary is required to act:

... 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. [ERISA §404(a)(1)(B)]

The fiduciary will fulfill its investment duties if it gives:

... appropriate consideration to those facts and circumstances that ... the fiduciary knows or should know are relevant to the particular investment or investment course of action involved [29 C.F.R. §2550.404a-1(b)(1)(A)]

For these purposes, “appropriate consideration” is defined in the DOL regulations to include, without limitation:

... a determination by the fiduciary that 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 the investment course of action [29 C.F.R. §2550.404a-1(b)(2)(A)]

In addition, the fiduciary should take into consideration the following factors:

(A) The composition of the portfolio with regard to diversification;

(B) The liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and

(C) The projected return of the portfolio relative to the funding objectives of the plan. [29 C.F.R. §2550.404a-1(b)(2)]

This last aspect, considering the projected return of the portfolio relative to the plan’s funding objectives, can be accomplished by the fiduciary by “modeling” the probable return a given investment strategy should produce.

Practice SA – 2.3 (continued)

[IBP] Although modeling a probable return and its associated risk for a given asset allocation strategy is difficult, most investment professionals develop expected asset class returns using a “risk premium” model. Under this model, an estimated premium for the greater risk of the particular investment is added to the risk-free rate of return on U.S. government bonds. This “risk premium” model has been recognized by the courts in several cases, as early as 1944 in *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1944), and later in *Communications Satellite Corporation v. Federal Communications Commission*, 611 F.2d 883 (D.C. Cir. 1977) and *Tennessee Gas Pipeline Company v. Federal Energy Regulatory Commission*, 926 F.2d 1206 (1991). This system follows modern portfolio theory, whereby a risk premium compensates for the risk associated with a particular investment or investment class.

The concept of modeling a probable return for a given asset allocation strategy goes to the core of the role of the fiduciary in discharging his duties -

... for the exclusive purpose of providing benefits to participants and their beneficiaries.
[ERISA §404(a)(1)(A)]

UPIA and UPMIFA Requirements

The UPIA and the UPMIFA identify the standard of care, portfolio strategy, and risk and return objectives, including the obligation to identify an investment strategy. Section 2 of the UPIA provides that:

A trustee’s investment and management decisions respecting individual assets must be evaluated not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust. [UPIA §2(b). *See also*, UPMIFA §3(e)(2)]

The UPIA and the UPMIFA describe some of the circumstances the trustee or institutional fund should consider in investing and managing assets, including, among others, such circumstances as general economic conditions, the possible effect of inflation or deflation, the expected tax consequences of investment decisions or strategies, the expected total return from income and the appreciation of capital, and the needs for liquidity, regularity of income, and preservation or appreciation of capital. [UPIA §2(c)(1-8); UPMIFA §3(e)(1)(A)-(H)]

The direction to the trustee and institution to look at “*the expected total return from income and the appreciation of capital,*” as well as the needs of the trust or institutional fund, require that they determine the investment objectives and then develop an investment course of action reasonably designed to produce the return and liquidity needed to achieve these objectives.

MPERS Requirements

Section 8 of MPERS imposes duties on the trustee when investing and managing trust assets. Section 8(a) is similar to section 2(c) of the UPIA in its list of non-exclusive factors the trustee should consider in investing and managing the assets of a retirement system. [MPERS §8(a)(1)(A-F)] Specifically, MPERS §8(a)(1)(D) states:

In investing and managing assets of a retirement system pursuant to Section 7 [of MPERS], a trustee with authority to invest and manage assets shall consider, among other circumstances, the expected total return from income and the appreciation of capital.

Under MPERS, the trustee with investment and management authority is required to have a statement of investment objectives and policies for each retirement program, with the statement including, among other factors, the desired rate of return on assets overall and the desired rates of return and acceptable levels of risk for each asset class. [MPERS §8(b)] These rates of return are estimates and are not intended to be specific predictions of actual returns, but MPERS §8(b) mandates that the trustee, at least annually, review the statement and change or reaffirm it.

Although modeling of a probable risk/return for an asset allocation strategy is difficult, the requirement under MPERS that the investment objectives statement be reviewed each year, at a minimum, is a protective measure for ensuring that investment objectives are analyzed and modified as necessary.

PRUDENT PRACTICES FOR INVESTMENT FIDUCIARIES

Practice SA - 2.4

Selected asset classes are consistent with the identified risk, return, and time horizon.

ERISA Requirements

Section 404(a) of ERISA imposes on fiduciaries an obligation to act prudently. A fiduciary is required to act:

... 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. [ERISA §404(a)(1)(B)]

The fiduciary will fulfill its investment duties if he or she gives:

... appropriate consideration to those facts and circumstances that ... the fiduciary knows or should know are relevant to the particular investment or investment course of action involved [29 C.F.R. §2550.404a-1(b)(1)(A)]

For these purposes, “appropriate consideration” is defined in DOL regulations to include, without limitation:

*... a determination by the fiduciary that 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 the investment course of action [Emphasis added] [29 C.F.R. §2550.404a-1(b)(2)(A)]*

In addition, the fiduciary should take into consideration the following factors:

(i) *The **composition of the portfolio with regard to diversification**;*

(ii) *The liquidity of the current return of the portfolio relative to the anticipated cash flow requirements of the plan; and*

(iii) *The **projected return** of the portfolio relative to the funding objectives of the plan. [Emphasis added] [29 C.F.R. §2550.404a-1(b)(2)(B)(i-iii)]*

Practice SA - 2.4 (continued)

A central theme of the regulations is that the fiduciaries diversify the plan's investment portfolio "as a mechanism for reducing the risk of large losses." [See Preamble to DOL Regulation §2550.404a-1, 44 FR 37255 (June 25, 1979)] In discussing the duties of the fiduciaries in investing plan assets, the DOL also emphasized the importance of looking at individual investments within the context of the plan's portfolio as a whole and the fact that certain investments may, in themselves, entail risk but that, in the context of the portfolio, may be appropriate. For example, in the Preamble to the regulations under ERISA Section 404(a), the DOL explained:

*The Department is of the opinion that (1) generally, the relative riskiness of a specific investment or investment course of action does not render such investment or investment course of action either per se prudent or per se imprudent, and (2) **the prudence of an investment decision should not be judged without regard to the role that the proposed investment or investment course of action plays within the overall plan portfolio.** [Emphasis added]*

The importance of asset allocation strategy is emphasized in case law. In *GIW Industries, Inc. v. Trevor, Stewart, Burton, & Jacobsen, Inc.*, 895 F.2d 729 (11th Cir. 1990), the court examined the role of the investment manager and whether a breach of fiduciary duty, specifically the duty to diversify under ERISA, had occurred. The court, in examining the investment manager's duty to diversify, cited the reasoning of the court in *Leigh v. Engle*, 858 F.2d 361 (7th Cir. 1988), to wit:

When investment managers make decisions, they do not view individual investments in isolation. Rather, the goal is to create a diversified portfolio that balances appropriate levels of risk and return for the investor. The risk of a given instrument is neutralized somewhat when the investment is combined with others in a diversified portfolio. The risk inherent in the entire portfolio is less than that of certain assets within that portfolio. Ideally, after diversification, only market risk remains. Likewise, the return from a portfolio over time should be more stable than that of isolated investments within that portfolio. [Leigh at 368]

By spreading plan investments over several prudently selected asset classes, a fiduciary may reduce a plan's exposure to losses due to adverse economic and market conditions, or against the fortunes of a particular field of business or industry, and thereby minimize the risk of large losses.

The DOL has emphasized the importance of asset allocation strategy in DOL Interpretive Bulletin 96-1, *Participant Investment Education*. [29 C.F.R. §2509.96-1] In explaining its views on the circumstances under which providing investment-related information to participants and beneficiaries in participant-directed individual account pension plans would not constitute the rendering of investment advice under ERISA, the DOL recognized the use of asset allocation models as an investment strategy. It stated that:

Asset allocation models must be based on generally accepted theories that take into account the historic returns of different asset classes (e.g., equities, bonds, or cash) over defined periods of time.

Practice SA - 2.4 (continued)

The DOL further stated that:

This requirement was included to ensure that any models or materials presented to participants or beneficiaries will be consistent with widely accepted principles of modern portfolio theory, recognizing the relationship between risk and return, the historic returns of different asset classes, and the importance of diversification.

Thus, the fiduciary is responsible for selecting different asset classes consistent with the plan's identified risk, return, and time horizon.

UPIA and UPMIFA Requirements

The UPIA and the UPMIFA identify the standard of care, portfolio strategy, and risk and return objectives associated with modern investment practice. Section 2 of the UPIA states:

A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust. [UPIA §2(b). See also, UPMIFA 3(e)(2)]

The Comments under UPIA §2 point out that “Returns correlate strongly with risk, but tolerance for risk may vary greatly with the financial and other circumstances of the investor, or in the case of a trust, with the purposes of the trust and the relevant circumstances of the beneficiaries.”

The Comments further point out that UPIA §2(b) follows the Prudent Investor Rule of the Restatement of Trusts which provides that the standard of prudent investing

is to be applied to investments not in isolation, but in the context of the trust portfolio and as part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.[See also, UPMIFA §3(e)(2)]

Further, the investment strategies reflected in the UPIA and the UPMIFA are based in the modern portfolio theory and the concept of allocating among asset classes as a tool for minimizing volatility and risk. Thus, they incorporate the concept of utilizing prudent asset allocation among different classes of investments to meet the identified risk, return, and time horizon.

MPERS Requirements

MPERS requires a trustee who has the responsibility for investing and managing the assets of a retirement system to adopt a statement of investment objectives and policies. This statement identifies, among other factors, the trust's risk and return objectives, and asset allocation goals. More specifically:

*A trustee with authority to invest and manage assets of a retirement system shall adopt a statement of investment objectives and policies for each retirement program or appropriate grouping of programs. The statement must include the **desired rate of return on assets overall, the desired rates of return and acceptable levels of risk for each asset class, asset-allocation goals**, guidelines for the delegation of authority, and information on the types of reports to be used to evaluate investment performance. [Emphasis added]*
[MPERS §8(b)]

As a result, under MPERS, the trustee has the obligation to select asset classes and identify asset allocation goals that will further the plan's risk, return, and time horizon objectives.

PRUDENT PRACTICES FOR INVESTMENT FIDUCIARIES

Practice SA - 2.5

Selected asset classes are consistent with implementation and monitoring constraints.

ERISA Requirements

The fiduciary standard of care, including the standards for prudent investment management, under ERISA generally is not related to plan or portfolio size. Nevertheless, the size of the portfolio has been recognized to be a factor in determining which investments are appropriate for a plan. The 1974 Conference Report on ERISA, in discussing the requirement under ERISA Section 404(a)(1)(C) to diversify the plan's investments, states:

*The degree of investment concentration that would violate this requirement to diversify cannot be stated as a fixed percentage, because a fiduciary must consider the facts and circumstances of each case. The factors to be considered include (1) the purposes of the plan; (2) **the amount of the plan assets**; (3) financial and industrial conditions; (4) **the type of investment, whether mortgages, bonds, or shares of stock or otherwise**; (5) distribution as to geographical location; (6) distribution as to industries; and (7) the dates of maturity. [Emphasis added] [H.R. Rep. No. 1280, 93rd Cong., 2d Sess. (1974) reprinted in 1974 U.S. Code Cong. & Admin. News 5038, 5084 - 5085 (Conference Report at 304)]*

In its preamble to the final Regulations under ERISA Section 404(a), the DOL states:

Under the "prudence" rule, the standard to which a fiduciary is held in the proper discharge of his investment duties is defined, in part, by what a prudent person acting in a like capacity and familiar with such matters would do. Thus, for example, it would not seem necessary for a fiduciary of a plan with assets of \$50,000 to employ, in all respects, the same investment management techniques as would a fiduciary of a plan with assets of \$50,000,000.

While nothing in ERISA or the Regulations under ERISA specifies that the number of asset classes should be related to portfolio size, it is recognized that portfolio size is a factor that may be considered by the plan fiduciaries in fulfilling their investment duties.

UPIA and UPMIFA Requirements

The UPIA and the UPMIFA identify the standard of care, portfolio strategy, and risk and return objectives of the trust or institutional fund. UPIA §2(b) states:

*A trustee's investment and management decisions respecting individual assets must be **evaluated not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.** [Emphasis added] [UPIA §2(b). See also, UPMIFA §3(e)(2)]*

Practice SA - 2.5 (continued)

Neither the UPIA, UPMIFA nor their Comments specify that the size of the investment portfolio is a factor to be taken into account in selecting investments, though the language in the UPIA requiring that the trustee evaluate the “trust portfolio as a whole” and similar language contained in the UPMIFA could be read to indicate that size is a relevant factor.

However, comments to the Restatement of Trusts 3d, upon which UPIA is largely based, do provide a further indication that the trust fiduciaries will fulfill their investment responsibilities even if the number of asset classes is limited:

There is no defined set of asset categories to be considered by fiduciary investors. Nor does a trustee’s general duty to diversify investments assume that all basic categories are to be represented in a trust’s portfolio. In fact, given the variety of defensible investment strategies and the wide variations in trust purposes, terms, obligations, and other circumstances; diversification concerns do not necessarily preclude an asset allocation plan that emphasizes a single category of investments as long as the requirements of both caution and impartiality are accommodated in a manner suitable to the objectives of the particular trust....

Significant diversification advantages can be achieved with a small number of well-selected securities representing different industries and having other differences in their qualities. Broader diversification, however, is usually to be preferred in trust investing. [Restatement of Trusts 3d: Prudent Investor Rule §227, comment g, at 26-27]

Finally, the Comments under UPIA §2 address the size issue:

The Drafting committee declined the suggestion that the Act should create an exception to the prudent investor rule (or to the diversification requirement of Section 3) in the case of smaller trusts. The Committee believes that subsections (b) [quoted above] and (c) [which provides factors a trustee should consider in investing trust assets] of the Act emphasize factors that are sensitive to the traits of small trusts.... [Comment, UPIA §2]

By implication, then, the trustees may take into account portfolio size in the selection of the classes of assets in which the trust’s assets will be invested.

Similar provisions are not contained in the UPMIFA. Although the UPMIFA does not explicitly discuss consideration of the size of the institutional fund, it does encourage institutions to consider the investments held in the portfolio as a whole.

MPERS Requirements

Section 8(a)(1)(C) of MPERS states what a trustee should consider in investing and managing the assets of the retirement system. These include:

*The role that each investment or course of action plays **within the overall portfolio of the retirement program** or appropriate grouping of programs.... [Emphasis added]*

Practice SA - 2.5 (continued)

As under the UPIA and the UPMIFA, there is no explicit requirement in MPERS or explanation in the Comments under the Act that would suggest plan size is a relevant factor in selecting asset classes for a plan's investments. The Prefatory Note to MPERS does indicate, however, that it is derived from the Prudent Investor Rule under the Restatement of Trusts 3d (discussed above). The Commentators indicate:

The Act facilitates the incorporation of modern investment practices.... Five generally accepted principles of modern fiduciary investment practice are implemented ...:

(1) The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments. In the retirement system setting, the term portfolio embraces the assets of each retirement program or appropriate grouping of programs. MPERS Act §10(2)

(2) The tradeoff in all investing between risk and return is identified as the trustee's central investment consideration. MPERS Act §10(2)

(3) All categoric restrictions on types of investments have been abrogated; the trustee can invest in anything that plays an appropriate role in achieving the risk/return objectives of the program and that meets the other requirements of prudent investing. MPERS Act §8(a)(4)

[Remaining sections are omitted. MPERS Prefatory Note]

Since the Act requires that the fiduciaries consider the role of each investment in the entire portfolio, and since under modern investment theory a relevant factor in creating a portfolio is the amount of assets under management (and the related cost considerations), the fiduciary standards of MPERS incorporate, by implication, the consideration of the size of the fund in developing the investment structure and determining the asset classes.

PRUDENT PRACTICES FOR INVESTMENT FIDUCIARIES

Practice SA - 2.6

There is an IPS which contains the detail to define, implement, and manage a specific investment strategy.

ERISA Requirements

The fiduciary standards of ERISA for a written investment policy are discussed in *Practice No. 1.1*. For purposes of this Practice, we assume the existence of an investment policy statement (IPS). But what must an IPS include?

The general fiduciary responsibility rules of ERISA require that the fiduciaries engage in a prudent process for the selection and monitoring of investment alternatives. In Interpretive Bulletin 94-2 (July 1994) [29 C.F.R. §2509.94-2], the DOL stated that:

*[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 §404(a)(1)(A) and (B).* [Emphasis added]

The referenced sections describe ERISA's general fiduciary requirements of loyalty and prudence. The DOL went on to state that investment policy statements

serve a legitimate purpose in many plans by helping to assure that investments are made in a rational manner....

Finally, in Interpretive Bulletin 94-2, the DOL explained:

*As used in this interpretive bulletin, a statement of investment policy provides general **instructions or guidelines to be applied in all applicable situations**, such as identification of applicable classes or types of investments, limitations on investment categories as a percentage of the plan's portfolio, or generally applicable guidelines regarding voting positions in proxy contests ... rather than specific instructions as to the purchase or sale of a specific investment at a specific time or specific instructions to vote specific plan proxies a certain way.* [Emphasis added] [29 C.F.R. §2509.94-2, Interpretive Bulletin 94-2 – Written Statements of investment policy, including proxy voting policy or guidelines (July 29, 1994)]

[IBP] In order for a fiduciary to comply with its legal obligation to prudently select and monitor the investments and fulfill the plan's funding policy, and in order to provide (as noted by the DOL) "general instructions or guidelines" that may be "applied in all applicable situations," the IPS would need to include sufficient detail to implement and monitor the plan's investment strategy. This presumably would include, among other things, information on selection criteria for asset classes and investment types (again as noted by the DOL in Interpretive Bulletin 94-2), a description of the monitoring process to be used, the criteria for monitoring, and the actions to be taken as a result of the monitoring.

UPIA and UPMIFA Requirements

The UPIA explicitly requires the fiduciary to manage the assets in conformity with the terms of the trust and the provisions of the UPIA. UPIA §4, “Duties at Inception of Trusteeship,” states:

[w]ithin a reasonable time after accepting a trusteeship or receiving trust assets, a trustee shall review the trust assets and make and implement decisions concerning the retention and disposition of assets in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust, and with the requirements of this [Act].

A similar provision is contained in Section 3(c)(5) of the UPMIFA. Again, we assume that the trust or institutional fund has an investment policy statement to permit the trustee or institution to fulfill its duties. (*See Practice No. 1.1*)

The UPIA in §2(b) describes the trustee’s duty to manage the trust investments prudently as follows:

*A trustee’s investment and management decisions respecting individual assets must be evaluated not in isolation, but in the context of the trust portfolio as a whole and as a part of an **overall investment strategy** having risk and return objectives reasonably suited to the trust. [Emphasis added]*

Again, the UPMIFA contains nearly identical language. [UPMIFA §3(e)(2)] In order to help the trustees and institutional funds implement, and the beneficiaries understand and measure compliance with, the trust’s “overall investment strategy,” the IPS would need to cover in sufficient detail such fundamental issues as the selection and monitoring of investments, the use of advisors, and so on. Under the UPIA and the UPMIFA, the trustees and institutions are charged with developing and executing the overall investment strategy to accomplish the objectives of the trusts and institutional funds. In implementing that strategy, the trustees will be required to engage in a series of specific steps in the selection and allocation of investments. This means that the trustees are required to perform these steps with a reasonable level of detail. **[IBP]** By reducing that detail to writing in the IPS, the trustees and institutions can avoid unnecessary differences of opinion and the resulting conflicts, can minimize the possibility of missteps due to lack of clear guidelines, can establish a reasoned basis for measuring their compliance, and can communicate with the beneficiaries to establish reasonable and clear expectations.

MPERS Requirements

In Section 8(b) of MPERS, the requirements for a statement of investment objectives and policies are laid out in some detail:

*A trustee with authority to invest and manage assets of a retirement system shall adopt a statement of investment objectives and policies for each retirement program or grouping of programs. The statement **must include** the desired rate of return on assets overall, the desired rates of return and acceptable levels of risk for each asset class, asset-allocation goals, guidelines for the delegation of authority, and information on the types of reports to be used to evaluate investment performance. At least annually, the trustee shall review the statement and change or reaffirm it. [Emphasis added] [MPERS §8(b)]*

Contrary to ERISA, the UPIA and the UPMIFA, MPERS is explicit in requiring a statement of investment policies prepared in significant detail. The specified level of detail in Section 8(b) is designed to facilitate achieving the plan's investment strategy.

The IPS defines the duties and responsibilities of all parties involved.

ERISA Requirements

ERISA requires employee benefit plans to be written and to establish the procedures for the allocation of responsibilities for the operation and administration of the plan, and permits plans to allocate fiduciary responsibilities under the plan.

ERISA §402(a)(1) states:

Every employee benefit plan shall be established and maintained pursuant to a written instrument. Such instrument shall provide for one or more named beneficiaries who jointly or severally shall have authority to control and manage the operation and administration of the plan.

ERISA §402(b)(2) then requires that the plan describe “any procedure under the plan for the allocation of responsibilities for the operation and administration of the plan” ERISA §402(c) goes on to provide:

(2) that a named fiduciary, or a fiduciary designated by a named fiduciary pursuant to a plan procedure described in section 405(c)(1), may employ one or more persons to render advice with regard to any responsibility such fiduciary has under the plan; or

(3) that a person who is a named fiduciary with respect to control or management of the assets of the plan may appoint an investment manager or managers to manage (including the power to acquire and dispose of) any assets of a plan.

Practice SA – 2.6 (continued)

Finally, ERISA §405(c)(1) provides:

The instrument under which a plan is maintained may expressly provide for procedures (A) for allocating fiduciary responsibilities (other than trustee functions) among named fiduciaries, and (B) for named fiduciaries to designate persons other than named fiduciaries to carry out fiduciary responsibilities (other than trustee responsibilities) under the plan.

ERISA also requires that plan assets be held in trust by one or more trustees, and that the trustee must be named in the trust instrument or the plan instrument. In the description of the authority of the trustees, ERISA sets out the following standards:

(a) Except as provided in subsection (b), all assets of an employee benefit plan shall be held in trust by one or more trustees. Such trustee or trustees shall either be named in the trust instrument or in the plan instrument described in section 402(a) or appointed by a person who is a named fiduciary, and upon acceptance of being named or appointed, the trustee or trustees shall have exclusive authority and discretion to manage and control the assets of the plan, except to the extent that ...

(2) authority to manage, acquire, or dispose of assets of the plan is delegated to one or more investment managers pursuant to section 402(c)(3). [ERISA §403(a)(2)]

We have discussed in detail the requirement for a written statement of investment policy in *Practice No. 1.1*. For the reasons discussed in that Memorandum, we conclude that the allocation and definition of duties for plans governed by ERISA would need to be in writing. Further, under ERISA §3(38)(C), an investment manager is specifically required to acknowledge its fiduciary status in writing.

The foregoing sections demonstrate the necessity for a plan governed by ERISA and for the fiduciaries of such plans to clearly delineate the responsibilities of fiduciaries to the plan, including those with investment responsibility and those who assist the fiduciaries in carrying out their functions.

UPIA and UPMIFA Requirements

The UPIA and the UPMIFA authorize the delegation of investment and management functions. Section 9 of the UPIA provides that:

A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in:

(1) Selecting an agent, and

(2) Establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust.... [UPIA §9(a)(1) – (2). See also, UPMIFA §5(a)]

Practice SA – 2.6 (continued)

The language in this section is derived from the Restatement of Trusts 3d: Prudent Investor Rule §171 (1992), which follows the modern trend of favoring delegation of trustee responsibilities, so long as the trustee maintains its duty to exercise fiduciary discretion and to act as a prudent person would act in similar circumstances.

The UPIA and the UPMIFA are explicit in requiring the trustee and institution to define the duties and responsibilities of those to whom it delegates authority.

MPERS Requirements

Section 6 of MPERS describes the delegation of trustee or administrator functions. This section follows the modern trend permitting prudent delegation:

(a) A trustee or administrator may delegate functions that a prudent trustee or administrator acting in a like capacity and familiar with those matters could properly delegate under the circumstances, and

(b) The trustee or administrator shall exercise reasonable care, skill, and caution in:

(1) Selecting an agent, and

(2) Establishing the scope and terms of the delegation, consistent with the purposes and terms of the retirement program [MPERS §6(a) and (b)]

MPERS §8(b) requires the trustee with the authority to invest and manage assets of a retirement system to adopt a statement of investment objectives and policies:

*A trustee with authority to invest and manage assets of a retirement system shall adopt a statement of investment objectives and policies for each retirement program or appropriate grouping of programs. The statement must include the desired rate of return on assets overall, the desired rates of return and acceptable levels of risk for each asset class, asset-allocation goals, **guidelines for the delegation of authority**, and information on the types of reports to be used to evaluate investment performance. At least annually, the trustee shall review the statement and change or reaffirm it. [Emphasis added] [MPERS §8(b)]*

Thus, in Section 6(b)(2), fiduciaries are authorized to delegate their duties and, under Section 8(b), are required to adopt a formal written policy statement establishing the guidelines for that delegation and defining the duties and responsibilities of each person to whom authority under the plan is delegated.

The IPS defines diversification and rebalancing guidelines.

ERISA Requirements

ERISA requires a fiduciary to discharge his duties with respect to the plan solely in the interest of plan participants and beneficiaries

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 [ERISA §404(a)(1)(C)]

The 1974 ERISA Conference report states that the reason for the diversification requirement is to eliminate the risk of large losses:

A fiduciary usually should not invest the whole or an unreasonably large proportion of the trust property in one type of security or in various types of securities dependent upon the success of one enterprise or upon conditions in one locality, since the effect is to increase the risk of large losses. [H.R. Rep. No. 1280, 93rd Cong., 2d Sess. 304]

The report went on to say:

The degree of investment concentration that would violate this requirement to diversify cannot be stated as a fixed percentage, because a fiduciary must consider the facts and circumstances of each case. The factors to be considered include: (1) the purposes of the plan; (2) the amount of the plan assets; (3) financial and industrial conditions; (4) the type of investment, whether mortgages, bonds, or shares of stock or otherwise; (5) distribution as to geographical location; (6) distribution as to industries; and (7) the dates of maturity

Ordinarily, the fiduciary should not invest the whole or an unduly large proportion of the trust property in one type of security or in various types of securities dependent upon the success of one enterprise or upon conditions in one locality, since the effect is to increase the risk of large losses. Thus, although the fiduciary may be authorized to invest in industrial stocks, he should not invest a disproportionate amount of the plan assets in the shares of corporations engaged in a particular industry. If he is investing in mortgages on real property, he should not invest a disproportionate amount of the trust in mortgages in a particular district or on a particular class of property so that a decline in property values in that district or of that class might cause a large loss. [H.R. Rep. No. 1280, 93d Cong., 2d Sess. (1974), reprinted in 1974 U.S. Code Cong. & Admin. News 5038, 5084-85 (Conference Report at 304)]

In its regulations under ERISA, the DOL has described the investment duties of fiduciaries. One of the factors deemed important by the DOL is the “*composition of the portfolio with regard to diversification.*” [DOL Regulation §2550.404a-1(b)(2)(i)]

Practice SA – 2.6 (continued)

The courts have also recognized the importance of diversification. In *Leigh v. Engle*, 858 F.2d 361, 368 (7th Cir. 1988), *cert. denied*, 489 U.S. 1078 (1989), the court said:

When investment managers make decisions, they do not view individual investments in isolation. Rather, the goal is to create a diversified portfolio that balances appropriate levels of risk and return for the investor. The risk of a given instrument is neutralized somewhat when the investment is combined with others in a diversified portfolio. The risk inherent in the entire portfolio is less than that of certain assets within that portfolio. Ideally, after diversification, only market risk remains. Likewise, the return from a portfolio over time should be more stable than that of isolated investments within that portfolio.

[IBP] While the requirement for diversification is clear, the need for rebalancing is not explicitly addressed by the statute, DOL regulations, or the courts. Nevertheless, the concept of rebalancing is inherent in the concept of diversification, especially where, as the *Leigh v. Engle* court stated, the goal is to create a portfolio that “balances appropriate levels of risk and return.” That balance, once achieved, can only be maintained as markets fluctuate and investment classes go in and out of style, by rebalancing the portfolio periodically to maintain appropriate diversification and risk management.

UPIA and UPMIFA Requirements

The UPIA and the UPMIFA identify the standard of care, portfolio strategy, and risk and return objectives of the trust or institutional fund.

[I]nvestment and management decisions respecting individual assets must be evaluated not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust [fund or institution]. [UPIA §2(b); UPMIFA §3(e)(2)]

Further, UPIA §3 and UPMIFA §3(e)(4) require trustees and institutions to

... diversify the investments of [the trust or institutional fund] unless [the trustee or institution] reasonably determines that, because of special circumstances, the purposes of the [trust or fund] are better served without diversification.

In the Comments under UPIA §3, the Committee explained the requirement with reference to modern portfolio theory:

Diversification reduces risk ... [because] stock price movements are not uniform. They are imperfectly correlated. This means that, if one holds a well diversified portfolio, the gains in one investment will cancel out the losses in another As long as stock prices do not move exactly together, the risk of a diversified portfolio will be less than the average risk of the separate holdings. [UPIA, Comments under §3]

Practice SA – 2.6 (continued)

[IBP] As under ERISA, while there is no explicit requirement or acknowledgment of the need for rebalancing, the concept is a part of the modern portfolio theory that underlies many of the concepts in the UPIA and the UPMIFA and is subsumed in the requirement of diversification.

MPERS Requirements

Section 8(a)(2) of MPERS requires the fiduciaries charged with investing and managing plan assets to “*diversify the investments of each retirement program or appropriate grouping of programs*” The concepts of investing public retirement plan assets are based on modern portfolio theory and current investment practices. (See Comments under MPERS §8) The Comments to §8 quote from the Restatement of Trusts:

There is no defined set of asset categories to be considered by fiduciary investors. Nor does a trustee’s general duty to diversify investments assume that all basic categories are to be represented in a trust’s portfolio. In fact, given the variety of defensible investment strategies and the wide variations in trust purposes, terms, obligations, and other circumstances: diversification concerns do not necessarily preclude an asset allocation plan that emphasizes a single category of investments as long as the requirements of both caution and impartiality are accommodated in a manner suitable to the objectives of the particular trust

Significant diversification advantages can be achieved with a small number of well-selected securities representing different industries and having other differences in their qualities. Broader diversification, however, usually is to be preferred in trust investing.” [Restatement of Trusts 3d: Prudent Investor Rule §227, comment g, at 26-27]

As under ERISA, the UPIA and UPMIFA, there is no explicit requirement for rebalancing. Nevertheless, implicit in this requirement for diversification and in the recognition of a variety of acceptable asset allocation strategies is the concept that the portfolio will be rebalanced periodically to maintain the diversification, and to execute the strategy in order to achieve the plan’s investment objectives.

The IPS defines due diligence criteria for selecting investment options.

ERISA Requirements

There is no explicit requirement under ERISA for fiduciaries to define due diligence criteria for the selection of plan investments. However, it is implicit in other requirements under ERISA for the performance of fiduciary duties. Fiduciaries are required to act prudently in carrying out their duties under a plan, including their investment duties. [ERISA §404(a)(1)(B)]

Practice SA – 2.6 (continued)

In describing those investment duties, in its regulations, the DOL states that the fiduciary must give:

... appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties. [29 C.F.R. §2550.404a-1(b)(1)(i)]

The term “*appropriate consideration*” is defined to include “*a determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio ... to further the purposes of the plan.*” [29 C.F.R. §2550.404a-1(b)(1)(A)]

Further, in Interpretive Bulletin 94-2, dealing with investment policy statements, the DOL stated that such a policy should provide “*general instructions or guidelines to be applied in all applicable situations, such as identification of applicable classes or types of investments, and limitations on investment categories as a percentage of the plan's portfolio*” [29 C.F.R. §2509.94-2]

The ERISA requirements for the adoption of a written statement of investment policy are discussed in detail in the Legal Memorandum for *Practice No. 3.1*. Of relevance here is the following statement by the DOL in Interpretive Bulletin 94-2:

... such statements serve a legitimate purpose in many plans by helping to ensure that investments are made in a rational manner and are designed to further the purposes of the plan and its funding policy. [29 C.F.R. §2509.94-2]

In commenting on the duty to perform due diligence when selecting investments for a plan, one court has said:

The most basic of ERISA's investment fiduciary duties [is] the duty to conduct an independent investigation into the merits of the particular investment. [In re Unisys Savings Plan Litigation, 74 F.3d 420, 435 (3d Cir.), cert. denied, 510 U.S. 810 (1996)]

Accordingly, a fiduciary must investigate the qualities, characteristics, and merits of each investment option considered for the plan, and define the role each investment option plays in furthering the purposes of the plan. However, such an investigation – and the related analysis – cannot be conducted in a vacuum – it must be within the context of the needs of the plan. Once the needs have been defined, and the general strategies developed, the specific investments should be chosen within the context of those strategies, that is, based on criteria designed to select investments consistent with the strategies for the plan or for the particular portion of the plan.

Practice SA – 2.6 (continued)

UPIA and UPMIFA Requirements

The UPIA explicitly requires the trustee to manage the assets in conformity with the terms of the trust and the provisions of the UPIA. Similar provisions are contained in Section 3(e)(5) of the UPMIFA. The UPIA provides that:

[w]ithin a reasonable time after accepting a trusteeship or receiving trust assets, a trustee shall review the trust assets and make and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust and with the requirements of this [Act]. [UPIA §4]

Further, the fiduciary standard of care is stated in UPIA §2(a):

A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution. [UPIA §2(a). See also, UPMIFA §3(b)]

While there is no explicit requirement for the trustee or institution to establish due diligence criteria regarding the selection of assets for the trust or fund, this duty is implicit in the review and prudence requirements. For example, the trustee must perform a review to “*bring the trust portfolio into compliance*” with the trust’s purposes and needs, and because the trustee must consider the trust purpose and financial requirements in order to fulfill its obligation to act prudently, the trustee must develop an investment strategy to accomplish the trust’s purposes, and then must select investments consistent with that strategy (that is, using criteria for selection that are consistent with the portfolio strategy).

[IBP] As discussed in more detail in the Legal Memorandum for *Practice No. 3.1*, the trustee should adopt an investment policy and reduce it to writing to enable the trustee to carry out its investment duties. A key element of a written investment policy would be the process and criteria used in the selection of trust investment options.

MPERS Requirements

MPERS specifically requires fiduciaries to adopt an investment policy statement. MPERS §8(b) states:

*A trustee with authority to invest and manage assets of a retirement system shall adopt a statement of investment objectives and policies for each retirement program or appropriate grouping of programs. **The statement must include the desired rate of return on assets overall, the desired rates of return and acceptable levels of risk for each asset class, asset-allocation goals, guidelines for the delegation of authority, and information on the types of reports to be used to evaluate investment performance.** At least annually, the trustee shall review the statement and change or reaffirm it. [Emphasis added]*
[MPERS §8(b)]

Practice SA – 2.6 (continued)

Section 8(a) also lists the steps the fiduciaries should take in investing and managing plan assets. Among other things, the fiduciaries are required to “*make a reasonable effort to verify facts relevant to the investment and management of assets of a retirement system*” [MPERS §8(a)(3)]

As a practical matter, these provisions require a trustee to define the due diligence process and criteria for selecting plan investments. As under ERISA, and consistent with the modern portfolio theory (which underlies MPERS’ investment provisions), this process should address the need for the fiduciary to investigate the qualities, characteristics, and merits of each investment, and to identify the role each investment option plays in the furtherance of the purpose of the plan in the context of the total investment portfolio.

The IPS defines monitoring criteria for investment options and service vendors.

ERISA Requirements

The fiduciary duty to monitor the performance of investment managers and other service providers is inherent in the obligations of fiduciaries to act prudently in carrying out their duties under ERISA.

Not long after the adoption of ERISA, the DOL issued a series of questions and answers regarding fiduciary duties under the Act. In response to a question about the duty of a fiduciary who has appointed other fiduciaries, the DOL stated:

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. [29 C.F.R. §2509.75-8 FR-17]

In Interpretive Bulletin 94-2, the Department of Labor (DOL) stated that:

*Maintenance of a statement of investment policy does not relieve the named fiduciary of its obligations under ERISA §404(a) with respect to the appointment and monitoring of an investment manager or trustee. In this regard, the named fiduciary appointing an investment manager **must periodically monitor the investment manager’s activities** with respect to the management of the plans assets.* [Emphasis added] [29 C.F.R. §2509.94-2]

The courts have long recognized the duty to monitor plan investments. For example, the court in *Morrissey v. Curran*, 567 F.2d 546, 548-49 (2d Cir. 1977) stated that “*ERISA fiduciaries must monitor investments with reasonable diligence and dispose of investments which are improper to keep.*” Another court stated: “*Once an investment has been made, a fiduciary has an ongoing duty to monitor investments with reasonable diligence and remove plan assets from an investment that is improper.*” *Harley v. Minnesota Mining and Manufacturing Company*, 42 F. Supp. 2d 898 (D.Minn. 1999), citing *Whitfield v. Cohen*, 682 F. Supp. 188, 196 (S.D.N.Y. 1988)

Practice SA – 2.6 (continued)

In addition to explaining the duty to monitor the performance of investment managers and the investments themselves, the DOL also has clearly stated the duty to monitor the performance of all service providers. In its interpretive bulletin discussing when the provision of investment education becomes the provision of investment advice, the DOL stated:

As with any designation of a service provider to a plan, the designation of a person(s) to provide investment education services or investment advice to plan participants and beneficiaries is an exercise of discretionary authority or control with respect to management of the plan; therefore, persons making the designation must act prudently and solely in the interests of the plan participants and beneficiaries, both in making the designation(s) and in continuing such designations(s). [29 C.F.R. §2509.96-1(e)]

In *Liss v. Smith*, 991 F. Supp. 278 (S.D.N.Y. 1998), the district court found that the fiduciaries of an employee benefit plan breached the fiduciary duty imposed by ERISA §404(a) by failing to exercise due diligence in the selection and monitoring of service providers to the plan. In defining the due diligence required to be followed in connection with the selection of service providers, the court stated:

At the very least, trustees have a duty to (i) determine the needs of a fund's participants, (ii) review the services provided and fees charged by a number of different providers, and (iii) select the provider whose service level, quality and fees best match the fund's needs and financial situation. [Ibid. at 300]

These elements should likewise be present in the ongoing monitoring of a plan's service providers.

[IBP] ERISA does not explicitly require that monitoring criteria be defined by the plan fiduciary. However, ERISA's overriding duty for fiduciaries to discharge their duties to employee benefit plans with care, skill, prudence, and diligence imposed by ERISA §404(a) requires that the fiduciaries actively monitor the investment managers and service providers. In addition, ERISA requires that the fiduciaries maintain records of their monitoring activities. (See DOL Interpretive Bulletin 94-2.) Inherent in those requirements is the evaluation of the investment managers as compared to the needs of the plans and the quality of services available in the marketplace. The determination of those services and needs establishes the minimum acceptable standards (or criteria) for the plan.

UPIA and UPMIFA Requirements

The UPIA and the UPMIFA provide direction for trustees and institutions regarding the delegation and monitoring of various functions. Section 9 of the UPIA states:

A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in:

Practice SA – 2.6 (continued)

- (1) *Selecting an agent;*
- (2) *Establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and*
- (3) ***Periodically reviewing the agent’s actions in order to monitor the agent’s performance and compliance with the terms of the delegation.*** [Emphasis added]
[UPIA §9(a). See also, UPMIFA §5(a)]

Thus, the plan trustee or institution has a duty to define responsibilities and to monitor how those responsibilities are being carried out by the investment manager and by other relevant service providers. The duty to “establish the scope and terms” of the delegation and to effectively communicate with and monitor the performance of a service provider, a prudent fiduciary would reduce the procedures to be followed and the expected standards of performance (or criteria) in such monitoring to writing. Further, implicit in the requirement that the agent be monitored for its “performance and compliance with the terms of delegation” is the establishment of standards for performance and specific terms of the delegation – in other words, criteria for monitoring performance.

[IBP] Ordinarily, prudence would mandate that those standards and terms be reduced to writing to ensure clarity and a mutual understanding by the parties.

MPERS Requirements

MPERS, in §8, is clear in its requirement that the fiduciaries establish a statement of criteria for the delegation of functions under the plan:

*A trustee with authority to invest and manage assets of a retirement system shall adopt a statement of investment objectives and policies for each retirement program or appropriate grouping of programs. The statement must include the desired rate of return on assets overall, the desired rates of return and acceptable levels of risk for each asset class, asset-allocation goals, **guidelines for the delegation of authority, and information on the types of reports to be used to evaluate investment performance.** At least annually, the trustee shall review the statement and change or reaffirm it.* [Emphasis added]
[MPERS §8(b)]

Further, in MPERS §6, the trustee must exercise reasonable care, skill, and caution in:

- (2) *Establishing the scope and terms of the delegation, consistent with the purpose and terms of the retirement program; and*
- (3) *Periodically reviewing the agent’s performance and compliance with the terms of the delegation.* [MPERS §6(b)(2) and (3)]

The IPS defines procedures for controlling and accounting for investment expenses.

ERISA Requirements

ERISA does not contain a specific requirement that an investment policy statement be maintained by the fiduciaries of an employee benefit plan. However, support for the proposition that an employee benefit plan must have a written investment policy statement is found in the Department of Labor regulations:

The 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 §404(a)(1)(A) and (B).... For purposes of this document, the term “statement of investment policy” means a written statement that provides the fiduciaries who are responsible for plan investments with guidelines or general instructions concerning various types or categories of investment management decisions.... A statement of investment policy is distinguished from directions as to the purchase or sale of a specific investment at a specific time.... [29 C.F.R. §2509.94-2(2)]

In *Liss v. Smith*, 991 F. Supp. 278 (S.D.N.Y., 1998), the district court found that the fiduciaries of an employee benefit plan breached the fiduciary duty imposed by ERISA §404(a) by failing to have a written investment policy statement. The court found that while the above-cited regulation states only that a written investment plan is *consistent* with ERISA’s fiduciary duty requirements, in the circumstances here, absence of any plan constitutes a breach of fiduciary duty. [Ibid. at 296] The court also stated, *at least in this instance ... such a policy is necessary to ensure that the plan investments are performing adequately and meeting the actuarial, liquidity and other needs of the Funds.* [Ibid.]

ERISA specifically requires fiduciaries to control and account for the costs of administering an employee benefit plan, including investment expenses. Section 404(a) requires the fiduciary of an employee benefit plan to:

... discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries, and for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan. [ERISA §404(a)(1)(A)(i) and (ii)]

Moreover, a fiduciary of an employee benefit plan is specifically prohibited from using plan assets to pay a *party in interest* such as a trustee, custodian, investment manager, investment advisor, or broker for services which are not appropriate and helpful to the plan in carrying out the purposes for which the plan is established or maintained, or to pay more than reasonable compensation for such services. [ERISA §§406(a)(1)(C) and 408(b)(2); 29 C.F.R. §2550.408(b)(2)]

Practice SA – 2.6 (continued)

Accordingly, in order for responsible fiduciaries to fulfill the general obligation of a fiduciary to discharge duties to an employee benefit plan with the requisite care, skill, and prudence required under ERISA; and the specific obligation of the fiduciary to defray only reasonable and necessary expenses of the plan; the fiduciaries must establish procedures for controlling and accounting for plan expenses, including investment expenses. **[IBP]** In order to clearly define those procedures and to facilitate their implementation, they should be reduced to writing – certainly as a matter of best practices and, most likely as a factor in measuring the prudent conduct of the fiduciaries.

With respect to such matters, the investment policy statement should address, among other things, (i) the use of and fees paid, direct and indirect, separately and in aggregation, to investment service providers such as trustees, investment advisers, investment managers, brokers, and custodians, (ii) the expense ratios of each investment option compared against the appropriate peer group, and (iii) the use of 12b-1, subtransfer agency fees, and other revenue sharing to offset recordkeeping and other administrative costs of administering the plan, where appropriate.

UPIA and UPMIFA Requirements

The UPIA and the UPMIFA also require trustees and institutions to only pay reasonable expenses. The UPIA provides that a

trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill and caution.
[UPIA §2(a)]

The term “managing,” as used in UPIA §2(a), embraces monitoring, that is, the trustee’s continuing responsibility for oversight of the suitability of investments already made as well as the trustee’s decisions respecting new investments. [Comments to UPIA §2]

UPIA §7 specifically addresses investment costs and requires that “[i]n investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee.” In other words, as the Comments to §7 explain, wasting the money of plan participants and beneficiaries is not prudent and therefore is forbidden.

As discussed previously, UPIA §7 was derived from the language of the Restatement of Trusts 3d §277. The Restatement, in discussing mutual funds and other pooling arrangements, said that “... it is important for trustees to make careful cost comparisons, particularly among similar products of a type being considered for a trust portfolio.” An Interpretive Letter with respect to the Restatement was written by the Office of the Comptroller of the Currency (OCC). The Interpretive Letter addresses the reasonableness of fees and costs associated with investments. It states:

Practice SA – 2.6 (continued)

Even assuming fiduciary care in comparing costs and avoiding excessive charges, fund managers inevitably must be compensated in one way or another. If the trustee also received commissions from the trust, they must be appropriate to the duties performed; and overall management costs to the trust estate must not be unreasonable in light of alternatives realistically available to the particular trustee. [OCC Interpretive Letter No. 722 (March 12, 1996), citing the Restatement of Trusts 3d: Prudent Investor Rule §227, comment m, at 58 (1992)]

The UPMIFA provides that only “reasonable and appropriate” expenses may be incurred. Section 3(c) of UPMIFA provides:

In managing and investing an institutional fund, an institution:

(1) may incur only costs that are appropriate and reasonable in relation to the assets, the purposes of the institution, and the skills available to the institution.

As under ERISA, both the general obligation of a fiduciary to discharge duties to an employee benefit plan with the requisite care, skill, and prudence required; and the specific obligation of the fiduciary to defray only reasonable and appropriate expenses of the trust or institutional fund; requires that a trustee or institution implement procedures for controlling and accounting for expenses, including investment expenses. **[IBP]** By documenting the procedures in the investment policy statement, the trustees and institutions will have a clear statement of the procedures to evaluate and implement – certainly a best practice and a factor in determining the prudence of the trustees.

MPERS Requirements

Section 7 of MPERS sets forth the general requirement that *a trustee or other fiduciary shall discharge duties with respect to a retirement system with the care, skill, and caution under the circumstances then prevailing which a prudent person, acting in a like capacity and familiar with those matters, would use in the conduct of an activity of like character and purpose.*” [MPERS §7(3)] Moreover, MPERS §§7(2) and (5) specifically require that a trustee or other fiduciary discharge duties with respect to the retirement system:

(2) For the exclusive purpose of providing benefits to participants and beneficiaries, and paying reasonable expenses of administering the system;

(5) Incurring only costs that are appropriate and reasonable

Practice SA – 2.6 (continued)

The Comments to §7(5) provide:

Wasting the money of participants and beneficiaries is imprudent ... determining what costs are appropriate and reasonable will depend on factors such as the purposes of the trust (which for retirement systems covered by this Act are specified in [MPERS §7(2) set forth above], the types of assets held, and the skills of the trustee or fiduciary. On this last factor, for example, trustees who are quite inexperienced on investment issues may be justified in expending more for investment advice than trustees who are quite experienced.

Furthermore, MPERS requires that the investments be managed in accordance with an investment policy statement:

A trustee with authority to invest and manage assets of a retirement system shall adopt a statement of investment objectives and policies for each retirement program or appropriate grouping of programs. The statement must include the desired rate of return on assets overall, the desired rates of return and acceptable levels of risk for each asset class, asset-allocation goals, guidelines for the delegation of authority, and information on the types of reports to be used to evaluate investment performance. At least annually, the trustee shall review the statement and change or reaffirm it. [MPERS §8(b)]

The Comments to §8(b) provide that:

[Section 8(b)] lists certain information that must be included in the statement [of investment objectives and policies], but the list is not exclusive. Where appropriate, a trustee may include other information in the statement ...

As under ERISA and MPERS, the combination of the general fiduciary duty of prudence and the duty to pay only appropriate and reasonable expenses from trust assets requires that prudent fiduciaries establish practices or procedures for controlling and accounting for investment expenses. **[IBP]** The documentation of those procedures in the statement of investment objectives and policies required by MPERS §8(b) facilitates their implementation and monitoring. At the least, such documentation is a best practice. In addition, when issues arise concerning the performance of a fiduciary, the development and documentation of such procedures will be a factor in determining the prudent behavior of the fiduciary.

PRUDENT PRACTICES FOR INVESTMENT FIDUCIARIES

Practice SA - 2.7

The IPS defines appropriately structured, socially responsible investment (SRI) strategies (where applicable).

ERISA Requirements

ERISA §403(c)(1) specifically mandates that, except in circumstances not relevant to this discussion, plan assets may not inure to the benefit of the employer, and must be held for the exclusive purpose of providing benefits to the participants in the plan and their beneficiaries, and defraying reasonable expenses of administering the plan. This “exclusive purpose” rule is echoed in the fiduciary duties set forth in ERISA §404. Section 404(a)(1) requires the fiduciary discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and

(A) For the exclusive purpose of:

(i) Providing benefits to participants and their beneficiaries; and

(ii) Defraying reasonable expenses of administering the plan.

(B) 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;

(C) 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; and

(D) In accordance with the documents and instruments governing the plan, insofar as such documents and instruments are consistent with the provisions of this title and title IV.
[ERISA §404(a)(1)]

Moreover, the regulations promulgated by the DOL under ERISA provide guidance as to the selection of investments. In so doing, the fiduciaries must, among other things, consider the role of the particular investment or investment course of action in the plan’s investment portfolio, taking into account such factors as diversification, liquidity, and risk/return characteristics. Because every investment necessarily causes a plan to forego other investment opportunities, fiduciaries must consider expected return on alternative investments with similar risks available to the plan. [29 C.F.R. §§2509.94-1 and 2550.404a-1]

Practice SA – 2.7 (continued)

In ERISA Opinion Letter No. 98-04A (the *Opinion Letter*), the DOL opined on the issue of whether a plan fiduciary's selection of a *socially responsible fund* as a plan investment or a designated investment for a plan designed to comply with ERISA §404(c) would, in itself, violate the general fiduciary duties and responsibilities imposed by §§ 403(c) and 404(a)(1) of ERISA, as set forth above. The *Opinion Letter* described a *socially responsible fund* as a mutual fund designed to achieve a defined investment goal through the use of traditional investment processes and, in addition, by investing in enterprises that the fund managers believe make a significant contribution to society through their products and services and the way they do business. In this regard, the *Opinion Letter* states that potential investments are first screened for their financial soundness and then evaluated according to the particular fund's social criteria, which vary from fund to fund and may include such indicia as the effect of a company's products on the environment, whether the company being invested in is managed with participation of its employees, whether the company negotiates fairly with its workers and provides a good working environment, and whether the company fosters a commitment to such human goals as creativity and productivity.

The *Opinion Letter* stated that the fiduciary standards of §§403 and 404 do not preclude consideration of collateral benefits, such as those offered by a “socially responsible” fund, in a fiduciary's evaluation of a particular investment opportunity. However, the *Opinion Letter* goes on to provide:

The existence of collateral benefits [such as those offered by a socially responsible fund] may be decisive only if the fiduciary determines that the investment offering the collateral benefits is expected to provide an investment return commensurate to alternative investments having similar risks. In this regard, the Department has construed the requirements that a fiduciary act solely in the interests of participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives ... A decision to make an investment, or to designate an investment alternative, may not be influenced by non-economic factors unless the investment ultimately chosen for the plan, when judged solely on the basis of its economic value, would be equal or superior to alternative available investments. [ERISA Opinion Letter No. 98-04A (May 28, 1998)]

The DOL also has issued an Interpretive Bulletin addressing the selection of ETI's, (economically targeted investments—investments selected for the economic benefits they confer upon others apart from their return to the employee benefit plan). Consistent with the above-cited *Opinion Letter*, the Interpretive Bulletin provides, in pertinent part:

The fiduciary standards applicable to ETIs ... are no different from the standards applicable to plan investments generally. Therefore, if the [requirements of ERISA §§403 and 404(a), as described above are satisfied] the selection of ETIs will not violate [ERISA] section 404(a)(1)(A) and (B) and the exclusive purpose requirements of [ERISA] section 403. [DOL Interpretive Bulletin 94-1, 59 Fed. Reg. 32606 (June 23, 1994), 29 C.F.R. §2509.94-1]

Practice SA – 2.7 (continued)

Accordingly, if a fiduciary will consider, or intends for those to whom it has delegated investment responsibility to consider, collateral benefits, such as those offered by *socially responsible funds* or *ETIs* as described above, in selecting plan investments or designated investments, it must do so in a manner which is designed to provide returns to the participants which are commensurate with competitive investments (determined without regard to the overlay of social responsibility).

[IBP] While ERISA does not explicitly require that such instructions be included in an investment policy statement, it would be a best practice to do so (for example, to ensure clarity, to prove compliance, to facilitate implementation, and so forth). In addition, should a dispute develop about the intent or actions of the fiduciaries in this regard, the development of the investment policy and its documentation almost certainly would be factors in the determination of the prudence of the fiduciaries.

UPIA and UPMIFA Requirements

As with a fiduciary subject to ERISA, trustees who are subject to the UPIA and institutions subject to the UPMIFA must act prudently in investing and managing trust assets. UPIA §2(a) requires that a trustee shall invest and manage trust assets as a prudent investor would and that in satisfying this standard, the trustee must exercise reasonable care, skill, and caution. Similar requirements apply under UPMIFA. [UPMIFA §3(b)] Both the UPIA and the UPMIFA provide nonexclusive lists of circumstances to be considered in investing and managing assets. UPIA §2 provides that the trustee should consider:

1. General economic conditions;
2. The possible effect of inflation or deflation;
3. The expected tax consequences of investment decisions or strategies;
4. The role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;
5. The expected total return from income and the appreciation of capital;
6. Other resources of the beneficiaries;
7. Needs for liquidity, regularity of income, and preservation of capital; and
8. An asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries. [UPIA §2(c). *See also*, UPMIFA §3(e)(1)]

As does ERISA §404(a)(1)(A), UPIA §5 imposes a duty of loyalty upon trustees stating that *[a] trustee shall invest and manage the trust assets solely in the interest of the beneficiaries.* [Emphasis added]

Practice SA – 2.7 (continued)

With respect to *socially responsible investing* the Comments to §5 provide that:

[n]o form of so-called “social investing” is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries – for example, by accepting below-market returns – in favor of the interests of the persons supposedly benefited by pursuing the particular social cause. [Emphasis added]

Accordingly, as with a fiduciary subject to ERISA, a trustee subject to UPIA is bound by dual duties of prudence and loyalty in making investments. As such, the existence of collateral benefits associated with a particular investment may only be decisive if the trustee determines that the investment offering the collateral benefits is expected to provide an investment return commensurate to alternative investments having similar risks and is equal or superior to alternative available investments.

[IBP] If collateral benefits are to be taken into account by a trustee or his delegate, then the best practice would be to document the intent to select socially conscious investments, subject to the UPIA standards for protecting beneficiaries, in the investment policy statement. Further, as explained in the discussion of ERISA’s standards (above), that documentation will almost certainly be a factor in determining the prudence of the conduct of trustees on these issues.

On the other hand, the UPMIFA requires an institution to consider, if relevant,

[an] asset’s special relationship or special value, if any, to the charitable purposes of the institution. [UPMIFA §3(e)(1)(H)]

The Comment to this provision explains that this subsection indicates

[t]hat a prudent decision maker can take into consideration the relationship between an investment and the purposes of the institution and of the institutional fund in making an investment that may have a program-related purpose but not be primarily program-related. The degree to which an institution uses an asset to accomplish a charitable purpose will affect the weight given that factor in a decision to acquire or retain the asset.

Thus, unlike under ERISA and the UPIA, UPMIFA allows the collateral benefits of an asset to be a decisive factor.

MPERS Requirements

A trustee or other fiduciary making investment decisions pursuant to MPERS is bound by the general duties of prudence and loyalty, as well as the exclusive purpose rule set forth in MPERS §7(1), (2) and (3). Moreover, in managing and investing assets, such a fiduciary is required to consider, among other circumstances:

- (i) The general economic conditions,*
- (ii) The possible effect of inflation or deflation,*

Practice No. 3.7 (continued)

- (iii) *The role that each investment or course of action plays within the overall portfolio of the retirement program or appropriate grouping of programs,*
- (iv) *The expected total return and the appreciation of capital;*
- (v) *Needs for liquidity, regularity of income, and preservation or appreciation of capital; and*
- (vi) *For defined benefit plans, the adequacy of funding for the plan based on actuarial factors. [MPERS §8(a)(1)]*

Further, the fiduciary is required to diversify the investments of each retirement program or appropriate grouping of programs unless the trustee reasonably determines that, because of special circumstances, it is clearly prudent not to do so. [MPERS §8(a)(2)]

MPERS, unlike ERISA and the UPIA, addresses the issue of socially responsible investing in the body of the statute. MPERS §8(a)(5) specifically provides that a trustee with authority to invest and manage assets

may consider benefits created by an investment in addition to investment return only if the trustee determines that the investment providing these collateral benefits would be prudent even without the collateral benefits.

The Comment to §8(a)(5) states that the section follows the basic approach of the DOL's Interpretive Bulletin 94-1. [Ibid.] The Comment goes on to state:

*Arrangements designed to bring areas of investment opportunity which provide collateral benefits to the attention of the trustee will not, by themselves, constitute a fiduciary violation, so long as the arrangements do not restrict the exercise of the trustee's investment discretion. Similarly, **the trustee does not violate any fiduciary responsibilities by making a decision based upon collateral benefits if the investment is justified even absent the collateral benefits.** [Emphasis added] Thus, as under [Interpretive Bulletin 94-1; 29 C.F.R. §2509.94-1] an investment would be appropriate under this section if it is expected to provide an investment return commensurate with available alternative investments having similar risks. On the other hand, an investment will not be prudent if it is expected to produce a lower expected rate of return than available investment alternatives with commensurate risks, or if it is riskier than available alternative investments with commensurate rates of return.*

Accordingly, a trustee or other fiduciary with the authority to invest and manage trust assets under MPERS may take the collateral benefits of investments into account in making investment decisions, but only to the extent the resulting investment decisions would not otherwise cause the fiduciary to breach his duties under MPERS §7(1), (2) and (3) and MPERS §8(a).

Practice SA – 2.7 (continued)

MPERS §8 also specifically requires that the investments be managed in accordance with an investment policy statement:

A trustee with authority to invest and manage assets of a retirement system shall adopt a statement of investment objectives and policies for each retirement program or appropriate grouping of programs. The statement must include the desired rate of return on assets overall, the desired rates of return and acceptable levels of risk for each asset class, asset-allocation goals, guidelines for the delegation of authority, and information on the types of reports to be used to evaluate investment performance. At least annually, the trustee shall review the statement and change or reaffirm it. [MPERS §8(b)]

Accordingly, if a fiduciary is to take collateral benefits into account in making decisions regarding the investment or management of trust assets, the investment policy statement governing the investment of the plan's assets should define appropriately structured, socially responsible investment strategies. **[IBP]** Such investment policy statement should require the fiduciary to subordinate considerations related to collateral benefits offered by investments to the other considerations listed in MPERS §8(a) which are directly tied to the economic benefits such investments are designed to yield to the retirement system. As explained under the discussion of ERISA's fiduciary standards (above), because of the legal sensitivity to the possible sacrifice of employee benefits due to socially conscious investing, if a dispute arises, the development and documentation of the policy on this issue almost certainly will be a factor in determining the prudence of a fiduciary's conduct.

PRUDENT PRACTICES INVESTMENT FIDUCIARIES

Practice SA - 3.1

The investment strategy is implemented in compliance with the required level of prudence.

ERISA Requirements

ERISA provides that the trustee of an employee benefit plan has the exclusive authority and discretion to manage and control the assets of such a plan, except to the extent that either:

- (i) the plan expressly provides that the trustee is subject to the direction of a named fiduciary who is not a trustee or*
- (ii) the authority to manage, acquire, or dispose of assets of the plan is delegated to one or more investment managers pursuant to ERISA §402(c)(3). [ERISA §403(a)(1) and (2)]*

ERISA §402(c)(3), in turn, states that an employee benefit plan may provide that a person who is a named fiduciary with respect to control or management of the assets of the plan may appoint an investment manager or managers to manage any assets of the plan.

The following discussion will first deal with the duty to act prudently in connection with the implementation of the investment policy. Then, because the selection of an investment manager may be a key factor in such implementation, the duty to exercise prudence (i) in determining whether to appoint an investment manager and (ii) in selecting and monitoring an investment manager will be discussed.

Duty to Act Prudently. Whether the trustee, a named fiduciary, or an investment manager implements the investment strategy, it must be done in a manner that satisfies the responsible fiduciary's duty to act prudently. In this regard, ERISA §404(a)(1)(B) requires that a fiduciary shall discharge his duties with respect to a plan

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.

Thus, the investment fiduciary is held to the standard of a "prudent expert," that is, "*of a prudent man ... familiar with such matters.*" [See *Howard v. Shay*, 100 F.3d 1484, 1488 (9th Cir. 1996)]

Due Diligence Process. ERISA §404(a)(1)(B) imposes on fiduciaries a duty to investigate prudently the merits of any potential investment they might make on behalf of an employee benefit plan. [*Fink v. National Savings & Trust Co.*, 772 F.2d 951, 957 (D.C. Cir. 1985); *Katsaros v. Cody*, 744 F.2d 270 (2d Cir.), *cert. denied*, 469 U.S. 1072 (1984); *Donovan v. Mazzola*, 716 F.2d 1226 (9th Cir. 1983), *cert. denied*, 464 U.S. 1040 (1984)]

Practice SA – 3.1 (continued)

One possible way of fulfilling this duty would be to adopt a due diligence process for implementing the investment strategy. Such a process could include the criteria to be examined in making investments in furtherance of the investment strategy and in recording relevant information concerning the investment options considered in making each investment. The process also could include a listing of the facts and circumstances that the fiduciary knows are relevant to the particular investment strategy, including the role the investment strategy plays in that portion of the plan's portfolio over which the fiduciary has investment responsibility. [See 29 C.F.R. §2550.404a-1(b)(1)]

[IBP] While ERISA contains no explicit requirement that there be a written due diligence process in implementing an investment strategy, such a process could provide the basis for and evidence the organization, planning, and investigation that satisfaction of the duty of prudence requires. Different investment strategies may require different elements in a written due diligence process but, in any event, it would appear to be prudent for such process to require and document sufficient investigation of investment options to support the fiduciary's determination that the particular investment or investment course of action made or taken is reasonably designed, as part of the plan portfolio (or, where applicable, that portion of the plan portfolio with respect to which the fiduciary has investment duties) 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. [See 29 C.F.R. §2550.404a-1(b)(2)]

The process also would include and document consideration of (a) diversification, (b) liquidity and current return relative to the anticipated cash flow requirements, and (c) projected return relative to the funding objectives relevant to that portion of the plan portfolio over which the fiduciary has investment responsibility. [See 29 C.F.R. §2550.404a-1(b)(2)]

Appointing an Investment Manger. One of the elements in implementing an investment strategy may be the appointment of an investment manager to manage that strategy. **[IBP]** There is nothing in ERISA that specifically requires that fiduciaries delegate investment authority to investment managers. However, in keeping with the prudent expert standard, courts have stated that *where the trustees lack the requisite knowledge, experience, and expertise to make the necessary decisions with respect to investments, their fiduciary obligations require them to hire independent professional advisors.* [See *United States v. Mason Tenders Dist. Council of Greater New York*, 909 F. Supp. 882, 886 (S.D.N.Y. 1995) (a trustee has a duty to seek independent advice where he lacks the requisite education, experience, and skill); *Trapani v. Consolidated Edison Employees' Mutual Aid Society*, 693 F. Supp. 1509, 1516 (S.D.N.Y. 1988) (A fiduciary who is ill-equipped to evaluate a claim may have a duty to seek outside assistance.)]

Accordingly, under the general fiduciary standards of ERISA, which require among other things that the fiduciaries act prudently in carrying out their investment duties, if the fiduciary lacks the necessary knowledge or sophistication to manage the plan's investment portfolio, the fiduciary should delegate the investment duties to a knowledgeable professional.

Practice SA – 3.1 (continued)

In appointing an investment manager, the named fiduciary is required to act 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. [ERISA 404(a)(1)(B)]

[IBP] While there is no specific requirement under ERISA for a written due diligence process to be followed in selecting an investment manager, a logical outgrowth of the duty to exercise prudence in all of his or her functions would appear to be that a prudent fiduciary establish practices or procedures for doing so. In effect, the due diligence process becomes the roadmap for the fiduciary to follow in making its selection of a money manager or, as discussed above, in selecting investments for the investment strategy. Presumably, the development, documentation, and following of such procedures would be factors taken into account in determining whether a fiduciary acted prudently if the selection of an investment manager were questioned after the fact.

A named fiduciary making a prudent appointment of an investment manager would need to make sufficient inquiry to ascertain whether the investment manager has the requisite expertise, knowledge, and information necessary to prudently implement the investment strategy to be delegated to such investment manager. [*Donovan v. Mazzola*, 716 F.2d 1226 (9th Cir. 1983), *cert. denied*, 464 U.S. 1040 (1984) (“A fiduciary who lacks the training and skill required to investigate adequately and structure a transaction may retain a qualified independent expert, provided he first determines the expert is independent, qualified, and has undertaken a sufficient analysis to have an informed opinion.”) (716 F.2d at 1234-35)]

Moreover, if the implementation of an investment strategy is delegated to an investment manager, the named fiduciary who made the delegation is under a continuing duty to monitor the performance of the investment manager. It is the view of the DOL that compliance with this duty to monitor necessitates proper documentation of the activities that are subject to monitoring, as well as of the monitoring process itself. [See 29 C.F.R. §2509.94-2(1) and (2)] Thus, a written due diligence process which governs the implementation of the investment strategy would serve as the *proper documentation of the activities that are subject to monitoring*. The lack of such documentation, as noted by the DOL in the above-cited regulation, would make execution of a prudent monitoring process extremely difficult, if not impossible.

UPIA and UPMIFA Requirements

Both the UPIA and the UPMIFA require prudence. Under UPIA §2(a), the trustee is under a duty to:

... invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill and caution.
[UPIA §2(a)]

Practice SA – 3.1 (continued)

UPMIFA §3(b) contains similar provisions. It states:

In addition to complying with the duty of loyalty imposed by law other than this [act], each person responsible for managing and investing an institutional fund shall manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.

The Comments to UPIA §2(a) provide that:

[E]arly formulations of the prudent person rule were sometimes troubled by the effort to distinguish between the standard of a prudent person investing for another and investing on his or her own account. The language of subsection [2](a), by relating the trustee's duty to "the purposes, terms, distribution requirements, and other circumstances of the trust," should put such questions to rest. The standard is the standard of the prudent investor similarly situated.

Moreover, UPIA §2(f) and UPMIFA §3(b) contain similar language requiring a person to use their skills or expertise in performing their duties. UPMIFA §3(b) states:

A person that has special skills or expertise, or is selected in reliance upon the person's representation that the person has special skills or expertise, has a duty to use those skills or that expertise in managing and investing institutional funds.

The Comments to UPIA §2(f) explain:

Because the standard of prudence is relational, it follows that the standard for professional trustees is the standard of prudent professionals; for amateurs, it is the standard of prudent amateurs. Restatement of Trusts 2d §174 (1959) provides: "The trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property; and if the trustee has or procures his appointment as trustee by representing that he has greater skill than that of a man of ordinary prudence, he is under a duty to exercise such skill." Case law strongly supports the concept of the higher standard of care for the trustee representing himself to be expert or professional.

The Drafting Committee declined the suggestion that the Act should create an exception to the prudent investor rule ... in the case of smaller trusts. The Committee believes that subsections (b) and (c) [of §2] emphasize factors that are sensitive to the traits of smaller trusts; and that subsection (f) adjusts helpfully for the distinction between professional and amateur trusteeship ... [Citations omitted]

Trustees under the UPIA and institutions under the UPMIFA are given the authority to delegate investment and management functions, as long as the following requirements are met:

A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in:

Practice SA – 3.1 (continued)

(1) Selecting an agent;

(2) Establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and

(3) Periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation. [UPIA §9(a)(1-3). See also, UPMIFA §5(a)(1)-(3)]

Whether the trustee or an investment manager selected by the trustee implements the investment strategy, the implementation of an investment strategy must be carried out in a manner that will satisfy the duty of prudence set forth in UPIA §2(a) and UPMIFA §3(b). In so doing, the responsible fiduciary must take into consideration such of the following factors as are relevant to the trust, the fund or their beneficiaries: (a) general economic conditions, (b) the possible effects of inflation or deflation, (c) the expected tax consequences of investment decisions or strategies, (d) the role that each investment or course of action plays within the overall portfolio, (e) the expected total return from income and the appreciation of capital, (f) other resources of the beneficiaries, (g) needs for liquidity, regularity of income, and preservation or appreciation of capital, and (h) an asset's special relationship or special value, if any, to the purposes of the trust or to the charitable purposes of the institution. [UPIA §2(c); UPMIFA §3(e)(1)]

[IBP] One approach for fulfilling this duty would be for the trustee or institution to adopt a due diligence process to implement the investment strategy. While a written due diligence process is not specifically required by the UPIA or the UPMIFA, it would appear to be consistent with the duty of prudence imposed upon the fiduciary with responsibility to implement an investment strategy, and may serve as the only credible evidence that the requisite prudence was exercised.

[IBP] As under ERISA, if a fiduciary delegates investment responsibility to an investment manager, the delegating fiduciary is under a continuing obligation to monitor the actions of the investment manager in implementing the investment strategy. [UPIA §9(a)(3); UPMIFA §5(a)(3)] Again, it would seem that a written due diligence process, and documentation of the results of that process, would facilitate the monitoring function.

MPERS Requirements

MPERS provides that:

A trustee or other fiduciary shall discharge duties with respect to a retirement system ... with the care, skill, and caution under the circumstances then prevailing which a prudent person, acting in a like capacity and familiar with those matters would use in the conduct of an activity of like character and purpose. [MPERS §7(3)]

The comments to MPERS §7(3) state as follows:

On the one hand, [§ 7(3)] is not intended to impose a rigid “prudent expert” rule. Retirement systems differ on a wide variety of parameters, and the prudence standard is sensitive to factors such as the size, complexity, and purpose of each system. Fiduciaries

Practice SA – 3.1 (continued)

should be evaluated, not against a single prudent expert, but in terms of the actions of prudent fiduciaries for other similar systems facing similar circumstances. At the same time, [§7(3)] does not permit comparison to a prudent amateur. Fiduciaries will be held to no lower standard than that of others “familiar” with those matters.

As with ERISA and UPIA, MPERS provides that a trustee may delegate duties, including the duty to manage and invest trust assets, to an investment manager. [MPERS §6(a)] In so doing, MPERS requires that the trustee act with reasonable care, skill, and caution. [MPERS §6(b)(1)]

Whether an investment strategy is implemented by a trustee with authority to invest and manage assets, or whether the investment strategy is implemented by an investment manager to whom such authority has been delegated by the trustee, the trustee has a duty see that the following circumstances are considered in so doing: (a) general economic conditions; (b) the possible effects of inflation or deflation; (c) the role that the investment course of action (or strategy) plays within the overall portfolio of the retirement program or appropriate grouping of programs; (d) the expected total return from income and the appreciation of capital; (e) needs for liquidity, regularity of income, and preservation or appreciation of capital; and (f) for defined benefit plans, the adequacy of funding for the plan based on reasonable actuarial factors. The trustee may bear this responsibility directly, by virtue of MPERS §8(a)(1), or indirectly through its duty to exercise reasonable care, skill, and caution in monitoring the performance of the appointed investment manager pursuant to MPERS § 6(b)(3).

Section 8(b) of MPERS, the requirements for a statement of investment objectives and policies are laid out in some detail:

*A trustee with authority to invest and manage assets of a retirement system shall adopt a statement of investment objectives and policies for each retirement program or grouping of programs. **The statement must include the desired rate of return on assets overall, the desired rates of return and acceptable levels of risk for each asset class, asset-allocation goals, guidelines for the delegation of authority, and information on the types of reports to be used to evaluate investment performance.** At least annually, the trustee shall review the statement and change or reaffirm it. [Emphasis added] [MPERS §8(b)]*

Contrary to ERISA and the UPIA, MPERS is explicit in requiring a statement of investment policies be prepared in significant detail. The specified level of detail in Section 8(b) is designed to facilitate achieving the plan’s investment strategy. At a minimum, the due diligence process should include requirements that the factors listed in MPERS §8(a)(1) are considered in the implementation of an investment strategy, and that the investment manager’s or trustee’s findings or conclusions as to such factors are documented. Such a practice would provide (i) a means to ensure that the minimum standard of care and bare legal requirements imposed by MPERS are being satisfied by the individual implementing the investment strategy, (ii) a tool to evaluate the performance of an investment manager where the implementation of an investment strategy has been delegated, and (iii) a means to demonstrate that the required level of care, skill, and caution was exercised in the implementation of the investment strategy.

PRUDENT PRACTICES FOR INVESTMENT FIDUCIARIES

Practice SA - 3.2

Applicable “safe harbor” provisions are followed (when elected).

ERISA Requirements

There are no bright-line *safe harbors* under ERISA, that is, provisions that set forth clear, specific, and objectively measurable guidelines which, if satisfied, will assure a fiduciary that he may not be held liable for a breach of fiduciary duty in connection with the performance of his investment duties with respect to an employee benefit plan. There are, however, three exculpatory provisions that sometimes are referred to as *safe harbors*. A determination that the fiduciary has complied with these provisions will insulate a fiduciary from claims that he or she has breached its fiduciary duty in connection with the plan’s investments. These three exculpatory provisions are set forth in the regulations promulgated under ERISA §404(a) (relating to the exercise of the requisite prudence in making investment decisions), ERISA §402(c)(3) (relating to the prudent appointment and monitoring of an investment manager), and ERISA §404(c)(1)(B) (relating to participant directed investments). Additionally, the Pension Protection Act of 2006 (the “PPA”) added safe harbors with respect to default investments and mapping.

Section 404(a) Regulations. Section 404(a)(1)(B) of ERISA provides that a fiduciary shall discharge his duties with respect to a plan 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. The DOL has promulgated regulations concerning the application of this requirement in connection with the fiduciaries’ fulfillment of their investment duties. [29 C.F.R. §2550.404a-1] The DOL’s preamble to those regulations states that the regulation

is in the nature of a “safe harbor” provision; it is the opinion of the [DOL] that fiduciaries who comply with the provisions of the regulation will have satisfied the requirements of the “prudence” rule, but no opinion is expressed in the regulation as to the status of activities undertaken or performed that do not so comply. [Fed. Reg., Vol. 44, p. 37255]

The regulation under ERISA Section 404(a) states that the prudence requirement with respect to an investment or an investment course of action taken by a fiduciary is satisfied if, among other things, the fiduciary:

(A) has given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary’s investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan’s investment portfolio with respect to which the fiduciary has investment duties; and

Practice SA – 3.2 (continued)

(B) has acted accordingly. [29 C.F.R. §2550.404a-1(b)(1)]

The regulation goes on to provide that:

“appropriate consideration” shall include, but not necessarily be limited to, (A) a determination by the fiduciary that 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, and (B) consideration of the following factors as they relate to such portion of the portfolio:

(i) The composition of the portfolio with regard to diversification;

(ii) The liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and

(iii) The projected return of the portfolio relative to the funding objectives of the plan.
[29 C.F.R. §2550.404a-1(b)(2)]

[IBP] Neither ERISA nor DOL regulations explicitly require that an investment fiduciary comply with the *safe harbor* provided in the regulation under Section 404(a). The preamble to the regulation leaves open the possibility that the prudence requirement might be satisfied in ways not specified in the regulation. However, it would appear that the better practice would be for fiduciaries to comply with this *safe harbor*.

Appointment of Investment Manager. If a plan appoints an investment manager, no other fiduciary is liable for the acts or omissions of such investment manager or managers [ERISA §405(d)(1)], although the appointing fiduciary must act prudently in appointing the investment manager and in monitoring its activities. [29 C.F.R. §§2509.75-8 (FR-17Q) and 2509.94-2]. While not a *safe harbor* as such, the appointment of an investment manager does relieve the other fiduciaries of liability for the investment of plan assets.

Participant Directed Investment. If participants have a right to control the investment of assets in their accounts, and if the plan complies with the requirements of ERISA Section 404(c), the plan fiduciaries are relieved of liability for losses sustained by participants arising out of their exercise of such control. Although the preamble to ERISA §404(c) provides that it is not a *safe harbor* provision, it often is often described as such. [See, e.g., DOL Miscellaneous Document, 4-13-98—Study of 401(k) Plan Fees and Expenses] Again, even though not a *safe harbor*, Section 404(c) does offer fiduciaries some relief from fiduciary liability for the plan’s investment fiduciaries. The judge in *Tittle v. Enron Corp.*, explained:

If a plan does not qualify as a 404(c) [plan], the fiduciaries retain liability for all investment decision made, including decision by the Plan participants. [Tittle v. Enron Corp., 284 F.Supp.2d 511, 578 (S.D. Texas 2003)]

Practice SA – 3.2 (continued)

Default Investments. If certain requirements are satisfied, participants who do not control the investment of assets in their accounts will be treated as if they did so in accordance with the requirements of ERISA Section 404(c). In order to comply with this safe harbor, the plan fiduciaries must invest such participants' accounts in a "qualified default investment alternative" (also known as a "QDIA") and provide these participants with a notice. Generally, a QDIA must be an age-based lifecycle fund, a risk-based lifestyle fund, a balanced fund, or a professionally managed account.

Mapping. The PPA provides that if a plan that previously satisfies ERISA Section 404(c) will continue to satisfy 404(c) if it maps the proceeds from a removed investment to a new investment with similar risk-and-return characteristics and certain other requirements are satisfied. Included in these requirements is the provision that participants must be given the opportunity to direct their investments before the mapping.

UPIA and UPMIFA Requirements

As with ERISA, the UPIA and UPMIFA provide no objectively determinable safe harbors. A determination that a fiduciary or institution has complied with UPIA §9(a) or UPMIFA §5, relating to delegation of investment responsibility, however, will protect such fiduciary or institution from claims for breach of fiduciary duty with respect to the investments made on behalf of the trust or fund. Section 9(a) of UPIA provides as follows:

A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in:

- (1) Selecting an agent;*
- (2) Establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and*
- (3) Periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation. [UPIA §9(a)(1-3). See also, UPMIFA §5(a)(1-3)]*

The UPIA and the UPMIFA then shield the trustee or institution from liability for the investment decisions of a money manager as long as the prudence requirements of UPIA §9(a) and UPMIFA §5(a) are met. Section 9(c) provides:

A trustee who complies with the requirements of subsection (a) is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated. [UPIA §9(c). See also, UPMIFA §5(c)]

These sections create a type of *safe harbor* for the trustee who appoints a money or investment manager, so long as the trustee acts prudently in selecting the manager, in establishing its duties, and in monitoring its activities periodically thereafter.

MPERS Requirements

As is the case under ERISA, the UPIA and the UPMIFA, MPERS also provides an exculpatory provision, compliance with which absolves the trustee of liability for the actions of a money or investment manager if the trustee exercises the requisite care, skill, and caution in selecting, delegating to, and monitoring the investment manager. That provision is set forth in MPERS §6(d), which provides as follows:

A trustee or administrator who complies with subsections [6](a) and (b) is not liable to the retirement system, or to its participants or beneficiaries for the decisions or actions of the agent to whom the function was delegated.

Section 6(a) gives the trustee the authority to delegate investment functions subject a prudence standard, so that the trustee is able to “delegate functions a prudent trustee acting in a like capacity and familiar with those matters could properly delegate under the circumstances.” [MPERS §6(a)] Section 6(b) then establishes the guidelines for the delegation:

The trustee ... shall exercise reasonable care, skill and caution in:

- (1) Selecting an agent;*
- (2) Establishing the scope and terms of the delegation, consistent with the purpose and terms of the retirement program; and*
- (3) Periodically reviewing the agent’s performance and compliance with the terms of the delegation.*

While limited in scope, MPERS does afford relief from liability for fiduciaries who act prudently in the selection, delegation, and monitoring of money managers.

PRUDENT PRACTICES FOR INVESTMENT FIDUCIARIES

PRACTICE SA - 3.3

Investment vehicles are appropriate for the portfolio size

ERISA Requirements

A fiduciary of an employee benefit plan is required to discharge his duties with respect to an employee benefit plan 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. [ERISA §404(a)(1)(B)] One of *the circumstances then prevailing* when a fiduciary makes an investment decision is the size of the plan. Another requirement imposed on such a fiduciary is that he or she diversify plan investments so that the risk of large losses is minimized:

A fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and

... 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 [ERISA §404(a)(1)(C) and 29 U.S.C. §1104(a)(1)(C)]

Although no statute or regulation specifies just what constitutes diversification of plan investments, the legislative history of ERISA contemplates that one factor to be taken into account in meeting the diversification requirement is the size of the plan:

The degree of investment concentration that would violate this requirement to diversify cannot be stated as a fixed percentage, because a fiduciary must consider the facts and circumstances of each case. The factors to be considered include:

- (1) The purposes of the plan;*
- (2) The amount of the plan assets;*
- (3) Financial and industrial conditions;*
- (4) The type of investment, whether mortgages, bonds, or shares of stock or otherwise;*
- (5) Distribution as to geographical location;*
- (6) Distribution as to industries; and*
- (7) The dates of maturity.* [Emphasis added] [H.R. Rep. No. 1280, 93rd Cong., 2d Sess. (1974), reprinted in 1974 U.S. Code Cong. & Admin. News 5038, 5084-5085 (Conference Report at 304)]

Practice SA – 3.3 (continued)

Numerous court cases have examined the importance of diversification of plan assets. *See, e.g., Metzler v. Graham*, 112 F.2d 207, 20 E.B.C. 2857 (5th Cir. 1997) and *Marshall v. Glass/Metal Ass'n. and Glaziers and Glassworkers Pension Plan*, 507 F. Supp. 378 (D.Haw. 1980). In one case, *GIW Industries, Inc. v. Trevor, Stewart, Burton, & Jacobsen, Inc.*, 10 E.B.C. 2290 (S.D.Ga. 1989), *aff'd* 895 F.2d 729 (11th Cir. 1990), the court examined the role of the investment manager and whether a breach of the duty to diversify under ERISA, had occurred. The court, quoting *Leigh v. Engle*, 858 F.2d 361, 368 (7th Cir. 1988), *cert. denied*, 489 U.S. 1078 (1989) said:

When investment managers make decisions, they do not view individual investments in isolation. Rather, the goal is to create a diversified portfolio that balances appropriate levels of risk and return for the investor. The risk of a given instrument is neutralized somewhat when the investment is combined with others in a diversified portfolio. The risk inherent in the entire portfolio is less than that of certain assets within that portfolio. Ideally, after diversification, only market risk remains. Likewise, the return from a portfolio over time should be more stable than that of isolated investments within that portfolio. [Leigh at 368]

Where the amount to be invested is relatively limited, it may be more difficult to achieve the level of diversification required by ERISA. Although arising in a different context, 29 C.F.R. §2550.404c-1(b)(3)(i)(C), dealing with participant directed investment, suggests a method of doing so:

Where such portion of the account of any participant or beneficiary is so limited in size that the opportunity to invest in look-through investment vehicles is the only prudent means to ensure an opportunity to achieve appropriate diversification, a plan may satisfy the requirements of this paragraph only by offering look-through investment vehicles.

UPIA and UPMIFA Requirements

The UPIA and the UPMIFA similarly impose upon a trustee the duty to invest and manage trust assets as a prudent investor would, *by considering the purposes, terms, distribution requirements, and other circumstances of the trust.* [Emphasis added] [UPIA §2(a). *See also*, UPMIFA §3] Thus, in making investment decisions consistent with this general prudence standard, a trustee or institution must take into account all of the relevant circumstances, including the size of the trust or fund. For example, the size of the trust may require the use of look-through investment vehicles to achieve prudent and cost-effective diversification.

Section 3 of the UPIA sets forth a trustee's duty with respect to investment diversification:

A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.

Practice SA – 3.3 (continued)

The Comments to UPIA §3 then discuss how the size of the trust can contribute to the difficulty of diversifying and suggests investments suitable to enable a small trust fund to diversify thoroughly by constructing its own portfolio of individually selected investments.

Transaction costs such as the round lot (100 share) trading economies make it relatively expensive for a small investor to assemble a broad enough portfolio to minimize uncompensated risk. For this reason, pooled investment vehicles have become the main mechanism for facilitating diversification for the investment needs of smaller trusts. [UPIA §3, Comments]

These comments recognize that, where a small trust is unable to achieve appropriate diversification through individual securities (because, for example, of transaction costs), prudence requires the use of pooled investment vehicles (*e.g.*, mutual funds). And while a large trust might be able to utilize eight or ten asset classes to achieve suitable diversification, a smaller trust might only be able to use four or five (again, through pooled vehicles) because there are not enough assets to invest in any one category to make the investment meaningful.

The UPMIFA contains similar language. It states:

An institution shall diversify the investments of an institutional fund unless the institution reasonably determines that, because of special circumstances, the purposes of the fund are better served without diversification. [UPMIFA §3(e)(4)]

The Comments explains the purpose of this requirement and notes that the language in the UPMIFA is modeled after the UPIA.

This subsection assumes that prudence requires diversification but permits an institution to determine that nondiversification is appropriate under exceptional circumstances. A decision not to diversify must be based on the needs of the charity and not solely for the benefit of a donor. A decision to retain property in the hope of obtaining additional contributions from the same donor may be considered made for the benefit of the charity, but the appropriateness of that decision will depend on the circumstances. This subsection derives its language from UPIA § 3.

MPERS Requirements

Section 7(3) of MPERS sets forth the general requirement that a trustee or other fiduciary discharge his or her duties with respect to a retirement system *with the care, skill, and caution under the circumstances then prevailing* (emphasis added) which a prudent person, acting in a like capacity and familiar with those matters, would use in the conduct of an activity of like character and purpose. The size of the trust corpus is one of the *circumstances then prevailing* that a trustee or other fiduciary must take into account when making investment decisions. As discussed above with respect to ERISA and the UPIA, the size of the trust corpus must be taken into account when the trustee or other fiduciary makes investment decisions bearing upon the composition and diversification of the trust's investment portfolio. However, as under ERISA and UPIA, the size of the trust corpus also must be taken into account whenever it would be prudent to do so, whether or not in the context investment diversification.

Section 8(a)(1) of MPERS provides a non-exclusive list of factors the trustee or other fiduciary must consider in investing and managing the assets of the retirement system. These include:

(C) The role that each investment or course of action plays within the overall portfolio of the retirement program (emphasis added) or appropriate grouping of programs; [and]

(E) Needs for liquidity, regularity of income, and preservation or appreciation of capital ...

Accordingly, under MPERS, investment decisions will be dependent to some degree on the overall portfolio, including its size, and the plan's needs for liquidity, income, and capital preservation or appreciation, which are also, in part, a function of the size of the investment portfolio.

PRUDENT PRACTICES FOR INVESTMENT FIDUCIARIES

PRACTICE SA – 3.4

A due diligence process is followed in selecting service providers, including the custodian

ERISA Requirements

ERISA requires that the written instrument of every employee benefit plan must name one or more fiduciaries who have the authority to control and manage the operation and administration of the plan and describe any procedure under the plan for the allocation of responsibilities for the operation and administration of the plan. [ERISA §§ 402(a)(1) and (b)(2)]

ERISA also requires that a fiduciary of an employee benefit plan discharge his duties solely in the interest of plan participants and beneficiaries and 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 like character and like aims. [ERISA §404(a)(1)(B)]

In selecting service providers for the plan, including the custodian of the plan assets, the fiduciary will need to comply with the general loyalty and prudence standards imposed by ERISA §404(a)(1). The DOL has amplified on this requirement. For example, in discussing the provision of investment education to participants, the DOL clearly stated the requirement that the fiduciaries act prudently in selecting and monitoring the activities of the service provider:

As with any designation of a service provider to a plan, the designation of persons to provide investment educational services or investment advice to plan participants and beneficiaries is an exercise of discretionary authority or control with respect to management of the plan; therefore, persons making the designation must act prudently and solely in the interest of the plan participants and beneficiaries, both in making the designation(s) and in continuing such designation(s). [Emphasis added] [DOL Interpretive Bulletin 96-1, 29 C.F.R. §2509.96-1]

While this statement relates specifically to the selection of persons to provide investment education, the general principle is not limited to this context; it applies to the designation of any fiduciary or non-fiduciary service provider.

The DOL has stated that:

[I]n choosing among service providers, as well as in monitoring and deciding whether to retain a service provider, the [responsible fiduciary] must objectively assess the qualifications of the service provider, the quality of the work product, and the reasonableness of the fees charged in light of the services provided. [DOL Information Letter, Qualified Plan Services (07/28/1998); See also, DOL Information Letter, Service Employee's International Union (02/19/1998)]

Practice SA – 3.4 (continued)

These Information Letters indicate the DOL's view that, in order to fulfill the duty of prudence in selecting a service provider (which would include a custodian for plan assets), plan fiduciaries must employ a due diligence process. While ERISA does not impose specific criteria for that process, such a process must include examination of the factors listed in the cited Information Letters, as well as other factors which may be relevant in a particular situation including, for example, the security policies and practices of a custodian.

UPIA and UPMIFA Requirements

The UPIA provides that:

A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. It also conditions this power by providing that: The trustee shall exercise reasonable care, skill and caution in: (1) selecting an agent; (2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and (3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation. [UPIA §9(a). See also, UPMIFA §5(a)]

Similar language is contained in the UPMIFA with respect to institutions.

This specific duty of prudence is coupled with the general rules of prudence set forth in the UPIA and the UPMIFA. UPIA §2(a) provides as follows:

A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution. [UPIA §2(a). See also, UPMIFA §3(b)]

UPIA §2(d) expounds upon this general prudence requirement by stating:

*[A] trustee **shall** make a reasonable effort to verify facts relevant to the investment and management of trust assets. [Emphasis added] [See also, UPMIFA §3(c)(2)]*

The trustee also is under an obligation to *only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee. [UPIA §7. See also, UPMIFA §3(c)(1)]* The Comments to UPIA §7 provide that:

[W]asting beneficiaries money is imprudent. In devising and implementing strategies for the investment and management of trust assets, trustees are obligated to minimize costs.

Practice SA – 3.4 (continued)

[IBP] Thus, the trustee subject to the UPIA and an institution subject to the UPMIFA have the authority to engage service providers, including a custodian, subject to the foregoing conditions. These requirements would appear to require the trustee or institution to engage in a rational due diligence process designed to engage service providers (including a custodian, where appropriate), who are competent to render the required services for the management of the trust or fund at no more than reasonable costs. The establishment of a written due diligence process, and documenting the trustee's or institution's actions in connection with these duties, would provide evidence of the satisfaction of the duty of prudence.

MPERS Requirements

As do ERISA, the UPIA and the UPMIFA, MPERS imposes an overriding general standard of prudence upon trustees or other fiduciaries in the performance of all of their duties, including the selection of a custodian or other service provider. This standard is set forth in MPERS §7 as follows:

A trustee or other fiduciary shall discharge duties with respect to a retirement system:

- (2) For the exclusive purpose of providing benefits to participants and paying reasonable expenses of administering the system;*
- (3) With the care, skill, and caution under the circumstances then prevailing which a prudent person acting in a like capacity and familiar with those matters would use in the conduct of an activity of like character and purpose; ...and*
- (5) Incurring only costs that are appropriate and reasonable ...*

MPERS §6 sets out the authority of the trustee to delegate certain functions and is similar to the delegation requirements of ERISA §§ 403(a)(2) and 404(a)(1)(B), but is more permissive than ERISA. In that sense, MPERS follows the delegation authority of UPIA §9(a)(1) and (2):

(a) A trustee or administrator may delegate functions that a prudent trustee or administrator acting in a like capacity and familiar with those matters could properly delegate under the circumstances.

(b) The trustee or administrator shall exercise reasonable care, skill, and caution in:

- (1) Selecting an agent; and*
- (2) Establishing the scope and terms of the delegation, consistent with the purposes and terms of the retirement program ... [MPERS §6(a) and (b)(1) and (2)]*

Practice SA – 3.4 (continued)

[IBP] As with ERISA and the UPIA, the general prudence standard imposed under MPERS, as well as the specific duty of the trustee or fiduciary to control costs, as discussed above, would seem to imply a requirement that a due diligence process be developed and implemented with respect to the selection of a service provider that will establish standards for the qualifications of such provider, require that an appropriate investigation is undertaken to ensure that the provider satisfies such qualifications, and set forth procedures to ensure that the costs for the services obtained are no more than reasonable under the circumstances and that the contract or other arrangement to be entered into does not impose any unreasonable or disadvantageous provisions upon the retirement system.

PRUDENT PRACTICES FOR INVESTMENT FIDUCIARIES

Practice SA – 4.1

Periodic reports compare investment performance against appropriate index, peer group, and IPS objectives

ERISA Requirements

ERISA states that any employee benefit plan may provide that the named fiduciary of such plan who controls the management of the plan assets may appoint an investment manager or managers to manage any assets of the plan. [ERISA §402(c)(3)] The investment manager must be prudently selected by the named fiduciary, and must satisfy the requirements of ERISA §3(38). The named fiduciary who made the appointment has an ongoing responsibility to monitor the performance of the investment manager. This *duty to monitor* is described in 29 C.F.R. §2509.75-8 (FR-17Q) as follows:

At reasonable intervals, the performance of trustees and other fiduciaries [such as investment managers] 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.

The duty to monitor has also been recognized by the courts. For example, in *Leigh v. Engle*, 727 F.2d 113 (7th Cir. 1984), the court held that the fiduciaries responsible for selecting and retaining plan administrators with the authority to direct and control plan investments, had a concomitant duty to appropriately monitor the administrator's actions. [727 F.2d at 134-35] [See also, *Atwood v. Burlington Indus. Equity, Inc.*, 18 E.B.C. 2009 (M.D.N.C. 1994) (failure to monitor appointees leads to liability for breach of fiduciary duty)]

[IBP] There is not a specific standard that dictates how often the monitoring must be conducted. Such monitoring must occur at intervals that are reasonable under the circumstances. As suggested by the DOL guidance noted above, formal meetings at which monitoring takes place should be conducted at intervals that are appropriate given such factors as the general economic conditions then prevailing, the size of the trust portfolio, the investment strategies implemented by the investment manager(s), and the volatility of the individual investments selected.

In addition, some degree of informal monitoring should take place between the scheduled monitoring meetings so that immediate action can be taken if there are extreme or sudden deviations from the standards in the investment policy. On a practical basis, most large plans have quarterly monitoring meetings, while small plans are more likely to monitor the investments annually. Even quarterly monitoring meetings may not be frequent enough if the facts and circumstances of a given case or time frame indicate that it would be reasonable and prudent to monitor more frequently.

Practice SA – 4.1 (continued)

Although ERISA does not have a specific requirement that plan fiduciaries establish an investment policy statement (“IPS”) (*See Practice No. 1.1*), DOL regulations ties the duty of prudence under ERISA to an IPS:

The maintenance [by an employee benefit plan] of a statement of investment policy ... is consistent with the fiduciary obligations set forth in ERISA §404(a)(1)(A) and (B) ... the term “statement of investment policy” means a written statement that provides the fiduciaries who are responsible for plan investments with guidelines or general instructions concerning various types of investment management decisions. [DOL Reg. §2509.94-2]

The cited regulations go on to describe the import and the contents of an investment policy statement as follows:

Statements of investment policy ... would be part of the “documents and instruments governing the plan” within the meaning of ERISA §404(a)(1)(D). An investment manager to whom such investment policy applies would be required to comply with such policy pursuant to ERISA §404(a)(1)(D) insofar as the policy directives or guidelines are consistent with titles I and IV of ERISA ...

*Maintenance of a statement of investment policy by a named fiduciary does not relieve the named fiduciary of its obligations under ERISA §404(a) with respect to the appointment and monitoring of an investment manager or trustee. **In this regard, the named fiduciary appointing an investment manager must periodically monitor the investment manager’s activities with respect to management of the plan’s assets. Moreover, compliance with ERISA §404(a)(1)(B) [the prudence requirement] would require maintenance of proper documentation of the activities of the investment manager and of the named fiduciary in monitoring the activities of the investment manager.** In addition ... a named fiduciary’s determination of the terms of a statement of investment policy is an exercise of fiduciary responsibility and, as such, statements may 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 of ERISA. [Emphasis added]*

Therefore, the DOL’s regulatory interpretation of ERISA is that the activities of an investment manager must be periodically monitored by the appointing fiduciary at reasonable intervals, and there must be written documentation of such monitoring.

[IBP] The IPS should set forth the appropriate benchmarks, indices, peer groups, and investment objectives against which the performance of the investments selected by the investment manager and the performance of the investment manager are to be evaluated. (*See Practice No. 3.5*) The IPS also should describe the actions to be taken when an investment fails to meet the criteria established in the IPS. Finally, when the performance of the investment manager is evaluated, reports should be prepared which document the information reviewed; the performance of the investments selected by the investment manager against the benchmarks, indices, peer groups, and investment objectives set forth in the IPS; and the conclusions reached.

UPIA and UPMIFA Requirements

The UPIA provides that:

[a] trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust ... In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution. [UPIA §2(a)]

Similar provisions are contained in the UPMIFA, which provides that:

In addition to complying with the duty of loyalty imposed by law other than this [act], each person responsible for managing and investing an institutional fund shall manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances. [UPMIFA §3(b)]

Managing as used in UPIA §2(a) and UPMIFA §3(b) embrace monitoring, that is, the trustee's or institution's continuing responsibility for oversight of the suitability of investments already made as well as the decisions respecting new investments. UPIA §9(a) specifically provides that:

[a] trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. [See also, UPMIFA §5(a)]

UPIA §9(a) goes on to state that:

[t]he trustee shall exercise reasonable care, skill, and caution in (1) selecting an agent, (2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust, and (3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation. [See also, UPMIFA §5(a)]

Thus, even when a trustee has acted within UPIA's standards in selecting an investment manager, the trustee retains the fiduciary responsibilities to define the scope and terms of the delegation, and to evaluate the investment manager's performance in light of the scope and terms of the delegation. Similar provisions apply to institutions under the UPMIFA.

[IBP] While the UPIA and the UPMIFA do not have specific requirements for an investment policy statement, its provisions contemplate that a fiduciary will engage in a prudent process in managing a trust's assets. An investment policy is inherent in that process, since it covers issues such as the selection and review of investments, the use of advisors, and so on. Whether that investment policy must be reduced to writing is a manner of best practices and of the facts of the particular case (*See Practice No. 3.1*).

Practice SA – 4.1 (continued)

As under ERISA, UPIA and UPMIFA do not establish specific criteria for the timing of the review of an investment manager's performance. Rather, they provide that the trustee or institution must

exercise reasonable care, skill, and caution in periodically reviewing the [investment manager's] performance and compliance with the terms of the delegation. [UPIA §9(a)(3); UPMIFA §5(a)(3)]

Accordingly, there is no *safe harbor* upon which a trustee or institution can rely in determining the frequency of monitoring which will satisfy its obligation to periodically review the investment manager's actions. A trustee or institution appointing an investment manager must determine the frequency of the reviews under the circumstances, taking into account such factors as the general economic conditions then prevailing, the size of the trust or fund corpus, the investment strategies employed, the investment objectives sought, and the volatility of the investments selected. **[IBP]** As noted in the discussion concerning ERISA, some degree of informal monitoring should take place between the scheduled monitoring meetings so that immediate action can be taken with respect to extreme or sudden deviations from the standards established in the investment policy.

[IBP] While there is no explicit requirement, best practices (and the general fiduciary requirements) suggest that the monitoring meetings and performance reviews should be documented in writing. Also, it may be difficult to prove compliance with UPIA §9(a) or UPMIFA §5(a) without written periodic performance reports which evidence the trustee's or institution's monitoring of the investment manager's performance against the benchmarks, indices, peer groups, and investment objectives in the investment policy statement.

MPERS Requirements

Section 6 of the Uniform Management of Public Employee Retirement Systems Act (MPERS) sets out the authority of the trustee to delegate certain functions:

(a) A trustee or administrator may delegate functions that a prudent trustee or administrator, acting in a like capacity and familiar with those matters, could properly delegate under the circumstances.

(b) The trustee or administrator shall exercise reasonable care, skill, and caution in:

(1) Selecting an agent;

(2) Establishing the scope and terms of the delegation, consistent with the purposes and terms of the retirement program; and

(3) Periodically reviewing the agent's performance and compliance with the terms of the delegation. [MPERS §6(a) and (b)(1 - 3)]

Practice SA – 4.1 (continued)

The Comments to §6 contemplate that the power to delegate includes the authority to delegate the investment and management of trust assets in stating that:

[A] trustee could not prudently agree to an investment management agreement containing an exculpation clause that leaves the trust without recourse against reckless mismanagement.

MPERS specifically requires that an IPS be developed:

A trustee with authority to invest and manage assets of a retirement system shall adopt a statement of investment objectives and policies for each retirement program or appropriate grouping of programs. The statement must include the desired rate of return on assets overall, the desired rates of return and acceptable levels of risk for each asset class, asset-allocation goals, guidelines for the delegation of authority, and information on the types of reports to be used to evaluate investment performance. At least annually, the trustee shall review the statement and change or reaffirm it. [MPERS §8(b)]

The Comments to Section 6 state:

Subsection 6(a) would generally not permit the trustees to delegate their obligation to adopt a statement of investment objectives and policies under Section 8(b), since prudent trustees would seldom delegate that function.

Requirements are imposed by §§6(b)(2) and (3) that (i) the IPS, or the portion thereof applicable to an investment manager's authority, responsibilities, and duties; should be incorporated in the document that establishes the scope and terms of the investment manager's engagement and (ii) the IPS will establish the framework pursuant to which the performance of the investment manager and the investment selections are evaluated.

Further, the trustee appointing an investment manager has a specific duty to periodically review the investment manager's performance and compliance with the terms of the delegation, *i.e.*, the applicable provisions of the IPS. Moreover, in so doing, the trustee must act with reasonable care, skill, and caution.

[IBP] Neither MPERS nor its comments specify the frequency for the periodic reviews required by MPERS §6(b)(3). Accordingly, in keeping with the duty of prudence, a trustee appointing an investment manager must determine the frequency of the reviews necessary under the circumstances, taking into account such factors as the general economic conditions then prevailing, the size of the trust corpus, the investment strategies employed, the investment objectives sought, and the volatility of the investments selected. Some degree of informal monitoring should take place between the scheduled monitoring meetings so that immediate action can be taken with respect to extreme or sudden deviations from the standards established in the investment policy.

Practice SA – 4.1 (continued)

The general fiduciary standards may require documentation of the monitoring and performance reviews. A trustee who has delegated investment and management functions in compliance with the requirements of MPERS §§6(a) and (b), including the duty to monitor, is not liable to the retirement system or to its participants and beneficiaries for the decisions or actions of the investment manager. [MPERS §6(d)] It may be difficult to prove compliance with MPERS §§6(a) and (b) without written periodic performance reports which evidence the trustee's monitoring of the investment manager's performance against the benchmarks, indices, peer groups, and investment objectives set forth in the investment policy statement.

PRUDENT PRACTICES FOR INVESTMENT FIDUCIARIES

Practice SA - 4.2

Periodic reviews are made of qualitative and/or organizational changes of investment decision-makers.

ERISA Requirements

ERISA provides that any employee benefit plan may provide that the fiduciary named by the plan to manage the plan's assets may appoint an investment manager or managers to manage any assets of the plan. [ERISA §402(c)(3)] An investment manager must be prudently selected and monitored, and must satisfy the requirements of ERISA §3(38). If an investment manager is appointed, the named fiduciary that made the appointment has an ongoing responsibility to monitor the performance of the investment manager at reasonable intervals. [29 C.F.R. §2509.75-8 (FR-17Q)]

[IBP] There is no specific standard that dictates how often the monitoring must be conducted. Such monitoring must occur at intervals that are reasonable and appropriate under the circumstances. Accordingly, monitoring must be conducted at intervals that are appropriate, given the considerations which could materially impact the investment managers and their performance, such as the general economic conditions then prevailing, the size of the trust portfolio, the investment strategies implemented by the investment manager(s), the volatility of the individual investments selected, and so forth.

In conducting the reviews of investment managers, the appointing fiduciary is under an obligation to act 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. [ERISA §404(a)(1)(B)] The DOL has interpreted this to include the duty to ensure that fees paid to service providers, including investment managers, are reasonable in light of the level and quality of services provided. [See, e.g., DOL Reg. §2550.408b-2(d) and .408c-2; see also, Booklet: A Look At 401(k) Plan Fees, U. S. Department of Labor and Pension and Welfare Benefits Administration, Reprinted 9/1998.]

[IBP] This means that, in addition to the quantitative review (discussed in Practice No. 5.1), periodic reviews of the qualitative performance and/or organizational changes to the investment manager must be made at reasonable intervals. Factors such as those listed below may be material, and courts may incorporate these factors in the monitoring requirements in specific cases:

- (a) **Staff turnover** - Has there been turnover in the professional or service staff of the investment manager such as that the quality of the service and investment results provided by the investment manager in the past may not be maintained in the future?

Practice SA – 4.2 (continued)

(b) **Organizational structure** - Are there, or have there been, any changes to the organization structure of the investment manager, including mergers and/or acquisitions involving the investment manager, such as that the quality of the service and investment results provided by the investment manager in the past may not be maintained in the future?

(c) **Level of service provided** - Does the investment manager provide the same or better level of service that is available in the marketplace for comparable fees? Where applicable, does the investment manager provide online access to account information for participants?

(d) **The quality and timeliness of the investment manager's reports to the fiduciary and, where applicable, to the plan participants and beneficiaries** - Do the reports contain all of the information that is necessary and useful to the appointing fiduciary? Are the reports consistently provided on a timely basis?

(e) **The quality and timeliness of the investment manager's response to requests for information** - Does the investment manager consistently respond to requests for information by the appointing fiduciary in a timely manner? Do the responses contain the information requested? Are the responses easily understood?

(f) **Investment education** - Where applicable, does the investment manager provide adequate explanation of the investment decisions it makes and the factors it considers in making such decisions so that the appointing fiduciary can understand and appropriately monitor such actions? Where applicable, does the investment manager provide adequate investment education to plan participants on a level that is suited both for the beginning and advanced investor?

UPIA and UPMIFA Requirements

The UPIA provides that:

[a] trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust ... In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution. [UPIA §2(a)]

Similar provisions are contained in the UPMIFA, which provides that:

In addition to complying with the duty of loyalty imposed by law other than this [act], each person responsible for managing and investing an institutional fund shall manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances. [UPMIFA §3(b)]

Practice SA – 4.2 (continued)

Managing as used in UPIA §2(a) and UPMIFA §3(b) embrace monitoring, that is, the trustee's or institution's continuing responsibility for oversight of the suitability of investments already made as well as the decisions respecting new investments. UPIA §9(a) specifically provides that:

[a] trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. [See also, UPMIFA §5(a)]

UPIA §9(a) goes on to state that:

[t]he trustee shall exercise reasonable care, skill, and caution in (1) selecting an agent, (2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust, and (3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation. [See also, UPMIFA §5(a)]

The fiduciary must exercise reasonable care, skill, and caution in the performance of his or her duties with respect to the investment and management of the assets. [UPIA §2(a). *See also*, UPMIFA §3(b)] As noted above, such duties include the duty to monitor the performance of investments and the investment manager at reasonable intervals. These duties also include the duty to only incur costs that are *appropriate and reasonable*. [UPIA §7; UPMIFA §3(c)] The comments to UPIA §7 succinctly state that: *Wasting beneficiaries' money is imprudent*. If the quality of the services provided by an investment manager do not meet the requirements of the trust, the fees being paid for such services could be found to have been wasted.

[IBP] The intervals at which such reviews are conducted should be reasonable and appropriate under the circumstances. The following factors may be material in determining the frequency, extent and monitoring of the investment managers in most circumstances: the volatility of investments, the trust size, and the services being required of the investment manager. The review would likely include the list of issues in the ERISA section of this Practice.

MPERS Requirements

A trustee subject to MPERS may delegate the authority to invest trust assets to an investment manager. MPERS §6(a) provides:

A trustee or administrator may delegate functions that a prudent trustee or administrator acting in a like capacity and familiar with those matters could properly delegate under the circumstances.

In making such a delegation, the appointing trustee is obligated to comply with MPERS §6(b) which provides as follows:

The trustee or administrator shall exercise reasonable care, skill, and caution in:

(1) Selecting an agent;

Practice SA – 4.2 (continued)

(2) Establishing the scope and terms of the delegation, consistent with the purposes and terms of the retirement program; and

(3) Periodically reviewing the agent's performance and compliance with the terms of the delegation.

Accordingly, if investment duties have been delegated to an investment manager, the trustee making such appointment is under a continuing duty to exercise reasonable care, skill and caution in monitoring the performance of the investment manager. A trustee subject to MPERS is under a duty to *incur only costs that are reasonable and appropriate*. [MPERS §7(5)]. The duty to exercise reasonable care skill and caution in monitoring the performance of an investment manager coupled with the duty to only incur costs that are reasonable and appropriate under the circumstances, requires that a periodic review of the quality and cost of the services provided by an investment manager be performed to ensure that the assets of the trust are prudently managed and the expenditures are properly applied. [See Comments to MPERS §7(5)] Such a review could include such of the issues listed at the end of the ERISA section of this Practice.

PRUDENT PRACTICES FOR INVESTMENT FIDUCIARIES

Practice SA - 4.3

Control procedures are in place to periodically review policies for best execution, “soft dollars,” and proxy voting.

ERISA Requirements

ERISA states that any employee benefit plan may provide that the named fiduciary of such plan for the management of the plan assets may appoint an investment manager or managers to manage any assets of the plan. [ERISA §402(c)(3)] An investment manager must be prudently selected and monitored, and must satisfy the requirements of ERISA §3(38). The named fiduciary that made the appointment has an ongoing responsibility to monitor the performance of the investment manager at reasonable intervals. [See, e.g., 29 C.F.R. §2509.75-8 (FR-17Q)] **[IBP]** It should be noted that this is a common issue for large plans, but not small plans which do not typically use investment managers.

[IBP] There is no specific standard for the frequency or timing of the monitoring. The appointing fiduciary must discharge his duty to monitor the investment manager with the care, skill, prudence, and diligence required by ERISA §404(a)(1)(B). Such monitoring must occur at intervals that are reasonable under the circumstances. (*See Practice No. 5.1*)

Best Execution. The DOL has described *best execution* as follows:

Those who invest plan assets and the broker-dealers, reporting dealers and banks who deal with them have traditionally been guided by the “best execution” principle, namely, securing the best price for the plan in executing the purchase or sale of securities without regard to whether the broker-dealer or bank functions in an agency (broker) relationship, or in a principal (dealer) relationship to the plan. [DOL Prohibited Transaction Exemption 75-1, Interim Exemption, 40 Fed. Reg. 5201 (Feb. 4, 1975)]

The duty to monitor an investment manager includes the duty

to ensure that the manager has secured best execution of the plan’s brokerage transactions (considering the cost of commissions for the transaction as well as the quality and reliability of the execution) and the commissions paid on such transactions are reasonable in relation to the value of the brokerage and research services provided to the plan. [DOL Information Letter, Prescott Asset Management (01/17/1992)(fn. 1)] [See also, DOL Information Letter, Refco, Inc. (02/03/1989) ([T]he plan fiduciary has an initial responsibility to determine that the broker is capable of providing the best execution for the plan’s brokerage transactions. In addition, the plan fiduciary has an ongoing responsibility to monitor the quality of the services provided by the broker and the reasonableness of the commissions in relation to the totality of services received by the plan.)]

Soft Dollars. PWBA ERISA Technical Release 86-1 (May 22, 1986) (the *Technical Release*) describes *soft dollar* arrangements, with respect to employee benefit plans, as typically involving situations in which an investment manager of an employee benefit plan or other plan fiduciary purchases goods or services with a portion of the brokerage commission paid by a plan to a broker for executing a securities transaction. The *Technical Release* describes the import of soft dollar arrangements in connection with the obligations of fiduciary's of employee benefit plans as follows:

Section 28(e) of the [Securities Exchange Act of 1934 (the "1934 Act")] provides generally that no person who exercises investment discretion with respect to a securities transactions will be deemed to have acted unlawfully or to have breached a fiduciary duty solely by reason of paying brokerage commissions for effecting a securities transaction in excess of the amount of commission another broker-dealer would have charged, if such person determined in good faith that the commission was reasonable in relation to the value of brokerage and research services provided by the broker-dealer. The limited safe harbor provided by Section 28(e) is available only for the provision of brokerage services to persons who exercise investment discretion with respect to an account as that term is defined in Section 3(a)(35) of the 1934 Act. The [Securities and Exchange Commission ("Commission")] has indicated that, if a plan fiduciary does not exercise investment discretion with respect to the securities transaction or uses "soft dollars" to pay for non-research-related services, the transaction falls outside the protection afforded by Section 29(e) of the 1934 Act, and may be in violation of the securities laws and the fiduciary responsibility provisions of ERISA.

* * *

Where an investment manager has entered into a "soft dollar" arrangement, Section 29(e) does not relieve anyone other than the person who exercises investment discretion from the applicability of the fiduciary provisions of ERISA. Therefore, the fiduciary who appoints the investment manager is not relieved of his ongoing duty to monitor the investment manager to ensure that the manager has secured best execution of the plan's brokerage transactions and to ensure that the commissions paid on such transactions are reasonable in relation to the value of the brokerage and research services provided to the plan. [footnotes omitted]

Thus, in connection with *soft dollar* arrangements, the fiduciary who appoints an investment manager retains his or her obligations to (i) monitor the investment manager's performance (as discussed above) and (ii) ensure that plan assets are used for the exclusive purpose of providing benefits to plan participants and their beneficiaries, and defraying reasonable expenses of administering the plan as required by ERISA §404(a)(1)(A) in a manner which satisfies the fiduciary's duty to exercise the care, skill, prudence, and diligence required pursuant to ERISA §404(a)(1)(B). This means that the appointing fiduciary should investigate whether the investment manager is engaging in any soft dollar arrangements and, if it is, the fiduciary must ensure that the soft dollars are expended only for brokerage and research services which are appropriate and helpful to the plan, and ensure that no more than reasonable compensation was paid by the plan for the value of the brokerage and/or research services rendered to the plan.

Practice SA – 4.3 (continued)

Proxy Voting. The fiduciary responsibility to vote proxies appurtenant to shares of corporate stock lies exclusively with the trustee of an employee benefit plan except to the extent that either (1) the trustee is subject to the direction of a named fiduciary pursuant to ERISA §403(a)(1) or (2) the power to manage, acquire, or dispose of the relevant asset has been delegated to an investment manager pursuant to ERISA §403(a)(2). [ERISA 403(a); *Herman v. NationsBank Trust Co.*, 126 F.3d 1354, 1368 (11th Cir. 1997), *cert. denied*, 525 U.S. 816 (1998)] With respect to monitoring an investment manager’s actions in connection with voting proxies, the DOL regulations state the following:

The fiduciary duties described at ERISA §404(a)(1)(A) and (B), require that, in voting proxies, the responsible fiduciary consider those factors that may affect the value of the plan’s investment, and not subordinate the interests of the participants and beneficiaries in their retirement income to unrelated objectives. These duties also require that the named fiduciary appointing an investment manager periodically monitor the activities of the investment manager with respect to the management of plan assets, including decisions made and actions taken by the investment manager with regard to proxy voting decisions. The named fiduciary must carry out this responsibility solely in the interest of the participants and beneficiaries, and without regard to its relationship with the plan sponsor.

It is the view of the Department that compliance with the duty to monitor necessitates proper documentation of the activities that are subject to monitoring. Thus, the investment manager or other responsible fiduciary would be required to maintain accurate records as to proxy voting ... the proxy voting records must enable the fiduciary to review not only the investment manager’s voting procedure ... but also to review the actions taken in individual proxy voting situations. [29 C.F.R. §2509.94-2(1)]

Accordingly, the fiduciary appointing an investment manager must monitor the procedures employed by an investment manager in voting proxies and actions taken in connection with the voting of proxies to ensure that the interests of plan participants and beneficiaries are protected by such actions (or inaction), and are not subordinated to other considerations.

UPIA and UPMIFA Requirements

A trustee subject to the requirements of the UPIA is under an obligation to

invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. [UPIA §2(a).]

Practice SA – 4.3 (continued)

Similar requirements apply for institutions under the UPMIFA, which provides:

Within a reasonable time after receiving property, an institution shall make and carry out decisions concerning the retention or disposition of the property or to rebalance a portfolio, in order to bring the institutional fund into compliance with the purposes, terms, and distribution requirements of the institution as necessary to meet other circumstances of the institution and the requirements of this [act]. [UPMIFA §3(e)(5)]

In satisfying this standard, the trustee shall exercise reasonable care, skill and caution. [UPIA §2(a)] When a trustee subject to the requirements of the UPIA delegates investment and management functions to an investment advisor pursuant to UPIA §9(a), he must exercise reasonable care, skill, and caution to: (i) establish the scope and terms of the delegation consistent with the purposes of the trust, and (ii) periodically review the investment manager's actions in order to monitor the agent's performance and compliance with the terms of the delegation. Similar language is included in UPMIFA §5(a).

UPIA §2(d) provides that:

A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets. [See also, UPMIFA §3(c)(2)]

Moreover, UPIA §7 provides that:

In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee. [See also, UPMIFA §3(c)(1)]

Taken together, these fiduciary obligations require that the terms of the delegation of investment and management functions are prudent and in the best interests of the beneficiaries including requiring that best execution practices are followed in all securities transactions made involving trust assets. Failing this, the trust or fund would be subject to the incurrence of unnecessary expense, either because too high a price was paid for investments made or too low a price was obtained for investments sold.

For the same reasons, a trustee's fiduciary obligations require that a prudent delegation of investment management authority include directions to the investment manager with respect to soft dollar arrangements. The failure to do so would subject the trust or fund to possible expenditures that yield no benefit to the trust or fund. The delegation could restrict such arrangements so that the *soft dollars* are expended for brokerage, research, or other services for the benefit of the trust or fund, and not for the benefit of the investment manager, the employer, or any other person or entity. Moreover, prudent monitoring would seem to require that procedures are in place to periodically review a money manager's policies with respect to soft dollar arrangements to make sure that the trusts assets are not wasted in violation of UPIA §7 or UPMIFA §3(c).

Practice SA – 4.3 (continued)

With respect to proxy voting, the trustee is under a duty to invest and manage trust assets as a prudent investor would, exercising reasonable care, skill, and caution in so doing. [UPIA §2(a); UPMIFA §3(b)] The trustee also is under a duty, pursuant to UPIA §9(a) to exercise care, skill, and caution to: (i) establish the scope and terms of the delegation consistent with the purposes of the trust, and (ii) periodically review the investment manager's actions in order to monitor the agent's performance and compliance with the terms of the delegation. These duties would appear to require that: (i) any delegation of investment management duties include a requirement that the investment manager have policies and procedures in place to assure that the voting of proxies associated with stock owned by the trust are voted in a manner most likely to preserve or enhance the value of such stock, and (ii) the investment manager's voting of proxies is periodically reviewed to ensure compliance with such requirement.

Of course, the efforts of the trustees or other fiduciaries, and the expenses incurred, must be commensurate with the value obtained for the trust or fund and their beneficiaries. That is, if the effort of the trustee or institution would produce little or only minor benefit, then the effort and expense should likewise be limited.

MPERS Requirements

MPERS likewise imposes duties upon a trustee or other fiduciary of a retirement system to discharge its duties:

(i) For the exclusive purpose of providing benefits to participants and beneficiaries and paying only reasonable expenses of administering the system [MPERS §(7)(2)];

(ii) With the care, skill, and caution which a prudent person, acting in a like capacity and familiar with those matters would use in the conduct of an activity of like character and purpose. [MPERS §7(3)]

Moreover, MPERS requires that:

A trustee with authority to invest and manage ... shall make a reasonable effort to verify facts relevant to the investment and management of assets of a retirement system. [MPERS §8(a)(3)]

MPERS further requires that:

A trustee or other fiduciary shall discharge duties with respect to a retirement system ... incurring only costs that are appropriate and reasonable. [MPERS §7(5)]

In making a delegation of the authority and duty to invest and manage assets, a trustee is under an obligation to:

exercise reasonable care, skill, and caution in ... establishing the scope and terms of the delegation, consistent with the purposes and terms of the retirement system ... periodically reviewing the agent's performance and compliance with the terms of the delegation. [MPERS §6(b)(2) and (3)]

Practice SA – 4.3 (continued)

Taken together, these fiduciary obligations require that the terms of the delegation of investment and management functions are prudent and in the best interests of the beneficiaries, and therefore must require that:

- (i) Best execution practices are followed in executing securities transactions so that trust assets are not wasted;
- (ii) *Soft dollars* are expended only for brokerage, research, or other services for the benefit of the trust, and are reasonable in relationship to the value of such services to the trust; and
- (iii) The voting of proxies associated with stock owned by the trust are voted in a manner most likely to preserve or enhance the value of such stock.

To satisfy the monitoring requirement imposed under MPERS §6(b)(3), the appointing fiduciary must monitor the performance of the investment manager to ensure that these requirements are met (in a manner that balances the cost of the monitoring with the potential benefit to the plan).

PRUDENT PRACTICES FOR INVESTMENT FIDUCIARIES

Practice SA - 4.4

Fees for investment management are consistent with agreements and with all applicable laws.

ERISA Requirements

ERISA requires that the fiduciary of an employee benefit plan control the costs associated with administering the plan and that in so doing the fiduciary must satisfy the general duty of prudence imposed by ERISA. ERISA §404(a) states that:

[A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and,

(A) For the exclusive purpose of:

(i) Providing benefits to participants and their

beneficiaries; and

*(ii) Defraying **reasonable** expenses of administering the plan*

(B) 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 ...

(D) in accordance with the documents and instruments governing the plan insofar as such documents are consistent with the provisions of [Titles I and IV of ERISA]. [Emphasis added] [ERISA §404(a)(1)(A), (B) and (D)]

The PWBA of the DOL, in a letter dated July 28, 1998 (the *July 28, 1998 Letter*), relied on the foregoing ERISA sections in setting out a process for fiduciaries to follow in determining whether the payment of any particular expense would be an appropriate expenditure:

Section 404(a)(1)(D) of ERISA requires plan fiduciaries to discharge their duties in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with Title I of ERISA. In evaluating the payment by a plan of particular expenses, the fiduciaries must first examine the language of the plan documents. If the expense would be permitted under the terms of the plan documents, then the fiduciaries must determine whether such payment would be consistent with Title I of ERISA ... In choosing among potential service providers, as well as in monitoring and deciding whether to retain a service provider, the trustees must objectively assess the qualifications of the service provider, the quality of the work product, and the reasonableness of the fees charged in light of the services provided ... [1998 WL 1638072 (P.W.B.A.)]

Practice SA – 4.4 (continued)

Accordingly, it is the position of the DOL that the first duty of a fiduciary in connection with the payment of fees to an investment manager is to determine whether the fees are consistent with the applicable law and with the terms of the plan. In fulfilling this duty, the fiduciary must determine whether the law and the plan documents permit investment managers to be paid from plan assets; then the fiduciary must determine that the fees charged are reasonable in light of the services to be provided to the plan.

In Advisory Opinion 89-28A dated September 25, 1989 (the *Opinion Letter*), the Department of Labor highlighted the fiduciary's duty to understand the manner in which an investment manager's compensation was determined so that the fiduciary could determine that the fees were reasonable:

[ERISA] Section 404 requires, among other things, a fiduciary to discharge his duties respecting a plan solely in the interest of the plan's participants and beneficiaries in a prudent fashion. Accordingly, the plan fiduciary must act prudently with respect to the decision to enter into a performance-based compensation arrangement with an investment manager, as well as to the negotiation of the specific formula under which compensation will be paid (including, where relevant, the choice of an appropriate index in relation to which the investment manager's performance is to be compared). The Department further emphasizes that it expects a plan fiduciary, prior to entering into a performance-based compensation arrangement, to fully understand the compensation formula and the risks associated with this manner of compensation, following disclosure by the investment manager of all relevant information pertaining to the proposed arrangement. In addition, the plan fiduciary must be capable of periodically monitoring the actions taken by the manager in the performance of its investment duties. [1989 WL 435076 (E.R.I.S.A.)]

While the foregoing definition of a plan fiduciary's duty for ensuring the reasonableness of fees paid to an investment manager was written in the context of a complicated performance-based compensation formula, the underlying principles of ERISA Section 404(a) apply to all fees paid to investment managers. That is, the plan fiduciary must: (i) act prudently, and (ii) clearly understand the amount of the fees which are to be paid the investment manager, and the value of the services.

Once the fiduciary understands the amount and nature of the compensation to be paid to an investment manager, the fiduciary must determine whether the amount of the fees are reasonable. As noted in the July 28, 1998 Letter, this determination must be made in light of the value of the services to be provided to the plan.

Finally, and as alluded to in the last sentence of the *Opinion Letter*, the plan fiduciary has an obligation to periodically review the performance of the investment manager. [29 C.F.R. §2509.75-8 (FR-17Q)] This review should include an evaluation of whether the fees remain reasonable in light of the services provided.

Practice SA – 4.4 (continued)

Moreover, ERISA Section 406(a)(1) provides that, except as provided in ERISA Section 408, a fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction

*... constitutes a direct or indirect ... furnishing of goods, services, or facilities between the plan and a **party in interest**; [or] transfer to, or use by or for the benefit of, a **party in interest** or any assets of the plan. [Emphasis added.] A “**party in interest**” includes a person providing services to the plan. [ERISA §3(14)(B)] ERISA Section 408(b)(2), however, provides that: *The prohibitions provided in section 406 shall not apply to ... [C]ontracting or making reasonable arrangements with a party in interest for office space, or legal, accounting, or other services necessary for the establishment or operation of the plan; if no more than reasonable compensation is paid therefor.* [Emphasis added]*

A service is necessary

if the service is appropriate and helpful to the plan ... in carrying out the purposes for which the plan is established or maintained. [29 C.F.R. § 2550.408(b)(2)]

Thus, a fiduciary that engages an investment manager to provide investment management services will not violate ERISA Section 406(a) in so doing, so long as the investment management fees constitute no more than reasonable compensation for the services obtained and such services are *appropriate and helpful* to the plan.

Accordingly, in engaging the investment manager, the fiduciary must negotiate all forms of compensation to be paid to the investment manager, directly or indirectly, by the plan to ensure that the aggregate of all such forms of compensation is no more than reasonable compensation for the services the investment manager will render to the plan. In keeping with the named fiduciary’s duty to monitor the performance of the investment manager at reasonable intervals, the fiduciary periodically should review the compensation received by the investment manager from the plan, including these forms of indirect compensation, to ensure that no more than reasonable compensation is being paid to the investment manager. [29 C.F.R. §2509.75-8 (FR-17Q)]

The DOL also has addressed the issue of appropriate fees and expenses, specifically for 401(k) plans. In a recent booklet designed for participants in 401(k) plans, the DOL stated:

ERISA requires employers to follow certain rules in managing 401(k) plans. Employers are held to a high standard of care and diligence and must discharge their duties solely in the interest of the plan participants and their beneficiaries. Among other things, this means that employers must:

Ensure that fees are paid to service providers and other expenses of the plan are reasonable in light of the level and quality of services provided ... [“A Look at 401(k) Plan Fees,” U.S. Department of Labor, Pension and Welfare Benefits Administration (2000)]

Practice SA – 4.4 (continued)

Thus a fiduciary under ERISA, in order to meet his responsibilities, must ensure that the fees paid to plan investment managers and other service providers are reasonable under the circumstances, and do not exceed those provided for in the investment manager's contract with the plan.

UPIA and UPMIFA Requirements

The duty of prudence is also a requirement of the UPIA and the UPMIFA. The UPIA provides:

A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.
[UPIA §2(a). See also, UPMIFA §3(b)]

The UPIA and the UPMIFA also addresses investment costs. UPIA §7 states:

In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee. [See also, UPMIFA §3(c)(1)]

As the Comments to UPIA §7 state:

Wasting beneficiaries' money is imprudent. In devising and implementing strategies for the investment and management of trust assets, trustees are obliged to minimize costs.
[UPIA §7, Comments]

So the duty under the UPIA and the UPMIFA to minimize costs is coupled with the trustees' and institutions' duties to act prudently. At the same time, the delegation of duties with respect to the investment and management of trust or fund assets in and of itself raises additional issues with respect to the reasonableness of costs incurred on behalf of the trust or fund by the fiduciary. In deciding whether to make such a delegation to an investment manager, the trustee or institution must be alert to protect the trust or fund beneficiaries from being charged twice for the same service. If, for example, the trustee's regular compensation schedule presupposes that the trustee will conduct the investment management function, it should ordinarily follow that the trustee will lower his or her fee when delegating the investment function to an outside investment manager. [UPIA §9, Comments]

Accordingly, a trustee or other fiduciary engaging an investment manager must be aware of and understand all forms of compensation to be paid to the investment manager, directly or indirectly, by the plan to be able to ensure that the aggregate of all such forms of compensation is no more than reasonable compensation for the services the investment manager will render to the trust or fund.

Practice SA – 4.4 (continued)

Moreover, UPIA §9(a) requires that when a trustee delegates investment duties, the trustee is under a duty to exercise

reasonable care skill and caution in ...establishing the scope and terms of the delegation... and periodically reviewing the agents actions in order to monitor the agent's performance and compliance with the terms of the delegation.

Similarly, UPMIFA §5(a) provides that:

An institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, in...establishing the scope and terms of the delegation ...and ...periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the scope and terms of the delegation.

In order to facilitate a common understanding of the terms of the delegation, and to assist in the monitoring function, all forms of compensation to be received by the investment manager should be addressed in the engagement agreement and the forms of indirect compensation received by the investment manager should be periodically reviewed to insure compliance with any fee offset provisions in the agreement's compensation terms.

[IBP] There is no explicit requirement that the delegation of the investment management be in writing. However, as a matter of best practices, the terms of the delegation should be documented. In addition, in a given case (*i.e.*, facts and circumstances), a court may find that the general fiduciary prudence rules of UPIA and the UPMIFA required that the terms of the delegation be reduced to writing.

MPERS Requirements

MPERS contains a section describing the duty of the trustee of a public retirement system to incur only reasonable costs. The trustee's general fiduciary duties are described in §7; this section is similar to ERISA.

A trustee or other fiduciary shall discharge duties with respect to a retirement system:

(2) For the exclusive purpose of providing benefits to participants and beneficiaries and paying reasonable expenses of administering the system; and

(5) Incurring only costs that are appropriate and reasonable [MPERS §7(2) and (5)]

Furthermore, §7(2)

requires fiduciaries to be motivated only by the objective of providing benefits and paying reasonable expenses. [MPERS §7, Comments]

Practice SA – 4.4 (continued)

As to the issue of *reasonable* expenses, the Comments to §7(5) states that the duty to incur only expenses that are reasonable and appropriate is a traditional fiduciary duty under the law of trusts.

As under the Restatement of Trusts and the Uniform Prudent Investor Act, determining what costs are appropriate and reasonable will depend on factors such as the purpose of the trust, the type of assets held, and the skills of the trustee or other fiduciary ... [F]or example, trustees who are quite inexperienced on investment issues may be justified in expending more for investment advice than trustees who are quite experienced. [MPERS §7, Comments]

As under UPIA, the delegation of duties by as trustee subject to MPERS with respect to the investment and management of trust assets in and of itself raises additional issues with respect to the reasonableness of costs incurred on behalf of the trust by the fiduciary. In deciding whether to make such a delegation, the trustee must be alert to protect the trust beneficiaries from unnecessary duplication of expenses. If, for example, the trustee's regular compensation schedule presupposes that the trustee will conduct the investment management function, it should ordinarily follow that the trustee will lower his or her fee when delegating the investment function to an outside investment manager. [MPERS §6, Comments]

Since an MPERS fiduciary has a legal duty to only pay reasonable expenses, the fiduciary must understand the total compensation to be paid to an investment manager, and must evaluate the reasonableness of that compensation relative to its value and to the marketplace. All forms of compensation to be received by the investment manager should be addressed in the engagement agreement, and the forms of indirect compensation received by the investment manager should be periodically reviewed to ensure compliance with the agreement's compensation terms. **[IBP]** While there is no explicit requirement for a written agreement, both best practices and the MPERS general fiduciary provisions may require that the scope of the delegation and the nature and amount of any compensation be reduced to writing.

PRUDENT PRACTICES FOR INVESTMENT FIDUCIARIES

Practice SA - 4.5

“Finder’s fees” or other forms of compensation that may have been paid for asset placement are appropriately applied, utilized, and documented.

ERISA Requirements

ERISA §404(a)(1)(A) provides that the fiduciary of an employee benefit plan

... shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries, and for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan.

ERISA §404(a)(1)(B), in turn, requires that, in performing his duties with respect to a plan, a fiduciary shall ac

... with the care, skill, prudence, and diligence 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.

In its Advisory Opinion 97-16A dated May 22, 1997 (the *Opinion Letter*), the DOL addressed an arrangement whereby a non-fiduciary service provider with respect to employee benefit plans, Aetna Life Insurance and Annuity Company (*ALIAC*), received 12b-1 fees and other forms of compensation from mutual funds or their advisers or distributors based upon the investments *ALIAC*'s client plans in such mutual funds. *ALIAC* provided the following services and products to its client plans: (i) a volume submitter plan document; (ii) recordkeeping and related administrative services; and (iii) investment options selected by *ALIAC* (from which plan fiduciaries selected investment options to be provided to the participants in their participant directed 401(k) plans). The DOL addressed several issues in the *Opinion Letter*, including whether or not *ALIAC* was a fiduciary with respect to its client plans. The *Opinion Letter* concluded with the following language which states, in part, the DOL's application of ERISA §404(a) to determine plan fiduciary's responsibilities where service providers, with respect to employee benefit plans, receive such compensation:

[I]t should be noted that ERISA's general standards of fiduciary conduct also would apply to the proposed arrangement. Under section 404(a)(1) of ERISA, the responsible Plan fiduciaries must act prudently and solely in the interest of the Plan participants and beneficiaries both in deciding whether to enter into, or continue, the above-described arrangement with ALIAC, and in determining which investment options to utilize or make available to Plan participants and beneficiaries. In this regard, the responsible Plan fiduciaries must ensure that the compensation paid directly or indirectly by the Plan to ALIAC is reasonable, taking into account the services provided to the Plan as well as any other fees or compensation received by ALIAC in connection with the investment of Plan assets. The responsible Plan fiduciaries, therefore, must obtain sufficient information

Practice SA – 4.5 (continued)

regarding any fees or other compensation that ALIAC receives with respect to the Plan's investments in each Unrelated Fund to make an informed decision as to whether ALIAC's compensation for services is no more than reasonable.

Thus, it is the DOL's position that compensation received by a party rendering services to an employee benefit plan in the form of 12b-1 fees, *finder's fees* marketing fees, and sub-transfer agency fees or other similar forms of compensation based upon the plan's investments is paid indirectly by the plan. Further, the *Opinion Letter* states the DOL's position that plan fiduciaries have a duty to:

- (i) *Know whether its service providers are receiving such compensation,*
- (ii) *Know the amount of such compensation; and*
- (iii) *Ensure that the total compensation, including such forms of indirect compensation, received by the service providers from the plan, directly or indirectly, is no more than reasonable compensation for the services provided to the plan.*

ERISA Section 406(a)(1) provides that, except as provided in ERISA Section 408, a fiduciary shall not cause a plan to engage in a transaction, if he knows or should know that such transaction

constitutes a direct or indirect ... furnishing of goods, services, or facilities between the plan and a party in interest, such as an investment advisor; [or] transfer to, or use by or for the benefit of, a party in interest or any assets of the plan.

ERISA Section 408(b)(2), however, provides that the prohibitions in Section 406(a) do not apply to contracting or making reasonable arrangements with a party in interest for office space; or legal, accounting, or other services, such as investment management services, necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid in respect thereof.

Accordingly, the critical analysis in determining whether a transaction prohibited transaction under ERISA §406 has occurred, is whether more than reasonable compensation is paid to a *party in interest*. [*Brock v. Robbins*, 830 F.2d 640, 644 (7th Cir. 1987)] As noted above, compensation received by a service provider (which would include an investment manager) in the form of 12b-1 fees, *finder's fees* or other forms of compensation in connection with the investments of an employee benefit plan must be included in determining whether more than reasonable compensation has been paid for services rendered. Therefore, in order to avoid causing a plan to engage in a prohibited transaction, plan fiduciaries need to be aware of all forms of compensation to be received, directly or indirectly, by its investment manager or other service providers in consideration of the services provided to the plan.

Practice SA – 4.5 (continued)

Moreover, ERISA Section 406(b)(1) prohibits a fiduciary, such as an investment manager with the discretionary authority and control to manage, acquire, and/or dispose of plan assets, from causing the plan to engage in a transaction which would cause such fiduciary to receive compensation for its own account, and ERISA 406(b)(3) prohibits such an investment manager from receiving any form of payment for its own account from a third party, such as a mutual fund or a mutual fund distribution company in connection with a client plan's investment in such mutual fund. These prohibitions apply to *finder's fees*, 12b-1 fees and other forms of compensation which an investment manager or other fiduciary receives from a mutual fund, or the mutual fund's distribution company, in which the investment manager has caused a plan to invest. [See, e.g., DOL Advisory Opinion 97-15A.]

Accordingly, pursuant to ERISA §404(a) plan fiduciaries must exercise the required degree of prudence to ensure that no more than reasonable compensation, including 12b-1 fees, *finders fees* and similar forms of payment indirectly paid by the plan, is paid to any investment manager or other service provider for services rendered to a plan. In addition, the receipt of such indirect compensation by an investment manager or other service provider, with respect to an employee benefit plan, can result in a prohibited transaction under ERISA §406.

UPIA and UPMIFA Requirements

UPIA requires that:

A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.
[UPIA §2(a)]

Similarly, the UPMIFA provides that:

Subject to the intent of a donor expressed in a gift instrument, an institution, in managing and investing an institutional fund, shall consider the charitable purposes of the institution and the purposes of the institutional fund...In addition to complying with the duty of loyalty imposed by law other than this [act], each person responsible for managing and investing an institutional fund shall manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.
[UPMIFA §3(a)-(b)]

UPIA and UPMIFA also contain specific sections that address investment costs. UPIA provides:

In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee. [UPIA §7. See also, UPMIFA §5(c)(1)]

Practice SA – 4.5 (continued)

As the Comments to UPIA §7 state:

Wasting beneficiaries' money is imprudent. In devising and implementing strategies for the investment and management of trust assets, trustees are obliged to minimize costs.
[UPIA §7, Comments]

So the duty under the UPIA and the UPMIFA to minimize costs is coupled with trustees' and institutions' duties to act prudently.

A New York court applied these principals in determining that it was inappropriate for an investment advisor appointed by a ward's guardian to manage the ward's funds. The investment advisor was subject to UPIA as modified and adopted in New York and set forth at McKinney's EPTL 11-2.3. [*In the Matter of Derek W. Bryant*, 188 Misc. 2d 462, 467, 729 NYS2d 309 (6/21/2001)] The investment advisor invested in several mutual funds, some of which were totally independent of the investment advisor and some of which had a relationship with the investment advisor in that either the investment advisor or an affiliate acts as an investment advisor for the mutual fund. New York's version of the *Prudent Investor Act* includes specific provisions applicable to the related mutual funds which force an investment advisor to choose between receiving advisor fees from the mutual funds or the trustee's commissions for the portion of the trust invested in such mutual funds. [McKinneys EPTL 11-2.3(d)] As to the third-party funds, the court described the arrangement as follows:

As to the third party funds ...the funds themselves charge fees ranging from .62% to 1.68% and [the investment advisor] receives a service fee of .25% [from the mutual funds] in addition to its investment advisory fees of 1.25% and 1.0%. It is ... unfair to the infant's funds to be charged twice for the investment advice, once by the third-party mutual fund and again by [the investment advisor]. While we recognize there is work and skill involved in selecting mutual funds to include in the respective portfolios for which reasonable compensation should be allowed, the total fees cannot be excessive ... [the investment advisor] should be limited to its .25% service fee or the difference between the third party fund charge and 1.25%, whichever is greater. [Ibid. 467 – 68]

Thus, the court determined that, where an individual rendering investment advice to a trust receives compensation both directly from the trust, and indirectly as a result of compensation received in connection with the investment of the trust assets, both the direct and indirect compensation must be taken into account, and the total compensation must not exceed reasonable compensation for the services provided to the trust. Accordingly, a trustee or other fiduciary responsible for managing and investing a trust's assets must investigate the total fees (including 12b-1 fees, *finder's fees*, and other forms of compensation) that are being paid and ensure that no more than reasonable compensation, including such forms of indirect compensation, is paid in connection therewith.

MPERS Requirements

MPERS requires that a fiduciary, in the discharge his or her duties, incur only costs on behalf of the public retirement system that are appropriate and reasonable. [MPERS §7(2) and (5)] Moreover, in delegating the performance of functions related to the management and investment of trust assets to an investment manager, a fiduciary must exercise reasonable care, skill, and caution in: (i) establishing the scope and terms of the delegation, and (ii) periodically reviewing the performance of the investment manager and its compliance with the terms of the delegation. [MPERS §6(b)(2) and (3)]

While MPERS does not have an explicit requirement that fiduciaries investigate the direct and indirect fees paid for asset placement and management, the general fiduciary standard that fiduciaries pay only reasonable costs would logically impose a requirement that the fiduciaries compare the cost of the services to the value received. In turn, that would impose a duty to reasonably investigate the fees paid, direct or indirect, and the services or goods received for those payments.

[IBP] As a matter of best practice, the investment manager’s engagement agreement should require disclosure of all *finder’s fees*, 12b-1 fees, commissions and other payments to the investment manager or its affiliates with respect to investments made by the retirement system’s trust. It also should specify whether the investment manager or the trust is entitled to such payments. Finally, consistent with the appointing fiduciary’s duty to monitor pursuant to MPERS §6(b)(3), such fiduciary must take appropriate action to see that such payments are accounted for, applied, utilized, and documented as provided for in the engagement agreement.

PRUDENT PRACTICES FOR INVESTMENT FIDUCIARIES

Practice SA - 4.6

There is a process to periodically review the organization's effectiveness in meeting its fiduciary responsibilities.

ERISA Requirements

In acting for the exclusive purpose of providing benefits for the participants, ERISA fiduciaries are held to the standard of a knowledgeable prudent person as provided in section 404(a)(1) of ERISA:

... a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and...

(B) 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... [ERISA §404(a)(1)(B) and 29 U.S.C. 1104 (a)(1)(B)]

Section 404(a)(1)(B) measures the conduct of fiduciaries by the standard of a hypothetical person who is familiar, or knowledgeable, about the issues involved in the operation of a retirement plan – the so-called “prudent person” standard. In acting prudently, the fiduciaries of a plan must consider the “circumstances then prevailing,” which may change over time. Thus, the fiduciaries must be attentive to changing circumstances and to their impact on decisions previously made.

The fiduciary duty to act prudently includes the duty to continually review the investments and services offered by, and/or provided to, the plan. Often referred to as the “duty to monitor,” this duty encompasses the fiduciaries’ obligation to make changes to the investments or services when needed.

The DOL has issued guidance applying the ongoing duty to monitor to the appointment and retention of fiduciaries:

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. [DOL Interpretive Bulletin 75-8, FR -17; 29 C.F.R. 2509.75-8, FR Q&A 17]

Practice SA - 4.6 (continued)

Although the DOL does not prescribe a specific procedure for monitoring the performance of trustees and fiduciaries, the DOL does acknowledge that the appointing fiduciary should have a procedure for performing this task. For example, in settling a lawsuit, the DOL entered into a consent order which outlines some of the tasks that fiduciaries of a plan should be performing on a consistent basis. Such tasks include monitoring of investments, investment managers and the conduct of the trustees. [Chao v. Chacon, Case No. 1:04 CV 35000 MDL Docket No. 1593 (N.D. Ohio 2005)]

Other cases have specifically applied the requirement to monitor to service providers and investments. (See, e.g., *Liss v. Smith*, 991 F.Supp. 278, 299 (S.D.N.Y. 1998) and *Harley v. Minnesota Mining and Manufacturing Company*, 42 F.Supp. 2d 898, 906 (D. Minn. 1999).)

Of course, a competent review of the performance of investment managers, trustees, and other fiduciaries and service providers involves the collection of information about their performance. In a DOL interpretive bulletin regarding written statements of investment policy, the DOL considered the importance of documentation:

It is the view of the Department that compliance with the duty to monitor necessitates proper documentation of the activities that are subject to monitoring. ... Moreover, compliance with ERISA §404(a)(1)(B) would require maintenance of proper documentation of the activities of the investment manager and of the named fiduciary of the plan in monitoring the activities of the investment manager. [DOL Interpretive Bulletin 94-2; 29 C.F.R. 2509.94-2]

The logical extension of the DOL guidance is that a prudent fiduciary must develop a framework to collect the information necessary to document the activities that are subject to monitoring. As stated in *Fink v. National Savings & Trust Co.*, 772 F.2d 951, 957 (D.C. Cir. 1985), “A fiduciary's independent investigation . . . is at the heart of the prudent person standard.”

In addition, a prudent fiduciary would need to develop a standard to gauge the performance of the fiduciaries. Of course, the ultimate test is whether the fiduciaries are performing their duties in accordance with expectations. While the quality of the services, as well as their cost, are obvious factors to be evaluated in the monitoring process, the litmus test is whether the services are producing the intended results. That is, are the activities of the fiduciaries effective?

In sum, in order to satisfy the duties to consider changed circumstances, to act for the exclusive purpose of providing benefits and to regularly monitor fiduciaries and service providers, a plan's fiduciaries must regularly review their effectiveness in fulfilling the fiduciary responsibilities assigned to them.

Practice SA - 4.6 (continued)

To satisfy those duties, a prudent fiduciary should develop a process to periodically review whether the assigned fiduciary responsibilities are being fully and effectively addressed. While there is no explicit legal or regulatory requirement for the creation of such a procedure, the creation and implementation of a procedure to periodically verify whether a fiduciary is fulfilling its obligations would demonstrate a process for meeting its fiduciary duty to conduct its affairs in a prudent manner.

UPIA and UPMIFA Requirements

As with a fiduciary subject to ERISA, a trustee whose conduct is governed by the UPIA or the UPMIFA must act prudently in investing and managing trust assets. Section 2(a) of the UPIA provides that:

A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.

Similar provisions are contained in the UPMIFA, which provides that:

In addition to complying with the duty of loyalty imposed by law other than this [act], each person responsible for managing and investing an institutional fund shall manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances. [UPMIFA §3(b)]

Thus, under section 2(a) of UPIA and 3(b) of UPMIFA a trustee is charged with managing the assets of the trust as well as monitoring the on-going suitability of the investments.

Section 2(d) of UPIA expands on the duty to act prudently by providing that a trustee has a duty of verification:

A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.

Similar provisions are contained Section 3(c) (2) of UPMIFA, which provides that:

In managing and investing an institutional fund, an institution shall make a reasonable effort to verify facts relevant to the management and investment of the fund.

Much like an ERISA fiduciary's obligation to consider the circumstances then prevailing, implicit in the obligation to consider "the purposes, terms, distribution requirements, and other circumstances of the trust," is the acknowledgement that such factors are subject to change. Of course, in performing this task, the trustee must exercise reasonable care, skill and caution.

Practice SA - 4.6 (continued)

Determining whether or not the trustee is exercising reasonable care, skill and caution in the performance of its duties requires an independent evaluation of the trustee. While there is an explicit requirement under UPIA and UPMIFA for the trustee to evaluate its performance, such review would be a factor for evaluating whether a trustee was engaging in a prudent process in the performance of its duties. The purpose of the review would be to verify whether the trustee is fulfilling its obligations and assess whether the trustee's policies and procedures should be modified.

MPERS Requirements

Similar to ERISA, a trustee or other fiduciary making investment decisions pursuant to the Uniform Management of Public Employees Retirement Act (MPERS) is bound by the general duties of prudence and loyalty, as well as the exclusive purpose rule set forth in MPERS section 7:

A trustee or other fiduciary shall discharge duties with respect to a retirement system:

- (1) solely in the interest of the participants and beneficiaries;*
- (2) for the exclusive purpose of providing benefits to participants and beneficiaries and paying reasonable expenses of administering the system;*
- (3) with the care, skill, and caution under the circumstances then prevailing which a prudent person acting in a like capacity and familiar with those matters would use in the conduct of an activity of like character and purpose;*
- (4) impartiality, taking into account any differing interests of participants and beneficiaries;*
- (5) incurring only costs that are appropriate and reasonable; and*
- (6) in accordance with a good-faith interpretation of the law governing the retirement program and system.*

While MPERS generally requires that a trustee or other fiduciary perform its duties in prudent manner, there is no explicit duty for the trustee or fiduciary to review its own performance. However, the general prudence standard imposed on trustee and fiduciaries to act “with the care, skill, and caution under the circumstances then prevailing which a prudent person acting in a like capacity and familiar with those matters would use in the conduct of an activity of like character and purpose,” appears to imply a requirement that the prudent trustee or fiduciary develop and implement a process to ensure that all fiduciary/trustee duties are fully and effectively addressed on an ongoing basis.

In addition, MPERS does explicitly recognize the importance of creating processes to evaluate and review certain fiduciary activities. For example, section 8(b) requires that the trustee with the authority and responsibility for investing the assets of a retirement plan adopt a statement of investment objective and annually review it:

Practice SA - 4.6 (continued)

*(b) A trustee with authority to invest and manage assets of a retirement system shall adopt a statement of investment objectives and policies for each retirement program or appropriate grouping of programs. The statement must include the desired rate of return on assets overall, the desired rates of return and acceptable levels of risk for each asset class, asset-allocation goals, guidelines for the deflation of authority, and information on the types of reports to be used to evaluate investment performance. **At least annually, the trustee shall review the statement and change or reaffirm it.** [Emphasis added.]*

As with the ERISA and UPIA prudence standards, the MPERS prudent person rule apparently contains an implicit duty for the fiduciaries to monitor their activities, as well as those of the other fiduciaries and service providers they oversee, to determine the effectiveness of their activities. For example, it seems difficult to imagine that the prudence standard would allow fiduciaries to fail to evaluate the results of their decisions or actions that were not effectively accomplishing their intended purpose. It is equally difficult to construe the prudence standard to reach a result other than that fiduciaries must periodically review the consequences of their decisions (*e.g.*, the effectiveness of their activities).

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