

The Evolution of Fiduciary Liability for Investment Losses – ERISA Plans, Non-Profits and Institutions

PRESENTED BY:



James J. Eccleston



Jeffrey M. Gershon

Online Seminar

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CPE candidates must prove interactivity by responding to the 2 identified poll questions within the presentation using the Q&A field. Proof of attendance will be e-mailed to you.

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- Established in 1960
- Full service business law firm
- Representing closely-held businesses, entrepreneurs and individuals
- From start-up to succession planning
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Restatement 3rd of Trusts (Prudent Investor Rule)

- **What is a restatement?**
 - a legal treatise that examines the common law and state statutes in a particular field of law and restates them as broad legal principles
- **First volume covering the Prudent Investor Rule was published in 1992**
 - to update the 1959 Restatement 2nd of Trusts (the first was published in 1935)
- **Overreaching committee goal was to revise and supersede the Prudent Man Rule**

Restatement 3rd of Trusts (Prudent Investor Rule)

- **Dissatisfaction with Prudent Man Rule began to appear as the tenets of Modern Portfolio Theory were applied in the 1960s**
 - wanted to incorporate modern theories of investment and finance into the general language
- **Represents the official views of the American Law Institute**
 - not a governmental body
 - no restatement of law has the sanction of any statute

The Uniform Prudent Investor Act (UPIA) (1994)

- **Published in 1994 by the National Conference of Commissioner on Uniform State Laws**
- **Sets forth prudent fiduciary standards governing the investment conduct of trustees of private family trusts**
- **However, terms make clear that standards have a bearing on the investment conduct of fiduciaries in other fields of investing, including those responsible for investing and managing the assets of ERISA retirement plans, public employee retirement plans, and charitable nonprofits, including foundations and endowments**

The Uniform Prudent Investor Act (UPIA) (1994)

- **The Act and the Restatement together define the standards of modern prudent fiduciary investing**
 - 44 states (not Delaware, Florida, Georgia, Kentucky, Louisiana and NY) and DC and U.S. Virgin Islands have enacted act into law
 - ABA endorsed act in 1995 as the American Bankers Association

The Uniform Prudent Investor Act (UPIA) (1994)

- **Reach of the act has spread into virtually all fields of U.S. trust investment law**
 - Fields covered by uniform acts published by the National Conference of Commissioners**
 - The Uniform Management of Public Employee Retirement Systems Act, 1997
 - The Uniform Principal and Income Act, 1997
 - The Uniform Trust Code, 2000
 - The Uniform Prudent Management of Institutional Funds Act, 2006
- **Governs the conduct of a variety of trustees in the investment and management of hundreds of billions of dollars**

Uniform Management of Public Employee Retirement Systems Act (1997)

- **Public pension plans regulated by state laws that**
 - vary considerably
 - have not kept up with modern investment practices
- **This act sets forth uniform standards governing the investment conduct of fiduciaries responsible for investing and managing the assets of public employee pension plans**
 - based on trust law
 - public employees are guaranteed the highest standard of conduct in management and investment of assets for retirement that the law can establish

Uniform Management of Public Employee Retirement Systems Act (1997)

- **Incorporates modern investment practices with relevant text and commentary from the Uniform Prudent Investor Act**
- **Wyoming and Maryland enacted the act into state law in 2005**
- **The fiduciary sections of the act became law in South Carolina in 1998**

Uniform Principal and Income Act (1997)

- **Gives new rules pertaining to principal and income allocation in trusts**
- **Meant to accommodate the duty of impartiality, Modern Portfolio Theory, Uniform Prudent Investor Act and the Restatement**
- **Now law in 41 states and DC**
- **Endorsed by ABA in 1998**

Uniform Trust Code (2000)

- **National codification of the laws of trust while incorporating modern investment practices**
- **Pertains to a series of duties required of a trustee concerning the investment, administration, and distribution of assets**
- **Section of the Prudent Investor Act are incorporated virtually verbatim into Article 8 of the Code:**
 - “special skills” of Uniform Prudent Investor Act section 2(f)**
 - “duty of loyalty” of Section 5**
 - “impartiality” of Section 6**
 - “investment costs” of Section 7**
 - “delegation” of Section 9**

Uniform Trust Code (2000)

- **Leaves sections to be incorporated into Article 9 by state legislators, such as:**
 - “prudent investor rule” of Section 1
 - “standard of care, portfolio strategy, and risk and return” of Section 2(a)-(e)
 - “diversification” of Section 3
 - “duties at inception of trusteeship” of Section 4
 - reviewing compliance of Section 8

Uniform Prudent Management of Institutional Funds Act (2000)

- **Governs the investment conduct of trustees responsible for non-profit money, such as foundations and endowments**
- **Revises the 1972 Uniform Management of Institutional Funds Act (currently law in 48 states and DC)**

Uniform Prudent Management of Institutional Funds Act (2000)

- **Unlike 1972 act, standards for investing and managing institutional charitable funds will be the same regardless of whether a charity is organized as a trust or a non-profit corporation, or in some other way**
- **Panel on the Non-Profit Sector released 9 Draft Supplemental Recommendations that were submitted to the Finance Committee of the U.S. Senate in October**

Employee Retirement Income Security Act - ERISA

- **Uniform Prudent Investor Act is important source of authority**
 - regulates investment conduct of trustees of private sector pension plans
- **Absorbs much of common law of trusts developed by the states**
- **Interpreted with eye on common law**
- **Uniform Prudent Investor Act powerfully affects the federal courts in their interpretation of ERISA**

Introduction

General Fiduciary Principles for Advisers - Defining Fiduciary

Introduction

- In 1963, USSC held that Section 206 of the Advisers Act imposes a fiduciary duty on advisers by operation of law (see *SEC v. Capital Gains Research Bureau*)
- Generally, the object of an adviser's fiduciary duty is to eliminate conflicts of interest and to prevent an adviser from taking advantage of a client's trust
- As such, an adviser is required to act in the client's best interest and to make full and fair disclosure of all material facts, especially when a conflict may arise

Introduction

- In *Capital Gains Research Bureau*, the Court stated that an adviser should continuously occupy an impartial and disinterested position, as free as humanly possible from the subtle influence of prejudice, conscious or unconscious; he should scrupulously avoid any affiliation, or any act, which subjects his position to challenge in this respect

Introduction

- **The SEC has stated, “The Investment Advisers Act imposes on investment advisers an affirmative duty to their clients of utmost good faith, full and fair disclosure of all material facts, and an obligation to employ reasonable care to avoid misleading their clients.”**

Pension Protection Act of 2006

- **On August 17, 2006, President Bush signed into law the Pension Protection Act of 2006 (“PPA”) and was hailed as the biggest reform of the U.S. pension law in over 30 years**
- **The main purpose was to improve the underfunding of the nation’s defined benefit pension plans**
- **The PPA requires defined benefit plans to accelerate the funding of their liabilities under such plans**

Pension Protection Act of 2006

- **Beginning in 2008, employers must fund 100% of the plan's funding target instead of 90% under current law**
- **All contributions to defined contribution plans (e.g., profit-sharing, 401(k), and money purchase pension plans) must have a faster vesting schedule**
- **Beginning in 2008, distributions from qualified plans, Section 403(b) annuities or Section 457 plans may be rolled over directly to a Roth IRA**

Pension Protection Act of 2006

- **The PPA permits non-spouse beneficiaries of a decedent's tax favored retirement account to roll it over into an IRA and have the inherited IRA rules apply**
- **Beginning in 2010, the PPA authorizes a new combined defined benefit and 401(k) plan for employers with fewer than 500 employees**
- **PPA legitimizes automatic enrollment for 401(k) plans**
- **PPA permits plans to provide participants with investment advice for self-directed accounts**

Liability Issues

- **The PPA has provided guidance on an issue that plan sponsors and fiduciaries have been wrestling for some time – the extent to which plan sponsors and fiduciaries can arrange for the provision of investment advice directly to participants without causing the plan to engage in a prohibited transaction or rendering themselves co-fiduciary liable for actionable advice**

Liability Issues

- **The PPA provides both prohibited transaction relief as well as some protection for plan fiduciaries with respect to investment advice (provided after 12/31/06)**
- **To qualify for relief under the statute, the advice must be provided by a “fiduciary adviser” pursuant to an “eligible investment advice arrangement”**

CPE Candidates:

Please respond to the following question by typing the answer yes or no into the Q&A field.

Q- Is the fiduciary adviser protected from liability?

- A. No**
- B. Yes**

A- No, fiduciary adviser is a fiduciary responsible for his/her advice and must admit such in writing. The receipt of compensation is not a prohibited transaction but the normal fiduciary rules otherwise apply.

Who Is a Fiduciary Advisor?

- The PPA creates a new category of advisers referred to as “fiduciary advisers.” For the relief to be available, the advice may only be provided by a “fiduciary adviser.” (ERISA § 408(g)(1))
- Under ERISA § 408(g)(11)(A), the term “fiduciary adviser” means a person who, with respect to a plan, is a fiduciary by reason of the provision of investment advice as defined for purpose of ERISA § 3(21)(A) (ii), and who falls within one of the following categories:

Who Is a Fiduciary Advisor?

- registered as an investment adviser under the Investment Advisers Act of 1940, or under the state laws of the state in which the fiduciary maintains its principal office and place of business;
- a bank, or similar financial institution, but only if the advice is provided through a trust department of the bank or
- similar financial institution or savings association which is subject to periodic examination and review by federal or state banking authorities;

Who Is a Fiduciary Advisor?

- an insurance company qualified to do business under state law;
- a person registered as a broker or dealer under the Securities Exchange Act of 1934;
- an affiliate of any of (1) through (4); or
- an employee, agent , or registered representative of any of the preceding who satisfies the requirements of applicable insurance, banking, and securities laws relating to the provision of advice.

Who Is a Fiduciary Advisor?

- For purpose of this provision, a person who develops the computer model used in the provision of the advice, as described below, or markets the investment advice program or computer model is also treated as both a fiduciary of the plan by reason of the provision of investment advice, and as a fiduciary adviser.
- However, ERISA § 408(g)(11)(A) gives the DOL the authority to prescribe rules pursuant to which only one fiduciary adviser may elect to be treated as a fiduciary with respect to the plan.

Who Is a Fiduciary Advisor?

- **Under this exemption, any transaction that's made in connection with the provision of investment advice by a fiduciary for compensation to a participant or beneficiary in a plan that permits the participant or beneficiary to direct the investment of plan assets in an individual account is not a prohibited transaction.**

Eligible Investment Advice Arrangement

- **Flat fee or computer model arrangement**
- **Annual audit**
- **Meet disclosure rules**
- **All trades at direction of participant**
- **Record retention rules**

Who Is a Fiduciary Advisor?

- **To be covered by the exemption, the computer model used by an investment advice program must:**
 - **apply generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time;**
 - **use relevant information about the participant, which may include factors such as age, life expectancy, retirement age, risk tolerance, etc.;**

Who Is a Fiduciary Advisor?

- use prescribed objective criteria to provide asset allocation portfolios comprised of investment options available under the plan;
- operate in a matter that's not biased in favor of investments offered by the fiduciary adviser or a person with a material affiliation or contractual relationship with the fiduciary adviser; and
- take into account all investment options under the plan in determining how a participant's account balance should be invested and not be inappropriately weighted toward any investment option.

Eligible Investment Advice Arrangement- Computer Model

- **Must be certified as meeting requirements by “eligible investment expert” prior to use**
- **Must be re-certified after material modification**
- **Only advice that may be provided is the advice generated by the computer model itself**

Annual Audit

- **Independent auditor must audit program each year for compliance with rules**
 - **person represent in writing that have appropriate technical training or experience and proficiency**
 - **unrelated to the person offering the investment advice and unrelated to any investment provider under the plan**

Who Is a Fiduciary Advisor?

Non-Fiduciary Investment Consultants

- Some investment consultants refuse outright in the contracts they sign with fiduciaries of 401(k) plans to acknowledge any fiduciary responsibility to such fiduciaries
- ERISA § 3(21)(A) provides that a person is a fiduciary with respect to a plan to the extent:
 - (1) it exercises any discretion authority or discretionary control respecting management of such plan or exercises any authority or control respecting management of such plans or exercises any authority or control respecting management or disposition of its assets;
 - (2) it renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has the authority or responsibility to do so; or
 - (3) it has any discretionary authority or discretionary responsibility in the administration of such plan.

Compensated Risk and Uncompensated Risk

- **Modern Portfolio Theory: risk can be managed through diversification**
 - Section 3 of Uniform Prudent Investor Act: “A trustee shall diversity 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.”

Compensated Risk and Uncompensated Risk

- **Doesn't prohibit outright undiversified portfolios**
 - shifts burden of proof to fiduciary
 - message of Act and Restatement 3rd of Trusts says prudent fiduciary investing ordinarily mandates diversification of risk
 - Commentary to the Restatement notes that duty to diversify risk is based on principles of Modern Portfolio Theory composed of 2 risks: compensated risk and uncompensated risk

Compensated Risk

- **Composes about 30% of total portfolio risk**
 - reflects how the market prices of many or all stocks are affected relatively the same by economic and non-economic news
- **Unavoidable by an investor that invests in the stock market**
 - can be thought of as the “price of admission”
- **Ordinarily is “good”**
 - investor must have a realistic prospect of realized gain commensurate with the risk assumed
 - financial markets reward investors for retaining this kind of risk
 - a fiduciary is under no duty to reduce compensated risk, but must manage it

Uncompensated Risk

- **Composes about 70% of total portfolio risk**
 - reflects how the market price of a particular stock is impacted uniquely by economic and non-economic news
- **Avoidable by an investor that invests in the stock market**
- **Ordinarily is “bad”**
 - financial markets don't reward investors for retaining this kind of risk
 - investors penalized with lower returns for retaining uncompensated risk
 - don't have realistic prospect of realizing gain commensurate with the risk assumed

Uncompensated Risk

- **Restatement Commentary defines broadest possible diversification: “The ultimate goal of diversification would be to [completely eliminate uncompensated risk and thus] achieve a portfolio with only the [compensated]...element of risk.”**
- **Commentary to Section 3 of the Act adds: “The object of diversification is to minimize [the] uncompensated risk of having too few investments.”**

-language derived from fundamental principles of Modern Portfolio Theory

Uncompensated Risk

- **Restatement Commentary describes penalty for not reducing uncompensated risk from a portfolio, “Failure to diversify on a reasonable basis in order to reduce uncompensated risk is ordinarily a violation of both the duty of caution and the duties of care and skill.”**

Uncompensated Risk

- Duties of caution, care and skill defined in Commentary to the Act as the very elements of “prudence”
- Breach of any one of these duties makes conduct of fiduciary imprudent and subject to liability

Fiduciary Focus

- **Naïve diversification**
 - objective of maximizing expected return
- **Rational diversification**
 - avoid stocks that have high covariance to each other to reduce portfolio risk and possibly increase return
- **Investing in a lot of different stocks without ensuring they have negative or low covariance to each other within portfolio is not prudent fiduciary conduct**

Fiduciary Focus

- **Those employing naïve diversification incur compensated risk and uncompensated risk**
 - naively diversified portfolios retain relatively significant amounts of uncompensated risk is contrary to how diversification is defined by modern prudent investing:
reduction of uncompensated risk

Commentary to Section 227 of the Restatement 3rd of Trusts (Prudent Investor Rule)

- **Cautions: “Because market pricing cannot be expected to recognize and reward a particular investor’s failure to diversify, a trustee’s acceptance of [uncompensated] risk cannot, without more, be justified on grounds of enhancing expected return.”**

Commentary contd.

- **Restatement Commentary integrates 2 principles of prudent fiduciary conduct:**
 - 1) **the duty ordinarily to diversify a portfolio to reduce its uncompensated risk**
 - 2) **a fiduciary's "central consideration" under the Uniform Prudent Investor Act: to make the tradeoff between a portfolio's risk and return**

Commentary contd.

- **Examination of Commentary: “Market pricing cannot be expected to recognize and reward a particular investor’s failure to diversify.”**
 - Any investor has the ability to eliminate some uncompensated risk from his/her portfolio is reason why financial markets won’t reward these investors for retaining risk

Commentary contd.

- **Examination of Commentary: “A trustee’s acceptance of [uncompensated] risk cannot, without more, be justified on grounds of enhancing expected return.”**
 - “more” indicates the need for a fiduciary to make a conscious assessment of the risks, costs and taxes of a portfolio’s proposed investment strategy
 - description of “central consideration” fiduciaries are charged with under the Uniform Prudent Investor Act.

Commentary contd.

- **A fiduciary's conduct is imprudent if its sole justification for making portfolio investments is the potential for higher returns**
 - a fiduciary cannot justify its portfolio selections by merely citing the possibility of higher returns for investments that it believes "have exceptional promise" or "are poised to outperform."
 - conduct isn't in accord with standards of prudent fiduciary investing
 - If a fiduciary concentrates high tech stocks in a trust portfolio, ordinarily it must still diversify the risk among those stocks

Commentary contd.

- **The goal of diminishing uncompensated risk through diversification should be in consideration of prudent investment management and ordinarily applies within specialized programs that may be incorporated into the overall investment strategy of portfolio**
 - real estate, venture capital, foreign stocks

Diversifying Risk vs. Stock-Picking

- **Ideal conditions for achieving investment success**
 - created by disciplined application of 3 major themes of modern fiduciary investing: broad diversification of risk, low costs, and low taxes
 - help give investors best chance of building long-term wealth of their portfolios while reducing risk
- **Dollars saved in investment costs and taxes increase return**
 - few investors and fiduciaries understand that broad diversification of risk also increases return

Diversifying Risk vs. Stock-Picking

- **Restatement suggests passive investing is best way for investors to lower portfolio risk**
 - invest in broadly diversified, low-cost, low-tax asset-class mutual funds that capture the returns offered by financial markets while incurring market-level risk
 - not only way to invest prudently, just the best way to invest prudently

Diversifying Risk vs. Stock-Picking

- **Consider Hedging Strategies in Addition to Holding or Selling**
- **Trustee may be held liable for breaching the duty to invest prudently by failing to hedge a concentrated position**
- **Fiduciaries required to understand and be able to implement various hedging, monetization, and tax deferral strategies.**
 - possible alternative to outright sale or continued holding of concentrated position
 - this emerging duty is a logical development due to derivative markets, ease of accessibility to information, and the regular use of derivatives and other risk-management strategies by most corporations and institutional investors to manage their risks

Evaluate Expected Tax Consequences of the Alternative Strategies

- **UPIA requires trustees to consider “the expected tax consequences of investment decisions or strategies”**
- **Comments to UPIA state that under current federal income tax system, taxable investors are best served by investment strategies that minimize the recognition of income taxes**
- **Significant because various combinations of financial tools can be assembled to have financial equivalency to each other**

Maintain Loyalty to Beneficiaries

- **UPIA imposes a duty of loyalty upon the trustee**
 - trustee works solely in the best interest of the beneficiaries, as opposed to acting for its own interest or that of a third party
 - any action of self-dealing or conflict of interest is strictly prohibited
- **Professional fiduciaries with in-house derivative desks need to be especially cautious**
 - fiduciary should procure competing bids from a number of dealers to assure that full price discovery has been achieved
 - fiduciary should be prepared to execute a transaction with an outside dealer if the pricing, terms, and conditions of the in-house desk are not as favorable

Minimize Transaction Costs and Fees

- **UPIA specifically addresses investment costs**
 - a trustee may incur only costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee
 - wasting beneficiaries' money is imprudent
- **Trustees are obligated to minimize costs**
 - important for trustees to make careful cost comparisons, particularly among similar products of a specific type being considered for a trust portfolio
 - achieving full price discovery is not optional – required by both the UPIA and the Restatement 3rd of Trusts

Prudent Investment Practices (Foundation For Fiduciary Studies)

1) Analyze Current Position

- review all documents relating to the establishment and management of the investments**
- ensure that the investment fiduciary knows his duties**
- the fiduciary must prudently manage investment decisions or obtain assistance from outside professionals**

Prudent Investment Practices (Foundation For Fiduciary Studies)

2) Diversify- Allocate Portfolio

- identify the risk level appropriate for the investments**
- fiduciary is required to state the presumptions that are being used to model the probable outcomes of a given investment strategy**
- identify the investment time horizon**
- the number of asset classes and investment options will depend upon many factors, including the size of the investment portfolio, sensitivity to investment expenses, and the decision-makers' investment expertise and ability to monitor the strategies and options considered**

Prudent Investment Practices Foundation For Fiduciary Studies)

3) Formalize Investment Policy

- prepare and maintain Investment Policy Statement (the “business plan”)**
- IPS defines the due diligence criteria for selecting investment options**
- IPS should define procedures for controlling and accounting for investment expenses**
- IPS defines the monitoring criteria for investment options and service vendors**

Prudent Investment Practices (Foundation For Fiduciary Studies)

4) Implement Investment Policy

- in compliance with the required level of prudence**
- fiduciary held to same expert standard of care as a professional money manager**
- fiduciary must choose appropriate investment vehicles**
- follow a due diligence process in selecting service providers such as the custodian**

Prudent Investment Practices (Foundation For Fiduciary Studies)

5) Monitor and Supervise

- fiduciary should prepare periodic reports that compare the investment performance of the portfolio against an appropriate index, peer group and IPS objectives**
- examine the qualitative and/or organizational changes of investment decision-makers**
- control procedures should be in place to periodically review matters such as best execution, soft dollars and proxy voting**
- fiduciary determines the fees paid to investment managers and others are consistent with agreements and the law**

Arbitration vs. Litigation

- Advantages
- Disadvantages

Case Discussion:

Comer v. Micor, Inc. (9th Circuit 2006)

CPE Candidates:

Please respond to the following question by typing the answer A or B into the Q&A field.

Q- Who is qualified to audit the computer model?

- A. An entity independent from the investment adviser**
- B. The investment adviser's audit staff**

A- ERISA says any person which meets such requirements as the Secretary of Labor may provide and does not bear any material affiliation or contractual relationship with any investment adviser or related person. In other words and independent auditor to be defined in yet to be issued regulations.

James J. Eccleston

JEccleston@SNSFE-law.com

Jeffrey M. Gershon

JGershon@SNSFE-law.com

Shaheen, Novoselsky, Staat,
Filipowski & Eccleston, P.C.
20 N. Wacker Drive, Suite 2900
Chicago, IL 60606-9719

312.621.4400
312.621.0268 (fax)

www.SNSFE-law.com
www.FinancialCounsel.com

Questions?

Thank you!