FIDUCIARY FUNDAMENTALS

COUNTY OF MONTEREY

November 2019

AGENDA

- Background
- Who is a fiduciary?
- Fiduciary duties
- Meeting fiduciary responsibilities
- Guidance from ERISA §404(c)
- Risks and protections

BACKGROUND: ABOUT ERISA

- 1974: Employee Retirement Income Security Act
  - Ford Administration; enacted on Labor Day

- Why?
  - Abuses of existing law by some firms and unions
  - Assets being misused
  - Ten-year "Cliff Vesting" resulting in many never gaining a pension
  - Confusion of conflicting state laws

- The Result: An approach that blends State trust laws to form a national standard for benefit plan definition and administration

- For the public sector, providers for best practices and accepted methods for plan design and operation

WHY ERISA

- Convenience: It is a comprehensive guide, with much information
- It is considered to be a high standard
- It is believed by many to be a model that the courts will look to for guidance when considering non-ERISA cases
- It is continually updated to reflect changing realities in the retirement plan and investment environment
- Many States follow ERISA closely and in some instances even call out certain statutes

PUBLIC SECTOR RETIREMENT PLAN FIDUCIARY OVERSIGHT MILESTONES

- **1994**: Orange County bankruptcy and 457 plan investment scandal
- **1996**: Federal Law passed placing 457 plan assets into "trust" status
- **2002**: EGTTRA legislation eliminated most differences between 457 plans and private sector 401(k) plans
- **2006**: Pension Protection Act; congress vows to make many public employer plans "more like 401(k) plans"
- **2008-Present**: Litigation over failure to oversee retirement plans increases, with most actions involving investments and fees
- **2017** – DOL unsuccessfully attempts to expand Fiduciary definitions

WHO IS A FIDUCIARY?

- Anyone with discretionary authority or control over the administration of a retirement plan or its assets

- Fiduciary by name:
  - Plan Sponsor
  - Trustee
  - Named Administrator

WHO IS A FIDUCIARY? (continued)

- Fiduciary by action: Anyone who acts as a fiduciary can be considered a fiduciary:
  - A Committee appointed by the Board, Trustees or Council
    - Anyone administering the Plan
    - Anyone selecting investment and service providers
    - Anyone giving investment advice for a fee (to Plan or Plan participants)
    - In April 2017, the Department of Labor tried to expand the definition of a fiduciary
    - In March 2018, DOL rule vacated by 5th Circuit Court, SEC now taking over

WHAT IS A PLAN FIDUCIARY?

- Persons who, by either function or appointment, have discretionary authority over plan assets and/or administration

- Fiduciary Functions:
  - Selecting, retaining or terminating record-keepers/plan administrators
  - Selecting, retaining, or terminating investment options
  - Processing and submitting participant contributions
  - Negotiating fees and expenses for plan services and investment

- Must be more than "Ministerial":
  - Maintaining records and other administrative roles are not covered
  - Processing payroll may qualify though, if decisions can delay deposits

FIDUCIARY DUTIES

DUTY OF LOYALTY:

1. Act solely in the best interests and for the exclusive benefit of plan participants
2. Defray plan expenses in a reasonable manner
3. No self-dealing

DUTY OF PRUDENCE:

1. Act with care and diligence of an expert
2. Procedural prudence – follow a prudent/reasonable process
3. Diversify investments to minimize the risk of large losses

DUTY TO FOLLOW PLAN DOCUMENT:

1. Comply with Federal and State laws
2. Operate the plan in accordance with the written plan document

DUTY OF LOYALTY

- Must not place own interests over those of the participant
- Avoid self-dealing
- Must not cause the plan to engage in transactions between the plan and a party in interest:
  - Parties in interest: Fiduciaries, trustees, plan counsel, employees or related persons
- Operate the plan for the exclusive purpose of providing benefits and offsetting reasonable expenses
- Plan expenses may be charged to the plan and it is the fiduciary's responsibility to decide which expenses to charge and whether they are reasonable
- Department of Labor (DOL) has issued guidance on what might constitute an appropriate plan expense, but they have been very limited in their guidance of what would be considered reasonable

DUTY OF PRUDENCE

- A fiduciary must execute his/her duties with the care, skill, prudence, and diligence under the prevailing circumstances that a prudent person acting in a like capacity and familiar with such matters would use:
  - Referred to as the "prudent expert" rule because of the familiarity assumption
  - Follow a prudent process (procedural prudence concept)
  - Allows for the hiring of "experts" to assist
  - Experts must be prudently selected and monitored

- A fiduciary must diversify the investments in the plan to minimize the risk of large losses unless, under the circumstances, it is clearly prudent not to do so

DUTY TO FOLLOW PLAN DOCUMENTS

- Must oversee and make sure the plan operates in compliance with the plan document, trust agreements and/or other documents

- Fiduciaries should be familiar with:
  - Plan documents
  - Federal and State law in relations to the documents

PLAN DESIGN AND ADMINISTRATION ISSUES

- Design the plan and fee allocation to be fair to all participants
- Establish appropriate rules and policies for participants
- Enforce plan rules consistently
- Communicate rules, policies and amendments to participants
- Review plan documents at least annually to ensure compliance
- Review trust, custodial and other service agreements regularly

PLAN GOVERNANCE

- Establish roles, rules and procedures for Committee functions
- Follow a prudent process when making decisions
- Select and train qualified people to serve on Committee
- Hold regular meetings
- Document decisions and keep minutes of fiduciary meetings

INVESTMENT RESPONSIBILITIES

- Create an Investment Policy Statement (IPS) that reflects the plan objective and clarifies the responsibilities of all parties

- Determine types of investment options to be offered:
  - Number of asset classes
  - Diversification
  - Target-date funds
  - Managed accounts

- Develop criteria for selecting, monitoring and removing investments and investment managers/advice providers

- Set guidelines for appropriate actions

DUTY TO DIVERSIFY

- The "Diversification Rule":
  - "A fiduciary must diversify investments in order to minimize risk of loss unless it would be considered prudent not to diversify investments"

- For Defined Contribution Plans with Self-Direction of Investments by Participants:
  - The duty is to provide sufficient investment options such that participants are able to construct a diversified portfolio from plan options
  - ERISA § 404(c) is an accepted guide to minimums, but only requires three options
  - Fiduciaries must balance the needs of diversification with the potential negative impacts of offering too many choices

SELECTION AND MONITORING OF SERVICE PROVIDERS

- All contracts should be in best interest of plan participants
- Competitive bid or search process should be based on objective criteria
- Follow a prudent process and be able to justify contract awards
- Establish appropriate performance standards
- Evaluate contractors regularly
- Have reasonable basis for determining appropriateness of provider fees:
  - Benchmarking
  - RFP

ERISA §404(c)

- Relieves fiduciaries from responsibility where participants control their accounts and certain requirements are met

- Regulations set forth what constitutes effective control:
  - Offer a broad range of investment options:
    - At least 3 diversified choices with materially different risk/return
    - At least one safety of principal option
  - Provide for flexibility of investment transfers
  - Provide information to participants

ERISA §404(c) (continued)

- Qualified Default Investment Alternative (QDIA) rules can provide added protection/waivers where additional criteria are met:
  - Diversified investment option – balanced, life cycle/target date, or managed account
  - Set automatic investment parameters
- Fiduciaries are not relieved from the duty to:
  - Select an appropriate menu of options
  - Select investment managers and service providers
  - Monitor performance of managers and services providers

FEE DISCLOSURES

Participant Disclosures:

- General plan information
- Administrative expenses
- Investment information:
  - Performance
  - Fees and expenses
- In practice, disclosure is created by the record keeper; however, a fiduciary must approve it

Plan Sponsor Disclosures:

- Required of service providers (e.g. record keeper, consultant)
- Description of services, fiduciary status and fees for each provider
- Determine that fees are reasonable for services provided

SUMMARY OF COMMITTEE RESPONSIBILITIES

- Fiduciary review of investments
- Fiduciary review of service providers
- Authorize changes to investments
- Authorize changes to investment providers
- Create or approve design of education/counseling programs
- Review and approval of hardship withdrawal requests
- Monitoring of fees and expenses

DEPARTMENT OF LABOR CONFLICT OF INTEREST REGULATION

- Expands definition of fiduciary to include those that provide recommendations regarding distributions from the Plan
  - IRA providers
  - Call center representatives
  - On-site education

- Additional focus on participant education and parameters
  - Potential biases
  - Confirmed education is acceptable

- Legal challenges and additional actions
  - Rule was vacated by 5th Circuit Court
  - SEC proposes similar rule

RISK AND PROTECTION FOR FIDUCIARIES

- What is at *RISK*?:
  - Cost of fiduciary breach
  - Penalties and taxes
  - Personal liability
  - Public relations problems

- Plan document /plan sponsor should protect fiduciaries from personal liability to the extent allowed by law:
  - State law may provide certain protections
  - Seek indemnification from employer
  - Evaluate fiduciary insurance and bonding needs

QUESTIONS?

CASE STUDY #1

The Committee has received a request from a plan participant to add a particular real asset fund to the 457 plan that has recently been performing very well. You actually know of the specific fund because you have invested in it through your IRA and it has performed very well for you. You have recently been considering adding more money to the fund.

As a Committee Member, do you vote to add the fund?

A. Yes – Because you know the fund and it has done very well for you
B. No – You abstain from voting because you don't feel you can be objective about the decision, given your personal experience with the fund
C. Maybe – Discuss whether real asset funds are appropriate for your Plan's participants based on their investment knowledge

CASE STUDY #2

As a Fiduciary Committee Member, you are approached by the plan's record keeper. He offers you two different share classes of the same mutual fund. One has an expense ratio of .70% annually, but rebates back .25% to the plan to help offset record keeping expenses. The other has an expense ratio of .55%, but rebates nothing to help offset expenses.

Which one do you choose?

A. The less expensive one because it is cheaper for participants
B. The more expensive one because revenue sharing pays all the plan's administrative expenses
C. Neither until you have assessed fee reasonableness and method for allocating plan expenses

CASE STUDY #3

Your Committee has identified an investment manager that is not performing in-line with expectations contained in the Investment Policy Statement.

What should you do?

A. Replace the manager immediately
B. Identify the reasons for failure to meet expectations
C. Consult the Investment Policy Statement for a watch list procedure and follow it
D. Both B. + C.
E. None of the above

CASE STUDY #4

As a fiduciary Committee Member, you have noticed that one of the other Committee Members rarely attends any of the meetings. This member also does not appear to make any effort to become informed about what they may have missed when not in attendance.

What should you do?

A. Nothing since you have a quorum without this member
B. Call your supervisor
C. Discuss the issue with the Committee since members may be responsible for the conduct of others on the Committee
D. Quit the Committee immediately

CASE STUDY #5

In spite of efforts to provide clear, concise communications to participants about the plan fees and structure, a participant continues to complain about the costs associated with the investments in the plan and claims everything is too expensive.

As a Committee Member, what would you do?

A. Tell the participant to call the consultant
B. Tell the participant to call his/her broker
C. Discuss the situation with the full Committee and determine a course of action
D. None of the above, participants are clueless

THANK YOU

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