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Considerations for Defined Benefit Plan Fiduciaries Who Hire Nondiscretionary Investment Consultants



BY JONATHAN M. CERRITO AND MICHAEL R. DAUM

This is the second in a series of articles about legal considerations under ERISA for pension plan fiduciaries in selecting and monitoring investment professionals to assist with the investment of plan assets.

Although there are a multitude of general differences between a defined benefit pension plan and a defined contribution pension plan where participants don't direct their investments, the high-level legal structure governing the investment of plan assets is similar. Essentially, there is one pool of money that the responsible plan fiduciaries are required to invest in a prudent manner, either to ensure that the plan has sufficient assets to pay promised plan benefits (in a defined benefit plan) or to increase and protect the amount available to participants in their individual bookkeeping accounts (in a defined contribution plan).

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The Employee Retirement Income Security Act of 1974, as amended (ERISA) sets forth a comprehensive scheme intended to ensure prudent investment of pension plan assets for defined benefit plans to be able to meet their obligations and defined contribution plans to protect and maximize participants' accounts. As part of this, plan fiduciaries often seek the assistance of investment professionals, who can both assist in the prudent investment of plan assets and assist plan fiduciaries in fulfilling their fiduciary duties under ERISA.

The level of protection under ERISA that fiduciaries receive from using investment professionals generally depends on how much discretion is given to the professional. If the plan engages the professional to serve the plan only as a nondiscretionary fiduciary consultant that provides investment advice for a fee under ERISA Section 3(21) (an "Investment Consultant"), the plan fiduciaries must make the final decision on investment matters and remain responsible as co-fiduciaries with the Consultant.¹ As such, the plan fiduciaries retain fiduciary duties with respect to both the selection and monitoring of the plan's investments, in addition to duties with respect to the general monitoring of the Investment Consultant.

Evaluating Recommended Investments

In general, the Investment Consultant will recommend a proposed asset allocation to the plan fiduciaries, and will then recommend specific investments or investment managers to fulfill that allocation. It is up to the plan fiduciaries to decide whether or not to accept the recommendations of the Investment Consultant, both as to the allocation strategy and the investments to fit therein. This, of course, is a fiduciary decision under ERISA subject to the prudence standards because it involves authority with respect to the management of the plan's assets.²

As the plan fiduciaries are ultimately responsible for accepting or rejecting the Investment Consultant's recommendations for plan investments, they need to ensure that they comply with ERISA's fiduciary duty provisions in making the decision. Under ERISA Section 404(a), the plan fiduciaries must invest the assets of the plan with the care, skill, prudence and diligence under

¹ See 29 U.S.C. § 1105(a).

² 29 U.S.C. § 1102(21)(A)(i).

the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of a like enterprise of a like character and with like aims.³ They must also diversify the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to.⁴

The appropriate benchmark to judge a fiduciary's investment behavior is "an objective one" to be "measured against the standard of the investment industry."⁵ The focus of any prudence inquiry is what steps the fiduciary took before making the decision to act, and not whether the action succeeded or failed.⁶

The right inquiry, therefore, is whether the fiduciary, prior to making the challenged transactions, employed appropriate methods to investigate the merits of the actions to be taken. So the court must look to the time the fiduciary was making the decisions regarding the Funds, and not consider hindsight.⁷

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In evaluating an investment, a fiduciary is required to "examine the characteristics of [the] investment, including its risk characteristics and its liquidity, to ensure that it is an appropriate plan investment, and that it is in the best interests of plan participants."⁸ In this regard, courts interpret the prudent person standard to require that fiduciaries, at the time of the transaction, utilize proper methods to investigate, evaluate and structure the investment, act in a manner as would others who have a capacity and familiarity with such matters, and exercise independent judgment when making investment decisions.⁹

³ 29 U.S.C. § 1104(a)(1)(B).

⁴ 29 U.S.C. § 1104(a)(1)(C).

⁵ *DiFelice v. Fiduciary Counselors, Inc.* 398 F. Supp.2d 453, 467, 36 EBC 1193 (E.D. Va. 2005)(220 PBD, 11/16/05; 32 BPR 2551, 11/22/05)(quoting *Ulico Casualty Co. v. Clover Capital Mgmt., Inc.*, 335 F. Supp.2d 335, 340, 34 EBC 1171 (N.D.N.Y. 2004)(182 PBD, 9/21/04; 31 BPR 2169, 9/28/04)).

⁶ *Donovan v. Cunningham*, 716 F.2d 1455, 1467, 4 EBC 2329 (5th Cir. 1983), cert. denied, 467 U.S. 1251, 5 EBC 2056 (1984).

⁷ *Ulico Casualty Company*, 335 F. Supp.2d at 337-38 (internal quotations omitted).

⁸ *DiFelice*, 398 F. Supp.2d at 467.

⁹ *Katsaros v. Cody*, 744 F.2d 270, at 279, 5 EBC 1777 (2d Cir. 1984); *U.S. v. Mason Tenders District Council of Greater New York*, 909 F. Supp. 882, at 886, 19 EBC 1467 (S.D.N.Y. 1995); *Lanka v. O'Higgins*, 810 F. Supp. 379, 387, 15 EBC 2851 (N.D.N.Y. 1992).

The U.S. Department of Labor ("DOL") has promulgated regulations providing that a fiduciary must give appropriate consideration to those facts and circumstances that, given the scope of the fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment involved, including the role the investment plays in the plan's investment portfolio, and must act accordingly.¹⁰ The regulations explain that the "appropriate consideration" in this context includes, but isn't necessarily limited to:

1. A determination by the fiduciary that the particular investment 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, and 2. Consideration of the following factors as they relate to the portfolio:

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.

11

Of course, when reviewing the plan fiduciaries' investment process, part of that includes their engagement of the Investment Consultant, presumably an expert entity, to provide advice and recommendations.

The Investment Consultant will also be a fiduciary under ERISA subject to the same rules in its provision of investment advice to the plan. As such, the plan fiduciaries generally rely on the Investment Consultant to assess potential plan investments and provide information and opinions concerning the specific matters set forth above as part of their analysis of the recommended actions. This can be helpful evidence that the plan fiduciaries have acted prudently in ultimately investing the plan's assets based on the Investment Consultant's recommendation.

However, as the plan fiduciaries retain the ultimate discretion over plan investments and remain subject to fiduciary liability, they cannot blindly rely on the Investment Consultant's recommendation without themselves understanding and approving the particular investment or course of action.

Thus, before approving any investment, the plan fiduciaries should understand the structure of the investment (from a legal and investment perspective) and the material terms thereof. In addition, the plan fiduciaries should assess the information concerning the legal status of the investment product or manager under ERISA in relation to the plan, and the fees and expenses to be charged to the plan in connection with the investment.

If the proposed investment is either with a fiduciary investment manager or in an investment product that holds "plan assets" under ERISA, this information will be part of the required ERISA Section 408(b)(2) fee disclosure that must be furnished to the plan fiduciary prior to entering into the arrangement.¹²

The plan fiduciaries can request that the Investment Consultant assist them in this undertaking by providing

¹⁰ 29 C.F.R. § 2550.404a-1(b)(1).

¹¹ 29 C.F.R. § 2550.404a-1(b)(2).

¹² 29 C.F.R. § 2550.408b-2(c)(1).

a synopsis of this information to the plan fiduciaries in plain English. Furthermore, the plan fiduciaries can request specific, written recommendations regarding the investment and its specific features (i.e. its fees, structure, investment-related contract terms and guidelines, etc.).

Every conclusion that needs to be drawn by the plan fiduciaries under ERISA to finally approve an investment, including, but not limited to, its fees being reasonable, the arrangement being reasonable, and the overall investment being prudent, should be opined on by the Investment Consultant as part of the plan fiduciaries' process. However, the plan fiduciaries must keep in mind that the Investment Consultant is merely making a recommendation with respect to these matters, and that they have the final authority in connection with the proposed investment and the terms thereof.

Monitoring Recommended Investments

When assessing compliance with ERISA's fiduciary provisions, courts generally focus on the process followed by plan fiduciaries when making plan investments as opposed to the results of those investments. However, this does not mean that the fiduciaries' job ends after the investment is made. This is because the plan fiduciaries remain responsible for monitoring the investment to ensure that it continues to be prudent to maintain the investment.

Similar to the initial investment decision, the plan fiduciaries can rely on an Investment Consultant for assistance with the general monitoring of plan investments, and to report the relevant information to the plan fiduciaries in understandable language. However, as the plan fiduciaries retain ultimate investment responsibility, they again cannot merely blindly rely on the Investment Consultant without obtaining any understanding of their own.

The type and extent of the monitoring that must be done by the plan fiduciaries will depend on the type and structure of the particular investment. For virtually any type of investment, the plan fiduciaries will want to periodically confirm that the manager or product is continuing to operate within the appropriate guidelines or strategy that was set out when the investment was made. For a discretionary investment manager, this will likely be contained in the manager's agreement with the plan, while, for an investment product, it will likely be set forth in the product's offering documents or prospectus. In addition, the plan fiduciaries should know if any key personnel members in charge of the underlying plan investments leave the manager or product. Finally, the plan fiduciaries will want to measure the performance of the investment against the appropriate benchmark or index.

Often, plan fiduciaries will task the Investment Consultant with monitoring and reporting on this information for each investment. As with the initial recommendation, the Investment Consultant can provide the information and should also be asked to provide opinions and recommendations in connection therewith.

For example, the Investment Consultant should from time to time confirm whether the investment is operat-

ing pursuant to the relevant strategy, and opine the appropriate benchmark or index on which to judge the particular investment and whether the investment is performing satisfactorily relative to that benchmark or index.

However, the plan fiduciaries need to be sure to understand the information provided by the Investment Consultant, and the opinions and recommendations based thereon, so they can satisfy their independent fiduciary duties in connection with deciding whether to act in accordance with such opinions and recommendations.

Monitoring the Investment Consultant

As part of their retained investment authority, plan fiduciaries also retain the duty to monitor the Investment Consultant and any advice given thereby. As noted by the DOL, because the plan fiduciaries are subject to co-fiduciary liability, they need to be aware of the actions of other fiduciaries on behalf of the plan, including the Investment Consultant.¹³ This includes confirming that the Investment Consultant is acting in accordance with the plan's agreement with the Investment Consultant and performing the investment recommendation and monitoring services that it was engaged to perform.

In addition, the plan fiduciaries will want to assess whether the investment portfolio recommended by the Investment Consultant is consistent with the portfolio desired by the plan fiduciaries in light of the risk tolerance and other characteristics of the plan, and that the performance of the recommended investments is comparable to the relevant benchmarks or indices.

When assessing the performance of the Investment Consultant, the plan fiduciaries can review information provided by the Investment Consultant regarding its performance, but will need to make an independent assessment with respect to whether they find that performance satisfactory.

Conclusion

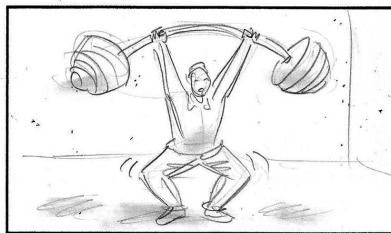
As with any other investment or fiduciary decision made by the plan fiduciaries, the steps taken by the plan fiduciaries to monitor the Investment Consultant, its recommendations, and the underlying plan investments should be documented in writing. This can generally be accomplished by requiring that the Investment Consultant furnish reports with the relevant information to the plan fiduciaries from time to time, and describing any relevant discussions in meeting minutes.

As noted, the general inquiry into the plan fiduciaries' prudence in the investment context involves the process that they used to make decisions; therefore, having clear documentation will serve as evidence of their prudence if questions are ever raised.

¹³ *Meeting Your Fiduciary Responsibilities*, U.S. Department of Labor, Employee Benefits Security Administration, p. 8, available at <http://www.dol.gov/ebsa/publications/fiduciaryresponsibility.html>.



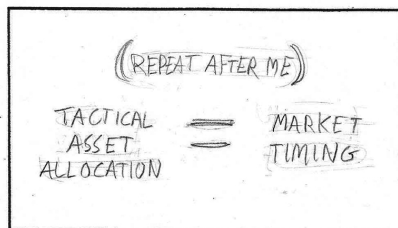
Nat's a trustee of a pension plan and as a full-time union officer he barely has enough time to shower



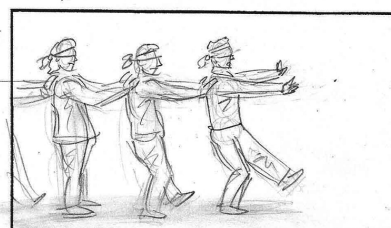
In his trustee position, Nat earns no money and is held to an even higher standard of performance



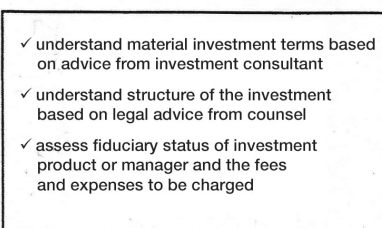
Nat knows enough not to go at it alone, so the plan hires an investment consultant to provide investment advice



Still, Nat cannot blindly rely on consultant's recommendation without understanding and approving the investment



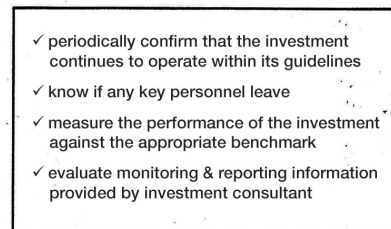
With no investment experience or knowledge, how can Nat evaluate the consultant's investment recommendations?!



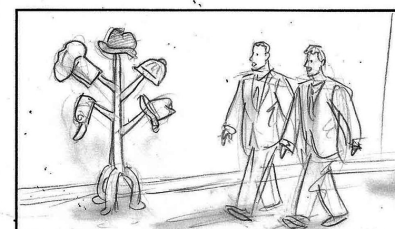
Nat should take steps to:



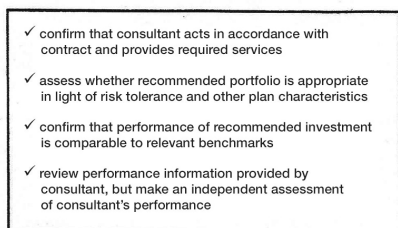
Nat is frustrated because he still remains responsible for monitoring the investment into the future



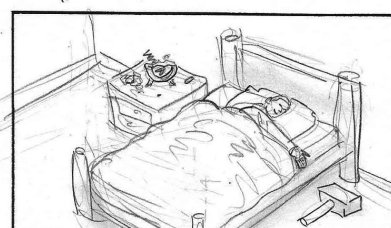
To monitor the investment, Nat will want to:



Nat's trustee responsibilities never end: he must also monitor the investment consultant



To do so, Nat will want to:



In case Nat's actions are questioned, the plan should have clear documentation of the investment process

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