THE FIDUCIARY SALE

E-version Edition

by

John Lohr and Ian Lohr

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Published by Isle Press

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INTRODUCTION

If your client is a fiduciary or in a fiduciary relationship such as an Employee Benefit Fund., Foundation, Personal Trust, or Plan Sponsor) there is no way the client can fulfill its fiduciary responsibility without your help.

Federal and state regulations mandate the hiring of investment management consultants.

In the following, you will see that a prudent fiduciary must have:

- Written investment objectives
- A time-tested process for investment selection
- A diversified portfolio
- A method of measuring success (portfolio monitoring)

We will take three steps to look at this conclusion.

1. Look at building blocks/laws, regulations, regulators
2. Case support (war stories)
3. Marketing suggestions (How to Use This)

Building Blocks

"Using ERISA—The Law is Your Friend"

The fiduciary sale can be an Investment Management Consultant's best friend. Anyone who is a fiduciary has significant responsibilities to those whose money they hold authority over, and they may or may not know it. The job of the Investment Management Consultant, in this area, is to help the fiduciary understand their responsibilities, and to pro-actively assist them in fulfilling these responsibilities.

A Discussion of fiduciary responsibility begs the question, “who is a fiduciary?” While this issue will be dealt with in much greater detail later on, for the time being a basic understanding of the concept of the fiduciary is essential. Someone has fiduciary responsibility when they are charged with managing, administering, advising to, or consulting to, a pool of assets, which is owned by someone else. Fiduciaries generally include trustees, investment advisors, CPAs, administrators, and investment management consultants.

Pools of assets subject to fiduciary duties and responsibilities include all employee benefit plans such as pensions profit sharing, welfare plans, 401(k)’s, IRAs, KEOGHs, all trusts, endowments, foundations, and many charities.

The regulatory laws and agencies, which relate to fiduciary responsibility, include:

- <u>DOL</u>

The Department of Labor regulates employee benefits plan through statute, regulation, audit and enforcement.

- <u>ERISA</u>

The Employee Retirement Income Security Act of 1974 is a Federal Statute, which applies to retirement and welfare benefit plans. It has specific provisions on Fiduciary Responsibility, standards of conduct of a Fiduciary and specific rules regarding the prudent investing of other people’s money.

- <u>State Regulators and Statutes</u>

Each state has adopted provisions, which control investment activities in that state. They are enforced by various department such as Banking, Commerce, Securities, etc. All investment advisors not eligible to register under the Federal Statute are required to register with State regulators. In addition, Federally registered advisors and their sales agents often have to file a "notice" filing as an Investment Advisor Representative (IAR) in at least their home State. State regulations govern State and local retirement and welfare funds, 403(b) plans, and common-law trusts, among others.

- <u>UPIA</u>

Most states have now adopted the Uniform Prudent Investor Act, which governs investments of private trusts. It generally mirrors ERISA, but has somewhat lower standards of care.

- UMIFA

The Uniform Management of Institutional Funds Act has also been adopted by many states. It governs the investment practices of endowments and foundations and applies slightly lower standards of care than the UPIA.

Herein, we describe the elements of Fiduciary law that mandate the hiring of a Investment Management Consultant to assist in the investing of the fiduciary plans described above, the underlying purpose is to assist those who are serious about doing the business correctly. There is a right way and a wrong way. This book will demonstrate the right way.

The first premise of the Fiduciary Sale is for the successful investment management consultant to make the following points to their clients:

That investing today is so complex, the clients cannot do it themselves

--and--

That the clients need the consultant's help

Presently there are far too many financial advisors out there intent only on capturing assets. There are more than 400,000 NASD registered representatives in this country, many of whom may not fully understand their duties with respect to fiduciary assets. This is the wrong way. Success in the fiduciary marketplace will belong to those consultants who properly address the needs of the fiduciary.

We expect the reader to understand that plan objectives must be in writing, investments must be made with the diligence of a prudent expert, managers should be prudently selected, plan assets must be diversified, and fund activities need to be monitored and evaluated.

This is, above all, a marketing piece—a training manual taken from articles, lectures and training sessions delivered to Investment Management Consultants all over the country over the past twenty years.

The ERISA regulations on the shelf will not offer much help in consulting to ERISA plans. A consultant needs to be aware of the requirements and duties prescribed by Congress in ERISA, and interpreted by the courts and the Department of Labor. Other regulations such as the UPIA and UMFIA

(which will be discussed later), state and local laws, and other policies also place demands on the fiduciary. These demands are also examined.

We will discuss the laws, courts' and regulator's interpretations, using a common language explanation of what all the regulations mean, with specific marketing suggestions as to how to use the material. In addition, certain responsibilities, duties, liabilities, penalties and do's and don'ts as set down by the law, and its interpreters, are given.

There are no absolutes, but what we offer is a prescription to assist you in helping your fiduciary clients to comply with legal and regulatory requirements. There are no guarantees; but if you do your job correctly, the client will have a greater chance of not violating their fiduciary responsibility. In this way, the consultant truly does a job for their client.

We begin with an overview of the regulations followed by the question of who is affected by the laws, what the standards of conduct are, liabilities and penalties and the specifics of investing employee benefit plans are examined. Diversification, manager selection, monitoring and evaluating fiduciary fund investment requirements are addressed.

More importantly, we will describe how each point may be used in presentations to clients and prospective clients. From the marketing perspective, after the Investment Management Consultant has mastered this material, learned the language of the laws, and attended training sessions in consulting to fiduciaries, they should be able to gain and retain clients by selling professional integrity using The Fiduciary Sale as a tool instead of a hindrance, so—use this information as the marketing tool it is intended to be.

BEGIN WITH ERISA

When the ERISA statute was segued into law by President Gerald Ford in 1974, it codified many basic principles of common law. While ERISA pertains strictly to private employee retirement and welfare benefit plans, it has long been held that money managers charged with investing someone else's money should not be expected to apply significantly lower standards to non-ERISA assets. So we use ERISA first as a proxy for any fiduciary sale.

In the 1990's, legislators drafted the Uniform Prudent Investor Act (UPIA) designed to apply principally to trustees of all other Trusts and their delegated agents who invest or manage trust assets. A state law, it has been adopted by most states since 1994. It essentially mirrors ERISA.

A 1972 act adopted by many states is the Uniform Management of Institutional Funds Act (UMIFA), which guides governing boards of eleemosynary institutions, particularly colleges and universities in investing endowments and other investment funds.

Each statute contains standards of investing and clarifications of what is accepted as prudent, but they range from the specific to the flexible.

ERISA STANDARDS

ERISA provides a federal standard of fiduciary conduct, which applies to all private employee benefit plans including retirement and welfare funds, including 401(k) plans. If a person exercises any authority or control over plan management or administration or over the disposition of plan assets or renders investment advice to the plan for a fee then they generally will be a fiduciary. If they have the authority to delegate this control to another party, then they will be regarded a fiduciary.

Each plan must be established and maintained in writing with designated "named" fiduciaries who have the authority and control to manage and operate the plan. A named fiduciary may appoint a registered investment advisor to manage a portion of the plan assets, which must be held in trust. Trustees manage or control plan assets subject to the direction of named fiduciaries or appointment of investment advisors.

In general, a fiduciary's duties must be discharged solely in the interest of plan participants and beneficiaries and for the exclusive purpose of providing benefits to the participants and beneficiaries. A fiduciary must make investment decisions with the care and skill that a prudent person familiar with such matters acting in a like capacity would use in a similar enterprise. Plan assets must be diversified in such a manner as to prevent the risk of large losses to the plan unless it is clearly prudent not to do so. Investments must be consistent with the plan documents and objectives.

Certain transactions between the plan and a party-in-interest, including service providers, the plan sponsor, union officers, members or agents, and officers, fiduciaries and employees of the plan are prohibited.

A breach of fiduciary responsibility results in personal liability on the part of the fiduciary including making good losses suffered, opportunities missed, or profits made by a party-in-interest.

Pools of assets subject to ERISA fiduciary responsibility provisions include most deferred compensation plans (whether qualified or not under federal tax law). Employee benefit plans such as pension, profit sharing, thrift and savings, stock bonus programs and employee welfare benefit plans such as medical, surgical, hospital care, disability, death or unemployment income plans, vacation, scholarship funds and prepaid services are all subject to the fiduciary standards dictated in ERISA.

In general, any plan, fund, or program in the private sector maintained by an employer or employee organization for the benefit of the employees falls into the category. State and municipal plans are not subject to ERISA, but are controlled by State statutes.

Any person with discretion, control, or authority over the administration or management of the above plans or plan assets generally will be a fiduciary. Generally, anybody who is involved in that plan, including under certain circumstances the attorney and actuary, is a fiduciary and has duties and liabilities. This includes the corporation, the owner, trustees, plan administrator, president of the union, principal shareholder, corporate officer, stockbroker, investment management consultant—all may be fiduciaries and have personal liabilities. In this respect, the fiduciary must act strictly within ERISA's guidelines or face civil and criminal penalties for any deviation.

There are five general standards of conduct set down by the ERISA regulations noted above. A fiduciary's duty with respect to the plan must be discharged:

1. Solely in the interest of participants and beneficiaries and the test, according to the DOL, is the individual plan participant. (Not the employee or union member or potential borrower.) But rather the fiduciary's duties must be carried out solely to provide secure retirement income or welfare for all individual plan participants. Plan participants have a right to monitor the activities of the fiduciary and the investments and the fiduciary has a duty of full disclosure and, as we will see later, that means more than just telling them how much is in the plan.

2. For exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable administrative expenses. Transactions

for benefit of other plans, trustees, parties-in-interest, or other fiduciaries are prohibited transactions.

3. Must be discharged in accordance with plan documents and instruments governing the plan. The plan must be in writing and should contain written investment objectives. The beneficiaries are dependent on proper determination of the fund's investment objectives. The trustees have a legal duty to establish these objectives consistent with exclusive purpose and solely in the interest tests. And further, the trustees have the right to rely on professionals to assist them and they have the right to pay them fair compensation.

4. Fiduciary's duties must be discharged "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."

This is the Prudent Expert rule. With respect to investments, the actions of a fiduciary (such as a trustee directing investments) require the competence of an experienced person, such as a professional investment counselor.

5. A fiduciary must diversify the investments of a plan so as to minimize the risk of large losses unless under the circumstances it is clearly prudent not to do so. ***In Dardaganis v. Grace Capital, (11EBC 2081), the money manager ignored the trustee's refusal to raise the percentage limitation on investments, and exceeded that limitation. The principal, Grace, was found to be personally liable as he signed on to personally oversee and manage the portfolio.***

I*n Laborers National Pension Fund v. Northern Trust Quantative Advisors, Inc., (17 EBC 2210) the money manager was hired to manage $170 million of a $1 billion portfolio. 6.5% was the fixed income component ($11 million) was invested in interest only bonds (I/Os). The fund guidelines said that:*

- ***Only holdings permitted under the prudent man rule were permitted***
- ***Bonds are limited to Federal or Agency or Corporate abb or better***
- ***No options, short sales, margin, letter stocks, private placement debt, commodities, venture capital, or foreign securities are permitted unless approved by the trustees***

- ***Diversification permitted mortgages as long as the goal is to preserve principle***
- ***The manager has full discretion***

The manager having established an account review committee considered the guidelines.

Since I/Os were not prohibited by the guidelines considering investments not in isolation but in the context of modern portfolio, the manager was found to be in compliance.

It fell to <u>GIW Industries v. Trevor Stewart, Burton and Jacobson,</u>(10 EBC 2290) to hold a money manager liable for not inspecting the investment objectives of a fund. Trevor Stewart invested 75% of GIW's portfolio in long-term government bonds. GIW knew of TSBJ's investment philosophy but hired them with no restrictions. No one at TSBJ read plan documents, knew the plan history, their cash needs or the demographics of the participants. When Trevor was terminated, they had lost over $700,000 and collected fees of $17,031.54. The court said TSBJ subjected GIW to too much market risk and liquidity risk and failed to diversify the investments. They were fined $537,000 and had to rebate their fees. In prudent investing, then, no risk may be too risky given the financial circumstances and demographics of the client.

A fiduciary will satisfy the prudent expert rule pertaining to investments if he considers action involved including how that investment fits the plan's objectives and the impact it will have in the plan's investment portfolio and then he has to act accordingly. This is an enormous burden. The Department of Labor says explicitly that a fiduciary's most prudent course of action would be to delegate those matters requiring specialized knowledge or expertise to a skilled professional.

ERISA requires that investment alternatives be analyzed according to five criteria. Investment alternatives must be analyzed to determine whether or not it is an appropriate investment in terms of its liquidity, diversification, return, security and other relevant economic factors in terms of the total portfolio. One must ask—

- What is the risk/return of investment
- How does it fit portfolio

- What is diversification of portfolio
- What is liquidity and current return of portfolio in relation to plan's funding objectives
- What is projected return on portfolio in relation to anticipated cash flow requirements

Once the asset class of the investment is determined, the fiduciary is obligated to seek the prevailing rate of return in a particular market consistent with the specific determined appropriate level of risk.

According to DOL personnel, a prudent fiduciary/employee investing other people's money and faced with alternative investments that involve equal degrees of risk does not accept a lower rate of return when a higher one prevails.

A Seattle Union's trustees were fined $74,000 for having all $9 Million of the plan assets in a local bank, paying slightly below market CD rates. The court said it was "too much risk"

Therefore, finally, there must be an objective standard for measuring the prudence of the investments judged solely on the basis of their economic value to the plan.

The Department of Labor says that monitoring the prudence of the investment is a two step process.

1. Funding and investment policies have to be determined and set down in written investment objectives.
2. The right managers to do the investing must be found.

The Department of Labor strongly urges fiduciary/trustee plans to improve the odds of providing better results by selecting managers. In fact it is mandated where the trustees lack the requisite experience to select investments with the expertise required by the law.

Actually, a substandard investment won't cause a breach of fiduciary liability as long as the trustees have prudent methods and standards of picking investment managers and alternatives. If the procedures are in place to evaluate and compare to other plans, other investments, other portfolios and indices, then whether or not one particular investment loses money is somewhat irrelevant. The DOL has established explicit minimum standards which a prudent fiduciary must follow in order to fulfull his fiduciary

responsibilities with respect to selecting, monitoring and evaluating and continuing the use of an investment manager.

Lastly, with regard to diversification, ERISA gives no fixed percentages for diversification, but each case must be considered in terms of its facts and circumstances including:

- Purposes of the plan
- Amount of plan assets
- Financial and industrial conditions (economic conditions respecting the investment)
- The type of investment
- Distribution as to geographic location
- Distribution as to industries
- The dates of maturity
- Composition of portfolio with respect to diversification of risk
- Volatility as measured by stock price movements
- Liquidity to meet payment demands
- Projected portfolio return measured by funding objectives

There is no maximum limitation on one single investment, though ERISA states a fiduciary should not invest an unreasonably large portion of a plan's portfolio in one investment. However, loans, real estate, limited partnerships, cash equivalents, bonds and speculative equities present particular problems and have been ruled on frequently. The governing standard of quality is the given risk parameters of the fund and how the investments fit as an aggregate.

The fiduciary is personally liable for breach or violation of these responsibilities. He is liable personally to restore lost profits. He is liable for the acts of a co-fiduciary if he even knows or should know of a violation by another fiduciary.

Under the prudent expert rule, he is personally liable for delegated responsibilities EXCEPT HE IS NOT LIABLE FOR THE ACTS OF A DULY APPOINTED INVESTMENT MANAGER (unless he did not act prudently in selecting or continuing the use of the investment manager).

Over the years, the courts have found liability on the part of the trustees in many situations, including the following:

- All investments were in regular savings accounts
- Investment was in an annuity when other contracts were offered at more favor able terms
- Loans were made when other investments with greater risk/reward balance are available
- Incorrect actuarial assumptions were made
- An incorrect income analysis was relied upon by fiduciary to make funding
- Improper investments were made in silver commodities
- The trustee was paid as a consultant
- Excessive fees were charged by the service provider
- The plan had no procedures for firing a manager
- The trustees improperly delegated investment discretion
- The trustees did not monitor the investments quarterly

In some of the above situations where improper investments were made, the plan lost its tax-exempt status.

To summarize, ERISA requires:

1. That a plan have written investment objectives
2. That selection of investment alternatives be made with the care and standards of a prudent expert
3. That risk/return appropriateness of investments be weighed and measured with regard to appropriateness of the plan
4. That economic, industrial, market considerations dictate asset allocation
5. That investment manager selection be made with the same prudent expert standards
6. That plan investments be diversified
7. That investments be continually monitored as to their position in the current marketplace, value compared to like investments, and value compared to other types of investments

8. That continual reporting and evaluation be available to the plan participants

UPIA INVESTMENT STANDARDS

We find that the Uniform Prudent Investor Act (UPIA) signed into law by most states as of 2003, sets slightly lower standards than ERISA.

Investments must be solely in the interest of beneficiaries. They must be diversified unless the trustee reasonably determines" that because of "special circumstances" the purposes of the trust would be better served without diversifying

Assets must be invested as a "prudent investor" would be exercising reasonable care, skill or control. While this falls short of ERISA's "prudent expert" provision, the use of the term "prudent investor" implies a higher standard than "prudent person". However, this provision can be modified (in either direction) by the language of the trust documents.

One charged with investing trust assets has to consider:

- The purpose of the trust
- The needs of the trust
- Costs of the investment
- Trust policies and objectives

Trustees are permitted to hire an expert such as a money manager or an investment management consultant as long as the delegation of investment management functions are those that a "prudent trustee of comparable skills could properly delegate under the circumstances". Money managers and investment management consultants are considered "special skills persons and have duties to use that expertise.

UMIFA STANDARDS

The Uniform Management of Institutional Funds Act (UMIFA), signed into law first in 1972,and currently adopted by many states, has still slightly lower standards of care. It applies state law definitions and requirements of fiduciary status and diversification and it differs state to state.

Under UMIFA, Trustees must exercise "ordinary business care and prudence" under the facts and circumstances prevailing at the time. Day to day investment management can be delegated to investment managers, but the institutions board remains responsible for the establishment of investment policies and the selection of competent agents.

Furthermore, investment considerations and powers are broader. An investing agent has to consider the long and short-term needs of the client and the anticipated resources and requirements, the expected total return on investments vs. price level trends and general economic conditions.

There have been some cases tried under the UPIA and UMIFA where executors, trustees or others have been found liable for investing improperly or failing to diversify by owning only one stock. For instance, in a case suit against Yale University, a donor made restrictions on a charitable gift, but Yale invested it along with other funds. The restriction did not have to be followed said the court "as long as the college's purposes were lawful." If it were an ERISA plan, the holding would likely have been different.

In the Wilde case from Maine an Executor was held liable because he imprudently invested in stocks and CDs.

And in the Atwood case from Oklahoma, a Trustee invested in one stock, and was liable because of the failure to diversify

Prudence Standards

A key case that established the prudence standards later incorporated into ERISA was the 1971 decision in:

Blankenship v. Boyle* (329 F.Supp., 1089) where trustees of the United Mine Workers were found to have breached their fiduciary responsibilities by letting substantial cash accumulate interest-free in a Union owned bank and also directed retirement trust funds to be invested in electric utility companies in order to give the Union proxy control, forcing the utilities to buy Union mined coal. Even though the beneficiaries' interests were clearly served because retirement contributions were directly related to Union mined coal, the trustees' investment activi**ties **were found to clearly advance the Union's interests first. The aid to the fund was only incidental to the Union enhancement. The court found the trustees' activities were clearly imprudent in accumulating excess cash and in directing investments not solely in the interest of participants.

Of the hundreds of ERISA cases supporting the "prudent expert" status, the following are key:

- ***The Prudence standard established a standard of conduct based on a measure of how prudent fiduciaries with experience dealing in a similar situation and familiar with administration of employee benefit plans would act, rather than how prudent lay persons would act***. Marshall v. Snyder (DC E NY, 8-21-79)

- ***ERISA standards or responsibilities imposed upon pension fund trustees are, as a matter of law, to be governed, interpreted and judicially determined both in the light of the common law of trusts and the special nature, purpose and intent of employee benefit plans. The trustees' prudence in determined by an objective test of prudence under surrounding circumstances on a case by case basis. The fact that trustees may have acted with good intentions or in good faith is no defense if their conduct did not meet the objective standard.*** Donovan v. Mazzola (DC N Cal, 11-17-81)

- A case which supports prudent practices by trustees is Donavon v. Walton. ***Charged with building a building for pension administration offices and the union and paying excessively for construction costs, not receiving rent from the union, the trustees were held not liable apparently because Judge Gonzales was satisfied that a prudent investment process was followed. The planning was diligent and the judge stated than an investment should not be arbitrarily judged on its success or failure. ". . .ERISA is concerned with the soundness of the decision to invest." The trustees provided a solid document trail of prudence: A building committee was formed to evaluate the investment program; extensive analysis with the research assistance of independent consultants was done as to the advisability of investing in real estate, independent studies on rental markets were obtained; their attorneys' advice was sought; professional engineers were hired and expert appraisals obtained; an economic review and a feasibility study were obtained from outside consultants; an independent real estate investment manager was hired to negotiate leases; and they met with their consultants on a frequent basis.***

Under these circumstances, the trustees' actions were "reasonable". Donovan v. Walton (#81-8281 CIV., DC S Fla) memorandum opinion by Judge Jose A. Gonzales, Jr.

HOW CAN AN INVESTMENT MANAGEMENT CONSULTANT USE THIS MATERIAL?

Since it is established that a plan has the right to pay for professional services and fiduciaries have a duty to employ professionals to assist in the investment process, there is a clear need for investment management consulting services by the employee benefit plan community.

Plans must have written investment objectives and the investments made must be in accordance with these objectives. If the company or trust is directing fund investments without professional advisors, they are charged with the ability to invest as if they were professional investors. The liability for improper investments is personal and stiff. If an investment manager is appointed, that selection process must be done with the same prudent standards as an investment. The fiduciary has oversight responsibility to monitor and evaluate investment performance and activities systematically on a comparative basis. Investments themselves must be diversified so as to avoid the risk of large losses. Evaluation of investments must be analyzed according to the risk versus return criterion.

ERISA requires the services of an Investment Management Consultant. It is inconceivable that all the duties, responsibilities and liabilities can be assumed by an individual fiduciary or group of trustees without hiring competent professional advisors to assist in the investment process. The trustee who does that runs substantial risk of incurring personal liability with an enormous burden he cannot possibly bear.

It is an enormous burden for the trustee or fiduciary to bear. While hiring an Investment Management Consultant, may not make their liability disappear completely, it will provide a comfortable layer of insulation for the trustee or fiduciary.

In order to effectively sell to the employee benefit marketplace, it is well established that the consultant who is not familiar with the language of ERISA and the specific requirements of employee benefit plans will not only be inappropriate to work this market, they will run the risk of personal liability as well. Managing ERISA assets is not for the financial advisor

who puts on their part-time consultant's hat and goes out to capture pension assets on the strength of their cold-calling skills. Rather the professional standards mentioned in the prior chapter take on increasing significance.

Certain facilities need to be available to the Investment Management Consultant in order to enable them to function professionally in the ERISA market. They must have the expertise and the tools to assist in drafting investment objectives, for this is the key function in the process. It cannot be accomplished without a working knowledge of the nature of all types of employee benefit plans. A Investment Management Consultant must be able to analyze and evaluate the objectives in order to determine appropriate investment alternatives including asset allocation, investment strategy style selection and manager selection. They must be thoroughly knowledgeable in different investment styles and with a variety of money managers within each style. They must have valid prior performance figures on the managers and be knowledgeable in regard to their adherence to the styles they profess to use. They must be equipped to do due diligence on the managers and have a quantitative as well as qualitative system of monitoring and evaluating each manager. The financial advisor who hands manager statistical sheets to a prospective ERISA client and tries to sell them on picking a money manager has no business doing fiduciary controlled business. Eventually, they will not; the regulators will see to that.

In order to capture fiduciary assets, the experienced consultant specializing in assisting fiduciary plans will be prepared to devote a long-time horizon to his growth. Only those financial advisors who are in it for the long run should enter the business.

Marketing is easy to structure after the requisite skills are acquired. It is simply an education processm by way of mailings, seminars, and well-placed articles. Once a plan sponsor, owner, fiduciary or trustee is aware of all the requirements he is charged with, there emerges only one prudent course of action. The fiduciary who does their job properly selects a consultant to assist them in the objective setting, manager selection, and monitoring and evaluating portion of the plan asset investment process. A consultant who has the resources, skills, and experience described herein will capture substantial assets by his integrity to the investment of employee benefit plan assets. Nothing less will suffice. Brokerage commission considerations must be secondary. This approach will be the one approach that will pay substantial dividends year after year.

WHO IS A FIDUCIARY? THIS IS YOUR TARGET MARKET

A common law principle, the concept of fiduciary duty applies to parties who deal with other parties money. ERISA set the standard in the following definition:

A fiduciary subject to ERISA's fiduciary responsibility provisions is defined as a person who--

1. Exercises any discretionary authority or discretionary control respecting management of an employee benefit plan subject to ERISA or exercises any authority or control respecting management or disposition of its assets

2. Renders investment advice for a fee or other compensation, direct or indirect with respect to monies or property of a plan or has authority or responsibility to do so or

3. Has any discretionary authority or responsibility in the administration of a plan. [Section 3(21)(A)]

Similar standards are applied by the individual States to non-ERISA accounts via the UPIA, UMIFA, and State common law.

Authority or responsibility in administration or authority or control over disposition of plan assets are keys to the interpretation of the law. Generally, to be a fiduciary there must be an element of authority either direct or implied. This becomes a question of fact for the court to determine. For example, it is unlikely that a person who is only a custodian of plan assets absent any control would be a fiduciary.

Trustees are vested with the responsibility for management of plan assets; they clearly are fiduciaries. A plan's officers and directors, members of the investment committee, fiduciaries "named" in plan documents, persons delegated fiduciary duties by "named" fiduciaries, persons who select fiduciaries—all of them fit the test. Someone who is authorized to perform these duties will be a fiduciary regardless of title. To the extent that plan consultants and advisors including accountants and attorneys influence or

exercise discretionary authority or control over plan management or investment of plan assets they are fiduciaries.

Purely clerical or ministerial duties like recordkeeping, reporting, processing, or disseminating information generally will not be enough to render fiduciary liability on a person absent the authority, discretion or control. The Plan Sponsor, corporate directors, officers, shareholders, and employees, however, are more likely to have the requisite control necessary to qualify as performing a fiduciary function. So, the company maintaining the plan, since it likely has discretionary authority (at least in a single employer plan), and any officer or employee who exercises discretionary authority on behalf of that company, is a fiduciary.

Members of a company's board of directors are fiduciaries to the extent that they perform fiduciary functions such as the selection and retention of other plan fiduciaries. The plan's sponsor (the Company) and its board of directors will be fiduciaries in virtually all single-employer plans. While the fiduciary responsibilities of the board members may appear to be limited to certain discreet matters, their status as fiduciaries may have broader implications with respect to co-fiduciary liability for prohibited transactions and breaches of the general duties.

While attorneys, accountants, and actuaries generally are not fiduciaries when performing their normal professional functions, if they advise on matters of plan policy or the advisability of certain investments, they may be considered a fiduciary. The law is becoming increasingly broadly construed.

Investment advisors are fiduciaries if they provide advice as to the value of securities or property or the advisability of purchasing or selling such property--AND--the advisor must generally have discretionary authority or control to purchase or sell. If the advisor renders advice to the plan on a regular basis with the understanding that his advice will be an integral factor in the investment decision-making process relative to the particular needs of the plan, then he will be a fiduciary. Note that Mutual Fund investment managers are <u>not</u> fiduciaries, as Mutual Funds are securities, bought and sold on exchanges, not controlled plans.

If the investment advisor is appointed to manage plan assets, trustees or named fiduciaries will not have co-fiduciary responsibility for acts or omissions of the advisor unless he knowingly participates in or tries to conceal those acts or omissions.

It is not only pension plans that are subject to fiduciary responsibilities, but welfare funds that provide medical, dental, accident, disability, death, unemployment or certain other specified benefits are all subject to the laws. Included are defined contribution, defined benefit plans, single employer, multi-employer, multiple employee, union collective bargaining plans and non-collective bargaining plans and, in the non-ERISA area, State and municipal retirement plans, other trusts, foundations, and endowments.

"THE UNKNOWING FIDUCIARY"

In his excellent article, "The Fiduciary Trap", noted ERISA authority the late Matthew McArthur, Esq., recounted the case of a company bookkeeper merely doing his job who was found to be a fiduciary of the company retirement fund because he was responsible for disbursing its assets. Under some financial duress, the company principals instructed the bookkeeper to advance fund assets to the company in the form of a loan. The loan significantly drew down plan assets so that the bookkeeper was unable to collect his own plan benefit when he left the company. When he sued for his benefit, the courts not only denied his claim, but held him liable for the improper loan. He was required to pay in the amount of the difference between the value of his benefit and the loan.

In defining the fiduciary duties of trustees, a self-trusteed fund defined their role as follows: "Without any question the firm is a fiduciary and each member of the Board of Directors (who hold management authority over the firm and the plan) is also a fiduciary. Any other firm employee is a fiduciary if he exercises or possesses any discretionary authority or responsibility in the administration or management or disposition of plan assets."

FIDUCIARY SUMMARY

To summarize, fiduciaries include, among others:

- Trustees
- Investment advisors
- Stockbrokers
- CPAs
- Officers of the company
- Owners of the company
- Directors of the company
- Plan administrators
- Investment management consultants

A fundamental factor in determining whether someone is a fiduciary or not is the client's reliance on what the party holds itself out to be.

Fiduciaries have to provide individualized investment advice pursuant to a mutual understanding (i.e. "Written contract with client) on a regular basis pertaining to valuations or recommendations as to investing, for a fee.

While ERISA has a provision that fiduciaries are required to acknowledge their fiduciary status in writing, failure to do so does not mean you are not a fiduciary. Non-ERISA venues do not have this provision. Courts have been eager to apply the "Duck" theory (although not actually by that name). If it looks like a duck, walks like a duck, smells like a duck, and acts like a duck, it's a duck. A fiduciary status will be defined by the actions of the party in question. Often, if the client relies on a party as fiduciary, it will be found to be one. In Blatt v. Marshall and Lasserman in finding an accounting firm to be a fiduciary because it controlled whether or not contributions were returned to plan participants, the court said that "ERISA fiduciary status is

determined by focusing on the function performed by the individual rather than on the individual's title."

WHAT THE COURTS SAY

Courts and regulators have been becoming consistently more liberal in their application of the question, "Who is a fiduciary?" Some things they have said about fiduciary status include the following:

- An employee benefit fund trustee is a fiduciary because they have "exclusive authority and discretion to manage and control assets of plan" and their loyalty is to the beneficiaries of the plan, not to the party who appointed them.

- Pension plan trustees are fiduciaries, but a bank acting only as depository for funds is not a discretionary.

- Attorneys who knowingly participate in breaches of duty committed by fiduciaries are also considered fiduciaries.

- Non-fiduciaries who aid fiduciaries in breach of duty are liable as if they were fiduciaries.

- An individual who was not a trustee, but who represented themselves as having such authority and control will be construed as a fiduciary.

- An insurance company may be fiduciary, because of its power to amend a group life insurance contract, altering its value

- An arrangement to pay pension benefits to one former employee creates an employee pension benefit subject to ERISA. James Williams worked 34 years for the Wright Pest Control Co. of South Carolina, Inc. Williams received a letter from WPCC's president, which described in detail a "plan, which will provide for an uninterrupted continuation of cash as you gradually alter your work schedule to a retirement status." The letter promised Williams, among other benefits, a monthly check in the amount of $500 and noted that "(t)hese benefits will continue until your death or when you have no use for them." The difficult question for the 11th Circuit was whether the payment of a $500 monthly retirement check to Williams created a "pension plan" within the meaning of section 3(2) of ERISA. The court held that an ERISA plan existed, due to the four factors necessary: (1) "intended benefits," (2) "beneficiaries," (3) the "source of financing" for the benefits, and (4) "procedures for receiving benefits.

- A stockbroker becomes a fiduciary when, without authorization, he invests the assets of an employee benefit plan in unsuitable.highly speculative securities and disregards the trustee's instructions to liquidate.

In Stanton v. Shearson Lehman, (7 EBC 1579), ***the court found a broker and her brokerage firm retained to handle fund assets to be an ERISA fiduciary. The firm can be directly liable for failing to exercise care and prudence in supervising and training its brokers should that failure cause a loss to an ERISA plan.***

The beneficiary of two retirement funds decided to self-direct them and opened two trading accounts with a Shearson account representative. The representative made investment recommendations to the beneficiary who then instructed that those trades be made. In 1983, $87,000 in commissions were paid and the trustees sued the firm and the broker for violating ERISA. The court ruled in favor of the trustees. If a broker executes transactions in accordance with trustee instructions with respect to investment recommendations the broker made, then this is sufficient authority and control over the management of the assets to warrant fiduciary responsibility.

A broker cannot become a fiduciary simply by executing transactions, but if the broker or a consultant makes recommendations, which may reasonably be believed to influence the investment of fund assets, then he will exercise the control to be held liable. If the broker is a fiduciary, then the firm is a fiduciary because it exercises control over the broker. So every brokerage or consulting firm retained to assist in the investment of ERISA assets is presumably an ERISA fiduciary. "It is reasonable to require such firms to exercise due care in training and supervising its employees assigned to ERISA accounts in order to guard against unauthorized acts by those employees in breach of ERISA."

Some not so obvious examples:

- An HR 10 plan if it covers both self employed and their employees.
- A collectively bargained vacation fund.
- Prepaid legal service.

- Group health, life and disability insurance plans.
- Apprenticeship and training plans.
- A collectively bargained vacation benefit account.
- A severance pay plan.
- A contributory hospitalization plan.
- Insured benefit program providing accident, medical and life coverage for less than 10 employees.
- Severance pay funds, under which certain employees would receive one week's pay for every year of service
- A non-contributory hospital benefit program for 4 employees
- Employee bonus program where cash is deposited into employee's IRA
- An employer's life insurance program under which the employer and participating employees split the premium costs.
- Group term life insurance and time loss benefits for disabilities.
- Financial assistance to an artist guild sick and relief fund.
- A relief fund that provides financial aid and other benefits to alleviate the financial hardship of a labor union's members in the event of sickness or death.
- A hospital's prepaid legal services plan which provides for both employer and employee contributions.
- A union death benefit fund.
- Guaranteed annual income fund.
- Death, disability and medical benefits for employees travelling on company business.
- Group insurance trust.
- Bond purchase plan.
- Dental benefits.
- Disability benefits.
- Collectively bargained severance program.

- Monthly benefits to employees retired on pensions with certain age and service requirements met.
- Union "remembrance fund" which provides burial expenses of $ 1,500 to union members.
- Association's contributory savings and security plan.
- Trust which makes monetary grants to industry apprenticeship and training programs established by employers and employee organizations.
- Bonus plan to key employees.
- An in-house confidential session with a psychological counselor who provides professional assistance.
- Welfare benefit plan for life and health insurance.
- Supplemental benefits to workers who meet certain requirements.
- Plan providing lump sum death and retirement benefits to current and retired fire department members.
- A production participation plan assigning royalty points to employees and making annual payments from property.
- An association formed to provide medical and medicinal services to its members.
- Medical, surgical, hospital care, sickness, accident, disability and death benefits for association members and union local.

The DOL, other regulators, and the courts can answer the facts of whom and what is subject to fiduciary responsibilities. If there are an employer and employees or employee organization and there is jurisdiction under the commerce clause under normal business activities, and benefits are provided to participants and/or their beneficiaries, the fiduciary responsibilities apply from Dr. Smith's four person KEOGH to IBM's pension fund.

HOW TO MARKET WITH THIS MATERIAL

Many classes of prospective clients who can employ the services of a consultant to assist in at least some facet of the investment process of employee benefit fund, trust, or institutional assets can be identified. Recognize that the regulations do not apply only to pension and profit-sharing funds, but also to state or municipal funds, trusts, foundations and

endowments. Anyone identified as a fiduciary is faced with potential liability problems concerning the investment of plan assets. All of these fiduciaries need to be educated as to their responsibilities and duties. It is not a matter of willful avoidance, but rather a matter of not knowing.

The consultant's job is to identify potential pools of assets by identifying a fund for the benefit of employees or another party or class of parties. That part is easy—you need only to look at employers. Potentially, any employer has a pool of assets in the class of employee benefits. A well-developed questionnaire or interview can find this out quickly. Once a pool of assets is discovered, there will be one or more fiduciaries in the form of trustees, owners, directors, shareholders, and officers. It is the fiduciary that the consultant needs to talk with. It is not difficult to find the fiduciaries since nearly everyone with authority and control will be in that category.

The consultant should point out to the person who has control and authority over plan assets that they have fiduciary responsibilities, what they are, what the penalties are for failing to meet these responsibilities and how the consultant can help relieve some of them. Think of yourself as Owens-Corning for fiduciaries.

One of the most effective attention getting lines I have heard a consultant use is, after identifying him/herself as a consultant specializing in employee benefit plans, stating that they assist such plans in reducing their fiduciary liability. Once a fiduciary is aware of the problem for possible violation, he will listen to someone who really can help.

The Fiduciary Sale, E-version 0-5.0995
Published by Isle Press
@Howling Wolf Enterprises, February, 2003
www.islepress.com