Fiduciary Responsibility
Under ERISA in an Evolving Marketplace:
The Importance of Process

Executive summary
What keeps fiduciaries up at night? For most plan sponsors, reducing the risk of liability and the exposure to lawsuit remains their highest priority. This white paper will seek to explore how plan sponsors can work with their advisors to construct a fiduciary risk management process to insulate themselves and their fiduciaries from concern and potential liability. We will examine the following topics:

• What the law says: An evolving standard for fiduciary responsibility
• What the courts say: Recent case law on fiduciary issues
• Upgrading the plan’s fiduciary process: Protecting your plan from liability

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For Plan Sponsor Use Only
When market risk becomes risk to your plan

Over the last 15 years, numerous shocks have roiled the domestic and international financial markets, including: the 1997–1998 Asian contagion, the Long Term Capital crisis, the burst of the dot com bubble, the subprime crisis, the 2008 market downturn, and the 2010 flash crash. These kinds of events will continue to add volatility to the financial markets.

Each time one of these events unfolds, the financial markets react precipitously. Many, if not most, plan participants have an emotional response: They tend to draw back from risk by reducing or eliminating their exposure to equities.

For investors recovering from the 2008 market downturn, even defined contribution default target date fund options — often billed as the only retirement investment you need — may still come up short. Part of the problem for older investors is that these funds were never designed to make up lost ground. Many Baby Boomers may not successfully retire at their current lifestyle.

Demographic trends are forcing plan sponsors to face this issue head-on. Consider that the Baby Boom generation, comprised of some 78 million people, is moving rapidly into a full retirement phase of life. Many have not prepared well. As this generation retires, the question becomes, “Will the Baby Boomers simply take responsibility for their reduced circumstances and live more modestly than they are now or will they seek to recover damages from the company and its fiduciaries?”

Plan sponsors, fiduciaries and participants are all concerned about market risk, but for different reasons. Plan sponsors and fiduciaries worry about lawsuits from participants. Participants are concerned that they will not have enough income and assets to retire comfortably. Plan sponsors and fiduciaries can help to allay both concerns by having a prudent fiduciary process in place. A sound process can fulfill two functions. It can help ensure that participants have the tools and investment options they need to invest successfully, and it can protect the plan sponsor from legal liability.
What the law says: An evolving standard for fiduciary responsibility

We will begin by examining the statutory responsibilities of plan sponsors and their appointed fiduciaries, as defined by evolving law and regulation. We will discuss how this standard has shifted over the last several decades, from “buyer beware” to the current Employee Retirement Income Security Act (ERISA) Fiduciary Standard of Care.

Caveat emptor, or “buyer beware”

In the earliest days of the investment industry, fiduciary responsibility was limited. Investors were expected to rely upon their own wits to determine whether an investment was right for them. But as the financial world evolved, stricter standards were set.

Suitability standard

Under the Securities Exchange Act of 1934, Congress held brokers to a “suitability standard of care.” That is, brokers were required to make suitable recommendations, though the client still ultimately had the final authority for all decisions. The “suitability” obligation to the client ceased once the transaction was completed.

Best interest standard

Six years later, Congress passed the Investment Advisers Act of 1940 and held Investment Advisors to a “best interest standard of care.” The Investment Advisor had to act in the best interest of the client at all times and, generally, had a continuing duty to monitor and advise the client regarding performance and material factors affecting the client’s investments.

ERISA standard of care

In 1974, Congress enacted ERISA, further defining the responsibilities of fiduciaries entrusted with retirement assets. ERISA Fiduciaries were subject to ERISA’s “fiduciary standard.” They were required to act solely in the interests of plan participants and beneficiaries at all times. According to the U.S. Department of Labor (DOL), ERISA’s obligations are among the “highest known to law.” ERISA is unambiguous in what it requires of fiduciaries: They must act to protect the plan participants’ interests. Fiduciaries under ERISA have certain duties and responsibilities:

- **Fiduciaries have a duty of loyalty.** They must put the interests of plan participants and their beneficiaries not just above their own. They must operate not just in the best interests of plan participants and beneficiaries. They must act solely in their interests. If corporate officers sit on the investment committee, as fiduciaries, they do not serve two masters; they must act solely in the interest of the plan participants and their beneficiaries. We will see later in this white paper what happens when fiduciaries breach this duty of undivided loyalty.
• **Fiduciaries have a duty of prudence.** They must act prudently in all matters relating to the plan. According to the courts, the standard is that of the care, skill, prudence and diligence of a *prudent expert*. Fiduciaries must do this not just at the time when investments are selected but *all the time*. The prudence standard applies to the monitoring process and certainly to the removal and replacement of investment options.

• **Fiduciaries have a duty to diversify plan assets.** The purpose of diversification is to both grow and protect plan assets. In a 401(k) plan, it is not sufficient merely to have several different investment options representing ostensibly different asset classes. The duty to diversify is once again not just a point in time but rather a process over time. Investment options must be monitored to ensure that portfolio drift and overlap are minimized. That monitoring process should include a returns-based analysis for continuously re-evaluating investment funds. Most plan investment policy statements will speak to a quarterly monitoring process, but if markets become volatile, a special meeting of the investment committee may be warranted.

• **Fiduciaries not only have affirmative responsibilities, they also have certain clear prohibitions.** They must not engage in *prohibited transactions*. These are transactions with related parties, referred to as *parties in interest*, and include transferring plan assets, selling or leasing property, lending money or extending credit. Transactions with parties in interest are prohibited under ERISA given the potential risk that they may not be truly made at arm’s length, or not entered into solely in the interests of participants and their beneficiaries. There are statutory exemptions for certain common, normal course of business scenarios. The DOL also issues class exemptions that allow certain types of transactions subject to various conditions, requirements and disclosures. In addition, a plan can seek an individual exemption from the DOL for a particular transaction.

• **A fiduciary must always avoid any transaction that involves self-dealing.**

  Self-dealing is always a *per se* prohibited transaction. Self-dealing is never the subject of an exemption and is always a violation of the duty of loyalty.

**Defining fiduciaries in your plan**

Now that we’ve discussed the role and responsibilities of fiduciaries, we must turn to an equally important question: Who exactly are the fiduciaries in your plan?

Certainly plan trustees are fiduciaries. Most companies have established investment committees and appointed both corporate officers and other employees to serve as investment committee members. Many times, a human resources director will be appointed to serve on the retirement plan investment committee. After the Enron case, it became clear that those who appoint fiduciaries are themselves fiduciaries. They have an ongoing responsibility to make sure the persons appointed continue to be a prudent choice. So in this way even the board of directors may be such a fiduciary. A plan administrator will be someone who is appointed to take discretion over the administration of the plan — *this is not a third-party administrator that is simply providing services*. A ‘40 Act Investment Manager hired by the plan would be a fiduciary under ERISA Section 3(38).
Appointing fiduciaries and other ways to limit liability

Under ERISA Section 3(21), a person is a fiduciary to the extent that he or she:

- Exercises discretionary authority or discretionary control over management of the plan or the disposition of its assets
- Renders investment advice for a fee with respect to plan assets
- Has any discretionary authority or responsibility in the administration of the plan

Fiduciaries include both natural persons and business entities such as banks and Investment Advisors.

Advising fiduciaries: Since most plan sponsors and their other fiduciaries do not want to give up control over the plan’s investment process, they will hire qualified investment advisors as ERISA Section 3(21) Advising Fiduciaries to render investment advice to the plan fiduciaries and/or the participants. The decision to act (or not act) on this advice remains with the plan’s “named fiduciary” or the participant. The plan can alternatively appoint an ERISA Section 3(38) investment manager to take discretionary authority and control over specific plan assets and/or the whole process of selecting, monitoring and replacing investments. Plan sponsors and other plan fiduciaries can never entirely eliminate or delegate away their fiduciary oversight role. Plan fiduciaries always retain the responsibility to monitor, assess and, if need be, remove and replace, other appointed fiduciaries.

Directed trustees: The plan document can also require a directed trustee to follow the instructions of a named fiduciary under the plan. The trust agreement might permit trustees to allocate duties among themselves and so limit their responsibility. ERISA Section 404(c) offers fiduciary relief by shifting responsibility to the 401(k) participants as long as the plan meets various requirements including providing participants with sufficient information to make informed investment decisions.

More recently, the Pension Protection Act allowed plan sponsors and other fiduciaries to avoid liability if the participant chose a qualified default investment alternative (QDIA). When the participant makes no choice, the plan can make investments such as target date funds the default option. Again, liability is limited by ERISA Section 404(c).

Accidental vs. intentional fiduciaries: The DOL defines the fiduciary role broadly and seeks to prevent even the most temporary or casual of advisors from escaping these responsibilities. For example, under a proposed definition of a fiduciary, it will be sufficient to provide advice even once and have this advice merely considered in making investment decisions. The result is that many investment advisors and brokers will be found to be fiduciaries, although accidental fiduciaries, under this proposed rule. The problem with accidental fiduciaries is that they lack process. Becoming a fiduciary under ERISA should always be an intentional action — the person is cognizant of his or her duties and responsibilities and has established a process to meet these fiduciary obligations under the law.

Advisors acting as Section 3(21) Advising Fiduciaries have become fiduciaries on purpose. As fiduciaries, they know what the rules are and construct their business model accordingly — prudence is a matter of process. As fiduciaries, they have a process, they document their actions and make sure that the plan sponsor dots the i’s and crosses the t’s of the plan’s own prudent process.
**What the courts say: Recent case law on fiduciary issues**

Over the years, there have been numerous lawsuits involving retirement plans in which the fiduciaries failed to fulfill their responsibilities under ERISA. We will examine a few because these cases can be instructive both in focusing on the violations themselves and in creating a process that will ultimately prevent these problems from developing.

**Emphasizing prudent process in investment due diligence**

*Martin vs. Tower Asset Management* involved a large asset pool and several trustees who acted as the fiduciaries for this plan. According to the facts, the fiduciaries had failed to pay close attention and execute against their responsibilities under ERISA. The resulting losses not only prompted lawsuits against the 3(38) investment manager, but the DOL also sued the trustees. This case, like many others, is about a failure of process. Specifically the fiduciaries *failed to prudently select and monitor the investment manager.*

The real importance of this case is that it represented one of the first times that the DOL provided a detailed analysis of what it expected from plan sponsors and other fiduciaries. When the DOL sued the trustees, instead of going through the full litigation process, the DOL and the trustees for the plan reached a settlement.

This settlement document provided a detailed description of the specific criteria for investment manager selection and the importance of an investment policy. It went on to detail what it expected in a prudent investment monitoring process. Finally, it explicitly required a year-end review and defined a process for demonstrating that an investment continued to be prudent. Many fiduciaries have used this settlement document to guide the development of their own prudent process.

Another case, *Donovan vs. Cunningham,* also highlights the importance of process. The Federal Court of Appeals in this case ruled that the heart of the matter was the fiduciaries’ methodology for prudent selection. This case established focus of judicial review. The Court stated that the test of prudence “…is one of conduct, not a test of the result of performance of the investment.” In other words: *Was there a prudent process in place for selection?*

Advisors can help plan sponsors establish and maintain this prudent process, using the guidelines established in *Martin vs. Tower Asset Management.* This will protect the plan sponsor and other fiduciaries.

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Forbidding conflict of interest

In addition to establishing a prudent process, plan sponsors and fiduciaries must demonstrate that they are putting their participants’ interests first, ahead of the company’s and their own. One of the earliest cases defining ERISA responsibilities relating to company stock within a plan, commonly known as stock drop cases, was Enron.¹

These stock drop cases typically allege that the executives continued to tout the companies’ stock when they had full knowledge that the fundamentals did not support the stock valuations. These suits are often filed as class action lawsuits, meaning that the suits were brought on behalf of all plan participants based on the same facts and the same claims.

The attorneys in ERISA class action stock drop lawsuits all make similar allegations: The fiduciaries for these plans failed to execute against their obligations and duties under ERISA. The problems identified by the various plaintiffs’ attorneys showed that the fiduciaries were not playing by the rules. The problems included a lack of prudence, a failure to diversify and a failure to monitor, as well as various accounting failures.

In order to successfully shift liability for losses to participants in a participant-directed plan, the plan must provide participants with sufficient information to make informed investment decisions. As a result, lawsuits generally also alleged that there was a lack of sufficient information under Section 404(c). If a plan failed to provide sufficient information under ERISA Section 404(c), its statutory defense would collapse. Fiduciaries could instead be found to be personally liable for losses in participant-directed accounts.

In addition, in these stock drop cases, the corporate officers who were acting as plan fiduciaries had a conflict of interest. Many of these corporate officers felt that they were restrained under the SEC insider trading rules from disclosing material information about the state of the company. They had a duty to the plan and a duty to the company. They felt that the duty to the company took precedence.

The DOL files an amicus brief (friend of the court brief) in those high-profile cases where it feels it can help the judge make a better decision. The DOL Amicus Brief in the Enron case makes several things clear:

• ERISA’s obligations are among the “highest known to law.”

• ERISA is unambiguous in what it requires of fiduciaries: They must act to protect the participants’ interests.

As Investment Advisors take on a 3(21) Fiduciary role in plan relationships, they must keep in mind that good intentions are not sufficient. ERISA requires fiduciaries to act to protect the interests of participants and their beneficiaries. Advisors acting as 3(21) Fiduciaries know they must execute their responsibilities under ERISA by taking appropriate action each time it is warranted.

³ Tittle v. Enron Corp. (No. H-01-3624, S.D. Tex.)
Ruling on excessive fees

Long before the DOL issued its various fee disclosure regulations, many large corporations were targeted by another wave of class action lawsuits. This time the focus was excessive fees and improper revenue sharing.

These excessive-fee suits alleged that plan sponsors and other fiduciaries failed to satisfy their fiduciary obligations under ERISA; they had not developed an ongoing process for determining whether plan fees are reasonable in light of the services provided.

Determining reasonableness of fees has been the explicit fiduciary obligation under ERISA Section 404(a)(1) since 1974. Once again the excessive-fee class action lawsuits have common themes. Some of the issues identified by plaintiffs’ attorneys in these excessive-fee class actions include:

- Fees and expenses were and are unreasonable and excessive
- Failure to exercise the care, skill, prudence and diligence of a prudent person
- Failure to monitor and control plan expenses, including hard dollar payments and indirect fees
- Failure to implement procedures to properly determine if fees were reasonable
- Failure to timely disclose conflicts of interest

An Advising Fiduciary can play an important role in helping the plan sponsor establish an oversight process for benchmarking investment fees and reviewing revenue sharing arrangements. Plan sponsors do not have to choose the least expensive options — rather they must ensure that fees are and continue to be reasonable in light of services rendered.

Holding administrators accountable

In another case called La Rue, a participant experienced a loss due to administrative failures. The lower court found that any recovery would need to benefit the plan as a whole. The U.S. Supreme Court, however, overturned the lower court and set a new precedent: Participants could mount legal actions to recover losses to their own individual accounts.

Making sure that investment policies are diligently followed

We can see from other cases that plan sponsors can fall severely short on proper policies and procedures. A prime example is having an investment policy but not following it. The investment policy statement (IPS) is the central governing document for the plan sponsor and other fiduciaries. When the plan fiduciaries do not follow this stated process the plan sponsor and the plan fiduciaries are in breach of their ERISA responsibilities. Plan fiduciaries must act prudently when they follow the criteria set forth in the IPS for investment fund selection and removal.

Also, selecting and retaining more costly classes of investments when other less expensive classes of the same investments are available and selecting share classes that provided more revenue sharing to defray per participant hard dollar charges have been determined to be a breach of fiduciary duty. Revenue sharing and cost are part of the decision but they are not the driver.
A 3(21) Advising Fiduciary can be the prudent expert that the plan has hired. Advising fiduciaries:
• Provide services to evaluate and make investment recommendations
• Provide proper analytics for performance and portfolio reviews
• Help ensure that the plan sponsor and its other fiduciaries have a prudent process
• Also help ensure against portfolio drift, overlaps and duplication among the underlying holdings in an investment option

A 3(21) Advising Fiduciary must operate intentionally. This means that it must establish policies, procedures and proper documentation for all investment consulting fiduciary relationships.

Implications of recent court rulings

Many times, court cases are important not so much for the particular facts but rather for the broader implications of a ruling:

Court holdings
• A fiduciary’s lack of experience is not an excuse.
• The standard is that of a prudent fiduciary with experience — a prudent expert.
• Fiduciaries have a duty to seek independent advice if they lack experience.
• Courts focus on fiduciaries’ conduct in investigating, evaluating and making the investment.
• Fiduciaries have a continuing duty to monitor investments.

Consequences
• Fiduciaries can be found personally liable for losses and lost opportunity costs.
• Reasonable attorney’s fees may be awarded.
• Courts can also require that fiduciaries cease certain conduct or modify the way a plan or its service providers operate.
• Civil action may be brought as a plan class action or individual participant lawsuits.
• The DOL may also sue and impose fines and penalties.
Upgrading the plan’s fiduciary process

We have discussed the current legal environment for fiduciaries, as well as a number of recent court cases that further define their roles. We now move to steps that plan sponsors can take to improve their fiduciary oversight.

We must start by recognizing that most plan sponsors and their other fiduciaries have little time or inclination to manage a rigorous fiduciary process. Still, a haphazard approach can be as bad as none at all. Poor implementation can result in litigation and, if successful, very substantial monetary damages.

It is clear that plan sponsors must develop a much tighter fiduciary process:

• Fiduciaries must prudently select and remove investment options.
• Fiduciaries must follow the plan’s investment policy statement.
• Fiduciaries must monitor plan fees.
• Plan assets cannot be used to subsidize other plans.

Fiduciaries must act prudently when they select and remove investment options. All investment decisions must be made solely in the interest of plan participants and beneficiaries. Prudence must drive all decisions. Revenue sharing and fees are certainly a factor but not to the extent of creating a conflict of interest. Fiduciaries have a singular duty of loyalty.

Fiduciaries should review, and revise if necessary, the IPS at least annually, to ensure that (1) their fiduciary actions are consistent with the stated policies set forth in the IPS and (2) the IPS is up to date and reflects both the plan sponsor’s intent and the new regulatory environment.

The IPS should be complete and cover a range of plan governance issues in line with ERISA’s fiduciary responsibilities. At the same time, however, plan sponsors should also make sure that the IPS is not so detailed and restrictive as to cause unintended liability.
The fiduciary rules also require reasonable contracts between employee benefit plans and the service providers performing services for the plan. The new DOL service provider fee disclosure rule is structured so that furnishing services to the plan will be a prohibited transaction unless these three criteria apply:

- The contract is reasonable.
- The services are necessary.
- No more than reasonable compensation is paid for these services.

The rules from the DOL also require that, for a service contract or arrangement to be reasonable, the service provider must disclose specified information to a “responsible plan fiduciary.”

Plan sponsors and other fiduciaries need to remain vigilant by developing an ongoing process for determining whether plan fees are reasonable in light of the services provided, and thoroughly documenting the basis for all investment decisions. A fiduciary must operate solely in the interests of plan participants at all times and can never use plan assets for the benefit of anyone but the plan participants and their beneficiaries.

**Make the right choice**

Some plan sponsors and fiduciaries find that they require outside advice and guidance in managing their fiduciary responsibilities. Indeed, they may wish to name an outside fiduciary to assist in certain aspects of their plan. A Section 3(21) Advisor can assist plan sponsors in implementing a prudent process which might include:

- **Annual review of fiduciary appointments:** Remember anyone who appoints a fiduciary is a fiduciary as well and therefore must review, re-approve or remove and appoint new fiduciaries.

- **Training fiduciaries and the benefits committee:** Fiduciary training is a way to keep appointed fiduciaries focused on their responsibilities and duties under ERISA.

- **Annual review of written investment policy:** The IPS must be a living document.

- **Quarterly reviews:** A prudent investment monitoring process.

- **Periodic investment committee meetings:** The IPS may speak to a quarterly investment committee process, but as an alternative, using the word “periodic” allows flexibility if quarterly is not always warranted.

- **Documentation of all processes:** Documentation demonstrates that the fiduciaries are following a prudent process. This documentation is the first line of defense in the case of a lawsuit or a DOL audit or enforcement action.

- **Creating and maintaining a fiduciary audit file:** A DOL Audit generally starts with a letter of notification setting a time, place and date for an audit and requesting various documents in advance including the last three years of 5500 reports, the latest plan valuation, the IPS, the minutes from the committee meetings, the plan correspondence file and the service provider contracts.

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5 If the plan sponsor has a service agreement with Bank of America Merrill Lynch for Defined Contribution Investment Consulting (DCIC) Services, Merrill Lynch will accept ERISA 3(21) fiduciary responsibility for the investment advice provided through DCIC. Merrill Lynch will stand behind their recommendations, which are backed by the investment screening process of Merrill Lynch’s Global Wealth Management Investment Management & Guidance group.
**Working toward peace of mind**

Working with Bank of America Merrill Lynch offers a number of compelling advantages, including:

- Bank of America Merrill Lynch offers plan sponsors the opportunity to tap into robust financial knowledge and experience through a service offering called Defined Contribution Investment Consulting (DCIC).  

- Through DCIC, plan sponsors have access to a group of highly credentialed and specialized Merrill Lynch Financial Advisors who can work with plan sponsors to help make their DC plan investment offering more efficient and valuable through a suite of services that will provide the foundation for helping plan sponsors establish and maintain a disciplined fiduciary risk management process. It is this process that helps to protect the plan sponsor and other fiduciaries and includes:
  - The Defined Contribution Investment Policy Service
  - Assistance with investment menu design based on plan needs and participant demographics
  - Initial and ongoing recommendations for investments and investment replacements
  - Quarterly performance monitoring and reporting

Under the DCIC service platform, Merrill Lynch will accept ERISA 3(21) fiduciary responsibility and stand behind its investment recommendations and the comprehensive investment screening process of Merrill Lynch. We believe that putting the expertise of a specialized DCIC Advisor to work for your plan is a smart solution to help you meet your fiduciary responsibilities.

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**For more information**

*For more information about how Bank of America Merrill Lynch can help you meet your plan fiduciary responsibilities, contact your Bank of America Merrill Lynch representative by calling 1.888.550.7705, or visit www.baml.com/consulting.*

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6 Bank of America Merrill Lynch’s Defined Contribution Investment Consulting Service is available to our full service and non-record-kept plans who meet certain eligibility criteria. Although Bank of America Merrill Lynch and its representatives will provide investment advice or recommendations on a non-discretionary basis with regard to qualified retirement plans, all decisions about qualified plans, including which investments to offer under a qualified retirement plan, are to be made solely by the plan sponsor.

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