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Sponsors' Risk Management and Fiduciary Risk

Track: Pension

Moderator: DANIEL P. CASSIDY
Panelists: DANIEL P. CASSIDY
MICHAEL M. C. SZE

Summary: This session explores current practices and techniques that plan sponsors use to address the risks associated with the exercise of fiduciary responsibility. Attendees gain a better understanding of some of the issues that plan sponsors face and discuss the tools that can be used to monitor and manage exposure to risks and uncertainty

MR. DANIEL CASSIDY: Mr. Sze will provide a global perspective of fiduciary standards, and I'm going to focus more on the U.S. viewpoint and recent developments.

MR. MICHAEL SZE: When we talk about fiduciary responsibility and all the litigation and possibility of penalties, we should put it in perspective and think about what would happen if there weren't such structures. I just came back from Egypt not so long ago, and luckily that gives me a very good example to look at. In Egypt, there are 60 million people with 600 pension plans, "defined benefit pension plans," but you wonder whether they are defined benefit or not. Number one, most of the plans, 90 percent, are completely sponsored and completely paid for by employee contributions. Number two, if the plan is underfunded, it's not a problem; they cut benefits or increase contributions. So the sponsor has no obligation whatsoever.

So, given that backdrop, a lot of plans are underfunded. I completed a survey using data that was about one or two years old; Egypt has a requirement of three-year

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valuation cycles.

On that basis, there are about 15 percent, one-sixth of the plans, that are underfunded by 50 percent. When you think about it that way, without all the structures that we have, what is going to happen? Do we still consider them to be defined benefit or defined contribution plans? Is there any retirement security at all? So Egypt is quite far away; it's almost halfway around the world. Let me go not so far away, to Canada.

In Canada, a lot of the multi-employer plans are not covered by the Pension Benefits Guaranty Fund (PBGF), so there's no equivalent of the PBGC.
What will happen if those plans are underfunded? You either increase the contribution or decrease people's benefits. Actually there are about 60 multi-employer plans in Ontario, of which quite a number have problems. Three of the multi-employer plans are so underfunded it's unbelievable, and one, United Cooperative of Ontario, is under litigation. What happened? Not so long ago that plan was fully funded. From the three years before the year 2000, all the other pension plans were making lots of money; everybody was earning 15–20 percent return. The people from United Cooperative are very smart. They want to hedge using derivatives. So they are one of the few plans that are not making money, but losing money in good years, and then you have the bad years. What happens now? You have $120 million in liabilities, with $64 million in assets. For multi-employer plans, what is the remedy? They either increase contributions, which they cannot do so easily, or decrease benefits. You are talking about some of the retirees being asked to cough up money because their situation has been going on for so long. For example, if you retired one year ago when you were given full benefits, now you should get only 50 percent of the benefits and cough up the 50 percent that you have been getting all last year.

Some of the other people are getting notice that their benefits are going to be reduced by more than 50 percent. One man's benefit was reduced 70 percent for various reasons. If that is the case, no wonder they should sue the company, sue the trustees and sue everybody in sight. Realistically, if you don't have any of these fiduciary responsibilities and governance structures, it's very dangerous. I know that we sometimes feel that it is potentially quite risky even for the agents who work for these fiduciaries. The flip side, I believe, is intolerable. I agree with the legislature that these structures have to be there. It's a matter of how we cope with it.

What are the major risks for the fiduciaries? What we want to talk about is the fiduciary responsibilities and therefore the personal liabilities for all the people who are involved with fiduciary responsibilities. If you're underfunded in the United States and Canada, you have to make a sizable increased contribution. If you're underfunded on a plan termination basis, then there are even more stringent contribution requirements, as well as additional premiums to the PBGC or PBGF, depending upon where the legislation is.

Who is a fiduciary? What are the principal responsibilities of a fiduciary toward a defined benefit plan? There are three things involved. First of all, he or she has discretionary authority. Secondly, the fiduciary can take action. Thirdly, whatever action the fiduciary takes would have an effect on the person that he or she is working for. Those three criteria are always used, whether it's the United States or Canada. Who is a fiduciary? First of all, the fiduciaries are the company's board of trustees or pension committee. The fiduciary responsibility could also extend to the agents who are working for the fiduciary.

What should the person do? As always, you should exercise care and prudence, and you should have the skills to do it. If you don't have the skills to do it, then you should hire someone who does. As always, the criterion is that it is the interest of the person that you're a fiduciary for that you should work for. It is not your own interest; it is the best interest of the other person.

What are the standards that should be adhered to? The standards are loyalty, no conflict of interest and you should not think of self-profit first. You should think of the other person first. Now, because no person is perfect or perfectly knowledgeable, you want to delegate some responsibility to others, but the most important criterion to remember is that you can delegate the work, but not the responsibility. That criterion should always be in the minds of the people who have fiduciary responsibility.

Let's look at a case. There is a case in the United Kingdom of the Mine Workers Pension Fund. It has joint trustees—half from the board and half from the workers. So now come the investments. The mine worker says, "We don't want you to invest in off-shore industries that compete with us." There is a conflict here between what is the best investment policy for just that plan and whether it is in the best interest of the workers. Often the argument was that you have to take into account the interest of the workers, not just the plan itself.

What are the penalties? You have all heard of the statutory penalties. There are the penalties in Canada, which are kind of small compared to penalties in the United States, but still there are penalties in Canada. But more importantly, there are common law penalties that if there is harm done you have to rectify it, and if you profit from it, you have to cough up the profits. When would fiduciaries be liable? They would be liable if they participate or otherwise cause some offense to be done. In Canada they go one step further. If you don't prevent the cause of such events, then you're liable. I hope that that will become more and more prevalent. As a fiduciary, you want to make sure that no wrong things are done. That should be one of the criteria.

Let's talk about the Enfield case in Canada. They have in-house money managers, and of the $35 million fund, they have $13 million invested in company stock. First of all, it violates Canadian investment rules, which say you should invest no more than 10 percent, but apart from that, this is clearly not diversified. What happens is

if the company is having trouble, then the retirement security is also in trouble. It’s a double whammy for all the participants. It's no wonder that three of the members of the pension committee are charged. What are the tools that a management can use? Of course, there is insurance that you can buy, but what is insurance? Insurance is coverage after the fact, after some wrongdoing has been done.

What I think we should be talking about in terms of management is prevention. You should try not to have that kind of thing happen, so if there are situations that you are not competent in, delegate. You can do outsourcing and have investment managers, but more importantly, like I said, you can delegate the work but not the responsibility. In the end, there must be due diligence. In other words, you must have a governance system to help you internally or how to delegate, how to monitor, and even among yourselves, who is in charge of what. That is the governance system that should be there.

What are the elements of the governance system? First of all, there has to be competence. The people who are involved should, in the aggregate, be competent. Then you should delegate and know how to delegate. You should know how to supervise and monitor. Last but not least, you have to document all the things that you are doing. These four elements are critical in any governance system.

Collectively you must have the competence to do things. You can seek advice from external managers, but ultimately you must continually train and educate yourselves so that you would know what the advisors are talking about and know if this advice is not really ethical and so on.

Let's talk about delegation. I said you can delegate the work but not the responsibility. How do you delegate so that you can still say you have been doing it prudently? You should be reasonable, choose the right people, make sure that they are suitable, monitor and supervise them, but look at the full extent that we are talking about. We are talking about the process. We are not talking about the results. If the process is right, the results will be good. You are not judged by the results, but you are judged by the process that you go through.

What about supervision and monitoring? There are external and internal controls, and the key word is "control." Externally you are using a lot of people to help you. What should you do? You should see who should be the right people, and make sure that you have clearly written guidelines. Don’t just say, "I tell you to do this, this, and this," and they’ll do it. Write it down, give it to them, and that is their mandate. Make sure that they frequently report to you, sign agreements and talk about all the obligations involved.

Now, externally you can still say that it is other people. It is the internal structure that is just as important or maybe even more important. First of all, the board must be competent, meet regularly, and all the meeting minutes must be

documented in writing. Then in terms of internal controls, you still need to say who is doing what, and you must make sure that there is continuing education. Always train the people who are doing each other's jobs to know what they should be doing, and then—this is extremely important—make sure that there's no self–interest and no conflict of interest. Documentation is extremely important because whenever there are bad results, everybody says that it was not their fault. Document it because then you can see what actually happened and who is doing what. All these must be communicated to the participants because fiduciary responsibility of a pension plan is to the participants. These are the people that you're trying to protect; communicate to them.

There are three areas of possible liabilities. Sometimes it is negligence. Nobody as a fiduciary would willfully try to do wrong often, but they often are negligent, and we will see some examples. Sometimes they have some contract obligations that they just break, and then there are some vulnerable areas that we should watch out for. In Spinks vs. Canada, Spinks came from Australia, started working in the government and joined the Public Service Pension Plan (PSPP). The PSPP in Canada would allow Australian service to be bought back as Canadian service. Now, at the time that he joined the Canadian plan, of course, he was younger and lower paid, so buying back that service would have been cheaper. Spinks joined the Royal Canadian Mounted Police, retired, got retirement counseling, and then they told him the benefit he was going to get. They had made the mistake of not putting in the early retirement reduction. He sued, and of course he got the full benefits.

At the time of retirement, there's retirement counseling in Canada just like in the United States. If you don't want to take joint and survivor benefits, both the spouse and the participant have to sign a waiver. In one case, they signed the waiver and the participant died in a year without the spouse benefit. The spouse sued the company for misinformation and got the spousal benefits. Why? Because it was not clearly explained to the spouse that if the participant dies there are no more benefits coming.

I worked for some of these auto plants and steel plants in Canada. Actually, I worked for those in the United States too. They just don't know, even if it's clearly explained to them upon retirement, that if they sign this waiver the spouse will not get any benefits when they die. You tell them very clearly. Yet I have seen very few spouses that would not sign the release. You have to make sure that you clearly document it, tell them very directly, "Now, if you sign that, your spouse will not get any benefits." Even after all this explanation and documentation, the spouse who signs the waiver may still come back after the participant's death to request a benefit, but at least you have a trail of documents.

Let's talk about breach of trust. It's very important to remember the contra preferentum rule that says if there are complicated situations, the court will always side with the weakest parties. In other words, if you have very complicated and convoluted plan documents, as we all know we have, this rule would apply to the

participant. We need to be careful about that. That is why all the employee statements and communication are very important. Let's talk about a contract, which slips the minds of many people. In Laurie vs. Deloro Stellite, Deloro was acquiring a company. As always in an acquisition, you will say that nobody will lose out, you will get the same benefit, the plan will not be changed, and your benefit will not be changed. The plan has a surplus, so now the employees sue the company, saying that the surplus belongs to them. You need to be quite careful about all these things.

There are other vulnerable areas. Whenever there are past service buy-backs, you need to be very careful. When you have defined benefit and defined contribution conversions, I'm sure that you have all made communications comparing the projected benefits on both bases. If you're not careful to say that all these are just estimates, and a participant says, "I used that to do my financial planning," you could be liable. Of course, all the supplemental pension promises are never well written. That is another gray area.

In Canada we just introduced what is called "flexible benefit plans," which say you can contribute some money, and in the end we will provide you some enhanced ancillary benefits like disability, death—that kind of benefit. But the catch is that these benefits are provided as required by law: use it or lose it. It would be hard to tell a retiree who then becomes disabled that, "Oh, sorry, your contribution is lost because you didn't use it."

What about defined contribution plans? I'll just raise some issues here. A lot of people say that the employer has no risk with defined contribution plans, which of course is not true. At least three directors of Enron are now in jail, or going to be, and what are the main areas of concern? First and foremost is company stock. Company stock in a defined contribution plan is very risky. The Enron situation clearly serves to show that. Then you will have to have investment information and the fund menu, and have to select and monitor all the investment options. Let me talk about each in a little bit of detail.

As far as company stocks, common sense tells you that there's conflict of interest and it is against principles of diversification to have a high investment in company stocks. Therefore you need to tell the employees that they should diversify and not put so much in company stock. You all know that if there's a change of the investment vehicles, there will be a blackout period because of the data transfer and so on. That period has to be as short as possible and the participants need to be notified.

In Canada you have similar limits surrounding diversification, except that the only limit is the 10 percent in a single stock, which is probably not stringent enough. In investment information you can have a safe harbor rule, and the safe harbor rule depends upon independent control over investments by the participants. How is it controlled? Are there enough choices? How is independent control defined,

informed decision? It's education, education, education. There are no specific rules in Canada, but now the Joint Forum of Financial Regulators is putting in some rules, and these are published. They are about the same as in the United States: diversify, make prudent choices, have reasonable default options, and recordkeeping and education. All these things are not unique to Canada. They should be done everywhere and in the United States as well.

We always want to get investment education and advice. What is the difference between education and advice? The difference is whether it's individual or not. Education is general information on the plan, the risk and diversification, and the horizon. But advice is individualized recommendations, so the plan sponsor should only give investment education and not investment advice, because otherwise you will be liable for wrong decisions on their part.

MR. CASSIDY: I'm going to first give a little perspective about the U.S. landscape, give you a background, and then talk about some methods to manage the risk.. There was a very good paper prepared for the Enrolled Actuaries in 2003 by Godofsky and Wagner. You should be able to get that on the Web or contact me. It's very well written, about 15 pages long and provides a nice overall look at fiduciary duty.

Again, I just want to highlight some of the things Mike mentioned earlier. Here in the United States people are focusing on the personal liability of the fiduciaries and the acts that they take and do. Before, it wasn't focused so much on the person doing the act. Now, my clients are asking me "Dan, do I really want to be on this committee? How are we electing people? Why am I here? Can I not be here?" Those conversations didn't happen five years ago.

You all know that ERISA has a bonding requirement of 10 percent of assets up to $500,000. The other thing is indemnification; people typically indemnify their fiduciaries.

MR. MARTIN SMITH: First of all, our practice focuses on small- to medium-sized clients, so most of them are under 100 participants. As most of you might be aware, there's a new requirement on the 5500 that—I don't remember the exact language—if more than some threshold of the assets are considered nonqualified assets, meaning they're in notes or collectibles, limited partnerships, things like that, they're not liquid investments, and then the bond actually needs to be equal to the value of those nonqualified assets, I believe. We've had a few plans where the value of the nonqualified assets exceeds $500,000, and when our plan sponsors go out and try to get a bond, they're being told, "No, we can only issue you a bond up to $500,000," because apparently that's a field directive that a lot of the agents have to work with. We've been having real trouble with this.

MR. CASSIDY: I myself don't have any clients with those non-liquid assets.

The colleagues or the clients that serve on these pension committees are typically indemnified by the plan sponsor in their acts and what they're doing on that committee, typically through just a rider on their directors and officers (D&O) insurance.

I thought I'd also focus a little bit on the Department of Labor (DOL) and some of their public statements and actions. They've been very active in the last couple of years, as you can imagine. You know, there have been the Enron amicus briefs that they've supplied. I'll talk about that later. There's been an advisory opinion. They had a working group on fiduciary education and training, and they have a voluntary fiduciary correction program. I actually asked the DOL how many people have filed under that. Does anyone want to take a guess on how many applications the DOL has received? There were 238 filings as of a couple weeks ago.

I had a client that was examining this; the decision was actually not to do it because of the limited relief that you get, and it doesn't get you much. I don't know if anybody else has any comments or has looked at this with their clients.

MS. CINDY BARKER: I've had to look at it from a corporate perspective. We looked at doing that program and decided it was just too onerous. You have to go in, and you have to notify all the participants. It just seemed very burdensome, and the only thing it got us out of doing would have been filing the 5330 for the prohibitive transactions. It didn't have a great deal of value from that perspective.

MR. CASSIDY: I looked at what the DOL has been doing lately and the four themes that I pull out of all of this. Delegation does not mean avocation, and that's pretty clear. That's probably their number one thing. When fiduciaries are hiring other people, the DOL is saying you've got to monitor them. As Mike said, you can delegate the work, but the responsibility is yours. That seems to be the number one theme. Director trustees and administrators can no longer hide under the defense of "I was just following orders." That is coming out of the Enron amicus briefs that I'm reading that are saying to the administrators, "You call yourself a director trustee, that's fine, you're trying to limit your liability, but we expect you to raise your hand if fiduciaries are telling you to do something that you believe is not proper." I haven't heard much discussion about this, but I'm wondering if this is going to be something that rears its head now and continually in the future, especially as our clients are renegotiating contracts with their administrators and outsourcing. I think it's going to be a major issue in the future.

Another theme is duty of loyalty and care. Participants may have more rights than shareholders. Again, this is coming up from the public companies where stock is in a plan, and the inherent conflict of a fiduciary sitting there. That fiduciary might also be a corporate officer. How do you reconcile those two roles? It can be done, but the DOL is pushing that participants clearly have significant rights to get as much information as possible about the assets in a plan, and it may or may not be available public information. It's an open issue, and I don't have any clients right

now that have their company's stock in a plan; they've all removed it because they don't want this conflict. It will be interesting how that actually rolls out in the future as well.

The last theme that I'm pulling out of the DOL's public statements is education. There's a greater need than ever before, especially for the small- and mid-sized plan fiduciaries, to do something. The DOL's working group on fiduciary education sees the small and mid-sized markets as needing a lot of education and a lot of service. The DOL is promoting it and trying to get things together to actually package it and send it out to fiduciaries of small plans. They're encouraging people to get education, go to meetings and bring them up to speed.

One of the topics of our meeting was to have a discussion about what risk management methods our clients are using to try to take care of their fiduciary risks. The classic types are the bonding insurance, riders on D&O insurance, giving investment choice and trying to push some of the responsibility on to participants. The focus of all of these has typically been on the assets lost due to bad decisions. One challenge that I see our clients facing is the increased costs of these insurances. The focus in the past has always been on the assets, but I see more and more discussions about the process and the other parts of fiduciary duties, the administration rather than simply the assets. Public companies are clearly, as I mentioned earlier, under intense scrutiny now with the operation of their retirement plans.

A recent DOL public statement seems to fly in the face of traditional defined contribution plan investment management where fiduciaries thought that adding more choice would lessen their fiduciary duty. The current view of the DOL is actually that more choice increases the oversight needed and raises your responsibility—and this is one that I can applaud and one that I've been talking to my clients about for years. A lot of people and a lot of mutual fund companies have been saying more choice is always better; giving more choice to participants reduces your responsibility. I think that will also ripple through our market place as plan sponsors focus in on this and actually realize that if they have an open architecture at a mutual fund company with 70 choices, they've got to review 70 funds. That's just incredible.

Outsourcing clearly is going to be an issue with the DOL's view of a directed trustee, because what outsourcing says is, "We'll take over all your administration, but we're only going to follow these rules, XYZ, that we all agree to." It will be interesting to see how those rules and the outsourcing play out in this whole issue of fiduciary responsibility in case it ever blows up and people start pointing fingers.

There are other risk management methods that people are using. I would call these proactive measures and maybe more nontraditional methods. In administrative audits, people are taking another look at their plan documents, their methods and how they're actually taking care of these plans. They're also reviewing their

insurance riders, being very explicit about what's covered, who's covered and dollar limits. In contracts, people are being very explicit about the language around the fiduciary duty and what services all the vendors are providing.

The manager-of-manager model is a very popular choice for both 401K plans and defined benefit plans on the investment side. I've had clients specifically go toward that model of investment management because they're very attracted to the embedded co-fiduciary status of that manager-of-manager model. They knew they were going to pay more for that, but they felt that was very important because it was one area of fiduciary duty that they wanted to push off on another party. These manager-of-manager models were very explicit in accepting that co-fiduciary status, and so it has been a very active area for the clients that I'm dealing with.

Then there is limiting investment choices, following up on the DOL's view that more choice means more responsibility. I've had clients actually cutting back funds, just dropping them and taking another look at what they're offering to the participants.

MS. JUDY LANA: Do you have any comment on the financial services industry that, at least in the United States, seems to have a pretty universal practice of using their own investment vehicles for their pension assets as well as their defined contribution plans as far as their investment options, that the family of funds comes from a family, how that plays to this and how that fits in with their fiduciary responsibilities?

MR. CASSIDY: You've mentioned a very well-known case in the States: two banks merged, they had internal funds of their own, and some of the participants were successful in suing since the funds chosen did not perform well. I don't have any clients that are in that market place.

MR. SZE: I don't work so much in the United States, so all that I'm talking about is Canadian experience. In the past, Canadian investment houses like banks or life insurance companies would provide funds of their own bank or insurance company, but now it's quite universal that they would extend all those choices to just about all the other major investment houses. In other words, for instance, an insurance company would have 70 or 80 funds that you can invest with, of which maybe eight or nine are managed by their insurance company.

MR. CASSIDY: In the States too, financial services companies want to monitor the trading activity of their employees.

MR. DAN WHITNAH: We recently worked with a company that in their 401K plan always put it to match in company stock, and I'd say we know many companies who are still putting company stock in 401K plans. In this company the employees had ridden the stock down from $60 a share down to $3 in the 401K plan, and along the way they've had some very positive communications from management to the company about how the company was going to turn around. The employees

actually resisted the idea that we would diversify the company match and put them into other options rather than company stock. I wondered if you wanted to expand your comments to the idea that when company management is addressing its employees, it's also addressing potentially shareholders through that stock and 401K plan.

MR. CASSIDY: That's a great comment. I think that management has to be very aware of what it's doing in all of its communication, in terms of what is viewed out there in the public as well as what's viewed internally by the plan participants. I think management has to be very careful with its public statements. Also, plan sponsors need to consider what extra value having company stock in the pension plan provides to the company and to the plan participants. I just wonder if it's worth it anymore

MR. SZE: I just know that most of my clients before, in the United States or in Canada, whenever they have company matching, love to have all the matching in the company stock. The reason is management control.

MR. CASSIDY: It brings up a point that I wanted to use to open up a discussion. I was sitting yesterday across the street at the Great Controversy meeting, and they're really making a point of the agency costs associated with these employee benefit plans, and that kind of goes to your question about company stock in pension plans. We always look at them as plans, self-contained entities, but one of the themes that I'm getting from across the street is that we need to think of these as flowing through the plan to the shareholders who hire management to execute the business. So that's the path that many of the Great Controversy speakers want us to consider. Financial economics wants us to look at these plans like that and the agency costs associated with it. I wonder how that melds with our practice of talking to fiduciaries, when these financial economic people are saying that pension plans are just pass-through entities to the shareholders. Management is just hired to take care of the plan, but ultimately we have to think of the shareholders. I wonder how we reconcile our thoughts of fiduciary status with the thoughts coming across the street. I'm thinking of this activity and trying to see how it might affect my practice in discussions to the management.

MR. GORDON LATTER: The difficulty is the question Jeremy Gold raised yesterday. Is anybody out there looking at the management of the 401K or plan in concert with the whole company? I think that's where you cross the ERISA boundaries. I don't have a good point to make; I was just curious if anybody was doing that. That's really the whole financial economics bringing the whole thing together, and I'm not sure if we're there yet.

MR. CASSIDY: Are you all picking up that theme as well? Before, we would have discussions saying, "You can contribute now, or you can contribute later, but it's a corporate finance function." For example, I may have said, "New CFO over there, it's your decision whether to take cash out of your business and put it into the plan.

It’s a corporate finance decision." Now, the financial economic people are saying that maybe is the wrong discussion. We need to push through and beyond that corporate finance role and ask, "From a shareholder’s perspective, what’s the best thing to do?"

I’m having a hard time in how we can translate that to active engagement and debate with our clients about what to do about this agency issue. I’m not reconciled to it yet; I haven’t figured it out yet. We have fiduciaries sitting in the middle. I’m having a hard time with it right now. That goes with the question about the communication from management about the stock in a plan and the impact of that. You have to step back and say, communication from management, they’re just sitting in the middle, and they’re hired guns for the shareholders, so how do you reconcile that with their fiduciary status? I’m having a hard time with that.

MR. SZE: I was at that session too. It strikes me as quite strange that we would always talk about the management managing the plan more for the shareholders than for the participants, because it’s clearly stated in ERISA and for that matter in the Pension Benefit Act in Canada too that pension plans are for the participants, and all the fiduciaries hold their loyalty to the participants. How is it that suddenly all the financial considerations shifted to looking after the interest of the shareholders? I really have a lot of difficulty reconciling that at all. Of course, as actuaries and lawyers and accountants we are paid by the management, but it doesn’t mean that we owe loyalty to the management or to the shareholders. We are specifically engaged to protect the little guys, the participants. In the end, we are hired to protect the little guys, but we work for the big guys.

MR. GEORGE BERAM: It may be a populist notion, but I personally am sick and tired about hearing about shareholders and shareholder value, and I think those of us who buy into that as actuaries have done a real disservice to participants. That’s why I also have the same problem that you do with the agency cost. I wasn’t quite sure what they were getting at, and if it’s what you think it is, I agree with you. I think there are some issues there.

MR. CASSIDY: From what I can understand, one of the key tenets of financial economics is that shareholders own the entire assets of the company including the pension plan, and we should look at it in total and not divide it into separate entities. When we talk about fiduciaries in management, they’re just hired guns for the shareholders, so we need to take that into consideration when we advise management. I think that’s where they want us to go.

Continuing this line of thinking, consider fiduciary status. Fiduciaries hire us to advise in the plan. Fiduciaries are holding money for other people, and that money is not the shareholders' but the participants'—or at least money to support benefit payments to participants. That’s where I’m having the challenge. How far should we go in considering this agency issue? All the way with selling equities? I'm not sure.

MR. BERAM: I understand what you're saying. I'm just saying there's maybe a much larger issue, and it's beyond the scope of this presentation, but just far too much attention in this country has been paid to shareholders and not enough to workers and plan participants. That's a real serious problem. To the extent that the profession has bought into that, I think that's a huge mistake, and I think we're paying for it now.

Since Mr. Sze mentioned something about Egypt, I'd like to mention something about Korea, where there's a somewhat similar situation. I'm Senior Advisor to Samsung Life Insurance Company. Right now there are no corporate pension plans, but there are mandatory retirement allowance plans, which are intended to function as pension plans. They do not have to be funded, and employees know very little about them. They basically get one month's pay for each year of service. If you work 30 years, you get 30 months' pay lump sum based on your last three months' average salary. So everybody takes the lump sum except, because of bankruptcies, at least 30 percent of people never actually get anything, and there are all sorts of issues swirling around. It's led to the introduction, starting July 1, 2004, of corporate pension plans—U.S.-, Japanese- and British-style corporate pension plans. All of these things that we've talked about, they now have to face for the first time. It's a major undertaking and a very interesting process.

MR. SZE: This is where we have some knowledge that some of these countries do not have. Not that we are great—we just have made more mistakes than they have. I think that it is therefore very important for us to tell them how things could have gone wrong, because we have been there before, so as to help them. I will give you the Egyptian ramifications in a little bit more detail, and you will see why the problem is so great. Exactly like George said, upon retirement these people will not be getting monthly benefits. They will be getting the lump-sum value of the benefit. Think of all the plans that are 30 percent or 40 percent funded. What you are doing is you are giving these retirees full benefits, and then asking the future generation to pay for it by making more contributions or by taking smaller benefits. Now, this is the greatest sham that I have seen, and you see the problem that can emerge if you don't have some kind of fiduciary and governance structure there.

FROM THE FLOOR: I'd like to get back to our discussion about the advisors acting in the sole interest of the beneficiaries of the plan. There's a term in ERISA that I haven't heard in this session, and that would be the employer acting as a settler in the settler function as opposed to the fiduciary function. The choice of the employer about whether to deliver compensation through a qualified plan at all is a settler function, and choices about changing the benefits could be part of that function. As advisors, many times we're working for employers as they're in that role. Even an individual in management can be in both a settler and fiduciary role at different times of the day. Probably a great illustration of that would be where someone could sit in a committee meeting discussing whether there would be an early retirement window as a settler, but the moment that they dropped any hint to an

employee that there was that discussion taking place, that became a communication from the plan administrator and something on which someone could take legal action.

MR. CASSIDY: The DOL advisory 2001-01A talks specifically about the settler function and gives examples of its current thinking. So I would suggest you look at that because it really separates when we're working on a settler issue and then switching over to plan administration/fiduciary issues.

MR. BRAD FOWLER: I wanted to ask a question related to the controversy session across the street. Would it be fiduciarily prudent in today's environment or in the environment of 1999, probably more the point, or 1996, to take the kind of action that's being advocated? Just to make the question balanced, I think a lot of the point of what's being discussed across the street ("The Great Controversy") is putting an appropriate value on the guarantee of benefit security to the participants. I think if that wasn't there, then it would be very hard to give a lot of credence to a revised investment policy that was merely for the benefit of the shareholders. When we think about the definition of a prudent man, to what extent is that contextual in the sense of what all of the other supposedly prudent persons are doing in the same period of time? Here's the question. Would our fiduciaries really be able very successfully to take the plunge into fixed income 100 percent? To put the question in context, we'd be talking about 1996, not 2003, when we could look over our shoulders and wish we'd done it before.

MR. CASSIDY: To give you an example, I currently work with a medium-sized, about a $20–$30 million, defined benefit pension plan. They were spun off from another public company and are very well funded—let's say, two times accrued benefits, over 200 percent on an ABO basis. When we were initially hired, we talked about immunization. We had that whole discussion about locking in these gains and just riding out the ups and downs of the market sitting in an immunized bond portfolio. The client did not decide to do that; they decided to stay engaged in the equity market place. The deciding point was that they enjoyed profit and loss (P&L) income. They had income on their balance sheets, and when we talked about immunizing, going to bonds, and I showed them the impact of that under FAS and what it would be long term based on some assumptions, they actively chose to still stay in equities. They're still fully funded. Not as well fully funded as they used to be, but they are still fully committed, so there's one minor case study of that exact point.

MR. SZE: In all my years of experience, when you talk to management in terms of investment and ask them to go completely in bonds (in the past at least we haven't gotten that much investment return), there's no way that they're going to listen to you because you can talk about the long term, but the management is looking only at two or three years. If they don't get good performance in two or three years, they're out of the door already, so there's no way that they would choose an investment that's long term. They are looking at a much shorter time

horizon.

FROM THE FLOOR: Michael, your situation you were describing in Egypt sounded exactly like a classic pyramid scheme. As an actuary for small defined benefit plans, I'm concerned about being a fiduciary. What can I do to make sure I avoid being a fiduciary, am I one per se, or are there some things that I do that make me one, other things I can avoid doing to avoid being one?

MR. CASSIDY: Do you practice in the States in Seattle? That's a big issue. Traditionally, Mike said that actuaries are fiduciaries there. In the typical role that we're providing, I would say that we are not fiduciaries in the activity that we typically do, but nowadays we cross over perhaps into other lines where we are making decisions, such as interpretations of plan documents. I, myself, even though I'm a tiny firm, try to identify in our communication when we get hired that we are not fiduciaries and to make sure the client understands that. Now, whether that has value in court, who knows, because I think fiduciary status is an activity-based determination, not a contract-based determination, so I don't think it protects me very much. I would say from the U.S. perspective it would be a determination looking back if there ever was a problem. What were you doing at that time, and was that activity a fiduciary? Whether or not you're identified as one, that's how I look at it, and I try to think about that when clients ask me to do a certain service. I try to stay on the nonfiduciary side of it and try to push any fiduciary side to the client.

MR. SZE: Let's not debate whether actuaries are fiduciaries or not. I used to be part of Hewitt Associates. You know what we always did; we were always very prudent. But we were sued with a case 10 years back that is quite well known—the Kaiser Aluminum case. Here the actuary was very prudent and advised the company that they were underfunded and that they should fund for it properly. The client just for financial reasons decided to fund at a lower rate. The actuary fully exercised prudence. Yet Kaiser Aluminum has no money and Hewitt has a lot, so the employees sued Hewitt, and Kaiser, of course. All the accounting firms and all these big competitors of Hewitt came and gave testimony in favor of Hewitt. Hewitt did everything right, but in the end Hewitt settled, not for a very big amount, but Hewitt did settle. So it's not a matter of whether you're a fiduciary or not. As soon as you are involved in giving advice, you could be liable; actually the advice was right and the advice was not taken, but you still could be liable. The only thing that you can do is what Hewitt did, but it didn't help very much. We recommend having everything in black and white. This is the prudent approach, and then you hope for the best.

MR. CASSIDY: The other thing I would recommend is to review your errors and omissions insurance. Make sure the services you provide are listed there and that you are very clear and up front in what you're doing as well.