RECORD Volume 30, No. 1*

Spring Meeting, Anaheim, CA
May 19–21, 2004

Session 34 PD
Retirement Plan Governance

Track: Pension

Moderator: ANNE M. BUTTON
Panelists: DAVID K. LINNEMAN
S. KAI PETERSEN

Summary: After Enron, what should plan administrators and advisors to qualified plans know about proper plan governance? This session discusses ERISA and Department of Labor requirements, the actuary's role in aiding the plan sponsor and pitfalls along the road to good governance.

MS. ANNE BUTTON: Our speakers today are David Linneman from Hewitt Associates; he's an FSA, FCA and an attorney, and Kai Petersen, an FSA and FCA.

MR. KAI PETERSEN: I'm going to begin by talking about plan governance framework and plan governance structure. David is going to cover the general fiduciary responsibilities and get into the technical details around that. I will then handle the retirement plan investment management and we'll have a few hot topics to throw out to the group.

Chart 1 covers a plan governance framework that contemplates the external and internal environments within which a retirement plan operates. It also covers organizational structure, a number of the activities that are involved in plan governance and the value creation proposition. The top of the chart covers the external environment within which retirement plans operate. There are various beliefs out there, such as those about stakeholder needs and the financial market. There are also issues around legislation, regulation standards and the legislative

*Copyright © 2004, Society of Actuaries

Note: The chart(s) referred to in the text can be found at the end of the manuscript.

environment in which we operate. Additionally, there are technology issues around portfolio management, technologies, investment industry structure, etc. Those are external to the company that is sponsoring a program.

The internal environment covers things like the mission of the company and the mission of the retirement plan within the company, presumably to support the overall mission of an organization. Consistent funding and investment policies are important to strategy, as is an ongoing commitment by the sponsor to regularly review mission and policy choices.

As far as the organization structure is concerned, there are three main elements involved. The first one is decision rights, which is how various types of decisions are made with respect to management plan. Performance evaluation, with respect to those individuals responsible for governing the plan, is the second main element. The third main element is the details of the reward system and what's rewarded and what isn't. The reward system is going to tie back up to the mission policies and strategies, and it's also going to relate to the various activities that a number of which are covered in the box on the chart.

On the far left side you've got activities related to legal and regulatory compliance, both in terms of the legal documents and operational compliance. Also there are government reporting and disclosure, and participant communications.

The middle of the box covers more of the financial area, such as GAAP reporting disclosure and ERISA funding. Underlying all that is the assumption-setting process.

On the right side, the activities are more involved, day-to-day operations, such as decisions around how to source the management of the plan, monitoring operations, investment oversight and vendor management.

Finally, the chart examines what kind of value is being created. First of all, you have to look at the stakeholders for whom you're trying to create value. That includes pensioners, shareholders and management. Government agencies are also on that list as stakeholders, although you're not necessarily trying to create value for them.

The next aspect of value creation is what kind of value you are creating for the company. Are there reputation benefits that the company is going to receive through the retirement program? How does it contribute to your overall people strategy, employer attraction and employee retention?

The last aspect is any issues you have around creating value through your investment strategy and funding policy. One of the big issues in recent years has been pension income and the question mark there. Is that creating value or not? Different companies might have different conclusions about that.

Chart 2 is a sample plan governance structure that we've encountered. In this example you have a board of directors, a board subcommittee, sometimes termed committees of the board, and then there may be other operational or management committees that report to the board committee. Examples of those types of committees might be the administrative committee that covers plan design, vendor management, the legal plan documents, funding policy, reporting disclosure and an investment committee that would cover things like the investment strategy and structure. Once that has been determined, the investment committee would be in charge of selecting investment consultants or investment managers to execute the strategy and structure.

Another structure that I encountered recently was a little more complicated than this. In that structure you basically had a board and four committees. The first committee was an audit committee and they were obviously overseeing the financial reporting and disclosure of the pension plan. There was a finance committee that was broadly responsible for issuing bonds and the equity of the organization. They were also concerned with the pension investments. The third committee was a compliance committee that was responsible for overseeing the retirement program, regulatory compliance, and operational compliance. The last committee was a benefits committee that was involved in plan design, vendor management, etc. One of the questions that I had was, to what extent do all these committees know what's going on in each committee, so that they cover all the activities on the list, and to what extent do they need to know?

I'm going to turn it over to David now.

MR. DAVID LINNEMAN: I'll be talking about fiduciary responsibilities under ERISA in general. Why? Well it seems important to talk about fiduciaries in any discussion of retirement plan governance, mostly because ERISA imposes obligations on many of the people making decisions affecting the plan, and the people making the decision, the fiduciaries, are subject to fiduciary duties. So ERISA forms a backdrop or regulatory environment in which plan decisions are made. I believe that that legal structure and those fiduciary duties really do have a big impact on how retirement plan decisions are made and how plans are governed in general. Also, it's a good governance practice to avoid violating the law, so it's important to know what it is and to take steps to comply.

First, I'll very briefly talk about some of the underlying reasons ERISA even contains fiduciary requirements, and then I'll talk about a few of the planned document and trust provisions that are particularly relevant to fiduciaries. With those preliminary items out of the way, I'll spend most of my time addressing the two key questions, who is the fiduciary, and what are some of the fiduciary duties owed under ERISA? I think those two questions are important issues in plan governance. Then finally, I'll spend a few minutes covering the topic of what might happen if those duties are breached.

So first is fiduciaries under ERISA. The major reason fiduciary duties are contained in ERISA is to ensure that the plan provides proper benefits to the plan participants and beneficiaries. In fact, the area of ERISA where fiduciary duties are laid out is Title I and Title I has the caption "Protection of Employee Benefits." One of the main motivating forces behind the enactment of ERISA was protection of employee, participant and beneficiary benefits.

Before ERISA, the conduct of people that ran pension plans was pretty much governed by a mixture of state laws, such as contract laws or trust laws, and federal statutes, like the Taft-Hartley Act. ERISA, of course, replaced all that with a comprehensive scheme designed to protect plan participants. An important part of that protection was through the fiduciary standards of conduct.

Generally, fiduciary duties apply to most pension plans. Of course, in ERISA there are always exceptions. There are some plans, such as some government plans, that don't require fiduciary duties.

Next, I'll talk a little bit about plan documents and trust agreements. Plan documents are probably second to ERISA in terms of impacting the behavior of fiduciaries. So I will point out a few of the key provisions that most directly impact fiduciaries. First, there are some mandatory provisions. The plan document must be in writing. Not having a written plan document is a breach in itself. Also, as a fiduciary, it would be difficult to comply with fiduciary duties without a written plan for guidance.

The plan is also required to name at least one fiduciary. It must also set forth procedures for allocating responsibility for operating and administering the plan. And other mandatory provisions that we won't discuss further involve funding policy and a procedure to grant authority for amendments.

There are also some discretionary provisions. ERISA doesn't require, but allows some optional plan provisions that can be very helpful to fiduciaries. First, a fiduciary can serve in more than one capacity. For example, a fiduciary can be both the trustee and a plan administrator. The second one is that a fiduciary can employ advisors. The third one is that a fiduciary can appoint an investment manager. And even though the plan provisions aren't required under ERISA, it's important that they be included in the plan if the fiduciary wants to take advantage of them. It's not a problem if they aren't in the plan, but it is a problem if they aren't in the plan and somebody tries to exercise authority under that basis.

Now I want to talk a little about trust requirements. Generally ERISA requires plan assets be held in a trust. There are a couple of exceptions to that, but typically there is a trust and a trustee. The trustee is either named in the plan document named in a trust agreement, or appointed by a named fiduciary. The trustee then becomes a fiduciary, and if the plan provides for it, a fiduciary can direct a trustee so that a directed trustee follows the proper directions of the fiduciary and then is

protected from a liability and reliance on that direction. The direction has to be proper, has to be in accordance with the plan, and cannot be contrary to ERISA. Exactly what standard is applied to determine that is open to debate at this point. Those are the plan and trust requirements that are most relevant to fiduciaries.

Now let's move on to the big question of who is a fiduciary? It's an important question because being a fiduciary carries with it obligations in liabilities if fiduciary duties aren't fulfilled. It's very unlikely that anybody would just accidentally comply with fiduciary duties, so the first step in compliance is to determine who the fiduciaries are.

Some fiduciaries may not even know that they're fiduciaries. Education, just to raise awareness on who is a fiduciary, can go a long way towards solving that problem. It's very helpful not to make an assumption about who a fiduciary is, but to take the extra time, be a little careful and go through some analysis to try to figure out who exactly a fiduciary is, because it's a threshold issue. If you make a mistake here, then everything else you assume is incorrect.

There are two ways to become a fiduciary. The first, which I mentioned a little earlier, was to be named in the plan document as a fiduciary. The second way is to just act like a fiduciary and become a fiduciary under ERISA's functional definition of fiduciary. Those fiduciaries are sometimes called deemed fiduciaries, but for this purpose, I'm going to call them functional fiduciaries, just to remind myself that they're fiduciaries by virtue of their function.

So the first way to become a fiduciary is to be named a fiduciary in the plan document. The plan document must name at least one fiduciary. It can be an individual. I think a popular way is by title, such as senior vice president of human resources. It can also describe a procedure, or it can be the members of a committee, such as an employee benefits committee. However it's done, it must be specified in the plan document. The named fiduciaries, either together or individually, have authority to control and manage the whole operation and administration of the plan. There are two important points about named fiduciaries. First, because they're named in the plan, they're easily identifiable. Participants, beneficiaries and other people that are interested can easily find out who they are. And that's probably one of the rationales underlying requiring a named fiduciary. Second, and probably more important, is that the named fiduciaries are basically presumed to be responsible for all phases of plan operation. I don't know if the buck stops with the named fiduciary, but it definitely starts with the named fiduciary. About the only way for a named fiduciary to narrow the responsibilities is to allocate some responsibility and divide the responsibility among other named fiduciaries. Then, apart from co-fiduciary responsibilities, which we'll discuss in a moment, the named fiduciary would only be responsible for the area for which they're assigned. Another way of narrowing responsibility is delegation, which involves appointing or hiring somebody else that is not a named fiduciary, In that case, the appointing

fiduciary would still have an ongoing duty to monitor that person. Delegation is one of the optional plan provisions.

Now I will discuss the second way to become a fiduciary, and that's through just acting like a fiduciary. These are the deemed, or functional, fiduciaries. Any individual or business entity who exercises any discretionary authority or control over the management of the plan or the disposition of the plan assets is considered a functional fiduciary. Also, anyone who renders investment advice for a fee or has a discretionary authority or responsibility for the administration of the plan is also considered a functional fiduciary. Generally, anyone who exercises any type of discretionary authority over some aspect of the plan will be considered a fiduciary and it doesn't take much. Discretionary authority about anything, I think, will really do it.

The responsibility that a functional fiduciary has is generally limited to the area in which they actually perform. So when you become a functional fiduciary in one area, by virtue of that function, it doesn't suddenly make you responsible for all other areas of the plan.

Under this definition, the plan administrator, plan sponsor, officers, principal shareholders, owners, boards of directors, retirement committee members, money managers, investment advisors, human resource managers and directed trustees also fall under the functional fiduciary definition. So the key to determine a functional fiduciary is to look at the actual substance of the activity performed. You have to ignore titles, ignore relationships and just look for discretionary authority. And because of that, the problem that can arise is that fiduciary status and liability can be inadvertently created for somebody who doesn't intend to become a fiduciary.

About the only way to avoid or at least minimize that, is to try to identify the people and specific roles and then really be diligent about administering the plan in that way. So get the right people and the right roles and then stick with that.

To answer the question of who is a fiduciary, it's helpful to look at who is not a fiduciary. Not everyone involved in plan decisions is automatically classified as a fiduciary. A lot of activities are just deemed not to have discretionary authority like administrative functions and offering advice. Actuaries, attorneys, accountants and those engaged in "settlor functions," when they're in their normal role, generally aren't considered to be fiduciaries.

Just because you're not a fiduciary, doesn't mean that there is no liability. There are sources of liability other than fiduciary liability. The standard of conduct might not be as exacting or as heightened, but for example, you can have state law claims under contract theories, such as a breach of contract, tort theory, negligence or professional liability. There's also the possibility of a nonfiduciary being liable for a

fiduciary breach in civil penalties, and maybe equitable damages under ERISA, not money damages, but equitable damages. That's an iffy area.

Another big area of nonfiduciary activity is settlor functions. The concept behind that is when you establish or terminate a plan, you're not really involved in the actual operation of a plan. It would be odd to impose fiduciary liability at that stage. In fact, it would be difficult to draw a line or limit it in any way. So settlor functions are outside of fiduciary activities. Some things may be a settlor function or a fiduciary function, depending on how they're actually carried out or what jurisdiction you're in. Sometimes one court will find the exact same activity to be a fiduciary function that in another circuit is viewed as a settlor function.

I read that somebody was advising that people who perform settlor functions should be different people than those performing fiduciary functions. I thought about that a little bit, and it seems like it would be nice if it could happen, but it is unrealistic. It seems like all the plan knowledge is embedded in the fiduciaries. When you have a big plan decision, to ignore that source of knowledge seems counterproductive.

Next I'll discuss the duties of a fiduciary.

First, just by way of introduction, the standard of conduct for fiduciaries is very high. I guess it reflects ERISA's purpose in protecting plan participants. It imposes the highest standard of conduct known to law, so it's kind of formidable. Not only is the standard of conduct high, but the consequences for not meeting those obligations are fiduciary liability. So there's a big downside, too. Fortunately, the fiduciary's standards of conduct are just that—standards of conduct. They are standards of results. So one of the keys to complying is just to try to follow the proper process. You don't have to guarantee a result if you conduct yourself in the proper manner. You have to make a conscious effort to comply. It's very likely you'll be successful. The standards really focus on the means, not so much on the ends.

So the keys to meeting the standards are probably a good faith effort to comply, good procedures and documentation of those procedures.There are plenty of duties that are listed under ERISA, but these are just four main duties in ERISA 404. The fiduciary must discharge duties: solely in the interest of plan participants and beneficiaries for the exclusive purpose of providing benefits; as a prudent person familiar with such matters; by diversifying plan investments; and according to plan documents to the extent that they are consistent with ERISA. The key is to focus on the process. Good intentions are not enough.

I believe good intentions are important. A good faith effort is necessary to comply with the rules, but that's just a first step. There needs to be more. You need to take a second step and follow up with some good procedures. One of the court cases that I read had a quote in it that was something like, "a good heart and an empty head is not enough." The fiduciary must opt for the exclusive purpose of providing

benefits to participants and defraying reasonable expenses of administering the plan.

If the fiduciary acts with the primary purpose of furthering interest other than plan participants, that's a breach. That's pretty easy to see. My favorite example of this is somebody that was both a fiduciary and an insurance agent. He had a positive plan to buy insurance products that maximized his commissions as an agent to the detriment of the plan. So that's the type of activity that would violate the duty of loyalty. In that situation, somebody has somewhat of a conflict. There's not necessarily a breach, just because of the conflict. As long as the primary purpose remains to further the plan participants, any other benefits are just incidental. It is probably difficult in a given circumstance to really decipher what the primary purpose is, but that's the rule.

A lot of things that are listed as separate duties in other places, I think, are really duties of loyalty, such as things involving steps necessary to collect money owed to the plan or like the fiduciaries may have a duty to sue somebody to recover money. I think that's really a duty of loyalty. Sometimes plan fiduciaries are required to answer questions from a participant honestly, for instance, if they're contemplating a plan change. If the fiduciary knows about it and a participant asks specifically about it, there's a duty to answer to the best of their knowledge. Sometimes that's listed as a separate duty, but I really think it's a duty of loyalty.

The next duty is prudence. Fiduciaries must act with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man, acting in like capacity and familiar with such matters, would use in the conduct of an enterprise of like character and aims.

So this is measured by objective, prudent person standards, so it's going to vary by the plan. It's going to vary by the circumstances. You must be familiar with such matters. If a fiduciary isn't familiar with such matters, he or she should probably reach out and seek some help from someone who is. If a fiduciary actually hires an expert, he or she can't just blindly rely on that person. There is probably a duty to collect information about that person's qualifications, supply correct information to the expert, help them make their determinations and, once you get the advice from the expert, act as a prudent person would with that advice. So just merely hiring an expert is not enough. You just can't punt to another person and then blindly rely on that person.

The test is whether at the time the transaction was engaged in, the investigation was sufficient to merit the final decision. So the focus is again on the process here and investigation. It's kind of a procedural prudence approach, and it's consistent with the other rules.

Diversifying plan assets is the next duty. Fiduciaries must act to diversify plan investments to minimize the risk of large losses unless circumstances make it

clearly prudent not to do so. So this is a two-part test to see if there is a breach. Those two prongs to the test are connected and both of those things must be present. There's really no clear guidance on when plans are sufficiently diversified. There are, however, seven factors by which diversity is measured.. These factors are: the purpose of the plan, the amount of the plan assets, the financial and industry considerations, types of investments, geography distribution, distribution of investment by industry and dates of maturity..

UNIDENTIFIED SPEAKER: You said you have to be clearly prudent. Clear to whom? Clear to me? Clear to my peers? Clear to a judge? Any thoughts on that?

MR. PETERSEN: I guess that's a multistage process. If you're being looked at by the Department of Labor (DOL), I guess the first stage would be imprudent to them. And then the next stage, if you wanted to take it a step further, would be imprudent to some court.

UNIDENTIFIED SPEAKER: Let me try a couple of facts on you within this context. Some of us believe that matching accrued liabilities with high quality bonds is a pretty prudent thing to do. We think it's more prudent than mismatching with equities. But obviously, we're not using the full spectrum of investments. And the burden shifts, because we have not diversified, doesn't it?

MR. PETERSEN: Yes.

UNIDENTIFIED SPEAKER: We have to demonstrate that it's clearly prudent, not merely prudent but clearly prudent, to do that. And we probably have to lose money in some way or other, or we're not going to get sued anyhow. But if, in fact, we match assets and liabilities, interest rates rise, and they both drop and the same time equities go up, it's a loss. It's an opportunity loss in the full context of the plan, but it's an asset loss, which happens to be well-matched by the reduction in liabilities. Who's prudence takes place? I think you said earlier that I lose because the prudence test is the prudent man of the day, regardless of whether my logic may be good or even better than the prudent man of the day.

MR. PETERSEN: Well the prudence standard is a slightly different test than the diversity test. So here, I think prudent means something closer to reasonable.

UNIDENTIFIED SPEAKER: But I lost 25 percent of the assets at the very same time that the liabilities went down by 25 percent. Am I in trouble or am I not in trouble?

MR. PETERSEN: Well, you're in trouble in a couple of ways I guess.
I think as a practical matter, it's going to come down to expert testimony. I read the synopsis of a case where some plan fiduciaries had a diversification problem. And they were able to trot out several experts who essentially made an argument that under the circumstances, it would not have been imprudent to do what they

did and the plaintiff failed to produce anybody that could at least match the defendant's experts. So I think as a practical matter, that's the type of proof you would need to offer in a litigation situation.

UNIDENTIFIED SPEAKER: Of course, my expert is better than your expert unless your expert beats me in court. So I really take a risk regardless, because a number of other experts would argue the bonds are the more prudent thing to do. Both sides can get hired guns.

FROM THE FLOOR: I am an ERISA attorney as well as an FSA, and in this situation I would argue that diversifying plan investments means to diversify over a lot of different bonds from different issuers, not diversifying between equities and bonds.

UNIDENTIFIED SPEAKER: I would agree with you, but I have been unable to get comfort on that exact issue. I agree that you should not put too many eggs in any bond basket. Diversification should be by geography, quality, industry, maturity, etc., but well-matched in the maturity structure. I haven't tried every law firm, but law firms are only willing to tell me that I'm not in violation, per se. That's no comfort at all. I knew that. I have another question or two related to this sequence. How much good does a DOL advisory opinion do me if I'm going to take this course? Can I get one? Do you think I can get one if, when I do this, the assets exceed the accrued liabilities? Do you also think I can get one when the assets are not equal to the accrued liability?

MR. LINNEMAN: Those are all difficult questions. I assume you mean in some sort of dispute?

UNIDENTIFIED SPEAKER: Well, we certainly can keep them from suing me if I complied and did what I said I was going to do.

MR. LINNEMAN: And I guess apart from that, it would just be a matter of how much weight that would carry.

On the ABA Web site at the moment, in the tax section, there's an interesting article on precedence and different types of regulations, but I would think that the technical answer to your question of how much weight the advisory opinion would carry would lie in an article such as that. What were your other two questions?

UNIDENTIFIED SPEAKER: Well, would I get the DOL advisory if I proposed this, and do you think that their willingness to give it to me might depend on what percentage of the plan was funded on an accrued determination basis. If the plan was 110 percent funded on an accrued determination basis, could the answer be different than if it were 90 percent funded on an accrued determination basis?

MR. LINNEMAN: That would be a question for someone from the DOL. I also have a question. You started earlier saying that there are named fiduciaries and

functional fiduciaries, and that named fiduciaries who want to delegate responsibilities should have authority under the plan to delegate. So a fiduciary might chooses to use the word of an expert because they don't feel competent to make all the decisions. To what degree do they have to be capable of understanding the advice, before their advisor becomes a functional fiduciary?

MR. PETERSEN: First, I would say that you really need to understand the advice of an expert to follow that advice. That's what a prudent person would do under the circumstances, I believe. That may not be true under every circumstance, but I think generally that's probably true. As far as how far can the expert go until he or she becomes a fiduciary, I think, as long as the person doesn't exercise discretionary authority under the plan and isn't actually making a plan decision, that person doesn't become a functional fiduciary. If somebody takes that person's expert advice and somehow misuses it, I don't think that necessarily tracks back upstream, forcing him or her into a position as a deemed fiduciary.

UNIDENTIFIED SPEAKER: I'm not sure this is really as hard as we may be making it, because the key thing is the process that you go through to make your decisions. For example, when I'm involved in a plan termination, clients have to go through a decision to basically put all their money in one basket. And as long as they go through a very thorough process to make that decision, they can put their money in one basket, the insurance company can go broke, and they're still okay, because they went through the process. So if somebody studied that very carefully and made a formal decision, wouldn't that protect them?

UNIDENTIFIED SPEAKER: I think that offers a degree of protection, but that does not prevent somebody from coming in and second guessing that decision.

FROM THE FLOOR: I have a comment on that. When you come into a plan termination situation, the liabilities, for example, are going to be settled at one time, just as the gentleman pointed out. When you make the decision to arrange an annuity as a process for concluding the arrangements to the plan, selecting the annuity provider is a fiduciary function that can be delegated to an expert. As long as a process used by the expert is consistent with ERISA, you're okay.

MR. LINNEMAN: Let's move on. Fiduciaries must act in accordance with plan documents to the extent that the plan documents are consistent with ERISA. So this duty can't be used as an end run around ERISA to put something in the plan document that's not allowed under ERISA. It has to be consistent with ERISA. There are two separate ways to breach the duty. First, if the fiduciary does not follow the plan. Second, if the fiduciary follows the plan but the plan doesn't comply with ERISA. So realistically, to comply, the fiduciary probably should be familiar with the plan and at least familiar with the requirements under ERISA.

I mentioned a little bit earlier that there is another important fiduciary duty left to protect against breaches by co-fiduciaries. We'll talk about that under the liability

section a little bit more, but I just wanted to mention now that another duty generally given to fiduciaries is that they must protect against breaches from another fiduciary.

So that's an overview of the duties. And now the key question is, how do you go about complying? Basically I think we've focused on procedure and I think that's the way to go. The duties are essentially requirements that a good decision making process be used. The prudence rule, for example, is focused on the quality of the investigation. So, because the fiduciary standards of conduct are generally focused on the process, it seems like a good place to focus compliance efforts as well. Establishing a good plan and procedural prudence is important. The proper process is probably the cornerstone for a good compliance program. And as part of that, documentation is important. Documentation is probably critical. In any circumstance, a fiduciary is probably going to need to demonstrate that they adhered to a good process. So a good, well-documented process, I think, is the key.

Another idea is that it might be helpful to memorialize your processes or procedures in some sort of document, such as a manual or a series of documents. The plan documents themselves usually don't have enough detail to really fully guide someone through the process, but a manual that's well written and really focused on the details of compliance can be very helpful. Of course, I think we all have experience with manuals that are pretty well written, but just never used. It's probably really only helpful if it's used in actual practice. And so, what happens if, despite everyone's best efforts, somehow there's a breach of fiduciary duty. I'm not going to spend a lot of time on the topic, but there are voluntary correction programs that are probably a good place to start. If it's beyond that for more serious breaches, the fiduciary may be liable for losses or damages to the plan. Fines may be levied and other bad things could happen.

We talked about co-fiduciary liability a little bit earlier, and a fiduciary may be liable for the breach of another fiduciary if we have three things. If he knowingly participates or conceals a breach, that's a breach by itself. So what the co-fiduciary liability is really saying is that a fiduciary is liable for whatever the other fiduciary is liable for as well.

The second one is that the fiduciary fails to comply with a fiduciary standard and that enables a breach. There generally has to be some connection between the fiduciary's failure and the co-fiduciary's breach. That's another way a fiduciary could be liable for a breach by another fiduciary. The final one is if the fiduciary has knowledge of the breach and fails to make reasonable efforts to remedy it.

I guess under the last one, if you have knowledge of a breach, you need to make reasonable efforts to fix the breach. I don't know how far that would go. I'm not sure what would be reasonable under those circumstances. To do otherwise would be a breach of your duty of loyalty and probably your duty of prudence as well. And by the way, knowledge there, I think, is usually taken to mean actual knowledge, so

there's no imputed knowledge. If you should have been aware of it, but weren't, I think it falls outside of these rules.

Finally, if there is a breach or some potential liability, there are still a few things that can help. For the plan, there could be a fidelity bond. In fact there should be a fidelity bond. ERISA requires that every fiduciary be covered by a fidelity bond. And there are some formulas for the amount. It's supposed to be 10 percent of the funds handled, with a pretty broad definition of the word "handled." And there are some floors and ceilings on that. There are different types of bonds, but ERISA does require that every fiduciary be bonded.

On the fiduciary side, contractual exculpation is specifically prohibited. That's where there's some contract language in the plan document or the trust agreement that purports the whole fiduciary harmless in case of a fiduciary breach. You just aren't allowed to have that type of language. If it's in there, it's going to be given no effect whatsoever. But, insurance protecting fiduciaries from liability is specifically allowed. If the employer or the fiduciary himself purchases the insurance, that's fine. If the plan purchases the insurance, the plan must have some recourse against the fiduciary for a breach.

Indemnification by the plan isn't allowed, but indemnification by a third party, such as an employer, is permitted. Also, plans can pay the reasonable cost incurred by a fiduciary, for instance, in connection with defending a lawsuit as long as there is no breach of fiduciary duty. So in a certain sense, there is some level of indemnification allowed, even though, in general, it's prohibited.

I'm going to discuss equitable contribution next. That's the situation in which there are several people that are liable and one person pays the full amount of damages and then tries to sue the other liable people for their portion of it. And this is something that is determined permissible depending on where you live. It's not specifically addressed by ERISA, and some jurisdictions allow it and some do not. Finally, if none of that works, you can just wait a while for the statute of limitations to run out. And just so you know, it's the earlier of six years after the date from the last action that constituted a breach or three years after the earliest date the plaintiff obtains actual knowledge of the breach.

MR. PETERSEN: We are going to move into the general retirement plan investment management activities. I'm going to quickly discuss some of the fiduciary procedures related to plan investment activities. First of all, it's important to develop your overall investment strategy and approach. We've already talked about the asset diversification aspect of that, and what that really means. The portfolio structure is another important decision.

It's also important to have a written investment policy supporting the strategy. In my experience, I find that most plans have some sort of a written policy. I do a lot of reviewing of plans being associated with an accounting firm. I do a lot of reviews

related to audits, and we ask questions about that. Most of the time we do find a written investment policy statement.

As David mentioned, it's important to be making the ongoing investment decisions with the skill and care of a prudent expert. You also need to be monitoring investment performance on an ongoing basis, so you're monitoring your service providers, not just picking them and letting them do their thing. Controlling I investment expenses in front is important both initially and on an ongoing basis. And you need to avoid prohibitive transactions as well.

There are several key investment considerations. The first one is the diversification of risk. We could have a very long discussion about what constitutes risk, and I think that's an important element here. There would be different definitions of that, which might lead to different conclusions as to what appropriate diversification is. You need to consider the volatility of your portfolio in the context of that particular plan. Plan liquidity is another important consideration. You should examine the projected return of portfolio relative to the plan funding objectives that prevail in current economic conditions and the asset and liability interaction in the context of the economic conditions. You should have particular funding objectives intended to be achieved in liquidity needs of the plan.

Asset-liability interaction is another area of importance, but one that's been discussed already. Then the other important consideration is the investment management decisions around active versus passive management. You want to use an investment consultant or manager of managers. That is where you've hired one manager to go out and monitor or select and monitor a number of other managers. You should switch them out from time to time. Rebalancing considerations are also important.

Chart 3 is intended to show a spectrum of the types of asset mixes that a plan sponsor may undertake. From left to right, you've got risk aversion to risk acceptance. On the far left, annuitizing your benefits would be an example of risk aversion. There are certain situations in which you would want to do that. For example, it would be something you could do if you want to protect your funded position. Obviously if you're ultimately terminating a plan, you're going to annuitize benefits that aren't paid out as lump sums. A reason why you might not want to do that is the high cost of annuitizing benefits, and to the extent that you want to benefit from the upside of a portfolio that has more exposure to, say, equities, you don't have the opportunity to do that.

In the middle of the spectrum is a situation in which you immunize or essentially do what a company called "Boots." I don't know how many people are familiar with this case, but this was a U.K. pharmaceutical company that at one point invested somewhere around 70 percent in equities and 30 percent in fixed income. They made the decision to invest 100 percent in bonds. This was in the U.K., so we're on a different regulatory guidelines and I don't purport to be an expert on those. But,

whatever those regulations were, it didn't prevent them from making the decision to invest 100 percent in bonds. Some of the reasons that they had for doing that were they wanted the lower volatility of cash flows and earnings by getting a better match of their liabilities and their investments. They also wanted to protect their funded position. They didn't want the more volatile fluctuations or their funding levels that went with exposure to equities. And, they didn't believe that there were rewards for significant surplus that they would receive from shareholders for investing in equity. So they decided to make that decision and it was a fairly controversial decision within that community. I guess the jury is still out on that in terms of the effectiveness of it.

Then finally, on the far right, companies will accept different degrees of risk and will diversify their investments between equities, bonds and some other investments, such as real estate, private equity and other types of alternative assets. They have different reasons for doing that. If they tend to view pension management as part of operations, they may want to take on more risk because of the beneficial effect it'll have on operations. And they may believe that they're adding value to corporations and shareholders that pay for pension income.

Reasons why you might not want to do that would be that you obviously have a more volatile portfolio, which is going to increase your volatility with respect to cash flows, leverage and earnings. And if you don't believe that shareholders pay for taking on equity risk, you're going to want to do that.
Again, I would say that many companies are somewhere on the right side of the spectrum. I typically see 40 percent equities and 60 percent fixed income and cash to 80 percent equities and20 percent fixed income.

Here's a quick list of what a comprehensive investment policy should include:

Investment objectives and goals

- Delegation of responsibilities
- Risk tolerance
- Asset allocation
- Security selection guidelines
- Performance measurement
- Criteria for selecting monitoring service providers
- Contents of policy will be tailored to the type of plan

There are also other related policies and procedures that are important to establish. Having an investment committee and determining the nature and frequency of the meetings is one of these. Document retention is very important. I It's about process and documenting process and being able to explain the basis for decisions that you've made if they're challenged. In particular, if you've got a 404(c) compliant or a plan that is intended to be 404(c) compliant, it's important to have documentation

around that. Some other items are bonding, proxy voting and fiduciary responsibilities.

As far as ongoing investment management, investment manager selection is very important. The main steps in the process are to identify potential managers through a screening process, come up with short lists of managers to evaluate more closely, go through the RFP process, examine manager due diligence issues and then perform manager interviews, due diligence issues and then interview managers. You should also have ongoing manager monitoring. This monitoring typically includes quarterly reporting, and that would involve looking at money managers against their peers and seeing where they rank. You also looking at performance versus various market benchmarks. There are also a number of quantitative and qualitative measures that you can use to evaluate performance that would be related to risk and risk-adjusted returns. Qualitative analysis would cover things like the investment process and personnel changes within an organization that could effect the performance of the manager going forward, etc.

Another issue to look at is manager termination. Usually there's a time horizon of three to five years. If there are situations where managers are put on a watch list, the frequency of reporting will increase. Often times managers, if they know that their performance is not meeting expectations and is under par, will take an initiative on a more frequent basis, just to keep that communication level up and show their improvement.

Then, as far as controlling expenses, I think that there are a couple of ways it can be done up front in the negotiation process with managers. Clients will often ask for most favorite nation clauses in their contracts. And on an ongoing basis, the manager performance reporting should be net of expenses. There are also methods by which transaction cost analysis can be done. There are various databases that investment committees can access to evaluate the transaction costs of their managers.

I'm going to go through the subject of prohibitive transactions fairly quickly. It's a fairly long list of different transactions, but essentially, certain transactions involving plan assets or parties of interest are prohibited. As David mentioned before, good intent or good result does not matter. But there are certain exemptions from the prohibitive transactions.

Prohibitive transactions

- Sale, exchange or lease of property
- Lending of money or other extension of credit
- Furnishing goods, services or facilities
- Transfer or use of plan assets between plan and party in interest
- Acquisition or holding of employer securities other than "qualifying employer securities."

Basically, they all involve different activities between the plan and parties of interest. Then, an individual can commit a prohibitive transaction through self dealing. This would be dealing with plan assets for his own account or interest. In one case, a committee or somebody related to a plan had taken an expensive vacation or gone to an expensive conference and charged the plan assets and there was a question as to whether that was appropriate.

Fiduciaries, service providers and employers whose employees are covered by a plan are all parties of interest. Fifty percent or more owner of an entity whose employees are covered by a plan are parties of interest, as are employees, officers, directors or 10 percent or more shareholders of the above named entities are also parties of interest.

Now I want to make a few comments on ERISA 404(c), which applies to defined contribution plans. Basically it provides a certain amount of relief from liability for investment decisions if the plan is qualified and the decisions comply with proper instructions of participants. The relief under 404(c) is limited, and it relieves a fiduciary to a degree that the participant actually has control. So they have to have had an opportunity to give instructions. They have to know how and when to give instruction. They have to have a certain frequency under which they can give instructions, at least every three months, and then they have to have enough information that they can make an informed investment decision.

You need to provide a broad range of investments, at least three diverse core investment alternatives, which would allow participants to manage the risk in return of their account. That would include an equity account, bonds or debt, and cash or guaranteed interest contracts.

There are certain fiduciary responsibilities that 404(c) doesn’t protect against, such as the duty to protect or prudently select investment alternatives offered under a plan. An investment committee is still on the hook for the 401(k) investment options that they select. They have responsibilities to disseminate information. It’s important to be monitoring performance of the investments so that you’re sure that the investments that you selected continue to be prudent investments. And with respect to any assets that a participant doesn’t have control over, those need to be invested. The prudent standard would apply in that case to the investment committee overseeing those investments. There are also some special situations related to blackout periods, voting and tender offers, and negative election plans.

In terms of information that participants must receive, they need information related to the available investment choices, prospectuses from investment funds and they need to know who the investment managers are. They need to have information regarding fees and expenses charged. They need to be able to give investment directions at least once in every three-month period.

Additionally, documents that must be provided to a participant upon request are annual operating expenses for each investment, copies of prospectuses' and financial statements and other reports regarding the alternatives. They also need lists of assets in the portfolio and their value, information on past and current investment performance and information about their accounts. A lot of this information is just provided routinely through, for example, their 401(k) vendor.

And as far as the 404(c) monitoring, again, you need to monitor investment performance on a periodic basis and make sure that the funds that you've selected in, say, a 401(k) plan are complying with investment guidelines. If they aren't, you need to either put them on a watch list or remove the funds. You also need to support and evaluate other service provider performance, review service provider agreements and fees, and keep an eye on internal controls.

Now we're going to move on to hot topics One of the issues that we're seeing a lot, from an accounting firm perspective, is around reporting and disclosure, and the increased attention that pension plans are getting companies. Just last week I assisted another partner in our firm with putting together a fairly lengthy presentation for the audit committee of the board of the company, which sought to explain to laymen FAS 87 and FAS 106. That was quite a challenge. But I think it emphasized the importance and the scrutiny that pension plans are getting.

Some of the key areas that are getting a lot of scrutiny are around the assumption setting, or the setting of the discount rate. We apply much greater rigor now than in the past around reviewing discount rates. Some of the guidance that we looked at was FASB EITF D 36, which talks about the construction of a high quality bond portfolio as the basis for selecting your discount rate. And then we also look at say, paragraph 10 of SFAS 87, which talks about the use of approximations if it doesn't yield the materially different result. We're examining the expected return on asset assumption and we're looking a lot more closely at the target asset mix of companies and what capital market assumptions they're using. When they develop a certain assumption, we look to see that it is within a reasonable range of outcomes.

So, what we're looking at often times, is the process by which they come to a particular assumption. For example, with expected return of assets, which is getting an increased level of scrutiny, and the target mix being what it is, we'll want to understand how they came to their capital market assumptions. That may involve reviewing reports from several different investment consultants. In some cases, plan sponsors will project out returns stochastically and provide us with the range of outcomes. Then they'll pick a return assumption within that range. The question becomes, what's a reasonable range? Is it the 50th percentile result, or the 75th percentile? There isn't a bright line test around that. I think it's safe to say that they don't have to pick the 50th percentile, but it's probably not the 99th percentile that you'd select.

The mortality assumption is not one that's gotten a lot of scrutiny in the past in a formal sense. I have recently heard comments here and there that SEC is getting smarter about reviewing the mortality assumption. It will notice if you have two plans that are demographically very different, but which use the same assumptions. The SEC will ask how you came to the same conclusion.

I had a situation come across my desk in the last few days in which a valuation actuary was proposing changing to the '94 GAM table from the '83 GAM table. They had evaluated the impact on the financial statements, and the company was coming back to us and asking us to explain the analysis and help them understand it, because it was increasing their other comprehensive income by changing the mortality table. So even though it's not something that's formally subject to review, it's something that the SEC is getting smarter on. The SEC has gone down the list, looking at the discount rate and expected return on assets, so the mortality could be next.

You know a lot of this increased scrutiny around the assumption setting is being driven by the Sarbanes-Oxley Act and the need to have more well-defined processes followed around the assumption setting. That's a scenario that is formalizing guidance that's evolved even before the Sarbanes-Oxley Act. Because of SEC scrutiny, we've stepped up our efforts in that regard and SARBOX is just providing more formal requirements.

I also have some quick thoughts on the mutual fund scandal. We titled this, "If We Knew Then, What We Know Now." I guess the idea is that a lot of plan sponsors were surprised by this. It was one of those things where, again, it gets back to the fiduciary processes. How could you know about something like this? But now that you do know this is an issue, what can be done? Investment committees should properly monitor this and make sure that they don't incur fiduciary liability. Ann Combs and the DOL made an interesting statement around this that was a reminder about fiduciary duty to engage in a prudent deliberative process. It is important that investment committee monitoring is an ongoing process to make sure that they had sufficient information to monitor funds. The committee may even have direct discussions with funds, if necessary, to ask the right questions so that it has done everything that it can to ensure that the fund family that they're using doesn't have the issues around delay trading and market timing.

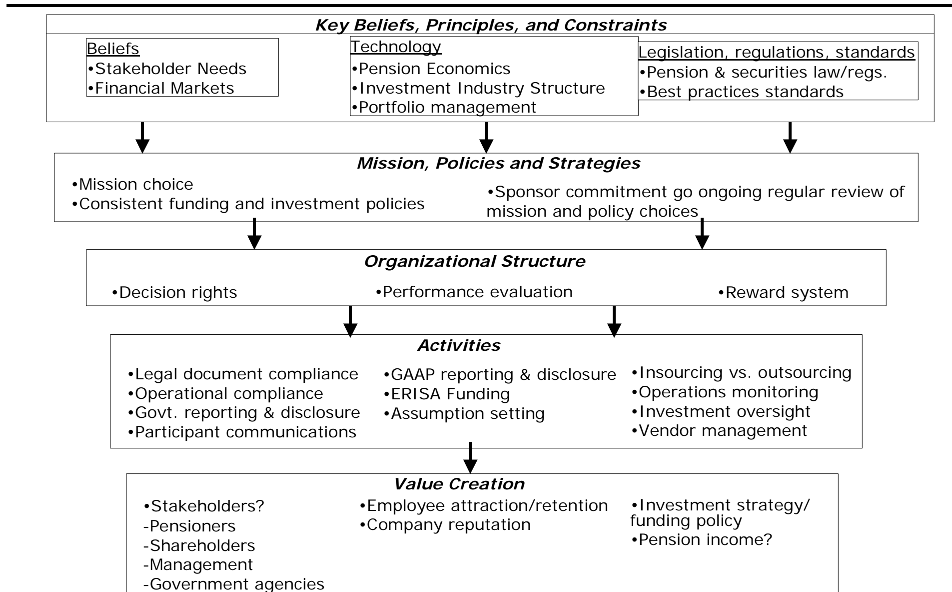
Now I am going to discuss some of the things to consider with respect to prevention and remediation and what fiduciaries should do going forward. It's important to consider the nature of the alleged abuse. Understand the economic impact and try to ascertain what preventive measures have been taken by the fund to prevent this from occurring. You might ask, should there be compensation for investor losses? Or, is there potential for certain preventive measures or limitations to impact 404(c) relief? For example, if you impose redemption fees on the funds, is that going to create a 404(c) problem and limit the control that plan participants can exercise over the funds? Another possibility would be placing trading restrictions so that you

couldn't have the short-term trading that you tend to see with the market timing. But again, you have to determine if that would create 404(c) issues.

Whatever the preventive measures are, they need to be allowed under the plan terms and disclosed to plan participants.

Chart 1

Plan Governance Framework

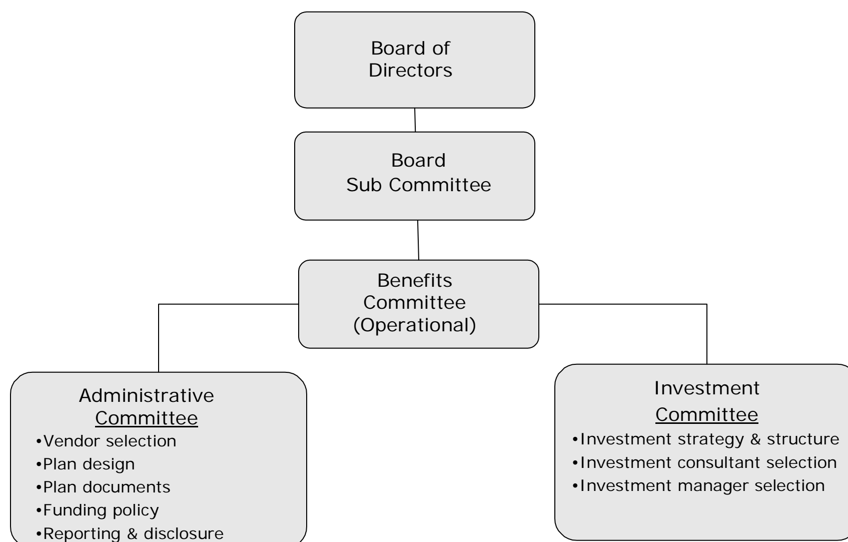


Source: "Pension Fund Excellence," by Keith P. Ambachtsheer and D. Don Ezra, 1998

2

Chart 2

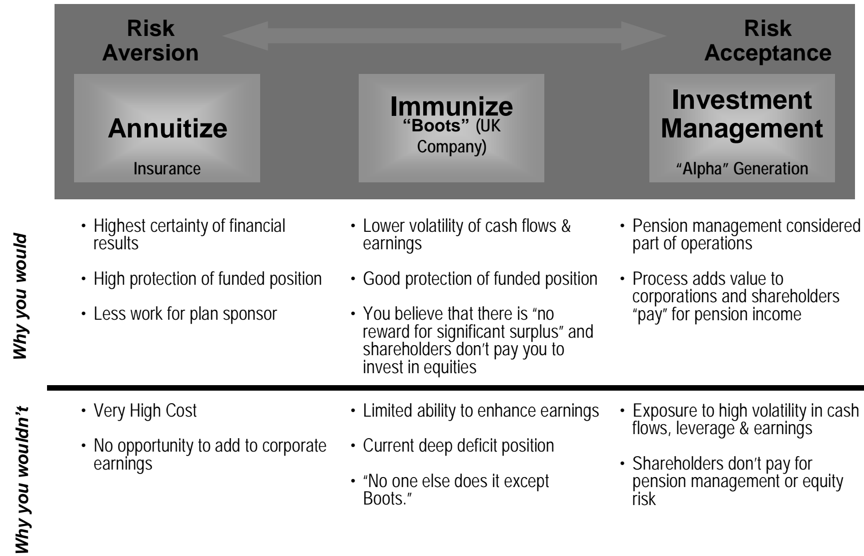
Example of Plan Governance Structure



3

Chart 3

Investment Strategy Considerations



32