506 ERISA Basics & Hot Topics

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Leslie C. Bender is the general counsel and chief privacy officer for the ROI Companies, a family of companies providing outsourced business and compliance consulting services to the health care industry. Ms. Bender specializes in transactional and compliance work primarily related to the health care and financial services industries. Over the past few years Ms. Bender has practiced largely in areas pertaining to privacy law matters, notably Gramm-Leach-Bliley and the Health Insurance Portability and Accountability Act of 1996 (HIPAA).

Prior to joining ROI, Ms. Bender held a two year political appointment and executive position in Baltimore's business retention and development program as part of its federally designated Empowerment Zone. Prior to her Empowerment Zone appointment, Ms. Bender spent nine years practicing at Washington, DC law firms, and thereafter becoming in-house counsel and a vice president and regional manager for NationsBank, N.A.

Ms. Bender is a member of the American Collectors' Association's Members' Attorneys Program, and is now serving on the MAP Committee, its governing body. She is also a member of ACCA, the American Health Lawyers Association, the International Privacy Officers Association, the WEDi-SNIP National Vendor Education Workgroup, MAHI Central, and the regional WEDi-SNIP unit where she cochairs its Education Committee. Ms. Bender is also providing HIPAA content for an on-line, web-based health care compliance company, roiWebEd Company. Ms. Bender has received numerous awards and commendations from the banking community and from governmental agencies including the U.S. Small Business Administration for excellence in financial advocacy and community outreach. Ms. Bender has served on a number of public and private boards and governing bodies including the board of a local geriatric hospital and Governor Glendening's statewide Policy Board on Neighborhood Business Revitalization.

Ms. Bender received her BA from Northwestern University and JD from the University of Notre Dame Law School.

Timothy J. Mahota

Timothy J. Mahota is general counsel for Integral Development Corporation in Mountain View, CA, an international software company serving the financial services industry. His areas of specialization are securities, intellectual property, and general corporate law, as well as ERISA. Mr. Mahota also serves as general counsel and chief compliance officer for Partnervest Financial Group LLC, in Santa Barbara, CA, a national broker-dealer, investment advisor and back-office operations service provider, which is a former subsidiary of Integral Development.

Prior to joining Integral, Mr. Mahota served as general counsel to Mercer Global Advisors, Inc., a national investment advisor and broker-dealer. Before that, Mr. Mahota was an attorney with the Securities and Exchange Commission (Division of Enforcement) and at the Pension Benefit Guaranty Corporation.

Mr. Mahota serves on the United States Department of Labor's ERISA Advisory Council by appointment of former Secretary of Labor Alexis Herman. Mr. Mahota is the chair of ACCA's ERISA Subcommittee, is on the *ACCA Docket* Advisory Committee. He participates in numerous professional securities organizations and is licensed by the National Association of Securities Dealers as a general securities principal, municipal securities principal, options principal, and as a general securities representative.

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John R. Paliga is an assistant general counsel with the Pension Benefit Guaranty Corporation (PBGC). PBGC is one of the three "ERISA agencies" along with the Department of Labor and the Internal Revenue Service. Mr. Paliga provides legal advice on all aspects of PBGC's role as the guarantor of private sector defined benefit plans. He concentrates on Title IV insurance coverage issues and pension issues arising in corporate insolvency proceedings.

Previously, Mr. Paliga was an associate at Gibson, Dunn & Crutcher, where he advised clients on tax-qualification issues in employee benefit and welfare plans. Before that, he was a judicial law clerk for the Honorable John W. Potter, United States District Judge for the Northern District of Ohio.

Mr. Paliga received a BS from Youngstown State University and a JD with honors from the Ohio State University School of Law. He has a Certificate in Employee Benefits from Georgetown University, and he expects to soon receive an LLM in Taxation.

Is the FTC's Eli Lilly Settlement a Prescription for Responsible Privacy and Security Practices under the Health Insurance Portability and Accountability Act of 1996 and the Gramm-Leach-Bliley Act?

By: Leslie C. Bender, Esquire

In July, 2001 the American Civil Liberties Union (the "ACLU") announced to a shocked public that it had learned that Eli Lilly and Company had inadvertently given out confidential information concerning nearly 700 patients over the Internet. In a letter to Timothy Muris, Federal Trade Commission Chairman, Barry Steinhardt, the ACLU's Associate Director wrote "[w]e hope that Federal regulators will do what is necessary to protect these individuals from further harm, and prevent similar mishaps from occurring in the future." Now, a full twelve months later, DigitalMass at Boston.com reports as follows on July 25, 2002:

> BOSTON -- Eight states including Massachusetts will divide $160,000 in a settlement with Eli Lilly and Co. over allegations the drug maker unintentionally released the e-mail addresses of more than 600 people taking Prozac.
>
> Indianapolis-based Lilly settled a suit over the matter with the Federal Trade Commission in January, promising better safeguards. It was the first time the FTC had prosecuted an unintentional violation of a Web site's privacy policies.
>
> On Thursday, Massachusetts Attorney General Thomas Reilly said the company would pay $160,000 to Massachusetts and seven other states: California, Connecticut, Idaho, Iowa, New York, New Jersey and Vermont.

In brief, the alleged facts were that on and before June 27, 2001, Eli Lilly and Company had provided a daily email service, "MediMessenger," that reminded Prozac users to take their anti-depressant medication. While Eli Lilly's assurances were considerable regarding its policies and procedures to assure both the privacy and security of its subscriber patients' confidentiality, in its last email announcing the discontinuation of this service to the nearly 700 subscribers, the final email included a long, publicly visible list of each participating individual with the name and email address of each under the "To" header in the email. Steinhardt urged the FTC to undertake a full investigation of the situation because "[t]his incident further underlines the clear and present need for greater privacy protections…the American people have waited too long for protection of their most sensitive information."

Since the passage of the Health Insurance Portability and Accountability Act of 1996 ("HIPAA"), and the Department of Health and Human Services' subsequent publication of Privacy Standards in December, 2000, professional and trade associations and corporation America have reviewed and discussed the facts of the Eli Lilly case. It serves as a colorful means for underscoring the imperative that each individual charged with compliance tasks study her or his company's privacy and security policies and procedures and measure them against actual

practices. Further, the alleged facts of the situation illustrate the following: first, the brand reputation damage publicity of an actual or suspected breach could cause an organization; and second, the irreparable and irreversible damage that could potentially flow to consumers from even an inadvertent breach of an individual's privacy.

The Eli Lilly facts as we knew them were relevant to each of us not only as persons who work with consumer's individually identifiable and non-public information each day in our jobs and are well acquainted with the incredible communication potential of the internet – but also as individuals each with a set of personal financial, health and medical information that we would expect to be protected and preserved against even inadvertent breaches of confidentiality.

As the FTC began and undertook its investigation of the Eli Lilly facts we returned to our jobs, soon to be faced with the tragedies of September 11, 2001, and the ensuing biological and other terrorist events and threats. Our focus changed, both expanding to a global security perspective and contracted to more immediate concerns about security at home: were our families safe? Were our children safe at schools and in public places? Could we entrust our safety to the commercial airlines? Were we safe as we quietly pursued our day-to-day tasks at our places of work and in public? Should we be concerned as we opened our mail? Do we continue to be willing to make certain sacrifices of our privacy in exchange for the conveniences of things like ATM cards, internet gift shopping, and e-mail?

Meanwhile, on January 18, 2002, the FTC issued a precedent setting decision regarding the terms and conditions of a settlement arrangement with Eli Lilly and Company. In essence, and under the jurisdiction of the Federal Trade Commission Act, the FTC found that the inadvertent and unintentional breach of confidentiality constituted an unfair and deceptive trade practice because Eli Lilly had made privacy promises to consumers that it could neither support nor keep. Given the facts and circumstances that are now public about the Eli Lilly situation, the FTC's enforcement response and mandate is critical for all businesses – even those that may not engage regularly in eCommerce (*see*, the FTC's 2002 Privacy Agenda – updated January 24, 2002, at www.ftc.gov/speeches/other/privacynotices.htm).

The features of the FTC's settlement, finalized on May 10, 2002, should be reviewed closely by corporate compliance, privacy and security officers, regardless of industry or trade, and should be viewed as a de minimis set of criteria or parameters for a sensible, workable privacy and security program.

Some additional facts that have now been shared with the public, all of which are publicly available on the FTC's website, and per the terms of the "Agreement Containing Consent Order" are neither conceded nor denied by Eli Lilly. These facts include the following: (1) that Eli Lilly readily distributed privacy statements throughout the Company's websites, www.prozac.com and www.lilly.com. Within the MediMessenger online text was a privacy statement containing numerous promises and representations about the Company's respect for its guests' privacy. In relevant part this Privacy Statement noted, "Eli Lilly and Company respects the privacy of visitors to its Web sites, and we feel it is important to maintain our

guests' privacy as they take advantage of this resource;" (2) on June 27, 2001, an Eli Lilly employee developed a new computer program to send a notice to all MediMessenger subscribers advising them that the service was being terminated. In so doing, the Eli Lilly employee listed all the subscribers names and email addresses in the "To" header of the email message. It was sent to all 669 of the subscribers; (3) Eli Lilly had neither maintained nor implemented internal measures to protect sensitive consumer information – e.g., there were no training programs, no oversight or assistance for employees such as this one in regard to privacy or security issues, no checks or controls on the process (such as reviewing the computer program with experienced personnel), and Eli Lilly's "failure to implement appropriate measures also violated certain of its own written policies; and (4) this particular employee was new and "had no prior experience in creating, testing or implementing the computer program used."

What are the components of the FTC's settlement agreement?

Remarkably similar to the Administrative Requirements section of the Health Insurance Portability and Accountability Act of 1996's Privacy Standards (*see*, 45 CFR Section 164.530), and now the FTC's Standards for Safeguarding Customer Information published pursuant to the FTC's rulemaking authority under the Gramm-Leach-Bliley Act, Public Law 106-102[1], the FTC/Eli Lilly settlement agreement (http://www.ftc.gov/os/2002/05/elilillydo.htm) calls for the establishment and maintenance of an information security program that protects any personally identifiable information collected from or about consumers which at a minimum contains the following features:

1. designating appropriate personnel to coordinate and oversee the program;
2. identifying reasonably foreseeable internal and external risks to the security, confidentiality, and integrity of personal information, including any such risks posed by lack of training, and addressing these risks in each relevant area of its operations, whether performed by employees or agents, including:
   a. management and training of personnel
   b. information systems for the processing, storage, transmission, or disposal of personal information; and
   c. prevention and response to attacks, intrusions, unauthorized access, or other information systems failures;
3. conducting an annual written review by qualified persons, which review shall monitor and document compliance with the program, evaluate the program's effectiveness, and recommend changes to it; and
4. adjusting the program in light of any findings and recommendations resulting from reviews or ongoing monitoring, and in light of any material changes to its operations that affect the program.

[1] The FTC published Standards for Safeguarding Customer Information as required by Section 501(b) of the Gramm-Leach-Bliley Act in the May 23, 2002, Federal Register, pages 36483-36494. Compliance with these standards is expected by May 23, 2003, although certain contracting requirements may allow for an additional year until May 24, 2004, so long as the contracts were entered into prior to June 24, 2002.

When analyzing and applying the final decision in Eli Lilly it is critical to bear in mind that the FTC has made it clear that "its focus on consequences [of misuse of information] leads [the FTC] to view privacy through a broader lens. Adverse consequences can occur whether the information was originally collected online or off" (*see*, Remarks of Howard Beales, Privacy Notices and the Federal Trade Commission's 2002 Privacy Agenda, http://www.ftc.gov/speeches/other/privacynotices.htm).

HHS's "administrative requirements" for a responsible privacy program under HIPAA include the following:

1. designation of a privacy official with responsibility for developing and implementing privacy policies and procedures
2. designation of a contact person or office responsible for receiving complaints and who is able to provide further information about an entity's privacy policies and procedures
3. written privacy policies and procedures, continually reviewed and updated as needed
4. training of all members of an entity's workforce
5. appropriate administrative, technical and physical safeguards to protect the privacy of individuals' protected health information
6. safeguards to protect protected health information from any unintentional or intentional use or disclosure
7. a process for receiving and resolving individuals' complaints
8. documentation of all administrative matters pertaining to privacy policies and procedures
9. sanctions for violations of privacy policies and procedures
10. mitigation – procedures in place to assure that any harmful effect, to the extent practicable, flowing from disclosures of protected health information are mitigated.[2]

How to implement an effective privacy and security program.

1. Don't make promises to consumers that you don't, can't or won't keep.

By using the Federal Trade Commission Act as its source of authority, the FTC has in effect confirmed that even inadvertent breaches of privacy and security of individually identifiable or protected information will be regarded as "unfair or deceptive trade practices" in instances where businesses have collected and use that information and have made promises in regard to the privacy and security of that information.[3] It matters little whether the policies or procedures are published on line or off line and whether or not the breaches occur on line or off – if a business uses consumer's individually identifiable information it owes consumers a duty to protect and preserve the confidentiality of it, to use and disclose it

[2] See, 45 CFR at 164.530.

[3] Note also that under the Fair Debt Collection Practices Act, abusive and deceptive collection practices led to the law's enactment to prevent "invasions of individual privacy." *See*, FDCPA at Section 1692(a).

consistent with any representations it has made to the consumer regarding the business' intentions.

In the Eli Lilly case, the FTC found that the privacy and security promises Eli Lilly made were numerous and readily available to the consumer. Meanwhile, the company lacked the privacy or security infrastructure to keep those promises. As a result, even an accidental breach (no hackers or interceptors were in any way involved) resulted in liability for the company. The consequences of this could be far-reaching as consumer advocacy groups and attorneys study concerns raised by consumers about the manner in which their individually identifiable or protected health information is used or disclosed. There are numerous studies demonstrating that consumers are gravely concerned about the privacy and security of their "non-public" information, whether health or financial related.[4]

In essence, this is the regulatory scheme in the HIPAA privacy regulations and now in the G-L-B Standards for Safeguarding Customer Information. Without a patient's consent, which consent is obtained after a patient has been provided with a proper notice of an entity's privacy policies and procedures, as a general rule an entity may not use or disclose that patient's individually identifiable health information. 45 CFR Section 164.502(a).[5] Similarly, under G-L-B, financial institutions are required to set consumers' expectations about how their individually identifiable financial information may be used by making up front disclosures of their policies and practices with respect to information shared with both affiliates and non-affiliated third parties.[6]

Depending upon the nature of an organization's business and consumer client base, it may be advisable or mandated to develop a consumer friendly notice of privacy practices and procedures and consent or authorization form to educate the consumer regarding how her or his individually identifiable information may be used or disclosed in the course of your organization's dealings.

2. Recognize that a company's privacy and security program can be jeopardized by its weakest link – train each and every employee at least to an "awareness" level on relevant privacy and security policies and procedures.

In the Eli Lilly situation, a new computer programmer employee was responsible for the inadvertent breach. This was an individual uninvolved in operations and uninvolved in direct interactions with consumers. Nonetheless, that individual's

[4] *See, e.g.*, remarks of FTC Chairman Timothy J. Muris at page 1, delivered on October 4, 2001, at a Privacy 2001 Conference in Cleveland, Ohio. Cite: http://www.ftc.gov/speeches/muris/privisp1002.htm

[5] In general, a covered entity may use or disclose protected health information without a patient's consent under circumstances including the following: (a) to the individual; consistent with a patient's consent for purposes of carrying out treatment, payment and operations; in emergency circumstances; pursuant to an authorization (a more limited grant of authority from the patient); to HHS to establish the entity's compliance with HIPAA; when treatment of the patient is required by law; if the entity attempts to obtain the consent but is unable to do so due to substantial barriers; if the patient is an inmate. 45 CFR Section 164.506.

[6] *See,* Privacy of Consumer Financial Information rule, 16 CFR Part 313, which took effect on November 13, 2000, and full compliance was required on or before July 1, 2001.

lack of awareness relative to privacy and security concerns led to the inadvertent breach. Regardless of the level of control or authority an individual in an organization has over the use, disclosure or management of individually or protected health information, each person should bear responsibility for at a minimum being aware of the importance of protected and preserving the confidentiality of that information. As a result, company wide privacy and security training programs are essential – including clear direction as to who to go to for additional information or as questions arise.

From a risk management perspective, the absence of demonstrated injury despite obvious harm, and the absence of a specific duty on the part of this computer programmer to the exact consumers harmed are irrelevant. Further, it is notable that the FTC imposed liability on Eli Lilly despite the fact that it was an individual employee's error – because the FTC determined that the employee had not been properly trained, lacked available resources written or human for direction, and was not properly supervised. The FTC neither looked for nor found any tort liability and did not deploy any of its many consumer protection on-line legislative tools.[7]

To make effective privacy and security policies and procedures a meaningful part of an organization's corporate culture, include continuous updates and reminders. Privacy or security messages at log in, helpful messages on screensavers, and generally incorporating privacy and security into day-to-day functions including an organization's mission or objectives may be helpful. Management experts contend that what gets measured gets done. Measure employees' proficiency and awareness and make the proficiency and awareness scores part of their individual evaluations and those of their team leader and work group. Establish suggestion or feedback boxes to allow employees to recommend innovative ideas or policies – or for bubbling up concerns or suspected vulnerabilities.

3. Put somebody in charge of privacy and security.

Designate a responsible privacy official or security official – or depending upon the size and nature of your business, designate more than one. In order to affect a corporate wide mindfulness about the importance of protecting and preserving the confidentiality of individually identifiable information, it is clear that one or more

[7] In contrast, see, Doe v. Dartmouth-Hitchcock Medical Center et al., U.S. Dist Ct for the District of New Hampshire, Decided 7/19/2001 …. Where the plaintiff sought to impose liability for an intentional breach under Computer Fraud and Abuse Act, 18 U.S.C. Section 1030 (2000), among other state common law and statutory causes of action. In the Dartmouth case, a psychiatric resident was authorized to access the computer system to access her patient's medical records and any other records pertaining to her employment or medical education. She was even given a software program that enabled her to access the Hospital's system from home. Evidently the psychiatric resident became socially acquainted with a patient at the Hospital and when their personal relationship deteriorated she began accessing the patient's records from home. At no time was Doe a patient of the psychiatric resident nor did she have any educational reason to access the patient's medical record. Doe contacted the Hospital believing that the psychiatric resident was improperly accessing her medical records. A Hospital audit eventually revealed that was the case – but because the psychiatric resident was not authorized or directed to review Doe's records by the Hospital and in fact it was proven that the resident violated the Hospital's policies in so doing, the federal court declined to impose liability on Dartmouth.

individuals in organizations must be charged with responsibility for directing, monitoring, assessing, assuring training and education is ongoing, and updating privacy and security policies and procedures. That individual need not be the only person with responsibility for carrying out the privacy policies and procedures. However, unless the importance of the task at hand is recognized and responsibility vested in an individual with sufficient authority to implement the privacy and security policies and procedures, it is difficult to establish and document on-going sensitivity and compliance.

4. Develop a workable set of privacy and security policies and procedures that are scaled to your organization and implement them.

Like human resources policies and procedures, so can privacy and security policies and procedures be either a shield or a sword. There are numerous kits, checklists, forms and other guides readily available through trade associations and commercial vendors for developing privacy and security policies and procedures. They are excellent starting points for drafting appropriate privacy security policies and procedures – but they need to be adapted to the unique circumstances of each business. Perhaps more in depth policies and procedures with more detailed guidelines will be appropriate for work associates with greater access to individually identifiable information.

After designing policies and procedures to fit a business' circumstances, the lesson of Eli Lilly is clear: implement those policies and procedures you have the resources and buy-in to live by, review their effectiveness, update them to shore up vulnerabilities and weaknesses, eliminate them if they are ineffective or unnecessary, and assure that all work associates are aware of them and put them to use.

5. Assess, audit and continuously approve.

For privacy and security policies and procedures to be meaningful, they have to be woven into a company's general compliance framework as part of a quality assurance effort. An organization needs to identify acceptable industry norms for privacy and security, conduct a risk or gap assessment to ascertain where weaknesses and vulnerabilities exist, and take prompt and meaningful steps toward correcting problems. The FTC's position in the Eli Lilly situation is that annual privacy and security compliance audits are necessary, at a minimum. Assessments and audits can be conducted by in-house personnel provided they are appropriately trained to conduct them or by outside experts. In either instance, the results should be documented as well as the effort. Assuming there is any potential for weaknesses to be identified, it may be advisable for the audit or assessment to be addressed to an organization's legal counsel so the organization can seek to avail itself of attorney-client privilege. Including legal counsel in the effort will also assure that any and all professional advice obtained to assist the organization may be privileged thus encouraging the free flow of information to assist the organization in its continuous improvement effort.

Once an assessment has been conducted, experts recommend developing action plans to address and remediate issues. The plans should not only identify the specifics of the issue to address, but a timeframe and schedule, budget, any third parties that should be brought in to achieve the desired solution, and deliverables. Further, one or more persons should be identified as "responsible persons" for carrying out the action plan. Follow up audits should then occur to assure old problems were corrected and new ones have not cropped up or otherwise resulted from solutions put in place to remedy old issues.

6. Document.

Management reports, policy development work product, progress notes, tracking, audit logs, and other pertinent written confirmation of the steps of the entire privacy and security policy and procedure development and implementation plan should be prepared and kept. As noted above, once documentation begins to occur it may be helpful and in fact advisable to have legal counsel involved and to explore reasonably parameters for the documentation and other work product to be subject to the attorney-client privilege.

Any training, education and other reminders and updates should be tracked and documented to keep a ready gauge on the privacy and security readiness of an organization's workforce. Determine whether or not the nature of your business is such that written confidentiality and non-disclosure agreements should be executed by all employees and potentially made available for inspection by clients. They may also serve as vital documentation in connection with any sanctions programs you implement to put teeth into your compliance program.

7. Develop a meaningful and accessible incident and complaint reporting procedure and make certain it is well known company wide.

As an early warning tool, an incident and complaint reporting mechanism should be developed and adopted. Complaint forms can be developed, a hotline phone number and/or email address can be established, or other feedback procedures can be established and communicated. Like the written policies and guidelines, it is essential to use and monitor incidents and complaints and to investigate them, develop an explanation for their cause and effect, and implement one or more plans to resolve them. The incident or complaint process should be available to an organization's workforce and customers. Effective feedback, incident or complaint procedures can lead to the early detection of problems, and assuming issues are resolved quickly and effectively can prevent or mitigate liability.

8. Physical and operational security.

Evaluate some general security matters in your workplace. How do co-workers identify each other (e.g., badges, name tags, and so forth)? How does each computer terminal authenticate the person signing in? Are there access controls in place customized to individual worker's needs for information and functions? Do any information systems track who has touched any consumer's records – and if so, does it generate audits or accountings in the event the consumer wished to see

who touched her or his information? Are any of these systems routinely monitored? Security experts have identified the following as some standard security risks:

- Files or papers containing individually identifiable information left in open areas, on worker's desks or file cabinets after the work day ends
- Computer screens displaying individually identifiable information left up after an employee walks away for a break
- Passwords that can be readily determined, are shared and exchanged, or that are not changed enough
- Paperwork and photocopy errors containing individually identifiable information thrown out in open trash receptacles
- Shredding or incineration programs where materials to be shredded or incinerated are in insecure locations awaiting their destruction
- Chaotic document retention policies making it nearly impossible to locate information and/or to know if any of it is missing; retaining excess materials containing individually identifiable information when the information or data is not needed
- Non-existent or inadequate access controls to databases of individually identifiable information.

Charging team leaders, supervisors and other line management with responsibility for identifying privacy and security risks in their own areas is important both for developing solutions and workable prevention policies. When these individuals identify the problems and are involved in developing solutions, they are more likely to be accountable for the outcome. Many companies, Microsoft included, report that they consider compliance with privacy and security policies as one of a number of criteria in annual performance evaluations of their personnel.

9. Terminated employees.

An essential part of privacy and security policies and procedures is a set of guidelines or a checklist for removing terminated employees' access to individually identifiable information on a timely basis. Removing access should include recovery of any written policies or other company materials, the return of keys or key cards, termination of passwords to computer systems and physical business locations. In addition, if an organization uses confidentiality and non-disclosure agreements, the documents should be drafted to include a survival clause indicating that the employee's covenants to protect and preserve confidentiality should extend beyond the employees' employment and at termination time a terminated employee should be reminded of the document and offered a copy at her or his exit interview.

Conclusions

While indeed it could be argued that the terms and conditions in the Eli Lilly agreement are unique to that corporate entity, they are consistent with the FTC's and HHS's Privacy Agenda and are indicative of each regulatory body's enforcement intentions. As such, it is advisable for any corporate entity dealing in the personally identifiable and non-public information of consumers to apply the

features of the Eli Lilly agreement to its own circumstances to assure that it is making proper privacy and security promises to consumers and has the wherewithal to keep them.

Note that while neither HHS under HIPAA nor the FTC under the Gramm-Leach-Bliley Act are directly regulating the vendors who perform vital services for either "covered entities" under HIPAA or "financial institutions" under Gramm-Leach-Bliley (by virtue of those laws), both regulators have made it clear that the privacy promises afforded consumers under those laws would be meaningless if the third party vendors who access and use consumers' non-public information are not held to similar standards.

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Course # 506 – ERISA Basics Outline

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This outline is offered in my private capacity, and not as a representative of the PBGC. It also does not necessarily reflect the views of PBGC.

ERISA Basics

I. Overview of ERISA

A. ERISA Was Passed in 1974 To Regulate the Voluntary System of Employee Benefits

1. Effective Date. ERISA was generally effective as of September 2, 1974.

2. Congressional Findings and the Policy of ERISA.

   a. In passing ERISA, Congress was attempting to redress inequities primarily in six areas of employee benefit plan administration: (1) disclosure and reporting to participants and beneficiaries of financial and other information, (2) standards for fiduciary conduct, (3) appropriate remedies, sanctions, and ready access to the Federal courts, (4) minimum participation and vesting standards, (5) minimum funding standards, and (6) termination insurance. See ERISA, § 2, 29 U.S.C. § 1001.

   b. Many of these concerns are still hot issues today. For example, the Enron, Polaroid and Worldcom cases have generated a number of legislative proposals directed at remedying the perceived lack of disclosure about the risks of investing in employer securities and plan fiduciaries' conflicts of interest.

3. Voluntary System. ERISA does not require companies to create or continue pension and welfare benefit arrangements, but the area is highly regulated once the employer decides to have a plan.

B. ERISA is divided into four "Titles" with overlapping rules. We will explore each one in greater detail below, but the following points provide a broad overview of the statute:

1. Title I of ERISA provides rules that govern participation, vesting, funding, reporting and fiduciary standards.
   - Many of the rules in Title I concerning coverage, participation, vesting, and funding overlap identical rules in the Internal Revenue Code (the "Code").

- The Department of Labor ("Labor") has primary jurisdiction over Title I of ERISA, though the Internal Revenue Service (the "Service") has primary jurisdiction over rules that concern coverage, participation, vesting and funding. The Pension Benefit Guaranty Corporation ("PBGC") also shares enforcement authority over one of the funding rules that applies to defined benefit plans.
- Title I also provides substantive rights to participants and beneficiaries, who can bring suit in federal court to enforce those rights.

2. Title II of ERISA provides tax qualification rules, including rules for coverage, participation, vesting, funding, and nondiscrimination.
    - The Service has primary jurisdiction over tax qualification issues.
    - Unlike Titles I and IV of ERISA, participants and beneficiaries generally have no substantive rights under Title II or the Code, and they generally cannot sue to enforce these rules.

3 Title III of ERISA provides rules that facilitate coordination among the three "ERISA agencies" – Labor, the Service and PBGC – and the establishment of a joint board of enrolled actuaries.

4. Title IV of ERISA provides additional rules governing termination of defined benefit plans.
    - The PBGC has primary jurisdiction of Title IV.
    - Participants and beneficiaries may file suit under Title IV if they are adversely affected by any act or practice of the PBGC or the plan sponsor or a fiduciary. See ERISA §§ 4003(f), 4070; 29 U.S.C. §§ 1303(f), 1370.

II. Types of Plans

A. One of the more typical ways of classifying employee benefit plans is based on their sponsor(s). Plans are either multiemployer plans or they are single-employer plans.

1. **Multiemployer plans**.

These are plans to which more than one employer is required to contribute and which are maintained pursuant to one or more collective bargaining agreements. ERISA § 3(37)(A); 29 U.S.C. § 1001(37)(A).

2. **Single-Employer plans**.

If the plan does not a multiemployer plan, it is a single-employer plan. ERISA. § 3(41); 29 U.S.C. § 1001(41).

a. Single-employer pension plans pay higher insurance premiums to the PBGC, and PBGC's guarantee limits are higher for those plans.

b. **Multiple Employer Pension Plans**. Sections 4063 and 4064 in Title IV of ERISA provide special rules for single-employer pension plans that have two or more contributing sponsors at least two of whom are not in the same controlled group.

* If a pension plan would be a multiemployer plan except that there is no collective bargaining agreement, it is likely to be a multiple employer plan.

** For example, joint ventures – 50/50 ownership of a business by two unrelated companies -- can result in multiple employer plans if one of the joint venturers allows the employees of the joint venture to participate in its pension plan.

B. Plans are also classified as either welfare plans or retirement plans.

1. All ERISA plans, both welfare and retirement, must have a writing. See ERISA § 402(a)(1), 29 U.S.C. § 1102(a)(1) ("Every employee benefit plan shall be established and maintained pursuant to a written instrument"); Code § 401(a)(2), 26 U.S.C. § 401(a)(2) and Treas Reg. § 1.401-1(a)(2) ("A qualified pension, profit-sharing or stock bonus plan is a definite written program and arrangement.. . ."); ERISA § 4041(a), 29 U.S.C. § 1341(a) (Title IV coverage for plans that the Secretary of Treasury has been determined to be described in Code §§ 401(a) or 404(a)(2).

2. Title I of ERISA requires the following requirements be addressed in the plan document of both welfare and retirement plans.

   a. A fiduciary must be named either in the document itself or through a procedure specified in the plan. ERISA § 402(a)(1), 29 U.S.C. § 1102(a)(1).
   b. The plan must have a funding policy. ERISA § 402(b)(1).
   c. Responsibilities for the plan's operation and administration must be allocated. ERISA § 402(b)(2), 29 U.S.C. § 1102(b)(1).
   d. There must be a procedure for amending the plan. ERISA § 402(b)(3), 29 U.S.C. § 1102(b)(3).
   e. The plan must specify the basis for making payments to and from it. ERISA § 402(b)(4), 29 U.S.C. § 1102(b)(4).
   f. Plan assets must be held in trust by one or more trustees, or the assets must consist of one of more insurance policies. ERISA § 403, 29 U.S.C. § 1103.
   g. Plan assets must be held for the exclusive purposes of providing benefits to participants and beneficiaries and defraying expenses of administering the plan, and they shall never inure to the benefit of the employer. ERISA § 403(c), 29 U.S.C. § 1103(c).
   h. Plans must have a claims review procedure, and it must explain that procedure to participants. ERISA § 503, 29 U.S.C. § 1133.

3. **Welfare Plans**

a. Definition Welfare plans can provide just about any type of benefit that is not deferred compensation. For example, health insurance, life insurance, sick leave, and severance and vacation pay are welfare benefits.

(i) The Code provides a broad definition of welfare benefits. Generally, welfare benefits are any type of employer-provided benefit other than deferred compensation and compensatory property transfers. See 26 U.S.C. § 419(e)(2); Treas. Reg. § 1.419-1T, Q&A-3(a).

(ii) Title I of ERISA covers a more narrow subset of welfare benefits. Under ERISA § 3(1), 29 U.S.C. § 1002(3)(1), an employee welfare benefit plan is defined as a plan that provides the following types of benefits:

(1) (i) medical, surgical, or hospital care or benefits,

(ii) benefits in the event of sickness, accident, disability, death or unemployment,

(iii) vacation benefits,

(iv) apprenticeship or other training programs,

(v) day care centers,

(vi) scholarship funds,

(vii) prepaid legal services, or

(viii) any benefit described in section 302(c) of the Labor Management relations Act of 1947, 29 U.S.C. § 186(c), (other than pensions on retirement or death, and insurance to provide such pensions).

(2) The DOL Regulations exclude typical "payroll practices" from the definition of "welfare plan." These include the following:

(i). payment of compensation for work performed other than during ordinary circumstances; i.e., overtime pay, shift premiums, holiday premiums, and weekend premiums;

(ii) payment of an employee's normal compensation from the employers' general assets due to the employee's being physically or mentally unable to work;
(iii) payment of an employee's normal compensation from the employer's general assets due to vacation leave, military service, jury duty, training, and sabbaticals or continuing education.

See 29 C.F.R. § 2510.3-1(b).

b. Sources of Funding for Welfare Benefit Plans

(i) Unlike retirement plan benefits discussed below, neither the Code nor ERISA require an employer to pre-fund welfare benefits. Instead, most employers use some variation of the following funding sources:

(1) Self-Insure -- the employer pays covered expenses out of corporate assets;
(2) Insurance -- the employer buys a policy from an insurance company to pay covered expenses; and
(3) Employee-funded -- the employees contribute towards the costs of the benefit with either pre-tax or after-tax contributions.

(ii) VEBA Trusts

(1) The VEBA trust is one of the more popular ways that companies pay for welfare benefits. VEBA stands for Voluntary Employees' Beneficiary Association. It is a tax-exempt trust under Code § 501(c)(9), meaning any earnings on trust assets generally are not taxed, and therefore can be used to fund the costs of the benefits.

(2) Contributions to the trust are deductible under other provisions of the Code. However, Code § 419 generally limits the deductible amount to the qualified cost of the welfare benefit fund for

the taxable year. The rules under section 419 are complex, and an actuary may be needed to certify the amount of qualified costs, especially if the employer is pre-funding post-retirement medical and life insurance benefits.

- Amounts paid from the VEBA trust to plan participants and beneficiaries for reimbursement of covered expenses are generally not tax-exempt unless a deduction is found elsewhere in the Code. See Treas. Reg. § 1.501(c)(9)-6.

(3) The VEBA trust is limited to paying for life, sick, accident or other benefits to the members of the association or their dependants or beneficiaries, and no part of the earnings may inure to the benefit of any private individual.

(4) The following types of benefits can be provided through a VEBA trust: vacation expenses, child-care facilities, job readjustment allowances, income maintenance payments in the event of economic dislocation, disaster relief, supplemental unemployment compensation benefits, severance benefits, education or training benefits, and certain types of personal legal service benefits. See Treas. Reg. § 1.501(c)(9)-3(d).

(5) Membership in the VEBA trust must be voluntary. In other words, employees must act to become members. Employers can require all employees to be members of the VEBA if the employees do not incur a detriment for being members, such as the requirement of paying fees. See Treas. Reg. § 1.501(c)(9)-2(c).

(6) The VEBA trust must be controlled by someone other than the employer. See Treas. Reg. § 1.501(c)(9)-2(c).

(iii) Insurance

(1) Many employers purchase insurance to cover all or part of the cost of welfare benefits, especially in the areas of health care and life insurance.

(2) These insurance policies often complicate the analysis of ERISA preemption issues. This is because ERISA generally preempts all state laws that relate to employee benefit plans. See ERISA § 514(a), 29 U.S.C. § 1144. However, that preemption does not extend to state laws that regulate insurance, banking or securities. See ERISA § 514(b)(2)(A), 29 U.S.C. § (b)(2)(A).

(iv) Employee-funding of Welfare Benefits

(1) Cafeteria Plans. A common way of having employees pay for some or all of the cost of welfare benefits is to package the benefits in what the Code calls a "cafeteria plan." These plans typically allow participants to defer a portion of their salary in exchange for non-taxable welfare benefits.

(i) Qualified benefits include:
- up to $50,000 of coverage under a group-term life insurance policy under Code § 79,
- coverage for accident or health plans under Code § 106, where the employee's portion of the cost is paid on a pre-tax basis,
- dependant care assistance under Code § 129, and
- purchase of vacation days.

(ii) There are many complex rules for maintaining a tax-qualified cafeteria plan, including:
- *Open Season*. Participants generally must make benefit

elections during an "open season" preceding the coverage period. See Proposed Treas. Reg. § 1.125-1, Q&A-15.

- *Use or Loose.* Participants cannot carry over benefits from one year to the next. In other words, they must use the nontaxable benefits in the coverage period or loose them. See Proposed Treas. Reg. § 1.125-2, Q&A-5.
- *Election Changes.* There are limits on participants' ability to change or revoke benefit elections under cafeteria plans. For example, changes are generally not allowed unless the participant's family status changes, he separates from service, or there are significant changes in the cost or coverage of health benefits. See Proposed Treas. Reg. § 1.125-1, Q&A-8; Proposed Treas. Reg. § 1.125-2, Q&A-6.
- *Uniform Coverage*. If the cafeteria plan includes a health care flexible spending account, the participant must be able to request the maximum amount of elected reimbursement even if the participant's total salary deferral at the time of the reimbursement is less. See Proposed Treas. Reg. § 1.125-2, Q&A-7.
- *Discrimination Rules*. The Treasury Regulations also impose nondiscrimination rules for eligibility, benefits and concentration, unless the plan is collectively bargained. See 26 U.S.C. § 125(g).

(2) Group Health Plan Continuation – COBRA. Since the passage of the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"), companies with group health plans must offer ex-employees and their dependants continued coverage under circumstances that would otherwise interrupt coverage.

(i) There are parallel COBRA provisions in the Code and Title I of ERISA. Cf. 26 U.S.C. § 4980B, with 29 U.S.C. § 601-609.

(ii) COBRA applies to employers with twenty or more employees during the preceding calendar year. Treas. Reg. § 54.4980B-2, Q&A-4.

(iii) COBRA covers the following "qualified beneficiaries" who have that status as of the day before a "qualifying event":

- the covered employee
- the spouse of the covered employee
- dependant children of the covered employee.

Treas. Reg. § 54.4980B-3.

(iv) COBRA coverage is triggered by "qualifying events." The following are qualifying events if they cause the loss of health care coverage:

- death of covered employee,
- employment termination other than by reason of the covered employee's gross misconduct,
- reduction in covered employee's hours of work,
- divorce or legal separation from the covered employee
- covered employee becomes entitled to Medicare benefits
- dependant child ceases to be dependant under terms of the plan
- Bankruptcy filing of the former employer of a retired employee.

Treas Reg. § 54.4980B-4.

(v) Length of COBRA coverage.

- If the loss of coverage is from termination or reduction in hours, the coverage period is 18 months from the qualifying event.
- If the qualified beneficiary becomes disabled any time during the first 60 days from the qualifying event, the coverage period is 29 months.
- For every other qualifying event, the coverage period is 36 months.
- Special rules apply to multiple qualifying events.

26 U.S.C. § 4980B(f)2)(B)(i); Treas. Reg. § 54.4980B-7, Q&A-1.

(vi) COBRA requires the employer to provide qualified beneficiaries with a "qualifying event notice." This notice tells them of the qualifying event and must include all relevant information to elect continuation coverage. The typical time line is as follows:

- The employer has 30 days from the qualifying event to notify the plan administrator of the qualifying event.
- The plan administrator then has 14 days to notify the qualified beneficiary of the qualifying event. (If the employer is the plan administrator, the 30 days period above is added here, for a total of 44 days.)
- The qualified beneficiary has 60 days to make the election.
- Employer cannot require the qualified beneficiary to pay until 45 days after the election.

Treas. Reg. § 54.4980B-6.

(vii) COBRA Costs

- Employers can charge 102% of the applicable health insurance premium for COBRA coverage.

Treas. Reg. § 54.4980B-8, Q&A-1.

3. **Retirement Plans**

a. A retirement plan is any plan, fund or program established or maintained by an employer to either (i) provide retirement income to employees or (ii) result in the deferral of income by employees for periods beyond covered employment. See ERISA § 3(2), 29 U.S.C. § 1002(2).

b. Retirement plans can be either defined contribution plans or defined benefit plans.

(i) Defined contribution plans, also known as individual account plans, provide an individual account for each participant. The participant's retirement benefit is based solely on amounts contributed to the account, and any income, expenses, gains and losses. The accounts may also receive any allocated forfeitures from the accounts of other participants. ERISA § 3(34), 29 U.S.C. § 1002(34).

(ii) Defined benefit plans, also known as pension plans, are plans that do not have individual accounts. ERISA § 3(35); 29 U.S.C. § 1002(35). A pension plan is "one where the employee, upon retirement, is entitled to a fixed periodic payment," according to the terms set forth in the plan. See Commissioner v. Keystone Consol. Indus., Inc., 508 U.S. 152-154 (1993).

c. A tax-qualified retirement plan must contain language that satisfies the requirements listed in Code § 401(a), 26 U.S.C. § 401(a), and plan administration must follow the written terms. Some of the more significant requirements are listed below:

(i) The trust must be for the exclusive benefit of employees, and it must be impossible for funds to be diverted prior to satisfaction of all liabilities. Code § 401(a)(2).

(ii) The plan must prohibit assignment or alienation of benefits, though it also must recognize Qualified Domestic Relations Orders ("QDROs"). Code § 401(a)(13).

(iii) The minimum vesting rules in Code § 411 must be satisfied. Code § 401(a)(7).

(iv) The plan must permit direct transfers of eligible rollover distributions. Code § 410(a)(31).

(v) The plan may not take into account a participant's annual compensation in excess of $200,000, and it must further limit benefits to the amounts provided under Code section 415. Code § 401(a)(16) and (17).

(vi) Benefits must be definitely determinable. Treas. Reg. § 1.401(1(b)(2).

(vii) Actuarial assumptions must be stated. Code § 401(a)(25).

(viii) Plans intended to be profit sharing plans and money purchase plans must state which type of plan they are. Code § 401(a)(27)(B).

(ix) Plans must require minimum benefit distributions in the year after a participant is age 70_. Code § 401(a)(9).

(x) Defined benefit plans may not allocate forfeitures to participants' benefits. Code § 401(a)(8). Cf. ERISA § 3(34) (defined contribution plans can allocate forfeitures).

(xi) Defined benefit plans must benefit the lesser of (a) fifty employees or (b) forty percent of all employees if there are more than 2. Code § 401(a)(26).

(xii) If the plan merges with another or consolidates or transfers its assets or liabilities to another plan, benefits must be protected. Code § 401(a)(12).

(xiii) Participants must be allowed to begin receiving benefit payments on the later of (a) sixty days after the end of the plan year in which the participant attains age 65, (b) ten years after entering the plan, (c) or leaving employment. Code § 401(a)(14).

(xiv) Plans generally cannot increase benefits when the employer is in bankruptcy. Code § 401(a)(33).

d. Defined benefit plans must meet the minimum funding standard. Generally, this means that the employer must make sufficient contributions to the plan to pay the plan's normal

cost (i.e. benefits accruing during the year) plus amortization of any past service credit. See Code § 412, 26 U.S.C. § 412; ERISA § 302, 29 U.S.C. § 1082.

III. Title I of ERISA – Requirements Regarding Reporting and Disclosure, and Fiduciary Responsibility

A. Reporting and Disclosure

1. There are a number of reports that employee plans may be required to file with government agencies. The most significant of them is the annual return on Form 5500. Both welfare and retirement plans must file this return each year. Code § 6058; ERISA § 103, 104. The return must be filed by the last day of the seventh month after the end of the plan year, though an automatic two and one-half month extension is routinely granted. All three ERISA agencies may share the data in these returns, and much of the information is made available to the public. See http:\www.freeerisa.com.

2. Employee plans must make the following information available to participants upon their request: (1) the plan and trust documents, (2) the latest Summary Plan Description ("SPD"), and (3) the latest Summary Annual Report ("SAR"). In addition, the Plan must provide each participant of a welfare or retirement plan with a SPD, SAR and a summary of material modification. ERISA §§ 101, 102, 104, 29 U.S.C. §§ 1021, 1022, 1024. The SPD must be distributed within 90 days of the employee becoming a participant in the plan. The SMM must be distributed within 210 days after the close of the plan year of the modification. The SAR must be provided within nine months of the close of the plan year.

3. The plan may use electronic media to (1) enroll participants, (2) allow participants to designate beneficiaries, (3) honor participants' direct rollover elections, (4) allocate future contributions among investment alternatives, (5) change investment allocations for account balances, (6) make inquiries of the plan administrator. See I.R.S. Notice 99-1, 1999-2 I.R.B. 8.

B Fiduciary Responsibility

1. Who is a Fiduciary? Courts have said the definition of fiduciary is both a functional and transactional test. In other words, one must

look at the transaction and see what functions each participant is performing. The plan's fiduciaries are the people who:

a. exercise any discretionary authority or discretionary control or discretionary responsibility in the management or administration of the plan, or
b. exercise any authority or control respecting management or disposition of plan assets, or
c. render investment advice for a fee or other compensation, direct or indirect, with respect to moneys or other property of the plan, or has responsibility or authority to do so.

ERISA § 3(21)(A), 29 U.S.C. § 1002(3)(21)(A).

2. To whom does the Fiduciary have a duty? The Fiduciary must discharge his duties solely in the interest of plan participants and beneficiaries.

3. What are the Fiduciary's Duties? Fiduciaries must
   a. act for the exclusive purpose of providing benefits and defraying reasonable administrative expenses,
   b. with the skill, prudence and diligence of a prudent expert,
   c. diversify investment to minimize the risk of large losses,
   d. follow the plan's terms, unless they are inconsistent with Titles I and IV of ERISA.

   ERISA § 404(a), 29 U.S.C. § 1104.

4. What are the plan assets?
   a. Mutual Funds and Insurance Companies
      (i) Mutual Funds – If a plan invests in the securities of an investment company registered under the Investment Company Act of 1940, the assets of the plan include the security but not, by reason of the investment alone, any assets of the investment company.
      (ii) Insurance Companies – If an insurer sells a guaranteed benefit policy to a plan, the assets of the plan include the policy but generally not the assets of the insurer.

      ERISA § 401(b), 29 U.S.C. § 1101(b) .

   b. Look Through Rule
      (i) General Rule. When a plan makes an investment in another entity, the plan's assets include the investment but do not include the underlying assets of the entity.

(ii) Exception. Plan investments include the underlying assets of an entity (and fiduciary duties will attach) unless one of the following factors is present:
(1) The plan does not have an equity position. The investment must be (a) treated as debt under state law and (b) must not have substantial equity features.
(2) The investment is in publicly offered securities or a mutual fund registered under the 1940 Act.
(3) The investment is in an operating company.
(4) Investment by benefit plan investors in the aggregate must not be significant (25% or more).

29 U.S.C. § 2510.3-101.

c. Attributes of a plan investment are also plan investments. For example, dividends, voting rights, choses in action for derivative suits, and the right to possess real or personal property.

d. Contributions to the plan. By regulation, Labor has ruled that employee contributions become plan assets on the earliest date the contributions can reasonably be segregated from the employer's general assets. This is defined as no later than the 15th business day of the month following the month in which the participant contributions were withheld. 29 C.F.R. § 2510.3-102.

C. Prohibited Transactions

1. Employee benefit plans may not engage in "prohibited transactions" with a "party in interest." These terms are discussed in greater detail below.

2. "Parties in Interest:

a. ERISA §(3)(14), 29 U.S.C. § 1002(3)(14), makes the following individuals "Core" parties in interest:
(i) fiduciaries, counsel and employees of the plan;
(ii) service providers;
(iii) employers as defined in ERISA § 3(5); and
(iv) employee organizations as defined in ERISA § 3(4).

b. There are also attribution rules to extend the reach of the party in interest definition beyond the Core parties identified above. See ERISA § 3(14)(E), (F), (G), (H), and (I).

3. The fiduciary of a plan may not allow the plan and a party in interest to enter into the following transactions, unless the transaction is allowed elsewhere in ERISA § 408:
   a. Transactions that constitute a direct or indirect
      (i) sale or exchange, or leasing, of any property;
      (ii) lending of money or extension of credit;
      (iii) furnishing of goods, services or facilities;
      (iv) assets being transferred to, or used by or for the benefit of a party in interest; and
      (v) acquisition of employer securities or employer real property in violation of ERISA § 407(a).
   b. Fiduciaries with authority or discretion to control or manage the plan's assets may not permit the plan to hold employer securities or employer real property in violation of ERISA § 407(a).

   ERISA § 406(a), 29 U.S.C. § 1106.

4. Title I of ERISA completely prohibits a fiduciary from the following acts:
   a. dealing with plan assets in his own interest or for his own account;
   b. acting in any transaction on behalf of a party whose interests are adverse to the plan or its participants and beneficiaries, and
   c. receiving consideration for personal account from anyone dealing with the plan in connection with a transaction involving plan assets.

   ERISA § 406(b), 29 U.S.C. § 1106(b).
   Note: For these transactions, there can be no exemption. See 29 C.F.R. § 2550.408b-2(e).

5. Prohibited Transaction Exemptions.
   a. Service Provider Exemptions
      (i) The Plan may enter into a transaction with a service provider party in interest for necessary services so long as it pays no more than reasonable compensation. See 29 C.F.R. § 2550.408b-2.
      (ii) A fiduciary that is a bank as defined in DOL Reg. 2550.408b-4(c) can invest all or part of the plan's

assets in deposits of the bank if the assets earn a reasonable rate of interest. ERISA § 408(b)(4).

b. Loans from the plan to participants can be made under certain circumstances. ERISA § 408(b)(1).

c. Certain loans to employee stock ownership plans are permitted. ERISA § 408(b)(3).

d. Insurance companies can invest their own plans' assets in their own insurance policies or annuity contracts if no more than adequate consideration is paid. ERISA § 406(b)(5), 29 U.S.C. § 1106(b)(5).

e. Class and Individual Exemptions. Labor has the authority to issue exemptions on a class or individual basis. Class exemptions generally can be relied upon by anyone similarly situated. Individual exemptions are only controlling authority for the entity that made the request.

IV. Title II of ERISA – Tax Qualification of Employee Benefit Plans

A. Title II of ERISA largely consists of amendments to the Internal Revenue Code (the "Code"). See ERISA § 1001. The Internal Revenue Service (the "Service") has jurisdiction of the Code in general, and specifically the amendments to it from Title II of ERISA.

1. As noted above, the amendments to the Code by Title II of ERISA (including subsequent legislative enactments) affect the plan sponsor's ability to maintain a tax-qualified plan. If the plan is not tax-qualified, the consequences are severe: the trust may be taxed, the participants and beneficiaries may be taxed for their constructive receipt of benefits, and the employer may loose tax deductions for amounts contributed to the plan and also may have to pay excise taxes.

2. Given the consequences to maintaining a plan that is not tax qualified, most employers request advance determinations from the Service that plans are qualified in form. IRS Form 5300 is used for requesting a "determination letter." Employers must provide advance notice to interested parties not less than seven days and not more than twenty-one days before requesting a determination letter. The Service is reconsidering whether it will continue to issue determination letters, or whether it will amend the process. See IRS Announcement 2001-83, 2001-35 I.R.B. 205.

3. Congress has passed many amendments to the Code since ERISA was enacted in 1974. In fact, the Code was restated in its entirety in 1986. Rather than discuss the ERISA-specific Code provisions here, we have discussed some of the requirements for tax-qualification in the sections above.

4. The Controlled Group Rules. Among the more significant ERISA-related rules in the Code are ones that concern businesses under "common control" and "controlled groups." These rules in effect pierce the corporate form, making all trades or businesses with a required level of common ownership responsible for certain ERISA requirements.

   a. Controlled Group. The special rule in Code § 414(b) provides that all employees of all corporations which are members of a controlled group of corporations are treated as employed by a single employer. The rule applies to the following Code requirements: § 401 (plan qualification), § 408 (individual retirement accounts), § 410 (minimum participation and coverage), § 411 (minimum vesting), § 415 (limitations on benefits and contributions) and § 416 (consequences of "top heavy" status).

   b. Common Control. The special rule in Code § 414(c) provides that all employees of trades or businesses (whether or not incorporated) which are under common control shall be treated as employed by a single employer. This rule applies to the same Code requirements identified above.

   c. The Service has promulgated regulations at 26 C.F.R. § 1.414(b), (c) that expand on these special rules. Under the regulations, businesses are under common control, or a controlled group exists, if they are part of either a Parent-Subsidiary Controlled Group or a Brother-Sister Controlled Group.

      (i) Parent-Subsidiary Controlled Group. A parent-subsidiary controlled group exists if a common parent has a "controlling interest" in its subsidiaries. A "controlling interest" exists if one of the following tests is met.

(1) For corporations, 80% or more ownership of the total voting power of all classes of stock, or 80% or more ownership of the total value of shares of all classes of stock,

(2) For partnerships, 80% or more ownership of the profits or capital interest,

(3) For trusts and estates, ownership of an actuarial interest of at least 80% of the trust or estate,

(4) For sole proprietorships, ownership of the sole proprietorship.

(ii) Brother-Sister Controlled Group. A brother-sister controlled group exists if (1) the same 5 or fewer individuals own a controlling interest in a business, and (2) taking into account the ownership of each individual only to the extent the such person's ownership is identical with respect to each business, the individuals are in "effective control" of the business. "Effective control" exists in the following circumstances:

(1) For corporations, the individuals own stock possessing more than 50% of the total combined voting power of all classes of voting stock or more than 50% of the total value of shares of all classes of stock.

(2) For partnerships, the individuals own an aggregate of more than 50% of the profits interest or capital interest of the business.

(3) For trusts and estates, the individuals own an aggregate actuarial interest of more than 50% of the trust or estate.

(4) For sole proprietorships, one of the individuals owns the sole proprietorship.

(iii) Impact of the Controlled Group Rules. The controlled group rules are very complicated, and our discussion above reaches just the "tip of the iceberg." However, they can have dire consequences for unwary businesses, both large and small. For example, the owners of a closely-held company may find all of their holdings exposed to ERISA liability if they buy a controlling interest in a business that has an ERISA plan. And even publicly-held corporations can have difficulty meeting certain tax-qualification requirements if affiliates that meet one of the controlled group tests have substantially different benefits packages for employees.

V. Title III of ERISA – Coordination Among the Three ERISA Agencies and the Joint Board of Enrolled Actuaries

A. Since ERISA contains so many parallel and complicated rules divided among three substantive Titles, and since there are three separate Federal agencies charged with interpretation and enforcement authority over those rules, Title III of ERISA was passed to facilitate resolution of the jurisdictional issues.

1. The Internal Revenue Service has jurisdiction over the statutory provisions in ERISA and the Code that deal with minimum participation standards, minimum vesting standards, and minimum funding standards. See ERISA § 3002, 29 U.S.C. § 1202.

2. The three ERISA agencies – the Department of Labor, Internal Revenue Service and the Pension Benefit Guaranty Corporation, are directed to coordinate with one another when performing their functions under ERISA. See ERISA § 3004.

B. Title III of ERISA also created the Joint Board for the Enrollment of Actuaries. This body sets professional standards for actuaries who provide services to employee benefit plans.

VI. Title IV of ERISA – Additional Requirements for Certain Defined Benefit Pension Plans

A. Pension Insurance and the Pension Benefit Guaranty Corporation

1. Title IV of ERISA, 29 U.S.C. §§ 1301-1461, as amended, establishes the mandatory termination insurance program for private-sector defined benefit pension plans. The Pension Benefit Guaranty Corporation ("PBGC"), a wholly-owned government corporation, administers the program and enforces its rules. ERISA § 4002(a), 29 U.S.C. § 1302(a). The PBGC's board of directors consists of the Secretaries of Labor, Commerce and Treasury.

2. The termination insurance program is not funded by tax dollars. Instead, plan sponsors pay insurance premiums to PBGC each year based on the number of plan participants and the amount of the plan's unfunded vested benefits. The insurance fund also receives the assets of terminated plans, liability payments from companies responsible for terminated plans and investment earnings on all of the above. See ERISA § 4005(b)(1), 4006, 4042 and 4062; 29 U.S.C. § 1305(b)(1), 1306, 1342 and 1362.

3. The PBGC has a broad grant of authority to promulgate regulations enforcing its rights and powers under Title IV and carrying out the purposes of Title IV. See ERISA § 4002(b)(3), 29 U.S.C. § 1302(b)(3).

B. Title IV Coverage

1. Generally, termination insurance under Title IV of ERISA is mandatory for all tax-qualified, private-sector, pension plans.

a. Section 4021(a)(2), 29 U.S.C. § 1321(a)(2), provides that Title IV applies to any plan that "is, or has been determined by the Secretary of Treasury to be, a plan described in section 401(a) of the Internal Revenue Code of 1986, or which meets, or has been determined by the Secretary of Treasury to meet, the requirements of section 404(a)(2) of such Code."

b. Section 4021(b), 29 U.S.C. § 1321(b) excludes thirteen types of plans, the most common of which are individual account plans (e.g. 401(k) plans), professional service provider plans, governmental plans, and so-called "top-hat" plans. See 29 U.S.C. § 1321(b)(1) , (2), (6) and (13).

c. The statue regards a successor plan as the continuation of the predecessor plan. ERISA § 4021(a), 29 U.S.C. § 1321(a). A successor plan is generally defined as a plan that covers a group of employees which includes substantially the same employees as a previously established plan, and provides substantially the same benefits as that plan provided. Id.

d. So-called "cash balance" plans or "hybrid plans" are a type of defined benefit plan. These are plans that typically express the participant's accrued benefit as a lump sum payment, payable upon the person's separation from employment. While these plans may appear to operate and communicate like defined contribution plans, they are subject to Title IV and must pay PBGC insurance premiums. While PBGC guarantees the annuity value of the benefit as of the participant's normal retirement age, it does not guarantee the lump sum value of the participants' benefits. See PBGC Opinion Letter 89-6 (August 8, 1989). PBGC also generally will not pay benefits in excess of $5,000 before a participant retires on or after reaching the age of 55. See 67 Fed. Reg. 16590 (April 8, 2002)

2. Overview of Other Significant Title IV Provisions.

a. Once the plan is covered, the employer and all members of its controlled group must pay PBGC premiums based on the plan's number of participants and amount of unfunded vested benefits. ERISA §§ 4006, 4007; 29 U.S.C. § 1306, 1307.

- The controlled group rules discussed above are also used in Title IV of ERISA.

PBGC premiums continue to accrue until either (1) all of a sufficient plan's assets are distributed pursuant to a standard termination, or (2) PBGC is appointed the statutory trustee of an insufficient plan pursuant to a distress or involuntary termination (discussed below). ERISA § 4007(a), 29 U.S.C. § 1307(a).

b. An employer cannot terminate the plan unless it complies with the requirements in section 4041 of ERISA, 29 U.S.C. §

1341. See Hughes Aircraft v. Jacobson (cite) (Title IV of ERISA provides the exclusive means of plan termination).

(i) Plans that have sufficient assets to pay all promised benefits terminate in a "standard" termination. To complete a standard termination, the plan administrator must generally notify participants of the termination within a specified "window" time period, and complete the distribution of plan assets after filing with PBGC.

(ii) Plans that do not have sufficient assets to pay all promised benefits terminate in a "distress" termination. The employer and each member of its controlled group must show that they are in financial distress before an underfunded plan can terminate. ERISA § 4041(c)(2)(B), 29 U.S.C. § 1341(c)(2)(B). Generally, this requires a showing that all controlled group members satisfy any one of the following three statutory criteria:

(1) liquidation in bankruptcy or court-supervised insolvency proceedings, or

(2) reorganization in a bankruptcy or court-supervised insolvency proceeding, and the court finds that the company will not be able to pay all of its debts pursuant to the reorganization plan unless the pension plan is terminated, or

(3) inability to stay in business and pay debts when due unless the plan is terminated or an unreasonably burdensome cost of providing pension coverage solely as a result of a declining workforce. Id.

(iii) PBGC has the power to seek termination of a pension plan without the employer's consent if, for example, it views a transaction as possibly increasing its risk of loss. ERISA § 4042(a)(4), 29 U.S.C. § 1342(a)(4). (Other so-called "involuntary" termination criteria are provided in ERISA § 4042(a)(1), (2) and (3).) PBGC

has published guidelines regarding its involvement in corporate transactions. See PBGC Technical Update 2000-3 (July 24, 2000).

(iv) Once an underfunded plan terminates and PBGC is appointed its statutory trustee, all members of the controlled group as of the plan termination date incur joint and several liability for the plan's unfunded benefit liabilities. ERISA § 4062(a), 29 U.S.C. § 1362(a).

(1) If the liable company fails to pay the amount of the liability after PBGC's demand, PBGC has a lien on the all of the company's property and rights to property for up to 30% of the controlled group's collective net worth. ERISA § 4068(a), 29 U.S.C. § 1368(a).

(a) PBGC's regulations generally provide for administrative appeal of its employer liability determinations, and court review is based on the agency's administrative record.

(v) PBGC is authorized to file and enforce certain liens that arise by operation of law in favor of the plan if the controlled group fails to pay more than $1 million in unpaid contributions. 26 U.S.C. § 412(n).

eBibliography

On the internet there are numerous excellent resources available to enhance your knowledge of HIPAA. Many of them are free. To follow is a guide to finding some of these resources quickly.

Resource	Where to Find It
HIPAA – Original Resources from HHS' Office for Civil Rights	http://aspe.os.dhhs.gov/admnsimp
HIPAA – Administrative Simplification – Original Resources from HHS' CMS	http://www.cms.hhs.gov/hipaa/hipaa2/default.asp
HIPAA – Ask CMS a question	You can email a question in at AskHIPAA@cms.hhs.gov
Unofficial Updated HHS Privacy Rule – with all modifications	http://www.hhs.gov/ocr/combinedregtext.pdf
The Privacy Perspective	www.healthprivacy.org
Privacy beyond HIPAA	www.privacy.org (not specific to health privacy) http://www.privacyalliance.com (the on-line privacy alliance, a private sector initiative) http://www.privacyalliance.com/resources/OPA_brochure.pdf - an excellent two page brochure on adopting on line privacy policies but useful tips generally http://www.epic.org (Electronic Privacy Information Center – often carries current news and events on electronic privacy developments) http://www.cdt.org/privacy (Center for Democracy & Technology)(website contains an excellent, even if a bit dated, research piece on Privacy in the Digital Age at http://www.cdt.org/publications/lawreview/1999nova.shtml) (website also contains useful glossaries, summaries of pending legislation, comparison charts) the Network Advertising Initiative – Web Beacons http://www.networkadvertising.org/default.asp

State Laws – Survey & Links	www.healthprivacy/resources.org
Electronic Transactions & Security of Health Information	http//snip.wedi.org www.cpri-host.org www.hcfa.gov/security/isecplcy.htm www.astm.org-cgi-bin/SoftCart.exe/COMMIT/COMMITTEE/E31.htm?L+mystore+rlbv0792+953158985 (ASTM E 1869-97: Standard Guide for Confidentiality, Privacy, Access, and Data Security Principles for Health Information Including Computer-Based Patient Records, cost is $59.00 to order the volume)
Transactions standards, implementation guides and data dictionary – Washington Publishing Company	http://www.wpc-edi.com/hipaa/HIPAA_40.asp
Information on the pharmacy industry and HIPAA including the retail drug claim standard – National Council for Prescription Drug Programs	http://www.ncpdp.org
Data Interchange Standards Association – ASC X12 control standards, and X12N standards for electronic data interchange, task groups, and workgroups, including minutes of their meetings	http://www.disa.org
EHNAC, an independent not for profit accrediting body.	http://www.ehnac.org/Accreditation/Overview.html
Accreditation Requirements	JCAHO www.jcaho.org/trkhco_frm.html NCQA www.ncqa.org
Training Resources	www.roiWebEd.com

Gap Assessment Tools	www.PrivaPlan.com www.NCHICA.org cost involved with each
Policy and Procedure Template Kit	www.clayton-macbain.com various versions of the kit available; cost involved with each
Forms and Other Resources – WEDi-SNIP site and some state sites as well as HealthKey	http://www.chcf.org/ http//snip.wedi.org http://www.hhic.org/hipaa/hipaa_links.html http://www.state.oh.us/hipaa/ http://healthkey.org
Health Information & Medical Records	www.ahima.org
OnLine "Seals of Approval"	eTrust - http://www.truste.com/ Better Business Bureau OnLine - http://www.bbbonline.org/ WebTrust - http://www.cpawebtrust.org/
E-alert from Association of American Physicians and Surgeons, Inc. on how to take advantage of the "country doctor" opt-out in HIPAA	http://www.aapsonline.org
Group list and other resources around issues of what it means to be "HIPAA compliant" - HCCO	http://www.hipaacertification.org

Other Online Privacy Resources	Alliance Privacy Resources for Businesses http://www.privacyalliance.org/businesses/ This page offers a review of what some OPA member companies have done to ensure privacy protection on their sites, and includes links to OPA resources including, guidelines for Effective Privacy Policies, guidelines for Effective Enforcement of Self-Regulation, principles for Children's Online Activities, etc. Department of Commerce International Safe Harbor Principles http://www.ita.doc.gov/td/ecom/shprin.html Electronic Privacy Information Center: Privacy by Topic: The A to Z's of Privacy http://www.epic.org/privacy/#topics This page offers a comprehensive listing of privacy-related definitions, issues, organizations and conferences Privacy Exchange: Legal Library http://www.privacyexchange.org/legal/contents.html This page includes links to legal information from international and multi-national laws, national laws, state and provincial laws, regulations and administrative orders, proposed and Pending Legislation, etc.
Joint Healthcare Information Technology Alliance – updates on legislation/regulation, telecommunications, and business processes	http://www.jhita.org
American Hospital Association – legislative updates, tools and resources, links to other resources	http://www.aha.org/hipaa

Association for Electronic Healthcare Transactions (AFEHCT)	http://www.afehct.org
Massachusetts Health Data Consortium (MHDC) – resources, HIPAA materials, events	http://mahealthdata.org
California Department of Health Services, Medi-Cal – HIPAA updates including background paper and links	http://medi-cal.ca.gov
Accredited Standards Committee X12 – information on EDI	http://www.x12.org
CMS's HIPAA Page	http://hcfa.gov/hipaa/hipaahm.htm
ACA International – the international trade association for credit and collections professionals has excellent HIPAA educational programs, both conferences and teleseminars for billing and collections agencies and their attorneys	http://acainternational.org

American Corporate Counsel Association
HIPAA Privacy Briefing

Leslie Bender, Esquire
General Counsel & Chief Privacy Officer,
The ROI Companies, including roiWebEd Company

Introduction

- The Health Insurance Portability and Accountability Act of 1996 ("HIPAA") as one of many federal privacy mandates
- Overview of HIPAA's privacy compliance administrative requirements

Some Notable Federal Privacy Laws and Regulations

- Federal Trade Commission Act (FTC Act)
- Gramm-Leach-Bliley Act (GLBA)
- Health Insurance Portability and Accountability Act of 1996 (HIPAA)
- The Family Educational Rights and Privacy Act (FERPA)
- Fair Credit Reporting Act (FCRA)

In the HIPAA compliance countdown, privacy problems may already be considered unfair or deceptive trade practices …

FTC Perspective: Privacy Problems as an Unfair or Deceptive Trade Practice

- Eli Lilly & Company enforcement action under Section 5 of the Federal Trade Commission Act
- July 2001 events and subsequent FTC action
- Subsequent state attorney generals' actions and $160,000 cash settlement
- FTC consent order – minimum of 20 years' duration
- How this relates to HIPAA

HIPAA

- Three interlocking sets of regulations published by HHS
  - Transactions and Code Sets (10/16/2002 if no extension, or 10/16/2003)
  - Privacy – sometimes referred to as the "Privacy Rule" (4/14/2003)
  - Security (regulations not yet in final form)
- HIPAA's Privacy Rule sets a national standard for medical privacy – so states still free to enact more stringent medical privacy requirements
- Each set of regulations published by HHS includes both standards and implementation specifications

HIPAA – Privacy Rule – Discussion Points

- Definitions
- Responsibilities of a Covered Entity under HIPAA relative to its Vendors – What Makes a Vendor a "Business Associate" Under HIPAA?
- Obligations of Vendors Receiving, Using, Disclosing or Creating Protected Health Information on Behalf of Covered Entities

HIPAA Definitions

- Covered Entities
- Protected Health Information
- Business Associates
- Use
- Disclosure

Who are “covered entities”?

- Providers
- Health plans
- Health care clearinghouses
- Certain self-insured employers offering medical benefits and having 50 or more participants in self insurance program

Protected Health Information

- PHI is “individually identifiable health information” --
- that is maintained or transmitted through or by electronic media
- it is health information, including basic demographic information, whether oral or written,
- collected from an individual by a health care provider, a health plan or a health care clearinghouse
- that identifies an individual (or with respect to which there is a reasonable basis to believe the information can be used to identify the individual), and
  - the health information relates to:
  - the past, present or future physical or mental health or condition of an individual,
  - the provision of health care to an individual, or
  - the past, present or future payment for the provision of health care to an individual

Data Elements that = PHI

- NAMES;
- ALL GEOGRAPHIC SUBDIVISIONS SMALLER THAN A STATE, INCLUDING STREET ADDRESS, CITY, COUNTY, PRECINCT, ZIP CODE, AND THEIR EQUIVALENT GEOCODES, EXCEPT FOR THE INITIAL THREE DIGITS OF THE ZIP CODE IF THE GEOGRAPHIC UNIT FORMED BY COMBINING ALL ZIP CODES WITH THE SAME INITIAL THREE DIGITS CONTAINS MORE THAN 20,000 PEOPLE (OR IF NOT, THE INITIAL THREE DIGITS OF THE ZIP CODE IS CHANGED TO 000;
- ALL ELEMENTS OF DATES (EXCEPT YEAR) FOR DATES DIRECTLY RELATED TO AN INDIVIDUAL SUCH AS BIRTH DATE, ADMISSION DATE, DISCHARGE DATE, DATE OF DEATH, AND ALL AGES OVER 89 AND ALL ELEMENTS OF DATES INDICATIVE OF SUCH AGE, EXCEPT THAT SUCH AGES AND ELEMENTS MAY BE AGGREGATED INTO A SINGLE CATEGORY OF AGE 90 OR OLDER;
- TELEPHONE NUMBERS;
- FAX NUMBERS;
- ELECTRONIC MAIL ADDRESSES;
- SOCIAL SECURITY NUMBERS;
- MEDICAL RECORD NUMBERS;
- HEALTH PLAN BENEFICIARY NUMBERS;
- ACCOUNT NUMBERS;
- CERTIFICATE/LICENSE NUMBERS;
- VEHICLE IDENTIFIERS AND SERIAL NUMBERS, INCLUDING LICENSE PLATE NUMBERS;
- DEVICE IDENTIFIERS AND SERIAL NUMBERS;
- URLS;
- IP ADDRESS NUMBERS;
- BIOMETRIC IDENTIFIERS, INCLUDING FINGER AND VOICE PRINTS;
- FULL FACE PHOTOGRAPHIC IMAGES AND ANY COMPARABLE IMAGES; AND
- ANY OTHER UNIQUE IDENTIFYING NUMBER, CHARACTERISTIC, OR CODE – EXCEPT THAT THE COVERED ENTITY MAY ASSIGN A CODE OR OTHER MEANS OF RECORD IDENTIFICATION TO ALLOW FOR RE-IDENTIFICATION BY THE COVERED ENTITY (SO LONG AS THE CODE CANNOT BE TRANSLATED TO IDENTIFY THE INDIVIDUAL AND IS NOT DISCLOSED BY THE COVERED ENTITY).

“Use” versus “Disclosure”

- “Use” of health information occurs within an organization
- “Disclosure” of health information occurs when an organization provides health information to third parties, even if the third parties are governmental agencies, vendors, other health care organizations

HIPAA – What if a health care organization regularly exchanges health information with other organizations?

- HIPAA allows this to continue – but crafts the concept of "business associate"
- Under HIPAA, "**business associate**" means a person (vendor) who with respect to a health care provider, health plan, or health care clearinghouse performs or assists in the performance of:
  - A function or activity involving the use or disclosure of individually identifiable health information, or
  - Any other function or activity regulated by the HIPAA Privacy Rule.

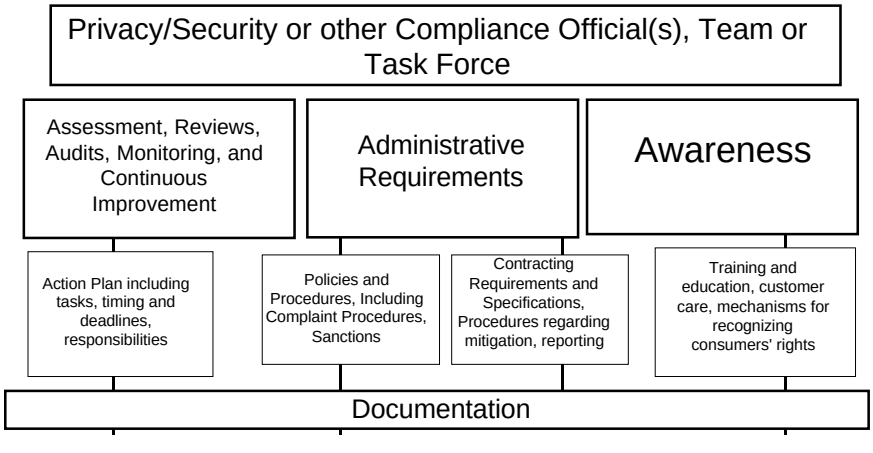
Business Associates

- Examples of "business associates" -
- Claims processors,
- Accountants,
- Billing companies and collections agencies,
- Benefits management firms,
- Attorneys,
- Health care consultants,
- Accreditation organizations.

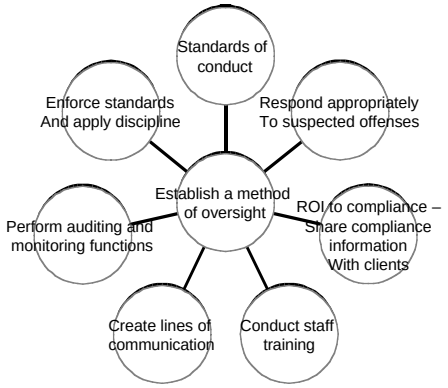
Important rights given individuals under the Privacy Rule

- Right to access for purposes of inspection or copying
- Right to request amendments
- Right to receive an accounting of disclosures
- Right to request additional privacy of health information
- Right to file a complaint with an organization or even HHS

What a Privacy Compliance Program Looks Like



Making Privacy Compliance Operational



Elements of a privacy compliance project

- Awareness kick off with key managers
- Central accountability – privacy official
- Gap or risk assessment
- Development of remediation plan
- Update of existing policies and procedures
- Customization of training and educational programs to include policies and procedures, practical examples, development of FAQs
- Training and education throughout organization, business associates
- Documentation, documentation, documentation
- Confirmation that privacy practices described in website are consistent with written privacy policies and procedures

Commercial Websites and Privacy

Next Steps – Value Proposition

- A privacy compliance program does not have to be perfect – but it does need to be effective
- Any privacy compliance program will only be effective if part of
  - Your corporate culture, and
  - Your workforce's mindset.
- With heightened privacy awareness among consumers, an effective privacy compliance program will provide you with strategic and marketing advantages (while managing your risks).

Privacy is your business

- HIPAA will obligate organizations to assure that privacy is everyone's business
- Any rules, policies, or procedures that an organization adopts should be properly document, accessible to workforce and public, and should be workable and operational

HIPAA Privacy and Business Associates

HIPAA's Privacy Rule and Business Associates

- Congress did not authorize HHS to directly regulate "business associates" under HIPAA so HHS developed regulations requiring covered entities to regulate business associates through a contract called a "business associate agreement." Through business associate agreements, covered entities pass along various HIPAA requirements to their vendors and other service providers.

Covered Entity's Responsibilities relative to Business Associates

- Privacy: Before disclosing PHI to a Business Associate a Covered Entity must obtain a "satisfactory assurance that the Business Associate will appropriately safeguard the information"
- *(See, 45 CFR Section 164.502(e)(1)(i))*

HIPAA and the Duty to Mitigate

- Note that under the HIPAA Privacy Standards, if a Covered Entity knows that harm has resulted from a misuse of PHI, even if by a business associate, a Covered Entity has a duty to mitigate. A covered entity may contract with a business associate to obligate a business associate to mitigate damages or harm it causes through contract language called “indemnities.”

Compliance Responsibilities

- Within the various regulations under HIPAA, vendors will need to comply with the following (and develop documentation relative to their compliance):
  - Basic contract drafting requirements
  - Operational requirements
  - Security standards
  - Transactions and codes sets standards, if applicable to business associate’s functions

GLBA

- Final Safeguards for Non-Public Financial Information Rule published by the FTC on May 17, 2002
- Compliance deadline: May 23, 2003
- “Service provider” language – with additional year to finalize written contracts

How do GLBA and HIPAA compare?

- GLBA has security and privacy features in one set of regulations
- Fewer data elements = non public financial information than = PHI
- Longer time to enter into a written contract with service providers
- Same privacy infrastructure generally required under each (e.g., training, policies and procedures, safeguards, sanctions, central “go to” person)

Timing Issues: When do the components of HIPAA take effect relative to GLBA?

- HIPAA Privacy (4/14/2003) thereafter)
- GLBA Safeguards Rule (5/23/2003) – with additional year on contracting requirements
- HIPAA Security (to be determined – Final Rule expected late 2002 – compliance expected 24+ months

What This Means …

- Regardless of what industry an organization is in, if it is using consumer's non-public financial information or health information, the FTC has determined that breaking privacy promises to consumers is a deceptive or unfair trade practices under the FTC Act
- For an organization serving clients in any of a variety of industries, selecting the most stringent privacy legislation or regulatory requirements and managing to them may be the most prudent course of action – or alternatively, manage separate divisions under separate sets of guidelines and compliance programs

What This Means …

- If your organization is a “business associate” or “service provider,” relying on the fact that privacy obligations may be indirect rather than direct under HIPAA or GLBA is short sighted since both sets of regulations obligate the “covered” organization to make amends to the consumer for harm and damage and are unlikely to do so without a strong indemnity from service providers
- Most states recognize a cause of action for invasion of privacy or breach of confidentiality – either by common law or statute

Appendix I. HIPAA Myths

- Myth. Separate agreements are required for meeting Business Associate, Chain of Trust and Trading Partner HIPAA Mandates – note that HIPAA never imposes a requirement that any of these obligations be spelled out in separate documents. HIPAA merely requires that there be a written document and in some instances related internal compliance documentation that includes these mandates
- Myth. A Business Associate, if not a Covered Entity, can be regulated by HHS under HIPAA – HHS is not authorized to regulate the activities of a Business Associate unless that Business Associate meets the definitional requirements of a "Covered Entity"
- Myth. HHS, OCR or CMS will be doing HIPAA Certifications
- Myth. HIPAA, HIPPOs, and HIPPIEs are the same thing in different eras
- Myth. Covered entities must actively monitor all business associates.

Appendix II. HIPAA Implementation Issues Covered Entities Face

- HIPAA EDI Issues. Are your clients trying to find a way to "opt out" of HIPAA or are they updating their software systems and becoming familiar with HIPAA's transactions and code sets?
- Assessment & Remediation. Gap assessment or analysis and development of remediation plan – do they have the resources to conduct their own assessment and to follow through on a remediation plan?
- Policies and Procedures. Review and update of written policies and procedures – have they ever had written policies and procedures or will this be a new administrative task?
- Business Associates. Business associate identification and contracting – how will they obtain reasonable assurances about their business associates' ability to adequately safeguard health information in their hands?

…implementation challenges

- Training & Education. Developing and conducting training and education for each member of their workforce – can your clients design and conduct the enterprise wide training and education HIPAA requires?
- Privacy Officer. Designation of a privacy officer and/or contact person – training and capacity building of same – do your clients have the internal resources to put these responsibilities on an existing staff member or will they need to hire or outsource this function?
- Sanctions; Corporate Culture Shift. Update to human resources practices – what sanctions, monitoring, and other changes will be necessary to your clients' general employment practices to make HIPAA meaningful?
- Safeguards. Administrative, physical and technical security – are adequate measures in place already or are resources tight and security will be a challenge?

…implementation challenges

- Patients' Rights and Privacy Practices. Development of a written notice of privacy practices and notice acknowledgement form – do your clients know that as of April 14, 2003, each patient will be entitled to receive a notice of privacy practices and sign an acknowledgement at or before the first date services are rendered? Are your clients familiar with all the rights HIPAA grants patients and how they may be exercised? Are you aware of your risks as a business associate if they do not or cannot meet this requirement on time?
- Health Information Use and Disclosure Rules. Development of HIPAA compliant forms including authorization, notice of privacy practices and consents, business associate agreements – and gaining an understanding of HIPAA's rules for when and how health information can be used and disclosed – what circumstances are routine, what are not, when a patient may or may not have a right to control how her/his health information is used?

GUIDE TO INVESTMENT FIDUCIARY PRACTICES

UNIFORM FIDUCIARY STANDARDS OF CARE	Step One Analyze	Step Two Diversify	Step Three Formalize	Step Four Implement	Step Five Monitor
1. Know standards, laws, and trust provisions.	1.1 – 1.6	1.5	3.1, 3.2, 3.7	1.1, 4.2	1.5, 5.1, 5.2
2. Diversify assets to specific risk/return profile of client.	1.1, 1.5	2.1 – 2.5	3.1, 3.3	4.1	3.3, 5.1
3. Prepare investment policy statement.	1.1, 1.5, 3.1, 3.2	3.3	3.1 – 3.7	4.1 – 4.4	3.5 – 3.7, 5.1
4. Use "prudent experts" (money managers) and document due diligence.	1.2, 4.1, 4.2	4.1	3.1, 3.2, 3.4	4.1 – 4.4	5.1 – 5.3
5. Control and account for investment expenses.	4.3, 5.4, 5.5	2.5	3.1, 3.6	4.3, 4.4, 5.3 – 5.5	5.3 – 5.5
6. Monitor the activities of "prudent experts."	1.4, 5.1	3.3, 5.1 – 5.3	3.1, 3.5 – 3.7	5.1 – 5.4	5.1 – 5.5
7. Avoid conflicts of interest and prohibited transactions.	1.1, 1.3, 1.4, 1.6	1.6	3.2, 3.7	1.3	5.5

Step One - Analyze

1.1 Investments are managed in accordance with applicable laws, trust documents, and written investment policy statements.

1.2 Fiduciaries are aware of their duties and responsibilities.

1.3 Fiduciaries and *parties in interest* are not involved in self-dealing.

1.4 Service agreements and contracts are in writing, and do not contain provisions that conflict with fiduciary standards of care.

1. 5 There is documentation to show timing and distribution of cash flows and the payment of liabilities.

1. 6 Assets are within the jurisdiction of U.S. courts, and are protected from theft and embezzlement.

Step Two - Diversify (Allocate Portfolio)

2.1 A risk level has been identified.

2.2 An expected, modeled return to meet investment objectives has been identified.

2.3 An investment time horizon has been identified.

2.4 Selected asset classes are consistent with the identified risk, return, and time horizon.

2.5 The number of asset classes is consistent with portfolio size.

Step Three - Formalize (Prepare IPS)

3.1 There is detail to implement a specific investment strategy.

3.2 IPS defines duties and responsibilities of all parties involved.

3.3 IPS defines diversification and rebalancing guidelines.

3.4 IPS defines due diligence criteria for selecting investment options.

3.5 IPS defines monitoring criteria for investment options and service vendors.

3.6 IPS defines procedures for controlling and accounting for investment expenses.

3.7 IPS defines appropriately structured, socially responsible investment strategies (when applicable).

Step Four - Implement

4.1 The investment strategy is implemented in compliance with the required level of prudence.

4.2 Fiduciary is following applicable "Safe Harbor" provisions (when elected).

4.3 Investment vehicles are appropriate for the portfolio size.

4.4 A due diligence process is followed in selecting service providers, including the custodian.

Step Five - Monitor

5.1 Periodic performance reports compare the performance of money managers against appropriate index, peer group, and IPS objectives.

5.2 Periodic reviews are made of qualitative and/or organizational changes to money managers.

5.3 Control procedures are in place to periodically review a money manager's policies for best execution, soft dollars, and proxy voting.

5.4 Fees for investment management are consistent with agreements and the law.

5.5 "Finders' fees," 12b-1 fees, or other forms of compensation that may have been paid for asset placement are appropriately applied, utilized, and documented.

Version: August 2002

*P*RUDENT *I*NVESTMENT *P*RACTICES

A HANDBOOK FOR INVESTMENT FIDUCIARIES

Written by the Foundation for Fiduciary Studies

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Legal Review by Reish Luftman McDaniel & Reicher

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*P*RUDENT *I*NVESTMENT *P*RACTICES

INTRODUCTION

The primary purpose of this handbook is to outline the *Practices* that define a prudent process for investment fiduciaries. It is intended to be a reference guide for knowledgeable investment decision makers, as opposed to a *How to* manual for persons who are not familiar with basic investment management procedures.

The term *fiduciary* is inclusive of the more than five million people who have the legal responsibility for managing someone else's money including members of investment committees of retirement plans, foundations, and endowments; trustees of private trusts; and investment advisors. Fiduciary status is determined by facts and circumstances, but generally is defined as a person who:

1. Manages property for the benefit of another;

2. Exercises discretionary authority or control over assets; and/or

3. Acts in a professional capacity of trust, and renders comprehensive and continuous investment advice.

PRIMARY DUTY OF THE FIDUCIARY

To *manage* a prudent investment process, without which the components of an investment plan cannot be defined, implemented, or evaluated. Statutes, case law, and regulatory opinion letters dealing with investment fiduciary responsibility further reinforce this important concept.

Illustration Intro. 1

Fiduciaries have the most important, yet most misunderstood role in the investment process: to manage the investment practices, without which the other components of the investment plan can be neither defined, implemented, or evaluated. Statutes, case law, and regulatory opinion letters dealing with fiduciary status further reinforce this important concept.

Introduction (continued)

The legal and practical scrutiny a fiduciary undergoes is tremendous, and it comes from multiple directions and for various reasons. It is likely that complaints and/or lawsuits alleging fiduciary misconduct will increase. Although some of these allegations may be entirely justified, most can be avoided by following the investment *Practices* outlined in this handbook. Fiduciary liability is not determined by investment performance, but rather on whether prudent investment *practices* were followed. *It's not whether you win or lose, it's how you play the game.*

A fiduciary demonstrates prudence by the process through which investment decisions were managed, rather than by showing that investment products and techniques were chosen because they were labeled as "prudent." No investments are imprudent on their face. It is the way in which they are used, and how decisions as to their use are made, that will be examined to determine whether the prudence standard has been met. Even the most aggressive and unconventional investment can meet that standard if arrived at through a sound process, while the most conservative and traditional one may not measure up if a sound process is lacking.

On a more positive note, the *Practices* also make good investment sense. Superior investment returns result from developing a prudent investment process, and then sticking to it. The *Practices* can provide the foundation and framework for such an investment process, and help to keep fiduciaries from making *ad hoc* investment decisions influenced by emotions, market noise, press-appointed investment gurus, and/or product peddlers.

This handbook covers twenty-seven *Practices* that define a prudent investment management process from beginning to end. Each *Practice* is followed by citations to the legislation, case law, and/or regulatory opinion letters that serve as the basis for the *Practice*. A second handbook has been published, *Legal Memorandums for Prudent Investment Practices*, which provides a much more detailed explanation and legal opinion on the citations for each of the twenty-seven *Practices*. [The legal memorandums were prepared by the law firm of **Reish Luftman McDaniel & Reicher**. To purchase a copy, contact the **Foundation for Fiduciary Studies** (412) 390-5080.]

The legislative basis for each of the twenty-seven *Practices* include:

ERISA – Employee Retirement Income Securities Act (impacts qualified retirement plans).

UPIA – Uniform Prudent Investor Act (impacts private trusts, and may impact foundations and endowments). [See *Comments Section* for states that have enacted UPIA.]

MPERS – Uniform Management of Public Employee Retirement Systems Act (proposed legislation that may impact state, county, and municipal retirement plans). [See *Comments Section* for states that have enacted MPERS.]

Introduction (continued)

A distinction will be made between what is required by law and what represents a generally-accepted practice in the investment industry. An **industry best practice** will be prefaced with **[IBP]**.

Throughout this handbook, periodically we will use the term *market segments* to refer to the different types of fiduciary accounts. To simplify this discussion, we have broken the different fiduciary accounts in to four groups: (1) defined benefit plans, in which investment decisions are generally committee-directed; (2) defined contribution plans, in which investment decisions generally are participant-directed; (3) foundations and endowments, also referred to eleemosynaries; and, (4) individual/family accounts.

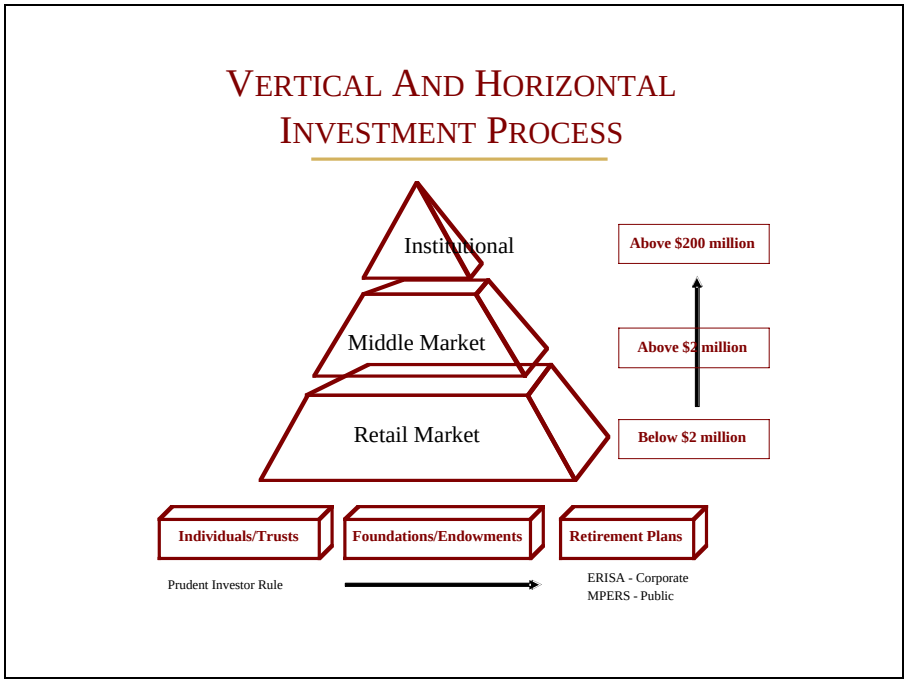


Illustration Intro. 2

This handbook is about the *Practices* that a fiduciary should follow to successfully manage investment decisions. By following a structured process based on these *Practices*, the fiduciary can be confident that critical components of an investment strategy are being properly implemented.

Comments Section

Several of the handbook's themes are from ***The Management of Investment Decisions*** *(McGraw-Hill, New York, 1996) by Donald B Trone, William R Allbright, and Philip R Taylor.*

The UPIA was released by the Uniform Law Commissioners in 1994, and subsequently approved by the American Bar Association and American Bankers Association.

Introduction (continued)

STATE ADOPTIONS:

Alaska	*Maine*	*Ohio*
Arizona	*Massachusetts*	*Oklahoma*
Arkansas	*Maryland***	*Oregon*
California	*Michigan*	*Pennsylvania*
Colorado	*Minnesota*	*Rhode Island*
Connecticut	*Missouri*	*South Carolina*
District of Columbia	*Nebraska*	*Tennessee*
Hawaii	*New Hampshire*	*Utah*
Idaho	*New Jersey*	*Vermont*
Illinois	*New Mexico*	*Virginia*
Indiana	*North Carolina*	*Washington*
Iowa	*North Dakota*	*West Virginia*
Kansas		*Wyoming*

***Substantially similar*

2002 INTRODUCTIONS:
Wisconsin

To date, only one state has formally adopted MPERS: South Carolina.

This handbook is not intended to be used as a legal opinion. The fiduciary should discuss results with an attorney knowledgeable in this specific area of the law. Nor is this handbook intended to represent specific investment advice.

*The primary purpose of this handbook is to outline the **Practices** that define a prudent investment process for investment fiduciaries. The scope of this handbook will not include: (1) financial, actuarial, and/or record keeping issues; (2) valuations of closely held stock, limited partnerships, hard assets, insurance contracts, hedge funds, or blind investment pools; (3) risk management issues such as the use of derivative and/or synthetic financial instruments; and/or (4) organizational/structural issues of the fiduciary.*

BENEFITS OF THE *PRACTICES* [1]

- Help to establish evidence that the fiduciary is following a prudent investment process, which may minimize litigation risk.

- The *Practices* are easily adaptable to all types of portfolios, regardless of size or intended use.

- Serves as a practicum for all parties involved with investment decisions (money managers, investment advisors, consultants, accountants, and attorneys), and provides an excellent educational outline of the duties and responsibilities of investment fiduciaries.

- May help to increase long-term investment performance by identifying more appropriate procedures for:

  - Diversifying the portfolio across multiple asset classes and peer groups;

  - Evaluating investment management fees and expenses;

  - Selecting money managers and/or mutual funds; and/or

  - Terminating money managers and/or mutual funds that no longer are appropriate.

- Help to uncover investment and/or procedural risks not previously identified, which may assist in prioritizing investment management projects with consultants, advisors, and vendors.

- Encourage fiduciaries to compare their practices and procedures with those of their peers.

- Assist in establishing benchmarks to measure the progress of an investment committee and/or consultant.

- May enable the fiduciary to negotiate a lower insurance premium for Errors and Omissions coverage.

[1] Several of the benefit concepts were developed by Independent Fiduciary Services, Inc., Washington, DC (202) 898-2270.

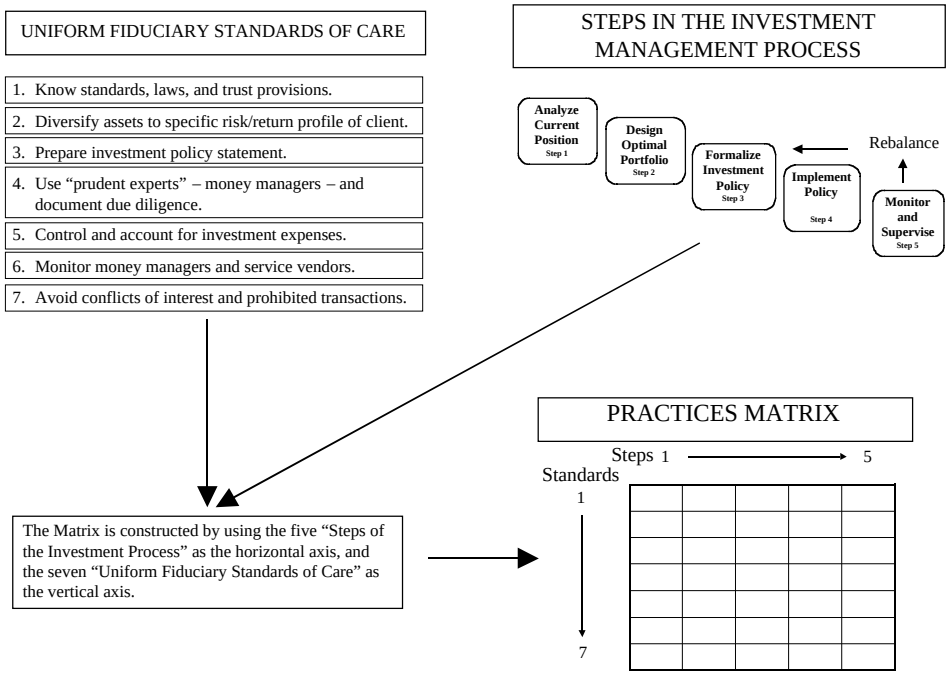
PRACTICES MATRIX

The twenty-seven *Practices* outlined in this handbook are intended to define a prudent investment process from beginning to end. A *Practices Matrix* has been constructed to facilitate the viewing of the *Practices*. Referring to the foldout in this handbook:

The vertical axis of the *Matrix* is the seven *Uniform Fiduciary Standards of Care;* the standards that are common to the three legislative acts that shape investment fiduciary standards – ERISA, UPIA, and MPERS. [The term *Uniform Fiduciary Standards of Care* has been coined by the authors to denote the seven standards of care that are common to the three legislative acts.]

The horizontal axis of the *Matrix* outlines the steps of a traditional investment management process, which we refer to as the *Five-Step Investment Management Process.*

The *Uniform Fiduciary Standards of Care* [legislated standards] and the *Five-Step Investment Management Process* frame a prudent investment process. To complete the picture, we have identified the twenty-seven *Practices* that provide the details to this process. For each cell of the *Matrix,* we have identified one or more *Practices.*



Selected Quotes
from the Department of Labor's
Amended Brief of the Secretary of Labor Opposing the Motions to Dismiss
Re: Pamela Tittle, et al.,
v. ENRON CORP., Oregon Corporation, et al.

The Secretary files this amicus brief expressing her view that, based on the allegations in the Complaint, ERISA required the fiduciaries to take action to protect the interests of the plans, their participants and beneficiaries, and that ERISA provides remedies for the failure to have done so. (Page 1)

ERISA's fiduciary obligations are among the "highest known to the law." Bussian v. RJR Nabisco, 223 F.3d 235, 294 (5th Cir. 2000). They do not permit fiduciaries to ignore grave risks to plan assets, stand idly by while participants' retirement security is destroyed, and then blithely assert that they had no responsibility for the resulting harm. (Page 2)

Corporate officers who appoint fiduciaries must "ensure that the appointed fiduciary clearly understands his obligations, that he has at his disposal the appropriate tools to perform his duties with integrity and competence, and that he is appropriately using those tools." Martin v. Harline, 15 EBC 1138, 1149 (D. Utah 1992). (Page 9)

Section 404(c) plan fiduciaries are still obligated by ERISA's fiduciary responsibility provisions to prudently select the investment options under the Plan and to monitor their ongoing performance. (Page 37)

The Supreme Court has expressly held that a nonfiduciary party-in-interest who has actual or constructive knowledge of the circumstances that made the fiduciary's actions a breach of duty and participates in that breach can be liable for appropriate equitable relief under ERISA. (Page 57)

Mission Of The Foundation For Fiduciary Studies

To develop and promote the Practices that define a prudent process for investment fiduciaries.

Fiduciary Code Of Conduct

If you're going to do it –
Do it right.

As you manage investment decisions:
Document the process; Hire competent professionals; Monitor results;
and *Always remember you have been entrusted with someone else's money.*

Never invest in something you don't understand or is difficult to value.
Know what you're paying for -
Don't hire the fox to count the chickens.

Understand that, when everyone is talking about making a killing -
The market already is dead.

Cautiously approach investments that promise superior results.
Believe in the statement -
The past is no indication of future performance.

Relish the opportunity to be a steward of sound investment practices
for, in the end,
it's *procedural prudence*, not performance, that counts.

❑ *Practice No. 1.1* Investments are managed in accordance with applicable laws, trust documents, and written investment policy statements[2]

Our starting point is for the fiduciary is to analyze and review all of the documents pertaining to the establishment and management of the investments. As in managing any business decision, the fiduciary has to set definitive goals and objectives that are consistent with the portfolio's current and future resources; the limits and constraints of applicable trust documents and statutes; and, in the case of individual investors, the goals and objectives of the individual investor.

The following documents should be collected, reviewed, and analyzed:

- ❑ A copy of the Investment Policy Statement (IPS), written minutes, and/or files from investment committee meetings [See also *Practice No. 3.1*]
- ❑ Applicable trust documents (including amendments) [See also *Practice No. 1.2*]
- ❑ Custodial and brokerage agreements [See also *Practices 4.4 and 5.3*]

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[2] ***Substantiating Code, Regulations, and Case Law for Practice No. 1.1:***

Employee Retirement Income Security Act of 1974 [ERISA]
§3(38)(C); §104(b)(4); §402(a)(1); §402(b)(1); §402(b)(2); §403(a); §404(a)(1)(D) §404(b)(2)

Regulations
29 C.F.R. §2509.75-5 FR-4; 29 C.F.R. Interpretive Bulletin 75-5; 29 C.F.R. §2509.94-2(2); 29 C.F.R. Interpretive Bulletin 94-2 (July 29, 1994)

Case Law
Morse v. New York State Teamsters Conference Pension and Retirement Fund, 580 F. Supp. 180 (W.D.N.Y. 1983), aff'd, 761 F.2d 115 (2d Cir. 1985); Winpisinger v. Aurora Corp. of Illinois, 456 F. Supp. 559 (N.D. Ohio 1978); *Liss v. Smith*, 991 F.Supp. 278, 1998 (S.D.N.Y. 1998); *Dardaganis v. Grace Capital, Inc.*, 664 F. Supp. 105 (S.D.N.Y. 1987), *aff'*d, 889 F.2d 1237 (2d Cir. 1989).

Other
Interpretive Bulletin 75-5, 29 C.F.R. §2509.75-5; Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2

Uniform Prudent Investor Act [UPIA]
§2(a) - (d); §4

Management of Public Employee Retirement Systems Act [MPERS]
§4(a) – (d); §7(6); §8(b)

Practice No 1.1 (continued)

- ❑ Service agreements with investment management vendors (custodian, money managers, investment consultant, actuary, accountant, and attorney) [See also *Practice No. 1.4*]

- ❑ Information on retained money managers; specifically the ADV for each separate account manager and prospectus for each mutual fund [See also *Practice No. 4.1*]

- ❑ Investment performance reports from money managers, custodian, and/or consultant [See also *Practice No. 5.1*].

After analyzing the aforementioned documents, there are several follow-on questions which must be answered:

1. Do trust documents identify trustees and named fiduciaries? [See also *Practice No. 1.2*]

2. Do trust documents, statutes, and/or client instructions restrict or prohibit certain asset classes? [See also *Practice No. 2.4*]

3. Do trust documents allow for the fiduciaries to prudently delegate investment decisions to others? [See also *Practice Nos. 4.1 and 4.2*]

Depending on the *market segment*, (see **INTRODUCTION**) there are additional documents that should be collected, reviewed, and analyzed:

For Defined Contribution Plans:

- ❑ Participant education material
- ❑ Enrollment activity reports
- ❑ Loan activity reports
- ❑ IRS Form 5500 - Including schedules
- ❑ Independent accountant's audit report (required by IRS if there are more than 100 participants)
- ❑ Summary Plan Description.

For Defined Benefit Plans:

- ❑ IRS Form 5500 - Including schedules
- ❑ Independent accountant's audit report (required by IRS if there are more than 100 participants)
- ❑ Summary Plan Description
- ❑ Actuarial reports showing status of:
  - Accumulated Benefit Obligation (ABO)
  - Projected Benefit Obligation (PBO)

Practice No 1.1 (continued)

- ❑ Actuarial reports showing assumptions for
  - Return
  - Interest rates
  - Participant pay/benefit rates.

For Foundations and Endowments - Review reports that provide information on:

- ❑ The organization's purpose and mission-based investment strategy (if one has been adopted) [See also *Practice No. 3.7*]
- ❑ Equilibrium Spending Rate (ESR) to calculate inflation and investment expense-adjusted payments:

  ESR = Modeled Return - Inflation - Investment Management Expenses

- ❑ Smoothing rules to determine market value for application of ESR to calculate size of grants:
  - Moving average (over three years)
  - Preset amount over previous year (inflation adjusted)
  - Judging the need - committee retains option to adjust grants each year.

For Individual/Family Wealth

- ❑ Tax status
- ❑ Estate and philanthropic objectives
- ❑ Spending rate.

❑ *Practice No. 1.2* Fiduciaries are aware of their duties and responsibilities[3]

As outlined in the **INTRODUCTION**, a fiduciary is defined as someone acting in a position of trust on behalf of, or for the benefit of, a third party. Fiduciary status is difficult to determine, and is based on *facts and circumstances*. In general, the issue is whether a person has control or influence over investment decisions. It is not uncommon for fiduciaries to be unaware of their status, which is one of the reasons why this *Practice* has been included.

Fiduciaries are responsible for the general management of the investments - in essence, the management of the twenty-seven *Practices* presented in this handbook. If statutes and trust provisions permit, the fiduciary may delegate certain decisions to professional money managers, trustees (co-fiduciaries), and/or investment advisors and consultants. But even when decisions have been delegated to a professional, a fiduciary can never fully abdicate his or her responsibilities; the fiduciary still has the ultimate responsibility for:

1. Determining investment goals and objectives

2. Approving an appropriate asset allocation strategy, or in the case of a 401k plan, the asset classes that will be represented by the investment options

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[3] ***Substantiating Code, Regulations, and Case Law for Practice No. 1.2:***

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)(1)(B)

Case Law
Marshall v. Glass/Metal Association and Glaziers and Glassworkers Pension Plan, 507 F. Supp. 378 2 E.B.C. 1006 (D.Hawaii 1980); *Katsaros v. Cody*, 744 F.2d 270, 5 E.B.C. 1777 (2d Cir. 1984), *cert. denied, Cody v. Donovan*, 469 U.S. 1072, 105 S. Ct. 565, 83 L.Ed. 2d 506 (1984); *Marshall v. Snyder*, 1 E.B.C. 1878 (E.D.N.Y. 1979); *Donovan v. Mazzola*, 716 F.2d 1226, 4 E.B.C. 1865 (9th Cir. 1983), *cert. denied*, 464 U.S. 1040, 104 S. Ct. 704, L.Ed.2d 169 (1984); *Fink v. National Savings and Trust Company*, 772 F. 2d 951, 6 E.B.C. 2269 (D.C. Cir. 1985)

Other
Joint Committee on Taxation, *Overview of the Enforcement and Administration of the Employee Retirement and Income Security Act of 1974* (JCX-16-90, June 6, 1990)

Uniform Prudent Investor Act [UPIA]
§1(a); §2(a); §2(d)

Management of Public Employee Retirement Systems Act [MPERS]
§7

Case Law:
National Labor Relations Board v. Amax Coal Co., 453 U.S. 322, 101 S. Ct. 2789, 69 L.Ed. 2d 672 (1981)

Practice No 1.2 (continued)

3. Approving an explicit, written investment policy statement consistent with goals and objectives

4. Approving appropriate money managers, mutual funds, or other *prudent experts* to implement the investment policy; or approving the due diligence process that will be used to select the same if investment discretion has been delegated to an investment advisor

5. Monitoring the activities of the overall investment program for compliance with the investment policy; or approving the performance measurement objectives and benchmarks that will be used to evaluate the same, if investment discretion has been delegated to an investment advisor

6. Avoiding conflicts of interest and prohibited transactions.

New trustees or investment committee members often are concerned about being qualified to perform their duties, citing their lack of Wall Street experience and acumen. This shouldn't be the case. The duties of an investment committee member are not too dissimilar to the responsibilities of any general line manager, which is: to identify goals and objectives; to determine how resources will be allocated; to prepare a business plan; to implement the business plan; and, on an ongoing basis, to monitor the results to see if the goals and objectives of the business plan are being met.

CHARACTERISTICS OF THE SUCCESSFUL FIDUCIARY

1. Does not require extensive experience in securities analysis or portfolio management.
2. A sincere commitment and courage to develop a consensus formulation of goals and objectives.
3. A personal interest in understanding the basics of capital markets.
4. The discipline to develop long-term investment policies, and the patience to evaluate events calmly in the context of long-term trends.
5. An understanding of personal and organizational strengths and weaknesses to determine when delegation and outsourcing is more appropriate.
6. The ability to get the right things done, otherwise known as effective management. A prudent process facilitates effective management by distinguishing important from unimportant tasks.

Illustration 1.1

❑ ***Practice No. 1.3*** **Fiduciaries and *parties in interest* are not involved in self-dealing**[4]

[IBP] If a fiduciary even thinks he or she may have a conflict of interest - they probably do. The best advice is end it, or avoid it. It's that simple.

An important concept associated with this *Practice* is the term *party in interest.* The term is inclusive of, among others:

> *Any friend, business associate, or relative of the fiduciary*
>
> *In the case of a retirement plan; any administrator, officer, trustee, counsel, or employee of the plan, or any person providing services to the plan.*

[IBP] An excellent question every fiduciary should ask before deciding or voting on an investment issue is: *Who benefits most from this decision?* If the answer is any party other than the client (in the case of an individual or family account), participant (in the case of a retirement plan), and/or the beneficiary (in the case of a personal trust), the likelihood is the fiduciary is about to breach his or her duties.

The fundamental duty of the fiduciary is to manage investment decisions for the exclusive benefit of the client, retirement plan participant, and/or trust beneficiary. No one should receive a benefit simply because they are a friend, business associate, and/or relative of the fiduciary.

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[4] ***Substantiating Code, Regulations, and Case Law for Practice No. 1.3:***

Internal Revenue Code of 1986, as amended [IRC]
§4975

Employee Retirement Income Security Act of 1974 [ERISA]
§3(14)(A) and (B); §404(a)(1)(A); §406(a) and (b)

Case Law
Whitfield v. Tomasso, 682 F. Supp. 1287, 9 E.B.C. 2438 (E.D.N.Y 1988)

Other
DOL Advisory Council on Employee Welfare and Benefit Plans Report of the Working Group on Soft Dollars and Commission Recapture November 13, 1997

Uniform Prudent Investor Act [UPIA]
§2; §5

Management of Public Employee Retirement Systems Act [MPERS]
§7(1) and (2); §17(c)(12) and (13)

Other
Forbes "Pay for Play," Sept 4, 2000; *Pensions & Investments*, "Trustee Queries Mercer on Work," p. 10; *Fortune* "The Seamy Side of Pension Funds," Aug 12, 2002.

Practice No 1.3 (continued)

Examples of common breaches:

- Using retirement plan assets to buy real estate for corporate expansion
- Trading a client's account solely to generate additional commissions (also referred to as *churning* a client's account)
- Using the assets of a public retirement plan to invest in local high-risk business ventures
- Using the assets of a private trust to provide unsecured loans to related parties and/or entities of the trustee
- Using a company retirement plan as collateral for a line of credit
- Buying artwork and/or other collectibles with retirement plan assets, and putting the collectibles on display.

Generally speaking, every investment program has at least three components:

1. The money manager who is selecting the stocks and bonds for the portfolio
2. The brokerage firm that is executing the trades
3. The custodian that is holding and safeguarding the securities.

[IBP] Larger, institutional portfolios ($200 million or more) should attempt to ensure that the three parties (money manager, broker, and custodian) are all separate and unrelated entities. This approach provides for a system of checks and balances. If one were to examine cases involving breaches of investment fiduciary responsibility, one would inevitably find that there was a breakdown in the checks and balances, and that the breaching party was fulfilling, or attempting to fulfill, multiple roles. A good example is the money manager who only uses its own broker dealer for executing trades.

[IBP] Another common problem is the pay-to-play schemes practiced by investment advisors/consultants that claim to be objective, independent third-parties, but are not. [This should not be confused with brokers who have properly disclosed that all or part of their compensation may be commission-based.]

Practice No 1.3 (continued)

The fiduciary has a responsibility to control and account for investment expenses (*Uniform Fiduciary Standards of Care*) and, therefore, should require his or her investment advisor/consultant to fully disclose and detail all revenue, benefits (such as trips for the purposes of *due diligence*), and /or income received as a result of:

1. Trades executed on behalf of the account, also known as directed brokerage [See also *Practice No. 5.3*]

2. Selling investment services, conference seminars, and/or any other consulting services to the very same money managers or service vendors that the advisor/consultant is recommending to the fiduciary.

❑ *Practice No. 1.4* Service agreements and contracts are in writing, and do not contain provisions that conflict with fiduciary standards of care[5]

A fiduciary is required to prudently manage investment decisions and should seek assistance from outside professionals, such as investment advisors/consultants and money managers, if the fiduciary lacks the requisite knowledge (assuming the trust documents permit the delegation of investment responsibilities). [See also *Practice No. 4.1*]

The fiduciary should take reasonable steps to protect the portfolio from loses, and to avoid misunderstandings when hiring such professionals. Therefore, fiduciaries should reduce any agreement of substance to writing in order to define the scope of the parties' duties and responsibilities; to ensure that the portfolio is managed in accordance with the written documents that govern the investment strategy; and, to confirm that the parties have clear, mutual understandings of their roles and responsibilities.

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[5] ***Substantiating Code, Regulations, and Case Law for Practice No. 1.4:***

Employee Retirement Income Security Act of 1974 [ERISA]
§3(14)(B) and (38)(C); §3(38)(C); §402(c)(2); §403(a)(2); §404(a)(1); §408(b)(2)

Case Law
Liss v. Smith, 991 F. Supp. 278 (S.D.N.Y. 1998); *Whitfield v. Tomasso*, 682 F. Supp. 1287, 9 E.B.C. 2438 (E.D.N.Y. 1988)

Other
Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2

Uniform Prudent Investor Act [UPIA]
§2(a); §5; §7; §9(a)(2)

Management of Public Employee Retirement Systems Act [MPERS]
§5(a)(2); §6(b)(2); §7

Practice No 1.4 (continued)

[IBP] A good practice is to review contracts and service agreements at least once every three years. The investment industry is constantly evolving, and the fiduciary is likely to discover:

1. There may be an opportunity to take advantage of price breaks because the portfolio has grown in size.

2. The vendor's fees may have been reduced because of competitive pressures.

3. The scope of services required by the fiduciary may have changed.

4. The vendor's product offering may have expanded - the fiduciary can benefit from more services without an increase in fees.

5. A *better* vendor has since come to market.

❑ ***Practice No. 1.5*** **There is documentation to show timing and distribution of cash flows, and the payment of liabilities**[6]

One of the fundamental duties of every fiduciary is to ensure there are sufficient assets to pay bills and liabilities when they come due, and in the case of a foundation or endowment, to provide a specified level of support when it has been promised.

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[6] ***Substantiating Code, Regulations, and Case Law for Practice No. 1.5:***

Employee Retirement Income Security Act of 1974 [ERISA]
§402(b)(1); §404(a)

Regulations
29 C.F.R. §2550.404a-1(b)(2)

Other
Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2; H.R. Report No. 93-1280, 93d Congress, 2d Session (1974)

Uniform Prudent Investor Act [UPIA]
§1 Comments; §2 Comments; §2(a); §2(b); §2(c)

Case Law
Harvard College v. Amory, 26 Mass. (9 Pick.) 446 (1830)

Management of Public Employee Retirement Systems Act [MPERS]
§7(1) and (2); §8(a)(1)(E)

Practice No 1.5 (continued)

It is important that the fiduciary prepare a schedule of the portfolio's anticipated cash flows for the coming five-year period, so that the investment time horizon can be determined. [See also *Practice No 2.3*] The time horizon is defined as that point-in-time when more money is flowing out of the portfolio than is coming in from contributions and/or from portfolio growth. If the time horizon is less than five years, it is considered *short*, and if the time horizon is five years or more, it is considered *long*. A *short* time horizon typically is implemented with fixed income and cash, whereas a *long* investment time horizon can be prudently implemented across most asset classes. [See also *Practice No. 2.4*]

[IBP] If the client has a material disbursement within five years, 120 percent of the anticipated amount needed should be held in cash or short-term fixed income instruments. For example, if $100,000 is going to be needed in three years, one would allocate $120,000 to cash and/or short-term fixed income in the asset allocation strategy.

The cash flow schedule also provides the fiduciary with information to more effectively rebalance a portfolio's asset allocation strategy. [See also *Practice No. 3.3*] As an example, if a particular asset class is outside the range of the investment policy statement's strategic limit, one could use the cash flow information to effectively rebalance the portfolio.

❑ *Practice No. 1.6* Assets are within the jurisdiction of U.S. courts, and are protected from theft and embezzlement[7]

The fiduciary has the responsibility to safeguard entrusted assets, which includes keeping the assets within the purview of the U.S. judicial system. This provides a regulatory agency the ability to seize the assets if, in its determination, it is in the best interests of the beneficiaries and/or participants.

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[7] ***Substantiating Code, Regulations, and Case Law for Practice No. 1.6:***

Employee Retirement Income Security Act of 1974 [ERISA]
§ 404(b); § 412(a)

Regulations
29 C.F.R. §2550.404b-1

Case Law
Varity Corporation v. Howe, 516 U.S. 489, 116 S. Ct. 1065, 134 L.Ed.2d 130 (1996)

Other
H.R. Report No. 93-1280 (93rd Congress, 2d Session, August 12, 1974)

Uniform Prudent Investor Act [UPIA]
§2(a); §5; §9(d)

Management of Public Employee Retirement Systems Act [MPERS]
§2(21); §6(e); §7; §11(c) and Comments

Practice No 1.6 (continued)

In addition, ERISA requires qualified retirement plans to maintain a surety bond to reimburse a plan for losses resulting from dishonest acts. Though not required for all other fiduciaries, it's a good industry practice to maintain similar coverage.

Exception: Investment advisors that are managing the personal assets of a high-net-worth client are not excluded from considering the establishment of offshore accounts. The presumption is that federal laws will continue to impose strict reporting and tracking requirements of foreign bank accounts and offshore trusts.

INTRODUCTION TO *PRACTICES 2.1 - 2.5*

The second step of the *Investment Management Process* is to diversify the portfolio's assets. *Practices 2.1 - 2.5* provide the details to the prudent procedures associated with Step 2.

The fiduciary's choice of asset classes and their subsequent allocation will have more impact on the long-term performance of the investment strategy than all other decisions. The fiduciary's role is to choose the appropriate combination of assets that optimizes (or approximately optimizes) a return (*Practice No. 2.2*) subject to a particular level of risk (*Practice No. 2.1*).

The acronym *TREAT* helps to define the key fiduciary inputs to the asset allocation strategy.

T Tax status of the portfolio, whether it is taxable or tax-exempt

R Risk level the investor or investment committee is willing to assume

E Expected return the portfolio needs to achieve to meet goals and objectives

A Asset class preferences of the investor or investment committee

T Time horizon of the investment strategy

Computer optimization models can mathematically assist the fiduciary in determining alternative optimal asset mixes. Yet, these technological tools and comprehensive databases have not reduced the asset allocation decision to a computerized, mathematical solution. Quite the contrary.

Introduction to Practices 2.1 - 2.5 (continued)

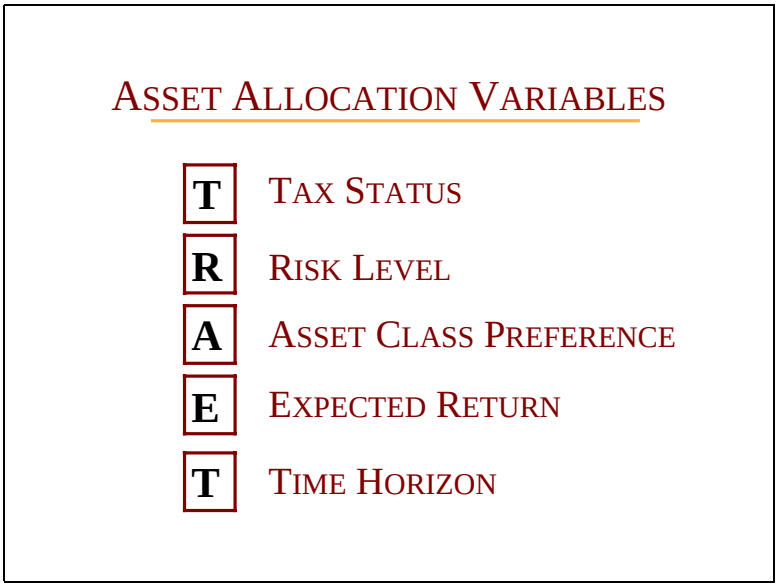

Illustration 2.1

An optimizer requires three inputs:

Expected Return - the *modeled* return assumption that will be used for each asset class

Standard Deviation - the *probable* level of variability each asset class will exhibit

Correlation Coefficient - the *estimate* of the degree to which each asset class will perform relative to another. (Traditionally, equities and fixed-income asset returns have not been similar over the same periods of time, therefore they would have a negative, or low correlation to one another.)

Note that all three optimizer variables are nothing more than estimates, models, or probable outcomes. The asset allocation strategy must be built upon carefully developed expectations for the capital markets and the way in which individual asset class is expected to perform in relation to, and in combination with, each other.

[IBP] The development of sound optimizer inputs involves as much *art* and intuition as *science*, and is well beyond the intended scope of this handbook. However, the fiduciary is well-advised to be familiar with the source and methodology used to develop any asset allocation strategy. Due to the great disparity between different models, the fiduciary is cautioned to carefully research the investment expertise of the source. The outputs of the computerized optimization models are only as good as the inputs. The old adage *garbage in - garbage out* has never been more applicable.

Introduction to Practices 2.1 - 2.5 (continued)

Experience has shown:

1. Intuition is sometime as good, if not a better, guide than the optimizer. If it doesn't feel right, it probably isn't. Optimizers are only useful for making the rough cut between equity and fixed income. The fiduciary shouldn't become so enamored with the optimizer that he or she forgets to use common sense and good judgment.

2. There is less risk in being conservative with the capital markets inputs. A fiduciary generally does not get sued when actual results are higher than what was *modeled*.

3. A corollary to the previous point is that liability increases exponentially with the number of places to the right of the decimal point. The fiduciary should not convey a degree of accuracy in the asset allocation strategy that does not exist. A good suggestion is to round all allocations to whole numbers, even rounding the allocations to the nearest five percent.

4. Asset allocation is a social science. If it does not reflect the needs of the client or the temperament of the investment committee, no matter how sophisticated the process by which it was determined, it likely will be abandoned at the first sign of short-term pain.

❑ *Practice No. 2.1* A risk level has been identified[8]

The term *risk* has different connotations, depending on the fiduciary's and/or the investor's frame of reference, circumstances, and objectives. Typically, the investment industry defines risk in terms of statistical measures, such as standard deviation. These statistical measures, however, often fail to adequately communicate the potential negative consequences an investment strategy can have on the fiduciary's, or the investor's, ability to meet investment objectives.

Simply stated, an investment strategy can fail by being too conservative or too aggressive. A fiduciary could adopt a very safe investment strategy by keeping a portfolio in cash, but then see the portfolio's purchasing power whither under inflation. Or, a fiduciary could implement a long-term growth strategy that overexposes a portfolio to equities, when a more conservative fixed income-strategy would have been sufficient to cover the identified goals and objectives.

One suggested approach is to stress test a proposed investment strategy by analyzing possible investment outcomes (worst case, most likely, and best case) over a one, three, and five-year period. The fiduciary should then consider the possible consequences of each outcome:

1. Will the investment results enable the fiduciary to cover short- and long-term liabilities and/or objectives?

2. Can the fiduciary stomach the *worst case* scenario? If not, the fiduciary will likely abandon a sound long-term strategy during a market downturn, and alter the investment strategy at precisely the wrong time and for the wrong reasons.

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[8] ***Substantiating Code, Regulations, and Case Law for Practice No. 2.1:***

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)(1)(B)

Regulations
29 C.F.R. §2550.404a-1(b)(1)(A); 29 C.F.R. §2550.404a-1(b)(2)(B)(i-iii)

Case Law
Laborers National Pension Fund v. Northern Trust Quantitative Advisors, Inc., 173 F.3d 313, 23 E.B.C. 1001 (5th Cir.), *reh'g and reh'g en banc denied*, 184 F.3d 820 (5th Cir.), *cert. denied*, 528 U.S. 967, 120 S.Ct. 406, 145 L.Ed.2d 316 (1999); *Chase v. Pevear*, 383 Mass. 350, 419 N.E.2d 1358 (1981)

Uniform Prudent Investor Act [UPIA]
§2(b) and (c); §2 Comments

Management of Public Employee Retirement Systems Act [MPERS]
§8(b); §8 Comments

Practice No 2.1 (continued)

[IBP] A good way to define risk is to evaluate the *worst case scenario* in a given year. Specifically, identify the statistical *worst-case scenario* at the 95th percentile of a mean-variance bell-shaped curve. This theoretically represents a 1-in-20 event that could be as bad, or worse, then the worse-case scenario. Or stated differently, there is a 5 percent probability that the *worst case scenario* will be *worse* then indicated.

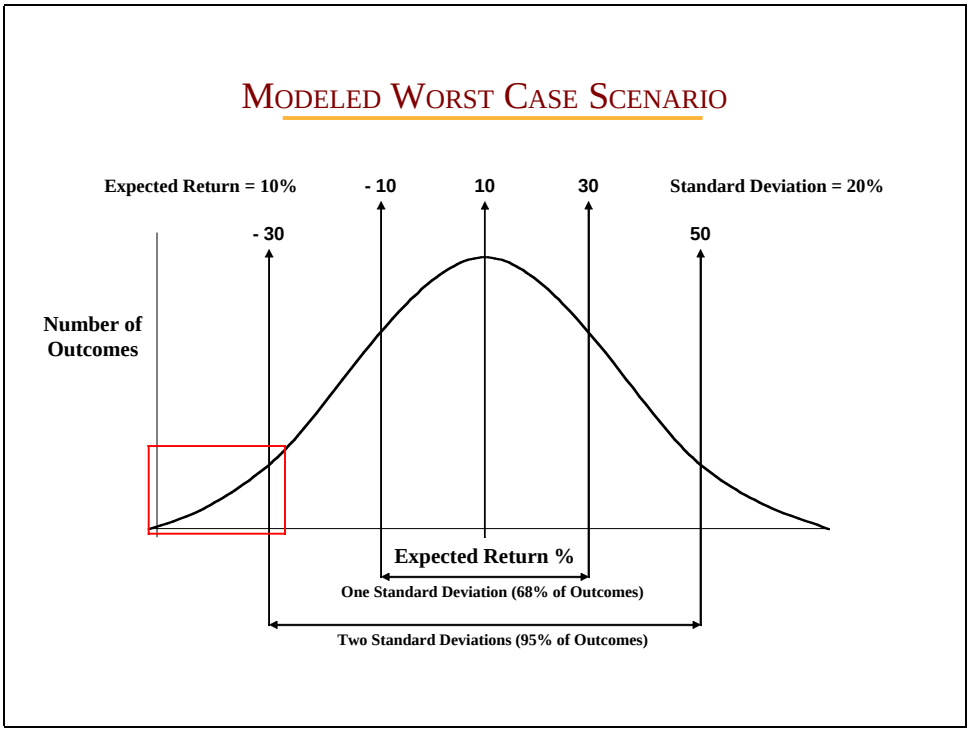

Illustration 2.2

Besides statistical risk, we also should explore whether the fiduciary, or investor, is concerned or impacted by other risk issues such as:

- Liquidity Risk - Will there be sufficient cash to meet anticipated disbursements? For example, if a foundation is committed to funding the construction of a new building that is scheduled to be completed in three years, is there sufficient cash and short-term fixed income to cover the cash calls during construction?

- Boardroom Risk - Is the board willing to set appropriate long-term investment strategies and stick to them? Boards of all sizes are subject to internal and external pressures. In light of these pressures, it can be difficult for board members to focus on long-term performance, particularly when they're serving for a limited term.

- Lost Opportunity Risk - Is the investment committee or the investor attempting to employ a market timing strategy in an effort to minimize short-term pain? In other words, has a long-term investment strategy been developed but do concerns over current market conditions keep the investment committee from implementing the strategy?

Practice No 2.1 (continued)

- Specific Issue, or Implementation Risk - Has the investment committee or investor prudently diversified a portfolio among appropriate asset classes, but has not prudently diversified the portfolio within the asset class? As an example, an allocation to equities presumes the portfolio will be invested in at least twenty securities. Less than twenty, and the portfolio may be subject to specific issue risk.

❑ *Practice No. 2.2* An expected, modeled return to meet investment objectives has been identified[9]

The fiduciary should determine whether trust documents, spending policies, and/or actuarial reports (for defined benefit retirement plans) establish a minimal investment return expectation or requirement. In all cases, the fiduciary should determine the *modeled,* or expected return a given investment strategy should produce. In this context, the term *model* means to replicate; to determine the probable returns of an investment strategy given current and historical information. There is no requirement, or expectation, that the fiduciary forecast future returns. Rather, the fiduciary is required to state the presumptions that are being used to *model* the probable outcomes of a given investment strategy.

The *modeling* of a probable return for a given asset allocation strategy is very difficult to develop. Simple extrapolations of recent historical data are not only likely to be poor estimates of future performance, they also may cause the fiduciary to overweight an asset class that has had recent superior performance and underweight the laggards, setting the stage for the fiduciary to make the classic investment mistake - buying high and selling low.

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[9] ***Substantiating Code, Regulations, and Case Law Practice No. 2.2:***

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)(1)(A) and (B)

Regulations
29 C.F.R. §2550.404a-1(b)(1)(A); 29 C.F.R. §2550.404a-1(b)(2)(A)

Case Law
Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1944); *Communications Satellite Corporation v. Federal Communications Commission*, 611 F.2d 883 (D.C. Cir. 1977); *Tennessee Gas Pipeline Company v. Federal Energy Regulatory Commission*, 926 F.2d 1206 (D.C. Cir. 1991)

Uniform Prudent Investor Act [UPIA]
§2(b); §2(c)(1-8)

Management of Public Employee Retirement Systems Act [MPERS]
§8(a)(1)(A-F); §8(b)

Practice No 2.2 (continued)

Be wary of an optimizer that derives its inputs only from historical data. Most investment professionals utilize a *risk-premium* model. Developing the *risk premium* is quite involved, but, simply stated, the process starts by calculating the *premium* each asset class has earned over the risk-free-rate-of-return. The *premium* is then adjusted, or tweaked, based on possible economic scenarios that may impact the asset class over the next five years. The adjusted, or tweaked, premium is then added to the anticipated risk-free-rate-of-return over the next five years (anticipated rate of inflation also could be used as a proxy) to come up with the final *modeled* return.

❑ *Practice No. 2.3* An investment time horizon has been identified[10]

It is important that the fiduciary prepare a schedule of the portfolio's anticipated cash flows so that the portfolio's investment time horizon can be identified. [See also *Practice No. 1.5*] The portfolio's investment time horizon is defined as the point in time when disbursements in a given year exceed the sum of contributions, and increase in assets as a result of investment performance. In other words, at what point in time is there more money going out then coming in? The identification of the portfolio's time horizon is one of the most important decisions the fiduciary has to manage.

The time horizon is the primary variable in determining the allocation between equities and fixed income. An investment time horizon of less than five years is considered *short*, while five years or more is considered *long*. Ordinarily, a *short-term* time horizon would call for an allocation to fixed income and cash, whereas a *long-term* strategy could include a prudent allocation to most other asset classes.

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[10] ***Substantiating Code, Regulations, and Case Law Practice No. 2.3:***

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)(1)(B)

Regulations
29 C.F.R. §2550.404a-1(b)(1)(A); 29 C.F.R. §2550.404a-1(b)(2)(A)

Case Law
Metzler v. Graham, *112 F.3d 207, 20 E.B.C. 2857 (5th Cir. 1997)*

Other
Interpretive Bulletin 96-1, 29 C.F.R. §2509.96-1; H.R. Report No. 1280, 93d Congress, 2d Session (1974)

Uniform Prudent Investor Act [UPIA]
§2(a); §2(b)

Management of Public Employee Retirement Systems Act [MPERS]
§8; §10(b)

Practice No 2.3 (continued)

There is a hierarchy to the decisions that the fiduciary has to manage. Illustration 2.3 depicts this hierarchy and shows that the most important decision the fiduciary has to manage is the determination of the time horizon. Based on the time horizon, the fiduciary then can determine which asset classes can be appropriately considered; what the allocation should be between the selected asset classes; whether there should be an allocation made among sub-asset classes; and, finally, which money managers or mutual funds should be retained to manage each asset class.

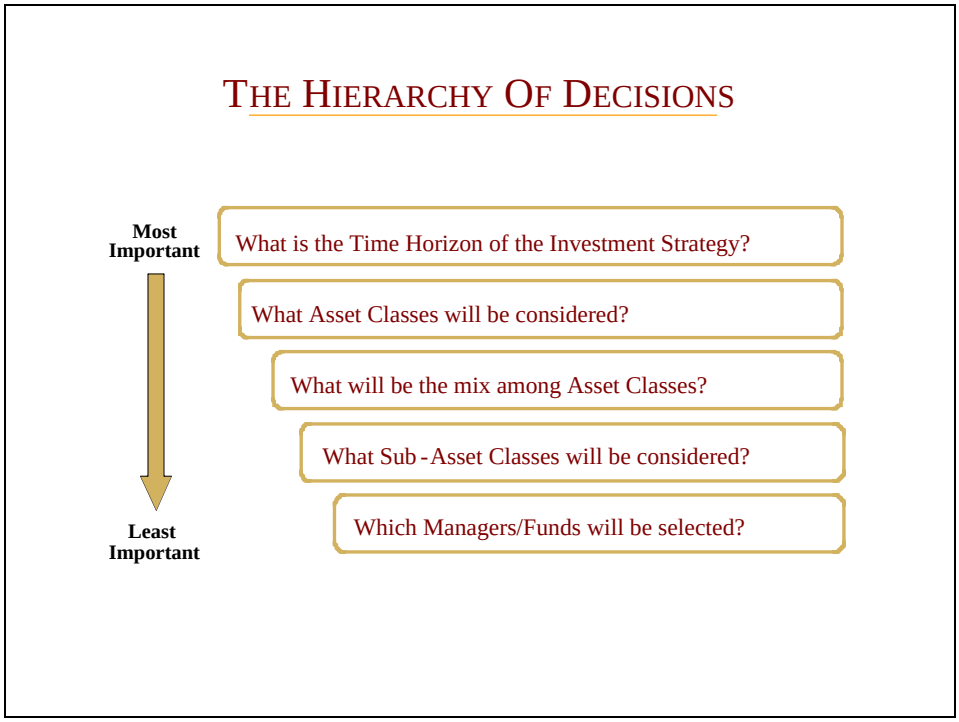

Illustration 2.3

Note that the least important decision in the hierarchy is the selection of the money managers or mutual funds. The inexperienced decision maker often will reverse this hierarchy - chasing Wall Street's latest hot manager and abdicating the most important decisions the investor has to manage, the asset allocation decisions, to a complete stranger - the money manager.

❑ ***Practice No. 2.4*** **Selected asset classes are consistent with the identified risk, return, and time horizon**[11]

The fiduciary's role is to choose the appropriate combination of asset classes that optimizes the identified risk and return objectives, consistent with the portfolio's time horizon. [See also *Practice*s *2.1 - 2.3*]

The fundamental question associated with this *Practice* is: Will investment goals and objectives be reasonably obtained with the allocation? Several examples are worth noting:

> Example 1: The retired individual investor/couple who want to maintain the purchasing power of their portfolio: Ordinarily, the only way an investment strategy can be made inflation-proof over the long-term is to have at least a 20 percent allocation to equities. An all fixed-income and cash portfolio has only a 70 percent probability of beating inflation over the long term. [See Illustration 2.4]
>
> Example 2: The defined benefit retirement plan that is nearing fully funded status and still is heavily invested in equities: If the funding objectives can be met in the near-term (less than five years) with a fixed-income strategy, the investment committee should be reducing equity exposure to reduce the risk associated with a major market correction.
>
> Example 3: The foundation that has made a commitment to build a new hospital wing within the next three years, and has a large percentage of the designated assets in long-term fixed-income securities: Ordinarily, the foundation is better off *immunizing* the fixed income strategy. That is, matching the maturity or duration of the fixed-income securities to the anticipated cash-call requirements of the building project.

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[11] ***Substantiating Code, Regulations, and Case Law for Practice No. 2.4:***

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)(1)(B)

Regulations
29 C.F.R. §2550.404a-1; 29 C.F.R. §2550.404a-1(b)(1)(A); 29 C.F.R. §2550.404a-1(b)(2)(B)(i-iii)

Case Law
GIW Industries, Inc. v. Trevor, Stewart, Burton & Jacobsen, Inc., 895 F.2d 729 (11th Cir. 1990); *Leigh v. Engle*, 858 F.2d 361 (7th Cir. 1988)

Other
Interpretive Bulletin 96-1, 29 C.F.R. §2509.96-1

Uniform Prudent Investor Act [UPIA]
§2(b)

Management of Public Employee Retirement Systems Act [MPERS]
§8(b)

Practice No 2.4 (continued)

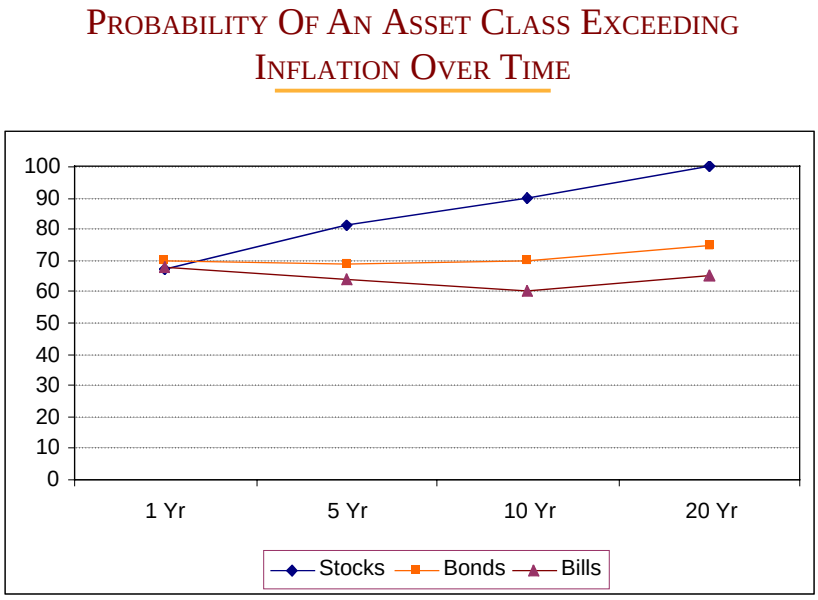

Illustration 2.4

Example 4: For fiduciaries of defined contribution plans where investment decisions are participant-directed: Fiduciaries should be aware of the "1/n" phenomenon, where "n" is the number of investment options provided to the participant. Research has shown that a large number of plan participants will equally allocate across all investment options; particularly, when the number of options is small (less than ten). As an example, if five investment options are offered, most participants will equally weight their allocation across the five options - putting 20percent in each option. Imagine the consequences if an emerging markets mutual fund were one of five investment options, considering the number of participants who would likely invest 20 percent of their portfolio in emerging markets.

This *Practice* also assumes that the investments within each asset class are appropriately diversified to eliminate *specific issue risk.* [See also *Practice No 2.1*] As an example, a fiduciary may have prudently diversified the portfolio with an allocation to equities only to discover that the equity investment option was heavily concentrated in only a few securities.

❑ ***Practice No. 2.5*** **The number of asset classes is consistent with portfolio size**[12]

There is no formula the fiduciary can follow to determine the *best* number of asset classes - the *appropriate* number is determined by facts and circumstances.

How many asset classes should be considered? Or in the case of participant-directed retirement plans, how many investment options should be offered? The answer is dependent upon the:

1. Size of the portfolio

2. Investment expertise of the investment decision makers

3. Ability of the decision makers to properly monitor the strategies and/or investment options

4. Sensitivity to investment expenses - more asset classes and/or options ordinarily will mean higher portfolio expenses. The additional *costs* should be evaluated in light of the *price* the fiduciary pays for being under-diversified.

[IBP] Which asset classes should be considered first? Illustration 2.5 is provided as a suggested frame of reference. The illustration is based on the premise that the time horizon is greater than five years. Ordinarily, the most appropriate asset classes to be used as a starting point are the broad market classes representing the full capitalization-weighted range of investment opportunities. Simply stated; stocks, bonds, and cash. From this starting point, additional asset classes and peer groups should be added that provide meaningful risk and return benefits to the overall investment strategy.

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[12] ***Substantiating Code, Regulations, and Case Law for Practice No. 2.5:***

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)(1)(C)

Other
H.R. Report No. 1280, 93rd Congress, 2d Sess.304, reprinted in 1974 U.S. Code Cong. & Admin. News 5038 (1974)

Uniform Prudent Investor Act [UPIA]
§2(b)

Other
Restatement of Trusts 3d: Prudent Investor Rule §227, comment

Management of Public Employee Retirement Systems Act [MPERS]
§8(a)(1); §8(a)(4); §10(2)

Practice No 2.5 (continued)

The fiduciary should keep in mind that the allocation also must be implemented and monitored. It makes no sense to make an allocation to an asset class that the fiduciary cannot effectively and efficiently implement and/or monitor on an ongoing basis. [See also *Practices 4.1 and 5.1*]

Illustration 2.6 is a table depicting four diversified portfolios using the methodology and *Practices* described in this handbook. The portfolios can also double as performance measurement indexes. The number in parenthesis (20, 40, 60, and 80) represents the total equity exposure in the index. The return of the index is calculated by multiplying the percentage represented by each asset class by the median mutual fund return for the respective peer group.

INTRODUCTION TO *PRACTICES 3.1 - 3.7*

The preparation and maintenance of the investment policy statement ("IPS") is one of the most critical functions of the fiduciary. The IPS should be viewed as the business plan and the essential management tool for directing and communicating the activities of the portfolio. It is a formal, long-range strategic plan that allows the fiduciary to coordinate the management of the investment program in a logical and consistent framework. All material investment facts, assumptions, and opinions should be included.

[IBP] The fiduciary is required to manage investment decisions with a reasonable level of detail. By reducing that detail to writing, preparing a written IPS, the fiduciary can: (1) avoid unnecessary differences of opinion and the resulting conflicts; (2) minimize the possibility of missteps due to lack of clear guidelines; (3) establish a reasoned basis for measuring their compliance; and, (4) establish and communicate reasonable and clear expectations with participants, beneficiaries, and investors.

There are a number of benefits to having a well-written IPS:

1. In the event of an audit, litigation, and or a dispute, it supports the *paper trail.* One of the first documents a litigator or auditor is likely to review is the IPS, because it should provide an outline of the overall investment strategy.

2. It helps negate *Monday morning quarterbacking*. Inevitably, there will be turn-over of investment committee members and trustees. Former investment decision makers don't want to be caught in the uncomfortable position of having new committee members second-guess their decisions.

3. It helps to insulate investment decision makers from *market noise*. During periods of over- and under-confidence in the capital markets, the IPS helps to keep decision makers focused on the long-term goals and objectives.

4. It helps to provide implementation guidance during estate planning, particularly when one spouse is still actively managing all or a significant portion of the investable assets. Inevitably, it's the *investing spouse* that is the first to become incapacitated, leaving the surviving spouse and/or executor with the near impossible task of continuing the former investment strategy. An IPS thoughtfully prepared in advance and integrated within the overall estate plan would help ensure the smooth transition of the investment strategy.

5. It helps to reassure donors of a foundation's or endowment's investment stewardship. Fundraisers should carry a copy of the IPS to show potential donors how the entrusted assets are being prudently managed.

❑ *Practice No. 3.1* There is detail to implement a specific investment strategy[13]

The IPS should have sufficient detail that a third party should be able to implement the investment strategy; be flexible enough that it can be implemented in a complex and dynamic financial environment; and yet not be so detailed it requires constant revisions and updates. The IPS should combine elements of planning and philosophy, and should address the management of each of the fiduciary standards of care (vertical axis of the Practices Matrix). Addendums should be used to identify information that will change on a more frequent basis such as the names of board members, accountant, attorney, actuary, and money managers/ mutual funds; and the capital markets assumptions used to develop the plan's asset allocation.

[IBP] We have provided a sample IPS in Enclosure 1. The sample is for a retirement plan in which the investment decisions are committee-directed. This sample also can be used as a template for an IPS for: (1) foundations and endowments; (2) high net-worth families/ investors; and, (3) retirement plans in which investment decisions are participant-directed.

Changes/additions that would have to be made to the sample IPS for foundations and endowments (eleemosynaries) include the following:

1. The background section of the IPS should address whether the eleemosynary has adopted a mission-based investment strategy. [See *Practice No. 3.7,* which covers the subject of mission-based and socially responsible investing.]

2. The IPS should address the eleemosynary's Equilibrium Spending Rate (ESR). The ESR is used to calculate the level of grants that can be made based on the eleemosynary's modeled asset allocation return, adjusted for inflation and investment expenses. [See *Practice No 1.1* and the **Glossary of Terms** for a more detailed explanation.]

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[13] ***Substantiating Code, Regulations, and Case Law for Practice No. 3.1:***

Employee Retirement Income Security Act of 1974 [ERISA]

Other
Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2

Uniform Prudent Investor Act [UPIA]
§2(b); §4

Other
Restatement of Trusts 3d: Prudent Investor Rule §227(a)

Management of Public Employee Retirement Systems Act [MPERS]
§8(b)

Practice No 3.1 (continued)

3. There should be a discussion of the smoothing rules that will be followed in applying the ESR. Typically the eleemosynary does not apply the ESR to the year-end market value, but rather averages the year-end value of the previous three years. This practice reduces the volatile swings in the dollar amounts of grants that the eleemosynary makes each year.

Changes/additions that would have to be made to the sample IPS for high net-worth families/investors include the following:

1. The background section of the IPS should identify the assets that are covered by the IPS versus the total net worth of the family/investor. For example, the family may have a net worth of $2 million, but $400,000 is invested in a vacation condo. Therefore, the IPS is only covering the investabal assets of $1.6 million.

2. If the family/individual has stock options or closely-held business assets, the background section of the IPS should contain a discussion of how the closely-held and/or restricted assets are going to be modeled, or not, in the overall investment strategy. There are two possible approaches. The first is to simply hold the value of the assets outside the scope of the IPS, recognizing that the anticipated cash value of the closely-held asset will be available for diversification at some point in the future. The second approach is to incorporate the closely-held asset in the overall asset allocation strategy.

3. Determine whether the taxable and tax-exempt assets are going to be segregated, each modeled with its own IPS, or whether all of the assets will be identified under one IPS. Again, there is no one right approach, but the later approach is preferred unless the client is retired or nearing retirement.

4. Note in the background section whether the IPS is tied to estate planning and, if so, note in the Appendix the person who is most familiar with the estate strategy.

5. For family offices, (typically formed when a family has in excess of $50 million) consideration should be given to developing a different IPS for each family unit or tax ID. The risk/return profile of the matriarch and patriarch is likely to be quite different from the risk/return profile of each of the siblings.

6. The background of the IPS should address whether the family has adopted a mission-based investment strategy. [See *Practice No. 3.7*]

Practice No 3.1 (continued)

Changes/additions that would have to be made to the sample IPS for retirement plans in which investment decisions are participant directed (such as most 401k plans) include the following:

1. Whether the plan sponsor has formally adopted 404c Safe Harbor provisions. [404c will be addressed in more detail in *Practice No. 4.2*.]

2. The number of investment options that will be offered in the plan.

3. The asset class that will be mapped to each investment option.

❑ *Practice No. 3.2* Investment policy statement defines the duties and responsibilities of all parties involved[14]

There are numerous parties involved in the investment process, and each should have their specific duties and requirements detailed in the IPS. This ensures continuity of the investment strategy when there is a change in fiduciaries; helps to prevent misunderstandings between parties; and helps to prevent omission of critical fiduciary functions. The IPS should include sections on:

1. The role of the investment committee [See also *Practice No. 1.2*]

2. The role of the investment consultant (if one is retained)

3. The role of the custodian [See also *Practice No. 4.4*]

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[14] ***Substantiating Code, Regulations, and Case Law for Practice No. 3.2:***

Employee Retirement Income Security Act of 1974 [ERISA]
§3(38)(c); §402(a)(1); §402(b)(2) and (3); §403(a)(2)
§405(c)(1)

Uniform Prudent Investor Act [UPIA]
§9(a)(1) and (2)

Other
Restatement of Trusts 3d: Prudent Investor Rule §171 (1992)

Management of Public Employee Retirement Systems Act [MPERS]
§6(a) and (b); §8(b)

Practice No 3.2 (continued)

4. The role of the separate account manager(s). [See also *Practice No. 4.1*] [Not necessary for mutual funds since the investment strategy of the fund already is specified in the fund's prospectus.] The instructions for the money manager should include:

    a. Securities guidelines

    b. Responsibility to seek *best price and execution* on trading the securities [See also *Practice No. 5.3*]

    c. Responsibility to account for *soft dollars* [See also *Practice No. 5.3*]

    d. Responsibility to vote all proxies [See also *Practice No. 5.3*].

❑ *Practice No. 3.3* Investment policy statement defines diversification and rebalancing guidelines[15]

One of the challenges of writing a complete IPS is to create investment guidelines specific enough to clearly establish the parameters of the desired investment process, yet provide enough latitude so as not to create an oversight burden. This is particularly true when establishing the portfolio's asset allocation and rebalancing limits.

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[15] ***Substantiating Code, Regulations, and Case Law for Practice No. 3.3:***

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)(1)(C)

Regulations
29 C.F.R. §2550.404a-1(b)(2)(i)

Case Law
Leigh v. Engle, 858 F.2d 361, 10 E.B.C. 1041 (7th Cir. 1988), *cert. denied*, 489 U.S. 1078, 109 S.Ct. 1528, 103 L.Ed.2d 833 (1989)

Other
H.R. Report No. 1280, 93rd Cong. 2d Sess. 304, reprinted in 1974 U.S. Code Cong. & Admin. News 5038 (1974)

Uniform Prudent Investor Act [UPIA]
§2; §3 and Comments

Management of Public Employee Retirement Systems Act [MPERS]
§8 and Comments

Other
Restatement of Trusts 3d: Prudent Investor Rule §227, comment g

Practice No 3.3 (continued)

The strategic asset allocation should be that specific mix of asset classes that meets the mutually agreed upon risk/return profile of the investor or investment committee. [See also *Practice No. 2.4*] **[IBP]** The acronym **TREAT** can assist in defining the specific variables that should be included in the asset allocation decision:

T Tax status of the portfolio, whether it is taxable or tax-exempt
R Risk level the investor or investment committee is willing to assume
E Expected return the portfolio needs to achieve to meet identified goals and objectives
A Asset class preference of the investor or investment committee
T Time horizon of the asset allocation strategy, defined as that point in time when there is a negative cash flow - more money being disbursed than is being contributed and/or as a result of portfolio growth.

If there are asset classes that have been omitted for a specific reason, these also should be identified in the IPS. As an example, if the investment committee states that they do not want high-yield bonds in the asset allocation, than this restriction should be noted in the IPS.

The rebalancing limits define the points when a portfolio should be reallocated to bring it back in line with the established asset allocation target. The discipline of rebalancing, in essence, controls risk and forces the portfolio to move along a predetermined course. It takes gains from stellar performers or favored asset classes, and reallocates them to lagging styles.

[IBP] While the legal requirement for diversification is clear, the need for rebalancing is not explicitly addressed. Nevertheless, rebalancing is an inherent concept of diversification, where the goal is to create a portfolio that balances appropriate levels of risk and return. That balance, once achieved, can only be maintained by periodically rebalancing the portfolio to maintain the appropriate diversification.

The process of setting an appropriate rebalancing limit is somewhat subjective. **[IBP]** Ordinarily, rebalancing limits of plus-or-minus five percent should keep the parameters tight enough to maintain the risk/return profile of the strategy, yet require rebalancing only once or twice a year. When it is necessary to rebalance, the fiduciary should determine the cash flows over the next quarter to determine if the portfolio can be rebalanced with contributions or disbursements. [See also *Practice Standard 1.5*]

❑ *Practice No. 3.4* Investment policy statement defines due diligence criteria for selecting investment options[16]

A well-written IPS can serve to insulate the fiduciary from *market noise*, or in the context of this *Practice*, the temptation to chase the latest hot manager on Wall Street. By establishing specific asset allocation parameters and money manager (or mutual fund) selection criteria, it is much easier to determine whether a prospective manager fits into the general investment program. [See also *Practices 2.4 and 4.1*]

[IBP] There is no explicit requirement for fiduciaries to define due diligence criteria for the selection of money managers, however, it is implicit in other fiduciary requirements. As a practical matter, these provisions require a fiduciary to define the due diligence process and criteria for selecting investment options.

The fiduciary should investigate the qualities, characteristics, and merits of each money manager, and to identify the role each plays in the furtherance of the investment strategy. However, such an investigation and the related analysis cannot be conducted in a vacuum - it must be within the context of the needs of the investment strategy. Once the needs have been defined, and the general strategies developed, specific money managers should be chosen within the context of this strategy.

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[16] ***Substantiating Code, Regulations, and Case Law for Practice No. 3.4:***

Employee Retirement Income Security Act of 1974 [ERISA]
§402(c)(3); §404(a)(1)(B)

Regulations
29 C.F.R. §2550.404a-1(b)(1)(A); 29 C.F.R. §2550.404a-1(b)(2)

Case Law
In re Unisys Savings Plan Litigation, 74 F.3d 420, 19 E.B.C. 2393 (3rd Cir.), *cert. denied*, 510 U.S. 810, 117 S.Ct. 56, 136 L.Ed.2d 19 (1996)

Other
Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2

Uniform Prudent Investor Act [UPIA]
§2(a); §4

Management of Public Employee Retirement Systems Act [MPERS]
§8(b); §8(a)

❑ *Practice No. 3.5* Investment policy statement defines monitoring criteria for investment options and service vendors[17]

The fiduciary duty to monitor the performance of investment managers and other service providers is inherent in the obligations of fiduciaries to act prudently in carrying out their duties. The investment management process triggers a number of reviews of the numerous parties involved in the investment process:

> *Monthly*, the custodial statement should be reviewed for accuracy and to determine whether hired money managers are continuing to seek *best execution* on trades. [See also *Practice No. 5.3*]
>
> *Periodically* [**IBP** - Quarterly], a performance report should be prepared indicating how well selected managers and/or funds are performing relative to the objectives set forth in the IPS, against their peers, and against an appropriate industry index. [See also *Practice No. 5.1*]
>
> *Annually*, the IPS should be reviewed to determine whether there have been any material changes to the goals and objectives, or to the risk/return profile. [See also *Practices 1.1 and 2.4*.]

Specific performance criteria and objectives should be identified for each money manager and/or mutual fund. The one decision that is typically more difficult to make than *Which manager or fund to hire?* Is *Is it time to fire the manager or fund?* When performance criteria are agreed to in advance, the decision is easier to manage and to make.

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[17] ***Substantiating Code, Regulations, and Case Law for Practice no 3.5:***

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)

Case Law
Morrissey v. Curran, 567 F.2d 546, 1 E.B.C. 1659 (2nd Cir. 1977); *Harley v. Minnesota Mining and Manufacturing Company*, 42 F. Supp.2d 898 (D.Minn. 1999), *aff'd*, 284 F.3d 901 (8th Cir. 2002); *Whitfield v. Cohen*, 682 F.Supp. 188, 9 E.B.C. 1739 (S.D.N.Y. 1988); *Liss v. Smith*, 991 F.Supp. 278 (S.D.N.Y. 1988)

Other
Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8; Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2(2)
Interpretive Bulletin 96-1, 29 C.F.R. §2509.96-1(e)

Uniform Prudent Investor Act [UPIA]
§9(a)(1), (2) and (3)

Management of Public Employee Retirement Systems Act [MPERS]
§6(b)(2) and (3); §8(b)

❑ *Practice No. 3.6* Investment policy statement defines procedures for controlling and accounting for investment expenses[18]

In order for the fiduciary to fulfill the general fiduciary obligation to manage investment decisions with the requisite level of care, skill, and prudence; and the specific obligation of the fiduciary to defray only reasonable and necessary expenses; the fiduciary must establish procedures for controlling and accounting for investment expenses. **[IBP]** In order to clearly define those procedures and to facilitate their implementation, they should be reduced to writing - most certainly as a matter of best practices and, most likely, as a factor in measuring the prudent conduct of the fiduciary.

Investment management costs and expenses can be broken down into four categories, and the IPS should contain instructions and procedures on how these fees and expenses will be accounted for and monitored. The fiduciary is cautioned that each can be obscured or moved from one category to another to create apparent savings. [See also *Practice No. 5.3*] The fiduciary should examine:

1. Money manager fees and/or the annual expenses of mutual funds

2. Trading costs, including commission charges and execution expenses

3. Custodial charges, including custodial fees, transaction charges, and cash management fees

4. Consulting and administrative costs and fees. In the case of defined contribution plans, demonstrate that 12-b-1 fees [See **Glossary of Terms**], subtransfer agency fees, and/or other revenue sharing arrangements have been appropriately applied to offset recordkeeping and other administrative costs of the plan.

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[18] ***Substantiating Code, Regulations, and Case Law Practice No 3.6:***

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)(1)(A)(i and ii); §406(a)(1)(C); §408(b)(2)

Case Law
Liss v. Smith, 991 F.Supp. 278 (S.D.N.Y. 1998)

Other
Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2

Uniform Prudent Investor Act [UPIA]
§2 Comments; §2(a); §7

Other
OCC Interpretive Letter No. 722 (March 12, 1996), citing the Restatement of Trusts 3d: Prudent Investor Rule §227, comment m at 58 (1992)

Management of Public Employee Retirement Systems Act [MPERS]
§7(2), (3) and (5); §7(5) and Comments; §8(b) and Comments

❑ *Practice No. 3.7* Investment policy statement defines appropriately structured, socially responsible investment strategies (when applicable)[19]

There is an increasing interest by fiduciaries to incorporate social, ethical, moral, and/or religious criteria into their investment strategy. The desire is to align investment decisions with the fiduciary's, investor's, and/or the beneficiary's core values. There are two terms that are used interchangeably by the industry; mission-based investing, and socially responsible investing (SRI).

However worthwhile or well-intended, fiduciary standards of care cannot be abrogated to accommodate the pursuit of a SRI strategy. As a general rule, any restriction on an investment program has the potential to reduce the portfolio's total return - itself a breach of fiduciary responsibility.

The key to successfully incorporating a SRI strategy is for the fiduciary to demonstrate that investment results were not negatively impacted. **[IBP]** It has become a generally accepted practice to permit the inclusion of a SRI strategy as a secondary screen to a normal (unrestricted) investment process. If there are equally attractive investment options, then social factors may be considered.

For fiduciaries guided by the UPIA, there are possibly three notable exceptions:

1. The trust documents establishing the private trust, foundation, or endowment permit the use of SRI

2. A donor directs the use of a SRI Strategy

3. A reasonable person would deduce from the foundation's/endowment's mission that SRI would be adopted. As an example, a reasonable person would expect that a foundation for a woman's shelter would exclude tobacco, firearms, and alcohol from its investment strategy.

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[19] ***Substantiating Code, Regulations, and Case Law for Practice no 3.7:***

Employee Retirement Income Security Act of 1974 [ERISA]
§403(c)(1); §404(a)(1)

Other
ERISA Opinion Letter 98-04A (May 28, 1998); Interpretive Bulletin 94-1, 29 C.F.R. §2509.94-1

Uniform Prudent Investor Act [UPIA]
§2(a); §2(c); §5

Management of Public Employee Retirement Systems Act [MPERS]
§7(1), (2) and (3); §8(a) (1) and (2); §8(a)(5); §8(b)

Practice No 3.7 (continued)

[IBP] For defined contribution plans, in which investment decisions are participant-directed, a general investment option of the same peer group should be offered alongside each SRI investment option. As an example, if the investment committee chose to offer a SRI large-cap equity index fund, then a second large cap equity index fund that is not constrained by a SRI strategy also should be offered.

There are a number of different approaches the fiduciary can employ to execute mission-based and SRI strategies. The following is a brief synopsis:

1. The fiduciary can direct a hired money manager (or search for a mutual fund) to incorporate certain securities screens. The screens may be either inclusionary, or exclusionary. Inclusionary qualitative screens might include companies that emphasize:

   - Product quality/consumer relations
   - Environmental performance
   - Community relations
   - Diversity
   - Employee relations

   Exclusionary screens might include:

   - The *sin* stocks - alcohol, tobacco, firearms
   - Nuclear power
   - Military weapons
   - Life ethics

2. The fiduciary may wish to pursue a strategy of shareholder activism - actually purchasing shares of stock in a targeted company so that the fiduciary can participate in corporate governance activities.

3. The fiduciary may wish to pursue Economically-Targeted Investing (ETI). ETI is the use of portfolio assets to produce collateral benefits such as jobs, housing loans, and venture capital. ETI is very popular with Taft-Hartley (multi-employer) plans and public retirement plans.

4. The fiduciary may wish to employ money managers that are minority and/or women-owned business enterprises.

The most widely used performance benchmark for mission-based and SRI investment strategies is the Domini 400 Social Index. The Domini Social Index is comprised of: 250 stocks from the S&P 500, 100 stocks from the next 1,000 largest companies, and 50 stocks from the small-cap universe. The cap weighting of the Domini Index is less than the S&P 500, but generally the Domini 400 Social Index has been comparable to the S&P 500 index.

Practice No 3.7 (continued)

Sample language for the IPS

The manager is instructed to evaluate all investment options according to objective economic criteria established by the manager and, if there are equally attractive investments, social factors may be considered.

INTRODUCTION TO *PRACTICES 4.1 - 4.4*

The *Practices* associated with Step 4 of the *Investment Management Process* detail the prudent procedures for implementing the investment strategy. Whether investment decisions are delegated to professionals (strongly encouraged) or retained by the fiduciary, the fiduciary should demonstrate that a due diligence process was followed in selecting each investment option.

Besides the prudence of such conduct, it also makes good sense. When managers or funds are selected without following a due diligence process, there are potential problems:

1. Important search criteria can be omitted.

2. Performance may be compared to inappropriate indexes or peer groups.

3. Information provided by the manager or fund may focus on what the manager or fund wants the fiduciary to hear, and not necessarily what the fiduciary needs to know.

One of the more important responsibilities of the fiduciary is the development of a due diligence process, which can be used to select and monitor the investment options. **[IBP]** As a general rule, the fiduciary should develop due diligence criteria with the following in mind:

1. Develop a process that can be applied to both mutual funds and separate account managers, so that investment decision makers can easily migrate from one alternative to another.

2. Develop a process that can be applied to any of the readily available databases on mutual funds and/or separate account managers.

3. Develop a simple process that can be easily understood by other fiduciaries, participants, and/or beneficiaries.

4. Develop screens that can serve a dual purpose - apply to searches as well as to the monitoring of the managers.

❑ ***Practice No. 4.1 The investment strategy is implemented in compliance with the required level of prudence***[20]

Investment returns and risks are largely determined by asset allocation decisions. But what starts as strategy must be translated into reality with implementation.

Fiduciary legislation does not expressly require the use of professional money managers and/or mutual funds. However, fiduciaries will be held to the same expert standard of care, and their activities and conduct will be measured against those of investment professionals. **[IBP]** The prudent fiduciary should follow the time-proven maxim of doing what one does best and delegating (when trust documents permit) the rest to professionals.

As previously stated in this handbook, the primary role of the fiduciary is to manage the investment process. It is not to make investment decisions - it is not to attempt to make individual stock and bond picks. Let professional money managers build the portfolio. The fiduciary can be far more effective and efficient spending his or her time managing the managers. Therefore, for the purposes of this handbook, the emphasis is going to be on the due diligence process the fiduciary should develop in selecting the money managers.

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20 ***Substantiating Code, Regulations, and Case Law No 4.1:***

Employee Retirement Income Security Act of 1974 [ERISA]
§402(c)(3); §403(a)(1) and (2); §404(a)(1)(B)

Regulations
29 C.F.R. §2550.404a-1(b)(1) and (2)

Case Law
Howard v. Shay, 100 F.3d 1484, 20 E.B.C. 2097 (9th Cir. 1996), *cert. denied*, 520 U.S. 1237, 117 S.Ct. 1838, 137 L.Ed.2d 1042 (1997); *Fink v. National Savings and Trust Co.*, 772 F.2d 951 (D.C. Cir. 1985); *Katsaros v. Cody*, 744 F.2d 270, 5 E.B.C. 1777 (2nd Cir.), *cert. denied*, 469 U.S. 1072, 105 S.Ct. 565, 83 L.Ed.2d 506 (1984); *Donovan v. Mazzola*, 716 F.2d 1226 (9th Cir. 1983), *cert. denied*, 464 U.S. 1040, 104 S.Ct. 704, 79 L.Ed.2d 169 (1984); *United States v. Mason Tenders Dist. Council of Greater New York*, 909 F.Supp. 882, 19 E.B.C. 1467 (S.D.N.Y. 1995); *Trapani v. Consolidated Edison Employees' Mutual Aid Society*, 693 F.Supp. 1509 (S.D.N.Y. 1988)

Uniform Prudent Investor Act [UPIA]
§2(c); §2(f); §9(a)(1-3)

Management of Public Employee Retirement Systems Act [MPERS]
§6(a); §6(b)(1); §6(b)(3); §7(3); §8(a)(1)

Practice No 4.1 (continued)

[IBP] The **Foundation for Fiduciary Studies** has identified a due diligence process which the **Foundation** believes constitutes the minimum due diligence process that should be followed in selecting a money manager. It can be used to screen both managers and funds; be applied to any data base; and can be used for both the searching and the monitoring of managers. The due diligence process includes eight screens:

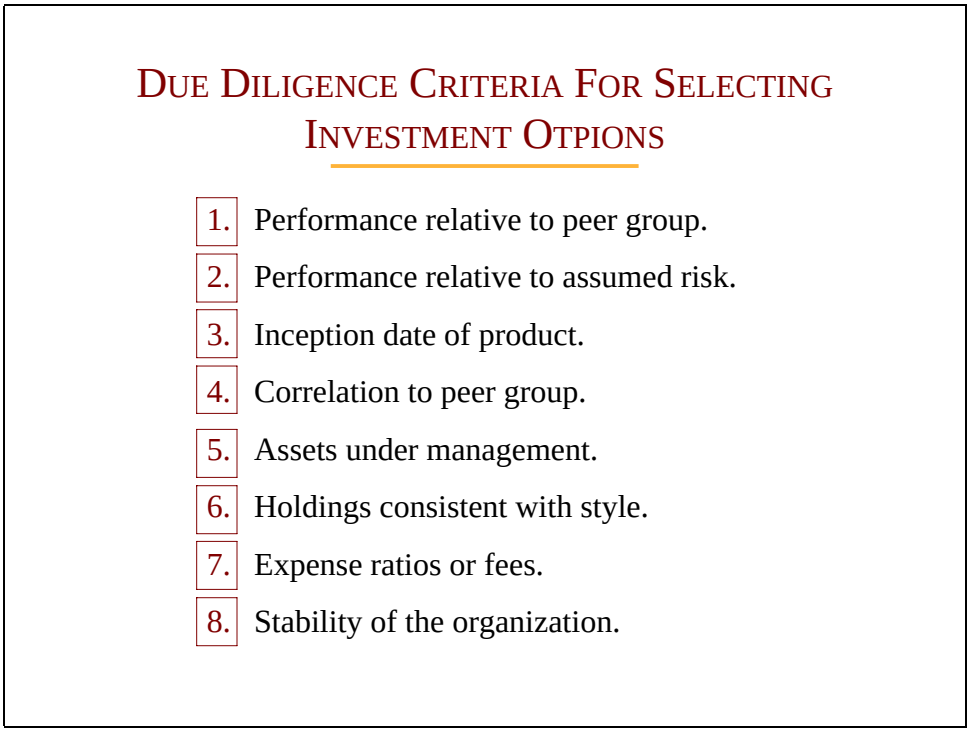

Illustration 4.1

1. *Rolling performance of the investment product on a 1-, 3-, and 5-year basis.* The performance comparison should be made against the median return of the manager's peer group. If the manager is performing below median for the 1-, 3-, and/or 5-year period, the manager would be deemed to have a *shortfall* - it doesn't mean the manager has failed, but simply that the performance should be evaluated in more detail to determine the source of the underperformance.

2. *Three-year investment performance adjusted for risk.* The more common screen would be to evaluate the manager's Alpha and/or Sharpe ratio. [See **Glossary of Terms**] The comparison should be made to the median Alpha and/or Sharpe ratio for the manager's peer group. An Alpha and/or Sharpe ratio below median would indicate a *shortfall*. Again, it doesn't mean the manager has failed, or shouldn't be considered, but simply the risk-adjusted performance should be evaluated in more detail to determine the source of the underperformance.

Practice No 4.1 (continued)

3. *Inception date of the investment product.* The appropriate threshold is three years. Investment statistics, such as the Alpha, Sharpe ratio, and standard deviation require a minimum of 12 observations (12 quarterly returns) before a meaningful calculation can be made.

4. *Correlation of the investment product to the asset class, or peer group, being implemented.* The selection of a money manager is based on the assumption the manager will adhere to a specific strategy or style. To do otherwise renders the search process useless, and makes monitoring of the manager a near impossible task. Furthermore, the asset allocation strategy being followed is based on the assumption that each asset class is going to be implemented by a manager and/or fund that exhibits the same performance characteristics (risk/return) as the asset class. Determining a manager's appropriate peer group, or sub-asset class, is a tricky business. There are no industry standards for determining a money manager's investment style, or peer group, which makes it virtually impossible to track the same manager across different data bases. The fiduciary should understand how a particular data base provider determines a manager's peer group. One data base might evaluate a manager's style by the securities held in the portfolio; another data base by the pattern of performance returns. Some databases have a policy that every manager is assigned to a peer group, while other databases only assign a manager to a peer group if there is a good fit. A good data base provider will examine both quantitative and qualitative data on the manager, and even take the time to interview the manager, to ensure that the information on record is correct.

5. *Total assets in the investment product being considered.* The threshold for this screen is $75 million. This can be a particularly slippery screen for mutual funds when there is more than one share class for a series of funds all being managed to the same process. It's reasonable, in such a situation, to total the assets across each of the share classes to determine if the $75 million threshold has been met.

6. *Holdings consistent with style.* 80 percent of the securities should be from the broad asset class associated with the product. As an example, if the fiduciary is examining a large cap growth fund, at least 80 percent of the securities should be in domestic equities.

7. *Fees and expenses associated with the investment product.* The fiduciary has a responsibility to control and account for investment expenses - including the fees paid for investment management. The industry has never drawn a line in the sand to say that expenses on this side of the line are reasonable, and expenses on the other side of the line are not. The **Foundation** has determined that a reasonable line can be drawn at the 75th percentile. That is, when the fees for a particular peer group are ranked least expensive (1st percentile) to most expensive (100th percentile), the shortfall occurs at the 75th percentile.

Practice No 4.1 (continued)

8. *Organizational stability - specifically manager tenure*. The same investment team should be in place for a minimum of two years. This screen also would include a review of qualitative information that may be available to the fiduciary. The fiduciary should check to see if there is pending litigation against the money management firm; internal management struggles; a recent change in ownership; and/or, a rapid growth or loss of assets under management. Common sense should prevail. Organizational instability, as with any business, will ultimately be reflected by poor performance.

On the surface the eight due diligence screens may appear to be relatively easy hurdles to clear but, on average, only 6 percent of the managers (or mutual funds) are able to pass each of the screens every quarter. That is not to say that 94 percent of all remaining investment products have failed, but rather the remaining investment products have one or more shortfalls, and the shortfalls define the agenda for the fiduciary for additional research and due diligence.

There are several other important concepts the fiduciary should be familiar with in the context of this *Practice*. **[IBP]** The first is to appreciate *the value of diversifying across multiple sub-asset classes, or peer groups*.

Illustration 4.2 depicts the familiar representation of peer groups by market cap size and style. The top row represents the large cap peer groups, the second row mid-cap, and the bottom row small-cap. The left-hand column represents value, the far right growth, and the middle blend or core.

EQUITY STYLE MATRIX

Large Equity	**Large Blend**	**Large Growth**
Mid-Cap Value	**Mid-Cap Blend**	**Mid-Cap Growth**
Small Value	**Small Blend**	**Small Growth**

Illustration 4.2

Practice No 4.1 (continued)

Keeping Illustration 4.2 in mind, examine Illustration 4.3, which depicts the median mutual fund return for each peer group for the period 1992 - 2001. As an example, in 1992 the median large-cap value mutual fund had a return of 10.4 percent and the median large cap growth manager had a return of 5.6 percent. An arrow is used to show the trend in annual performance. The tail of the arrow is on the worst performing peer group and the head is on the best. Next, the difference between the performance of the head and tail is calculated for each year. Surprisingly, the average annual differential is 23.2 percent or 2,320 basis points. [See **Glossary of Terms**] All too often, fiduciaries under-allocate across the peer groups, resulting in relative underperformance.

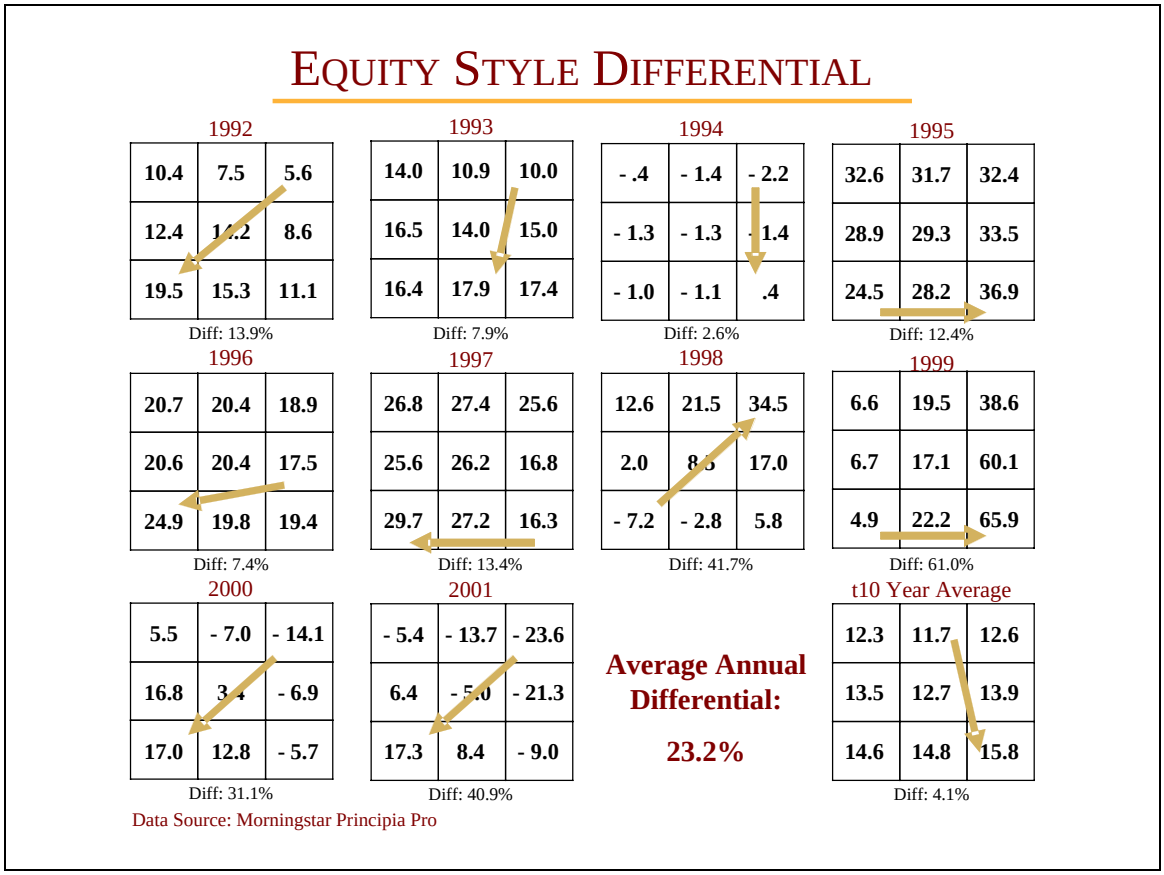

Illustration 4.3

Active versus passive investing, or the appropriate application of index funds. Academia has written volumes on this subject, and this handbook won't attempt to revisit the debates. **[IBP]** What is emerging as an industry best practice is to index those market sectors that receive the most attention from securities analysts, such as large cap core. It's difficult for an active money manager to consistently discover gold nuggets in a data stream that already has been panned by so many others. Active money management makes more sense in the outlying peer groups - the far edges of value and growth, and with mid-cap and small-cap stocks. The decision to use index funds or active money managers is not an either/or decision - the fiduciary is smart to use a combination of both.

Practice No 4.1 (continued)

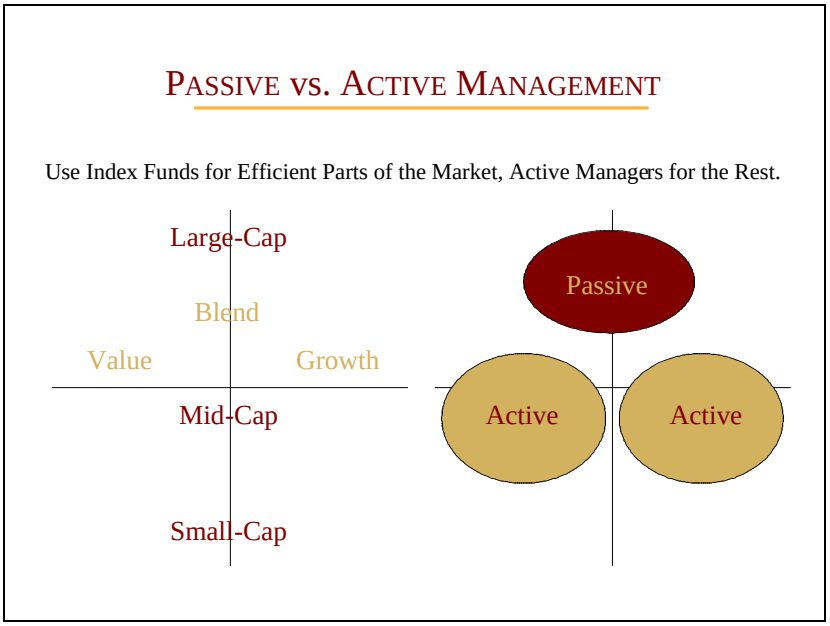

Illustration 4.4

The fiduciary also should be familiar with the different fixed income strategies. Fixed income management can simply be broken down into four strategies:

1. The fixed-income manager who can add value over a buy-and-hold strategy by anticipating changes in interest rates.

2. The fixed-income manager who can add value by anticipating changes in an issuer's credit quality.

3. By capitalizing on trading inefficiencies. As an example, there's a very successful municipal bond manager who buys munis from brokers in Florida, where there's no state income tax, and therefore is able to purchase the bonds from the brokers at a discount. The money manager then sells the very same bonds back to brokers in the states where the bonds were issued, where the brokers are willing to pay a premium for the bonds.

4. The fixed-income manager who can add value by being proficient in sector selection – knowing when to rotate out of government bonds and into corporate bonds, or vice versa.

[IBP] There are many fiduciaries who believe a buy-and-hold strategy for a fixed income portfolio is the best approach, but the recommended approach is the use of professional money managers. [See also *Practice No. 4.2*] First, the money manager often can cover his or her fees by obtaining better execution in the purchase of the bonds. And second, the fiduciary that attempts the buy-and-hold strategy is still going to be held to a *prudent expert* standard. If the fixed-income portfolio blows up, the fiduciary is going to be held accountable.

❑ ***Practice No. 4.2*** **Fiduciary is following applicable *Safe Harbor* provisions (when elected)**[21]

Only two of the twenty-seven *Practices* are elective; *Practice No 3.7*, and this *Practice*, *No 4.2*.

[IBP] Though *Practice No. 4.2* is a voluntary *Practice*, the fiduciary is forewarned that it is incredibly foolhardy not to take advantage of available *safe harbor* provisions. When the *safe harbor rules* are adopted, the fiduciary may be insulated from certain liabilities associated with the management of the portfolio's assets. There are no certainties with this or any of the *Practices*, except to say that, if the *safe harbor rules* are not adopted, the fiduciary will have far more liability exposure.

If investment decisions are being managed by a committee and/or by an investment advisor, then there are five generally recognized provisions to the *safe harbor rules*:

1. *Use **prudent experts** to make the investment decisions.* The fiduciary should *manage* the investment decision making process. In turn, hired professional money managers should *make* the investment decisions - actually select the stocks and bonds for the portfolio. Simply stated, a *prudent expert* is defined as a regulated financial services entity, including: banks, insurance companies, registered investment advisors, and registered investment companies (mutual funds). As of the publication of this handbook, there is pending pension-reform legislation that also will recognize registered representatives (brokers) as appropriate sources of *expert* advice.

2. *Demonstrate that the **prudent expert** was selected by following a due diligence process. Practice No. 4.1* captures the substance of this provision - in fact, if all of the *Practices* in this handbook are followed, all five of the *safe harbor* provisions will be met by the fiduciary.

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[21] ***Substantiating Code, Regulations, and Case Law for Practice No. 4.2:***

Employee Retirement Income Security Act of 1974 [ERISA]
§402(c)(3); §404(a) and (c); §405(d)(1)

Regulations
29 C.F.R. §2550.404a-1; 29 C.F.R. §2550.404a-1(b)(1) and (2)

Other
Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8 (FR-17Q); Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2; DOL Miscellaneous Document, 4/13/98 – Study of 401(k) Plan Fees and Expenses; Fed. Reg., Vol. 44, p. 37255

Uniform Prudent Investor Act [UPIA]
§9(a); §9(c)

Management of Public Employee Retirement Systems Act [MPERS]
§6(b); §6(d)

Practice No 4.2 (continued)

3. *Give the **prudent expert** discretion over the assets.* This is best accomplished with an appropriately worded services agreement [See also *Practice No. 1.4.]* and by inclusion in the *Duties and Responsibilities Section* of the investment policy statement. [See *Practice No. 3.2*]

4. *Have the **prudent expert** acknowledge their co-fiduciary status.* This, again, is best accomplished with the services agreement, and by having the *expert* sign the fiduciary's investment policy statement. Mutual funds are excluded from the necessity of signing the investment policy statement. Instead, the fiduciary is advised to keep the most recent copy of the mutual fund's prospectus.

5. *Monitor the activities of the **prudent expert** to ensure that the **expert** is performing the agreed upon tasks.* [See also *Practices 5.1 - 5.5.*]

If investment decisions are participant-directed, as often is the case for defined contribution plans (401k plans), then there are ***additional*** provisions. The word, ***additional***, is emphasized because the investment committee, which is constructing the matrix of investment options which will be made available to the participants, should start with the previously stated *safe harbor* provisions, and then add the following four additional provisions:

1. *Plan participants must be notified that the plan sponsor intends to constitute a 404(c) plan*, including a statement that the fiduciaries of the plan may be relieved of certain liabilities.

2. *Participants must be provided at least three different investment options*, each with a unique risk/return profile to provide the participant the opportunity for prudent diversification.

3. *Participants must receive sufficient education on the different investment options* so that each participant can make an informed investment decision. **[IBP]** Participant education should include:

    a. Each investment option's most recent prospectus, or similar document
    b. A general description of the investment objectives and risk/return characteristics of each investment option
    c. Information on the fees and expenses associated with each investment option
    d. A listing of the securities held by each investment option
    e. The performance of each investment option
    f. Portfolio statistics, such as the Alpha, Sharpe ratio, and standard deviation of each investment option.

4. *Participants must be provided the opportunity to change their investment strategy/allocation* with a frequency that is appropriate in light of market volatility. **[IBP]** The current industry practice is to permit changes at least quarterly.

❑ ***Practice No. 4.3*** **Investment vehicles are appropriate for the portfolio size**[22]

The primary focus of this *Practice* is the implementation of the investment strategy with appropriate investment vehicles, specifically the proper use of mutual funds and separate account managers. Other investment vehicles such as Exchange-Traded Funds (ETFs) and iShares will not be covered, but only because of the volume of material that needs to be covered, and not because they may be deemed inappropriate in a fiduciary setting.

To help illustrate the need for this *Practice,* consider the following two examples:

1. The investment committee, which is implementing an investment strategy for a portfolio with $400,000 in total assets, and implements the portfolio with two wrap fee separate account managers. There is a very high probability that the portfolio will not be prudently diversified if only two managers are retained. **[IBP]** A more appropriate structure would be the use of one separate account manager to manage a core strategy, and the use of mutual funds to round out the diversification needs.

2. The investment advisor who is implementing a strategy for a $100,000 portfolio and is using 20 different mutual funds. Diversification also carries a cost, and over-diversification can erode the associated benefits.

A challenging question for most fiduciaries is: *At what point should there be a migration from mutual funds to separate account managers?* **[IBP]** The following is a suggested guide:

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[22] ***Substantiating Code, Regulations, and Case Law for Practice No. 4.3:***

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)(1)(B); §404(a)(1)(C)

Regulations
29 C.F.R. §2550.404c-1(b)(3)(i)(C)

Case Law
Metzler v. Graham, 112 F.3d 207, 20 E.B.C. 2857 (5th Cir. 1997); *Marshall v. Glass/Metal Ass'n and Glaziers and Glassworkers Pension Plan*, 507 F. Supp. 378 (D.Hawaii 1980); *GIW Industries, Inc. v. Trevor, Stewart, Burton & Jacobsen, Inc.*, 10 E.B.C. 2290 (S.D.Ga. 1989); *aff'd*, 895 F.2d 729 (11th Cir. 1990); *Leigh v. Engle*, 858 F.2d 361, 10 E.B.C. 1041 (7th Cir. 1988), *cert. denied*, 489 U.S. 1078, 109 S.Ct. 1528, 103 L.Ed.2d 833 (1989)

Other
H.R. Report No. 1280, 93rd Congress, 2d Sess. (1974), reprinted in 1974 U.S. Code Cong. & Admin. News 5038 (1974)

Uniform Prudent Investor Act [UPIA]
§2(a); §3; §3 Comments

Management of Public Employee Retirement Systems Act [MPERS]
§7(3); §8(a)(1)

Practice No 4.3 (continued)

1. For portfolios with total assets of less than $300,000 implementation should be with just mutual funds. For portfolios with less than $300,000, the operative word is *diversification*. To effectively *diversify* a portfolio across the broad asset classes (both domestic and international), the fiduciary should consider the use of mutual funds.

2. For portfolios between $300,000 and $30 million, a combination of both funds and separate account managers. For portfolios between $300k and $30 million, the operative word is *effectiveness* - the most *effective* way to implement investment portfolios of the middle market is with a combination of funds and separate account managers. Separate account manager minimum account sizes, however, will vary from asset class to asset class. The logical minimum account size for a large-cap equity manager is going to be quite different than the effective minimum account size for an intermediate fixed-income manager. Consider the following *suggested* separate account minimums:

For large-cap equities	$100,000
Small-to-mid cap equities	$250,000
International equities	$250,000
Intermediate fixed-income	$1 million
And, for global fixed-income	$5 million.

3. For portfolios greater than $30 million, the operative term is *cost efficiency*. It is at this level that implementation with separate accounts can, as a general rule, be more *cost-effective* than with funds. But even at these levels, there are notable exceptions. The implementation of a large-cap blend strategy may still be more efficiently and effectively implemented with an index fund. Short-term, fixed-income, emerging markets, and most alternative investment strategies, also may still be more efficiently implemented with funds.

It is important for the fiduciary understand the pros and cons of both mutual funds and separate account managers. No one implementation structure is *right* for all occasions.

The benefits of mutual funds can be summarized as follows:

1. Greater liquidity - there is ease in entering and exiting the asset class.

2. Requires smaller dollar amounts to open accounts.

3. Ease in putting cash to work while money is in transition. For example, if the investment committee of a large pension plan has increased its allocation to equities, but a separate account manager has yet to be selected, the assets could be put in an equity fund while the manager search is conducted.

4. For smaller allocated amounts, the mutual fund can achieve a greater degree of diversification.

Practice No 4.3 (continued)

5. Generally speaking, there is greater ease in meeting asset allocation and rebalancing guidelines. A combination of specialized funds can achieve more-specific asset allocation guidelines than a broadly defined separate account manager mandate.

6. There is far greater ease in conducting due diligence on mutual funds.

7. A corollary to the previous benefit, mutual fund information is required to be audited.

8. Ease in implementing international portfolios, particularly investments in foreign entities that have more arcane securities registration and tax laws.

9. Cash-flows coming in to a mutual fund may meet disbursement requirements, eliminating the need for the manager to liquidate positions.

10. Fees may be netted from distributions, reducing taxable income.

Likewise, there are a number of benefits associated with separately managed accounts:

1. Accounts can be funded and opened with securities-in-kind. This is particularly valuable to taxable clients that have assets with low or preferred tax basis.

2. Separate accounts do not generate a phantom tax, which has been the bane of many mutual fund investors. Depending on when the investor purchases a mutual fund, the investor may be hit with taxable gains even though the investor never benefited from a performance gain.

3. Permits for year-end tax harvesting and the gifting of appreciated securities to charitable organizations.

4. It is easier to ascertain which securities are held in the portfolio, and information on the portfolio is reported on a more timely basis.

5. There is an opportunity to negotiate for a reduction in fees as total assets grow.

6. Brokerage can be directed for soft dollar or commission recapture programs. [See also *Practice No. 5.3*.]

7. Managers can be given specific securities guidelines, such as socially responsible investment instructions. [See also *Practice No. 3.7*]

8. Management fees may be tax deductible.

Practice No 4.3 (continued)

One of the challenges the fiduciary may face if the portfolio is less than $30 million is determining whether the separate account manager being considered is really part of the *institutional*, varsity team. The fiduciary needs to be particularly sensitive to this issue when selecting a money manager from a managed-account or wrap-fee program. The fiduciary's analysis should include:

SEPARATE ACCOUNTS VS. MANAGED ACCOUNTS (WRAP FEES)
DUE DILIGENCE PROCESS

	Separate Accounts	Managed Accounts
Performance	Results of institutional clients	Compare institutional to managed results
People	Identify persons who created institutional results	Identify persons who created managed results
Process	Process followed to create institutional results	Process followed to create managed results
Procedures	Procedures to ensure "best execution"	Management of queue list
Taxable Procedures	Individual tax lot management	Quasi-omnibus account management

Illustration 4.5

1. If shown a money manager's performance, ask whether the performance reflects clients in the manager's managed account program, or the performance of the institutional clients. Get both records and compare the two. One would ordinarily expect institutional clients to receive better performance because management fees will be less. But, if the performance differential is more than 50 basis points, the fiduciary should dig deeper to determine if there is a material difference between the investment process the institutional clients are receiving versus the managed account clients.

2. Ask for the name of the person, or persons, responsible for the creation of the institutional track record and the managed account record. Ascertain if it is the same team for both.

3. Inquire into the average number of securities held in the portfolios of the institutional clients and compare that to the number of securities in the managed account. The typical institutional equity portfolio will have about 86 securities - the typical managed account, about 36.

Practice No 4.3 (continued)

4. Determine how the account will be traded: will the securities be block-traded with the rest of the institutional clients (which typically translates to the better execution of trades and at lower commissions - both of which have a positive impact on performance), or will the trades have to flow back to the broker dealer sponsoring the managed account?

5. In the case of managers offering tax-sensitive investment management, determine whether the manager has the capacity for tax-lot portfolio management. If the manager is not tracking the adjusted basis of the individual securities within the portfolio, then it is arguably very difficult for the manager to claim that a fully tax-sensitive strategy is being employed.

The implementation of an investment strategy with mutual funds is fairly straightforward. As the fiduciary migrates to the use of separate account managers, the learning curve gets steeper and there are a number of additional factors that should be considered:

1. What will be the electronic protocol that will link the money manager, custodian, and fiduciary. With today's technology, there's no reason why this electronic protocol should not be Internet-based, enabling all parties to review portfolio account data on a daily basis. A common protocol also facilitates the production of performance reports. [See also *Practice No. 5.1*]

2. How long will it take for the equity money manager to become fully invested? Not all managers become fully invested as soon as money becomes available. The fiduciary may want to avoid a situation in which there is an anticipation that the manager is going to put new money to work right away, and then discover at the end of the quarter that half the portfolio is still sitting in cash. Conversely, during a bear market the fiduciary may prefer the manager that is holding cash, patiently waiting for buying opportunities.

3. How does the money manager seek *best price and execution* in trading the account? The manager has a fiduciary responsibility to shop the trades - to seek the best strike price and the best commission for each trade. Money managers may use a particular brokerage firm to generate soft dollars [See **Glossary of Terms**] to pay for research the brokerage firm has generated, which ordinarily, is an acceptable practice. However, when if the fiduciary sees all of the trades, or the bulk of the trades going through one brokerage firm, then the fiduciary may have a situation where the manager is not seeking *best execution*.

4. The fiduciary has a responsibility to ensure proxy votes are properly executed. The most expeditious way of handling this requirement is to delegate the responsibility to the money manager. The money manager also is the most logical choice - after all, it is the manager who has conducted the research on the company, and he or she in the best position to determine the impact that a proxy vote may have on a company.

Practice No 4.3 (continued)

5. For taxable investors - Will the manager handle low-basis or restricted stock? Having a professional money manager unwind the stock over appropriate periods of time can be a great advantage to the taxable client. Will the manager accept tax-lot information on the low-basis or restricted stock? And, will the manager do tax-lot accounting and reporting?

6. Will the manager review the portfolio of a previous manager? If the fiduciary is terminating a manager and hiring a new one, the fiduciary should not liquidate the holdings of the *old* manager until the *new* manager has reviewed the portfolio. The last thing the fiduciary needs is to generate expenses by selling a security in the *old* portfolio, only to have the new manager buy the same security. This is particularly true for taxable clients. If the fiduciary is considering two money managers, the fiduciary should show the *old* portfolio to both and ask them which of the securities they would continue to hold. All other things being equal, the money manager that can work with the most securities from the *old* portfolio would be preferable because it would generate fewer taxable gains and reduce the overall expenses of the transition.

7. Will the manager take SRI direction? [See also *Practice No. 3.7*] Most money managers can handle the usual SRI objectives, such as no sin stocks - tobacco, alcohol, and firearms - but some managers will struggle with such exclusions.

8. Will the manager produce a performance report? **[IBP]** The fiduciary should request performance reports from the money managers and the custodian, even if the plan is for someone else to produce the report, such as an investment consultant. Performance reporting always is a challenge, and having different parties calculating the performance for the same portfolio can help triangulate and locate the position of reporting errors.

When a manager or mutual fund is offering tax-sensitive investment management, it’s important for the fiduciary to determine the strategy, or strategies, the money manager is going to employ. Generally, there are four broad strategies, and as is often the case in the investment world, no one strategy works best in every type of market environment. The ideal situation is when the manager is capable of implementing any one or combination of strategies when appropriate: (1) Buying low-dividend stocks; (2) Harvesting losses at year end; (3) Implementing a low-turnover strategy; and, (4) When thinning a position, reducing the number of shares of a particular company, selling the shares with the highest basis first, referred to as HIFO (Highest In, First Out).

❑ *Practice No. 4.4* ***A due diligence process is followed in selecting service providers, including the custodian***[23]

Custodial selection is one of the most overlooked fiduciary functions. Most fiduciaries simply abdicate the decision to a vendor, advisor, or money manager. Yet, as with other prudent practices, there are a number of important decisions that need to be managed.

The role of the custodian is to: (1) hold securities for safekeeping; (2) report on holdings and transactions; (3) collect interest and dividends; and, (4) if required, effect trades.

At the retail level, the custodian typically is a brokerage firm. Most securities are held in street name, with the assets commingled with those of the brokerage firm. To protect the assets, brokerage firms are required to obtain insurance from the Securities Investor Protection Corp (SIPC).

[IBP] Most institutional investors choose to use trust companies as custodians. The primary benefit is that the assets are held in a separate account, and are not commingled with other assets of the institution.

The fiduciary's inquiry should include:

1. An examination into the financial stability of the custodian.

2. An examination of the expense ratio of the cash sweep vehicle that will be used. Custodians often offer an array of cash sweep vehicles, and the expense ratios can vary from 8 to 80 basis points.

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[23] ***Substantiating Code, Regulations, and Case Law for Practice No. 4.4:***

Employee Retirement Income Security Act of 1974 [ERISA]
§402(a)(1); §402(b)(2); §404(a)(1)(B)

Other
Interpretive Bulletin 96-1, 29 C.F.R. §2509.96-1; DOL Information Letter, Qualified Plan Services (7/28/98); DOL Information Letter, Service Employee's International Union (2/19/98)

Uniform Prudent Investor Act [UPIA]
§2(a); §7; §7 Comments; §9(a) (1), (2) and (3)

Management of Public Employee Retirement Systems Act [MPERS]
§6(a) and (b)(1) and (2); §7

Practice No 4.3 (continued)

3. The level of detail the custodian is able to provide in the monthly statement. The fiduciary needs to have the capacity to see transaction data, specifically, the name of the broker dealer used for each transaction, the strike price of the security being purchased/ sold, and the commission paid.

4. If the account is holding mutual funds, whether the custodian is willing to provide corrected year-end statements? Many mutual funds pay out their dividend at year-end, which causes havoc in the pricing of the mutual fund shares at year-end.

5. Will the custodian provide tax reporting? This can greatly reduce the cost and pain of tax preparation.

6. Will the custodian provide performance reporting? This is a service the fiduciary may have to request; it's often not offered as part of a standard package. However, if the fiduciary negotiates for performance reporting upfront, the additional charge typically is nominal.

INTRODUCTION TO PRACTICES 5.1 - 5.5

Once the optimal portfolio has been designed and the investment policy statement prepared and implemented, the final critical step is the ongoing monitoring and supervision of the investment process. The monitoring function extends beyond a strict examination of performance; by definition, monitoring occurs across all policy and procedural issues previously addressed in this handbook.

A long-term investment strategy requires alteration only when the underlying factors of the investment objectives change: **TREAT** - tax status, risk tolerance, expected return, asset class preferences, and time horizon. [See also *Practice No. 2.4*] These changes tend to be infrequent, if not rare, and reviews directed toward constantly reassessing existing policy tend to be counterproductive.

An effective monitoring program should provide the fiduciary with sufficient information to evaluate the investment program's strength and weaknesses, and to keep the program on track in achieving investment objectives. The establishment of appropriate performance measurement objectives:

1. Facilitates effective communications between the fiduciary and service providers and money managers, and helps to confirm mutually agreed-upon goals and objectives of the investment policy [See also *Practice No. 3.5*]

2. Facilitates the evaluation of the asset allocation strategy as directed by the investment policy statement with respect to the portfolio's risk tolerance and modeled return expectations [See also *Practice No. 3.3*]

Introduction to Practices 5.1 - 5.5 (continued)

3. Supports the qualitative judgment about the continued confidence, or lack of it, in the money manager's abilities [See also *Practice No. 5.2*]

4. Facilitates effective communications between all parties involved in determining the continued appropriateness of the overall investment policy.

Monitoring includes an analysis of not only *what happened*, but also *why?* The analysis combines the elements of performance measurement - the *science* - with performance evaluation - the *art*. Performance measurement primarily is a technical accounting function that computes the return of the portfolio and component parts. Performance evaluation uses the information generated by performance measurement to determine what contributed to, or detracted from, the portfolio's return.

❑ *Practice No. 5.1* Periodic performance reports compare the performance of money managers against appropriate index, peer group, and IPS objectives[24]

The ongoing review, analysis, and monitoring of the money managers and/or mutual funds is just as important as the due diligence implemented during the manager selection process. There is considerable legal substantiation for the fiduciary requirement to monitor all phases of the investment management program, particularly the monitoring of the money managers and/or mutual funds. What has not been specified is the frequency of the monitoring meetings or the requirement that the monitoring reports be reduced to writing.

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[24] ***Substantiating Code, Regulations, and Case Law for Practice 5.1:***

Employee Retirement Income Security Act of 1974 [ERISA]
§3(38); §402(c)(3)

Case Law
Leigh v. Engle, 727 F.2d 113 , 4 E.B.C. 2702(7th Cir. 1984); *Atwood v. Burlington Indus. Equity, Inc.*, 18 E.B.C. 2009 (M.D.N.C. 1994)

Other
Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8 (FR-17Q); Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2

Uniform Prudent Investor Act [UPIA]
§2(a); §9(a) (1 - 3)

Management of Public Employee Retirement Systems Act [MPERS]
§6(a) and (b)(1 - 3); §6 Comments; §6(d); §8(b)

Practice No 5.1 (continued)

In keeping with the duty of prudence, a fiduciary appointing a money manager (or selecting a mutual fund) must determine the frequency of the reviews necessary, taking into account such factors as: (1) the general economic conditions then prevailing; (2) the size of the portfolio; (3) the investment strategies employed; (4) the investment objectives sought; and, (5) the volatility of the investments selected. Some degree of informal monitoring should take place between the scheduled monitoring meetings so that immediate action can be taken when there are extreme or sudden deviations from the performance objectives established in the investment policy statement. [See also *Practice No. 3.5*]

[IBP] The fiduciary should establish performance objectives for each money manager and/or mutual fund, and record the same in the investment policy statement. Money manager performance should be evaluated in terms of an appropriate market index (as an example, the S&P 500 index for large-cap domestic equity manager) and the relevant peer group (as an example, the large-cap growth mutual fund universe for a large-cap growth mutual fund).

On a periodic basis [**IBP** - at least quarterly] the fiduciary should review whether each money manager and/or mutual fund continues to conform to the performance objectives, specifically:

1. The manager's adherence to the guidelines established by the investment policy statement

2. Material changes in the manager's organization, investment philosophy, and/or personnel

3. Any legal, SEC, and/or other regulatory agency proceedings that may affect the manager.

The investment policy statement also should describe the actions to be taken when a money manager fails to meet the established criteria. [See also *Practice No. 3.5*] The fiduciary should acknowledge that fluctuating rates of return characterize the securities markets, particularly during short-term time periods. Recognizing that short-term fluctuations may cause variations in performance, the fiduciary should evaluate manager performance from a long-term perspective. **[IBP]** Ordinarily, in this context, a *long-term* perspective would be defined as two to three years.

[IBP] There often will be times when a money manager is beginning to exhibit shortfalls in the defined performance objectives but, in the opinion of the fiduciary, does not warrant termination. It is strongly suggested that, in such situations, the fiduciary establish in the investment policy statement specific *Watchlist* procedures.

[IBP] As an example, a money manager may be placed on the *Watchlist* when:

1. A money manager performs below median for their peer group over a 1-, 3-, and/or 5-year cumulative period.

2. A money manager's 3-year risk adjusted return (Alpha and/or Sharpe) falls below the peer group's median risk adjusted return.

Practice No 5.1 (continued)

3. There is a change in the professionals managing the portfolio.

4. There is a significant decrease in the product's assets.

5. There is an indication the money manager is deviating from his/her stated style and/or strategy.

6. There is an increase in the product's fees and expenses.

7. Any extraordinary event occurs that may interfere with the manager's ability to fulfill his or her role in the future.

[IBP] When a money manager is placed on the *Watchlist*, an evaluation may include the following steps:

1. A letter to the money manager asking for an analysis of their underperformance

2. An analysis of recent transactions, holdings, and portfolio characteristics to determine the cause for underperformance or to check for a change in style

3. A meeting with the money manager, which may be conducted on-site, to gain insight into organizational changes and any changes in strategy or discipline.

The decision to retain or terminate a manager cannot be made by a formula. It is the fiduciary's confidence in the money manager's ability to perform in the future that ultimately determines the retention of a money manager.

[IBP] While there is no explicit requirement that the performance reviews be documented in writing, best practices and general fiduciary requirements suggest otherwise. The reports should include, at a minimum, the performance of each money manager and/or mutual fund against indices, peer groups, and the performance objectives established in the investment policy statement. [See also *Practice No. 3.5*]

A common mistake is the failure to compare a money manager to an appropriate peer group, or comparing the manager to benchmarks that may not be relevant. For example, not all equity managers should have their performance compared to the S&P 500. Equity managers that follow a value strategy should be compared against other value managers.

❑ ***Practice No. 5.2*** **Quarterly reviews are made of qualitative and/or organizational changes to money managers**[25]

The fiduciary has a continuing duty to exercise reasonable care, skill, and caution in monitoring the performance of investment decision makers, particularly when investment duties have been delegated to a money manager. The fiduciary's review of a money manager and/or mutual fund must be based on more than recent investment performance results, for all professional money managers will experience periods of poor performance. Fiduciaries also should not be lulled into rethinking their manager lineup simply because of the reported success of other managers.

[IBP] In addition to the quantitative review of the money manager, [See also *Practice No. 5.1*] periodic reviews of the qualitative performance and/or organizational changes to the investment manager should be made at reasonable intervals:

1. **Staff turnover** - Has there been turnover in the professional or service staff of the investment manager such as that the quality of the service and investment results provided by the investment manager in the past may not be maintained in the future?

2. **Organizational structure** - Are there, or have there been, any changes to the organization structure of the money manager, including mergers and/or acquisitions involving the money manager, such as that the quality of the service and investment results provided by the money manager in the past may not be maintained in the future?

3. **Level of service provided** - Does the money manager provide the same or better level of service that is available in the marketplace for comparable fees? Where applicable, does the money manager provide online access to account information?

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[25] ***Substantiating Code, Regulations, and Case Law for Practice 5.2:***

Employee Retirement Income Security Act of 1974 [ERISA]
§3(38); §402(c)(3); §404(a)(1)(B)

Regulations
29 C.F.R. §2550.408b-2(d); 29 C.F.R. §2550.408c-2

Other
Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8; Booklet: A Look at 401(k) Plan Fees, U.S. Department of Labor, Pension and Welfare Benefits Administration

Uniform Prudent Investor Act [UPIA]
§2(a); §7; §9(a)

Management of Public Employee Retirement Systems Act [MPERS]
§6(a) and (b)(1 - 3); §7(5)

Practice No 5.2 (continued)

4. **The quality and timeliness of the money manager's reports to the fiduciary** - Do the reports contain all of the information that is necessary and useful to the appointing fiduciary? Are the reports consistently provided on a timely basis?

5. **The quality and timeliness of the money manager's response to requests for information** - Does the investment manager consistently respond to requests for information by the fiduciary in a timely manner? Do the responses contain the information requested? Are the responses easily understood?

6. **Investment education** - Where applicable, does the money manager provide adequate explanation of the investment decisions it makes and the factors it considers in making such decisions so that the fiduciary can understand and appropriately monitor such actions?

❑ ***Practice No. 5.3*** **Control procedures are in place to periodically review money managers' policies for best execution, soft dollars, and proxy voting**[26]

The fiduciary has a responsibility to control and account for investment expenses - that the expenses are prudent and are applied in the best interests of the investor, participant (in the case of a retirement plan), or beneficiary (in the case of a private trust, foundation, or endowment). The fiduciary, therefore, must monitor that:

1. *Best execution* practices are followed in securities transactions.

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[26] ***Substantiating Code, Regulations, and Case Law for Practice No. 5.3:***

Employee Retirement Income Security Act of 1974 [ERISA]
§3(38); §402(c)(3); §403(a)(1) and (2); §404(a)(1)(A) and (B)

Case Law
Herman v. NationsBank Trust Co., (Georgia), 126 F.3d 1354, 21 E.B.C. 2061 (11th Cir. 1997), *reh'g denied*, 135 F.3d 1409 (11th Cir.), *cert. denied*, 525 U.S. 816, 19S.Ct. 54, 142 L.Ed.2d 42 (1998)

Other
Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8 (FR-17Q); Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2(1); DOL Prohibited Transaction Exemption 75-1, Interim Exemption, 40 Fed. Reg. 5201 (Feb. 4, 1975); DOL Information Letter, Prescott Asset Management (1/17/92) (fn. 1); DOL Information Letter, Refco, Inc. (2/13/89); ERISA Technical Release 86-1 (May 22, 1986)

Uniform Prudent Investor Act [UPIA]
§2(a); §2(d); §7; §9(a)

Management of Public Employee Retirement Systems Act [MPERS]
§6(2) and (3); §7(5); §8(a)(3)

Practice No 5.3 (continued)

2. *Soft dollars* are expended only for brokerage, research, or other services for the benefit of the investment program, and are reasonable in relationship to the value of such services.

3. *Proxies are voted* in a manner most likely to preserve or enhance the value of the subject stock.

The terms, *best execution*, *soft dollars*, and *proxy voting* have specific technical meanings, and warrant further discussion.

Best Execution. The fiduciary has an ongoing responsibility to periodically monitor the trades of the money manager to determine whether the manager is seeking *best execution* in trading the portfolio's securities. In seeking *best execution*, money managers are required to *shop* their trades with various brokerage firms, taking into consideration: (1) commission costs; (2) an analysis of the actual strike price of the security; and, (3) the quality and reliability of the trade.

The DOL has described *best execution* as:

> *Those who invest plan assets … have traditionally been guided by the* ***best execution*** *principle, namely, securing the best price for the plan in executing the purchase or sale of securities without regard to whether the broker-dealer or bank functions in an agency (broker) relationship, or in a principal (dealer) relationship to the plan.* [DOL Prohibited Transaction Exemption 75-1, Interim Exemption, 40 Fed. Reg. 5201 (Feb. 4, 1975)]

Soft Dollars represent the excess in commission costs; the difference between what a brokerage firm charges for a trade versus the brokerage firm's actual costs.

As an example:

Commission	6 cents/share
Brokerage firm's actual cost for trade	2 cents/share
Soft Dollar	4 cents/share

The fiduciary has a responsibility to ensure that s*oft dollars* are applied to the purchase of goods and services that directly support the investment program, such as: consulting services, investment research, custodial services, rating or technical services, and/or subscriptions to investment periodicals. The failure of the fiduciary to monitor *soft dollars* may subject the investment program to expenditures which yield no benefit, itself a fiduciary breach.

Practice No 5.3 (continued)

The DOL has described *soft dollars* as follows*:*

> *Section 28(e) of the [Securities Exchange Act of 1934] provides generally that no person who exercises investment discretion with respect to a securities transactions will be deemed to have acted unlawfully or to have breached a fiduciary duty solely by reason of paying brokerage commissions for effecting a securities transaction in excess of the amount of commission another broker-dealer would have charged, if such person determined in good faith that the commission was reasonable in relation to the value of brokerage and research services provided by the broker-dealer.* [PWBA ERISA Technical Release 86-1 (May 22, 1986)]

Proxy voting. The fiduciary also has a responsibility to account for the *voting of proxies*. The fiduciary can either retain the power to vote the proxies, or instruct the money manager to vote on behalf of the fiduciary. **[IBP]** Typically, only the largest of fiduciary portfolios elect to take responsibility for voting their proxies. The majority of fiduciaries delegate that responsibility to the money manager via instructions in the investment policy statement. [See also *Practice No. 3.2.*]

The DOL has described *proxy voting* as follows*:*

> *The fiduciary duties described at ERISA §404(a)(1)(A) and (B), require that, in voting proxies, the responsible fiduciary consider those factors that may affect the value of the plan's investment, and not subordinate the interests of the participants and beneficiaries in their retirement income to unrelated objectives. These duties also require that the named fiduciary appointing an investment manager periodically monitor the activities of the investment manager with respect to the management of plan assets, including decisions made and actions taken by the investment manager with regard to proxy voting decisions. The named fiduciary must carry out this responsibility solely in the interest of the participants and beneficiaries, and without regard to its relationship with the plan sponsor.*
>
> *It is the view of the Department that compliance with the duty to monitor necessitates proper documentation of the activities that are subject to monitoring. Thus, the investment manager or other responsible fiduciary would be required to maintain accurate records as to proxy voting … the proxy voting records must enable the fiduciary to review not only the investment manager's voting procedure … but also to review the actions taken in individual proxy voting situations.* [29 CFR 2509.94-2(1)]

❑ *Practice No. 5.4* Fees for investment management are consistent with contracts and service agreements[27]

The fiduciary responsibility in connection with the payment of fees is to determine: (1) whether the fees can be paid from portfolio assets [See also *Practice No 1.1*]; and (2) whether the fees are reasonable in light of the services to be provided to the plan. [See also *Practice No 1.4*] Accordingly, the fiduciary must negotiate all forms of compensation to be paid for investment management to ensure that the aggregate (and individual components) is reasonable compensation for the services rendered.

Money manager fees vary widely, depending on the asset class to be managed, the size of the account, and whether the funds are to be managed separately or placed into a commingled or mutual fund. Fees usually are charged in terms of basis points (100 basis points = 1.0%) and are applied to the market value of the portfolio at the end/beginning of a calendar quarter. Fees often decline significantly with increasing asset size.

[IBP] Illustration 5.1 depicts the quartile rankings for the expense ratios of mutual funds for each peer group. As discussed in *Practice No. 4.1*, the **Foundation** has proposed that the 75th percentile be a reasonable expense cutoff. That is, if the expense ratio of a mutual fund is greater than the expense ratio at the 75th percentile, the fiduciary should be concerned about a potential breach.

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[27] ***Substantiating Code, Regulations, and Case Law for Practice 5.4:***

Employee Retirement Income Security Act of 1974 [ERISA]
§3(14)(B); §404(a)(1)(A), (B) and (D); §406(a)

Regulations
29 C.F.R. §2550.408(b)(2)

Other
Booklet: A Look at 401(k) Plan Fees, U.S. Department of Labor, Pension and Welfare Benefits Administration; DOL Advisory Opinion Letter (7/28/98) 1998 WL 1638072; DOL Advisory Opinion Letter 89-28A (9/25/89) 1989 WL 435076; Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8 (FR-17Q)

Uniform Prudent Investor Act [UPIA]
§2(a); §7 and Comments; §9 Comments

Management of Public Employee Retirement Systems Act [MPERS]
§7(2) and (5); §7 Comments

Practice No 5.4 (continued)

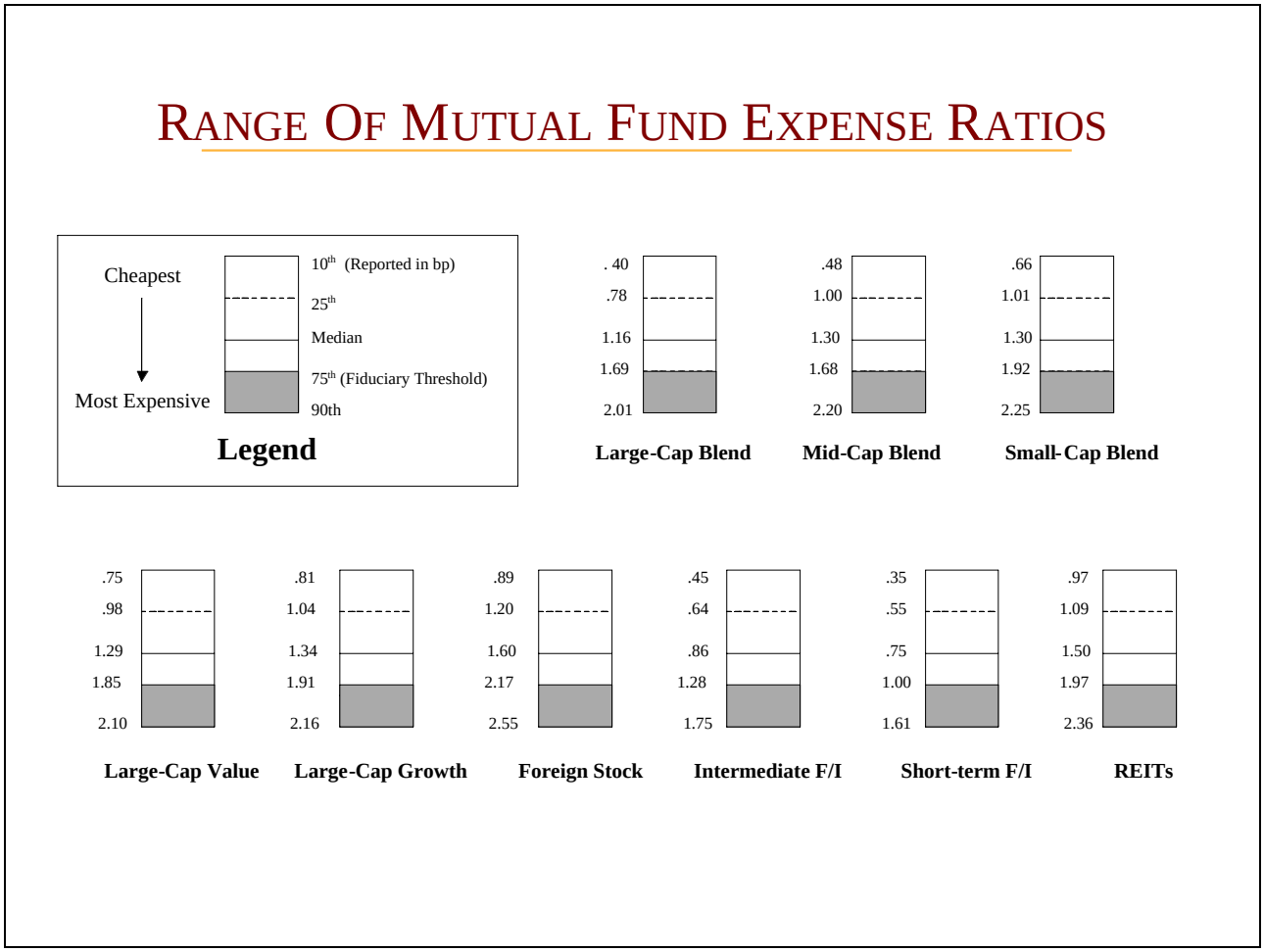

Illustration 5.1

A minority of money managers offer performance-based fees. Under these arrangements, the manager receives a higher fee if they are able to exceed a predesignated benchmark over a specified period of time. Performance-based fees are not permitted in all states and, where permitted, may only be used by entities with assets in excess of $1 million.

❑ *Practice No. 5.5* "Finders fees," 12b-1 fees, or other forms of compensation for asset placement are appropriately applied, utilized, and documented[28]

The fiduciary has a duty to control and account for investment expenses. [See also *Practices 3.6, 4.3, 5.3, and 5.4*] This requires the fiduciary to account for all dollars spent for services, whether those dollars are paid directly from the account or through *soft dollars*, 12b-1 fees [See **Glossary of Terms**], or other fee-sharing arrangements.

In addition, the fiduciary has the responsibility to identify those parties that have been compensated for placing portfolio assets with a particular vendor to ensure that no party is unduly compensated. It is not uncommon for a broker to receive a commission stream in perpetuity on assets placed with a particular vendor. Though the broker should, ordinarily, be entitled to some form of compensation for the *introduction*, the fiduciary has a responsibility to apply a *reasonableness* test to the amount of compensation received by the broker.

In the case of a *bundled*, *wrap*, or *all-inclusive fee* investment product, there are basically four cost components. The fiduciary should investigate how the various service vendors associated with each component are compensated to ensure that no one vendor is receiving unreasonable compensation, and to compare the costs of the same services on an *ala carte* basis. The four components are:

1. The money manager who is selecting the stocks and bonds for the portfolio

2. The brokerage firm that is executing the trades

3. The custodian that is holding and safeguarding the securities

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[28] ***Substantiating Code, Regulations, and Case Law for Practice 5.5:***

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)(1)(A) and (B);§406(a)(1); §406(b)(1); §406(b)(3)

Case Law
Brock v. Robbins, 830 F.2d 640, 8 E.B.C. 2489 (7th Cir. 1987)

Other
DOL Advisory Opinion Letter 97-15A; DOL Advisory Opinion Letter 97-16A (5/22/97)

Uniform Prudent Investor Act [UPIA]
§2(a); §7; §7 Comments

Case Law
Matter of Derek W. Bryant, 188 Misc. 2d 462, 729 NYS 2d 309 (6/21/01)

Other
McKinneys EPTL11-2.3(d)

Management of Public Employee Retirement Systems Act [MPERS]
§6(b)(2) and (3); §7(2) and (5)

Practice No 5.5 (continued)

4. The investment advisor, or broker, who is servicing the account

In the case of defined contribution plans, it is customary to offer investment options that carry 12-b-1 fees. The 12-b-1 fees are often used to offset the plan's record-keeping and administrative costs. For a new plan with few assets, such an arrangement is, ordinarily, beneficial for the participants. **[IBP]** However, as the assets grow, the fiduciary should periodically determine whether it is more advantageous to pay for the record-keeping and administrative costs on an *ala carte* basis, switching to mutual funds that have a lower expense ratio, and reducing the overall expenses of the investment program.

CONCLUSION

The *Practices* identified in this handbook prescribe a timeless and flexible process for the successful management of investment decisions. Once familiar with the *Practices*, the fiduciary will understand that no new investment product or technique will be good or bad *per se*, nor will it be valuable because it worked for other fiduciaries. Furthermore, the *Practices* will help the fiduciary understand which new investment strategies, products, and techniques fit into their priorities, and which do not.

The intelligent and prudent management of investment decisions requires the fiduciary to maintain a rational, disciplined investment program. The mind-boggling array of investment choices coupled with *market noise* from Wall Street understandably can result in financial paralysis from information overload. Fiduciaries clearly need a framework for making investment decisions that allows them to consider developing investment trends, and to thoughtfully navigate the possibilities.

Enclosure 1

INVESTMENT POLICY STATEMENT

FOR

ABC COMPANY

(DEFINED BENEFIT PLAN)

Approved on September 13, 2002

By ABC Investment Board

This investment policy statement should be reviewed and updated at least annually. Any change to this policy should be communicated in writing on a timely basis to all interested parties.

This investment policy statement has been prepared by the Foundation for Fiduciary Studies. It is intended to serve as an example of the type of information that would be included in a comprehensive IPS. Clients are advised to have legal counsel review their investment policy statement before it is approved.

Enclosure 1: (continued)

EXECUTIVE SUMMARY

Type of Plan: Defined Benefit Plan

Plan Sponsor: ABC Company

Plan IRS Tax Identification: 56-1234567

Current Assets: $200,000,000

Time Horizon: Greater than 5 years

Modeled Return: 7.6% (4.6% over CPI)

Modeled Loss: -8.9% (Probability level of 5%)

Asset Allocation:	**Lower Limit**	**Strategic Allocation**	**Upper Limit**
Domestic Large-Cap Equities			
Value	5%	10%	15%
Blend	5%	10%	15%
Growth	5%	10%	15%
Mid-Cap	5%	10%	15%
Small-Cap	5%	10%	15%
International Equities	5%	10%	15%
Intermediate-Term Fixed Income	30%	35%	40%
Cash Equivalents	0%	5%	10%

Evaluation Benchmarks:

Trustee Counseling Index™ (Equity Exposure)*

	LCV	LCB	LCG	MCB	SCB	IE	MM	SB	IB
TCI(20)	5	5	5	0	0	5	10	30	40
TCI(40)	10	10	10	0	5	5	5	20	35
TCI(60)	10	10	10	10	10	10	5	0	35
TCI(80)	15	15	15	10	10	15	5	0	15

* The TCI™ series of indexes are designed to illustrate the performance of a diversified portfolio, calculated by using the performance of the median mutual fund manager for each peer group represented in the allocation.

Enclosure 1: (continued)

PURPOSE

The purpose of this Investment Policy Statement (IPS) is to assist the Defined Benefit Board of Trustees (Board) [See Appendix A] in effectively supervising, monitoring and evaluating the investment of the Company's Retirement Plan (Plan) assets. The Plan's investment program is defined in the various sections of the IPS by:

1. Stating in a written document the Board's attitudes, expectations, objectives, and guidelines for the investment of all Plan assets.

2. Setting forth an investment structure for managing all Plan assets. This structure includes various asset classes, investment management styles, asset allocation, and acceptable ranges that, in total, are expected to produce a sufficient level of overall diversification and total investment return over the long-term.

3. Providing guidelines for each investment portfolio that control the level of overall risk and liquidity assumed in that portfolio, so all Plan assets are managed in accordance with stated objectives.

4. Providing rate-of-return and risk characteristics for each asset class represented by various investment options. [See Appendix B]

5. Encouraging effective communications between the Board, the investment consultant (Consultant), and hired money managers.

6. Establishing formal criteria to monitor, evaluate, and compare the performance results achieved by the money managers on a regular basis.

7. Complying with all ERISA, fiduciary, prudence, and due diligence requirements experienced investment professionals would utilize, and with all applicable laws, rules and regulations from various local, state, federal, and international political entities that may impact Plan assets.

This IPS has been formulated, based upon consideration by the Board of the financial implications of a wide range of policies, and describes the prudent investment process the Board deems appropriate.

Enclosure 1: (continued)

BACKGROUND

The Plan is a defined benefit plan established in conjunction with the spin-off of Defined Benefit in July 1985. The Plan covers the hourly employees of Defined Benefit, including those who were previously covered under the Defined Benefit Corporation Retirement Plan for Hourly Rate Employees. The Board will discharge its responsibilities under the Plan solely in the long-term interests of Plan participants and their beneficiaries.

The Plan currently covers 364 employees. The number is anticipated to increase at the rate of 10% per year for the next 5 years. Plan size currently is $200,000,000 and annual contributions are currently not required due to the well-funded status of the Plan. Under current regulations, the Plan is not [is] required to make any quarterly contributions for the current year.

Key Information:

Name of Plan:	ABC Retirement Plan
Plan Sponsor:	ABC Company
Plan IRS Tax ID:	56-1234567
Other Related Retirement Plans:	ABC Defined Contribution Plan

Key information, which is subject to change from time-to-time, is contained in Appendix A.

STATEMENT of OBJECTIVES

This IPS has been arrived at upon consideration by the Board by a wide range of policies, and describes the prudent investment process the Board deems appropriate. This process includes offering various asset classes and investment management styles that, in total, are expected to offer participants a sufficient level of overall diversification and total investment return over the long-term. The objectives are:

1. Maintain the purchasing power of the current assets and all future contributions by producing positive real rates of return on Plan assets.

2. Maintain a fully funded status with regard to the Accumulated Benefit Obligation and 90% of the Projected Benefit Obligation.

3. Have the ability to pay all benefit and expense obligations when due.

Enclosure 1: (continued)

4. Maintain a funding cushion for unexpected developments and for possible future increases in benefit structure and expense levels.

5. Maintain flexibility in determining the future level of contributions.

6. Maximize return within reasonable and prudent levels of risk in order to minimize contributions.

7. Control costs of administering the plan and managing the investments.

Investment results are the critical element in achieving the investment objectives, while reliance on contributions is a secondary element.

Time Horizon

The investment guidelines are based upon an investment horizon of greater than five years. Interim fluctuations should be viewed with appropriate perspective. Similarly, the Plan's strategic asset allocation is based on this long-term perspective. Short-term liquidity requirements are anticipated to be nonexistent, or at least should be covered by the annual contribution.

- or -

[There is a requirement to maintain sufficient liquid reserves to provide for the payment of retirement benefits. Analysis of the cash flow projections of the Plan indicates benefit payments will exceed contributions for at least several years. The Board's Secretary will notify the Investment Managers well in advance of the withdraw orders to allow sufficient time to build up necessary liquid reserves.]

Risk Tolerances

The Board recognizes the difficulty of achieving the Plan's investment objectives in light of the uncertainties and complexities of contemporary investment markets. The Board also recognizes some risk must be assumed to achieve the Plan's long-term investment objectives. In establishing the risk tolerances of the IPS, the ability to withstand short- and intermediate-term variability were considered. These factors were:

- ABC Company is in an industry that should experience milder fluctuations than the general economy. ABC believes it should be able to achieve above average growth during the next several years.

- ABC's strong financial condition enables it to adopt a long-term investment perspective.

Enclosure 1: (continued)

- Demographic characteristics of participants suggest an above-average risk tolerance due to the younger-than-average work force.

- Actuarial data related to future projected benefit payments, along with future projected expenses of the Plan, are significantly less than conservative forecasted investment income projections. Therefore, liquidity requirements are immaterial over the next ten years, which implies that a higher risk profile is acceptable.

- Current Plan assets have been accumulated to exceed the value of the Plan's total accrued benefit liability, allowing for a less aggressive risk tolerance.

In summary, ABC Company's prospects for the future, current financial condition, and several other factors suggest collectively the Plan can tolerate some interim fluctuations in market value and rates of return in order to achieve long-term objectives.

Performance Expectations

The desired investment objective is a long-term rate of return on assets that is at least 7.6%, which is 4.6% greater than the anticipated rate of inflation as measured by the Consumer Price Index (CPI). The target rate of return for the Plan has been based upon the assumption that future real returns will approximate the long-term rates of return experienced for each asset class in the IPS.

The Board realizes market performance varies and a 7.6% rate of return may not be meaningful during some periods. Accordingly, relative performance benchmarks for the managers are set forth in the **Control Procedures** section. Over a complete business cycle, the Plan's overall annualized total return, after deducting for advisory, money management, and custodial fees, as well as total transaction costs; should perform above a customized index comprised of market indices weighted by the strategic asset allocation of the Plan.

Enclosure 1: (continued)

ASSET CLASS GUIDELINES

The Board believes long-term investment performance, in large part, is primarily a function of asset class mix. The Board has reviewed the long-term performance characteristics of the broad asset classes, focusing on balancing the risks and rewards.

History shows that while interest-generating investments, such as bond portfolios, have the advantage of relative stability of principal value; they provide little opportunity for real long-term capital growth due to their susceptibility to inflation. On the other hand, equity investments, such as common stocks, clearly have a significantly higher expected return but have the disadvantage of much greater year-by-year variability of return. From an investment decision-making point of view, this year-by-year variability may be worth accepting, provided the time horizon for the equity portion of the portfolio is sufficiently long (five years or greater).

The performance expectations (both risk and return) of each asset class are contained in Appendix B. The following eight asset classes were selected and ranked in ascending order of risk (least to most):

Money Market (MM)
Intermediate Bond (IB)
Large-Cap Value (LCV)
Large-Cap Blend (LCB)
Large-Cap Growth (LCG)
Mid-Cap Blend (MCB)
Small-Cap Blend (SCB)
International Equity (IE)

The Board has considered the following asset classes for inclusion in the asset mix, but has decided to exclude these asset classes at the present time:

Global Fixed Income
Real Estate

Rebalancing of Strategic Allocation

The percentage allocation to each asset class may vary as much as plus or minus 5%, depending upon market conditions. When necessary and/or available, cash inflows/outflows will be deployed in a manner consistent with the strategic asset allocation of the Plan. If there are no cash flows, the allocation of the Plan will be reviewed quarterly.

Enclosure 1: (continued)

If the Board judges cash flows to be insufficient to bring the Plan within the strategic allocation ranges, the Board shall decide whether to effect transactions to bring the strategic allocation within the threshold ranges. (Strategic Allocation)

DUTIES and RESPONSIBILITIES

Board Investment Committee

As fiduciaries under the Plan, the primary responsibilities of the Board are:

1. Prepare and maintain this investment policy statement
2. Prudently diversify the Plan's assets to meet an agreed upon risk/return profile
3. Prudently select investment options
4. Control and account for all investment, record keeping, and administrative expenses associated with the Plan
5. Monitor and supervise all service vendors and investment options
6. Avoid prohibited transactions and conflicts of interest.

Investment Consultant

The Board will retain an objective, third-party Consultant to assist the Board in managing the overall investment process. The Consultant will be responsible for guiding the Board through a disciplined and rigorous investment process to enable the Board to meet the fiduciary responsibilities outlined above.

Investment Managers

As distinguished from the Board and Consultant, who are responsible for *managing* the investment process, investment managers are responsible for *making* investment decisions (security selection and price decisions). The specific duties and responsibilities of each investment manager are:

1. Manage the assets under their supervision in accordance with the guidelines and objectives outlined in their respective Service Agreements, Prospectus, or Trust Agreement.

Enclosure 1: (continued)

2. Exercise full investment discretion with regards to buying, managing, and selling assets held in the portfolios.

3. If managing a separate account (as opposed to a mutual fund or a commingled account), seek approval from the Board prior to purchasing and/or implementing the following securities and transactions:

    - Letter stock and other unregistered securities; commodities or other commodity contracts; and short sales or margin transactions

    - Securities lending; pledging or hypothecating securities

    - Investments in the equity securities of any company with a record of less than three years continuous operation, including the operation of any predecessor

    - Investments for the purpose of exercising control of management

4. Vote promptly all proxies and related actions in a manner consistent with the long-term interest and objectives of the Plan as described in this IPS. Each investment manager shall keep detailed records of the voting of proxies and related actions and will comply with all applicable regulatory obligations.

5. Communicate with the Board all significant changes pertaining to the fund it manages or the firm itself. Changes in ownership, organizational structure, financial condition, and professional staff are examples of changes to the firm in which the Board is interested.

6. Effect all transactions for the Plan subject to *best price and execution*. If a manager utilizes brokerage from the Plan assets to effect *soft dollar* transactions, detailed records will be kept and communicated to the Board.

7. Use the same care, skill, prudence, and due diligence under the circumstances then prevailing that experienced investment professionals, acting in a like capacity and fully familiar with such matters, would use in like activities for like retirement Plans with like aims in accordance and compliance with ERISA and all applicable laws, rules, and regulations.

8. If managing a separate account (as opposed to a mutual fund or a commingled account), acknowledge co-fiduciary responsibility by signing and returning a copy of this IPS.

Enclosure 1: (continued)

Custodian

Custodians are responsible for the safekeeping of the Plan's assets. The specific duties and responsibilities of the custodian are:

1. Maintain separate accounts by legal registration

2. Value the holdings

3. Collect all income and dividends owed to the Plan

4. Settle all transactions (buy-sell orders) initiated by the Investment Manager

5. Provide monthly reports that detail transactions, cash flows, securities held and their current value, and change in value of each security and the overall portfolio since the previous report.

INVESTMENT MANAGER SELECTION

The Board will apply the following due diligence criteria in selecting each money manager or mutual fund:

1. *Regulatory oversight:* Each investment manager should be a regulated bank, an insurance company, a mutual fund organization, or a registered investment adviser.

2. *Correlation to style or peer group:* The product should be highly correlated to the asset class of the investment option. This is one of the most critical parts of the analysis, since most of the remaining due diligence involves comparisons of the manager to the appropriate peer group.

3. *Performance relative to a peer group:* The product's performance should be evaluated against the peer group's median manager return, for 1-, 3-, and 5-year cumulative periods.

4. *Performance relative to assumed risk:* The product's risk-adjusted performance (Alpha and/or Sharpe Ratio) should be evaluated against the peer group's median manager's risk-adjusted performance.

5. *Minimum track record:* The product's inception date should be greater than three years.

Enclosure 1: (continued)

6. *Assets under management:* The product should have at least $75 million under management.

7. *Holdings consistent with style:* The screened product should have no more than 20% of the portfolio invested in "unrelated" asset class securities. For example, a Large Cap Growth product should not hold more than 20% in cash, fixed-income, and/or international securities.

8. *Expense ratios/fees:* The product's fees should not be in the bottom quartile (most expensive) of their peer group.

9. *Stability of the organization:* There should be no perceived organizational problems - the same portfolio management team should be in place for at least two years.

CONTROL PROCEDURES

Performance Objectives

The Board acknowledges fluctuating rates of return characterize the securities markets, particularly during short-term time periods. Recognizing that short-term fluctuations may cause variations in performance, the Board intends to evaluate manager performance from a long-term perspective.

The Board is aware the ongoing review and analysis of the investment managers is just as important as the due diligence implemented during the manager selection process. The performance of the investment managers will be monitored on an ongoing basis and it is at the Board's discretion to take corrective action by replacing a manager if they deem it appropriate at any time.

On a timely basis, but not less than quarterly, the Board will meet to review whether each manager continues to conform to the search criteria outlined in the previous section; specifically:

1. The manager's adherence to the Plan's investment guidelines

2. Material changes in the manager's organization, investment philosophy, and/or personnel

3. Any legal, SEC, and/or other regulatory agency proceedings affecting the manager.

Enclosure 1: (continued)

The Board has determined it is in the best interest of the Plan's participants that performance objectives be established for each investment manager. Manager performance will be evaluated in terms of an appropriate market index (e.g. the S&P 500 stock index for large cap domestic equity manager) and the relevant peer group (e.g. the large cap growth mutual fund universe for a large cap growth mutual fund).

Asset Class/ Peer Group	**Index**	**Peer Group Universe**
Large Cap Equity		
Large-Cap Value	*S&P 500*	*Large-Cap Value*
Large-Cap Blend	S&P 500	Large-Cap Blend
Large-Cap Growth	S&P 500	Large-Cap Growth
Mid-Cap Equities	S&P 400	Mid-Cap Blend
Small-Cap Equities	Russell 2000	Small-Cap Blend
International Equity	MSCI EAFE	Foreign Stock
Fixed Income		
Intermediate Bond	Salomon 3 - 7 Year Treas.	Intermediate-Term Bond
Money Market	90 day T-Bills	Money Market Database

A manager may be placed on a *Watchlist* and a thorough review and analysis of the investment manager may be conducted, when:

1. A manager performs below median for their peer group over a 1-, 3-, and/or 5-year cumulative period.

2. A manager's 3-year risk adjusted return (Alpha and/or Sharpe) falls below the peer group's median risk adjusted return.

3. There is a change in the professionals managing the portfolio.

4. There is a significant decrease in the product's assets.

5. There is an indication the manager is deviating from his/her stated style and/or strategy.

6. There is an increase in the product's fees and expenses.

Enclosure 1: (continued)

7. Any extraordinary event occurs that may interfere with the manager's ability to fulfill their role in the future.

A manager evaluation may include the following steps:

1. A letter to the manager asking for an analysis of their underperformance

2. An analysis of recent transactions, holdings, and portfolio characteristics to determine the cause for underperformance or to check for a change in style

3. A meeting with the manager, which may be conducted on-site, to gain insight into organizational changes and any changes in strategy or discipline.

The decision to retain or terminate a manager cannot be made by a formula. It is the Board's confidence in the manager's ability to perform in the future that ultimately determines the retention of a manager.

Measuring Costs

The Board will review, at least annually, all costs associated with the management of the Plan's investment program including:

1. Expense ratios of each investment option against the appropriate peer group

2. Custody fees: The holding of the assets, collection of the income and disbursement of payments

3. Whether the manager is demonstrating attention to *best execution* in trading securities.

The Board will review this IPS at least annually to determine whether stated investment objectives are still relevant, and the continued feasibility of achieving the same. It is not expected that the IPS will change frequently. In particular, short-term changes in the financial markets should not require adjustments to the IPS.

Prepared:	Approved:
_____	_____
Consultant	Board
September 13, 2002	September 13, 2002

Enclosure 1: (continued)

APPENDIX A

Board or Investment Committee Members

_____, Chairman

_____, Secretary

_____, Investment Committee Member or Trustee

_____, Investment Committee Member or Trustee

_____, Investment Committee Member or Trustee

_____, Investment Committee Member or Trustee

_____, Investment Committee Member or Trustee

_____, Investment Committee Member or Trustee

Enclosure 1: (continued)

APPENDIX B

Summary of Capital Markets Inputs

Asset Class	Modeled Return	Modeled Standard Deviation	Index Proxy
Large-Cap Equity	9.13	15.98	S&P 500
Mid-Cap Equity	9.55	19.00	S&P Mid-Cap 400
Small-Cap Equity	9.63	20.89	Russell 2000
International Equity	9.06	19.00	MSCI EAFE IL
REITS	7.32	15.29	Wilshire REIT
Global Fixed Income	6.08	12.00	Salomon Bros. Non-$ World Gov.
Broad Fixed Income	5.81	7.00	Lehman Bros. Aggregate
Intermediate Fixed Income	5.36	5.00	Lehman Bros. Interm. Govt.
Short-Term Fixed Income	4.62	3.31	Lehman Bros. 1-3 Year Govt.
Money Market	2.84	1.30	3 Month T-Bill

ENCLOSURE 2: GLOSSARY OF TERMS

This glossary was compiled from the following sources.

Eugene B. Burroughs, CFA, ***Investment Terminology (Revised Edition)***, International Foundation of Employee Benefit Plans, Inc., 1993.

John Downes, Jordan Elliot Goodman, ***Dictionary of Finance and Investment Terms (Third Edition)***, Barron's Educational Series, Inc.

John W. Guy, ***How to Invest Someone Else's Money***, Irwin Professional Publishing, Burr Ridge, Illinois.

Donald B. Trone, William R. Allbright, Philip R. Taylor, ***The Management of Investment Decisions***, Irwin Professional Publishing, Burr Ridge, Illinois.

Donald B. Trone and William R. Allbright, ***Procedural Prudence for Fiduciaries***, self-published, 1997.

AIMR Performance Presentation Standards These standards, effective January 1, 1993, are designed to promote full disclosure and fair representation in the reporting of investment results in order to provide uniformity in comparing manager results. These standards include ethical principles, and apply to all organizations serving investment management functions. Compliance is verified at two levels: Level 1 and Level 2. (Level 2 is a more comprehensive verification process). Specific information regarding these standards can be obtained by calling **AIMR** at (804) 980-3547.

Alpha This statistic measures a portfolio's return in excess of the market return adjusted for risk. It is a measure of the manager's contribution to performance with reference to security selection. A positive alpha indicates that a portfolio was positively rewarded for the residual risk, which was taken for that level of market exposure.

Asset Allocation The process of determining the optimal allocation of a fund's portfolio among broad asset classes.

Basis Point 100 Basis Points = 1%

Best Execution This is formally defined as the difference between the strike price (the price at which a security is actually bought or sold) and the "fair market price", which involves calculating opportunity costs by examining the security price immediately after the trade is placed. Best execution occurs when the trade involves no lost opportunity cost, for example, when there is no increase in the price of a security shortly after it is sold.

Beta A statistical measure of the volatility, or sensitivity, of rates of return on a portfolio or security in comparison to a market index. The beta value measures the expected change in return per one percent change in the return on the market. Thus, a portfolio with a beta of 1.1 would move 10% more than the market.

Cash Sweep Accounts A money market fund into which all new contributions, stock dividend income, and bond interest income is placed ("swept") for a certain period of time. At regular intervals, or when rebalancing is necessary, this cash is invested in assets in line with the asset allocation stipulated in the IPS.

Commingled Fund An investment fund that is similar to a mutual fund in that investors purchase and redeem units that represent ownership in a pool of securities. Commingled funds usually are offered through a bank-administered plan allowing for broader and more efficient investing.

Commission Recapture An agreement by which a plan Fiduciary earns credits based upon the amount of brokerage commissions paid. These credits can be used for services that will benefit the plan such as consulting services, custodian fees, or hardware and software expenses.

Correlation Coefficient Correlation measures the degree to which two variables are associated. Correlation is a commonly used tool for constructing a well-diversified portfolio. Traditionally, equities and fixed-income asset returns have not moved closely together. The asset returns are not strongly correlated. A balanced fund with equities and fixed-income assets represents a diversified portfolio that attempts to take advantage of the low Correlation between the two asset classes.

Defined Benefit Plan A type of employee benefit plan in which employees know (through a formula) what they will receive upon retirement or after a specified number of years of employment with an employer. The employer is obligated to contribute funds into the defined benefit plan based on an actuarially determined obligation that takes into consideration the age of the workforce, their length of service and the investment earnings that are projected to be achieved from the funds contributed. Defined Benefit Plans are over funded if the present value of the future payment obligations to employees is less than the current value of the assets in the Plan. It is under funded if the obligations exceed the current value of these Plan assets. The **Pension Benefit Guarantee Corporation** insures a specified amount of these future pension benefit payments on a per employee basis.

Defined Contribution Plan A type of employee benefit plan in which the employer (Fiduciary) makes annual contributions (usually discretionary in amount or possibly based on a percentage of the profits of the company e.g. **Profit Sharing Plan**) into the plan for the ultimate payment to employees at retirement. Each employee's account value will be determined by the contribution made, the earnings achieved and (usually a vesting percentage - e.g., 20% per year after one year of service).

Directed Brokerage Circumstances in which a board of trustees or other fiduciary requests that the investment manager direct trades to a particular broker so that the commissions generated can be used for specific services or resources. See **Soft Dollars**.

Dollar-weighted Rate of Return Method of performance measurement that calculates returns based on the cash flows of a security or portfolio. A dollar-weighted return applies a discounted cash flow approach to obtain the return for a period. The discount rate that equates the cash inflow at the end of the period plus any net cash flows within the period with the initial outflow is the dollar-weighted rate of return. This return also is referred to as the internal rate of return (IRR).

Economically-Targeted Investment (ETI) Investments where the goal is to target a certain economic activity, sector, or area in order to produce corollary benefits in addition to the main objective of earning a competitive risk-adjusted rate of return.

End Point Sensitivity The performance of a manager/fund may vary depending on which ending time periods are used to analyze performance. Therefore it is important to look at performance for a number of market cycles or time periods to gain an accurate assessment of the manager/fund's performance.

Equal Weighted In a portfolio setting, this is a composite of a manager's return for accounts managed that gives equal consideration to each portfolio's return without regard to size of the portfolio. Compare to **Size-Weighted Return**. In index context, equal weighted means each stock is given equal consideration to the index return without regard to market capitalization. The Value Line Index is an example of an equal weighted index.

Equilibrium Spending Rate Specific to foundations and endowments, the "spending rate" which offsets inflation and additional cost increases.

9.0%	-	3.5%	-	1.5%	=	4%
(return)		(inflation)		(cost increases)		(equilibrium spending rate)

ERISA The Employee Retirement Income Security Act is a 1974 law governing the operation of most private pension and benefit plans. The law eased pension eligibility rules, set up the **Pension Benefit Guaranty Corporation**, and established guidelines for the management of pension funds.

Fiduciary Indicates the relationship of trust and confidence where one person (the Fiduciary) holds or controls property for the benefit of another person. For example, the relationship between a trustee and the beneficiaries of the trust.

> Any person who (1) exercises any discretionary authority or control over the management of a plan or the management or disposition of its assets, (2) renders investment advice for a fee or other compensation with respect to the funds or property of a plan, or has the authority to do so, or (3) has any discretionary authority or responsibility in the administration of a plan.

Funding-Support Ratio The *funding-support ratio* (the fraction of the budget supported by the fund) is the key strategic variable used by experienced committees to track and manage contributions to an institution's or recipient's annual budget. Although increasing the spending rate increases the fund's current contribution to the overall budget, more spending obviously means less reinvestment, a smaller growth rate and, all other things being equal, a lower funding support ratio in the future.

Geometric Return A method of calculating returns which links portfolio results on a quarterly or monthly basis. This method is best illustrated by an example, and a comparison to **Arithmetic Returns**, which does not utilize a time link. Suppose a $100 portfolio returned +25% in the first quarter (ending value is $125) but lost 20% in the second quarter (ending value is $100). Over the two quarters the return was 0% - this is the geometric return. However, the arithmetic calculation would simply average the two returns: (+25%)(.5) + (-20%)(.5) = +2.5%.

Liquidity Risk The risk that there will be insufficient cash to meet the fund's disbursement and expense requirements.

Market Capitalization A common stock's current price multiplied by the number of shares outstanding. It is the measure of a company's total value on a stock exchange.

Market Timing A form of **Active Management** that moves funds between asset classes based on short-term expectations of movements in the capital markets. (Not recommended as a prudent process.) It is very difficult to improve investment performance by attempting to forecast market peaks and troughs. A forecasting accuracy of at least 71% is required to outperform a buy and hold strategy.

Market-Weighted Typically used in an index composite. The stocks in the index are weighted based on the total **Market Capitalization** of the issue. Thus, more consideration is given to the index's return for higher market capitalized issues than smaller market capitalized issues.

Money Markets Financial markets in which financial assets with a maturity of less than one year are traded. Money market funds also refer to open-end mutual funds that invest in low-risk, highly liquid, short-term financial instruments and whose net asset value is kept stable at $1 per share. The average portfolio maturity is 30 to 60 days.

Profit Sharing Plan Retirement plan that receives contributions as a percentage of the company's profits. See **Defined Contribution Plan**.

Proxy Voting A written authorization given by a shareholder to someone else to vote his or her shares at a stockholders annual or special meeting called to elect directors or for some other corporate purpose.

Real Estate Investment Trust (REIT) An investment fund whose objective is to hold real estate-related assets, either through mortgages, construction and development loans, or equity interests.

Residual Risk Residual risk is the unsystematic, firm-specific, or diversifiable risk of a security or portfolio. It is the portion of the total risk of a security or portfolio that is unique to the security or portfolio itself and is not related to the overall market. The residual risk in a portfolio can be decreased by including assets that do not have similar unique risk. For example, a company that relies heavily on oil would have the unique risk associated with a sudden cut in the supply of oil. A company that supplies oil would benefit from a cut in another company's supply of oil. A combination of the two assets helps to cancel out the unique risk of the supply of oil. The level of residual risk in a portfolio is a reflection of the "bets" which the manager places in a particular asset class or sector. Diversification of a portfolio can reduce or eliminate the residual risk of a portfolio.

Risk-adjusted Return The return on an asset or portfolio, modified to explicitly account for the risk of the asset or portfolio.

Risk Free Rate of Return The return on a 90-day Treasury bills. This is used as a proxy for no risk due to its US Government issuance and short-term maturity. The term is really a misnomer since nothing is free of risk. It is utilized since certain economic models require a "risk free" point of departure. See **Sharpe Ratio**.

R-squared (R^2) Formally called the coefficient of determination, this measures the overall strength or "explanatory power" of a statistical relationship. In general, a higher R^2 means a stronger statistical relationship between the variables that have been estimated, and therefore more confidence in using the estimation for decision-making.

Safe Harbor Rules A series of guidelines which when in full compliance *may* limit a fiduciary's liabilities.

Sharpe Ratio This statistic is a commonly used measure of risk-adjusted return. It is calculated by subtracting the **Risk-free Return** (usually 3-Month Treasury Bill) from the portfolio return and dividing the resulting "excess return" by the portfolio's total risk level (standard deviation). The result is a measure of return gained per unit of total risk taken. The Sharpe ratio can be used to compare the relative performance of managers. If two managers have the same level of risk but different levels of excess return, the manager with the higher Sharpe ratio would be preferable. The Sharpe ratio is most helpful when comparing managers with both different returns and different levels of risk. In this case, the Sharpe ratio provides a per-unit measure of the two managers that enables a comparison.

Socially-Targeted Investment An investment that is undertaken based upon social, rather than purely financial, guidelines. See also **Economically-Targeted Investment**.

Soft Dollars The portion of a plan's commissions expense incurred in the buying and selling of securities that is allocated through a **Directed Brokerage** arrangement for the purpose of acquiring goods or services for the benefit of the plan. In many soft dollar arrangements, the payment scheme is effected through a brokerage affiliate of the consultant. Broker-consultants servicing smaller plans receive commissions directly from the counseled account. Other soft dollar schemes are effected through brokerages that, while acting as the clearing/transfer agent, also serve as the conduit for the payment of fees between the primary parties to the directed fee arrangement.

Standard Deviation A statistical measure of portfolio risk. It reflects the average deviation of the observations from their sample mean. Standard deviation is used as an estimate of risk since it measures how wide the range of returns typically is. The wider the typical range of returns, the higher the standard deviation of returns, and the higher the portfolio risk. If returns were normally distributed (i.e., has a bell shaped curve distribution) then approximately 2/3 of the returns would occur within plus or minus one standard deviation from the sample mean.

Strategic Asset Allocation Rebalancing back to the normal mix at specified time intervals (quarterly) or when established tolerance bands are violated (±10%).

Tactical Asset Allocation The "first cousin" to **Market Timing** because it uses certain "indicators" to make adjustments in the proportions of portfolio invested in three asset classes - stocks, bonds, and cash.

Time-Weighted Rate of Return Method of performance measurement that strips the effect of cash flows on investment performance by calculating sub period returns before and after a cash flow and averaging these sub period returns. Because dollars invested do not depend on the investment manager's choice, it is inappropriate to weight returns within a period by dollars.

Trading Costs Behind investment management fees, trading accounts for the second highest cost of plan administration. Trading costs usually are usually quoted in cents per share. Median institutional trading costs range around 5 to 7 cents per share.

90-Day US Treasury Bill The 90-Day T-Bill provides a measure of risk less return. The rate of return is the average interest rate available in the beginning of each month for a T-Bill maturing in 90 days.

Variance The Variance is a statistical measure that indicates the spread of values within a set of values. For example, the range of daily prices for a stock will have a variance over a time period that reflects the amount that the stock price varies from the average, or mean price of the stock over the time period. Variance is useful as a risk statistic because it gives an indication of how much the value of a portfolio might fluctuate up or down from the average value over a given time.

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EMPLOYEE BENEFITS & TAX LAW UPDATES

SEPTEMBER 2002 FEATURES

DOL Amicus Brief Filed in Enron Case

The Department of Labor ("DOL") filed an amicus brief, at the end of August 2002, in the case brought by Enron plan participants seeking relief for losses to their retirement plan accounts as a result of Enron's collapse, Tittle v. Enron (S.D. Tex.). The amicus brief opposes the defendants' motions to dismiss the case brought by the plan participants. The positions taken by the DOL in this brief are based upon the factual allegations stated in the plaintiffs' complaint.

The DOL has taken several significant positions in this brief, in particular with respect to the fiduciary obligations of the corporation (Enron), the Chief Executive Officer (Ken Lay) and the Compensation Committee of Enron's Board of Directors (collectively referred to in this summary as the "Appointing Fiduciaries"). Initially, the DOL concludes that, because they had the power to appoint, retain and remove the members of the Administrative Committee (the named plan administrator and plan fiduciary), the Appointing Fiduciaries have discretionary authority over the management and administration of the plan and thus are plan fiduciaries under ERISA.

As plan fiduciaries, the DOL argues that the Appointing Fiduciaries do not just have the obligation to monitor the actions of the appointed fiduciaries and remove or replace such fiduciaries if they are acting imprudently, but, in addition, the Appointing Fiduciaries have the broader obligation to insure that the appointed fiduciaries have accurate and critical information that the appointed fiduciaries need to carry out their duties (such as, information about the corporation's financial condition) and to take any necessary action (such as, freezing plan investments) if the appointed fiduciaries do not or cannot take such action because the appointed fiduciaries do not have the necessary information. This position is much broader than the current rule that fiduciaries can only be held liable for conduct that falls within their fiduciary authority and that they cannot be held directly liable for decisions over which they had no control.

The DOL further argues that the Appointing Fiduciaries also have co-fiduciary liability under ERISA § 405 because the Appointing Fiduciaries knowingly concealed critical financial information regarding Enron from the appointed fiduciaries which thus enabled the appointed fiduciaries to breach their duties to serve the interests of the participants and beneficiaries. Again, this position is much broader than the current rule that co-fiduciaries are only liable for bad acts that they know other fiduciaries are intentionally entering into and that the co-fiduciaries do not take action to stop or correct.

Other obligations that the DOL argues the Appointing Fiduciaries, as plan fiduciaries, had to satisfy include: (1) an affirmative duty to protect plan participants from misleading information and to correct inaccurate or misleading information so that participants and beneficiaries will not be injured as a result

of such information, pursuant to the holding in Varity v. Howe, 516 U.S. 489 (1996); and (2) perhaps additional disclosure duties beyond correcting misinformation. This latter duty arises if the fiduciaries are aware of particular threats to plan assets (e.g., information that could have an "extreme impact" on the plan assets), in which case they have the duty under ERISA § 404(a) to disclose to participants material information necessary to protect the plan participants and beneficiaries from those threats. See, McDonald v. Provident Indemnity Life Insurance Co., 60 F.3d 234 (5th Cir. 1995).

Further, the DOL takes the position that the 3rd Circuit holding in Confer v. Custom Engineering Co., 952 F. 2d 34 (3rd Cir. 1991), (held that a corporate officer who exercises discretion on behalf of a corporation is not a fiduciary unless he has an individual discretionary role over the employee pension plan) is not correct. The DOL argues that this position would effectively insulate officers from fiduciary liability to the extent that they are acting for the corporation. Instead, DOL argues that the position taken by 5th and 9th Circuits is correct (held that, in any action, a corporate officer may be acting both as a plan fiduciary and as a representative of the employer if the officer has discretionary authority or responsibility in the administration of the plan). See, Bannistor v. Ullman, 287 F.3d 394 (5th Cir. 2002); Kayes v. Pacific Lumber, 51 F.3d 1449 (9th Cir. 1995).

In response to arguments that corporate officers are prohibited from disclosing material nonpublic information under SEC Rule 10b-5 (even to the appointed plan fiduciaries), the DOL argues that the corporate officers could have taken one of the following three actions in the present case and such actions would have satisfied both the SEC requirements and the ERISA fiduciary obligations of the corporate officers: (1) disclose the poor financial condition of Enron to all shareholders (both public and plan participants) at the time questions about Enron's financial condition were initially raised internally; (2) eliminate Enron stock as a participant option and an employer match at the time questions about Enron's financial condition were initially raised internally; or (3) report to the SEC and DOL that potential misinformation is being provided to plan participants and beneficiaries at the time questions about Enron's financial condition were initially raised internally.

The brief further states that plan fiduciaries (both appointing and appointed) have an obligation to monitor the performance of plan investments and, even if the plan directs the manner in which plan assets are to be invested (such as in an ESOP), the plan fiduciaries have a duty to ignore those plan provisions if such investment directions become imprudent under ERISA section 404. See, Kuper v. Iovenko, 66 F.3d 1447 (6th Cir. 1995); Moench v. Robertson, 62 F.3d 553 (3rd Cir. 1995).

For participant-directed investments, ERISA section 404(c) does not automatically relieve the plan fiduciaries of responsibility for investment losses. The plan fiduciaries must prove that they satisfied all of the requirements under ERISA section 404(c). In addition, the plan fiduciaries are obligated to prudently select the investment options made available under the plan and to monitor their on-going performance. In its brief, the DOL takes the position that the plan fiduciaries in Enron had an obligation to remove Enron stock as an option as soon as they had knowledge of Enron's failing financial condition and implies that the plan fiduciaries had an obligation to stop following participant instructions to invest in Enron stock at such time as well.

The DOL argues that, once the plaintiffs prove a breach of fiduciary duty and a prima facie cause of loss to the plan, the burden shifts to the plan fiduciaries to prove that the loss was not caused by the breach of duty. See, McDonald v. Provident Indemnity Life Insurance Co., 60 F.3d 234 (5th Cir. 1995).

Monetary relief against breaching fiduciaries is equitable when it restores the beneficiary to the position he would have been in if the plan fiduciary had not committed the breach of trust. See, Great-West v. Knudsen, 122 S. Ct. 708 (2002). Since the plaintiffs are seeking relief for fiduciary breaches, the DOL

takes the position that the plaintiffs have a valid claim for equitable relief under ERISA section 502(a)(3); it is not a cause of action for benefits under ERISA section 502(a)(1)(B). Further, the plaintiffs may seek monetary relief to individual participants as equitable relief under ERISA section 502(a)(3); the equitable relief sought need not be limited to monetary relief that benefits the entire plan trust. See, Varity v. Howe, 516 U.S. 489 (1996).

The DOL concludes that, based on the plaintiffs' allegations, the ministerial trustee (Northern Trust), who was following instructions of the appointed plan fiduciary to begin a "lockdown period" when switching from one plan administrator to another, was a plan fiduciary because it followed directions that it knew at the time were imprudent and, thus, contrary to the interests of the plan participants and beneficiaries. This knowledge was based on public information available at the time regarding Enron's financial condition as well as requests Northern Trust was alleged to have received from plan participants to postpone the lockdown.

The DOL further states that Arthur Andersen LLP may be liable as a nonfiduciary party-in-interest who had actual or constructive knowledge of the circumstances that made the plan fiduciary's actions a breach of duty and who participated in that breach. As such, Andersen can be held liable for appropriate equitable relief under ERISA section 502(a)(3). See, Harris Trust & Sav. Bank v. Salomon Smith Barney, Inc., 530 U.S. 238 (2000).

Employer's Tip: The obligations cited in the DOL's amicus brief are much broader than the duties employers have traditionally believed applied to plan fiduciaries. In particular, corporate executives and board members who appoint named plan fiduciaries and administrators have relied on the argument that they have only limited fiduciary liability with respect to employee benefit plans. If the DOL is successful in many of its assertions in this amicus brief, corporate officers and board members would be well advised to directly monitor material aspects of the operation of corporate employee benefit plans and to document the review that they undertake.

For further information regarding this or any other employee benefits matter, please contact Bosley Hutzelman at (703) 299-9177 or bh@uspensionlaw.com.

FIDUCIARY LIABILITY OF EMPLOYERS

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FIDUCIARY LIABILITY OF EMPLOYERS SPONSORING PENSION PLANS

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FIDUCIARY LIABILITY OF EMPLOYERS

SPONSORING PENSION PLANS

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I. Introduction.

This outline provides an overview of the fiduciary responsibilities that an employer must satisfy when it sponsors an employee pension plan (including 401(k), profit-sharing and money purchase pension plans). A review is included of the liabilities that may be imposed upon an employer that breaches its fiduciary duties with respect to an employee pension plan.

II. Title I of ERISA: Compliance Requirements.

The Employee Retirement Income Security Act of 1974 ("ERISA") is the primary body of Federal law that regulates employee benefits. Title I of ERISA (referred to as "Title I of ERISA" and "ERISA") provides for the protection of employee benefit rights by setting forth reporting and disclosure, participation and vesting, funding, and fiduciary responsibility standards which must be met by all covered plans. Title I of ERISA is under the regulatory and enforcement jurisdiction of the Department of Labor ("DOL"). Title II of ERISA (referred to as "Title II of ERISA" and Internal Revenue Code ("IRC" or "Code")) sets forth the requirements which must be satisfied for a covered plan to receive tax-favored treatment. Title II of ERISA is under the regulatory and enforcement jurisdiction of the Department of Treasury and its agency, the Internal Revenue Service ("IRS").

Title I of ERISA sets forth the requirements that must be satisfied by an employee pension benefit plan. An "employee pension benefit plan" is defined as any plan established by an employer to provide retirement income to employees or which results in a deferral of income by employees for periods extending to the termination of covered employment or beyond. ERISA section ("§") 3(2)(A).

Certain types of plans are excepted from coverage under Title I of ERISA, including: (1) individual retirement annuities or accounts ("IRAs"); (2) church plans; (3) governmental plans; (4) unfunded excess benefit plans; (5) plans outside the United States for the benefit of non-resident aliens; (6) plans maintained solely for compliance with applicable workman's compensation and unemployment laws; and (7) certain tax-sheltered annuity programs with limited employer involvement. *See generally* ERISA § 4(b).

Employee pension benefit plans covered under Title I of ERISA are generally subject to the following types of requirements:

(1) certain disclosure and reporting requirements, including regular notices that must be provided to employees eligible for plan benefits and plan participants and beneficiaries and an information return / report (i.e., Form 5500) that must be filed annually for each employee pension benefit plan (unless the plan is specifically exempted from this requirement) (*See generally* ERISA §§ 102, 103 and 104.);

(2) certain plan funding requirements, including a general requirement that "plan assets" must be deposited in the plan as soon as such assets can be reasonably segregated from the employer's general assets, but no later than the 15th business day after the end of the month in which received for pension plans and no later than 90 days after the date of receipt for welfare plans (Labor Regs. § 2510.3-102.);

(3) benefit claims management procedures (*See generally* ERISA § 503.);

(4) fidelity bond and fiduciary insurance requirements (*See generally* ERISA § 412.); and

(5) fiduciary obligations (*See generally* ERISA § 404.).

ERISA § 514 provides for the broad preemption of state laws that "relate to" employee benefit plans. The purpose of this provision is to afford employers sponsoring employee benefit plans some comfort that requirements regarding employee benefits will be enforced on a consistent basis, regardless of the state in which the employer, the participant and/or the plan trust is located.

III. Definition of Plan Fiduciary.

Title I of ERISA sets forth the obligations that a fiduciary of an employee pension benefit plan must satisfy.

An employer may be considered to be a plan fiduciary to the extent that the employer maintains any authority or control over the management of the plan's assets or the plan in general or have any responsibility for the administration of the plan.

A. Statutory Definition of Plan Fiduciary.

ERISA § 3(21)(A) provides that an individual (or entity) is a "fiduciary" with respect to a pension or welfare benefit plan to the extent that the individual:

(1) exercises any discretionary authority or discretionary control respecting the management of a plan or exercises any authority or control respecting the management or disposition of plan assets;

(2) renders investment advice for a fee or other compensation, direct or indirect, with respect to any plan assets or has any authority or responsibility to do so; or

(3) has any discretionary authority or discretionary responsibility in the administration of the plan.

Subsection (1) of the provision "imposes fiduciary status on those who exercise discretionary authority, regardless of whether such authority was ever granted," while subsection (3) imposes fiduciary status on "those individuals who have actually been granted discretionary authority, regardless of whether such authority is ever exercised." *See*, *Olson v. E.F. Hutton & Co., Inc.*, 957 F.2d 622, 625 (8th Cir. 1992).

The term "fiduciary" also includes any person who is a "named fiduciary" under the plan, as well as any person designated by a named fiduciary to carry out fiduciary responsibilities. A "named fiduciary" is a fiduciary who is named in the plan document or who, in accordance with a procedure specified in the plan, is identified as a fiduciary of the plan. ERISA § 402(a)(2). The employer sponsoring the plan may be designated as a "named fiduciary" in the plan document. Labor Regs. § 2509.75-5.

B. DOL Interpretation of Statutory Definition of Plan Fiduciary.

In Interpretive Bulletin 75-8, the Department of Labor ("DOL") stated that a person who performs administrative functions for an employee benefit plan, within a framework of policies, interpretations, rules, practices and procedures made by other persons, is not a plan fiduciary under ERISA § 3(21). *See*, DOL Regulations §§ 2509.75-5 and 2509.75-8. The Interpretive Bulletin identified administrative functions for a plan as follows:

(1) application of rules determining eligibility for participation or benefits;

(2) calculation of services and compensation credits for benefits;

(3) preparation of employee communications material;

(4) maintenance of participants' service and employment records;

(5) preparation of reports required by government agencies;

(6) calculation of benefits;

(7) orientation of new participants and advising participants of their rights and options under the plan;

(8) collection of contributions and application of contributions as provided in the plan;

(9) preparation of reports concerning participants' benefits;

(10) processing of claims; and

(11) making recommendations to others for decisions with respect to plan administration.

C. Review of Fiduciary Status.

The courts and DOL have consistently taken the position that a functional test is required for determining fiduciary status. Under the functional test, an investigation is made into who is actually making discretionary decisions about plan provisions or benefits. Thus, the determination of an individual's fiduciary status is an inherently factual inquiry and requires analysis of the specific facts and circumstances of each case.

In most cases, an employer is a "named fiduciary" and, thus, is a plan fiduciary by definition. However, in situations where the employer is not a "named fiduciary, the employer will generally be a plan fiduciary under the functional test. For example, the employer usually exercises discretionary authority with respect to the administration of the plan, such as by selecting the plan administrator or reviewing and approving plan loans or distributions.

IV. Fiduciary Obligations – In General

Under Title I of ERISA, a fiduciary of an employee pension benefit plan has a duty to act:

> solely in the interest of the participants and beneficiaries and –
>
> (A) for the exclusive purpose of:
>
> (i) providing benefits to participants and their beneficiaries and
>
> (ii) defraying reasonable expenses of administering the plan;
>
> (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
>
> (C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and
>
> (D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this title [Title I] and Title IV [of ERISA].
>
> ERISA § 404(a)(1).

A plan fiduciary includes, by definition, the employer sponsoring the plan if the employer exercises any discretionary authority or control with respect to the administration of the plan and/or the investment and disposition of plan assets. ERISA § 3(21)(A). Most employers sponsoring employee pension plans exercise discretionary authority or control over the plan and, as a result, are fiduciaries with respect to the plan for purposes of Title I of ERISA. As a fiduciary of the pension plan, each employer has a responsibility to act "solely in the interest" of the plan participants and beneficiaries, pursuant to the requirements of ERISA § 404(a)(1).

Each employer that sponsors a pension plan is obligated since the initial establishment of its plan to satisfy the fiduciary requirements of ERISA § 404(a)(1) with respect to the plan, including insuring that the pension plan satisfies all other applicable requirements of Title I of ERISA.

For example, each employer, as a fiduciary of the pension plan, has an obligation to insure that plan contributions are used for the exclusive benefit of the participants

and beneficiaries of the plan. ERISA § 404(a)(1)(A)(i). For example, no portion of the plan assets may be used by the employer to pay for the employer's share of expenses with respect to the plan or added to the employer's general assets. To do so would be in violation of the exclusive benefit rule of ERISA § 404(a)(1)(A)(i) and also a prohibited transaction between the employer and the plan under ERISA § 406. *See*, DOL Advisory Opinion 2001-01A.

When making decisions regarding the investment of plan assets, the employer should be aware that many of its decisions may be considered to be fiduciary decisions regarding the pension plan, subject to the fiduciary duties of Title I of ERISA. For example, the employer's selection of the types of funds that will be offered as investment vehicles under the pension plan is a fiduciary decision. For this reason, the employer should conduct a cost/benefit analysis of expenses related to plan investment fund offerings and document this analysis. Similarly, the employer, as fiduciary of the pension plan, should exercise fiduciary prudence by regularly reviewing the performance of the investment funds offered under the pension plan and deciding at the time of each review to replace or maintain each fund.

Each employer, as fiduciary of the pension plan, must act prudently and in the interest of the plan participants and beneficiaries when deciding when and for what amount to dispose of assets held by the plan. ERISA § 404(a)(1)(B). The employer has a competing obligation under ERISA § 404(a)(1)(C) to diversify the investments of the pension plan so as to minimize the risk of large losses, unless it is clearly prudent not to do so. To carry out these fiduciary duties, the employer must analyze the market price history of the plan investment when to dispose of the plan asset (e.g., disposing of a plan asset in a deflated market may expose the employer to fiduciary liability). In addition, the employer must evaluate whether it is prudent to hold the plan asset for a period of time or to sell the asset and invest in other funding vehicles to diversify the plan investments. As with all fiduciary actions, the employer should document all analyses and evaluations it makes with respect to the plan and the rationale that led to its decision that the action taken was in the best interest of the plan participants and beneficiaries. Failure to act with fiduciary prudence in making these decisions could result in a breach of fiduciary duty and subject the employer, as well as its officers and other managers, to civil and criminal liability. ERISA §§ 409(a), 501, 502(a)(3), and 502(l).

V. Liability for Failure to Satisfy Fiduciary Obligations.

Violation of the fiduciary obligation provisions under Title I of ERISA results in a breach of fiduciary duty by the employer, which may subject the employer to civil law suits brought by plan participants and beneficiaries and/or the DOL to recover losses incurred by the plan. ERISA § 502(a)(3). Further, civil penalties may be asserted by the DOL against each plan fiduciary for breaches of fiduciary duty, including a penalty of 20% of the amount at issue. ERISA § 502(l). If there is

more than one plan fiduciary (either in name or in function), the employer may be subject to co-fiduciary liability for actions taken by another other plan fiduciary. ERISA § 405. In certain egregious cases, criminal liability may be found. ERISA § 501.

Officers of the employer, as well as employees who exercise fiduciary discretion regarding the plan, also may be held personally liable for any breaches of fiduciary duty attributed to the employer. ERISA § 409(a).

An employer, as plan fiduciary, may be held liable for a fiduciary breach based on either action or inaction taken in any particular circumstance.

Equitable relief is generally not available under ERISA. However, an individual plan participant or beneficiary may obtain relief to the extent that the participant or beneficiary is put back in the position in which he or she would have been absent the fiduciary breach.

Further, participation in a prohibited transaction subjects the employer to a 15% excise tax (as well as an additional 100% excise tax, if the prohibited transaction is not timely corrected), to be enforced by the Internal Revenue Service ("IRS"). Internal Revenue Code sections ("Code §§") 4975(a) and (b). The employer may also be subject to a 100% excise tax for reversion of any portion of a welfare benefit fund to the employer under Code § 4976(a) or a 20% or 50% excise tax for reversion of any portion of an Code § 401(a) qualified plan to the employer under Code § 4980(a).

VI. Examples of Specific Fiduciary Actions.

A. Investment Policy.

An employer who sponsors a retirement plan should consider drafting a statement of investment policy; such a policy statement is consistent with the employer's fiduciary obligations. The investment policy statement should be distinguished from directions regarding the purchase or sale of a specific investment at a specific time. An employer may condition the appointment of an investment manager on acceptance of the statement of investment policy of the plan. In the absence of such an express requirement to comply with an investment policy, the authority to manage plan assets placed under the investment manager's control would lie exclusively with the investment manager. Labor Regs. § 2509.94-2.

An investment policy can buttress the protection provided for plan fiduciaries by having participant-directed accounts. *See* ERISA 404(c). An employer, as a fiduciary, should establish fairly specific investment goals

for its pension plans, particularly if such plan has participant-directed accounts, and write a policy to cover the issues that may arise in the operation of the plan. These issues include (but are not limited to):

(1) age and dynamics of the workforce;

(2) encouragement of maximum employee contributions;

(3) asset allocation and diversification;

(4) selection of asset classes and investment managers within each class;

(5) range of employee investment horizons;

(6) performance and benchmarking;

(7) employee education and risk tolerance;

(8) cash flow requirements; and

(9) recordkeeping and management fees.

B. Regular Review of Plan Investment Funds.

A regular review should be undertaken of the costs associated with the investment funds offered under the pension plan and the performance of the investment fund. This review can be conducted pursuant to the investment policy established for the pension plan. A cost / benefit analysis of each of the investment funds should be documented on a regular basis and an effort should be made to identify the costs of each fund in a manner that like costs of each fund may be compared. For a list of sample questions to consider and a method of comparison of § 401(k) plan fees, see DOL publications "A Look at 401(k) Plan Fees . . . for Employees;" "A Look at 401(k) Plan Fees . . . for Employers;" and a sample "401(k) Fee Disclosure Form."

The analysis of each plan investment fund should be documented. Documentation should also be made of the deliberations made and the decisions reached by the plan fiduciary as to whether the investment fund should be retained or replaced for that review period. Such documentation should be retained in the permanent files for the plan.

C. Fiduciary Bond.

As a general rule, every fiduciary of an employee benefit plan and every person who handles funds or property of the plan must be bonded. ERISA

§ 412(a). The amount of the bond is required to be $1,000 or 10% of the amount of funds handled, whichever is greater. The bond amount may not generally exceed $500,000. A bond must furnish protection to the plan against loss through fraud or dishonesty on the part of a plan official, directly or through connivance with others. *Id*. Often a company may have an insurance policy that will cover the fiduciaries; however, the Department of Labor may require a separate rider to an insurance policy to specifically cover violations of ERISA.

D. Monitor Plan to Identify and Correct Prohibited Transactions.

The prohibited transaction rules of both the Code and Title I of ERISA bar a person who is a fiduciary (i.e., a plan trustee) from engaging in certain transactions, such as dealing with plan assets for the person's own interest. In general, a plan will not be disqualified for engaging in a prohibited transaction; rather, a party-in-interest (called a disqualified person by the Code) who participates in a prohibited transaction is subject to civil (and possibly criminal) action for breach of fiduciary duty and at least one and possibly two excise taxes. A disqualified person who participates in a prohibited transaction is subject to an initial 15% excise tax and, if the prohibited transaction is not timely corrected, an excise tax of 100% of the amount involved is imposed. The initial excise tax was increased from 10% to 15% of the amount involved for prohibited transactions occurring after August 5, 1997. Code § 4975; *see also* ERISA § 406.

The period during which a prohibited transaction may be corrected begins with the date the prohibited transaction occurs and ends 90 days after the date the IRS mails a notice of deficiency to the taxpayer regarding the 100% excise tax. Code § 4963(e); Treas. Regs. § 53.4963-1. The correction of a prohibited transaction generally involves undoing the self-dealing transaction to the extent possible, while placing the plan in a financial position no worse than that it would have been in if the disqualified person were acting under the highest fiduciary standards.

Some limited exceptions exist for prohibited transactions. For example, the purchase by the plan of certain types of employer stock is not a prohibited transaction. Code § 4975(d)(13).

Some examples of prohibited transactions include:

(1) any loan or other extension of credit between a plan and a disqualified person or a party in interest (including a plan trustee or plan administrator) beyond what is permitted under the plan, the Code and Title I of ERISA;

(2) purchasing real estate from a disqualified person or party in interest using plan assets;

(3) purchasing art or other collectibles (coins, stamps etc.) that are held by a disqualified person or party in interest with plan assets;

(4) purchasing jewelry that is used by a disqualified person or party in interest with plan assets; and

(5) failing to deposit plan participant contributions in the plan trust on the date the amounts can be segregated from employer assets, but which is within 15 business days after the month in which the participant contributions were withheld from the participant's salary.

Code § 4975(c)(1)(B); ERISA § 406(a)(1)(B) and (b)(1); Labor Regs. §§2550.408b-1 and 2550.408c-2(b)(4).

E. Identification of Eligible Employees.

The DOL initiated litigation against Time Warner Inc. and three of its subsidiaries, alleging misclassification of hundreds of employees as independent contractors or temporary employees and thus denial of benefits coverage. *Herman v. Time Warner Inc.*, 25 BPR 43 (Nov. 2, 1998). DOL officials stated that this was not a benefit entitlement case. Rather, it is the DOL's position that the plan fiduciary in this case did not fulfill its fiduciary obligation under ERISA § 404 to determine who is eligible and who is not eligible for benefits. The fiduciary did not have a procedure in place to identify eligible employees under the terms of the benefit plans at issue and to notify such eligible employees of their right to participate in the benefit plans. The relief that the DOL sought was the appointment of an independent fiduciary to make the determination on a regular basis as to who is and who is not entitled to benefits and to ensure that those entitled to benefits receive them, both prospectively and retroactively for those eligible employees who were not given the opportunity to participate in the benefit plans. A confidential settlement was reached in the case.

F. Benefit Claim Determinations.

The plan fiduciary has the responsibility to review benefit claims submitted by plan participants and determine if such claims should be paid or denied. A benefit claims administrative process must be implemented that offers both an initial review of the benefit claim and an opportunity for

administrative appeal of the initial claim determination. ERISA § 503. In general, the administrative claim review procedures must provide that the benefit claimant receive written notice that the claim for benefits under the plan is wholly or partially denied within a reasonable period of time, but not later than ninety (90) days after receipt of the claim by the plan administrator (who may be the employer), unless the plan administrator determines that special circumstances require an extension of time for processing the claim. *See*, Labor Regs. 2650.503-1. If the plan administrator determines that an extension of time for processing the claim is required, written notice of the extension must be furnished to the claimant prior to the termination of the initial ninety (90) day period. The extension may not exceed a period of 180 days after receipt of the claim by the plan administrator. The period of time within which a benefit determination is required to be made must begin at the time a claim is filed in accordance with the reasonable procedures of the plan, without regard to whether all the information necessary to make a benefit determination accompanies the filing. The extension notice must indicate the special circumstances requiring an extension of time and the date by which the plan administrator expects to render the benefit determination.

The plan administrator must provide the benefit claimant with a written or electronic notification of any adverse benefit determination. The notification must set forth, in a manner calculated to be understood by the claimant, the following information:

(1) the specific reason or reasons for the denial of the benefit claim;

(2) specific reference to the pertinent plan provisions on which the denial is based;

(3) a description of any additional material or information necessary for the claimant to perfect the claim and an explanation of why such material or information is necessary;

(4) an explanation that a full and fair review by the plan administrator of the decision denying the claim may be requested by the claimant or his authorized representative by filing with the plan administrator, within 60 days after such notice has been received, a written request for such review;

(5) a statement that the claimant or his authorized representative shall be provided, upon request and free of charge, reasonable access to, and copies of, all documents, records, and other information relevant to the claimant's claim for benefits within the same 60 day period specified in (4) above (whether a document, record, or other information is relevant to a claim for benefits shall

be determined by reference to the definition of "relevant" documents below);

(6) a statement that, if a request for appeal of the benefit claim determination is so filed, the claimant or his authorized representative may submit written comments, documents, records, and other information relating to the claim for benefits in writing within the same 60 day period specified in (4) above; and

(7) a statement advising the claimant that he has the right to bring a civil action under ERISA § 502(a) following an adverse benefit determination on review.

Any electronic notification provided to the claimant must comply with the standards imposed by Labor Regs. §§ 2520.104b-1(c)(1)(i), (iii) and (iv).

Upon receipt of a written request for review of an initial adverse benefit determination, the plan administrator must provide for a review that takes into account all comments, documents, records, and other information submitted by the claimant relating the claim, without regard to whether such information was submitted or considered in the initial benefit determination. The plan administrator must notify the claimant of the determination regarding the review of the adverse benefit determination within a reasonable period of time, but not later than sixty (60) days after the plan administrator's receipt of the claimant's request for review of the initial adverse benefit determination, unless the plan administrator determines that special circumstances (such as the need to hold a hearing, if the plan's administrative procedures provide for a hearing) require an extension of time for processing the claim. If the plan administrator determines that an extension of time for processing the request for review of the adverse benefit determination is required, written notice of the extension must be furnished to the claimant prior to the termination of the initial sixty (60) day period. Such extension may not exceed a period of 120 days after receipt of the claimant's request for review of the initial adverse benefit determination by the plan administrator. The period of time within which a benefit determination on review is required to be made must begin at the time an appeal is filed in accordance with the reasonable procedures of the plan, without regard to whether all the information necessary to make a benefit determination on review accompanies the filing. The extension notice shall indicate the special circumstances requiring an extension of time and the date by which the plan administrator expects to render the determination on review.

The Plan Administrator must provide a claimant with written or electronic notification of the benefit determination on review. In the case of an

adverse benefit determination, the notification shall set forth, in a manner calculated to be understood by the claimant, the following information:

> (1) the specific reason or reasons for the denial of the benefit claim on review;
>
> (2) specific reference to the pertinent plan provisions on which the denial of the claim on review is based;
>
> (3) a statement that the claimant or his authorized representative is entitled to receive, upon request and free of charge, reasonable access to, and copies of, all documents, records, and other information relevant to the claimant's claim for benefits (whether a document, record, or other information is relevant to a claim for benefits shall be determined by reference to the definition of "relevant" documents set forth below); and
>
> (4) a statement describing any voluntary appeal procedures offered by the plan and the claimant's right to obtain information about such procedures and a statement advising the claimant that he has the right to bring a civil action under ERISA § 502(a) following an adverse benefit determination on review.

Any electronic notification provided to the claimant shall comply with the standards imposed by Labor Regs. §§ 2520.104b-1(c)(1)(i), (iii) and (iv).

If the plan administrator fails to follow claims procedures consistent with the regularoy claims procedure requirements, a claimant will be deemed to have exhausted the administrative remedies available under the plan and will be entitled to pursue any available remedies under ERISA § 502(a) on the basis that the plan has failed to provide a reasonable claims procedure that would yield a decision on the merits of the claim.

Definitions: For purposes of the claims procedure requirements, the following definitions apply:

> (1) "Adverse benefit determination" means any of the following: a denial, reduction, or termination of, or a failure to provide or make payment (in whole or in part) for, a benefit, including any such denial, reduction, termination, or failure to provide or make payment that is based on a determination of a plan participant's or beneficiary's eligibility to participate in a plan.

(2) "Notice" or "notification" means the delivery or furnishing of information to an individual in a manner that satisfies the standards of Labor Regs. § 2520.104b-1(b) as appropriate with respect to material required to be furnished or made available to an individual.

(3) A document, record, or other information shall be considered "relevant" to a claimant's claim if such document, record, or other information:

(i) was relied upon in making the benefit determination;

(ii) was submitted, considered, or generated in the course of making the benefit determination, without regard to whether such document, record, or other information was relied upon in making the benefit determination; and

(iii) demonstrates compliance with the administrative processes and safeguards designed to ensure and verify that benefit claim determinations are made in accordance with governing plan documents and that, where appropriate, the plan provisions have been applied consistently with respect to similarly situated claimants.

In most circumstances, the plan document will provide that the plan administrator will have the exclusive right to interpret the terms and provisions of the plan and to determine any and all questions arising under the plan or in connection with the administration thereof, including, without limitation, the right to remedy or resolve possible ambiguities, inconsistencies, or omissions, by general rule or particular decision. The plan administrator will only be limited by the requirement that any action undertaken or determination made by the plan administrator must be undertaken or made in a nondiscriminatory manner based upon uniform principles consistently applied and must be consistent with the intent that the plan be treated as a qualified plan under the terms of Code § 401(a), and related regulations, and in accordance with the requirements of Title I of ERISA.

G. Plan Administrative Procedures.

While there are no administrative procedures required by government rules and regulations, the IRS and DOL may look to the plan procedures in an

examination of a plan in order to determine the extent of a violation. In addition, should a plan participant challenge a contribution or benefit under the plan, the administrative procedures of the plan can support the actions of the employer and plan administrator. An employer should establish and maintain a written set of administrative procedures covering a qualified retirement plan, specifically policies regarding areas such as: determining employee eligibility, testing contributions annually and approving distributions (including loans and hardship withdrawals). Forms for any required actions should be included in the administrative procedures.

H. Fiduciary Procedures.

Formal written procedures regarding the process of making fiduciary decisions are recommended. These procedures will establish the framework by which any fiduciary determination will be made. The procedures should require that inquiries made and deliberations undertaken for any fiduciary action must be documented. Such documentation must be maintained in the permanent plan file.

VII. Reporting and Disclosure Requirements.

A. Employee Communications.

Pursuant to Title I of ERISA, pension plans must meet certain disclosure requirements. These requirements include preparing and distributing a summary plan description to participants, preparing and distributing a summary of material modifications to participants when a plan is amended and preparing and distributing a summary annual report to participants. When distributing this information, the employer should use methods that are reasonably calculated to result in full distribution and to ensure actual receipt of the material by the plan participants and beneficiaries. Such methods include hand delivery or first class mail but not leaving documents in an area frequented by employees.

1. *Summary Annual Report*.

Specific information about the financial position of the pension plan, such as the plan's total assets and liabilities and annual aggregate contributions, must be provided to participants on summary annual reports and properly filed with the DOL, as an attachment to the Form 5500. ERISA § 104(a)(1) and (b)(1). As an alternative to a separate summary annual report, a copy of the annual information return for the plan, i.e., Form 5500, may be provided to participants.

This Form 5500 must be accompanied by a cover page indicating that this Form 5500 information is provided as a summary annual report.

2. *Summary of Material Modifications*.

The employer sponsoring a pension plan must distribute to participants a description of any material modification to a plan or change in information within 60 days after the modification or change is adopted or occurs. The copy of the summary plan description furnished to new plan participants and beneficiaries receiving benefits must be accompanied by all summaries of material modifications or changes in information required to be included in the summary plan description which have not been incorporated in the summary plan description. Prior to August 5, 1997, a copy of every summary of material modifications for the plan was required to be furnished to the DOL. This requirement no longer applies.

3. *Summary Plan Description*.

A summary plan description, which is a summary of plan provisions written in a manner intended to be understood by plan participants, must be distributed to all plan participants, generally within 90 days after the employee becomes a participant. ERISA § 104(b)(1); Labor Regs. § 2520.102-1. In the case when amendments are made to the plan, a new summary plan description need not be drafted, as long as a summary of material modifications describing the amendments is distributed to all employees. Every five years, the employer must provide each participant and each beneficiary receiving benefits under the plan an updated summary plan description which includes all plan amendments made within the last five year period.

If no amendments have been made to the plan during the five year period, this requirement need not be met, but a summary plan description must be furnished to plan participants and beneficiaries receiving benefits under the plan every ten years regardless of whether plan amendments have been made. ERISA § 104(b)(1). Prior to August 5, 1997, a copy of every summary plan description for the plan was required to be furnished to the DOL. This requirement no longer applies.

4. *Other Plan Related Documents*.

Upon making a written request to the employer and/or plan administrator, any participant in the pension plan or any beneficiary receiving plan benefits is entitled to receive a copy of the latest updated summary plan description and summaries of material modification for amendments not included in the summary plan description, the latest annual report, any bargaining agreement referencing the plan and the trust agreement, contract or other instruments under which the plan is established or operated. ERISA § 104(b)(4). The employer is also required to provide participants and beneficiaries with a copy of the plan, if so requested. The employer also has a duty to disclose information and documents relating to the initial establishment or status of a plan's provisions at a time when those provisions affect a participant's rights.

An employer or plan administrator who fails or refuses to comply with the request for information from a participant or beneficiary may be fined an amount up to $110 a day, payable to the participant or beneficiary. ERISA § 502(c)(1); Labor Regs. § 2570.502c-1.

5. *Annual Participant Benefit Statements*.

Each participant may also be provided with an annual accounting of the participant's assets in the plan, although many plans provide for a more frequent participant statement.

B. Annual Information Returns / Reports.

1. *Form 5500 Annual Return and Report*.

Title I of ERISA and the Code require that the Form 5500 (Annual Return/Report for Employee Benefit Plan) must be filed annually for most qualified pension plans. Plans with fewer than 100 employees are permitted to file the version of the form applicable to small plans. If a plan has between 80 and 120 participants at the beginning of the plan year, the plan can continue to file the same type of form that was filed the previous year (i.e., the small plan or large plan version of the form, whichever is applicable). Labor Regs. § 2520.103-1(d). Filings made for plan years before 1999 were filed with the IRS. Beginning with the 1999 plan year, filings are submitted to the DOL. The employer or plan administrator of an employee pension benefit plan is responsible for filing the Form 5500 return. If no administrator is named specifically in the plan, the employer) is treated as the plan administrator. Code § 6058; Regs. § 1.6058-1(b); ERISA §§ 104 and 3(16). To provide a record of timely filing, returns should be mailed by certified mail with a return receipt requested, and a copy of the cover letter and the signed return should

be maintained by the employer. To reduce the potential for personal liability, individuals signing the Form 5500 should use their name and title (e.g., Joe Smith, Trustee).

Employers are required to file schedules, if applicable, along with the Form 5500, such as: Schedule A (Insurance Information), Schedule B (Actuarial Information), Schedule C (Service Provider Information), Schedule H (Financial Information) or Schedule I (Financial Information – Small Plan), Schedule SSA (Separated Vested Participant Information) and Schedule P (Trust Fiduciary Information).

The Code and Title I of ERISA provide separate penalties for failing to file a Form 5500. The instructions to the Form 5500 series return sets forth these penalties in detail. The primary sanction under the Code is $25 per day, up to $15,000 maximum, for failure to file the Form 5500. In addition, ERISA § 502(c)(2), as interpreted in Labor Regs. § 2570.502c-2, provides for a civil penalty of $1,100 per day for failing or refusing to file a complete Form 5500.

2. *Summary Annual Report*.

As discussed above with respect to "Employee Communications," if a Form 5500 is required to be filed, information about the plan needs to be provided to participants on summary annual reports.

3. *Annual Audit by Independent Public Accountant*.

With certain exceptions for annuity plans, an employer is required to engage on behalf of all plan participants an independent qualified public accountant to review the plan. The accountant generally must conduct an examination of any financial statements of the plan and any other necessary books and records. The ERISA definition of a qualified public accountant includes either a certified public accountant or a licensed public accountant (licensed by a regulatory authority of the state). ERISA § 103(a)(3)(D).

However, plans with fewer than 100 participants that file the schedules of the Form 5500 applicable to small plans (formerly referred to as a Form 5500-C/R) need not either engage an independent qualified public accountant to examine the financial statements of the plan or include a report by such an accountant within the annual report (i.e., Form 5500 for small plans or former Form 5500-C/R) provided the plan assets are held by entities satisfying regulatory requirements, proper disclosure regarding the handling of plan assets is provided to participants and beneficiaries,

and, in limited situations, an appropriate bond is held by the person handling the plan assets. Labor Regs. § 2520.104-46.

6. *Other Reports -- Form 1099-R*.

Form 1099-R (Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.) is used to report to employees and their beneficiaries information regarding plan distributions. These reports must be furnished to the participant by January 31 following the year of distribution and must be filed with the IRS no later than the end of February following the year of distribution. Form 1099-R must be transmitted to the IRS with a Form 1096. A distribution may also be subject to 20% withholding if not directly rolled over to another qualified pension plan or individual retirement account under the appropriate rules. Code § 3405(a). Any withholding of federal income tax should be noted on the Form 1099-R.

VIII. Exception to Fiduciary Obligations.

A. Participant Self-Directed Accounts.

One way to reduce fiduciary exposure is to provide under the terms of a retirement plan, such as a Code § 401(k) plan, that the individual plan participant will direct the investment of that participant's accounts, i.e., using "participant self-directed" accounts. *See* ERISA § 404(c). An individual who is otherwise a plan fiduciary is not liable for losses incurred by the individual accounts of participants as long as the fiduciary does not exercise control over the assets in the participants' accounts. However, the individual fiduciary must take care to not give participants specific individual advice concerning their investment choices in order to take advantage of this "participant-directed investment" safe harbor from fiduciary liability.

IX. Employer Responsibilities in Establishing and Maintaining a Pension Plan.

A. Employer Responsibilities.

In general, an employer who institutes an employee pension benefit plan is responsible for ensuring that the plan meets all statutory and regulatory requirements. This means that the employer must confirm that all plan documentation is in order, the plan operates according to its documentation,

and the trust (if any) is maintained according to the fiduciary rules associated with trusts. Should the employer fail to maintain the form, operation, or fiduciary responsibilities associated with the plan, the employer may lose its tax deductions for contributions, employees may be forced to include trust amounts (including contributions and earnings thereon) in income, and the employer may be subject to civil liability for fiduciary breach, excise taxes and penalties.

B. Services Needed.

In order to establish an employee benefit plan, the employer will need to employ several professionals to provide necessary documentation and administrative services. A general description of the most common service providers follows:

1. *Legal Services*.

All qualified pension plans must have written plan documents. In addition to preparation of these documents, legal services may include preparing submissions to the IRS regarding the qualified status of a retirement plan and providing advice on an ongoing basis regarding the operation of the plan and any necessary changes that need to be made to maintain the plan in compliance with current statutory and regulatory requirements.

2. *Recordkeeping Services*.

Recordkeeping services are key to running a qualified retirement plan correctly. On a day-to-day basis, general bookkeeping will need to be done to insure proper credit of contributions, earnings, and losses to the trust. In addition, certain plan administration functions may be performed by the accountant or recordkeeper, including preparation of participant statements, maintenance of records documenting who is in the plan and who has retired from the plan, and the payment of benefits.

3. *Investment Advisor*.

The employer may wish to hire an investment advisor to assist in the management of the trust funds. In some instances, hiring an investment advisor may limit the liability of the employer if the investment advisor is assuming certain fiduciary functions with respect to the plan. *See*, ERISA § 3(38).

4. *Actuary*.

In the event the employer is establishing a defined benefit retirement plan, an actuary will need to be engaged to calculate the benefits to be paid and the necessary contributions that will need to be made to the trust to insure that sufficient funds will be available to pay promised benefits.

C. Plan Maintenance.

Once an employee benefit plan is established, the ongoing maintenance of the plan will include many of the professionals needed to implement the plan. On a yearly basis, the trust fund will need to be valued, contributions and distributions will need to be recorded, and nondiscrimination testing will need to be conducted. In addition, if there are law changes, plan documentation will need to be updated.

D. Steps to Establish an Employee Benefit Plan.

A summary of the steps that an employer should follow to establish an employee benefit plan is set out below. This summary may be used by the employer as a checklist or guide during the period of consideration and establishment of its employee benefit plan.

1. *Preparation*.

   a. Gather the following information:

      i. Employee information. Survey employee population to determine turnover, age of employees, etc.

      ii. Employer information. Determine how much money can be spent on the plan.

      iii. Corporate Purpose. Determine the reasons for setting-up the plan.

   b. Select Type of Plan. Analyze the information gathered and choose the type of plan to be established. This step includes the selection of options that will be made available under the plan.

2. *Plan Documentation*.

   For all types of plans, the documentation that must be developed to establish the employee benefit plan is as follows:

   a. plan document (and adoption agreement, if applicable);

   b. IRS determination letter (applicable to retirement plans; not required, but recommended);

   c. summary plan description (SPD) to be provided to participants;

   d. trust agreement (as applicable);

   e. service agreement for services of the third party administrator (TPA) (as applicable);

   f. administrative procedures manual;

   g. employee enrollment forms;

   h. distribution forms for requests for benefit distribution;

   i. confirmation forms for confirming participant decisions or elections; and

j. fidelity bond and fiduciary insurance for persons handling plan funds or involved in plan administration.

3. *Implementation of the Plan*.

The following steps should be taken to implement the employee benefit plan:

a. Execute a plan document that meets the employer's corporate goals as well as the statutory and regulatory requirements.

b. Communicate the plan to employees.

c. Obtain an IRS approval letter (if applicable).

d. Establish internal and external administrative procedures to operate the plan.

e. Establish a relationship with professionals needed to operate the plan, including a recordkeeper, investment advisor, and legal advisor.

4. *On-going Maintenance of the Plan*.

Once the plan has been established, on-going maintenance of the plan will require that attention be given to the following areas:

a. annual nondiscrimination testing (as applicable);

b. annual contribution calculations;

c. on-going administration; and

d. government filings.

X. Use of Third Party Administration.

An employer may elect to engage a third party administrator (TPA) to assist it with administrative functions required to implement and maintain its pension plan. Even if a TPA is engaged, the employer remains obligated to satisfy its fiduciary responsibilities with respect to the plan. For this reason, the employer must select the TPA and regularly monitor the actions of the TPA in a manner that reflects fiduciary prudence. If the TPA is a plan fiduciary in name or in action, the

employer should be aware of actions taken by the TPA, especially in view of any potential co-fiduciary liability of the employer for such actions.

A. Selection of Third Party Plan Administrator.

In general, when interviewing a prospective TPA, employers should ask the candidate questions about its fee arrangement. Most provide a "bundled" package for the various services offered and charge an additional fee per year based on the number of participants covered. The employer must make inquiries about the services it will receive under the package. The employer must also determine if the TPA will make administrative decisions regarding the plan or if the TPA will merely act on those decisions certified or approved by the employer, internal administrator, or other plan fiduciary. For example, the employer should ask who determines whether a participant is eligible to receive a plan distribution. The current trend is that the employer must "sign off" on any distribution request before the TPA will make the requested distribution payment.

If the plan is a retirement plan providing for individual accounts, the employer should determine if the TPA will agree to be responsible for allocating funds among the participants' accounts and tracking investment returns for each account on an account-by-account basis. The employer also must determine which nondiscrimination tests the TPA will perform and which tests the employer will be responsible for performing. In all circumstances, the employer is ultimately responsible for reviewing all plan data used by the TPA in performing nondiscrimination testing to ensure that the information on which the test results are based is accurate.

Many TPAs will prepare the annual information return/report for each plan (Form 5500), but the employer must review the Form 5500 for any errors. Review is particularly needed because the TPA may not have all of the information necessary to complete the Form 5500 fully and accurately. Before contracting with a TPA, the employer should determine if the TPA will charge for any changes made to the Form 5500 return because of incorrect or missing data.

B. Sample Questions to Ask a Prospective Third Party Plan Administrator (TPA) Regarding Plan Administration Services.

1. Request a copy of the TPA's service agreement to review before it is signed. Also request a copy of the trust agreement, if evaluating whether the TPA (or its affiliate) should be appointed as plan trustee.
2. When will the TPA be able to have employee accounts ready (i.e., from information transferred from the prior plan administrator for an existing plan or from the information provided by the employer for a

new plan) to receive employee contributions deferred from the employees' salaries?

The employer does not want to begin or change over payroll deductions for deferrals until the TPA is ready to receive and allocate contribution amounts. For example, for pension plans, it is important that all employee contributions be deposited in the plan and allocated to the employees' accounts within 15 business days after the end of the month in which the contributions are withheld from the employees' pre-tax salaries.

Further, the employer does not want a lengthy "black-out" period to arise during which employees may not change investment selections. If a "black-out" period of some duration arises due to the transfer of information to the new TPA, the employer could face potential fiduciary liability for the employees' "lost" investment opportunities.

3. If the TPA will be assuming plan administration of an existing plan, ask which recordkeeper will be responsible for current plan year testing. Confirm that the TPA will have all year-to-date information needed to do the current plan year testing. If not, determine what information is needed and if it can be supplied by the employer or the prior TPA.

4. For a § 401(k) plan, ask if the TPA will do end-of-year testing for the following tests for the plan (and ask if the testing is included in the base annual fee or if there is an additional charge for doing the testing and the amount of the charge) and provide the employer with a copy of the test results:

    a. actual deferral percentage / actual contribution percentage (ADP/ACP) test;

    b. § 415(c) annual contribution limit test;

    c. § 402(g) annual deferral limit;

    d. top-heavy test; and

    e. § 410(b) minimum coverage test.

For other defined contribution plans (e.g., profit-sharing, money purchase), ask if the TPA will perform end-of-year testing and provide the employer with a copy of the test results for the following tests: § 415(c), top-heavy, and § 410(b) coverage test.

For certain welfare plans, such as § 125 (cafeteria) plans and self-insured health plans, ask if the TPA will perform annual nondiscrimination testing and provide the employer with a copy of the test results.

5. Ask if the TPA will provide the employer with forms that will be needed for various plan events / transactions and ask if the employer must use the TPA's forms or if the employer may use its own custom designed forms, if desired.

6. Ask the TPA how the employer is to transmit monthly contribution information to the TPA, i.e., by the employer's submission of a monthly employee census showing all employees participating in the plan and the amount of employee and employer contributions. Must the employer identify highly compensated employees on this census? Ask if the employer can see a sample of the employee census information that must be submitted. Ask how the census information must be submitted. Must it be submitted on diskette or by electronic mail and in what format is the information to be presented? Ask by what date after the end of the payroll period (or month) the employer must furnish employee census information to the TPA.

   The employer should confirm how to properly identify highly compensated employees and how to calculate compensation for the purposes for which such information will be used by the TPA.

7. Ask how often the TPA will permit the employer to add new participants. Is there an additional charge for entry dates more frequent than quarterly, for example?

8. Ask the TPA how plan distribution requests are handled. Will the employer be responsible for giving employees distribution request forms and assisting them in filling out the forms? Must the employer sign off on the distribution request form before the TPA will process the form? What is the expected turnaround time by which the employee should receive the distribution requested from the date of submission of the request form to the TPA?

   If the employer is responsible for approving plan distributions, the employer should confirm the situations in which plan distributions are permitted under the terms of the plan and applicable statutory and regulatory requirements.

9. Will the TPA provide an annual or more frequent report to the employer of all distributions made from the plan, indicating the plan participant and the type and amount of distribution made?

10. Will the TPA provide an annual or more frequent report to the employer of all loan balances held by the plan?

11. Ask the TPA for a copy of its standard loan procedures. Ask if the employer may make changes to the loan procedures to customize the procedures for its employees. If so, is there an additional charge for the TPA to administer customized loan procedures? (Confirm if employees can renegotiate plan loans to take out a new loan while prior loan principal is still outstanding; determine if a loan payoff is required before a plan distribution can occur.)

12. Ask the TPA for a copy of its procedures regarding qualified domestic relations orders (QDROs) and qualified medical child support orders (QMCSOs). Ask if the employer may make changes to the procedures to customize the procedures for its employees. If so, is there an additional charge for the TPA to administer customized procedures?

13. Ask whether the TPA permits any telephonic distribution requests. If so, does the TPA subsequently request paper authorization of these requests by employees and their spouses? If not, does the TPA send confirmations of these requests to employees and their spouses? Ask to see samples of any documentation sent to employees and their spouses regarding distribution requests.

14. Ask for sample copies of notices that will be sent to participants regarding plan administration changes, investment information, and any other employee notices.

15. Ask if the TPA will prepare the Form 5500 and what information is needed from the employer for the filing. Ask if there is an extra charge for the TPA to prepare the Form 5500 and/or to make any changes to the Form 5500 requested by the employer.

    If the TPA will prepare the Form 5500, the employer should confirm the type of information for which it is responsible for providing to the TPA. For example, the employer is usually responsible for providing the total number of employees and the total number of employees eligible to participate in the plan during the plan year.

16. Ask if the TPA is bonded and ask for proof that the TPA is covered by an errors and omissions insurance policy.

C. Third Party Administrator as Plan Fiduciary.

    1. *Background*.

On an increasing basis, TPAs are finding that the services they provide may classify them as fiduciaries with respect to pension and welfare benefit plans. As fiduciaries, TPAs could be held personally liable by plan participants, beneficiaries, fiduciaries and the DOL for any breaches of fiduciary duty under ERISA. This section provides an overview of circumstances in which TPAs may be considered to be fiduciaries of the pension and welfare benefit plans they administer and references the view of these relationships held by the courts and the Department of Labor (DOL).

a. Services Limited to Administrative Functions.

In general, TPAs who perform only administrative functions for an employee benefit plan are not considered to be plan fiduciaries. A TPA may be determined to be a fiduciary, however, if he or she exercises any discretionary authority or control in administering the plan. *See* ERISA § 3(21). The TPA's status as a fiduciary will depend upon the facts and circumstances surrounding the TPA's activities.

b. Contractual Limitation on Services.

As protection against personal fiduciary liability under ERISA, TPAs have historically relied upon statements in their service agreements that they will be providing only non-fiduciary, ministerial duties with respect to the employee benefit plan. However, courts are looking beyond the service contracts and making determinations regarding fiduciary status based upon the facts and circumstances of each case. The DOL is taking an active role in filing amicus curiae briefs with the courts in support of the independent review of the TPA's fiduciary status. The courts and the DOL find support for an independent determination of a TPA's fiduciary status in ERISA itself. A TPA who is determined to be a plan fiduciary cannot contractually waive his or her fiduciary responsibility under Title I of ERISA. With certain statutory exceptions, any contractual provision that purports to relieve a plan fiduciary from fiduciary responsibilities or liabilities is void as against public policy under ERISA § 410(a).

2. *Review of Fiduciary Status*.

Under the functional test used by courts for determining fiduciary status, a TPA who is actually making plan decisions will often be

determined to be a plan fiduciary. DOL officials have publicly stated that, if an employer indicates that the TPA is making plan decisions and the employer's only involvement is to send the TPA a regular payment, the DOL would have a strong case that the TPA is actually a plan fiduciary, even though the terms of the service agreement between the TPA and the employer may provide that final decision-making authority rests with or is reserved for the plan sponsor.

3. *Case Findings*.

As exemplified by the cases described below, courts are reviewing the facts and circumstances regarding the services provided by a TPA to determine if the TPA is a plan fiduciary. If the TPA is determined to be exercising discretionary authority or discretionary control with respect to an employee benefit plan or plan assets, the courts are generally finding that the TPA is a plan fiduciary under ERISA. As the United States Supreme Court has stated, professional service providers "become liable for damages when they cross the line from adviser to fiduciary." *Mertens v. Hewitt Associates*, 508 U.S. 248 (1993).

a. IT Corporation

In *IT Corporation v. General American Life Insurance Co.*, 107 F.3d 1415 (9th Cir. 1997), *cert. denied,* 118 S.Ct. 738 (1998), the United States Court of Appeals for the Ninth Circuit determined that a TPA was a fiduciary of a health benefits plan. Under its service agreement with the plan sponsor, the TPA was to pay all claims that it determined were covered under the plan. Any contested or doubtful claims were to be referred back to the plan sponsor for a determination of liability and instruction. The Ninth Circuit found that the TPA exercised discretionary authority because it had to interpret the plan to determine whether a benefits claim ought to be paid or referred back to the plan sponsor.

The Ninth Circuit opinion indicated that the TPA could have structured the agreement to provide for a non-fiduciary relationship with the plan, by agreeing to only perform "cut and dried things" under the plan sponsor's direction. However, because the TPA did not use a procedural framework in which the TPA just matched claims to a schedule of illnesses and medical treatments with a dollar limit and referred all others back to the plan sponsor, the

court found that the TPA's decisions about benefit claims involved plan interpretation and judgment.

The TPA's ability to write checks to be drawn against plan funds was also determined to be "authority or control respecting management or disposition of its assets." The Ninth Circuit stated that "any control over disposition of plan money makes the person who has the control a fiduciary," as a matter of law. The Ninth Circuit reached this conclusion because the TPA had fiduciary functions to perform under its contract, even though the contract between the plan sponsor and the TPA stipulated that the TPA was not a plan fiduciary, acted only as an agent of the plan sponsor, and had limited liability in the event of error or misjudgment.

b. Klosterman

In prior case law, the courts did not so narrowly define the type of procedural framework a TPA could use to process benefit claims when it is performing only ministerial functions. In a case involving a claims adjudication process similar to that in *IT Corporation*, the Seventh Circuit determined that the TPA was not a plan fiduciary. In *Klosterman v. Western General Management, Inc.*, 32 F.3d 1119 (7th Cir. 1994), the TPA for a health plan developed a computer program based on the parameters of the partially self-funded health benefit plan. The computer program assisted the TPA in making initial claims and coverage determinations. The TPA also referred to other documents, not provided by the plan sponsor, when making those initial determinations. The terms of the service agreement between the TPA and plan sponsor provided that the TPA was to process claims "in accordance with the claims procedures and standards established by [the plan sponsor]."

The Seventh Circuit found that these activities did not demonstrate discretionary authority. The plan sponsor retained the authority to make the ultimate decisions in all doubtful or contested claims. Even though the TPA developed the computer program that formed the basis for determining eligibility, the Seventh Circuit concluded that the program was based upon the "framework of rules (i.e., the plan) established by the employer;" therefore, it was determined that the TPA was not a plan fiduciary, because it performed only ministerial functions.

It is questionable whether this same conclusion would be reached, if considered today. Based upon the expanding definition of fiduciary in subsequent case law and the DOL's support of the expanded definition, a court could find that a TPA similar to the one in *Klosterman*, in developing its computer program for claims adjudication, necessarily would have interpreted specific plan provisions. These interpretations of plan provisions would be similar to those made by the TPA in *IT Corporation* to determine whether a benefits claim ought to be paid or referred to the plan sponsor, which the Ninth Circuit found to be an exercise of discretionary authority.

c. Six Clinics Holding Corporation.

The Sixth Circuit, in *Six Clinics Holding Corporation, II v. Cafcomp Systems, Inc.*, 119 F.3d 393 (6th Cir. 1997), found that the authority of the TPA as set forth under its Administrative Services Agreement was sufficient to establish the TPA as fiduciary of a cafeteria plan. Under the service agreement, the TPA agreed to provide: (1) legal documentation, including updates and amendments "as [the TPA] deemed necessary;" (2) preparation of annual reports "as required in the judgment of [the TPA];" and (3) transmittals of summary plan descriptions "as required in the judgment of [the TPA]." The agreement also provided that the TPA had the authority to amend the plan. Further, the TPA's promotional material indicated that it assumed the role of a fiduciary by stating that it "contractually assumes the cost of maintaining the . . . Plan Document. As [the TPA] deems it to be necessary, the Plan Document will be amended, re-stated or re-drafted to assure compliance." There was no indication that the TPA would have to obtain the approval of the plan sponsor for any amendments to the plan.

Because the TPA appeared to have discretionary authority with regard to the preparation of legal documentation regarding the plan, including plan amendments, annual reports, and summary plan descriptions, the Sixth Circuit determined that the TPA acted as a fiduciary with respect to the plan. In view of the peculiar factual circumstances of this case in which the TPA contractually assumed discretion over a series of non-fiduciary functions, it appears that this holding will have limited applicability in broader contexts.

d. Joseph F. Cunningham Pension Plan.

In contrast, even in a circumstance where the TPA was the named plan fiduciary, the Fourth Circuit looked to the facts and circumstances of the activity at issue to determine whether such activity was within the scope of the TPA's fiduciary duties and, thus, subjected the TPA to liability for a fiduciary breach under ERISA. In *Joseph F. Cunningham Pension Plan v. Mathieu*, 1998 WL 403324 (4th Cir. 1998), the employer sought recovery of its costs for defending a participant's claim for benefits that arose as a result of the TPA's alleged miscalculation of the amount of the participant's benefits. The Fourth Circuit found that the TPA was not liable as a fiduciary in regard to the TPA's calculation of the participant's benefits.

In reaching its conclusion, the Court stated that, under ERISA, "a party is a fiduciary only as to the activities which bring that person within the definition of fiduciary." Therefore, calculation of benefits is not a fiduciary duty within the meaning of the definition of fiduciary under ERISA § 3(21)(A). Because the calculation of benefits is not a fiduciary duty, the Fourth Circuit determined that the TPA was not acting as a fiduciary in calculating the participant's benefits. Therefore, the TPA could not have breached a fiduciary duty to the plan in calculating the participant's benefits. For this reason, the Fourth Circuit concluded that, without a breach of fiduciary duty, there can be no liability for fiduciary breach under ERISA § 409, and thus, the TPA is not liable for the costs of the litigation.

Comment: It is not likely that all courts will follow this analysis and seek to differentiate between administrative and fiduciary actions taken by a TPA who is determined to be a plan fiduciary. It appears that the Fourth Circuit stretched to reach this conclusion because the plan itself incurred no actual loss as a result of the actions of the TPA. The significance of this case, however, is that, in determining the TPA's liability for its actions, the court looked beyond the named status of the TPA and analyzed the nature of the activity engaged in by the TPA.

e. CSA 401(k) Plan.

The Ninth Circuit found, in *CSA 401(k) Plan v. Pension Professionals, Inc.*, 195 F.3d 1135 (9th Cir. 1999), that a TPA was not acting as a "functional fiduciary," even when the TPA took actions to encourage the named plan fiduciary to repay embezzled assets to the plan.

When the TPA discovered that the chief executive officer (CEO) of the employer / plan sponsor was embezzling § 401(k) plan assets, the TPA agreed to continue providing its services for the employer on the conditions that: (1) the CEO adhere to a repayment schedule that he proposed in a letter to the TPA, and (2) the TPA would include language in participant account statements indicating that 401(k) assets had not been deposited in the plan's trust account, in violation of IRS and DOL requirements. The Ninth Circuit determined that the TPA did not become a plan fiduciary by imposing conditions regarding the repayment of plan assets as a condition of its continued agreement to provide administrative services because "the conditions that [the TPA] proposed were designed to assert control over its own engagement, and not to exercise discretionary authority or control over the Plan's management or administration." If the court had found the TPA to be a plan fiduciary, the TPA could have been held liable as co-fiduciary for the losses the plan suffered by virtue of the named fiduciary's embezzlement pursuant to ERISA § 405(a).

Because the TPA was a non-fiduciary, the Ninth Circuit further held that the TPA did not have a duty to warn the plan participants of the missing plan assets. The court found that only a plan fiduciary had a duty to protect the plan participants and beneficiaries. The Ninth Circuit also based its conclusion on the fact that the TPA's service agreement contained no provision for communication between the TPA and plan participants and required that all statements that the TPA prepared must be reviewed by the employer / plan sponsor before distribution to plan participants. Because the TPA did not have the authority to notify the plan participants directly and the TPA fulfilled its contractual responsibilities by insisting on the disclosure notice in the plan account statements, the Ninth Circuit determined that the TPA, as a non-fiduciary, had no further duty to warn the plan participants.

4. *DOL Enforcement Actions*.

In enforcement actions regarding the pass-through to ERISA plan participants of discounts received from health care providers, the DOL has taken the position that providers of services under "administrative-services-only" (ASO) contracts for health plans have become plan fiduciaries through their functional behavior. For example, the DOL contended that Blue Cross and Blue Shield of Massachusetts (BCBSMA) had become a fiduciary of the health plans it serviced under its ASO contracts because BCBSMA exercised discretion with respect to various plan provisions to a degree that met the definition of fiduciary under ERISA. *Herman v. Blue Cross and Blue Shield of Massachusetts, Inc.*, No. 95-12522 (D. Mass., Jan. 30, 1998). Under the series of DOL and participant-initiated case law regarding the pass-through of provider discounts, TPAs of health plans have been found to exercise discretion regarding the plan when the TPA decides whether to pay benefits on health plan claims without the benefit of a specific framework of claim procedures provided by the employer and/or final authorization of the payment or denial of the claim by the employer.

In contrast, it is to be noted that the DOL has ruled that an entity (such as the insurance company undertaking the demutualization) would not be exercising discretionary authority or control over the management of a plan or its assets solely as a result of providing information to its policyholders or clients for whom it provides recordkeeping or other administrative services regarding the actions that are administratively feasible for the policyholder or client to implement in connection with corporate and state laws that require action to be taken by the policyholder for the plan. Therefore, as long as the appropriate plan fiduciary makes the decision as to which of the feasible actions should be implemented, the third party implementing the decision (e.g., the insurance company) would not become a plan fiduciary. DOL Advisory Opinion 2001-02A.

5. *Contractual Provisions Sought by Employers*.

In view of the many open issues regarding the status of a TPA with respect to the employee benefit plan that the TPA is servicing, the knowledgeable employer will often attempt to reach an agreement as to the TPA's responsibilities when negotiating the service agreement. When contracting with a TPA for plan administrative services, the employer may request the TPA to acknowledge that the TPA is a plan fiduciary in the service agreement. In the alternative, the employer may seek the TPA's contractual agreement to provide that the TPA will meet a higher "standard of care" than the

"ordinary prudence standard" used in most business relationships. The employer will also seek the TPA's agreement to indemnify the employer against third party claims based on the negligence, rather than gross negligence, of the TPA in its performance of services. The TPA, in turn, will often seek indemnification from the employer for actions taken by the employer regarding the plan.

6. *Consequences for TPAs*.

Despite the expanding definition of an ERISA fiduciary under current case law, it is possible for a TPA to perform administrative functions for an employee benefit plan without becoming a plan fiduciary. To protect themselves from classification as fiduciaries, TPAs must ensure that, in performing services for the plan, they do not interpret plan provisions or make discretionary decisions regarding plan assets, including the payment of plan benefits. TPAs should be careful that they do not inadvertently cross over the line from adviser to fiduciary by allowing the employer to defer to or rely on the TPA to make decisions regarding the plan. A TPA may fill the role of adviser to the employee benefit plan client only to the extent that the TPA explains and presents options available to the client. In order to avoid classification as a fiduciary, the TPA must rely on the client to make final decisions regarding the plan, the plan's assets and benefits paid under the plan.

The best defense that a TPA has against any fiduciary breach claim are the measures that the TPA has taken on a regular basis to closely monitor its own actions and contemporaneously document its files to explain any actions taken by the TPA that are outside its normal course of business with respect to the plan. For example, if a TPA receives payroll information from the employer on a piecemeal basis during one month, and, as a result, the TPA decides to hold employee deferrals and employer matching contributions in a suspense account until all payroll information is received, the TPA should contemporaneously advise the plan fiduciaries, in a written communication, of the delay, the employer's failure to timely provide payroll information to the TPA, and the TPA's recommended action to hold such amounts in a suspense account for a specified period. The TPA should retain a copy of this written communication in its own files. Without such communication to the plan fiduciaries, the DOL could view the TPA's decision to hold the plan assets in a suspense account for a short time as an exercise of authority or control over the plan's assets and, accordingly, could determine that the TPA is a plan fiduciary.

A TPA should make sure that it has its own adequate errors and omissions insurance coverage at all times in the event that a fiduciary breach claim is brought against the TPA. The fidelity bond and fiduciary insurance held by the employee benefit plan generally is not written to cover a TPA and should not be relied upon by the TPA for its own insurance coverage.

Furthermore, a service agreement should be used by a TPA to define its relationship with the employee benefit plan client. It is important to review the service agreement to be sure that it describes the actual services that the TPA provides to the plan. The service agreement should clearly specify the responsibilities of the TPA and of the employer. The service agreement should not include any provisions that indicate that the TPA will exercise its own judgment or discretion with respect to plan functions. Further, the agreement should contain appropriate disclaimers of any fiduciary status and power with respect to the TPA.

Although outside the scope of this discussion, it is important to note that the TPA may be found liable under state law negligence or malpractice provisions. Such state law claims can be successful even though the TPA is not determined to be a fiduciary under ERISA. Generally, the issue in the state law claims is whether the TPA fell below the applicable standard of care in providing its services. Another common issue in such cases is whether the employer was contributorily negligent to such extent that it is liable in whole or in part for any damages incurred by the plan or the employer / plan sponsor. *See, e.g.*, *Steiner Corp. v. Johnson & Higgins of California*, 23 EBC 2979 (Utah 2000).

Overall, a TPA should keep in mind that it will be treated as a plan fiduciary under ERISA if it makes any discretionary decisions regarding a plan, the plan's assets or plan benefits. If a TPA is unable to restrict client services to purely administrative functions, the TPA should perhaps adopt the advice informally given by a DOL official: accept the fact that the TPA has become a fiduciary under ERISA and act accordingly.

