FIDUCIARY LIABILITY INSURANCE, BONDING, AND SERVICE AGREEMENTS FOR SPONSORS

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I. <u>Who is a Fiduciary Under ERISA?</u>

A. <u>General Definition</u>. A fiduciary under ERISA is any person who:

1. Exercises discretionary authority or control over the plan's management;

2. Exercises *any* authority or control over the management or disposition of the plan's assets;

3. Renders investment advice for a fee or other compensation with respect to plan funds or property; or

4. Has discretionary authority or responsibility with respect to plan administration.

B. <u>Investment Advice.</u> A person renders investment advice to a plan within the meaning of the general definition only if his activities are described by both of the following requirements:

1. The advice relates to the value of securities or other property or constitutes a recommendation as to the advisability of investing in, purchasing, or selling securities or other property; and

a. Either

(i) The person has discretionary authority or control with respect to purchasing or selling securities or other property of the plan, or

(ii) The person renders advice to the plan on a regular basis under an agreement or understanding (written or otherwise) that it will be a primary basis for investment decisions, and that it will consist of individualized investment advice to the plan based on its particular needs.

2. A recommendation with regard to a plan service provider probably does not constitute investment advice, because it does not relate to the plan's purchase of securities or property. Similarly, if there is no discretionary control over investments, general advice relating to investment strategy, such as the asset classes that are consistent with long-term investing, does

not fall within the definition of investment advice, because it is not geared to the particular needs of a plan.

3. Compensation. To make a person rendering investment advice a fiduciary, he or she must be compensated for the advice. The compensation may take the form of a fee or some other form of direct of indirect compensation. The receipt of a commission may be sufficient for this purpose, even though no payment has been specifically allocated to the provision of investment advice. Indirect forms of compensation, such as soft-dollar arrangements and revenue sharing, pursuant to which an advisor receives something of value from an investment provider would be taken into account for purposes of determining fiduciary status.

C. Functional Test. The test for determining fiduciary status is a functional one. In other words, if a person or entity acts or possesses powers, as described in I.A, above, the person or entity will be deemed to be a fiduciary regardless of his title or official designation. Thus, if a person actually renders investment advice, as described above, for which he is compensated, he or she will be treated as a fiduciary.

D. Effect on RIAs and Brokers. Most RIAs can be described under either I.A.2 or I.A.3. Broker-dealers that only engage in traditional broker-dealer activities are generally not fiduciaries, but their activities can cause them to cross the line. For example, in the recent case of *Ellis v. Rycenga Homes, Inc.,* No. 1:04-cv-694, 2007 WL 837224 (W.D. Mich. 2007), periodic meetings between a broker and a plan trustee to review plan investments over the course of a 20 year relationship that were the plan's only source of investment advice and that resulted in the plan's consistently following the broker's suggestions led to the court's holding that the broker and its broker-dealer were fiduciaries.

II. Fiduciary Responsibilities

A. Basic Fiduciary Duty. The basic duty of a fiduciary under ERISA is to discharge his or her duties solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits for the participants and their beneficiaries (and defraying reasonable administrative costs of the plan). These responsibilities will be imposed equally on all co-fiduciaries, unless the duties have been properly divided or delegated among the co-fiduciaries. As to the responsibilities of co-fiduciaries, see Item III.B, below.

1. Fiduciary Duties Relating to Plan Investments. Affirmative fiduciary duties include such responsibilities as selecting proper investments and monitoring them to ensure that they yield a reasonable return, properly diversifying investments, and seeing to it that the plan has sufficient liquidity.

2. Managing the Plan and Selecting Vendors and Advisers. Additional fiduciary duties involve managing the administrative aspects of the plan,

including the selection of consultants and investment advisers. See Section IV, below, for questions that may be asked during the selection process in order to minimize exposure to liability for fiduciary breach.

B. Standard of Care under ERISA. A fiduciary is subject to the "prudent expert" standard of care; that is, he or she must act "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. Investment Advisers Act Standard. Under the Investment Advisers Act, an investment adviser (generally, a person who exercises discretion with respect to an account) has a fiduciary duty to provide only suitable investment advice and to disclose all conflicts of interest. An investment adviser is also obligated to obtain the client's consent before selling stocks or other securities from the firm's inventory.

1. Merrill Lynch Rule. The Investment Advisers Act provides an exemption from the definition of an investment advisor who would otherwise be subject to the Investment Advisers Act standard, for "any broker or dealer (1) whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and (2) who receives no special compensation therefore." In 2005, the SEC adopted the so-called Merrill Lynch rule that revised the obligations of broker dealers in two respects. First, it characterized discretionary brokerage as well as comprehensive financial planning services performed by brokers as investment advice subject to the Investment Advisers Act. Second, it would have exempted broker-dealers from the Investment Advisers Act standard, even if they received fixed or asset-based fees rather than a traditional brokerage commission, as long as any advice rendered was solely incidental to brokerage services and the customer received certain standardized disclosure. This overturned the historical approach to distinguishing between investment advisory services and brokerage services based on the nature of the compensation received.

2. Merrill Lynch Rule Overturned. In *Financial Planning Association v. SEC,* decided by the United States Court of Appeals for the District of Columbia Circuit on March 30, 2007, the SEC exemption for broker-dealers was overturned on the ground that the SEC's general exemptive authority was not sufficient to override the basic conditions of the statutory exemption which, as noted above, prohibits the receipt of compensation other than traditional commissions. One result of this case may be that the trend toward dual registration as both an investment advisor and as a broker will accelerate.

D. <u>NASD Standard.</u> Under NASD Rule 2310, brokers are subject to a "suitability" standard that requires them to have reasonable grounds for a recommendation to purchase, sell or exchange a security based on its suitability for the customer. Suitability is to be determined on the basis of the facts disclosed by the customer as to its financial situation and needs as well as the broker's reasonable efforts to obtain information concerning the customer's financial and tax status and its investment objectives and other relevant information. This standard does not impose a fiduciary duty to provide nonconflicted advice, and thus represents a lower standard of care than the standard that applies to investment advisers. However, even under the SEC' Merrill-Lynch rule, discussed above, discretionary accounts, where the broker may make trades without client permission, are subject to the Investment Advisers Act standard, not the NASD standard. In light of the reasoning in the *Financial Planning Association* decision, it is doubtful that there will be any change with respect to the standards applicable to discretionary accounts.

III. <u>Fiduciary Liability</u>.

A. <u>Breach of Fiduciary Duty</u>. ERISA permits a civil action to be brought by a participant or beneficiary against a fiduciary who has breached his or her duty. The fiduciary will be held <u>personally liable</u> for any losses to the plan resulting from his or her breach. Any profits obtained by the fiduciary through the use of plan assets must be turned over to the plan.

A fiduciary, however, cannot be held liable for a breach of fiduciary duty that was committed prior to his or her becoming a fiduciary. Although the fiduciary may not be liable for the original breach (e.g., high hidden administrative costs), if he or she knows or should know about the breach, he or she should take steps to remedy the situation. Failure to do so might constitute a subsequent independent breach of fiduciary duty by the successor fiduciary.

B. <u>Liability for Actions of Co-Fiduciaries</u>. In addition to liability for actions caused directly by a fiduciary, in certain circumstances ERISA imposes liability for breaches of duty by co-fiduciaries. Thus, a plan fiduciary will be liable for a breach of fiduciary responsibility by another fiduciary if -

1. He participates knowingly in or knowingly undertakes to conceal, an act or omission of the other fiduciary, knowing that such act or omission is a breach;

2. He has enabled the other fiduciary to commit a breach by his failure to comply with fiduciary rules as they apply to his own specific responsibilities; or

3 He has knowledge of a breach by the other fiduciary, unless he makes reasonable efforts to remedy the breach.

IV. <u>DOL and SEC Issue Guidance with Respect to Pension Consultants and Potential Conflicts of Interests</u>. The DOL has published "tips" to help plan fiduciaries determine if pension consultants have conflicts of interest when it comes to advising the plan. The tips provide the following questions that plan fiduciaries should ask to assist them in evaluating the objectivity of the recommendations provided, or to be provided, by a pension consultant. Plan consultants should be prepared to answer these questions forthrightly.

A. Are you registered with the SEC or a state securities regulator as an investment adviser? If so, have you provided me with all the disclosures required under those laws?

B. Do you or a related company have relationships with money managers that you recommend, consider for recommendation, or otherwise mention to the plan for our consideration? If so, describe those relationships?

C. Do you or a related company receive any payments from money managers you recommend, consider for recommendation, or otherwise mention to the plan for our consideration? If so, what is the extent of these payments in relation to your income (revenue)?

D. Do you have any policies or procedures to address conflicts of interest or to prevent these payments or relationships from being considered when you provide advice to your clients?

E. If you allow plans to pay your consulting fees using the plan's brokerage commissions, do you monitor the amount of commissions paid and alert plans when consulting fees have been paid in full? If not, how can a plan make sure it does not overpay for its consulting fees?

F. If you allow plans to pay your consulting fees using the plan's brokerage commissions, what steps do you take to ensure that the plan receives the best execution for its securities trades?

G. Do you have any arrangements with brokers-dealers under which you or a related company will benefit if money managers place trades for their clients with such broker-dealers?

H. If you are hired, will you acknowledge in writing that you have a fiduciary obligation as an investment adviser to the plan while providing the consulting services we are seeking?

I. Do you consider yourself a fiduciary under ERISA with respect to the recommendations you provide the plan?

J. What percentage of your plan clients utilize money managers, investment funds, brokerage services, or other service providers from whom you receive fees?

V. Best Practices.

The DOL has made it clear that in enforcing ERISA it will not judge fiduciaries on the results they achieve, but on the processes they follow. Such processes should not be static but should change with the times. For example, processes that were appropriate in the 1990s would not necessarily be appropriate in 2007 because fiduciaries are being held to increasingly greater expectations. So, as standards for fiduciaries evolve, fiduciaries should take the steps to withstand a challenge from the DOL. Such steps include the following:

A. Prepare a written investment policy statement. ERISA requires an investment policy. While not required to be in writing, it is easier to demonstrate compliance with the policy statement if it is in writing. An investment policy statement should include clear standards for choosing investments, how they will be monitored and what triggers must occur to place an investment manager on a watch list. The roles of interested parties should also be clearly stated. The policy should contain enough detail so that the DOL (or a plaintiff's counsel) can clearly understand how or why an investment decision was made. The investment policy should be reviewed annually and modified as necessary.

B. Document Reviews of Investment Vehicles. Fiduciaries should document their reviews of investment vehicles, including associated or hidden fees. (See Item VII, below.) Such documentation should address key questions and discuss how decisions were made. The ability to provide documentation demonstrates a thoughtful process and alleviates the need to rely on memory.

C. Continuous Monitoring. Continuous monitoring should be the standard for all plans, and when appropriate, quarterly reporting for all but the smallest plans. Monitoring should directly reference back to the plan's investment policy. Monitoring should also include a broad range of qualitative and quantitative metrics for each fund and/or manager. Fiduciaries should understand what the analysis means for the plan and the participants (*e.g.*, what are the fees? are they reasonable with respect to the services being provided?)

D. Utilize an Independent Third Party Investment Expert. Vendors often furnish reports or make recommendations with respect to selecting an investment option, placing funds on watch or replacing funds. However, there is an inherent conflict of interest when vendors report on proprietary funds or sub-advised funds. As a result, fiduciaries should consider using the advice of an independent third party investment expert in these situations.

E. Certain Situations Call for Decision Making by an Independent Fiduciary. When a vendor is a fiduciary, there is a potential conflict of interest where long-term business relationships and revenue agreements of the vendor may compromise the integrity of the decision making process with respect to the selection of investment options. Such conflicts may exist regardless of whether the investments under consideration involve proprietary or nonproprietary funds. In such situations, vendors with an interest in the outcome of a decision should exclude themselves from the decision making process, and the choice should be made by an independent fiduciary that has been furnished with all the relevant facts.

F. Replace Funds that Do Not Meet Investment Criteria. Many fiduciaries are reluctant to make decisions to replace poorly performing funds, and as a result, often add funds. This could demonstrate an unwillingness on the fiduciary's part to perform his or her duties as required under ERISA.

G. Expense ratios/fees. An investment's expense ratio or manager's fees should not be above the median of its peer group (exceptions may be made for funds or managers with superior performance).

H. Conduct Fiduciary Audit. When appropriate, the fiduciary should hire an independent third party to conduct a fiduciary audit. A fiduciary audit should be conducted when vendors fail to adequately disclose fees or fees do not seem reasonable.

VI. Plan Fees. Determining the fees of plan investment vehicles and evaluating whether they are reasonable is an important part of an employer's procedural and substantive due diligence if it is to meet its fiduciary responsibilities.

A. Participant Directed Accounts. Under ERISA Section 404(c), if a plan provides for individual accounts and permits a participant to exercise control of the assets in his or her account, then the plan's fiduciaries will not be liable for any loss by reason of any breach resulting from the participant's exercise of control. However, fiduciaries still retain significant responsibility with respect to the investments offered under a participant directed account plan. The fiduciary has an obligation to prudently select investment vehicles available under such a plan and to periodically evaluate such vehicles to determine if they should continue to be offered under the plan.

B. Questions Plan Fiduciaries Should Ask A Consultant, Invest Advisor and/or Broker.

1. With Respect to Soft Dollars. Soft dollars consist of extra commission that a brokerage firm may charge that can be used to purchase additional services, such as investment research. Using soft dollars for purposes other than the exclusive benefit of participants and beneficiaries or payment of the operational costs of the plan is a fiduciary breach

a. Do you receive 28(e) soft dollars from mutual funds within our plan?

b. If yes, what exact benefits do you/have you received?

c. Exactly how many 28(e) soft dollars are attributed to our plan?

2. With Respect to Sub-transfer Agent Fees. Brokerage firms and mutual funds often sub-contract the accounting of participant shares to a third party called a sub-transfer agent. Payments to these third parties are sub-transfer agent fees. The problem is not with whom is receiving the fee, but whether the fee fairly represents the value of the services being rendered.

    a. Do you or any other entity receive sub-transfer agent fees?

    b. If yes, are these fees offset directly against stated costs as described in a service agreement?

    c. Do invoices reflect the offset against what otherwise would be fees paid directly by the employer or plan via invoice?

3. With Respect to 12(b)-1 Fees. 12(b)-1 fees are charges against mutual fund accounts for advertising and promoting the mutual fund and/or paying commissions to brokers. Mutual funds may increase their internal expense ratio by up to 1% in the aggregate (*e.g.*, 0.5% for sales and 0.5% for servicing). Fiduciary audits have revealed that some plan sponsors that have invested in mutual funds with high 12(b)-1 fees could have invested in a similar mutual fund without paying any 12(b)-1 fee or a lower 12(b)-1 fee.

    a. Are you acting under a suitability or a fiduciary standard (*i.e.*, are you a non-fiduciary registered representative or are you a fiduciary registered investment advisor?)

    b. If you are a registered representative, are you receiving 12(b)-1 fees?

    c. If yes, what is the annual value of the 12(b)-1 gross revenue you receive? You should obtain this information in writing, and compare it with the information originally presented to you.

    d. Can our same funds be purchased for a different share class with a lower 12(b)-1 fee?

    e. Were our assets placed in this particular share class for a reason?

    f. If yes, please explain. Was it because this share class paid higher 12(b)-1 fees?

g. If yes, could this be reasonably argued as constituting a breach of fiduciary duty for failing to properly investigate and pay only those fees that were appropriate and reasonable?

C. <u>DOL on Disclosure of Fees</u>.

1. <u>Form 5500 Reporting</u>.

a. <u>Current Rule.</u> Fees and expenses paid by the plan must be disclosed on the Form 5500 using either the Schedule A which is used to report commissions or related fees paid to insurance companies or the Schedule C which is used to report fees paid to service providers. Service providers, such as insurance companies, have traditionally narrowly interpreted their duty to disclose. For example, investment management fees, soft dollars and internal fund expenses are not disclosed on either Schedule A or C of the Form 5500. There is little reporting of hidden fees.

b. <u>Proposal</u>. In July of 2006, the Department of Labor proposed changes to Schedule C that would require reporting of virtually all "indirect compensation," i.e., payments to plan service providers by third parties "in connection with that person's position with the plan or services rendered to the plan." This change will be effective for reporting years beginning on January 1, 2008 and will effectively place the burden of obtaining such information on the plan administrator. By itself, this change would not require the cooperation of service providers. However, such cooperation would be required if the proposal described in Item VI.C.3, below, is implemented.

2. <u>Change to Prohibited Transaction Regulations</u>. Plan service providers are parties in interest to a plan, and, as such, must satisfy the statutory and regulatory conditions for exemption from the prohibited transaction rules. Under DOL Regulation Section 2550. 408b-2(a), these conditions require that the services be "necessary," that the arrangement under which they are provided be "reasonable," and that no more than "reasonable compensation" be paid for the services. The DOL is considering a proposal to amend this regulation to make disclosure by the service provider a condition of exemption. The required disclosure would likely be designed to ensure that service providers furnish a plan fiduciary with information sufficient to allow the plan fiduciary to determine

a. Whether the plan is paying reasonable fees for services,

b. Whether the service provider's total compensation, including indirect payments from third parties, is reasonable, and

c. Whether the service provider's advice is affected by conflicts of interest.

VII. Protection of the Plan and Fiduciaries through Insurance.

A. ERISA Bond.

1. Coverage. ERISA Section 412 requires bonding for every plan fiduciary and every person that handles funds or other property of the plan. The bond must provide protection to the plan against loss by reason of acts of fraud or dishonesty on the part of fiduciaries or plan officials handling plan funds or property.

2. Amount of Bond. The bond amount must be 10% of plan assets with a minimum of $1,000 and a maximum of $500,000. Effective for plan years beginning after December 31, 2007, the maximum bond amount will increase to $1 million for plan that hold employer securities. The increased maximum applies to every person required to be bonded, even if that person does not have any duties relating to employer securities.

3. Special Rule for Registered Brokers and Dealers. Entities that are registered as a broker or a dealer under Section 15(b) of the Securities Exchange Act of 1934 will be exempt from the bonding requirement, provided that they are subject to the fidelity bond requirements of a self-regulatory organization. This rule is effective for plan years beginning after August 17, 2006, the date of enactment of the Pension Protection Act of 2006.

B. Fiduciary Liability Insurance.

1. Coverage. Pays the plan and/or insured fiduciaries for liabilities incurred as a result of a breach of fiduciary duties under ERISA, including the cost of defending claims.

2. Insureds. Generally, a trust or trustee of an employee benefit plan, the sponsoring employer, and any officer or employee of the trust, the plan, or the sponsoring employer.

3. Limitation. This type of insurance may be purchased either by the employer or by the plan. However, if the plan is the purchaser, Section 410 of ERISA requires that the policy permit recourse by the insurer against the fiduciary. This is consistent with the DOL's position that

arrangements for the indemnification of a fiduciary by the plan are void. However, the DOL allows a fiduciary to purchase, with the fiduciary's own assets, elimination of recourse coverage.

C. Professional Liability Insurance.

1. Coverage. This insurance would be sought by plan consultants and investment advisers and would cover claims for improperly administering a retirement plan as well as imprudent decisions or improper processes with respect to investment issues. It may also be referred to as errors and omissions insurance and may be part of a commercial general liability (CGL) package. The language of the policy should be read carefully to make sure that it covers the activities engaged in by the insured.

2. Exclusions. Most policies will come with an additional schedule or addendum known as an endorsement. Endorsements exclude certain types of claims from coverage. Example of such exclusions include:

   a. Claims arising out of the propriety or impropriety of compensation paid out of the plan for administrative services;

   b. Claims arising from late trading and market timing activities;

   c. Claims arising from soft dollar or revenue sharing arrangements.

3. Embedded Exclusions. Additional exclusions may be found embedded in the insurance policy, itself. These are harder to identify, but should not be ignored. For example, embedded exclusions frequently exclude commission related complaints.

4. Importance of Negotiation. Exclusions can often be modified or eliminated by negotiation, particularly if the insured has a good history with respect to a particular issue. For example, if you can demonstrate that your fees are consistent with fees charged by similar service providers, insurers will consider the elimination of the exclusion relating to claims arising out of compensation matters. Because of the rise in litigation over soft dollar and revenue sharing practices, an insurer will require detailed disclosure of your treatment of these matters before it limits or eliminates exclusionary language in this area. The assistance of a skilled broker is often vital in negotiating the terms of an exclusion.

5. Policy Limits. Attention should also be addressed to the sufficiency of dollar limits on policy coverage. A significant issue is whether the coverage of defense costs is outside the limits of the policy, since such costs can quickly exceed the policy coverage.

VIII. Contractual Limitations on Liability.

A. Limitation on Liability Provisions. These provisions require a plan and/or employer to limit damages for causes of action against a service provider to a predetermined amount, typically equal to one year's fee.

B. Indemnification of Service Providers. These provisions require the plan and/or the employer to indemnify and hold harmless a service provider from any third party claims or liability arising from or in connection with the service provider's services to the plan.

DOL Position as Stated in Advisory Opinion 2002-08A.

1. Fraud or Willful Misconduct. If the attempt to limit liability applies to fraud or willful misconduct by the service provider, it is void. In addition, a plan fiduciary's acceptance of such limitations would violate ERISA's prudence standards.

2. Negligence or Unintentional Malpractice. Limitation of liability and indemnity provisions, other than those relating to fraud or willful misconduct, are not per se imprudent under ERISA's general standards of fiduciary duty.

3. Due Diligence Procedures. Since liability limitations related to negligence or unintentional malpractice may or may not be consistent with a plan fiduciary's duties to the plan, the fiduciary should take the following steps:

a. Assess the reasonableness of the relationship as a whole. This should include a cost benefit analysis that compares the cost of service arrangements with other service providers that do not require such limits.

b. The plan fiduciary should document the assessment made in Item VIII.C.3.a, taking into account the potential risk of loss and costs to the plan that might result from a service provider's act or omission that would be subject to a limitation of liability or indemnification provision.