

PRUDENT PRACTICES FOR INVESTMENT FIDUCIARIES

Practice SA - 1.3

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

ERISA Requirements

Title I of the Employee Retirement Income Security Act of 1974 (ERISA) prohibits certain specified transactions between a plan and parties in interest. [ERISA §406(a)] A *party in interest* is a person or entity who is closely related to the plan as defined in ERISA §3(14) and includes, among others:

(A) any fiduciary (including but not limited to, any administrator, officer, trustee, or custodian), counsel, or employee of such employee benefit plan;

(B) a person providing services to such plan [ERISA §3(14)(A) and (B)]

Note: The ERISA Title I definition of a party in interest is similar to the Internal Revenue Code definition of “disqualified person” under IRC §4975. In addition to the remedies under ERISA, a disqualified person is subject to a tax on each prohibited transaction under IRC §4975.

The definition of a party in interest includes fiduciaries as well as other persons, but certain of the ERISA prohibitions are specifically directed at fiduciaries. The prohibited transactions for parties in interest are found in ERISA §406 and, in general, they cover the following transactions: engaging in sales, exchanges, or leases of property with the plan; lending money or extending credit to or from the plan; furnishing goods, services, or facilities to or from the plan; and the transfer of plan assets to, or use of plan assets by or for the benefit of, a party in interest. [ERISA § 406(a)]

In addition, ERISA §406(b) prohibits fiduciaries from engaging in acts of self-dealing:

A fiduciary with respect to a plan shall not –

(1) Deal with the assets of the plan in his own interest or for his own account;

(2) In his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, or

(3) Receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan. [ERISA §406(b)]

Practice SA - 1.3 (continued)

In one case, a court explained the rationale for these prohibited transaction rules:

In addition to the general fiduciary duties of loyalty and prudence, ERISA also regards specific types of transactions between a plan and related persons, known as “parties in interest,” as inherently susceptible to abuse. [Whitfield v. Tomasso, 682 F. Supp. 1287, 1301, 9 E.B.C. 2438 (E.D.N.Y. 1988)]

Furthermore, the court said:

In addition to the prohibitions of section 406(a), section 406(b), 29 U.S.C. §1106(b), prohibits plan fiduciaries from placing themselves in a conflict of interest situation where their loyalty to the plan may be divided. [Whitfield at 1301]

Some exemptions from the prohibitions of §406 are allowed, and exemptions come in several forms: statutory, regulatory, class, and private exemptions.

UPIA and UPMIFA Requirements

Unlike ERISA, UPIA and UPMIFA do not contain provisions that explicitly prohibit self-dealing. However, the Comments to several sections of the UPIA make it clear that the general fiduciary provisions prohibit self-dealing. Under the UPIA, as in ERISA §404(a)(1)(A), the trustee must

invest and manage the trust assets solely in the interest of beneficiaries. [UPIA §5]

According to the Comments to §5, this duty of loyalty is the most characteristic of trust law and requires the trustee (a fiduciary) to act exclusively for beneficiaries, as opposed to acting for the trustee’s own interest or that of third parties. [UPIA §5, Comments]

Similarly, the UPMIFA emphasizes donor intent. The Prefatory Note to the UPMIFA states:

UPMIFA improves the protection of donor intent with respect to expenditures from endowments. When a donor expresses intent clearly in a written gift instrument, the Act requires that the charity follow the donor’s instructions. When a donor’s intent is not so expressed, UPMIFA directs the charity to spend an amount that is prudent, consistent with the purposes of the fund, relevant economic factors, and the donor’s intent that the fund continue in perpetuity. This approach allows the charity to give effect to donor intent, protect its endowment, assure generational equity, and use the endowment to support the purposes for which the endowment was created.

Practice SA - 1.3 (continued)

The trustee's duty to abstain from self-dealing is discussed in the Comments to UPIA §2, which describes the trustee's standard of care and portfolio strategy. One of the modern investment practices described in UPIA §2(e) is the removal of restrictions on the kinds of investments the trustee may make.

A trustee may invest in any kind of property or type of investment consistent with the standards of this [Act] [UPIA §2(e)]

However, that general provision is limited by an example described in the Comments to §2 of the UPIA:

Were the trustee to invest in a second mortgage on a piece of real property owned by the trustee, the investment would be wrongful on account of the trustee's breach of the duty to abstain from self-dealing [UPIA §2, Comments]

Thus, the requirements of UPIA §§2 and 5 require the loyalty of the fiduciaries to the beneficiaries and prohibit self-dealing on the part of the trustee. Although the UPMIFA requires the protection of donor intent, it does not specifically prohibit self-dealing. However, self-dealing would appear to be inconsistent with using the endowment for the purpose it was intended for.

MPERS Requirements

MPERS requires trustees to act exclusively for the participants and beneficiaries, as opposed to acting for the fiduciaries' own interests or those of third parties.

A trustee or other fiduciary shall discharge duties with respect to a retirement system:

(1) Solely in the interest of the participants and beneficiaries; and

(2) For the exclusive purpose of providing benefits to participants and beneficiaries.... [MPERS §7(1) and (2)]

This general requirement that fiduciaries place the interests of the participants and beneficiaries above their own effectively places any self-dealing under great scrutiny and may, in effect, prohibit self-dealing. That is, it is difficult to imagine a situation in which a fiduciary engages in a transaction with a retirement system without placing its own interests equal to or ahead of the interests of the participants and beneficiaries. To avoid violations of the general fiduciary rules, fiduciaries should either avoid self-dealing or have an independent fiduciary negotiate on behalf of the retirement system.

MPERS does not contain a set of negative duties or prohibited transactions, as does ERISA §406, and according to the Comments in §7 there are several reasons for this omission: ERISA's prohibited transactions rules have necessitated a complex set of statutory exemptions and administrative waivers; the negative duties add little to the affirmative duties of MPERS; the negative duties duplicate state law protections; and MPERS requires disclosure of transactions between the retirement system and significant actors. [MPERS §7, Comments]

Practice SA - 1.3 (continued)

This last reason perhaps is the most important justification for the specific prohibition against self-dealing, for in MPERS §17(c)(12) and (13) the plan must include, in its annual disclosure of financial and actuarial status, the following details:

(12) A description of any material interest, other than the interest in the retirement program itself, held by any public employer participating in the system or any employee organization representing employees covered by the system in any material transaction with the system within the last three years or proposed to be effected;

(13) A description of any material interest held by any trustee, administrator, or employee who is a fiduciary with respect to the investment and management of assets in the system, and, if the fiduciary is an individual, by a related person of the beneficiary, in any material transaction with three system within the last three years or proposed to be effected.
[MPERS §17(c)(12) and (13)]

The requirement of the disclosure of information about self-dealing and conflicts reinforces the limitations on self-dealing between a retirement system and a fiduciary.