

PRUDENT PRACTICES FOR INVESTMENT FIDUCIARIES

Practice SA - 1.4

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

ERISA Requirements

ERISA recognizes that a fiduciary, in discharging his duties, may need to seek assistance from other persons, such as investment advisors and managers, and may delegate certain responsibilities to them.

A fiduciary ... may employ one or more persons to render advice with regard to any responsibility such fiduciary has under the plan. [ERISA §402(c)(2)]

However, when hiring advisors or purchasing goods or services, ERISA's general fiduciary rules would require that the fiduciaries take reasonable steps to protect the plan from losses and misunderstandings. Thus, 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 plan is managed in accordance with the written documents that govern the plan, and to confirm that the parties have clear, mutual understandings of their roles in conducting plan business.

Under ERISA, investment managers are required to acknowledge in writing that they are a fiduciary with respect to a plan. [ERISA §3(38)(C)] Except for investment managers, however, there is nothing explicit in ERISA requiring a written service agreement or contract. But the fiduciary standards of ERISA imply that service agreements and contracts be reviewed carefully and therefore by extension suggest that they be in writing.

A written service agreement typically would also set forth the costs for these services, and could possibly avert a breach of fiduciary duty. A service provider is a "party in interest" under ERISA since the definition of "party in interest" includes "a person providing services to such a plan." [ERISA §3(14)(B)] For example, transferring plan assets directly or indirectly to a party in interest is a prohibited transaction under ERISA, but an exemption is allowed for

... contracting or making reasonable arrangements with a party in interest for office space or legal, accounting or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefore. [ERISA §408(b)(2)]

The fiduciary must discern if the fees paid for services are reasonable, and this would be difficult if not impossible without a written service agreement to review.

Practice SA - 1.4 (continued)

A written agreement also furnishes the plan fiduciary with a document for measuring and monitoring the service provider's activities. A failure to monitor can lead to breach of fiduciary duty under the general duties of ERISA §404(a)(1). In Interpretive Bulletin 94-2, the DOL expressed its view that:

... compliance with the duty to monitor necessitates proper documentation of the activities that are subject to monitoring. [DOL Reg. §2509.94-2, Interpretive Bulletin 94-2 – Written statements of investment policy (July 29, 1994)]

In at least one court case the court explained that:

... at the very least, trustees have an obligation to (i) determine the needs of a fund's participants, (ii) review the services provided and the fees charged by a number of different providers, and (iii) select the provider whose service level, quality and fees best match the fund's needs and financial situation. [In addition,] [t]rustees also have an ongoing obligation to monitor the fees charged and services provided by service providers with whom a fund has an agreement, to ensure that renewal of such agreements is in the best interest of the fund. [Liss v. Smith, 991 F. Supp. 278, 300 (S.D.N.Y. 1998), citing Whitfield v. Tomasso, 682 F. Supp. 1287, 1304, 9 E.B.C. 2438 (E.D.N.Y. 1988)]

UPIA and UPMIFA Requirements

The duties of loyalty and prudence also are fiduciary requirements under the UPIA and the UPMIFA. The UPIA states that:

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

A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.
[UPIA §2(a)]

Section 2 of the UPIA sets out standard of care requirements that support modern investment practice, including the duty to monitor investments.

The UPMIFA also contains the duties of loyalty and prudence. Section 3(b) of the UPMIFA states:

In addition to complying with the duty of loyalty imposed by law other than this [act], each person responsible for managing and investing an institutional fund shall manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.

Practice SA - 1.4 (continued)

The UPIA and the UPMIFA also favor the modern trend toward delegating duties, including investment and management functions. Section 9 of the UPIA states:

A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in ... establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust [UPIA §9(a)(2), similar to the delegation rule under ERISA §403(a)(2)].

The UPMIFA also includes a section on the delegation of management and investment functions. It states:

Subject to any specific limitation in law other than this [act], an institution may delegate to an external agent the management and investment of an institutional fund to the extent that an institution could prudently delegate under the circumstances. An institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances ...[UPMIFA §5(a)]

[IBP] Best practices also favor reducing the terms of the delegation to a writing since it would be difficult to establish the scope and terms of the delegation without a written agreement. This also would ensure that the trustee and the service provider have clear understandings of their roles and responsibilities.

The UPIA and the UPMIFA require the trustee and the institution to be prudent with beneficiaries' money and to minimize costs.

In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee. [UPIA §7. See also, UPMIFA §3(b) and (c)]

A written agreement, therefore, would provide a mechanism for monitoring costs and the scope of services.

MPERS Requirements

In the powers authorized to the trustee in §5 of MPERS, the trustee has the exclusive authority to

obtain by [employment or] contract the services necessary to exercise the trustee's powers and perform the trustee's duties including actuarial, auditing, custodial, investment, and legal services.... [MPERS §5(a)(2)]

Thus, a contract supports the best practice of outlining roles and responsibilities of the parties involved in administering the trust.

Practice SA - 1.4 (continued)

MPERS also follows the modern investment trend of permitting prudent delegation of the plan trustee's duties, here in the retirement system setting. [MPERS §6] MPERS also imposes the general fiduciary duties of prudence and loyalty [MPERS §7], which apply when duties are being delegated:

The trustee or administrator shall exercise reasonable care, skill, and caution in ... establishing the scope and terms of the delegation, consistent with the purposes and terms of the retirement program. [MPERS §6(b)(2)]

Therefore, in all cases the fiduciaries must define the scope and terms of the engagement. And in matters of substance, where a misunderstanding or conflict could result in a material loss or cost to the plan, prudence customarily would dictate that the provisions of the engagement be reduced to a detailed written agreement between the parties.