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VER: [SC_01125-Local:17 Jul 07 16:25]**[MX-SECNDARY:** 31 May 07 19:37]**[TT-:** 07 Jun 07 18:35 loc=usa unit=00500-ch0016s] **0**

CHAPTER 16

The Impact of 401(k) Fiduciary Governance Structures on Corporate and Board Liability Risk

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§ 16.01 INTRODUCTION

The form of fiduciary governance structure is a critical component of the liability risk of both the sponsor corporation and its board of directors. While this fact is now obvious to most corporate legal counsel, what is less obvious is that fiduciary governance structures influence the fiduciary governance cultures through which decisions are made about the investment alternatives and resources that will be provided to plan participants. What is more, these resources also affect fiduciary governance cultures; and, in turn, it is the fiduciary governance culture that largely determines the ongoing shape of the fiduciary governance structure itself.

When it comes to establishing a fiduciary governance structure that fits the plan sponsor's organization and culture, lawyers, at least in their strict role as legal advisors, have a rather limited and subordinate role. More than liability risk is involved in establishing a governance structure. Technology and investment tools will continue to affect corporate fiduciary cultures, and fiduciary cultures will continue to drive the selection of fiduciary governance structures. There is no one-size-fits-all organizational structure; and certainly no solution for all time.

This chapter will review the liability implications of alternative fiduciary

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structures for corporate 401(k) plans.[1] But governance will impact the tools that are made available to participants for achieving performance and managing risk. And these tools in turn affect plan governance.

§ 16.02 THE PROCESS FOR MAKING FIDUCIARY APPOINTMENTS IS SUBJECT TO ERISA FIDUCIARY STANDARDS

ERISA fiduciaries must act solely in the interest of plan participants;[2] and the appointing and monitoring of plan fiduciaries is a fiduciary act.[3]

This duty to consider only what is best for plan participants exists even when a fiduciary has simultaneous duties of loyalty to the corporation sponsoring the plan.[4] Obviously, serving two masters is a difficult, and sometimes impossible,

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[1] Largely for the purpose of economy, the term "401(k)" will be used in this chapter without the caveat that the reference often applies to other forms of defined contribution plan.

[2] ERISA § 404(a). The central ERISA § 404(a) contains the "solely and exclusively" fiduciary standard. The section requires that a fiduciary, when acting as a plan fiduciary, must not only act "solely" in the interest of participants, but also for the "exclusive purpose" of providing benefits to plan participants and defraying the costs of administering the plan.

[3] *Ed Miniat, Inc. v. Globe Life Ins. Group, Inc.,* 805 F.2d 732, 736 (7th Cir. 1986), *cert. denied*, 482 U.S. 915 (1987) ("The power to amend a plan includes the power to appoint, retain and remove plan fiduciaries."); *accord Hickman v. Tosco Corp.*, 840 F.2d 564, 566 (8th Cir. 1988); *Leigh v. Engle*, 727 F.2d 113, 135 (7th Cir. 1984), *cert. denied*, 489 U.S. 1078 (1989); *Gelardi v. Pertec Computer Corp.*, 761 F.2d 1323, 1325 (9th Cir. 1985). *Martin v. Feilen*, 965 F.2d 660, 669–70 (8th Cir. 1992), *cert. denied*, 506 U.S. 1054 (1993); *Coyne & Delany Co. v. Selman*, 98 F.3d 1457, 1465–66 (4th Cir. 1996) ("A plan sponsor becomes a fiduciary . . .to the extent it retains or exercises any discretionary authority over the management or administration of a plan. [The sponsor] retained the power through plan amendment to appoint, retain and remove [the] plan fiduciary. This power constitutes discretionary authority over the management or administration of a plan. This authority carries with it a duty to monitor appropriately those subject to removal."); *Liss v. Smith*, 991 F. Supp. 278, 311 (S.D.N.Y. 1998) ("[t]he power to appoint and remove trustees carries with it the concomitant duty to monitor those trustees' performance."); *Mehling v. New York Life Ins. Co.*, 163 F. Supp. 2d 502, 510 (E.D. Pa. 2001). See also DOL Interpretive Bulletin 75-8 ("[M}embers of the board of directors of an employer which maintains an employee benefit plan will be fiduciaries only to the extent that they have responsibility for the functions described in section 3(21)(A) of the Act. For example, the board of directors may be responsible for the selection and retention of plan fiduciaries. In such a case, members of the board of directors exercise "discretionary authority or discretionary control respecting management of such plan" and are therefore, fiduciaries with respect to the plan. 29 C.F.R. § 2509.75-8,D-4 (1975).

[4] This article is primarily addressed to the issues of defined contribution plans where the consequences of fiduciary actions tend to have direct impact on participants rather than indirect impacts, as might be the case in a plan where investment management decisions, at least initially, only affect funding obligations on the plan sponsor.

task.[5] This difficulty, however, does not exist with respect to the establishment of the 401(k) plan itself; although it probably does extend to both any ongoing authority — written or implied — for the officers and directors of the corporation to name fiduciaries as well as the equivalent authority to modify the fiduciary governance structure in the plan document.[6]

While the naming of fiduciaries is a fiduciary function (expect possibly when the fiduciary is named irrevocably in the plan document) the establishing and modification of 401(k) plan design and benefit levels are not fiduciary functions. Although the analogy is not perfect, that function has been termed a "settlor" function, and it is not subject to ERISA's fiduciary standards.[7] "[O]nly when fulfilling certain defined functions, including the exercise of discretionary authority or control over plan management or administration," will a person be a fiduciary under ERISA.[8]

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[5] Luke 16:13 ("No servant can serve two masters").

[6] *See* fn 3 above. *See also Kayes v. Pacific Lumber*, 51 F.3d 1449, 1460 (9th Cir.), *cert. denied*, 516 U.S. 914 (1995). ([U]nder the broad scope of the ERISA fiduciary definition, corporate employees and officers who fit under section 1002(21)(A), while nevertheless acting on behalf of a corporate entity, face potential fiduciary liability in their individual capacities with no necessity of piercing the corporate veil. . . . A contrary approach would ignore "[t]he broadly based liability policy underpinning ERISA and its functional definition of 'fiduciary,' "and allow a corporation "to shield its decision-makers from personal liability" in contravention of what Congress intended in ERISA; *Musmeci v. Schwegmann Giant Super Markets*, 159 F.Supp.2d 329, 353 (E.D. La. 2001) (citing *Kayes*); *In re WorldCom, Inc. ERISA Litig.*, 263 F.Supp. 2d 263 F. Supp. 2d 745, 765 (S.D.N.Y. 2003); *In re Enron Corp. Sec. Derivative & ERISA Litig.,* 284 F. Supp. 2d 511, 553 (S.D. Tex. 2003) (defendants "could not abdicate their duties under ERISA merely through the device of giving their lieutenants primary responsibility for the day to day management of the trust. [Defendants] were obliged to operate with appropriate prudence and reasonableness in overseeing their appointees' management of the trust") (quoting *Leigh*, 727 F.2d at 134–35); see also *Enron*, 284 F. Supp. 2d at 661 (appointing fiduciaries were "charged by the plans to perform the selection, and therefore the monitoring, of the Administrative Committee with respect to its control over Plan investment and the prudence of investing in Enron stock as one of the Savings Plan's investment options").

[7] *See Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432 (1999); ERISA § 3(21)(A) ("Except as otherwise provided in subparagraph (B), a person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan. Such term includes any person designated under section 405(c)(1)(B) of this title.").

[8] *Lockheed v. Spink*, 517 U.S. 882, 890 (1996).

Prudence in appointing fiduciaries generally relates to finding, pursuant to a documented process, that the knowledge, skill and experience of the appointed fiduciary is a good fit with the fiduciary role assigned to that fiduciary. This requirement to evaluate the available information that is relevant to the naming of a fiduciary is not unique to ERISA. In fact, it generally matches the standard for the evaluation process required of directors in the exercise of their fiduciary duty to shareholders, at least where we can assume that the appointment of a named fiduciary is significant to the corporation.[9]

The formal standard for this naming process is the same standard against which all fiduciary activity is evaluated. The appointment must be made 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."[10] This is a higher standard, but the framework for the evaluation process is not totally dissimilar to the standard against which a director would be judged while wearing his or her corporate "hat".[11]

The ERISA formulation of the standard is perhaps especially relevant to the naming of a plan fiduciary because the plan sponsor must first establish the fiduciary governance structure that defines the named fiduciary's role before an evaluation of the credentials of any person or firm can be matched to the role. For example, if a board of directors names an investment fiduciary to make decisions about asset classes, and about the selection and monitoring of the specific funds corresponding to those asset classes, then the objective prudence of this appointment will be measured against the set of skills, knowledge, and experience that a prudent board, familiar with the process of appointing persons to manage and control plan investments, would have obtained for a plan of like character and like aims.

The selection standards may be very different if the named fiduciary is not expected to be the investment manager; but rather, to have authority to select,

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[9] *See Smith v. Van Gorkom*, 488 A.2d 858, 893 (Del. 1985) (the Delaware Supreme Court found gross negligence because the board failed to obtain all reasonably available information before making an important decision).

[10] ERISA 404(a)(1)(B) (emphasis added).

[11] It is well established that corporate directors and corporate officers both have fiduciary duties toward the corporation itself, and to the corporation's shareholders. *See* e.g., *Van Gorkom*, at 893; *Paramount Communications v. QVC Network Inc*., 637 A.2d 34, 43 (Del. 1993). *See also In re Caremark International, Inc*., 698 A.2d 969 (1996).

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coordinate, and provide oversight to, and determine the allocation of fiduciary responsibilities among investment managers.[12] In this structure, not only is the plan sponsor not responsible for appointing investment managers, but so long as the plan document created by the plan sponsor "expressly" provides a procedure for allocating fiduciary responsibility, then liability will have shifted to the managers who are directly responsible for managing and operating the plan.[13]

The plan sponsor and its directors must still prudently name a fiduciary to select, monitor, and coordinate the plan's managers.[14] But when the plan sponsor limits its role to naming an oversight fiduciary, the sponsor and its directors are no longer responsible for the selecting, directing and coordinating of the persons who will actually manage and operate the plan.

It is important to restate the standard for determining whether an appointing fiduciary has breached its fiduciary duty. Every fiduciary named by the plan sponsor must be appropriately appointed and monitored, and replaced if necessary. If directors appoint a named fiduciary committee that in turn appoints the actual investment managers, then the breach potential is limited to the prudence of the oversight appointment, and does not extend to the prudence of investment manager selection.

§ 16.03 ERISA LIABILITY FOLLOWS ERISA ACCOUNTABILITY

Understanding ERISA named fiduciary liability is all about understanding accountability; and the allocation and formal identification of that accountability. Understanding corporate and board liability under ERISA is all about understand-

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[12] *See* ERISA 402(a)(1) ("Every employee benefit plan shall be established and maintained pursuant to a written instrument. Such instrument shall provide for one or more named fiduciaries who jointly or severally shall have authority to control and manage the operation and administration of the plan."); *also see* ERISA 405(c)(1) (The instrument under which a plan is maintained may expressly provide for procedures (A) for allocating fiduciary responsibilities (other than trustee responsibilities) among named fiduciaries, and (B) for named fiduciaries to designate persons other than named fiduciaries to carry out fiduciary responsibilities (other than trustee responsibilities) under the plan.").

[13] ERISA 402(a)(2) ("If a plan expressly provides for a procedure described in paragraph (1), and pursuant to such procedure any fiduciary responsibility of a named fiduciary is allocated to any person, or a person is designated to carry out any such responsibility, then such named fiduciary shall not be liable for an act or omission of such person in carrying out such responsibility. . .").

[14] Regardless of the fiduciary status of directors under ERISA, when directors fail to affirmatively exercise oversight to ensure that an effective compliance and control system, this can be viewed as a breach of the directors fiduciary duty of care, at least where the failure could result in a substantial loss to the corporation. *See McCall vs. Scott*, 250 F3rd 997 (6th Cir 2001).

ing who is responsible for the coordination, oversight, and monitoring of manager performance. The "named" fiduciary is the lynchpin of the ERISA accountability scheme. This named fiduciary is simply an accountable person or firm named in the plan document, or named pursuant to a procedure described in the plan. When this named fiduciary is not the investment manager, but instead, is responsible for appointing and monitoring the investment managers, the board is no longer responsible for the coordination, oversight, and monitoring of manager performance.

Central to the creation of an ERISA fiduciary governance structure is that the corporate board of directors can provide for the delegation and allocation of fiduciary responsibility to fiduciary managers, and for the designation of other managers who are not named fiduciaries to carry out fiduciary responsibilities.[15] Indeed, perhaps the most central liability section in ERISA concerning the structuring of fiduciary management tells us that when the named fiduciary assigns responsibilities (pursuant to any such expressly provided allocation procedure) that the named fiduciary is not liable for the acts or omissions of the person or organization carrying out the responsibility.[16] But the named fiduciary will still be liable if it was not prudent in:

(i) the allocation or designation of responsibility; or

(ii) "with respect to the establishment or implementation" of the procedure for allocating responsibility and designating persons to carry out these responsibilities; or

(iii) allowing the allocation or designation to continue.[17]

The board of directors can establish an express procedure in the plan for the named fiduciary to allocate fiduciary responsibility, and to designate other persons to carry out fiduciary responsibilities. If the board of directors does not establish these procedures, but instead appoints a named fiduciary to manage and control the plan's investment, it will likely have taken responsibility by default for appointing the plan investment manager.

The mechanism for limiting corporate and board fiduciary liability is largely the plan's accountability structure. This structural aspect to limiting board liability is largely governed by one simple principle; namely, that plan management need not

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[15] § 405(c)(1) (the plan document should "expressly" provide for this).

[16] § 405(c)(2).

[17] § 405(c)(2)(A).

be assigned to the persons, firm, or committee charged with oversight and coordination of the investment and other plan managers.

Just as a corporation with a board of directors does not (typically) have the board function as the corporation's management, a fiduciary governance structure can separate and distinguish between plan oversight and plan management. Of course, it is a breach of fiduciary duty to assign management roles to persons or firms who are not suitable investment managers. Moreover, when the plan sponsor does not assign oversight and coordination to a named fiduciary other than the investment manager, this is an invitation for the functional realities of the governance structure to result in the plan sponsor itself acting as the coordinating fiduciary.

The next few sections will examine actual approaches to structuring both the oversight and management of a 401(k) plan's investments. There is no one-size-fits-all fiduciary structure that is right for every corporate and fiduciary culture; but as we will see in the following sections, modern participant services and new investment delivery mechanisms are now increasingly compatible with fiduciary governance structures that separate plan investment management from fiduciary oversight.

§ 16.04 ERISA'S DEFAULT APPROACH TO SEPARATING INVESTMENT MANAGEMENT AND FIDUCIARY OVERSIGHT

The default governance structure[18] provided by ERISA gives plan investment management and control to a trustee.[19] The trustee can be named in the plan, or selected by a named fiduciary.[20] But the trustee has exclusive authority to manage and control all plan assets, except to the extent that the plan document "expressly" provides that the trustee is subject to the direction of a named fiduciary who is not a trustee, or unless qualified investment managers have been appointed to manage

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[18] The assets of all 401(k) plans, except those funded exclusively through insurance contracts, are required to be controlled and managed by a trustee. *See* ERISA 403(a) ("Except as provided in subsection (b). . ., all assets of an employee benefit plan shall be held in trust by one or more trustees.").

[19] ERISA § 403(a) ("[T]he trustee or trustees shall have exclusive authority and discretion to manage and control the assets of the plan, except to the extent that — (1) the plan expressly provides that the trustee or trustees are subject to the direction of a named fiduciary who is not a trustee, . . . or (2) authority to manage, acquire, or dispose of assets of the plan is delegated to one or more investment managers. . .").

[20] ERISA § 403(a).

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plan assets.[21]

The discretionary trustee as investment fiduciary is still a powerful model for the management of benefit plan investments. But a complete understanding of fiduciary governance in most corporate benefit plans requires a broader understanding of the concept of the "named" fiduciary. Every ERISA plan has one or more accountable "named" fiduciaries who, jointly and severally, have the authority to "control and manage" the operation and administration of the plan.[22] This authority may include the power to appoint and direct the trustee, or to appoint one or more investment managers to manage plan assets.[23] The "named" fiduciary is the central concept in ERISA; but again, it is also simply an accountable authority that is named in the plan document, or named pursuant to a procedure described in the plan.[24]

§ 16.05 THE STRUCTURAL APPROACH FOR SEPARATING THE SPONSOR AND ITS BOARD FROM ACCOUNTABILITY FOR APPOINTING THE INVESTMENT MANAGER

When corporations do not use the ERISA default structure, there are three basic fiduciary governance alternatives. Of course, the fiduciary that is responsible for the management and control of plan investments can be a trustee under any of the three alternatives. What changes in these three alternatives is the accountability (and consequent liability risk) to the plan sponsor and its board for appointing and monitoring the plan's trustee and/or investment manager.

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[21] ERISA § 402(c)(3) ("[T]he trustee or trustees shall have exclusive authority and discretion to manage and control the assets of the plan, except to the extent that — (1) the plan expressly provides that the trustee or trustees are subject to the direction of a named fiduciary who is not a trustee, . . . or (2) authority to manage, acquire, or dispose of assets of the plan is delegated to one or more investment managers. . .").

[22] ERISA § 402(a)(1) ("Every employee benefit plan shall be established and maintained pursuant to a written instrument. Such instrument shall provide for one or more named fiduciaries who jointly or severally shall have authority to control and manage the operation and administration of the plan.").

[23] ERISA 402(c) ("Any employee benefit plan may provide. . .(3) that a person who is a named fiduciary with respect to control or management of the assets of the plan may appoint an investment manager or managers to manage (including the power to acquire and dispose of) any assets of a plan.").

[24] ERISA § 402(a)(2) (". . .the term 'named fiduciary' means a fiduciary who is named in the plan instrument, or who, pursuant to a procedure specified in the plan, is identified as a fiduciary (A) by a person who is an employer or employee organization with respect to the plan or (B) by such an employer and such an employee organization acting jointly.").

These are the three basic fiduciary governance types described with respect to the management of plan investments:

I. The corporation both oversees and manages the plan, including investment management;

II. The corporation directly names the fiduciaries who manage the plan's investments; and

III. The corporation names a fiduciary committee to appoint, hire, contract, monitor, and provide coordination and oversight to plan managers.

When these choices are laid out in this simple way, the basic liability implications of each alternative are almost intuitive. And while the alternatives described above apply to any size plan, the development of the implications in this chapter will focus on those plans that now primarily use mutual funds as investment vehicles. This is a very large subset of 401(k) plans and includes most small plans; but currently includes many Fortune 500 companies.

The following short descriptions of the structure of each alternative show the continuum of plan sponsor involvement in the management of plan investments. In the first alternative, the corporation is the investment manager. The corporation would, of course, select mutual fund options for participants; but mutual funds do not fit the ERISA definition of an investment manager. In the second alternative, the corporation selects the investment manager who then selects the investment funds. And in the third alternative, the corporation selects the oversight fiduciary which then selects the investment manager.[25]

I. **The Corporation as Named Fiduciary**

When choosing this approach, the corporation undertakes all fiduciary responsibility for managing the plan. Of course, unless a corporation has the time and internal talent commensurate with the skills, knowledge and experience required of a defined contribution investment portfolio manager, a prudent corporation

[25] When there is no investment manager and no discretionary trustee, the named fiduciary retains responsibility for selecting the range and mix of investments to be offered to participants under the plan. Mutual fund companies are not investment managers, even though they may be designated to carry out tasks that the named fiduciary is not prepared to execute itself. Named fiduciaries also commonly designate other persons within the corporation or third party organizations to carry out recordkeeping and administration responsibilities. See fn 12 and fn 13.

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may subsequently delegate this aspect of plan management.[26] This delegation would essentially migrate the corporate governance structure into approach II.

II. **The Corporation Names a Fiduciary to Manage the Plan**

In order to prudently name a managing fiduciary under this approach, the corporation's officers and directors are under a dual ERISA and corporate law duty to evaluate all reasonably available information relevant to making this appointment. Basic prudence requires that the persons appointed to any plan management role, perhaps especially the plan's investment portfolio manager, have the ability and qualifications to carry out this role. Because this approach entails the direct appointment of a critical plan manager, the corporation becomes the ERISA fiduciary responsible for the evaluation and monitoring of the named fiduciary who manages the plan, including the plan's investment portfolio.[27]

III. **A Committee is Named to Appoint and Monitor Plan Managers**

The skills, knowledge, experience and other credentials needed to prudently appoint and monitor a portfolio investment manager, are more widely available than the credentials of experienced portfolio investment managers. A board of directors that appoints corporate employees to a named fiduciary committee can be more certain that it has made prudent appointments when

[26] Many 401(k) plans almost exclusively use mutual fund investments. Mutual funds will not, and can not, accept responsibility as an investment manager. In such circumstances no liability is transferred from the corporation to the mutual fund.

[27] The minimum requirement for the prudent appointment of a fiduciary committee that undertakes direct management of the investment portfolio is that the committee has the ability to apply the level of effort and resources needed to both: a) prudently manage the appropriate level of services from a professional consultant, and b) understand and evaluate the underlying basis of the recommendations coming from this professional. Committees with less skill, knowledge and expertise require more time and effort, as well as greater education, training, and investment advisor resources. A heightened level of communication and coordination is always necessary when the authority to make decisions lies with the fiduciary, and the knowledge and experience necessary to make the decisions lies with an outside professional. As this separation of accountability and expertise becomes wider, the more likely it is that decisions may not get made, that the timing of the decisions becomes longer, and that the effort required becomes greater.

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it is not selecting persons who will themselves act as the portfolio investment manager.

Structure alternative III above contemplates that a plan sponsor will name a fiduciary to a role that is, with respect to the plan, analogous to the role of its own board of directors with respect to the sponsor of the plan. This structure removes the sponsor and its board from the role of appointing investment managers. And while establishing this structure is in the self interest of the sponsor and its board, a sponsor's fiduciary duty would seem to require that it not take on such an appointing and monitoring role if an alternative governance structure and process would likely make better and more informed decisions about the selection and appointing of ERISA plan managers with the same or reduced use of corporate resources. This obligation derives directly from the duty of any fiduciary, when acting as a fiduciary, to consider only what is best for plan participants.

An oversight fiduciary has authority to select plan managers; and, as previously discussed, this oversight fiduciary will also determine the allocation of fiduciary responsibilities among the managers that it selects.[28] And again, so long as the plan document created by the plan sponsor "expressly" provides a procedure for allocating fiduciary responsibility, then liability will have shifted to the managers who are directly responsible for managing and operating the plan.[29]

Another consideration for any corporate board of directors is that the time and effort by the sponsor and its board of directors will not be the same under each of the alternative governance structures. ERISA fiduciary standards are more likely to be met, and with less sponsor and board of director effort, when a plan sponsor acts with the care, skill, diligence and prudence necessary to appoint the fiduciary who will select, monitor and coordinate the plan's managers. The advantages of this fiduciary governance approach for a plan sponsor and its directors may thus include either reduced time and effort or reduced liability risk, or both.

§ 16.06 GOVERNANCE STRUCTURE AS A FACTOR IN DETERMINING PARTICIPANT INVESTMENT PERFORMANCE

Risk management with respect to ERISA benefit plans involves more than the purely formal aspects of a governance structure. In fact, the best liability risk mitigation is a well run plan. However, whether a plan will be well run depends very much on the quality and performance of the plan's managers, especially its

[28] ERISA 402(a)(1). See fn 12.

[29] ERISA 402(a)(2). See fn 13.

investment managers. Therefore, a very practical question for those directors who now directly appoint a lay fiduciary committee comprised of company employees to directly manage the plan's investment portfolio is whether or not a more focused fiduciary committee — perhaps even the same persons now appointed to manage the investment portfolio — would do a better job than the board itself in finding, appointing, and monitoring an investment manager or managers for the plan.

The appointment of a fiduciary committee, not to directly manage the investment portfolio, but to appoint, monitor and provide oversight to the investment managers, clearly provides the strongest structural liability protection to the board. But the fiduciary question is whether or not this structure should be expected to produce better manager appointments? Bottom line, no board of directors should accept the liability risks inherent in the direct appointing of plan managers if these appointments can be better handled by a focused named fiduciary committee.

A portfolio manager requires skills that are more analogous to a shipping company fleet manager who is simultaneously monitoring five or six computer screens in order to evaluate cargo needs, ship availability, weather, as well as the suitability, health, and schedules of ships, captains and crews. Any such shipping executive would be said to be managing; even if the captains of each ship are accountable for the safety of passengers and crew once the ship leaves the dock. But this raises another problem with the ship captain analogy.

Mutual funds do not accept responsibility for passengers or cargo in the event of a financial storm. If the mutual fund is not seaworthy, the fund still will not hesitate to go out to sea; and it may never pull into a port to get out of a financial storm. The responsibility for pulling into a port and changing ships typically lies with the named fiduciary that was directly appointed by the plan sponsor and its board of directors. Despite this responsibility, the typical fiduciary committee will only get a report on the performance of these funds every quarter — usually a month or so following the end of the quarter. And if there is an investment policy statement, this statement will typically call for changing funds — the equivalent of pulling a ship into port during a storm — after the fund performance measurement statistics fall outside of the policies guidelines for four or five quarters.

Some corporations have attempted to put a barrier between the plan sponsor's responsibility for monitoring named fiduciary committee appointments by appointing an internal committee to carry on this role. Another approach adopted by some fiduciaries is to ask its registered investment advisor to accept fiduciary

responsibility as an ERISA § 3(38) investment manager.[30] This change in role for the advisor is less expensive than asking the advisor to keep the fiduciary committee as up to date on the funds and capital markets as is the professional staff of the advisor.

The § 3(38) investment manager may still report to the fiduciary committee quarterly; and it will still have the same strategic discussions with the committee as before. But the investment manager is responsible for the portfolio at all times. Of course, the fiduciary committee is no longer liable for this delegated function; and the plan sponsor and its board is not liable for any breach of duty in the selection of the investment manager.

Approaches now exist for a fiduciary committee to give participants the investment expertise of investment managers who will accept fiduciary responsibility for investments. One approach is to offer participants the availability of managed accounts. The cost of computerized asset allocation tools have come down to such an extent that many plans now have the majority of plan participants elect to have their 401(k) monies allocated and regularly rebalanced by asset allocation software that takes into account each participant's risk preferences, and even his or her non-plan monies. The participant is no longer forced to optimize his or her own portfolio; or rather, to accept grossly suboptimal portfolio allocations. Instead, the participant provides information about objectives and risk tolerance, and professionals handle the optimization. In some situations, underlying mutual fund investments are held in collective trusts in order to reduce expense and to better permit the investment manager to change the asset allocations based on the manager's view of the markets; for example, to decrease the equity allocation during a financial storm.

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[30] ERISA §3 (38) ("The term 'investment manager' means any fiduciary (other than a trustee or named fiduciary, as defined in section 1102(a)(2) of this title) —

(A) who has the power to manage, acquire, or dispose of any asset of a plan;

(B) who (i) is registered as an investment adviser under the Investment Advisers Act of 1940 [15 U.S.C. 80b-1 et seq.]; (ii) is not registered as an investment adviser under such Act by reason of paragraph (1) of section 203A(a) of such Act [15 U.S.C. 80b-3a(a)], is registered as an investment adviser under the laws of the State (referred to in such paragraph (1)) in which it maintains its principal office and place of business, and, at the time the fiduciary last filed the registration form most recently filed by the fiduciary with such State in order to maintain the fiduciary's registration under the laws of such State, also filed a copy of such form with the Secretary; (iii) is a bank, as defined in that Act; or (iv) is an insurance company qualified to perform services described in subparagraph (A) under the laws of more than one State; and

(C) has acknowledged in writing that he is a fiduciary with respect to the plan.").

Another approach is the "fund of fund" approach. In this approach, the named fiduciary selects an investment manager to manage a fund of fund approach for one or more asset classes. The named fiduciary does not pick a particular fund to represent an asset class; and the participant does not choose any particular fund. Instead, the investment manager will combine several funds and change those funds or the weighting of funds as it determines is appropriate at any point in time. One advantage to this approach, of course, is that a fund that is seen to pose unnecessary risk — or otherwise not viewed as "seaworthy" by the investment manager — can be immediately removed from the mix. By delegating to the fund of funds investment manager, the named fiduciary committee can improve on the old pattern whereby the committee received a report from its investment advisor at the end of a quarter, and then, if it was able to make a quick decision, advise participants of some future mapping of monies from fund that it has deemed less than seaworthy into some other new fund.

In all of these examples the fiduciary is delegating fiduciary responsibility to an investment manager and is migrating, to a greater or lesser degree, the fiduciary governance structure from the standpoint of the liability risk to the plan sponsor and its board. But most of these migrations did not take place because of a legal analysis of the optimum structure from the standpoint of risk to the board. Rather, these migrations in structure happened because new tools were available at a low cost for providing participants with they needed.

At least since Harry Markowitz won his Nobel Prize in 1990, it has been clear that no participant, indeed no named fiduciary committee, can appropriately select any one investment fund without fitting that fund into an entire portfolio. It is true that risk adjusted return statistics and portfolio optimizing tools are typically available through independent investment advisors; but for these tools to be used, the named fiduciary must understand how to use these tools and have the time to put them to work. And in the typical 401(k) plan, it is not just the fiduciary that must understand and apply modern portfolio theory, but the plan participant.

Almost no participant is able to optimize an investment portfolio. Participants commonly engage in what is called naive diversification, dividing their investments equally among all the funds offered by the plan. Participants will even forgo the company match even when they are 60 years old, completely vested, and planning to retire the next month, at which time they could withdraw both their own money and the company match without a penalty.

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VER: [SC_01125-Local:17 Jul 07 16:25][MX-SECNDARY: 31 May 07 19:37][TT-: 07 Jun 07 18:35 loc=usa unit=00500-ch0016s] 0

§ 16.07 AN OVERSIGHT ROLE FOR THE PLAN SPONSOR'S BOARD THAT GOES BEYOND INVESTMENT MANAGER OVERSIGHT

The *T.J. Hooper* was a tug boat that was pulling a string of barges up the Atlantic coast in 1928. A storm caught the captain and his crew by surprise because the tug did not have a working radio. All the barges and the cargo they carried were lost at sea. By 1928, the radio was a common risk reduction device, especially in ocean transportation. But the custom and practice of most tug boat owners was still to leave the decision and the securing of any radios to the captain and its crew. The argument of the tug boat owner was that the standard for evaluating owner liability was essentially the ERISA standard; *viz.,* what other tug boat owners were doing.

Learned Hand's decision, one of the most famous fiduciary decisions of all time, has lessons for corporate plan sponsors on many levels. The most important lesson is not just that at a certain point even if all other fiduciaries are wrong, this does not necessarily make it right. Rather, the lesson is that the emerging tools that fiduciaries have available can change the standards for what is prudent.

Plan sponsors and boards of directors need to ask whether the new tools and techniques that are available for managing a 401(k) are now effective enough and available at a low enough cost that it would be imprudent not to use those tools. The new tools that are now emerging may seem at odds with old "cultural" approaches, but prudence demands that both the named fiduciary, and the fiduciary that appoints the named fiduciary, evaluate the cost and benefits of the new tools.

> It is not fair to say that there was a general custom among coastwise carriers so to equip their tugs. One line alone did it; as for the rest, they relied upon their crews, so far as they can be said to have relied at all. [ ]
>
> Is it then a final answer that the business had not yet generally adopted receiving sets? There are, no doubt, cases where courts seem to make the general practice of the calling the standard of proper diligence; we have indeed given some currency to the notion ourselves. (Citations omitted.) **Indeed in most cases reasonable prudence is in fact common prudence; but strictly it is never its measure; *a whole calling may have unduly lagged in the adoption of new and available devices. It never may set its own tests, however persuasive be its usages.* Courts must in the end say what is required; there are precautions so imperative that even their universal disregard will not excuse their omission.** (Emphasis added.)

T.J. Hooper, 60 F.2d 737 (2nd Cir. 1932).

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Many of the new "radios" or tools that are becoming available to 401(k) investment fiduciaries seem to have one important characteristic in common. They are all directed at helping participants to do what the old 401(k) world had left them to do on their own. And these tools will also facilitate changes in fiduciary cultures. When professionals are charting safe and direct courses to the participant's goals and objectives, and perhaps also to making the decision to immediately pull into port during a financial storm, fiduciary investment fiduciary governance structures will also naturally tend to give up the twin prejudices of the old 401(k) model; namely, in-house control of the investment menu, along with total participant responsibility for creating investment portfolios out of this menu.

How this will all evolve depends on the cost/benefit analysis of the new tools that have become available, and future tools that are only now being developed. But when plan sponsors adopt new fiduciary tools for helping participants, and when these new tools involve the delegating of fiduciary investment management responsibility, fiduciary governance structures will naturally change in ways that will reduce the liability of the plan sponsor and its board of directors. For the corporations involved in this change, board oversight will generally migrate toward the oversight of an overall coordinating "named" fiduciary who will in turn appoint one of more § 3(38) investment managers to actually take fiduciary investment management responsibility.

§ 16.08 CONCLUSION

The paradigm shift that is developing in the 401(k) world is one that involves the twin principles of investment delegation and a focus on the portfolio. In no way is this development radical. In fact, the new paradigm essentially adopts the long established twin principles of the 401(k) fiduciary's elder brother, the defined benefit fiduciary.

Where the defined benefit fiduciary uses ERISA §3(38) investment managers, charges them with specific implementation of the plan's investment policy, and requires each manager to acknowledge its fiduciary responsibility in writing, the 401(k) fiduciary will often use mutual funds. These mutual fund managers will not accept fiduciary responsibility, and will not ever look at a plan's investment policy. The 401(k) fiduciary will itself often act as the investment manager, and where this is the case, the 401(k) plan sponsor is not appointing an oversight fiduciary, but the actual investment manager.

Where the defined benefit fiduciary world has long been engaged in sophisticated portfolio optimization with respect to specific objectives and risk considerations, this world view is still being developed by the 401(k) fiduciary. The

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reason for this is obvious. Most 401(k) plans allow participants to create their own portfolios. And these portfolios may or may not be optimized with respect to specific participant objectives and risk considerations. Moreover, it is much easier to measure the performance of a mutual fund against benchmarks for that particular fund than it is to measure whether the participants in a 401(k) plan have created optimized portfolios for themselves.

The key to the future of the 401(k) paradigm shift is the measurement of participant portfolio performance and portfolio optimization. This will obviously be required where managed accounts are used to actually create and manage portfolios for participants. But there are other paths to achieving participant portfolio optimization objectives that need to be measured and evaluated. Technology now allows the efficient measurement of participant portfolio optimization, regardless of the path taken to create those portfolios.

This new measurement ability brings with it the potential for the development of additional alternative approaches and paths toward participant portfolio optimization. And to the extent that these new approaches and tools continue to facilitate fiduciary delegation, the 401(k) fiduciary will continue to migrate toward the twin principles of defined benefit fiduciary culture. This new culture will not only be better positioned for achieving participant success, but also for simultaneously reducing the liability risks of the named fiduciary and of the appointing board of directors.