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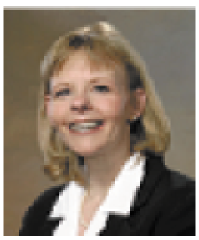
An Economist's Perspective of Fiduciary Monitoring of Investments



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It is virtually impossible to ignore the intense attention being paid to who oversees the U.S. retirement money pot in excess of $18 trillion and a worldwide retirement system of more than $33 trillion.[1] Headlines are replete about a pension global crisis and the implications for fiscal and monetary policies. Bankruptcy filing is no longer out of the question for those municipal and corporate plan sponsors that do not have enough cash to satisfy benefit obligations.

Regulators and courts are busy too. On April 20, 2015, the U.S. Department of Labor (''DOL'') proposed regulation to clarify who is an ERISA fiduciary and conflicts of interest (72 PBD, 4/15/15)[2] A month later, a unanimous U.S. Supreme Court put fiduciary responsibilities on the map once again (96 PBD, 5/19/15). In its long-awaited opinion in *Tibble v. Edison*, the court wrote that ''a trustee has a continuing duty to monitor trust investments and remove imprudent ones,'' leaving a lower court to rule on what exactly constitutes ''fiduciary monitoring.''[3]

From an economic perspective and speaking generally, an assessment of whether investment fiduciaries have breached their duties will importantly depend on facts and circumstances. There is no secret sauce that divines good or bad practices in a vacuum. However, there are some principles that can and should be applied, starting with a recognition that investment selection and ongoing oversight is an exercise in risk management. This is true for all types of ERISA plans, whether designed as a defined benefit, defined contribution or hybrid offering.

Risk Management Is a Never Ending Process

There is never a discrete end point to investment risk management. Critical inputs are in a constant state of flux. Interest rates move. Market volatility goes up and down. Capital market rules get modified. The financial wellbeing of a plan sponsor can take a turn for the worse or vastly improve.

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[1] http://www.ici.org/pdf/2015_factbook.pdf

[2] http://webapps.dol.gov/FederalRegister/HtmlDisplay.aspx?DocId=28201&AgencyId=8&DocumentType=1

[3] http://www.bloomberglaw.com/public/document/Tibble_v_Edison_Intl_No_13550_US_May_18_2015_Court_Opinion

Participant attributes such as lifespan, income and education can radically veer from past experience due to mergers, acquisitions, divestitures or realignment with improved technology. Competitive pressures to attract talented workers with the lure of generous benefits can motivate a redesign of one or more retirement plans. The list is long.

The rate of change and the materiality of any changes should logically influence the frequency, duration and specificity of investment committee meetings and whether other groups such as Human Resources, Legal and Operations should be involved. Similarly, the frequency of issuing a Request for Proposal (''RFP'') to potentially hire a new vendor is a function of what is happening with a plan and its sponsor. Tumult in the investment environment is another consideration. Following the financial crisis of 2008, debt of companies that were downgraded below investment grade level might have caused a violation of ERISA plan investment guidelines that did not change to recognize a deterioration of credit risk.

Numbers Alone Are Seldom Sufficient

Historical performance numbers can be helpful but are no substitute for asking questions about the nature of expected future returns, adjusted for uncertainty. When historical numbers are used as part of investment monitoring, the issue of appropriate time horizon is an issue. Does it make sense to more heavily weight recent activity and related red flags as a bellwether of future risk-adjusted returns or examine a longer period?[4] What risk factors keep the portfolio manager up at night now and what could cause things to change? How is he or she mitigating those risk factors? Has the investment fund manager deviated from a stated investment goal? If so, why? Is there an anticipated drag on returns due to parking money in cash, even if based on sound thinking about market direction? Are future actions likely to change in the event of the departure of a key trader?

Even through a ''what if'' lens, numbers can be misleading if they ignore qualitative problem areas such as poor trading controls, weak segregation of duties between trading and the back office, high staff turnover and compensation that encourages risk-taking by an internal or outside portfolio manager.

Leverage Is a Double-Edged Sword

Although famed investor Warren Buffet once referred to derivatives as ''time bombs'' and waxed prophetic about systemic linkages among counterparties, valuation and credit risk, the global over-the-counter market is gigantic at nearly $700 trillion in mid-2014.[5] The use of derivatives to hedge, create an asset or sector exposure or try to enhance returns is commonplace for both ERISA plans as well as the third party investment funds they select. The key is to understand that there is no free lunch and that the risk-return profile changes when financial engineering is part of an investment structure. In a bad market and absent checks and balances to curtail the use of leverage, expected performance can deteriorate much faster than for an unleveraged fund. In 2010, the U.S. Securities and Exchange Commission (''SEC'') announced its plan to ''evaluate the use of derivatives by mutual funds, exchange-traded funds (ETFs) and other investment companies.''[6]

DOL made clear some time ago that plan fiduciaries ''have a duty to determine the appropriate methodology used to evaluate market risk and the information which must be collected to do so. Among other things, this would include, where appropriate, stress simulation models showing the projected performance of the derivatives and of the plan's portfolio under various market conditions.''[7] Regarding the use of derivatives by a ''pooled fund which is managed by a party other than the plan fiduciary who has chosen the fund, then that plan fiduciary should obtain, among other things, sufficient information to determine the pooled fund's strategy with respect to use of derivatives in its portfolio, the extent of investment by the fund in derivatives. . .''[8] Other forms of leverage such as anticipatory short selling are likewise familiar to myriad investment professionals.

Service Provider Due Diligence

Knowing a lot about who provides investment-related services is a sine qua non at any time, including the present, when the fiduciary outsourced model appears to be gaining traction. On Nov. 13, 1996, the U.S. Department of Labor published its working group proceedings about service provider selection and monitoring with a recommendation that fiduciaries query about items such as organizational structure, experience, staff size, financial strength, conflict of interest policy, current or past litigations or enforcements and much more.[9] In its 2004 ''Tips For Selecting And Monitoring Service Providers For Your Employee Benefit Plan,'' the DOL suggests that ERISA plan decision-makers ask potential vendors ''to be specific about which services are covered for the estimated fees and which are not,'' reminding readers that the cheapest provider is not necessarily the mandated choice.[10] In 2014, the ERISA Advisory Council offered contracting recommendations to include a clear definition of the scope of work and ''full, and *understandable*, disclosure of how (and how much) the outsourcer will get paid.''[11]

Contract disputes due to expectation discrepancies between ERISA plan investment committees and service providers generally follow large losses and can be expensive, time-consuming and distracting. Sometimes a service provider can look good on paper but fall short of its stated governance structure. ''In a recent well-publicized matter, case documents described the existence of a risk management committee and a valuation committee, each made up of prominent financial service executives. Upon further inspection, it turned out

[4] Heavner, Lee, ''Expert Analysis: Using Simulation to Assist Courts in Assessing the Prudence of Retirement Plan Investment Decisions,'' *Pension & Benefits Daily*, July 15, 2014 (135 PBD, 7/15/14; 41 BPR 1522, 7/22/14)

[5] http://www.berkshirehathaway.com/letters/2002pdf.pdf and http://www.bis.org/publ/otc_hy1411.pdf

[6] https://www.sec.gov/news/press/2010/2010-45.htm

[7] http://www.dol.gov/ebsa/regs/ILs/il032196.html

[8] Ibid.

[9] http://www.dol.gov/ebsa/publications/srvpro.htm

[10] http://www.dol.gov/ebsa/newsroom/fs052505.html

[11] http://www.dol.gov/ebsa/publications/2014ACreport3.html

that neither committee met on a regular basis to discuss key decisions.''[13]

Participant Education

Knowledge-sharing may go a long way to ease participant worries and forestall or possibly prevent litigation. Outreach format can vary but might include educational pamphlets, social media, smart phone applications or in-person or virtual regular town hall events during which investment committee members answer questions about what monitoring activity is being done, who does the monitoring and what it costs to carry out reviews of investments and asset managers.

Plan counsel can no doubt recommend what information can and should be transmitted to participants to protect the sensitive nature of certain discussions between the plan buyer and service provider seller. This is especially apropos for those private funds (i.e. hedge funds, venture capital funds, private equity funds, etc.) that are reluctant to share detailed holdings data and what they deem to be proprietary investment strategy information.

Looking Forward

Whether additional ERISA litigation materializes as the result of *Tibble v. Edison* as pundits predict, is unknowable. What is certain is that the topic of investment fiduciary monitoring will not disappear but rather receive further scrutiny. Peering into a crystal ball, one possible outcome of the *Tibble v. Edison* decision by the U.S. Supreme Court is that advisers, consultants and independent fiduciaries will be asked to play a more active role in monitoring investments, vetting asset managers and crafting asset allocation strategy. If that trend occurs, in-house ERISA fiduciaries could face a Hobson's choice. Pay more for the additional help to regularly review investments and incur the upset of participants who want to contain plan expenses or instead do nothing different and risk being sued. The life of an ERISA investment fiduciary is about to get even busier.

[13] Mangiero, Susan, ''ERISA Plans and Service Provider Due Diligence: Going Beyond the Background Check, *Pensions & Benefits Daily*, July 10, 2012 (131 PBD, 7/10/12; 39 BPR 1382, 7/17/12)