FOOTHILL-DE ANZA
Community College District

March 31, 2009

TO: Audit and Finance Committee

FROM: Andy Dunn

SUBJ: GASB 45 Service Provider

Background

GASB 45 is an accounting statement that requires Community College Districts, beginning in 2007 for the largest districts, to treat the unfunded post-employment benefit obligations on an accrual basis rather than on a pay-as-you-go cash basis. These new rules became effective in 2007-08 for districts with revenues of $100 million or more, which would include the Foothill-De Anza Community College District (FHDA), in FY 2008-09 for districts with revenues between $10 million and $100 million and in FY 2009-10 for those districts with revenues less than $10 million. GASB requires participating districts to recognize and disclose the liability and supplementary information.

FHDA has taken all the necessary steps to fully comply with this new requirement. FHDA was an active participant in forming a statewide community college retiree benefits trust through the Community College League of California (CCLC). FHDA was also an early implementer of these standards. Based on the criteria noted above, FHDA was required to come into compliance with the GASB 45 requirements in the 2007-08 FY. FHDA joined the Joint Powers Authority (JPA) established by the CCLC and began making contributions in the 2006-07 FY.

At the June 16, 2008 Board of Trustees Meeting, the Audit/Finance Committee approved staff's recommendation that the Internal Retirement Board, which is comprised of the Audit & Finance Committee Chair, the Vice Chancellor of Business Services, and the Controller, review and compare the OPEB trust program offered by the Public Employees Retirement System (PERS) with the plan sponsored by the Community College League of California (CCLC). Further investigation indicated there were multiple vendors offering this service and that FHDA would be best served by a broad examination of all available and/or interested service providers.

Business Services subsequently wrote and notified the CCLC benefit trust that FHDA may elect to withdraw. This notice, if acted upon, would be effective July 1, 2009. Business Services also contracted with the RPM Group (Chuck Thompson) to assist with developing a Request For Qualifications (RFQ), evaluate, analyze and rank Statements of Qualification (SOQ's) received in response to the RFQ and draft a recommendation. An initial selection committee was formed, consisting of the Vice Chancellor of Business Services, Controller and representatives from each college. Ten SOQ's were ultimately received and four firms, felt to be those best qualified, were short-listed for further consideration. As a part of the due-diligence process telephone interviews between each firm and the core committee were conducted to gain a better understanding of the firm's qualifications. At the March 2, 2009, meeting of the Audit/Finance Committee, each of the four finalists were invited in to present their qualifications to the Committee. Mr. Thompson of the RPM Group developed the supporting quantitative analysis and helped lead these interviews. This was an informational presentation and a subsequent meeting was scheduled for a staff recommendation to be presented.

Status

As the selection committee began to formulate a recommendation some differences of opinion emerged largely centering on fiduciary liability and how the district might be exposed to that risk in terms of choosing an investment platform under scenarios offered by the four service providers under consideration. While staff felt strongly that a service provider such as CalPERS, who offers no discretion in investment platforms to its clients, would largely mitigate the risk associated with investment decisions, the RPM Group voiced concern that absent specific contractual language this was not a matter that could be mitigated. Business Services looked to our General Counsel, John Shupe, to help resolve these differences and he subsequently analyzed the materials previously reviewed by the core committee. One key issue that emerged is the applicability of the Employment Retirement Income Security Act (ERISA) to public sector agencies referenced in RPM materials and Mr. Shupe's research and subsequent opinion point out that the fiduciary liability provisions in ERISA are not applicable to public employee retirement systems.

Recommendation

1. Accounting Requirements
   From an accounting perspective our Controller has noted that the vendor proposals submitted by CalPERS, Community College League of California, Keenan, and Wells Fargo all satisfy applicable requirements of GASB 43 and 45. As noted previously, the vendors are offering varying levels of service, but any of these proposals are satisfactory in helping us meet the GAAP and audit requirements.

2. Level of Service
   A key indicator for staff was the level of service offered by the various providers. The Committee concurs with the RPM Group that the Keenan and Wells-Fargo proposals offer the highest level of service and we recognize that this is an important marker for many districts. However, as FHDA was an early implementer of these GASB regulations, we have for example, already developed the Substantive Plan required under GASB 43. We also have at our disposal a wide array of service providers including our Auditor, Actuary, General Counsel and special advisors such as the RPM Group should the need for additional management support services arise.

3. <u>Investment Decision Making</u>

Our over-arching concern however was to mitigate the liability associated with either the Audit/Finance Committee or Retirement Board directing investment decisions. Only the CalPERS model takes the district out of that decision making process and would therefore best mitigate the districts liability exposure in investment decision-making. However CalPERS has only one investment platform which reflects a 75% equity and 25% fixed asset portfolio. A means to buffer the potential risk of this more aggressive investment structure would to allow the funds already invested with the CCLC program to remain in their current 50/50 platform. While the CCLC indicated during their interview they would be open to such an arrangement, we do not have a definitive answer to this question from CalPERS. Staff is however recommending that the district pursue contract negotiations with CalPERS.

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Plan Name	CERBT	Futuris	Retiree Health Benefit Program	Wells Fargo
Plan Sponsor	**CalPERS**	**Keenan Financial Services**	**CCLC**	**Wells Fargo Institutional Trust Co.**
Plan Benefits & Features	**Response**	**Response**	**Response**	**Response**
Administration & Documents				
Substantive Plan Development and Maintenance	No	Yes	No	Yes
Substantive Plan Documents Provided	No	Yes	No	No
Website Look Up Access by Employer and Employee	No	Yes	No	Yes
Retirement Board Of Authority Recommended	No	Yes	No	No
IRS Private Letter Ruling (PLR) Provided	No	Yes	Yes	Yes
Brown Act Meeting Installation Support Offered	No	Yes	No	No
Contract Length	3 Years No Termination	3 or 4 Years Standard Clause Negotiable	3 Years No Termination	3 or 4 Years Standard Clause Negotiable
Performace Guarantees	No	Yes	No	No
Plan Modifications	CalPERS Only	District Input	2/3 Majority Vote of All Members	District Input
Plan Flexibility	None	Complete	Limited	Complete
Trustee				
Trustee Structure				
IRC 115 Trust	Yes	Yes	Yes	Yes
Irrevocable	Yes	Yes	Yes	Yes
Revocable	No	Yes	No	No
Employer	No	Yes	No	Yes
Multi-Employer	Yes	No	No	No
JPA Structure	No	No	Yes	No
Trustee Function				
Discretionary	No	Yes	No	Yes
Directed	Yes	No	Yes	No
Investment Manager (RIA)				
Investment Policy (I/P) Statement Type	Same I/P for All Districts	Individual I/P District Approved	Same I/P for All Districts	Individual I/P District Approved
Choice of Specific Asset Allocation Portfolios	No	Yes	No	Yes
Plan Investment Risk Tolerance Allocation Range Equity%/Fixed%	High Only	Low to High	Low to High	Low to High
Risk Tollerance Process Provided	No	Yes	No	Yes
Investment Manager Function (RIA)				
Discretionary	Yes	Yes	No	Yes
Directed	No	No	Yes	No

Foothill De Anza Community College District

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Plan Sponsor	**CalPERS**	**Keenan Financial Services**	**CCLC**	**Wells Fargo Institutional Trust Co.**
Plan Functions & Features	**Response**	**Response**	**Response**	**Response**
Fiduciary Liability Mitigation				
Prudent Man Investment Mitigation Fiduciary Structure	Yes	Yes	Yes	Yes
Investment Manager (RIA) Fiduciary Mitigation Only	Yes	No	No	No
Trust and Investment Manager Fiduciary Mitigation Structure	No	Yes	No	Yes
Retirement Board of Authority Recommended	No	Yes	No	No
Conflict of Interest Mitigation				
Proprietary Funds Allowed in Investment Platform	Yes	No	Yes	Yes/Optional
Plan Receive 12(b) 1 or Revenue Sharing Fees from Fund Company	Information Not Provided	Not Received	Received	Received
Trust Company Does Not Own Investment Manager or Vice Versa	Owned	Not Owned	Not Owned	Owned
Rebating of Revenue Sharing Allowed	Information Not Provided	Not Allowed	Information Not Provided	Allowed
GASB Qualifications, Experience & Service				
Public Entity GASB Experience Partners	No	Yes	No	No
Public Entity GASB Experienced Sponsor	No	Yes	No	No
Number of GASB Experienced Field Service Staff	None	10	1	4
Field Service Office Location	Sacramento	San Jose	Sacramento	San Francisco
Number of Trusts Created	115	22	13	2
Number of Trusts Funded	Not Provided	15	13	2
Number of Community College Clients	1	12	13	1
Number of K-12 Clients	1	10	0	0
Estimated $ Funded	$640 Million	$240 Million	$64 Million	$50 Million

Notice: The information contained within this presentation material has been taken from the information submitted and discussions with the various vendors listed in the above comparative analysis. Errors in the presentation material are not intentional. please notify us of any errors discovered so the error can be corrected.

Notice: RPM Consultant Group is not a legal firm, an accounting firm or an actuarial firm. You should contact your professionals for any information pertaining to the operation of the Distrct in these important areas of compliance.

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Plan Name	CERBT	Futuris	Retiree Health Benefit Program	Wells Fargo
Plan Sponsor	CalPERS	Keenan Financial Services	CCLC	Wells Fargo Institutional Trust Co.
Plan Fees & Returns as of 12/31/08	Response	Response	Response	Response
$10 Million -- 50%/50%				
Mutual Funds				
Annual $		$145,700	$99,894	$91,520
Annual (bps) %		1.46%	0.90%	0.92%
Otr		11.40%	13.92%	10.85%
1 Year		21.80%	25.26%	18.31%
3 year		1.65%	4.62%	0.91%
5 year		3.10%	0.87%	2.69%
Mutual Funds/ETFs				
Annual $		$124,700		$75,000
Annual (bps) %		1.25%		0.75%
Otr		10.20%		9.80%
1 Year		18.95%		19.28%
3 year		0.60%		1.42%
5 year		3.70%		2.13%
Exchange Traded Funds (ETFs)				
Annual $		$97,700		$54,000
Annual (bps) %		0.98%		0.54%
Otr		7.40%		8.90%
1 Year		14.60%		18.71%
3 year		1.30%		1.32%
5 year		3.40%		1.95%
$25 Million -- 50%/50%				
Mutual Funds				
Annual $		$268,750	$231,487	$216,300
Annual(bps) %		1.08%	0.90%	0.87%
Otr		11.40%	13.92%	10.80%
1 Year		21.80%	25.26%	18.26%
3 year		1.65%	4.62%	0.86%
5 year		3.10%	0.87%	2.74%
Mutual Funds/ETFs				
Annual $		$216,250		$175,000
Annual (bps) %		0.87%		0.70%
Otr		10.20%		9.75%
1 Year		18.95%		19.23%
3 year		0.60%		1.37%
5 year		3.70%		2.18%
Exchange Traded Funds (ETFs)				
Annual $		$148,750		$121,500
Annual(bps) %		0.60%		0.49%
Otr		7.40%		8.85%
1 Year		14.60%		18.67%

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00050%/50%

3 year		1.30%		1.27%
5 year		3.40%		2.00%

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Plan Name	CERBT	Futuris	Retiree Health Benefit Program	Wells Fargo
Plan Sponsor	**CalPERS**	**Keenan Financial Services**	**CCLC**	**Wells Fargo Institutional Trust Co.**
Plan Fees & Returns as of 12/31/08	**Response**	**Response**	**Response**	**Response**
$10 Million -- 75%/25%				
Mutual Funds				
Annual $		$153,700	$112,312	$98,400
Annual (bps) %		1.54%	1.03%	0.98%
Otr		17.50%	19.65%	18.65%
1 Year		32.00%	34.64%	29.21%
3 year		4.50%	6.75%	4.51%
5 year		2.90%	0.76%	1.35%
Mutual Funds/ETFs				
Annual $		$132,700		$77,000
Annual (bps) %		1.33%		0.77%
Otr		16.50%		17.80%
1 Year		29.80%		29.15%
3 year		3.10%		4.65%
5 year		3.10%		0.95%
Exchange Traded Funds (ETFs)				
Annual $	$50,000	$97,700		$58,000
Annual (bps) %	0.50%	0.98%		0.58%
Otr	28.55%	16.20%		17.15%
1 Year	23.07%	28.70%		28.99%
3 year	2.54%	4.40%		4.80%
5 year	2.96%	1.30%		0.46%
$25 Million -- 75%/25%				
Mutual Funds				
Annual $		$288,750	$262,545	$233,500
Annual (bps) %		1.16%	1.02%	0.93%
Otr		17.50%	19.65%	18.60%
1 Year		32.00%	34.64%	29.21%
3 year		4.50%	6.75%	4.51%
5 year		2.90%	0.76%	1.35%
Mutual Funds/ETFs				
Annual $		$236,250		$179,500
Annual (bps) %		0.95%		0.72%
Otr		16.50%		17.75%
1 Year		29.80%		29.15%
3 year		3.10%		4.65%
5 year		3.10%		0.95%
Exchange Traded Funds (ETFs)				
Annual $	$125,000	$148,750		$132,500
Annual (bps) %	0.50%	0.60%		0.53%
Otr	28.55%	16.20%		17.10%
1 Year	23.07%	28.70%		28.99%
3 year	2.54%	4.40%		4.80%
5 year	2.96%	1.30%		0.46%

GASB 43 & 45 Vendor Selection RFP Overview of the District's Due Diligence, the District's Audit/Finance Committee Interviews and the GASB Consultant's Recommendation

Date: April 6, 2009

Executive Summary:

The Foothill De Anza Community College District (District) has a GASB 43 & 45 (GASB) compliance program in place since March 2006 through the Community College League of California (CCLC). The program has been operating to the District's satisfaction since the programs initial installation in 2006. The District installed the CCLC plan a time when other programs were not available.

As part of the District's due diligence and their fiduciary liability mitigation on October 2, 2008 a GASB compliance vendor selection request for proposal (RFP) was sent to approximately 10 GASB compliance vendors requesting a proposal for GASB compliance services. The District received proposals from 5 vendors as follows: the Community College League of California (CCLC), CSBA/PARS (PARS), Keenan Financial Services (KFS), PFM Financial Services (PFM) and Wells Fargo (WF). In addition a memo was received from CalPERS indicating they could not respond to the District's RFP but would be interested in presenting an "Investment Platform" proposal to the District if the District contacted CalPERS in Sacramento.

The District was seeking proposals from qualified entities and/or firms to submit their proposals to provide administration services, trust and investment management for a GASB 43 & 45 compliance Other Post-Employment Benefit (OPEB) program. It was the intent of the RFP to provide all firms a fair opportunity for their services to be considered by the District.

The RFP objectives in meeting the primary goals of the District are to:

1. Contract with a single entity for as many OPEB GASB 43 & 45 compliance services as needed.
2. Maximize the advantages of pre-funding some or all of the District's GASB 45 liabilities.
3. Obtain competitive investment returns with the lowest possible expenses.
4. Obtain a fair price for services. However, price will not be the sole determining factor
5. Ensure the ease and reasonable turnaround for the withdrawal of invested funds.
6. Ensure that the District's OPEB Trust is fully compliant with all applicable Federal, State and GAP Statutes

The District hired the GASB consulting services of Chuck Thompson, President/CEO of RPM Consultant Group to assist the District in preparing a GASB compliance RFP template and to review, summarize and make recommendations to the District concerning the District's overall GASB compliance plan both past, present and for the future.

The District's GASB vendor selection staff (District) and the District's Audit/Finance Committee (Committee) have conducted formal conference calls and face to face interviews with four GASB compliance vendor finalist including CalPERS, Keenan Financial Services, the CCLC and Wells Fargo.

The District and the Committee agreed to conduct one additional joint meeting on April 6, 2009 to have the District's GASB consultant present an overview of the four finalist GASB compliance programs including benefits, features and fees for each. Additionally, the consultant has been asked to make a recommendation for the selection of the District's GASB compliance vendor finalist(s). Once the selection of a GASB compliance vendor(s) is completed the next steps in the vendor selection process will be to obtain from the Committee the authorization to negotiate final terms, conditions and the documents with the vendor(s). The results will be to be presented to the District's Board of Trustees for approval to engage the services of the GASB compliance vendor finalist to be effective on or after July 1, 2009.

GASB Compliance Vendor Comparisons Summary Forms and "White Papers":

Attached to this GASB 43 & 45 Vendor Selection RFP Overview are the following documents:

a. A summary by plan sponsor of the vendors GASB compliance plan benefits and features.
b. A summary by plan sponsor of the GASB compliance plan fees and investment rates of returns as of 12/31/08 for the 75%/25% and 50%/50% risk tolerance asset allocation platform at the $10 million and $25 million of assets under management level.
c. What is Fiduciary Liability, and should I be concerned about it? "White Paper".
d. What is Conflict of Interest, and should I be concerned about it? "White Paper".

The Vendor Comparison Summary Forms are designed to focus and address the following major plan benefits and features for each GASB compliance vendor finalist. In the paragraphs that follow, each vendor plan will be reviewed and compared for the pluses and minuses of each vendor plan in the major plan category identified as follows:

1. Administration and Documents
2. Trustee
3. Investment Manager (RIA)
4. Fiduciary Liability Mitigation
5. Conflict of Interest Mitigation
6. GASB Qualifications, Experience and Service
7. Fees and Rates of Return Comparisons

1). Administration and Documents;

The major benefits and features of each vendor plan reviewed in the paragraphs that follow include the "Substantive Plan", Website Capability, Retirement Board of Authority, IRS Private

Letter Ruling (PLR), Brown Act Meetings, Contract Terms, Performance Guarantees and Plan Modifications and Plan Flexibility.

The "Substantive Plan"

Most Districts are not familiar with the need and degree of involvement it takes to develop and maintain a District's comprehensive "Substantive Plan". The details of the need, development and maintenance of a GASB 43 compliant "Substantive Plan" can be found in GASB 43 guidelines.

It appears from the various proposal responses received and reviewed that the development and maintenance of the District's "Substantive Plan" will be provided by KFS and WF. Each firm provides full service and assistance with the District's "Substantive Plan".

KFS has developed a Compliance Plan Document (CPD) that ensures the proper documenting and reporting of the District's "Substantive Plan". The creation and availability of the KFS CPD will save the District significant time and money with the updating and the continued development of the District's current "Substantive Plan".

The CCLC also provides assistance with a District's "Substantive Plan" by subcontracting the development and maintenance of a District's "Substantive Plan" to a third party. The District is expected to pay the expense for the development and maintenance of the "Substantive Plan" to the third party vendor.

CalPERS does not provide for the development and maintenance of a District's "Substantive Plan" services in any form as part of their GASB compliance services.

Website Capability

KFS and WF offer full employer and employee look up capability for plan reports and other related GASB compliance program options. The communication of important plan notices and information on each of the vendors Websites is another service that both Websites can provide at no additional cost to the District.

CalPERS and the CCLC GASB compliance vendors do not have a Website look up capability or other GASB compliance options available to the District at this time.

Retirement Board of Authority

The California State Constitution in article XVI, code section 17 recommends the creation of a Retirement Board of Authority (RBOA) by the District who has decided to fund their GASB liability through a qualified GASB irrevocable investment trust. The main purpose of the District's RBOA is to oversee the management of the District's GASB compliance plan. In order to mitigate the District's and its employee's fiduciary liability the establishment of a RBOA is highly recommended by the State's Constitution code sections.

KFS, WF and CCLC recommend the establishment of a RBOA by the District. Only KFS will automatically assist the District with all aspects of the development and the operation of a RBOA for the District.

CalPERS states that they do not believe that RBOA is required as part of the District's GASB compliance plan and fiduciary mitigation. CalPERS advises that is up to the District and their attorney's to decide if a RBOA is necessary.

IRS Private Letter Ruling (PLR)

With the exception of CalPERS the other vendors will/have assist(ed) the District in obtaining, at no cost to the District, an IRS Private Letter Ruling (PLR) for the District's GASB compliance plan. The KFS and WF plans will submit all the paperwork to the IRS for obtaining an individual District PLR which is required by the IRS to be submitted directly by the District who would like to receive approval for their GASB compliance plan from the IRS.

The CCLC is a joint power authority program (JPA) and has submitted and received their PLR for the JPA for all Districts who join the JPA to have access to the CCLC GASB compliance plan.

Brown Act Meetings

Only KFS is currently prepared to support the District in this area. All meetings conducted by the District's RBOA must be conducted under strict adherence to the "Brown Act' guidelines.
Support for preparing of, announcing of, conducting of and taking minutes for **"**Brown Act" meetings for the acceptance and management of the District's GASB compliance plan and the on-going management of the District's GASB compliance plan would be provided by KFS.

Initially and over the next 18 months from the plan's implementation date the RBOA fiduciary mitigation responsibly will be to meet each quarter to discuss all aspects of the District's GASB compliance plan including but not limited to investments, employee plan communications, risk tolerance and other GASB compliance issues.

Contract Terms

KFS and WF offer similar contract language for the length of term of the initial plan documents. Both firms are flexible concerning the offering of three to four year contract terms and both firms do not include mandatory non-cancellation clauses in their contracts.

CalPERS and the CCLC plans do include a minimum three year non-cancellation clause and non opt-out provision language in their contracts.

It has been my experience that GASB compliance plan contract terms are negotiable with KFS and WF. The CCLC has limitations as to what can be modified in their documents due to the requirement that a 2/3rd vote of all members for major modifications be obtained in order to change the language in their documents or the operation of their plan.

CalPERS determines what terms will or will not be in their documents as well as how their plan will be operated. Little if no input is taken from CalPERS plan participants pertaining to changes in contract terms or the operation of the plan. (See comments in the "Plan Modifications and Plan Flexibility" section below for more comments)

Performance Guarantees

KFS has offered to include a comprehensive plan performance guarantee as part of their standard plan document language. A monetary penalty will be paid by KFS to the District for not meeting established timelines for the delivery of specific items agreed to by all parties. KFS has also indicated in their proposal that they would be willing to discuss paying for an annual independent third party overall plan services and administration performance review audit.

WF indicated in their GASB compliance proposal that they will offer a performance guarantee to the District but details of the plan were not given. WF did not mention offering to pay for an independent third party overall plan annual performance review audit

Neither CalPERS nor the CCLC have offered or have they indicated that they would offer performance guarantees or other guarantees to the District.

Plan Modifications and Plan Flexibility

KFS and WF both allow for individual District input pertaining to the modification of the GASB compliance plan or contract language modifications. A District will receive assistance from both firms in determining their individual investment risk tolerance. Once the investment risk tolerance is determined for a District an investment policy will be created that will be managed by the selected Trust company.

KFS and WF plan operation or agreement modifications can be made with more flexibility than the approach the CalPERS and the CCLC have to take to make modifications.

The CCLC cannot change the provisions of their operation or agreements without a 2/3rd vote of all plan District participants. The CalPERS organization cannot change the provisions of their operation or agreements without requesting State legislative action which can take months to prepare, submit and obtain.

It should be very important to a District that a GASB compliance plan be very flexible to be in the position to act quickly in an economic environment that requires quick action to protect the District's plan assets.

Trustee:

Of the eight major benefits and features reviewed in this section all of the vendors compared favorably to each other in most major areas. The exception to this is in a major area of fiduciary liability exposure mitigation for the District who employs, in their compliance plan, either a Discretionary or Directed Trustee.

The delegation of investment and operational management functions of a compliance plan to a Discretionary Trustee that appoints prudent experts and acknowledges fiduciary status for investment purposes, is an exculpatory protocol that greatly reduces liability for the plan fiduciary (the District)

For maximum investment and administration fiduciary services, a Discretionary Trustee is a much more comprehensive and a protective service than a Directed Trustee relative to the mitigation of fiduciary liability. As a Discretionary Trustee investment and operational fiduciary liability exposure is mitigated for the District with a reduced work load because the Trustee makes decisions rather than giving investment and administration advice for the District to make.

The KFS and WF programs offer higher levels of fiduciary liability mitigation and less workload for the District who turns over the full investment and administration of the District's GASB compliance plan to the plans Discretionary Trustee.

Both the CalPERS and CCLC plans employ a Directed Trustee which as indicated above does not maximize the mitigation of the District's fiduciary liability but rather increases the District's fiduciary liability as well as the employees who are acting in a GASB compliance fiduciary capacity.

Investment Manager (RIA):

The KFS and WF plans offer similar benefits and features concerning the investment policy, asset allocation, risk tolerance and discretionary investment areas. Both the KFS and WF plans provide an individual investment policy which is designed to accommodate the individual District's level of risk tolerance including a range of low to high equity to fixed asset investment levels.

Only KFS and WF provide the maximum fiduciary liability mitigation in their plans structure by the inclusion of a Discretionary Trustee and Investment Manager (RIA). When a GASB compliance plan employs a Discretionary RIA **only** in the GASB compliance plan the District is assuming all fiduciary liability associated with the administration of the GASB compliance plan.

A RIA 's fiduciary standards are established by Section 206 of the Investment Advisor's Act of 1940, enforced by the Securities and Exchange Commission, ("SEC"), and are instead a list of prohibitions against self-dealing. While RIA's do have a fiduciary standard against self-dealing, you as the trust sponsor would otherwise be solely liable for the trustee fiduciary standards without the presence of a Discretionary Trustee, simply because an RIA does not have trust powers and cannot assume those responsibilities from you.

A Discretionary RIA is included in the CalPERS plan but not a Discretionary Trustee. The CCLC plan includes both a Directed Trustee and RIA in their GASB compliance plan. If a GASB compliance plan includes a Directed Trustee and RIA the District is retaining a major portion of the fiduciary liability with this GASB compliance approach.

Another major difference between the various vendors GASB compliance plans is in the area of investment risk and asset allocation. The CalPERS plan offers one investment platform which has very high risk 75% equity/ 25% fixed asset allocation platform. Additionally, the CalPERS investment platform invests assets in indexed funds on an active or passive basis. Normally, this investment approach does not maximize the highest rate of return possible as compared to the plans that have an actively managed fund investment portfolio approach.

The current and past investment results received by CalPERS appear to validate the above statement. As a result of the high level of risk that the CalPERS plan utilizes in this current upside down economy and market the CalPERS investment program has experienced very high rates of return losses and lower rates of return gains during the first quarter, 1 year, 3 years and 5 years as of the 12/31/08 investment period. (See all competitor fees and rates of return summary forms attached)

KFS and WF offer variable investment options from low to high risk options and most investments are actively managed. The KFS and WF plans have Mutual Funds, a Blend of Mutual Funds and Exchange Traded Funds and an all Exchange Traded Fund investment options available to the District. The purpose for a mixture of actively and passively managed funds is to lower overall plan expenses and to maximize the KFS and WF plans rates of return for long term investing.

The CCLC GASB compliance plan offers variable investment options from low to high risk options. However, the CCLC investment platform does not offer alternatives to their straight Mutual Fund approach.

Fiduciary Liability Mitigation:

The only similarity between the four plans in this important and critical review area is in the application of the "Prudent Man" investment mitigation of fiduciary liability for the District by all vendors.

CalPERS' does offer additional fiduciary liability mitigation by the inclusion of an investment manager (RIA) in their plan but the liability mitigation is limited to the investment of assets area only and not for the overall administration exposure a plan has with a GASB compliance plan. (See the above explanation of the differences in fiduciary mitigation provided by a Trustee and a RIA).

Since the CCLC does not employ a Discretionary Trustee or Discretionary RIA the District has limited fiduciary liability mitigation in place for the District other than the "Prudent Man" investment approach employed by all vendors.

The KFS and WF GASB compliance plans offer the maximum fiduciary liability mitigation available to a District by including a Discretionary Trustee and Investment Manager in their plan structure. (See attached "What is Fiduciary Liability, and should I be concerned about it? A "White Paper" on fiduciary liability legal documentation).

<u>Conflict of Interest Mitigation:</u>

The awareness of "Conflict of Interest" has become increasingly more of an issue as a result of the DOL's proposed regulations under ERISA section 408(b)(2). The proposed regulation would have required disclosures of certain "Conflicts of Interest" by service providers, regardless of whether or not they were fiduciaries. In addition, as a result of the resent downturn in the US and International Financial Economies and the fraudulent investment schemes being reported as a partial reason for the downturn means that plan fiduciaries must become more familiar with possible GASB compliance plan "Conflicts of Interest" and Prohibited Transactions that may be present.

A copy of a "White Paper' titled "What is Conflict of Interest, and should I be concerned about it?" is attached to this memo for your review. There are four questions in the District's RFP that deal with possible "Conflict of Interest" by and through a vendors GASB compliance plan.

Four questions included in the RFP that measure the possibility of vendor "Conflict of Interest" are as follows: 1). Is their inclusion by a vendor of proprietary funds in the Plan?, 2). Do any of the plan vendors receive 12(b) 1 and Revenue Sharing Fees?, 3). What are the vendor ownership relationships to each other? and, 4). Does revenue rebating to a District by a vendor exist in the GASB compliance plan?

After a review of the vendor proposal responses the KFS compliance plan is the only plan that currently does not appear to have a possible "Conflict of Interest" in the operation of their GASB compliance plan since KFS does not have one or all of the possible "Conflict of Interest" areas mentioned above in their plan.

The other program vendors do have a possible "Conflict of Interest" indicated as follows: CalPERS has a possible conflict with number 1) and number 3) , The CCLC appears to have conflicts with number 1) and the number 2) and Wells Fargo has a possible conflict with all four "Conflict of Interest" issues.

District's are currently being told by their financial advisors that the "Disclosure and Transparency" especially in the fees paid to a vendor and by a vendor is critical to the prudent financial management of a GASB compliance plan. However, even if the "Conflicts of Interest' issues are disclosed and are transparent this may not be good enough to protect the District from exposure to legal issues that could possibly impact the District.

GASB Qualifications, Experiences & Service

There appears to be a wide degree of disparity in most review areas that exist between all vendors in this plan benefits and features vendor review and comparison area. CalPERS and Wells Fargo are both very new at providing GASB compliance services to the education market place. As a result both have limited qualifications, experience and service experience with their clients who include GASB compliance plans for Community Colleges and K-12 clients.

CalPERS does have a significant amount of GASB compliance assets under management with Counties, Cities and Special Districts. This is the result of the large penetration of their medical plan that CalPERS has with these public entities. However, CalPERS has not been the GASB compliance plan of choice by Community Colleges and K-12 Districts as much as you would think they would be.

The reasons vary among the education entities as to why they do not elect to go with CalPERS as their GASB compliance plan. The District's that I work with and have talked to me have expressed their concern about CalPERS service issues, the lack of CalPERS support and that CalPERS does not offer a complete GASB compliance program but rather a investment platform option only.

Another major difference between all vendors is in the number of GASB experienced field services representatives that each firm currently has to service their GASB compliance clients.

KFS currently has 8 GASB experienced field service representatives available to their clients statewide.

CalPERS has zero GASB experienced field service representatives. CalPERS has indicated that they do not intend to provide field service representative, stating that their "service requirements are limited to providing an investment platform only which does not require field service representatives".

Wells Fargo currently has 2 limited experienced field services representatives and 2 experienced field GASB compliance services representatives currently in place in California. They will be adding several more field support service representatives later this year.

The CCLC has 1 limited GASB experienced field service representative. They have not indicated if they are planning to hire additional field service representatives.

KFS and the CCLC have about the same number of Community College clients 12 versus 13 accounts. KFS has a total of 22 trusts created which includes 10 K-12 clients. CalPERS has 1 Community College and 1 K-12 clients under contract. However, CalPERS does have a significant number of other public entities participating in their GASB investment platform numbering approximately 113 accounts.

CalPERS reports that they have total of $640 million in assets under management. CalPERS did not provide a breakdown as to the amount of invested dollars they have under management through the two education clients that they have under contract.

KFS is next with assets under management at an estimated amount of $240 million. The remaining two vendors the CCLC and Wells Fargo have $64 million and $50 million respectively under management.

Fees and Rates of Return Comparisons:

In analyzing the plan fees for services provided and the various historical rates of return for the 75% equity/25% fixed and the 50% equity/50% fixed asset allocation risk tolerance investment platforms as of 12/31/08, you need to keep in mind that there are differences in the pricing structures utilized by each GASB compliance firm depending what is included or not included in the firms GASB compliance plan.

An example of a pricing structure difference is when a Discretionary versus a Directed Trustee is included in the vendors GASB compliance plan. Normally, a higher fee is charged by the GASB compliance plan for the inclusion of a Discretionary Trustee in the GASB compliance plan. The reason for this increased pricing is the assumption of fiduciary liability that the Discretionary Trustee underwrites by contract for the District.

Attached to this memo are two summary reports that illustrate annual fees both in a $ and basis points (bps). Also included on these summary reports are the quarterly, 1 year, 3 years and 5 years rates of return for the 75% equity/25% fixed and 50% equity/50% fixed asset allocation investment platforms for each vendor. Several but not all of the vendors investment programs incorporate various investment platform approaches such as a full mutual fund platform option, a blended mutual fund and exchange traded fund option and an all exchange traded fund investment platform option.

KFS and WF offer all forms of investment platform options in their GASB compliance plans. The CCLC offers a mutual fund platform only and CalPERS offers an indexed exchange traded fund (ETF) investment platform only. In addition CalPERS only offers a high risk 75% equity/25% fixed asset allocation investment option.

When comparing the cost of each vendors GASB compliance plan you should review and compare the plans add-on fees, the fund expense ratios and the plans historical annual rates of return. Differences in each vendors rates of return on invested dollars can and do have a direct impact on the GASB compliance plans overall costs. A half a (bps) to 1 (bps) swing in an investment rate of return can significantly alter a District's GASB actuarial calculated funding cost liability.

CalPERS illustrated in their memo proposal their expected, but not guaranteed, plan add on fees. CalPERS estimated add on fees appear to be competitive. However, CalPERS has not/will not disclose any of their plans additional investment fund expense ratio fees.

The actual costs to operate the CalPERS investment GASB compliance investment plan for the previous year are published after the plans fiscal year. If expenses are higher than expected CalPERS retroactively charges and collects from the District the higher fee cost difference.

Net-net rates of return are defined as the rate of return results on invested assets after all add-on, expense ratios and other expenses are subtracted from the plans gross rates of return. One way to evaluate the CalPERS total plan costs is to compare the historical investment net-net rates of returns with the other plans net-net rates of return for similar asset amounts. The difficult thing to judge what the value of benefits and services are when included in one GASB compliance plan but not the other.

Currently, the high risk investment exposure of the 75% equity/25% fixed investment asset allocation level that CalPERS makes available to Districts has resulted in high rates of return losses and lower than normal rates of return gains when compared to their competitors during the same current financial market conditions.

Additionally, under the CalPERS compliance plan investment approach the District retains more fiduciary liability and has little or no control or say in the District's GASB compliance plan.

A review of the 50% equity/50% fixed asset allocation investment platforms offered by KFS, and WF indicate significant investment lower rates of return losses and higher investment rates of return gains as of the 12/31/08 period.

The CCLC fees are considered to be high given the absence of specific services and the lack of assuming fiduciary and conflict of interest mitigation for the District. The CCLC offers a mutual fund only investment platform. The District selects their level of asset allocation for their self determined risk tolerance. The CCLC rates of return for the 75% equity/25% fixed and the 50% equity/50% fixed investment platform indicate higher losses and lower gains with their plans compared to the KFS and WF plans.

<u>GASB Consultant Recommendation:</u>

After a careful review and consideration of all issues leading up to a selection of a District GASB compliance vendor(s) it is this GASB compliance consultant's recommendation that the District select both the KFS and WF plans to begin negotiating a final GASB compliance plan agreement with, and ultimately selecting the one vendor who will best fit the needs of the District concerning its overall GASB compliance plan.

<u>NOTICE:</u>

The information contained within this presentation material has been taken from the information submitted and discussions conducted with the various GASB 43 & 45 compliance vendors listed in the above comparative analysis. Errors in the presentation material are not intentional or done in a willful or misleading way. Please notify us of any errors discovered so they can be corrected.

***RPM* Consultant Group is not a legal firm, an accounting firm or an actuarial firm. You should contact your professionals for any information pertaining to the operation of the District in these important areas of compliance.**

What is Fiduciary Liability, and should I be concerned about it?

There has been a significant amount of discussion and information researched and published in the past several years pertaining to fiduciary liability as a result of GASB 43 & 45 compliance guidelines being issued and becoming a reality. You will find references to fiduciary liability issues in the GASB 43 & 45 compliance guidelines. However, the GASB 43 & 45 compliance guidelines do not address the full fiduciary structure that a public entity should consider since the GASB 43 & 45 guidelines are geared to accounting and auditing issues not necessarily fiduciary liability structures of the public entities plan.

Whenever a public agency invests funds designated to provide employee benefits, the representatives of the local agency authorized to make the investment decisions are considered fiduciaries. Fiduciaries must act solely in the interests of the participants of the plan for which they are given responsibility for the assets. Fiduciaries are required by law to make investment decisions subject to the standards of a “prudent investor,” which means they are expected to invest with the care, skill, prudence and diligence that a prudent person would exercise knowing the conditions, objectives and circumstances.

When considering and developing a GASB 43 & 45 compliance plan a number of documents, codes, guidelines and federal and state laws need to be referenced. To name a few of these, you should consider what is documented in the State Constitution, the Education Code, GASB 43 & 45 Guidelines, and the Employee Retirement and Income Security Act (ERISA) as you develop your GASB 43 & 45 compliance plan on a coordinated and integrated basis.

As you already know California law restricts the range of investments that may be made with public funds. In many cases, only fixed-income investments with government backing are permitted, and the funds would typically be deposited with a County Treasurer or the Local Agency Investment Fund (LAIF). In 1998, new provisions were added to the Government Code to permit a wider expansion of investments for funds designated to provide retiree health benefits. The Legislature intended this expansion to allow assets to gain higher yields and reduce unfunded retiree benefit liabilities. However, public agencies may not always have staff with sufficient expertise to prudently invest funds.

Local agencies may appoint outside investment managers to invest assets on a **discretionary basis**, provided the local agency (this is Foothill De Anza CCD) exercises prudent selection, and **imposes appropriate safeguards to oversee the activities of the investment manager.** In the case of a GASB 43 & 45 retiree health and welfare benefit plan, a structured relationship that defines the monitoring of performance, investment policy statement, and ongoing financial reporting, should allow it to meet its obligations for prudently selecting the program, trustee and investment manager. In addition, a set of procedures must be spelled out and followed by the public agency to effectively meet their obligation to monitor the activities of the plan trustee and investment managers. A well-designed GASB plan should contain the necessary protections to mitigate the agency and its designated officers from potential fiduciary liability for their investment of public funds.

There have been numerous conversations that have taken place concerning the introduction of a “Retirement Board” as a necessary component of a public entities GASB 43 & 45 compliance plan. The need for the use of a “Retirement Board” which will be discussed a little later in this “White Paper” is specifically mentioned in the “California Constitution”. However, not everyone has completed their due diligence to determine what is necessary with any investment plan that the public entity institutes to be in compliance with the GASB 43 & 45 compliance guidelines.

The following information has been taken from a review of the California Constitution [Copy of the California Constitution Article XVI, sections and 17 is attached] The California Constitution generally prohibits public funds from being invested in corporate stock, but provides an exception for the investment of public pension or retirement system funds by the retirement board of a pension or retirement system. The California Government Code reflects that exception in two places. Government Code sections 53215-53224 establish the duties of the board of a retirement system. And Government Code sections 53620-53622 expressly discuss the authority of the governing body of a local agency to invest funds designated for the payment of employee retiree health benefits in any form or type of investment deemed prudent by the governing body.

A District’s GASB 43 & 45 compliance plan either developed on their own or as a result of selecting one of the “Turnkey” programs that are available in the market to provide investment services should be designed to conform with Article XVI, section 17, as well as both cited portions of the Government Code cited above, reference to the use of a “Retirement Board” is specifically mentioned in this section of the Government code.

A “Retirement Board” in a fiduciary capacity needs to be aware of, or seek the input from, a qualified GASB 43 & 45 expert (E. G. of an expert a attorney, a consultant, a actuary or a auditor) pertaining to the differences in the degree of fiduciary mitigation applicable to utilizing a “Prudent Man”, a Investment Manager, a Trust Company or all of the above compliance utilities when establishing the entities GASB 43 & 45 compliance plan.

Briefly, maximum fiduciary mitigation program compliance is achieved by the public entity not only through engaging an Investment Manager, but rather in partner with a Trust Company both acting in a “Discretionary” capacity through the “Retirement System” structure mandated under the California Constitution.

A “Discretionary Trustee” has sole authority for making any distributions from the irrevocable account in the trust. The trustee will provide ongoing support to the public agency including maintenance of records, trust account statements, electronic access to trust financial information via the Internet, telephone support and participation in meetings, as needed and much more

The “Investment Manager” does have fiduciary standards that they must comply with in a “Discretionary” capacity. However, the public entity would be solely liable for the trustee fiduciary standards (more detailed) without the presence of a Discretionary Trustee, simply because an “Investment Manager” does not have trust powers and cannot assume those responsibilities from you.

Further, the obligation to administer the program and document decisions is achieved through a comprehensive "Substantive Plan" that gives the public entity all necessary documentation of the OPEB obligation, as well as helping set the agenda for periodic Board meetings and producing meeting minutes that detail the actions taken by the Board in fulfilling their fiduciary obligations.

The management of the public entities fiduciary mitigation can be implemented directly by the employer under ERISA guidelines utilizing the" Prudent Man" investor rules and the fiduciary mitigation provided by a "Discretionary Investment Manager". However, as outlined above the public entity still maintains a major portion of the public entities fiduciary liability exposure under this limited fiduciary mitigation approach.

In summary a GASB 43 & 45 compliance plan for a District should be developed based on the extensive input of legal counsel, consultants and other professional sources. A number of legal organizations including Greg Harrington and Donald S. Field of Orrick, Herrington & Sutcliffe LLP, Catherine DeBono Holmes of Jeffer Mangels Butler & Marmaro LLP and Bruce Ashton of Reish Luftman Reicher & Cohen have been actively involved in rendering their legal opinions pertaining to the fiduciary liability structures and the establishment of "Retirement Boards" to oversee a District's GASB 43 & 45 compliance plans.

RPM Consultant Group is not a legal firm but as a result of providing GASB 43 & 45 compliance consulting services we have reviewed and researched and concur with the areas referenced above. We would be interested to direct you to the knowledgeable legal firms that can assist you with answering your questions in this important area know as fiduciary liability.

What is Conflict of Interest and should I be concerned about it?

While conflicts of interest—which can often also constitute prohibited transactions—have been an issue for some time, the awareness of conflicts was elevated by the DOL's proposed regulation under ERISA section 408(b)(2). The proposed regulation would have required disclosures of certain conflicts of interest by service providers, regardless of whether or not they were fiduciaries. It appears that approach is becoming engrained into the fabric of the benefits community. For example, the Defined Contribution Fee Disclosure Act recently introduced by Senators Harkin and Kohl also proposes to require disclosures of conflicts of interest.

As a result, service providers need to be diligent about disclosing their conflicts and fiduciaries need to be rigorous in their analysis of potential conflicts . . . and in taking steps to protect their plans and participants from those conflicts. Needless to say, that is particularly true where the conflicts also constitute prohibited transactions under ERISA and the Internal Revenue Code.

To make matters worse, the appeal of conflicted transactions is even greater during difficult economic times . . . similar to those we are now experiencing. The potential conflict of interest that could exist with vendors who provide GASB 43 & 45 compliance programs may be in the following areas:

1. The use of proprietary investment funds in a investment platform
2. The ownership relationships between vendors such as the Trust Company and the Investment Manager
3. Receiving 12(b) 1 fees (commissions) as additional compensation for services
4. Receiving revenue sharing from fund companies for providing services
5. Rebating revenue sharing from fund companies to lower fees

The GASB 43 & 45 compliance area is still a relatively new field for investing by public entities. Most of the conflict of interest information published by the various GASB 43 & 45 expert legal counsel has been published about pension programs such as 401(k) plans and defined contribution plans. However, a GASB 43 & 45 compliance plan is also looked upon as a retiree benefit and does fall under most guidelines for pension programs especially ERISA.

The legal firm of Reish Luftman Reicher & Cohen have published a "White Paper" titled "The Fiduciary Duty to Avoid Conflicts of Interest in selecting Plan Service Providers deals with many if not most the same decisions public entities encounter when reviewing and selecting a GASB 43 & 45 compliance vendor(s). The "White Paper" contains a discussion of the relevant law and specific examples of conflicted situations. Attached is a copy of the "White Paper" for your review.

RPM Consultant Group is not a legal firm but as a result of providing GASB 43 & 45 compliance consulting services we have reviewed and researched and concur with the areas referenced above and attached. We would be interested to direct you to the knowledgeable legal firms that can assist you with answering your questions in this important area know as conflicts of interest.

Shupe and Finkelstein

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March 24, 2009

CONFIDENTIAL
ATTORNEY-CLIENT PRIVILEGE

Andy Dunn, Vice Chancellor
Foothill-De Anza Community College District
12345 El Monte Road
Los Altos Hills, CA 94022

Re: Vendor Responses to GASB 43 and 45 Compliance RFP; Comparison of Fiduciary Liability Risk

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Dear Mr. Dunn:

INTRODUCTION

You have asked us to review and analyze the assumptions underlying Consultant Chuck Thompson's evaluation of four vendor responses to the District's Request for Proposals ("RFP") for GASB 43 and 45 compliance. In order to do so I reviewed the District's RFP and the responsive proposals of vendors Wells Fargo, Keenan, League of California Community Colleges Foundation ("League") and CalPERS. I also reviewed some of consultant Thompson's input concerning the risks of liability for breach of fiduciary duty and conflict of interest associated with GASB compliance, as well as Statements 43 and 45 and certain GASB guidance publications available on the GASB website. Finally, on March 20, 2009 I spoke with Mr. Thompson in an effort to clarify and understand the basis for some of his opinions.

BACKGROUND AND ASSUMPTIONS

GASB 43 and 45 require the District to account for and report its activities and liabilities in providing retirement health benefits ("OPEB") in ways not previously necessary. Because the OPEB accounting and reporting requirements are both new and complex, the District issued an RFP for vendors to help the District craft the necessary GASB compliance plan. Presently, the responsive proposals of four vendors are still in the mix: Wells Fargo, Keenan, the League, and CalPERS. The District's deadline to select a vendor is approaching.

Chuck Thompson/RPM was retained to help evaluate the RFP responses. In the course of doing so he has focused on the District's potential liability for breach of fiduciary duties, finding such exposure in both California laws and in the federal retirement law, ERISA. He has stated his view that mitigating such risks, including those under ERISA, is the most important criterion in selecting the vendor to help prepare and implement the compliance plan. Mr. Thompson's application of that criterion to the four vendor proposals leads him to favor those of Wells Fargo and Keenan. Mr. Thompson favors their proposals because he believes that they are more comprehensive in mitigating fiduciary liability exposures in all aspects of OPEB activities, then are the proposals made by the League and CalPERS. In discussing this with Mr. Thompson he clarified that Wells and Keenan score better on the criterion of fiduciary liability risk minimization because they will offer contracts which require that they or other selected vendors/consultants *assume* the District's fiduciary obligations and exposures in all areas of OPEB activities. Mr. Thompson states that he has reviewed the contracts offered by League and CalPERS, and they do not include such liability assumption clauses.

DISCUSSION

My analysis does not address the question of which vendor proposal best fits the needs of the District, as that is a policy rather than legal judgment. Rather, both you and Controller Hector Quinonez have expressed concern about some of the assumptions behind Mr. Thompson's opinions that (a) mitigation of the risk of breach of fiduciary duty liability imposed by ERISA should be the primary criteria in evaluating vendor proposals, and (b) application of that criterion to the vendor proposals here necessarily favors the proposals of Wells and Keenan. As I explain below, because several of the assumptions Mr. Thompson relies upon are questionable, his stated vendor preferences may also be open to some question.

A. <u>Breach of Fiduciary Duty Liability: Overview</u>. Because the concept plays such a major role in Mr. Thompson's analysis of the vendor proposals, it is worth providing a brief overview of the applicable law.

A "fiduciary relationship" is any "relation existing between parties to a transaction wherein one of the parties is duty bound to act with the utmost good faith for the benefit of the other party. Such a relation ordinarily arises where a confidence is reposed by one person in the integrity of another, and in such a relationship, the party in whom confidence is reposed, if he voluntarily accepts or assumes to accept the confidence, can take no advantage from his acts relating to the interest of the other party without the latter's knowledge or consent...". (*Wolf v. Superior Court* (2003) 107 Cal.App.4th 25, 29) An act amounting to breach of fiduciary duty can arise from negligent failure to exercise due care, or from other tort, or from breach of contract. (*Kangarlou v. Progressive Title Co., Inc.* (2005) 128 Cal.App.4th 1174) Fiduciary relationships often arise in situations where one party agrees to handle the money of another for specified purposes; stockbroker-principal and trustee-beneficiary relationships are examples. "The relationship between a broker and a principal is fiduciary in nature and imposes on the broker the duty of acting in the highest good faith toward the principal. (*Twomey v. Mitchum, Jones & Templeton, Inc.* (1968) 262 Cal.App. 2d 690) "Good faith" includes avoiding conflicts of interest, self dealing and failure to meet the reasonable investor standard. In lawsuits against fiduciaries, once plaintiff establishes the existence of the relationship, the burden switches to the trustee to justify his actions. (*LaMonte v. Sanwa Bank California* (1996) 45 Cal.App. 4th 509, 517) However, the broker who has no authority to make trading or investment decisions, and merely executes the orders of one who does, cannot be liable for breach of fiduciary duty if those trading or investment decisions produce bad results for the principal. (*Mars v. Wedbush Morgan v. Securities, Inc.* (1991) 231 Cal.App.3d 1608, 1615) An analogous principle is recognized by federal courts in ERISA litigation: fund managers lacking authority to make investment decisions, who merely execute the decisions of those giving the directions, are not exposed to breach of fiduciary duty claims based on bad outcomes of those decisions. (*E.g., Wright v. Oregon Metallurgical Corp.* (9th Cir. 2004) 360 F.3d 1090)

When our Legislature authorized public entities to set up employee pension plans, the resulting statutes either explicitly imposed, or used words implying, the employer's fiduciary status viz a viz the plan beneficiaries. (Government Code §§53216.1 (pensions), 53622 (retiree health benefits)) See also, California Constitution, Article 16, sec. 17) With that fiduciary status come the duties, and potential liability for breach, recognized by California law for many decades. (See generally, decisions arising under the County Retirement law, such as *Masters v. San Bernardino County Employees Retirement Assoc.* (1995) 32 Cal.App.4th 30)

B. <u>Fiduciary Duty and Risk of Breach Arising from ERISA</u>. Several of Mr. Thompson's written submittals suggest that risk mitigation as regards to breach of fiduciary duty is of primary importance because of the liability provisions in the federal retirement law, ERISA (29 U.S.C. §1000 et seq.) See, for instance, <u>What is Conflict of Interest and should I be concerned about it</u>, page 1, in which Mr. Thompson states "However, a GASB 43 and 45 compliance plan is also looked upon as a retiree benefit and does fall under most guidelines for pension programs especially ERISA."

In fact the fiduciary liability provisions in ERISA are *not* applicable to public employee retirement systems. (29 U.S.C. §1003(b)(1))

When I spoke with Mr. Thompson on March 20 I asked him if he understood that these parts of the ERISA statute are not applicable to public employer retirement systems, and therefore could not be imposed by GASB standards, which are, of course, also only applicable to public employers. He said yes, but then offered his belief that, regardless of the wording of 29 U.S.C. §1003(b)(1), ERISA standards on breach of fiduciary liability do apply because lawyers he has worked with for many years have assured him that they do. When I asked him to supply me with any written lawyer opinion so stating, he referred to materials supplied to him by GASB 43/45 compliance vendors. He agreed with my observation that these statements might be doubtful due to their source. In further discussion he stated that the lawyers he has worked with over the years have told him that California law effectively imports ERISA standards by using similar phrases in Government Code section 53622 and California Constitution Article 16, sec. 17. When I asked him again if he could supply me with anything in writing from those lawyers so opining, he referred me to the "Whitepaper" from the law firm of Reisch Luftman Reicher & Cohen , which Mr. Thompson had given to Hector. I reviewed that document and it discusses only ERISA provisions and does not state or even suggest that ERISA applies to California law on public employee retirement plans.

I conclude that to the extent Mr. Thompson's selection of fiduciary liability risk mitigation as the most important criteria in evaluating vendor responses is driven by fear of ERISA liability, that fear is of questionable validity.

C. <u>Application of Mr. Thompson's Fiduciary Liability Risk Mitigation Criterion to the Four Vendor Proposals</u>. Regardless of whether it is appropriate to make fiduciary liability risk mitigation the most weighty criterion in evaluating the vendor responses to the District's RFP, you and Hector have expressed concern about Mr. Thompson's *application* of that criterion to the vendor proposals. Mr. Thompson's application results in him favoring the proposals of Wells and Keenan over those of League and CalPERS. However, as indicated below, whether application of this criterion favors one vendor over another depends on the assumptions inherent in the analysis one uses.

Mr. Thompson states that he favors the proposals of Wells and Keenan because they **mitigate** the risks of fiduciary liability **in a more comprehensive way** than do the proposals of League and CalPERS. These conclusions ("better mitigation", "more comprehensive") are dependent upon certain assumptions Mr. Thompson relies upon, and which should be carefully analyzed.

Mitigation. In speaking with Mr. Thompson I learned that the "mitigation" factor he relies most heavily upon is a fiduciary liability assumption clause which he states is in the contracts which Wells and Keenan offer. I reviewed the sample forms of agreement within the appendices to the Wells and Keenan proposals. I saw no assumption of liability clause. Instead, what I saw were typical mutual indemnity clause, in which each party promises to indemnify the other for claims resulting from the error of the first. These clauses would not create a defense, to the District, in the event an unhappy retiree sued the District claiming that the task undertaken by the District vendor who provided that clause breached some fiduciary duty to the retiree. Moreover, even if a true fiduciary liability assumption clause were actually included in the sample agreements provided by these two vendors, I have some doubt that the District could lawfully contract away its fiduciary duties. Such duties, imposed by our public employee retirement laws, may well be non-delegable. (See, Government Code sec. 815.6, making public entity liable for negligence of its independent contractor to the same extent as a private entity) If that is true, the value to the District of the quoted contractual provision is that it would require the contractor offering it to indemnify the District against a judgment for breach of fiduciary duty arising from the contractor's mistake or error. This is the same outcome the District could obtain through liability insurance. That outcome is of course of value to the District, but is of a wholly different character than a mitigation measure which prevents the imposition of liability in the first instance.

Comprehensive. My discussion with Mr. Thompson also clarified what he means by "comprehensive" mitigation measures. As expressed by Mr. Thompson, the Wells and Keenan proposals include arranging for appropriate consultants/contractors to perform not only the fund management and investment decision making, but also the claims administration work presently performed by District employees. Neither the League nor CalPERS proposals involve those vendors in claims administration functions. In Mr. Thompson's view the League and CalPERS proposals area therefore less comprehensive.

In his application of these assumptions, however, Mr. Thompson does not seem to distinguish between the level of risk associated with claims administration decisions and fund management/investment decisions. The risk level is best viewed as a scale or continuum. Erroneous health benefit claims decisions affecting retirees might give rise to fiduciary duty liability suits. However, the exposure such a suit presented would be insignificant, compared to the exposure presented by a poor investment decision which ends up depleting the benefit trust fund.

Moreover, in his application of these assumptions Mr. Thompson does not account for the additional breach of fiduciary duty risks which the Wells and Keenan proposals could place on the District compared to the CalPERS proposal. By any measure the largest potential exposure for claims of breach of fiduciary duty arises from fund management and investment decisions. If the GASB compliance plan the District implements includes the District remaining involved with those decisions - even if only through a contractor whose investment authority is "discretionary" - then it would appear that the District exposure remains (albeit, "mitigated" by the contractual indemnity clauses addressed above). The CalPERS proposal would take the District entirely out of the process as to fund management and investment decisions. Having no involvement in making fund management and investment decisions, it seems doubtful that the District could be successfully sued for breach of duty regarding those decisions. (*Mars*, supra, 231 Cal.App.3d at 1615) In his conversation with me Mr. Thompson discounted this factor by pointing out that CalPERS' contract includes no "assumption of liability" clause. However, as noted above, I saw no such clause in the sample contracts contained in the appendices of the Wells and Keenan proposals. Even if there were, the lack of an "assumption" clause in an agreement with CalPERS would not alter the outcome. In the event of a poor fund management or investment decision by CalPERS which depleted our retiree's trust account, whether or not there was such a clause the only viable defendant in that suit would be CalPERS. The District would not be a viable defendant because it was simply not involved in and had no control over CalPERS decisions.

I conclude that application of risk mitigation as the predominant criterion for selecting among the four competing vendors favors the Wells and Keenan proposals if (a) one assumes that true fiduciary duty assumption clauses will actually be offered by Wells and Keenan, and will provide the District with a complete defense (as opposed to a right to indemnity) in the event of suit for breach of fiduciary duty; and (b) one also assumes that the CalPERS proposal, which takes the District completely out of any decision making with respect to fund management and investment decisions, nonetheless imposes the same potential breach of fiduciary duty liability upon the District for poor fund management and investment decisions as could exist with respect to the Wells and Keenan proposals. As noted above, both of these assumptions seem questionable.

CONCLUSION

My review of this matter leads me to the following conclusions. First, to the extent Mr. Thompson's selection of fiduciary liability risk mitigation as the predominant criterion in evaluating the four vendor proposals is driven by fear of ERISA liability, that fear, and the outcome it dictates, is misplaced. ERISA does not apply to public employer retirement systems, and ERISA is not imported by GASB 43 and 45. Second, the application of the fiduciary liability risk mitigation criterion to our four proposals will favor one vendor over another depending upon the assumptions inherent in one's analysis. It appears that Mr. Thompson's assumptions regarding the effect of supposed fiduciary duty assumption clauses, and regarding the relative risk impact of the CalPERS proposal, are open to question.

Thank you for your attention to this opinion letter. Please let me know if you have any questions or instructions regarding the foregoing.

Very truly yours,

SHUPE AND FINKELSTEIN

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The Fiduciary Duty to Avoid Conflicts of Interest in Selecting Plan Service Providers

A WHITE PAPER

by

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I. EXECUTIVE SUMMARY

In the course of our legal practice and in our conversations with others in the retirement plan industry, we have seen and heard about increasing numbers of conflicts of interest for fiduciaries in their dealings with investments and service providers. The purpose of this White Paper is to analyze the law relating to conflicts of interest that retirement plan fiduciaries may encounter in selecting the investments and service providers for 401(k) plans.

As part of our analysis, we review several scenarios that raise issues about conflicts of interest and we analyze how those conflicts may violate the Employee Retirement Income Security Act of 1974 ("ERISA"). Specifically, we discuss conflicts in the context of ERISA's fiduciary duty and prohibited transaction rules. In that context, it is clear that plan sponsors, and the officers and managers who serve as fiduciaries, are required to identify and evaluate conflicts of interest and to protect the plan and the participants from their consequences. The failure to do so is a breach of fiduciary duty for which those officers and managers are personally liable. It is equally clear that where plan sponsors and their fiduciaries engage in prohibited transactions (that is, certain specified conflicts), they will be liable for disgorging any benefits and for making the plan whole.

In our practice, we find that fiduciaries often do not recognize that they are engaging in conflicts of interest. Our goal in writing this White Paper is to educate fiduciaries and their advisors about how these conflicts arise and the legal dangers they present.

Examples of potentially conflicted situations are:

1. A bank offers a manufacturing company favorable business banking terms if the company transfers its retirement or 401(k) plan to the bank.
2. The retirement plan's trustee buys and sells securities through a particular broker-dealer. The broker-dealer – using a portion of the commissions received from the purchase and sale transactions – pays for the trustee to attend investment strategy conferences in exotic locations
3. A financial institution offers a fiduciary favorable mortgage terms on his personal residence if the company transfers its 401(k) services to the financial institution.
4. A law firm provides legal services for a trust company. During the course of the relationship, the trust company notifies the law firm that it prefers to send its legal work to law firms that maintain their 401(k) assets with the trust company. The law firm transfers its plan assets to the trust company.

Conflicts of interest adversely affect the integrity of the private retirement system. At the least, the appearance of impropriety calls into question fiduciaries' loyalty to participants. At worst, a conflict of interest can have a direct adverse impact on the plan and its participants. For instance, a conflict of interest, gone unchecked, can result in the plan paying more than reasonable compensation to service providers or result in fiduciaries offering mediocre and overly expensive investment options when superior products are available at equal or less expense. Conflicts of interest, therefore, can adversely affect the benefits available to participants at retirement – the exclusive purpose for which retirement plans exist.

When fiduciaries seek to benefit the employer or themselves, they are – sometimes unwittingly – engaged in violations of ERISA. That is, fiduciaries may not recognize or take the time to consider that their actions are in conflict with the best interests of the plan and with the fiduciaries' duty of loyalty to the participants. Conflicts may seem innocuous to many fiduciaries. After all, it is not uncommon for companies to give more favorable terms to those businesses to whom they provide multiple services. The rules, however, change when retirement plans are involved.

In an effort to increase the transparency – and simplify the evaluation – of conflicts of interest, the United States Department of Labor ("DOL") issued a proposed regulation in 2007 requiring service providers to disclose certain conflicts of interest that may affect plans. Although that proposed regulation has not been finalized, it reflects the thinking of the DOL about what is required in order for fiduciaries to be able to fulfill their duties to plan and is likely to increase the expectation that fiduciaries will prudently review and respond to the disclosed information. It is reasonable to assume that, in the future, the DOL and plaintiffs' attorneys will focus more on conflicts of interest and the conduct of fiduciaries in evaluating those conflicts.

When a conflict exists for fiduciaries of a retirement plan that is governed by ERISA, two distinct sets of ERISA requirements are implicated: (1) the rules governing breaches of fiduciary duty found in ERISA §404(a) and (2) the prohibited transaction rules in ERISA §§406(a) and (b).

The fundamental fiduciary duties are set forth in the so-called "prudent man" rule, the duty of loyalty and the "exclusive benefit" rule. These duties require fiduciaries to carry out their duties as would "a prudent man engaged in a like capacity and familiar with such matters," to act "solely in the interest" of plan participants and to act for the exclusive purpose of providing retirement benefits to participants.

Fiduciaries are obligated under ERISA's fiduciary responsibility rules to (1) identify conflicts (or potential conflicts) that may impact the management of a plan; (2) evaluate those conflicts and the impact they may have on the plan and its participants; (3) determine whether the conflicts will adversely impact the plan; (4) consider protections that would protect the plan and participants from any potential adverse affect of the conflict (for instance, appointing an independent fiduciary to evaluate the investment or proposed service provider) and; (5) if the conflict adversely impacts the plan and its participants, change service providers, investments or other circumstances related to the conflict.

Although a conflict of interest may exist in connection with a proposed transaction, entering into the transaction may or may not be a breach of fiduciary duty – the determining factors are whether the fiduciary prudently evaluates the conflict, and acts solely in the interest of the participants and for the exclusive purpose of providing benefits. If material adverse impact on the participants cannot be avoided or properly mitigated, entering into the transaction would not be prudent and would trigger a fiduciary breach.

Furthermore, if a conflict of interest is precluded under ERISA's prohibited transaction rules, the fiduciaries cannot, as a matter of law, allow the plan to become a party to the transaction – even if the action were otherwise reasonable or profitable to the plan.

Absent an exemption, fiduciaries are absolutely precluded from entering into a contemplated transaction if it meets the criteria of the prohibited transaction provisions of ERISA §406 – even if doing so could otherwise be considered "prudent" and therefore satisfy ERISA §404.

Fiduciaries should be aware of both of sets of rules and conduct themselves accordingly.

ANALYSIS AND DISCUSSION

A. <u>Introduction</u>

In the course of our practice and in speaking with others in the retirement plan community, we have encountered numerous conflicts of interest that affect plan sponsors and fiduciaries. For ease of reference, we will refer to both plan sponsors and their fiduciaries (*e.g.*, plan committee members) as "fiduciaries."

The law governing how fiduciaries are to address conflicts of interest has not changed significantly since Congress passed the Employee Retirement Income Security Act of 1974 ("ERISA"). However, our experience is that fiduciaries often fail to understand when they are operating under a conflict of interest, fail to understand the rules that govern their conduct and do not know how to comply with their obligations in that setting. Our goal is to educate those fiduciaries and thereby help them avoid potential liability by fulfilling their duties to act prudently and for the exclusive purpose of providing benefits to participants.

At least two recent changes warrant renewed focus on conflicts of interest. The first is the current wave of high-profile litigation that is premised, in part, on claims that fiduciaries have acted under conflicts of interest, thereby breaching their fiduciary duties and engaging in transactions prohibited by ERISA. For example, in one case the plaintiffs criticize the plan trustee and recordkeeper for limiting the plan's investment options to funds for which the trustee's affiliate provides investment management services.[1]

The second reason is the increased focus by the United States Department of Labor ("DOL") on the conflicts of interest that may adversely affect the services they provide to plans. In late 2007, the DOL issued a proposed regulation focusing largely on the conflicts of interest affecting the plan's service providers (rather than the benefits that the fiduciaries may enjoy by virtue of directing the plan to do business with a particular service provider).[2] Although that proposed regulation has not been finalized (and deals with service provider conflicts rather than the conflicts affecting plan sponsors), it is likely to increase expectations by the DOL, participants and plaintiffs' attorneys that fiduciaries must be aware of the conflicts that infect their own relationships with the plan's other fiduciaries and service providers. Fiduciaries, therefore, should inform themselves about the law that governs those conflicts, the ways in which conflicts can arise and what should be done when they do arise. Avoiding conflicts of interest – and at a minimum, taking appropriate steps to mitigate any effect they have on a plan – is a must, both to manage the risk of litigation and to properly protect participants' retirement benefits.

The first step in avoiding conflicts of interest is to recognize them. That isn't always easy. Fiduciaries may believe that, in order for a conflict of interest to exist, the fiduciary must somehow act in a manner that is adverse to the plan. However, the better approach is for fiduciaries to ask themselves whether someone other than the participants benefits as a result of the selection of a service provider or an investment decision. The second step is, of course, to prudently evaluate any conflicts.

Later in this White Paper, we discuss cases we and others have encountered that create conflicts for plan fiduciaries. In some of the circumstances, the decision made by the fiduciaries may not have been "bad" from the standpoint of the participants. However, in each example the fiduciary arguably entered into the transaction or selected the service provider for the wrong reasons – to benefit themselves or their employer – and unwittingly subjected themselves to liability. To understand why, fiduciaries need to know the rules that govern their relationship to their plan.

[1] *See, e.g.,* Complaint in *Hecker v. Deere & Co.*, United States District Court for the Western District of Wisconsin, Case No. 06-C-0719-S.
[2] The text of the proposed Regulation, which has not been finalized, can be found at 72 FR 70988, 71004-71005.

B. The Law Governing Conflicts of Interest

Among a fiduciary's fundamental responsibilities is the "avoidance of conflicts of interest."[3] While conflicts of interest can arise in any number of ways, they are not always easy to identify. What at first appears to be a "win-win" transaction may in fact be a conflict of interest. After all, in the business world, companies and their owners commonly receive more favorable terms from their vendors and service providers when they do business on several fronts. For instance, a business owner may have access to better home mortgage interest rates from the lender with whom the business banks. The business itself might receive more favorable line of credit facilities in exchange for having the same bank handle its payroll services. However, the rules change when a transaction involves an ERISA-governed retirement plan. Those transactions implicate ERISA's fiduciary duties and prohibited transaction rules.

1. Who Are The Fiduciaries?

The first step in discussing a fiduciary's obligations is to determine whether someone is a fiduciary. ERISA defines "fiduciary" as follows:

> 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.[4]

For purpose of this White Paper, we will focus on the first and third definitions: the asset manager fiduciary (who selects the plan's investments) and the administrator fiduciary (who selects the plan's provider).

Employers, as plan sponsors, are, by definition, fiduciaries.[5] Indeed, unless the plan specifies otherwise, the plan sponsor is the "administrator"[6] and therefore a fiduciary.

As the DOL has noted, certain plan officers such as trustees, administrators and members of a plan's committee are fiduciaries simply by virtue of their appointment to a plan-related office:

> Some offices or positions of an employee benefit plan by their very nature require persons who hold them to perform one or more of the functions described in section 3(21)(A) of the Act. For example, a plan administrator or a trustee of a plan must, be the very nature of his position, have "discretionary authority or discretionary responsibility in the administration" of the plan within the meaning of section 3(21)(A)(iii) of the Act. Persons who hold such positions will therefore be fiduciaries.[7]

Selecting and monitoring the plan's service providers is one of the fiduciary functions of the plan administrator.[8] Thus, those who select the plan's service providers must comply with their fiduciary duties when doing so.

Other persons become fiduciaries by virtue of the functions they perform, regardless of title or whether they think of themselves as fiduciaries. For example members of a company's board of directors may themselves be fiduciaries to the extent they are responsible for appointing the plan's fiduciaries, since they have discretionary authority or discretionary control with respect to the management of the plan:

> Members 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 [ERISA]. 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.[9]

As a result, the plan sponsor, officers appointed to plan committees or otherwise designated to make plan decisions, and directors who appoint plan fiduciaries, are all fiduciaries under ERISA. Therefore, they are subject to the law's fiduciary and prohibited transaction rules in their administrative decisions (such as selecting service providers) and investment decisions (such as selecting the investments for the plan).

The next step in our analysis is to review those rules.

2. What Are The Fiduciaries' Fundamental Duties?

ERISA imposes high standards upon fiduciaries. The courts refer to those duties as "the highest known to law."[10] The three fundamental obligations of

[3] *Mertens v. Hewitt Assoc.*, 508 U.S. 248, 251-52, 113 S.Ct. 2063, 124 L.Ed.2d 161 (1993).

[4] ERISA §3(21)(A).

[5] *See, generally, In re Enron Corp. Securities, Derivative & ERISA Litigation*, 284 F.Supp.2d 511, 551 (S.D. Tex. 2003).

[6] ERISA §3(16)(A)(ii).

[7] 29 C.F.R. §2509.75-8 at D-3.

[8] *Liss v. Smith*, 991 F.Supp. 278, 300 (S.D.N.Y. 1998).

[9] 29 C.F.R. §2509.75-8 at D-4.

[10] *Sommers Drug Stores Co. Employee Profit Sharing Trust v. Corrigan*, 793 F.2d 1456, 1468 (5th Cir. 1986); *Donovan v. Bierwirth, 680 F.2d 263, 272 n. 8 (2d Cir.), cert. denied* , 459 U.S. 1069, 103 S.Ct. 488, 34 L.Ed.2d 631 (1982).

ERISA fiduciaries are set forth in ERISA §404(a). The first two are the duty of loyalty and the exclusive purpose rule:

> [A] fiduciary shall discharge his duties with respect to a plan ***solely in the interest of the participants*** and ***beneficiaries*** [the duty of loyalty] and –
>
> (A) for the ***exclusive purpose*** [the exclusive purpose rule] of:
>
> > (i) providing benefits to participants and their beneficiaries; and
> > (ii) defraying reasonable expenses of administering the plan . . .
> > (Emphasis added.)

Plan fiduciaries, therefore, have a duty of loyalty that runs directly to the participating employees. This means that the fiduciaries must "exclude all selfish interest and all consideration of the interests of third persons."[11]

They must also act for the *exclusive purpose* of providing retirement benefits to the participants. When corporate directors and officers are acting in their capacity as plan fiduciaries, their exclusive purpose must therefore be to provide benefits – they are obligated "to avoid placing themselves in a position where their acts as directors or officers of the corporation will prevent their functioning with the complete loyalty to participants demanded of them as trustees."[12]

The third duty is to act prudently – fiduciaries must act "with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent [person] 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."[13]

Consequently, when selecting service providers, fiduciaries must engage in an appropriate process: "… [T]he failure to exercise due care in selecting and monitoring a fund's service providers constitutes a breach of . . . fiduciary duty."[14] "At the very least, trustees have an obligation to (i) determine the needs of a fund's participants, (ii) review the services provided and fees charged by a number of different providers and (iii) select the provider whose service level, quality and fees best matches the fund's needs and financial situation."[15]

As part of that process, fiduciaries must take conflicts of interest into account. As the DOL recently stated:

> With regard to the prudent selection of service providers generally, the Department has indicated that a fiduciary should engage in an objective process that is designed to elicit information necessary to assess the provider's qualifications, quality of services offered and reasonableness of fees charged for the service. ***The process also must avoid self dealing, conflicts of interest or other improper influence***.[16]
> (Emphasis added.)

Although it has not been finalized, the DOL's proposed Regulation under ERISA §408(b)(2) reflects the DOL's thinking regarding the need to avoid conflicts of interest, and to ferret out all of the compensation the service providers are to receive:

> The Department believes that in order to satisfy their ERISA obligations, plan fiduciaries need information regarding all compensation to be received by the service provider ***and any conflicts of interest that may adversely affect the service provider's performance*** under the contract or arrangement. [17]
> (Emphasis added.)

In selecting the plan's investments, fiduciaries are obligated to focus first on the plan's interests. That is, they cannot consider factors other than the plan's benefit unless and until they determine that investments they might otherwise select are equally beneficial to the plan. As the DOL explained in describing the fiduciaries' duty in evaluating "economically targeted investments":

> ERISA's fiduciary standards expressed in sections 403 and 404 do not permit fiduciaries to select investments based on factors outside the economic interests of the plan until they have concluded, based on economic factors, that alternative investments are equal. A less rigid rule would allow fiduciaries to act on the basis of factors outside the economic interest of the plan in situations where reliance on those factors might compromise or subordinate the interests of plan participants and their beneficiaries.[18]

Fiduciaries who violate their duties can be held personally liable to restore to the plan any losses resulting from the breach.[19] Consider, for example, a fiduciary that hires a bank to provide recordkeeping services for the plan based on the bank's offer to make a favorable mortgage loan to the fiduciary. If the cost of the trustee services are greater than what other qualified recordkeepers charge for similar services, the fiduciary is liable to the plan for the difference. Alternatively, consider a fiduciary who hires an investment manager for a retirement plan because of collateral

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[11] *McMahon v. McDowell*, 794 F.2d 100, 110 (3rd Cir. 1986), *cert. denied*, 479 U.S. 971 (1986), citing 7 G. Bogert, *The Law of Trusts and Trustees* § 543 at 197-98 (2d rev.ed 1978)
[12] *Donovan v. Bierwirth*, 680 F.2d 263, 271 (2nd Cir. 1982) cert. denied 459 U.S. 1069, 103 S.Ct. 488, 74 L.Ed.2d 631 (1982).
[13] ERISA §404(a)(1)(B).
[14] *Mahoney v. J.J. Weiser & Co., Inc.*, 564 F.Supp.2d 248, 255 (S.D.N.Y. 2008).
[15] *Liss v. Smith*, *supra*, 991 F.Supp. at 300.
[16] DOL Field Assistance Bulletin No. 2007-01, Feb, 2, 2007
[17] 72 FR 70988, 70989.
[18] 29 C.F.R. §2509.08-1, Supplemental guidance relating to fiduciary responsibility in considering economically targeted investments.
[19] ERISA §409(a).

benefits to the fiduciary personally (for example, favorable personal or corporate financing, or discounted personal investment management services), rather than engaging in a prudent process focused on the needs of the plan. If the plan investments selected by the investment manager underperform the return from a prudently selected portfolio of similarly priced investments, the fiduciary may be liable for the difference. That is, a court would decide what the plan would be worth "… if the funds had been invested prudently."[20]

3. ERISA's Prohibited Transaction Rules

In addition to the general fiduciary duties under §404, ERISA regulates the relationships between (1) fiduciaries and plans (§406(b)) and (2) plans and their service providers (406(a)). This is accomplished through a second and distinct set of rules – ERISA's prohibited transaction rules.

Violations of ERISA's prohibited transaction rules are often described as "per se" violations. In adopting the prohibited transaction rules, "Congress intended to create an easily applied *per se* prohibition of the type of transaction in question."[21] This means that, in order for a violation of the prohibited transaction provisions to occur, there need be no "fiduciary misconduct."[22] Indeed, a violation of the prohibited transaction rules can occur even in cases where there is "… no taint of scandal, no hint of self-dealing, no trace of bad faith … the result of a misunderstanding."[23] On the other hand, the mere fact that a fiduciary avoids a prohibited transaction does *not* immunize the fiduciary from liability under §404's general duties of prudence and loyalty. Therefore, while a transaction may be subject to a statutory exemption – and, therefore, not violate the prohibited transaction rules – the fiduciary is still obligated to comply with the general fiduciary obligations set forth in §404: "… Section 408 [which provides a statutory exemption for certain otherwise prohibited transactions] does not sanction any derogation from the strict requirements of Section 404."[24]

Since transactions that violate §406 – particularly the transactions described in §406(b) – are illegal per se, some courts have found that it is not necessary for a plaintiff to show that the plan was harmed in order to show a violation: "… whether one of the provisions has been violated does not depend on whether any harm results from the transaction."[25]

We now take a closer look at the two broad categories of prohibited transactions.

a. ERISA §406(a) – Transactions between a plan and a party in interest:

ERISA §406(a) prohibits fiduciaries from enabling the plan to enter into certain transactions with "parties in interest." Service providers are one type of person or company that ERISA refers to as "parties in interest."[26] Other parties in interest include other fiduciaries, plan accountants and attorneys, plan advisors or brokers, and the plan sponsor.[27] Generally, §406(a) prohibits fiduciaries from allowing the plan to engage in certain transactions with the plan, including selling or leasing property, lending money or extending credit and transferring plan assets to a party in interest.

Avoiding §406(a) prohibited transactions requires fiduciaries to understand who the parties in interest are and to investigate the benefits they might be receiving as the result of a plan transaction. For example, a plan can loan money (as long as the loan is a prudent investment) – but it can't loan money to a party in interest.

Fiduciaries must therefore "… act with prudence in investigating whether a party in interest relationship exists."[28] The ERISA Conference report indicates that whether a fiduciary has prudently carried out its obligation must be determined on a case-by-case basis. At a bare minimum, however, the fiduciary has a duty to inquire about the service provider's relationships:

> The type of investigation that will be needed to satisfy the test of prudence will depend upon the particular facts and circumstances of the case. In the case of a significant transaction, generally for a fiduciary to be prudent he must make a thorough investigation of the other party's relationship to the plan to determine if he is a party-in-interest. In the case of a normal and insubstantial day-to-day transaction, it may be sufficient to check the identity of the other party against a roster of parties-in-interest that is periodically updated.[29]

b. ERISA §406(b)– Fiduciary self-dealing

ERISA §406(b) focuses on benefits the fiduciaries themselves receive. It prohibits fiduciaries from three basic types of conduct:

(1) Dealing with the assets of the plan for his own interest or for his own account.

(2) Acting adverse to the plan in a transaction involving the plan

(3) Receiving consideration from a party dealing with the plan in a transaction involving plan assets.

§406(b) presents "a blanket prohibition of certain transactions, no matter how fair."[30]

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[20] *Meyer v. Berkshire Life Ins. Co.*, 250 F.Supp.2d 544, 572, fn. 36 (D.Md. 2003).
[21] *Cutaiar v. Marshall*, 590 F.2d 523, 529 (3rd Cir. 1979).
[22] *Id.*
[23] *Id.* at 528.
[24] *McMahon v. McDowell, supra*, 794 F.2d at 110.
[25] *Raff v. Belstock*, 933 F.Supp. 909, 916 (N.D. Cal. 1996), citing *McDougall v. Donovan*, 552 F.Supp. 1206 (N.D. Ill. 1982).
[26] ERISA §3(14)(B).
[27] ERISA §3(14).
[28] *Marshall v. Kelly*, 465 F.Supp. 341, 351 (W.D. Okla. 1978).
[29] H.R.Rep. 93-1280, Cong., 2d Sess. at p. 307; 1974 U.S.Code Cong. and Admin.News at p. 5087.
[30] *Id.* at 530.

When a fiduciary engages in a transaction prohibited under §406(b), the fiduciary is liable to the plan regardless of whether the plan suffers any damage from the transaction. The focus in prohibited transaction cases "… is not the *loss* of plan assets but instead the *risking* of the trust's assets at least in part to aid the defendants." [31] (Emphasis in original.) The amount of the fiduciary's liability is measured by the benefit that the fiduciary received in connection with the transaction:

> ERISA clearly contemplates actions against fiduciaries who profit by using trust assets, even where the plan beneficiaries do not suffer direct financial loss. [Footnote omitted] A fiduciary who breaches his duties "shall be personally liable ... to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary."[32]

Therefore, any benefit that the fiduciary realizes as a result of the prohibited transaction must be disgorged to the plan. The DOL's Voluntary Fiduciary Correction program discusses the amount that needs to be restored to the plan:

> the principal amount involved, plus the greater of lost earnings, starting on the date of the loss and extending to the recovery date, or profits resulting from the use of the principal amount, starting on the date of the loss and extending to the date the profit is realized.[33]

C. Situations Giving Rise to Conflicts of Interest

Conflicts of interest – which can trigger violations of ERISA's fiduciary duty and prohibited transaction rules – are not always easy to spot. As mentioned above, however, the fact that a fiduciary has no malicious intent and may be perceived to act "fairly" to the plan is not likely to shield him from liability, particularly if the transaction violates the prohibited transaction rules. Here are some of the situations that we have encountered – and a discussion of how the law applies to those situations.

1. The president of a manufacturing company secures more favorable banking terms for the company if it transfers its plan to the bank.

At first glance, transferring the plan's assets to the bank may appear to be an innocuous transaction, especially if there is no discernible "harm" that the plan would suffer, and if the president obtains no direct benefit from the transaction. In reality, however, the president (who is making the decision regarding who will provide services to the plan and is, therefore, acting as a fiduciary) and the plan sponsor may be breaching their fiduciary duties and violating ERISA's prohibited transaction rules.

Beginning with the prohibited transaction rules, the decision to transfer plan assets in exchange for better banking terms for the company violates the provisions of ERISA §406(b). That is, the transaction violates 406(b)(1) and (3) because the responsible fiduciary (the plan sponsor) has dealt with the assets of the plan for its own benefit (*i.e.*, better banking terms) and has received consideration (*e.g.*, lower interest rates) from a third party in a transaction involving plan assets.

The president and the company may also have independently breached their fiduciary duties. For instance, assume the sponsor failed to adequately investigate the investments and services offered by the bank before making the switch. If better performing or lower-priced equivalent investments were reasonably available, and there is no other reason justifying the transfer, the fiduciary breached its duties to act prudently and for the "exclusive purpose" of providing retirement benefits.

2. A law firm provides legal services for a trust company. During the course of the relationship, the trust company notifies the law firm that it prefers to send its legal work to law firms that maintain their 401(k) assets with the trust company. The law firm transfers its plan assets to the trust company.

As a condition of obtaining legal work from the trust company, the trust company requires the law firm to transfer its plan to the trust company. The law firm – a plan fiduciary – is effectively using the plan's assets to benefit itself and violating ERISA §406(b) in the process. And, as in the prior example, the firm may be committing an independent breach of fiduciary duty if it makes the switch without adequately investigating the investments and services offered by the trust company and comparing them to other service providers offering similar services and investment products.

In this circumstance, under the prohibited transaction rules, the law firm could be required to disgorge to the plan all of the benefit it received (the proceeds from the legal work that it may have otherwise foregone) as a result of transferring the plan to the bank.

3. A financial institution offers a plan fiduciary favorable mortgage terms on his personal residence if the company transfers custody of its 401(k) plan assets to the financial institution.

In this case, the plan sponsor receives no direct benefit from the decision about service providers, but the fiduciary who makes the decision (for example, the CFO) receives a favorable mortgage on his personal residence in exchange for using his influence to transfer the plan to the financial institution.

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[31] *Leigh v. Engle*, 727 F.2d 113, 122 (7th Cir. 1984), citing ERISA §409(a).
[32] *Id.*
[33] Voluntary Fiduciary Correction Fact Sheet, May 2006, available at http://www.dol.gov/ebsa/newsroom/fs2006vfcp.html.

The circumstance is similar to a court case (*Whitfield v. Tomasso*[34]), in which the trustee invested significant percentages of a union trust fund's available assets in certificates of deposit ("CDs") issued by an insurance company. In return, the insurance company's founder arranged for another of his companies to make mortgage loans to the trustee and his associates, gave the trustee money for causing the fund to loan money to the insurance company and forgave payments due on the loans to the trustee from the affiliated company. The trust fund's fiduciaries failed to adequately investigate the quality and creditworthiness of the insurance company that issued the CDs, or even consider that CDs are usually issued by banks and not insurance companies. They also enabled the union that sponsored the trust fund to retain employer contributions that were owed to the fund. The court concluded that, in making the investments in the insurance company at the same time the insurance company's affiliate loaned money to the trustees, the trustees breached their fiduciary duty of loyalty,[35] dealt with the fund assets in their own interest and for their own account,[36] received consideration for their own account from a party dealing with the fund in a transaction involving fund assets[37] and caused the fund to lend money to a party in interest,[38] all of which were violations of ERISA's prohibited transaction rules.

Among other things, the court held the trustees personally liable for the several hundreds of thousands of dollars invested in the CDs by the fund.

4. **<u>The plan's investment fiduciary (*e.g.*, the chair of the plan committee) buys and sells securities through a particular broker-dealer. The broker-dealer – using a portion of the commissions received from the purchase and sale transactions – pays for the fiduciary to attend conferences at expensive resorts</u>.**

[34] 682 F.Supp. 1287 (E.D.N.Y. 1988).
[35] *Id.* at 1301.
[36] *Id.* at 1302.
[37] *Id.*
[38] *Id.*

This example is a so-called "soft dollar" or directed commission arrangement. It's possible for a plan to benefit by these arrangements – provided the plan recaptures the portion of the commission that otherwise would be received by the broker-dealer. However if, as in this example, the fiduciary is the beneficiary of the arrangement, he violates the prohibited transaction rules and breaches his fiduciary duties:

> **A fiduciary with respect to an ERISA plan is generally prohibited, by section 406(b)(1), from causing the plan to engage in a transaction if the fiduciary has an interest in the matter which may affect the fiduciary's best judgment as a fiduciary.** For example, an employer which is the named fiduciary for its plan and which does not exercise investment discretion would normally be prohibited from directing the plan's brokerage transactions through designated broker-dealer who agrees to utilize a portion of the brokerage commissions received from the plan to procure goods or services for the benefit of the employer … Each use of the broker-dealer that results in the receipt of goods and services by the employer following that designation would create an additional violation of sections 406(a)(1)(D) and 406(b)(1) of ERISA. (Emphasis added.)

As a result, in our example the fiduciary would be liable to restore the cost of the resort trips, together with the missed earnings on these amounts, to the plan. In addition, if the plan overpaid for the services of the broker-dealer, the fiduciary could be liable to the plan for those amounts.

5. **<u>A retirement plan administration firm refers the plan to a money manager for investment advisory services. The money manager makes payments to the administration firm for each plan that uses the money manager's services. Neither the money manager nor the administration firm disclose the payment to the fiduciary.</u>**

In this case (unlike in most of the examples above), no one associated with the plan sponsor receives any benefit as a result of the plan's decision to use the money manager's services. However, the fiduciary has enabled one of the plan's service providers (the administration firm) to receive a benefit beyond that which the administration firm contracted to receive from the plan.

Fiduciaries are legally responsible for determining the amount of compensation received by service providers (and any potential conflicts related to that compensation) and assessing whether that compensation is reasonable in relationship to the services provided. When they fail to do so, they engage in a breach of fiduciary duty (since they have failed to carry out their responsibilities prudently).

Claims such as these are not, by the way, merely hypothetical. Alleged failures to identify and determine the reasonableness of revenue sharing payments received by service providers are at the root of a number of high profile recent lawsuits against plan fiduciaries.[39]

D. <u>What Should A Fiduciary Do?</u>

To avoid liability for fiduciary breaches related to conflicts of interest and prohibited transactions, plan sponsors and their officers need to know whether there is a possibility of liability.

The first step in that analysis is to know whether you are a fiduciary. As a practical matter, committee members and the officers and managers who

[39] *See, e.g.,* Complaint in *Taylor v. United Technologies Corp.*, United States District Court, District of Connecticut, Case No. 3:06-cv-01494 (WWE), filed September 22, 2006; Complaint in *Renfro v. Unisys Corp.*, currently pending in the United States District Court, Eastern District of Pennsylvania (and originally filed in the United States District Court, Central District of California), Case No. 2:07-cv-2098 (BWK).

have discretion over the selection of a plan's service providers or investments are fiduciaries.

The second step is for the identified fiduciaries to engage in a thoughtful, prudent analysis of the transactions the plan enters into and the persons hired to provide services and investments to the plan. What does this mean? At the outset, it means that fiduciaries must determine whether anyone other than the participants (and particularly whether the plan sponsor or a fiduciary) are benefiting from a decision. Does the employer benefit (for example, when it obtains favorable banking terms in exchange for allowing the bank to handle the 401(k))? Does the fiduciary himself benefit? If the answer is "yes," it is possible, if not likely, that the transaction – the hiring of the service provider or selection of the investments – violates the prohibited transaction rules. Specifically, the fiduciaries should:

- avoid any transactions that use the plan or its assets to benefit the employer or the fiduciaries;
- avoid any arrangements where the employer gets payments or other value (*e.g.*, favorable loans) from a provider;
- avoid any "quid pro quo" transactions, where the plan sponsor or the fiduciaries receive anything in exchange for plan transactions, assets or services.

In addition to the prohibited transaction issues, those decisions may be fiduciary breaches. To avoid that outcome, fiduciaries should:

- compare the service provider to competing providers;
- analyze the scope and quality of services provided;
- reach an informed and reasoned conclusion that the compensation being paid is reasonable; and
- ensure that conflicts of interest do not adversely affect the plan and the participants.

E. Conclusion

Fiduciaries must scrupulously identify, examine and, where possible, avoid conflicts of interest. Some conflicts may, if properly managed, be acceptable under the fiduciary responsibility rules. However, even then, transactions involving conflicts will cause the decisions made by plan fiduciaries to be more closely scrutinized. However, certain conflicts – those classified as prohibited transactions by ERISA – are never permissible (unless there is a specific legal or regulatory exemption). Where fiduciaries allow their plans to engage in prohibited transactions, they are subject to both sanctions (*i.e.*, excise taxes) and personal liability for any losses to the plan or personal gains from the transactions.