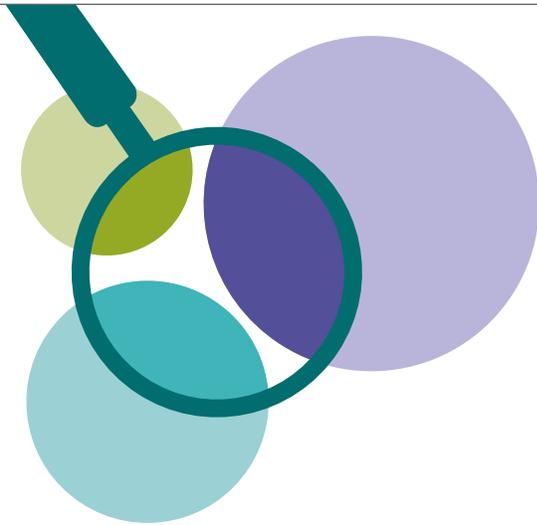


APR 2014 | Prepared by The Wagner Law Group

DON'T TAKE YOUR PLAN FOR GRANTED



Clearing up misconceptions about
fiduciary risk and plan investments.

All investments involve risk, including possible loss of principal.

Important note: The Wagner Law Group has prepared this white paper on behalf of Legg Mason & Co., LLC. This paper includes suggested practices that plan sponsors, and the financial professionals who work with plan sponsors, may wish to consider concerning the Employee Retirement Income Security Act of 1974 (ERISA) and the related rules governing the fiduciary standards for selecting a plan's designated investment alternatives.

It is important to note that the suggested practices are not the exclusive means of complying with ERISA's prudence requirements in the management of a plan and its investments. Other combinations of practices also may be effective in meeting such requirements. Plan sponsors and other fiduciaries should consult with their own legal counsel concerning their responsibilities under ERISA in the management of their respective plans.

Future legislative or regulatory developments may significantly impact these suggested practices and the related matters discussed in this paper. Please be sure to consult with your own legal counsel concerning the application of ERISA to the selection of plan investments and any related future developments.

This white paper is intended for general informational purposes only, and it does not constitute legal, tax or investment advice on the part of The Wagner Law Group or Legg Mason & Co., LLC and its affiliates. Plan sponsors and other fiduciaries should consult with their own legal counsel to understand the nature and scope of their responsibilities under ERISA and other applicable law.

INVESTMENT PRODUCTS: NOT FDIC INSURED • NO BANK GUARANTEE • MAY LOSE VALUE



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INTRODUCTION



Misconceptions about plan sponsor's duty to monitor

Because of the large amount of work required to establish a defined contribution retirement plan, plan sponsors may mistakenly feel that their job is finished once the plan is up and running. In actuality, plan sponsors have a duty to proactively monitor the plan's investments on an ongoing basis, and they should be mindful of the fiduciary risks associated with mishandling the plan's investments. The rules governing a fiduciary's ongoing duties are not always intuitive, which can lead to misconceptions about a plan sponsor's continuing obligations to the plan and its participants.

These misconceptions may even cause a plan sponsor to grow complacent enough to neglect the fiduciary maintenance work that is required. The reality is that a failure to properly manage the plan's investments can be a costly mistake. The courts in many instances have held plan sponsors accountable for their actions or, to be more precise, their lack of action. The good news is that we can draw valuable lessons from these court cases, and they can help clear up various misconceptions about fiduciary risk and the investment duties imposed on plan sponsors.

MISCONCEPTION NUMBER



No litigation risk

“Our plan participants would never sue me.”

When times are good, people may find it difficult to imagine relationships breaking down to the point where lawsuits are filed against one another. Similarly, employers that go to the trouble of establishing a 401(k) plan may find it hard to envision plan participants turning on them one day and suing them. However, as a practical matter, employees and plan participants do not always remain on good terms with their employer. In addition, if a participant suffers a heavy financial loss that could potentially be related to the employer’s mismanagement of the plan, the participant may feel that he or she has no choice but to move forward with a legal claim against the plan sponsor.

The federal law that governs legal claims against plan sponsors and other fiduciaries is known as the Employee Retirement Income Security Act of 1974, as amended (“ERISA”). ERISA litigation and the related case law involving defined contribution plans have grown considerably in recent years. One possible explanation

is *LaRue v. DeWolff*, a 2008 Supreme Court decision that definitively ruled that individual participants may recover from their employer or other plan fiduciaries when their plan accounts suffer a loss caused by a fiduciary breach.¹ Another likely factor is the success with which plaintiffs’ attorneys² have been able to use class action lawsuits³ to file ERISA claims on behalf of all similarly harmed participants under a single plan.

As a result of the successful track record for plaintiffs’ attorneys and the related exposure in the media, many participants now understand that they have recourse under the law if the plan or its investments are ever mismanaged. Plan sponsors should be mindful of this development, and they should not blindly assume that their participants will never file a legal claim against them. Instead, they should consider implementing prudent review procedures as further described in Exhibit A.

¹ *LaRue v. DeWolff*, *Boberg & Associates, Inc.*, 552 U.S. 248 (2008).

² Plaintiffs’ attorneys specialize in representing individuals who claim that they have been harmed by other parties. They may be willing to represent such individuals for contingency fees that are payable only if the case is won.

³ See, e.g., *Spano v. The Boeing Co.*, No. 13-8026, (7th Cir. November 29, 2013).

MISCONCEPTION NUMBER

2

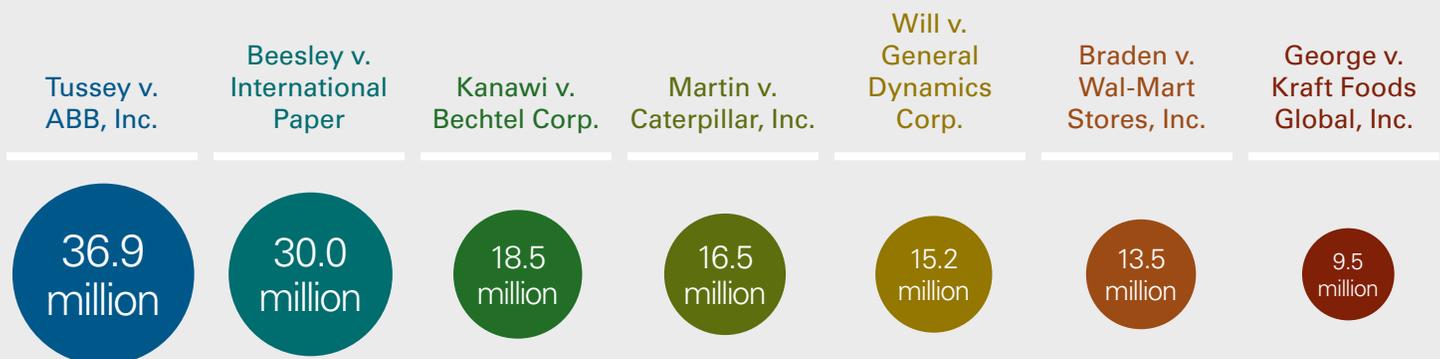
No investment oversight required

“We don’t need to revisit the plan’s investments.”

Plan sponsors have a fiduciary duty under ERISA to prudently select the investments that are to be offered to their participants, and to monitor these investment options on an ongoing basis.⁴ In general, these monitoring duties require plan sponsors to review the plan’s investments regularly and to replace investment options as necessary. But the reality is that certain plan fiduciaries may not fully appreciate the importance of their monitoring duties, and they may not prioritize them. Some may even question the need to revisit the plan’s investments so frequently, putting themselves at fiduciary risk by leaving the plan’s investments on “autopilot.”

If a plan fiduciary fails to monitor the plan’s investments properly, the fiduciary becomes personally liable to the plan for any resulting losses.⁵ Participants may recover from the responsible fiduciary by seeking assistance from the U.S. Department of Labor (the “DOL”). They can also recover from the plan sponsor by taking legal action. Plaintiffs’ attorneys have become effective at recovering money on behalf of participants, as illustrated in the cases below.

ERISA monetary settlements and awards for participants (\$)



⁴ Section 2550.404c-1(d)(2)(iv) of the U.S. Department of Labor regulations.

⁵ ERISA Section 409.



In these cases, it is typically alleged that the plan sponsor failed to monitor the plan's investments properly. Additionally, the respective participants claimed that the plan sponsor had failed to monitor the reasonableness of the plan's investment fees and expenses, including the revenue sharing payments made from the plan's investment funds to the plan's recordkeeper (e.g., shareholder service fee, 12b-1 fee). Based on these and other facts, the courts made substantive and procedural rulings in favor of the participants, resulting in the monetary settlements and awards to the plan participants as described above.

To minimize fiduciary risk and potential liability, plan sponsors should consider conducting reviews of the plan's investment menu at regular intervals (e.g., quarterly). These reviews should examine investment performance as well as the reasonableness of investment fees and any revenue sharing payments that are payable to the plan's recordkeeper. A fee policy statement ("FPS") can provide easy-to-follow guidelines for evaluating such fees and expenses, and plan sponsors may use an FPS to monitor any revenue sharing payments made to the recordkeeper. If a plan sponsor needs assistance monitoring the plan's investments and the related fees or implementing a fee policy statement, it should consider consulting a qualified advisor.

Legg Mason's Guidelines for FPS

For more information about fee policy statements, be sure to ask for Legg Mason's Guidelines for Creating a Fee Policy Statement (FPS).

MISCONCEPTION NUMBER

3

Reliance on menu size

“As long as the plan offers a lot of investment options, I’ve done my job.”

Investments by their nature have risks associated with them. In the case of 401(k) and 403(b) plans as well as other similar plans with participant-directed investments, plan sponsors may incorrectly assume that all investment responsibility resides with the participant. A plan sponsor may even believe that there is no liability risk for the plan sponsor when it comes to the plan’s designated investment options, as long as the plan menu is large enough to give participants plenty of choice.

As a matter of law, plan sponsors have a duty to prudently select the plan’s investment options, which means that they must screen out any unsuitable investment choices as well as discontinue any designated investment alternatives that become unsound at any point in the future. There is a “safe harbor” under ERISA Section 404(c), which protects plan fiduciaries from any liability for losses that result from the participants’ exercise of control over their accounts.⁶ However, the DOL’s long-standing position is that the act of designating investment options for plan participants is a fiduciary function, and that Section 404(c) cannot eliminate the plan fiduciary’s obligation to periodically evaluate whether the investment options should continue to be made available to participants.⁷ The DOL’s position was recently affirmed by an appellate court in *Tibble v. Edison International*, which expressly confirmed that “the selection of the particular funds to include and retain as investment options in a retirement plan is the responsibility of the plan’s fiduciaries.”⁸

Rather than focusing solely on the quantity of investment options offered to participants, plan sponsors should pay attention to the quality and the diversity of the plan’s available investments for participants. To ensure the plan menu covers a sufficiently diverse range of asset classes, plan sponsors should consider maintaining an investment policy statement (“IPS”) and using it to guide their fiduciary review of the plan investment menu. In assessing the quality of the plan’s investment options, plan fiduciaries can also use the applicable investment criteria from the IPS to help them monitor investment performance as well as investment fees and expenses. IPS guidelines can also help plan sponsors prudently determine whether and when an investment option should be replaced.

Legg Mason’s Guidelines for IPS

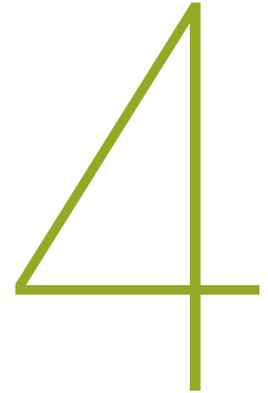
For more information about investment policy statements, be sure to ask for Legg Mason’s Guidelines for Creating an Investment Policy Statement (IPS).

⁶ ERISA Section 404(c) and the related DOL regulations include various administrative and investment-related requirements. These conditions must be met in order for the safe harbor protection to become available.

⁷ Preamble to DOL regulations under ERISA Section 404(c), 57 Fed. Reg. 46,906 (October 13, 1992).

⁸ *Tibble v. Edison International*, No 10-56406 (9th Cir. March 21, 2013).

MISCONCEPTION NUMBER



Investment tips from administrative providers

“An administrative provider is responsible for its investment tips, even if it says it’s not a fiduciary.”

Plan sponsors often need to engage two types of administrative providers for their plans, a recordkeeper and a third party administrator (“TPA”). A recordkeeper establishes and maintains individual accounts for the plan’s participants. A TPA is often required to assist with plan design, annual compliance testing and regulatory filings. Although recordkeepers and TPAs are not in the business of providing investment advice, they may offer ancillary support to plan fiduciaries when they are choosing the plan’s investment options. A recordkeeper or TPA may volunteer their personal views concerning the quality of a particular investment fund. If asked, these providers may even provide informal recommendations concerning the plan’s investments based on what their other plan clients are doing and other relevant information.

However, plan sponsors should not rely on any investment tips that they might receive from their administrative providers in the same way that they might rely on fiduciary investment advice. From the plan sponsor’s own fiduciary perspective, it would be imprudent to trust the investment recommendations of a firm that is not formally in the business of providing such advice. Firms that provide investment-related services are subject to heavy regulation, making them accountable for their recommendations under federal and state securities laws as well as ERISA.

Conversely, recordkeepers and TPAs generally take the position that they are not fiduciaries. If a provider is not a fiduciary for ERISA purposes, then it is not responsible or subject to liability

for any imprudent investment recommendations. In fact, to minimize their exposure to any potential fiduciary liability, it is customary for administrative providers to include disclaimers in their service agreements, stating that they are not fiduciaries or that their services do not include any fiduciary advice. Of course, a provider that is not appointed to serve as a fiduciary can still be deemed a “functional” investment fiduciary, but only if it regularly provides individualized investment recommendations under a mutual understanding that the plan will be relying on such advice.⁹ However, as noted in *Mortgage Lenders Network USA v. CoreSource*, a contractual disclaimer is still relevant for purposes of determining a provider’s fiduciary/non-fiduciary status, even if it is not conclusive evidence of its status.¹⁰

If a plan sponsor tried to hold an administrative provider accountable for any investment advice, the provider would presumably assert that it was not a functional fiduciary because (i) it does not regularly provide investment recommendations, (ii) its recommendations are generic and are not individualized to particular plans, (iii) there is no mutual understanding that it would be providing fiduciary advice, and (iv) assuming that its service agreement has the customary language, a contractual disclaimer confirms that it does not serve as a fiduciary. In light of the foreseeable challenges of trying to hold a recordkeeper or TPA accountable as an investment fiduciary to the plan, plan sponsors should not automatically rely on the provider’s investment recommendations. They should independently evaluate a provider’s recommendations, and only follow them if they are able to reach the same conclusions prudently based on their own investment analyses.

⁹ See, e.g., *Thomas, Head & Greisen Employees Trust v. Buster*, 24 F.3d 1114 (7th Cir.), cert. denied, 115 S.Ct. 935 (1994). The courts have generally adopted the functional definition for fiduciary “investment advice” under Section 2510.3-21 of the DOL regulations. The DOL has recently announced that it will be releasing proposed regulations which, if adopted, would broaden this definition.

¹⁰ *Mortgage Lenders Network USA v. CoreSource*, 335 F. Supp. 2d 313, 319-323 (D. Conn. 2004).

MISCONCEPTION NUMBER

5

Investment role of recordkeeper

“Our recordkeeper takes care of everything, including the plan menu.”

In addition to maintaining individual participant accounts, the plan’s recordkeeper customarily also provides an investment platform. This platform gives the plan and its participants the ability to access a universe of investment funds. Accordingly, the investment options to be offered to the plan’s participants will be selected from the investment funds that are made available on the recordkeeper’s platform. In many programs, the recordkeeper will determine the specific share class of the investment funds that are made available to its plan clients. Furthermore, since the recordkeeper may make changes to its fund universe from time to time, the recordkeeper typically reserves the right to add or remove investment options from a plan client’s investment menu for the purpose of making corresponding changes. Once the plan sponsor designates the investment options that are to be offered, the recordkeeper generally implements the offering to participants and provides any necessary investment disclosures to them.

Because of the critical role that the recordkeeper plays in the operation of the plan’s investment menu, plan sponsors may assume that the recordkeeper is acting as an investment fiduciary. However, given the limited scope of a traditional recordkeeper’s investment role, plan sponsors should not automatically make this assumption. For example, in *Leimkuehler v. American United Life Insurance Co.*, the court ruled that a recordkeeper’s “product design” decisions, which determined the universe of funds available to the plan as well as their share class, did not turn the recordkeeper into a fiduciary.¹¹

Although recordkeepers play a vital role in the implementation of the plan’s investment menu, plan sponsors should not view them as advisors when it comes to the management of the investment menu. Plan sponsors should consider engaging a separate provider, such as a qualified financial advisor, to help them select and monitor the plan’s investment options. An advisor can provide helpful guidance concerning the selected funds as well as the other investments available from the recordkeeper’s fund universe. Additionally, if a recordkeeper’s program requires the plan menu to include one or more funds pre-selected by the recordkeeper, the advisor can provide an independent assessment of the prudence of utilizing such funds. Consistent with their duty to monitor the plan’s investments on an ongoing basis, plan sponsors should also consider meeting with the advisor regularly (e.g., quarterly) to assist with the reviews of each of the plan’s investment options. Any recommendations made by the advisor should be considered by the plan sponsor in light of the advisor’s investment expertise and experience as well as the advisor’s status as a fiduciary or non-fiduciary to the plan.

¹¹ *Leimkuehler v. American United Life Insurance Co.*, Nos. 12-1081, 12-1213 & 12-2536 (7th Cir. April 16, 2013). It should be noted that the case law in this area is mixed, and it is possible for a court to rule that a particular recordkeeper should be held accountable as a functional fiduciary based on the particular facts of the case. However, it would not be prudent for plan sponsors to automatically assume that the court will rule in their favor.

CONCLUSIONS

It is important for plan sponsors to have an accurate understanding of their continuing obligations to their respective plans and participants, and to avoid misconceptions about their duties as plan fiduciaries.



The relevant case law under ERISA provides valuable guidance on the true nature of fiduciary risk and the importance of monitoring the plan's investments regularly. Plan sponsors should not assume that they are immune from fiduciary liability.

Accordingly, they should consider conducting reviews of the plan's investment menu on a regular basis (e.g., quarterly), and using an FPS to evaluate investment fees as well as any revenue sharing payments made to the plan's recordkeeper. Rather than focusing solely on the quantity of investment options, plan sponsors should evaluate the quality and diversity of the plan's investment options using an IPS. If an administrative provider offers any investment tips, plan sponsors should independently evaluate them and not automatically rely on them. Lastly, plan sponsors should consider engaging a qualified advisor to help them monitor the plan's investments on an ongoing basis.

We have attached a Plan Sponsor Self-Assessment and Checklist (Exhibit A), which provides a brief summary of the various misconceptions and related court cases discussed in this paper. This checklist can be used by plan sponsors to perform their own fiduciary assessment and to help them determine whether any corrective action should be taken.

EXHIBIT A

Plan sponsor self-assessment and checklist

Fiduciary misconceptions	Actual ERISA case law	Suggested corrective actions
<p>1 No litigation risk</p> <p>“Our plan participants would never sue me.”</p>	<p>LaRue v. DeWolff</p> <p>This Supreme Court case confirms that a participant who suffers a loss due to plan mismanagement is entitled to recover from the responsible plan fiduciary.</p>	<p>Acknowledge that participants have recourse under the law if the plan or its investments are mismanaged, and implement prudent review procedures.</p> <p><input type="checkbox"/> This practice is already in place.</p> <p><input type="checkbox"/> Further action/review is required.</p>
<p>2 No investment oversight required</p> <p>“We don’t need to revisit the plan’s investments.”</p>	<p>Tussey v. ABB, Inc.</p> <p>In this case and others like it, the court ruled that a plan sponsor is responsible for monitoring the plan’s investment funds and the related fees and expenses, including any revenue sharing paid from the funds to the recordkeeper.</p>	<p>Monitor the performance and fees of the plan’s investments regularly (e.g., quarterly), and use a fee policy statement to evaluate any revenue sharing payable to the plan’s recordkeeper.</p> <p><input type="checkbox"/> This practice is already in place.</p> <p><input type="checkbox"/> Further action/review is required.</p>
<p>3 Reliance on menu size</p> <p>“As long as the plan offers a lot of investment options, I’ve done my job.”</p>	<p>Tibble v. Edison International</p> <p>This case confirmed that the plan sponsor is responsible for the prudent selection and retention of each investment option under the plan.</p>	<p>Use an investment policy statement to prudently evaluate the quality and diversity of the particular investment options offered to participants.</p> <p><input type="checkbox"/> This practice is already in place.</p> <p><input type="checkbox"/> Further action/review is required.</p>
<p>4 Investment tips from administrative providers</p> <p>“An administrative provider is responsible for its investment tips, even if it says it’s not a fiduciary.”</p>	<p>Mortgage Lenders Network USA v. CoreSource</p> <p>According to the court, a contractual disclaimer stating that the administrative provider is not a fiduciary is relevant in determining the provider’s status (even if it is not conclusive evidence of status).</p>	<p>Does the administrative provider’s agreement state that it is not a fiduciary? If so, independently evaluate the provider’s investment recommendations and do not automatically rely on them.</p> <p><input type="checkbox"/> This practice is already in place.</p> <p><input type="checkbox"/> Further action/review is required.</p>
<p>5 Investment role of recordkeeper</p> <p>“Our recordkeeper takes care of everything, including the plan menu.”</p>	<p>Leimkuehler v. American United Life Insurance Company</p> <p>This case held that a recordkeeper’s “product design” decisions, which may determine the universe of funds available to the plan as well as their share class, do not turn the recordkeeper into a fiduciary.</p>	<p>Rely on the recordkeeper for administrative assistance only, and meet with a qualified financial advisor regularly (e.g., quarterly) to assist with the monitoring of the plan’s investments.</p> <p><input type="checkbox"/> This practice is already in place.</p> <p><input type="checkbox"/> Further action/review is required.</p>

Batterymarch
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ClearBridge Investments
Legg Mason Global Asset Allocation
Permal
Royce & Associates
Western Asset Management

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About Marcia Wagner and The Wagner Law Group

Marcia S. Wagner is a specialist in pension and employee benefits law, and she is the principal of The Wagner Law Group, one of the nation's largest boutique law firms, specializing in ERISA, employee benefits and executive compensation, which she founded over 18 years ago.

A summa cum laude and Phi Beta Kappa graduate of Cornell University and a graduate of Harvard Law School, she has practiced law for over 28 years. Ms. Wagner is recognized as an expert in a variety of employee benefits issues and executive compensation matters, including qualified and non-qualified retirement plans, all forms of deferred compensation, and welfare benefit arrangements.

Ms. Wagner was appointed to the IRS Tax Exempt & Government Entities Advisory Committee and ended her three-year term as the Chair of its Employee Plans subcommittee, and received the IRS' Commissioner's Award. Ms. Wagner has also been inducted as a Fellow of the American College of Employee Benefits Counsel.

For the past six years, 401k Wire has listed Ms. Wagner as one of its 100 Most Influential Persons in the 401(k) industry, and she has received the Top Women of Law Award in Massachusetts and is listed among the Top 25 Attorneys in New England by *Boston Business Journal*. Ms. Wagner has written hundreds of articles and 14 books about retirement and benefit plans. Ms. Wagner is widely quoted in business publications such as *The Wall Street Journal*, *Financial Times*, *Pension & Investments*, and more, as well as being a frequent guest on FOX Business, CNN, Bloomberg, NBC and other televised media outlets.

* As of December 31, 2013

All investments involve risk, including loss of principal.

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