Does the Fiduciary Standard Impede Risk Management in Troubled Times?

By Blaine F. Aikin, AIFA®, CFA®, CFP®, and Kristina Fausti, JD, AIF®

We live in a time in which black swans abound with profound consequences for investors and the fiduciaries who serve them. A persistent global credit crisis, massive government and personal debt, extreme market volatility, and severe and pervasive underfunding of retirement plans are usually rare events and yet they all exist at once today. Add the political gridlock in Washington that stymies meaningful action to address the root causes of the financial crisis, dramatic socio-political upheaval in the Middle East with uncertain consequences, active U.S. military interventions in Iraq and Afghanistan, enormous natural disasters around the globe, and environmental catastrophes such as the nuclear meltdown in Japan, and the black swans seem overwhelming. As a result (and notwithstanding the recent resilience of the domestic securities markets), many investment advisors and managers have become quite bearish in their outlook for equities and bonds as they assess the potential financial ramifications of the current confluence of these calamitous events.

The saying “desperate times call for desperate measures” may come to mind, but investment advisors and investment managers acting as fiduciaries still must be sure their recommendations or discretionary actions conform to core fiduciary duties and principles. This article explores how uncommon circumstances influence a responsible fiduciary’s ability to depart from orthodox portfolio management techniques under uncommon circumstances.

Fiduciary law is well-developed in the United States and generally is applied most strictly under the Employee Retirement Income Security Act (ERISA), which governs qualified retirement plans. Consequently, the discussion herein relies on provisions of ERISA, Department of Labor (DOL) advisory opinions that govern implementation of ERISA requirements, and ERISA case law examples to address a fiduciary’s unique obligations.

The Prudent Expert and Procedural Prudence

ERISA Section 404(a) provides a useful starting point because it establishes the foundational obligation of fiduciaries to adhere to what commonly is referred to as the “prudent expert” standard of care in managing portfolio assets under their purview. Under this provision, fiduciaries are expected to do more than simply exercise the good judgment of a businessperson; they must specifically act “… with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims.”

DOL rules under ERISA clarify that a fiduciary fulfills the expectation to act prudently by giving “appropriate consideration to those facts and circumstances that, given the scope of the fiduciary’s investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved.” DOL rules further state that appropriate consideration includes the following: 1) a determination by the fiduciary that the particular investment or investment strategy is reasonably designed to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain associated with the investment or investment strategy; and 2) consideration of the composition of the portfolio with regard to diversification, the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan, and the projected return of the portfolio relative to the funding objectives of the plan.

There is no “legal list” of acceptable investments available in DOL guidance or elsewhere in fiduciary law; rather, the propriety of a fiduciary’s actions is determined largely by evidence of procedural prudence—the extent to which the fiduciary assembled, evaluated, and acted upon pertinent information in a manner consistent with generally accepted investment theories. In fact, case law and DOL advisory opinions suggest that fiduciaries are permitted considerable latitude in providing investment advice or making investment decisions when they can show they engaged in a prudent process.

Diversification

A key component of procedural prudence is the fiduciary duty of diversification. ERISA Section 404(a) provides fiduciaries broad latitude in the degree to which they diversify so long as due consideration is given to the value of diversification in minimizing the risk of large losses. Moreover, diversification is not required in those limited circumstances where it clearly would not be prudent to not diversify (e.g., in cases of an imminent need to liquidate a portfolio or where a nondiversified approach is required by governing documents).
The fiduciary also should determine whether it possesses the requisite expertise, knowledge, and information to understand and analyze the nature of the risks and potential returns involved in a particular derivative investment.

Based on the collective case law and DOL guidance, three key steps to the prudence process have been identified by ERISA attorneys. These three steps include: 1) the duty to investigate relevant information, 2) the duty to maintain records to document the process, and 3) the duty to use experts when the fiduciary does not have the requisite knowledge, experience, or access to data to allow the fiduciary to investigate properly. If a fiduciary can show it took these steps, then it is likely that it reached an informed and reasoned decision through procedural prudence.

**Substantive Prudence**

It is important to note, however, that procedural prudence alone does not complete a fiduciary’s obligations. In a case that involved a claim of breach of fiduciary duty, then-D.C. Circuit Judge Antonin Scalia addressed the importance of substantive in addition to procedural prudence as follows:

“I know of no case in which a trustee who has happened—through prayer, astrology or just blind luck—to make (or hold) objectively prudent investments ... has been held liable for losses from those investments because of his failure to investigate and evaluate beforehand. Similarly, I know of no case in which a trustee who has made (or held) patently unsound investments has been excused from liability because his objectively imprudent action was preceded by careful investigation and evaluation. In short, there are two related but distinct duties imposed upon a trustee: to investigate and evaluate investments, and to invest prudently. Neither does the faithful discharge of the first satisfy the second, nor does breach of the first constitute breach of the second. To be sure, the extent of the trustee’s investigation and evaluation is often the focus of inquiry in imprudent-investment suits. [case citation omitted] But that is because the determination of whether an investment was objectively imprudent is made on the basis of what the trustee knew or should have known; and the latter necessarily involves consideration of what facts would have come to his attention if he had fully complied with his duty to investigate and evaluate.”

Critical elements of substantive prudence can be drawn from a closer look at ERISA Section 404(a). DOL requirements discussed earlier regarding “appropriate consideration” refer to the need for investments to be aligned to the cash flow requirements and investment objectives of the portfolio. Thus, it would be objectively imprudent for a fiduciary to select or recommend investments or an investment course...
of action that would necessarily prevent core portfolio objectives and requirements from being achieved.

In addition, ERISA Section 404(a) specifically requires fiduciaries to manage the portfolio in accordance with the documents and instruments governing the plan. Therefore, it also would be objectively imprudent to undertake an investment course of action that would be at odds with governing documents, which include, among other things, plan or trust documents and investment policy statements.

Fiduciaries, therefore, must carefully observe any substantive requirements and limitations set forth in governing documents as a part of their prudent process to select investments, provide advice, or implement investment strategies. In troubled times, extra vigilance may be required because a fiduciary may seek to heavily weight the portfolio toward cash or to use hedging strategies in order to reduce certain risks. The fiduciary should review governing documents to assure that changes contemplated under such a risk mitigation strategy are permitted. If the strategy is not aligned with the requirements of the governing documents, either the documents or the investment strategy (or both) must be changed to bring them into alignment. Similarly, to be substantively prudent, extraordinary measures taken to deal with risk must not be undertaken without having addressed any resulting conflict with the plan’s cash flow requirements and stated investment objectives.

Conclusion

There is little evidence to suggest that the fiduciary standard materially impedes the ability of investment advisors and other investment fiduciaries from applying a wide range of investments and investment strategies needed to serve investors’ best interests, even in troubled times. Indeed, the fiduciary obligations of substantive and procedural prudence are specifically intended to assure that investors’ best interests are, in fact, served. These obligations do not impose barriers to using more-complex investments and investment strategies but they do require fiduciaries to align the depth and breadth of their prudent processes to that complexity.

Blaine F. Aikin, AIFA®, CFA®, CFP®, is president and chief executive officer of fi360, which provides training, tools, and resources to promote fiduciary responsibility and improve decision-making processes among investment fiduciaries. He earned an MS in public policy and management from the Heinz School of Carnegie-Mellon University.

Contact him at blaine@fi360.com.

Kristina Fausti, JD, AIF®, is director of legal and regulatory affairs of fi360. She earned a JD cum laude from Georgetown University Law Center, an MBA from Georgetown University’s McDonough School of Business, and a BSBA in accounting magna cum laude from Robert Morris University.

Contact her at Kristina@fi360.com.

Endnotes

2 29 C.F.R. § 2550.404a-1(b)(1)(i).
3 29 C.F.R. § 2550.404a-1(b)(2).
4 29 USC §1104(a)(1)(C)
5 Id.
6 An LDI strategy typically involves matching the cash flows produced by (predominantly) laddered fixed income instruments to the anticipated withdrawal requirements of the portfolio.
9 Id.
11 Id.
13 29 USC §1104(a)(1)(D).
14 In reaching the conclusion that the fiduciary standard is not an impediment to using complex investments or strategies, the next natural question to arise is whether a fiduciary must consider complex investment strategies, such as hedging, in particularly troubled times. Rosenburgh and Spieler (2009) noted, “Although applicable law is sparse and uncertain, it does appear plausible for ERISA fiduciary liability to arise in connection with a failure to adopt such safeguards, particularly where the decision-making process involved in choice or monitoring of investment strategy is found to be inadequate.” See Rosenburgh, Martin, and Andrew C. Spieler. 2009. 21st Century Pensions: The Risk, The Hedge and The Duty to Consider. Journal of International Business and Law 8, no. 1 (April): 45–61, available at http://www.hofstra.edu/media/blogs/a/21st%20Century%20Pensions%20The%20Risk%20the%Hedge%20and%20the%20Duty%20to%20Consider.pdf.