

# PRUDENT PRACTICES FOR INVESTMENT FIDUCIARIES

## *PRACTICE SA – 3.4*

*A due diligence process is followed in selecting service providers, including the custodian*

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### *ERISA Requirements*

ERISA requires that the written instrument of every employee benefit plan must name one or more fiduciaries who have the authority to control and manage the operation and administration of the plan and describe any procedure under the plan for the allocation of responsibilities for the operation and administration of the plan. [ERISA §§ 402(a)(1) and (b)(2)]

ERISA also requires that a fiduciary of an employee benefit plan discharge his duties solely in the interest of plan participants and beneficiaries and 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 like aims. [ERISA §404(a)(1)(B)]

In selecting service providers for the plan, including the custodian of the plan assets, the fiduciary will need to comply with the general loyalty and prudence standards imposed by ERISA §404(a)(1). The DOL has amplified on this requirement. For example, in discussing the provision of investment education to participants, the DOL clearly stated the requirement that the fiduciaries act prudently in selecting and monitoring the activities of the service provider:

*As with any designation of a service provider to a plan, the designation of persons to provide investment educational services or investment advice to plan participants and beneficiaries is an exercise of discretionary authority or control with respect to management of the plan; therefore, persons making the designation must act prudently and solely in the interest of the plan participants and beneficiaries, both in making the designation(s) and in continuing such designation(s). [Emphasis added] [DOL Interpretive Bulletin 96-1, 29 C.F.R. §2509.96-1]*

While this statement relates specifically to the selection of persons to provide investment education, the general principle is not limited to this context; it applies to the designation of any fiduciary or non-fiduciary service provider.

The DOL has stated that:

*[I]n choosing among service providers, as well as in monitoring and deciding whether to retain a service provider, the [responsible fiduciary] must objectively assess the qualifications of the service provider, the quality of the work product, and the reasonableness of the fees charged in light of the services provided. [DOL Information Letter, Qualified Plan Services (07/28/1998); See also, DOL Information Letter, Service Employee's International Union (02/19/1998)]*

**Practice SA – 3.4 (continued)**

These Information Letters indicate the DOL's view that, in order to fulfill the duty of prudence in selecting a service provider (which would include a custodian for plan assets), plan fiduciaries must employ a due diligence process. While ERISA does not impose specific criteria for that process, such a process must include examination of the factors listed in the cited Information Letters, as well as other factors which may be relevant in a particular situation including, for example, the security policies and practices of a custodian.

**UPIA and UPMIFA Requirements**

The UPIA provides that:

*A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. It also conditions this power by providing that: The trustee shall exercise reasonable care, skill and caution in: (1) selecting an agent; (2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and (3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation. [UPIA §9(a). See also, UPMIFA §5(a)]*

Similar language is contained in the UPMIFA with respect to institutions.

This specific duty of prudence is coupled with the general rules of prudence set forth in the UPIA and the UPMIFA. UPIA §2(a) provides as follows:

*A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution. [UPIA §2(a). See also, UPMIFA §3(b)]*

UPIA §2(d) expounds upon this general prudence requirement by stating:

*[A] trustee **shall** make a reasonable effort to verify facts relevant to the investment and management of trust assets. [Emphasis added] [See also, UPMIFA §3(c)(2)]*

The trustee also is under an obligation to *only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee.* [UPIA §7. See also, UPMIFA §3(c)(1)] The Comments to UPIA §7 provide that:

*[W]asting beneficiaries money is imprudent. In devising and implementing strategies for the investment and management of trust assets, trustees are obligated to minimize costs.*

*Practice SA – 3.4 (continued)*

*[IBP]* Thus, the trustee subject to the UPIA and an institution subject to the UPMIFA have the authority to engage service providers, including a custodian, subject to the foregoing conditions. These requirements would appear to require the trustee or institution to engage in a rational due diligence process designed to engage service providers (including a custodian, where appropriate), who are competent to render the required services for the management of the trust or fund at no more than reasonable costs. The establishment of a written due diligence process, and documenting the trustee's or institution's actions in connection with these duties, would provide evidence of the satisfaction of the duty of prudence.

*MPERS Requirements*

As do ERISA, the UPIA and the UPMIFA, MPERS imposes an overriding general standard of prudence upon trustees or other fiduciaries in the performance of all of their duties, including the selection of a custodian or other service provider. This standard is set forth in MPERS §7 as follows:

*A trustee or other fiduciary shall discharge duties with respect to a retirement system:*

- (2) For the exclusive purpose of providing benefits to participants and paying reasonable expenses of administering the system;*
- (3) With the care, skill, and caution under the circumstances then prevailing which a prudent person acting in a like capacity and familiar with those matters would use in the conduct of an activity of like character and purpose; ...and*
- (5) Incurring only costs that are appropriate and reasonable ...*

MPERS §6 sets out the authority of the trustee to delegate certain functions and is similar to the delegation requirements of ERISA §§ 403(a)(2) and 404(a)(1)(B), but is more permissive than ERISA. In that sense, MPERS follows the delegation authority of UPIA §9(a)(1) and (2):

*(a) A trustee or administrator may delegate functions that a prudent trustee or administrator acting in a like capacity and familiar with those matters could properly delegate under the circumstances.*

*(b) The trustee or administrator shall exercise reasonable care, skill, and caution in:*

- (1) Selecting an agent; and*
- (2) Establishing the scope and terms of the delegation, consistent with the purposes and terms of the retirement program ... [MPERS §6(a) and (b)(1) and (2)]*

*Practice SA – 3.4 (continued)*

*[IBP]* As with ERISA and the UPIA, the general prudence standard imposed under MPERS, as well as the specific duty of the trustee or fiduciary to control costs, as discussed above, would seem to imply a requirement that a due diligence process be developed and implemented with respect to the selection of a service provider that will establish standards for the qualifications of such provider, require that an appropriate investigation is undertaken to ensure that the provider satisfies such qualifications, and set forth procedures to ensure that the costs for the services obtained are no more than reasonable under the circumstances and that the contract or other arrangement to be entered into does not impose any unreasonable or disadvantageous provisions upon the retirement system.