

James G. Cashman  
DIRECTOR

## What it Means to be a Fiduciary with Respect to Transition Management

### *A Brief History of ERISA*

In 1974, in a belated response to the bankruptcy of The Studebaker Company in 1963, the U.S. Congress created The Employee Retirement Income Security Act (ERISA) which established the fiduciary principles for U.S. corporate pension plans. ERISA officially governs every qualified private employee benefit plan in the country, but given its comprehensive scope, it casts a large shadow over all types of pensions. Even plan sponsors who would otherwise be exempt from ERISA like charitable organizations, foundations, endowments, and public pension plans find, in this landmark legislation, excellent guidelines for any trustee or fiduciary.

ERISA Section 3(21)(A) defines a person as a fiduciary if he or she:

- Exercises any discretionary authority or discretionary control with respect to the management of the plan or exercises any authority or control with respect to the management or disposition of plan assets;
- Renders investment advice for a fee or other compensation, direct or indirect, with respect to any plan asset or has any authority or responsibility to do so;
- Has discretionary authority or discretionary responsibility in the administration of the plan.

Under ERISA, fiduciaries are obligated to act with the skill and care of a “prudent person” and solely in the best interests of the plan’s beneficiaries. Consistent with this guiding principle, ERISA obligates fiduciaries to diversify plan assets in order to minimize the risk of large losses. In addition, the Department of Labor considers the voting of proxies to be an integral part of the management of plan investments.

### *Not Only What You Must Do, But What You Mustn’t...*

ERISA proscribes a number of minimum requirements that fiduciaries must fulfill as part of their obligations to plan beneficiaries. Among those are to refrain from prohibited transactions including many forms of self-dealing and conflicts of interest. This includes prohibitions to:

- (1) deal with the assets of the plan in his own interest or for his own account,
- (2) in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, or

James G. Cashman  
DIRECTOR

(3) receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.<sup>1</sup>

### ***How This Can Impact Transition Management?***

ERISA was written with traditional investment management in mind. Transition management didn't even exist at the time the legislation was adopted. Nevertheless, more and more plan sponsors and consultants are recognizing the merits of tapping a fiduciary to oversee that period "in between investment managers" when the plan's assets are in transition. While this trend has obvious positive implications for a plan's beneficiaries, the focus on fiduciary status has become problematic for broker/dealers offering transition management services.

### **Must the Transition Manager Be a Fiduciary?**

#### **Pros**

- 1. Protection for plan sponsor and beneficiaries**
- 2. Transparency of transition fees**
- 3. Proxy voting**

#### **Cons**

- 1. Can't commit capital for trading**

As trading commissions have declined in recent years, broker/dealers have increasingly looked to "proprietary trading" as a source of revenue growth. When running a "prop" trading book, the dealer looks to garner as much trading flow as possible against which it can selectively position itself. In many cases, the dealer will offer to trade at low or zero commission in order to increase its trading volume. In order to make this strategy profitable, the dealer must sell its inventory, on average, at a higher price than where it purchased it. As *The Wall Street Journal* noted in a recent exposé:

*"...(A) problem often arises when an institutional client asks several brokerage firms to bid on a big trade it is planning, without disclosing the actual transaction. There's a lag before the client actually places the order. In the meantime, the brokers approached have some idea of what's about to happen.*

*In April 2002, a fund manager contacted **Deutsche Bank** AG to sound out its interest in handling a large stock trade. The manager wanted to know how much the bank's Morgan Grenfell securities unit would charge to handle a trade on the London Stock Exchange of £65 million, or about \$125 million, worth of stocks, according to a regulatory order. The money manager was soliciting a "blind bid." It provided limited information, including that the trade would involve 55 stocks in the FTSE 100 Index. Until the money manager chose a broker, it wouldn't identify the stocks or say whether it was a buyer or a seller.*

---

<sup>1</sup> ERISA §406(b)

James G. Cashman  
DIRECTOR

*But Morgan Grenfell traders correctly guessed the identities of seven stocks and that the fund manager was going to buy them, says the regulatory order, from the U.K.'s Financial Services Authority. It says that for 18 minutes before Morgan Grenfell won the bid, its traders -- armed with the belief that a big buyer was poised to push up demand for those stocks -- purchased them for its own account. Their actions drove one issue, **Daily Mail & General Trust**, 10% higher before the client's order for that stock was filled, says the FSA.*

*The regulator in March fined Deutsche Bank £190,000, or about \$366,000. It also ordered the bank to disclose to clients in the future if it planned to trade in advance of winning their bids.”<sup>2</sup>*

For reasons that should now be clear, the role of the fiduciary with respect to plan assets is absolutely critical. Understanding the fiduciary's obligations to the beneficiaries of the plan (and conversely, being cognizant of what the fiduciary **cannot** do) as part of the investment process is of paramount importance when investing assets. It should be no less important during the transition of assets when the transition manager assumes the role of interim fiduciary. Yet not every transition manager will wear the fiduciary hat. Should this matter? Ultimately it depends on the fundamental objectives and constraints of the plan sponsor. But as even the most sophisticated investors have discovered, hiring a counterparty instead of a strategic partner can mean unforeseen risks and very real costs.

Confidential- Do Not Duplicate  
© 2005 Mellon Bank, N.A.

---

<sup>2</sup> “Client Comes First? On Wall Street It Isn't Always So”; *The Wall Street Journal*; December 16<sup>th</sup>, 2004