

ERISA FIDUCIARY LIABILITY:
WHAT YOU SHOULD KNOW

*Responsible Management
of Employee Benefit Plan Assets*



RAYMOND JAMES®
CONSULTING SERVICES

Acknowledgment

The following document is not intended to be a legal opinion. Rather, it is an interpretation of a number of sources believed to be accurate, relating to the management of assets in qualified retirement plans in accordance with ERISA standards. There is no one set of black letter law which clearly defines ERISA standards. If this document presents issues of which you are unaware, the only prudent course of action is to consult a qualified attorney.

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Table of Contents

	PAGE NO.
Introduction	4
Background.....	4
Plans Affected by ERISA.....	5
Fiduciary and Co-fiduciary Defined	5
Participant-Directed or Trustee-Directed Plans.....	6
Documented Prudence.....	6
Liability and Exposure Under ERISA.....	7
Investment Policy and the Investment Policy Statement	8
Allocation of Assets.....	9
Investment Decisions and the Prudent Expert	10
Diversification	13
Monitoring Plan Performance	15
Avoid Prohibited Transactions.....	16
Transaction Costs and Other Services	19
Conclusion.....	21

Fiduciary Responsibility and Your Financial Advisor

As the person responsible for handling your firm's qualified retirement plan, you may be considered to be a fiduciary. At a minimum, you probably assist fiduciaries in the fulfillment of their duties. In the course of executing your fiduciary responsibilities, you may have selected several well-qualified professionals to assist in the establishment, management, and maintenance of your plan. You may have retained an attorney to draft the plan and provide legal oversight, a third party administrator for the maintenance of the plan, and an accountant to audit the plan and file the necessary Internal Revenue Service (IRS) documents. You may, however, have overlooked the need to add one more professional to your "team" – namely a Financial Advisor. This advisor can assist you with meeting your legislatively imposed fiduciary responsibilities regarding the management of the assets in the plan. It is generally believed that a substantial number of small plans are probably not in compliance with the Employee Retirement Income Security Act of 1974 (ERISA) principles pertaining to the management of those assets. The enforcement of these standards continues to be on the rise through governmental oversight and plan participant demands.

ERISA: Protection for Employees

According to statistics released in February 2006 by the Department of Labor (DOL), as of the end of 2001, there were over 733,000 retirement plans in the U.S., (including Individual Retirement Accounts (IRAs) but excluding self-employed owner-only plans), which covered more than 100,000,000 participants. In addition, according to an Employee Benefit Research Institute (EBRI) study updated in 2004, as of the end of 2002, total assets held in qualified U.S. retirement plans exceeded \$10 trillion. Approximately 24% of this amount was held in IRAs and the balance was held in private (47%) and public (28%) employer

sponsored qualified retirement plans. The need for prudent management of these assets cannot be overemphasized. If these assets are not prudently managed, the average worker may be left to inadequate government entitlements to supplement retirement benefits during his or her retirement years. For this reason, the DOL and the IRS have continued to step up auditing and enforcement efforts against employee benefit plans.

ERISA was enacted "to protect the ... interests of participants in employee benefit plans and their fiduciaries by requiring the disclosure and reporting to participants and their beneficiaries of financial and other information with respect thereto, by establishing standards of conduct, responsibility, and obligation for fiduciaries of employee benefit plans, and by providing for appropriate remedies, sanctions, and ready access to the federal courts." (ERISA Section 2[b], 29 U.S.C.A. 1001[b]). The IRS also has an interest in qualified plans because of the tax-deferred status of the plan assets. Section 4975 of the Internal Revenue Code of 1986 mirrors several of the same standards contained in the Labor provisions (Title 1) of ERISA.

The provisions of ERISA Sections 402 through 412 and Section 4975 of the Code are intended, among other things, to provide a basis for standards of conduct for plan fiduciaries. As with most black letter law, these sections have undergone interpretation by the DOL, the IRS, and the courts. In summary, these standards are:

- 1) *Investment policy statements should be in writing.*
- 2) *Investment decisions must be made against a "prudent expert" standard.*
- 3) *Plan assets must be diversified.*
- 4) *Plan investment performance must be monitored.*
- 5) *Prohibited transactions must be avoided.*
- 6) *Duties must be discharged for the exclusive purpose of providing benefits to participants and to defray reasonable administrative expenses.*

Though the fiduciary can never be fully insulated from liability, or transfer the full responsibility for compliance to someone else, your responsibilities as a fiduciary under ERISA can be addressed by employing a complete team of knowledgeable advisors.

Plans Affected by ERISA

Specifically, ERISA provisions cover fiduciary responsibilities for the following employee benefit plans:

- Profit Sharing Plans
- Money Purchase Pension Plans
- Defined Benefit Plans
- Target Benefit Plans
- Cash or Deferred 401(k) Plans
- Funded Welfare Benefit Plans including: medical, dental, prepaid legal services, unemployment, vacation benefits, day care centers, scholarship funds, workers' compensation, and death and disability funds
- Some Simplified Employee Pension Plans
- Some 403(b) Plans
- Some Simple IRA Plans

Plans maintained by governmental bodies are exempt from ERISA, but most states have imposed their own standards that closely follow the ERISA requirements. Plans maintained by churches and non-qualified deferred compensation plans set up by employers are also generally exempt.

IRAs and one-participant plans, in which only the sole participant and/or spouse are covered by a plan, are subject only to the prohibited transaction provisions of Section 4975 of the Internal Revenue Code; they are not subject to the prohibited transaction provisions of ERISA. This is because the original ERISA language establishes that the statute, and the regulations promulgated thereunder, were adopted to protect the interest of participants in "employee benefit plans" and an employee benefit plan by definition had to cover at least one regular or "common law" employee in addition to the owner/plan sponsor.

Thus, a plan involving the fiduciary, and no one else (other than a spouse), was not originally regulated under ERISA and, therefore,

was unenforceable by the DOL. However, in 1978 jurisdiction of sole participant plans was transferred to the DOL in order to ensure the handling of prohibited transactions under the Code, as well as certain fiduciary issues, would be uniform. Responsibility for oversight of plan funding, as well as participation and vesting of benefit rights, is the domain of the Department of Treasury. The Department of Labor possesses regulatory authority to oversee fiduciary obligations. Both departments, however, possess enforcement powers.

Who are Fiduciaries and Co-fiduciaries?

As defined in ERISA, a fiduciary includes: a) any person who has discretionary authority or control over the management of a plan, or the management or disposition of plan assets; b) a person who has any discretionary authority or discretionary responsibility in the administration of a plan; or (c) a person who renders investment advice for a fee or other compensation (direct or indirect) with respect to any monies or other property of the plan, or has any authority or responsibility to do so. This last may be based on a written or unwritten agreement but does involve a situation where it is generally understood that such advice will serve as the primary basis for investment.

A co-fiduciary is any other person who meets the definition above with respect to the same plan. Depending on the facts and circumstances, co-fiduciaries may include an investment manager, the plan's accountant, plan administrator, attorney, and/or Financial Advisor if the individuals have sufficient influence or authority over the management of plan assets. Anyone with investment oversight responsibility has a duty to ensure that appropriate procedures are followed on an initial and ongoing basis. To do otherwise begs for problems and litigation and exposes anyone possibly related to the management of the plan assets to liability.

Who Should Manage the Money in an ERISA Plan?

All employee benefit plans can be broken into two categories: 1) plans that allow for participants to direct how their monies should be invested (usually from a menu of choices) and, 2) plans that are trustee-directed (usually through the use of an employer investment oversight committee). The first type (participant-directed plan) typically takes the form of a defined contribution plan (e.g., 401(k) plan) while the second type is generally a defined benefit or trustee-directed defined contribution plan (e.g. traditional pension plan). Either type still requires that appropriate prudent procedures be followed.

For participant-directed plans, these procedures may especially be critical if an employer is attempting to avail itself of the protection afforded by ERISA Section 404 (c), strict compliance with which would permit a plan fiduciary to avoid liability for a participant's poor investment choices. Some of the requirements of Section 404(c) are as follows.

The Plan Sponsor or administrator must:

- Provide an opportunity for participants to choose from at least three investment options, each of which must have a unique risk/return profile. For example, a plan that offered as investment options a money market, small-cap, and an international fund would probably not satisfy the requirement because of the common risk/return characteristics of the two equity funds. A Plan Sponsor that offers its own stock as an investment option must still offer three additional investment options.
- Provide an opportunity for participants to “exercise control” over the assets in their individual accounts – this is defined as the opportunity to change investment options at least quarterly. (There are those who believe

that the volatility of the equity markets warrant the ability for participants to make changes more frequently.)

- Provide participants with certain mandatory disclosures including applicable fund prospectuses, information regarding the investment options and managers, the associated fees, how and how often investment instructions are to be relayed, and certain other information or documents upon a participant's request. In addition, the plan document and Summary Plan Description must contain certain language if it is the Plan Sponsor's intent to comply with section 404(c).
- Over and above this, it is in a Plan Sponsor's best interest to provide sufficient education so participants can make intelligent choices among investment options. This education component should include, as a minimum:
 - Information on investment fundamentals, including the importance of diversification and the asset allocation decision.
 - The relationship between risk and return.
 - The impact of the investment time horizon and the effect of inflation on investment growth.
 - Instruction on the time value of money, particularly the effects of compounding.
 - Discussion of the securities that make up each of the different investment options.

The Law Requires Documented Prudence

ERISA standards revolve around one basic theme – documented prudence. The courts view compliance with ERISA standards as more significant than subsequent investment performance results. A fiduciary is rarely surcharged by the courts for poor performance results if his/her

investment decisions were prudently undertaken and properly documented. [See e.g., *Donovan v. Mazzola*, 716 F.2d 1226 (9th Cir. 1983); *Sandoval v. Simmons*, 622 F. Supp. 1174 (D.C. Ill. 1985); *Davidson v. Cook*, 567 F. Supp. 225 (E.D. Va. 1983); *aff'd mem.*, 734 F.2d 10 (4th Cir.); *cert. denied*, 469 U.S. 899 (1984).]

On the other hand, there are numerous cases where a fiduciary has been held liable for taking imprudent risks that resulted in losses or substandard performance. The cases have always found liability because deficient documentation and/or poor procedures were followed in making the initial investment decisions. [See *Marshall v. Teamsters Local 282 Pension Trust Fund*, 458 F.Supp. 986 (E.D.N.Y. 1978); *Freund v. Marshall & Ilsley Bank*, 485 F.Supp. 629 (W.D. Wisc. 1979); *Donovan v. Bierwith*, 538 F. Supp. 463 (E.D.N.Y. 1981); *mod. on other grounds* 680 F.2d 263 (N.Y. Ct. App. 1982); *cert. denied*, 103 S. Ct. 488, 459 U.S. 1069, 74 L. Ed. 2d 631; *Palino v. Casey*, 664 F.2d 854 (Mass. Ct. App. 1981). But see *Brock v. Walton*, 794 F.2d 586 (11th Cir. 1986); *Bidwill v. Garvey*, 943 F.2d 498 (4th Cir. 1991); *Meinhardt v. Unisys Corp.*, 1994 U.S. Dist. LEXIS 12713 (E.D. Pa. 1994); and *In re Unisys Savings plan Litigation*, 74 F. 3d 420 (3rd Cir.), *cert. denied*, 117 S. Ct. 56 (1996).]

Liability & Exposure Under ERISA

What is your exposure if you do not prudently manage the assets in your plan? First and foremost, you may have to face an unhappy employee if plan assets do not grow at an acceptable pace. Plan assets represent the most significant savings most employees will have for their retirement years. Participants in your plan can bring suit against you for failing to properly fulfill your duties as a fiduciary, and they can sue for performance losses and court costs. The number of court cases brought by participants is increasing dramatically, especially as participants become more sophisticated

about investment performance, the benefits of diversification, modern portfolio theory – and have immediate access to relative performance results. Second, the DOL and IRS can audit your plan at any time. Both federal agencies have an interest in the management of your plan assets. If the DOL determines that there has been any breach of fiduciary responsibility or other fiduciary violation (as described in part 4 of subtitle B of Title I of ERISA), it can file personal suit in federal court against the Plan Sponsor or other participating fiduciaries. The DOL can also assess a civil penalty equal to 20% of the “applicable recovery amount,” which generally means the amount recovered from a fiduciary or other person as a result of the breach or violation and is based on a settlement with the DOL and/or a court order. The IRS can also disqualify a plan if it finds that the plan’s assets have not been managed for the exclusive benefit of the participants or for lack of compliance with the plan terms or regulatory requirements. Plan disqualifications may be made retroactive to the date of the initial compliance problem. Furthermore, to the extent a plan is disqualified, the assets in the plan may become immediately taxable and the Plan Sponsor may become subject to various penalties.

ERISA specifically addresses the extent of personal liability:

“Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this title shall be personally liable to make good to such plan any losses to the plan resulting from such breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary.”

(ERISA Sec. 409[a], 29 U.S.C.A. 1109[a].)
(Emphasis added.)

The courts are quick to assign liability for investment losses or poor performance when it can be supported by imprudent or inappropriate actions. Therefore, prudence dictates that documented, appropriate steps be undertaken.

Your Investment Policy Statement: Put It In Writing

A written Investment Policy Statement is an important document to use in assisting fiduciaries to discharge their responsibilities in compliance with ERISA.

ERISA mentions the necessity of a written investment policy under several provisions:

“Every employee benefit plan shall provide a procedure for establishing and carrying out a funding method consistent with the objectives of the plan and the requirements of this subchapter.”

(ERISA Sec. 402 [b][1]. 29 U.S.C.A. 1102[b][1].)

“A fiduciary shall discharge his duties with respect to a plan ... in accordance with the documents and instruments governing the plan.”

(ERISA Sec. 404[a] [1][D]. 29 U.S.C.A. 1104[a].)

The DOL has not specifically mandated the development of a written statement; however, each fiduciary is measured against the standard in existence in the industry. Investment policy statements are now so commonplace that DOL officials have indicated that the absence of a written Investment Policy Statement makes compliance with ERISA standards virtually impossible. In the case of an audit by the DOL or the IRS, a fiduciary will be asked to produce a written investment policy as part of the examination. This document is probably the best insurance against liability – assuming it is correctly drafted, implemented and followed.

The fiduciary should distinguish between having a written Investment Policy Statement and the requirement that plan and trust documents be in writing. The plan documents, which must always be in writing, are the trust documents that establish the plan and are filed with the IRS. They should not be confused with the Investment Policy Statement.

There are two principal reasons why the investment policy for the plan should be put into writing in the form of an Investment Policy Statement. First, investment decisions should be made pursuant to the strategies developed in the investment policy. Without a written Investment Policy Statement, fiduciaries may make ad hoc or knee-jerk decisions based on market emotion or a persuasive salesperson. Having an Investment Policy Statement provides the fiduciary with a reference from which to build the investment portfolio. Second, an Investment Policy Statement establishes a rationale against which subsequent judgments can be made and evaluated. If the program is spelled out, then actions can later be justified as part of the overall strategy. In addition, if the plan’s needs change, the objectives of the plan can be evaluated and modified to conform to the current situation.

While the Investment Policy Statement does not have to be long and complicated, it should be specific enough to address the plan’s needs. An Investment Policy Statement should identify:

- The name of the Plan Sponsor and name of the plan
- The goals and objectives of the Plan Sponsor with respect to the investments of the plan
- The investment accounts to be managed
- The asset allocation methodology to be followed
- Any investment restrictions (such as no investments in hedge funds, employer stock, etc.)
- Time horizon and re-balancing guidelines
- Acceptable levels of risk
- Liquidity and income needs (to cover projected participant distributions)

Your Financial Advisor Can Draft Your Policy Statement

A financial advisor well versed in the investment planning process should draft the Investment Policy Statement. The development of the Investment Policy Statement may require several meetings and should represent a “meeting of the minds” of all involved. An abbreviated sample Investment Policy Statement follows. As with any plan document, it should be reviewed carefully by all of the professionals involved in the plan’s maintenance and management.

- Procedures and criteria for selecting “prudent experts” to manage the assets
- Procedures for monitoring and evaluating the “prudent experts”
- Procedures to be followed for reviewing and amending any of the items listed above

Allocation of Assets

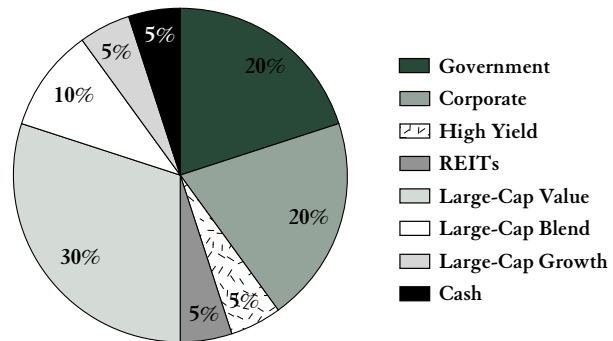
The Investment Policy Statement should address the allocation of assets among stocks, bonds and cash. (Other asset classes that may be used in plans include gold, real estate, equipment leasing, oil and gas and guaranteed investment contracts.) Asset allocation is the process of distributing assets among various investment classes to attempt to yield maximum return within the established risk parameters.

The basic premise behind efficient asset allocation is that asset classes do not move in lockstep with one another and that losses sustained by one asset class can be offset by gains in a different asset class. The overall effect is to attempt to reduce the volatility in portfolio performance (e.g., reduction of the overall standard deviation). This is the core of modern portfolio theory. Respected studies on the performance of portfolios have shown that asset allocation decisions have the greatest impact on overall long-term portfolio volatility (*Brinson, Beebower & Associates, 1986, 1991, 1995 and Ibbotson & Kaplan, 2000*). In “Determinants of Portfolio Performance,” Brinson, Beebower and team attribute 91.5% of portfolio volatility to asset allocation, 4.6% to the individual selection of securities and 3.9% to timing and other factors. Even though only 4.6% of the volatility is attributed to individual stock and/or bond selection, this is the area where many fiduciaries spend most of their time and energy.

A problem every fiduciary must face when developing an investment policy is the need to focus on two related, but often conflicting, investment goals: [1] the need to protect the principal value of the portfolio, and (2) the need to enhance performance of the portfolio. A plan’s overall portfolio should maintain purchasing power (i.e., keep up with inflation). This suggests the inclusion of equities in a portfolio with a long-term investment horizon since cash and bond portfolios are generally more susceptible to inflation over time than equities. Asset allocation has historically enhanced the value of the portfolio relative to inflation while still investing within stated risk tolerances. (There is no assurance that any trend will continue.)

Sample Asset Allocation Model

This is one example of how a professional portfolio manager might allocate assets to diversify holdings in an attempt to dampen volatility and preserve capital, while taking advantage of equity opportunities in a portion of the portfolio.



The chart above is included for illustrative purposes only and does not constitute a recommendation.

Selecting an Investment Manager

As mentioned earlier, plan assets may represent the single most significant source of funds on which workers will depend during their retirement years. It is crucial that investment decisions be made with utmost diligence. It is for this reason that Congress, the IRS, and the courts have strongly encouraged the appointment of professional investment advisors to manage plan assets. A fiduciary may substantially reduce his or her own liability for the investment performance of the plan if investment managers have been diligently selected and monitored to ensure prudent handling of the plan's investments.

ERISA deals directly with the use of professional investment advisors by plan fiduciaries:

“Any employee benefit plan may provide that a named fiduciary may employ one or more persons to render advice with regard to any responsibility such fiduciary has under the plan; or that a person who is named fiduciary with respect to control or management of the assets of the plan may appoint an investment manager(s) to manage (including the power to acquire and dispose of any assets of a plan).”

(ERISA Sec. 402[c][2]. 29 U.S.C.A. 1102[a][2].)

In addition, the fiduciary will be held to a high standard of conduct in his capacity as the overseer of plan assets:

“[A fiduciary shall discharge his duties with respect to a plan solely in the interests of the 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 a like character and with like aims.”

(ERISA Sec. 404[a][1][B]. 29 U.S.C.A.104[a][1][B].)

Section 404[a][1][B] is commonly referred to as the “prudent expert” rule. This rule states that investment decisions will be evaluated against the standards of a “prudent expert,” e.g., an experienced professional investment advisor. In addition, the fiduciary has the right to rely on professionals to assist with investment decisions and to pay those advisors fair compensation. In reviewing disputed transactions, the courts have consistently held fiduciaries to the higher “prudent person” test versus the “business judgment” rule.

Under ERISA, *employment of an investment manager, in addition to helping the fiduciary discharge his/her responsibilities, reduces the fiduciary's personal liability* to the extent justifiable reliance is placed on such advisor:

“If an investment manager or managers have been appointed under Section 402(c)(2), then, notwithstanding subsection (a)(2) and (3) and subsection (B), no trustee shall be liable for the acts or commissions of such investment manager or managers, or be under an obligation to invest or otherwise manage any asset of the plan which is subject to the management of such investment manager.”

(ERISA Sec. 405[d][1]. 29 U.S.C.A. 1105[d][1].)

The “Safe Harbor” Rule

Section 405(d)(1) is referred to as the “safe harbor” rule. Fiduciaries, however, must still establish an investment policy, prudently select money managers, and monitor and evaluate the performance of the selected manager(s).

In interpreting these provisions, the courts have been direct about the necessity of a fiduciary using an investment manager. For example, the appointment of an investment manager was a court-imposed remedy in order to protect the plan assets and the interests of participants and beneficiaries. [See e.g., *Donovan v. Mazzola*, 716 F.2d 1226 (9th Cir. 1983) *cert. denied* 104 S. Ct. 704, 79 L. Ed. 2d 169.] If a fiduciary takes responsibility for investment decisions, he/she shall be measured by the standards of performance of professional investment managers knowledgeable in their specific area (i.e., prudent real estate investor, prudent mortgage lender, etc). [See e.g., *Davidson v. Cook*, 567 F. Supp. 225 (D.C. Va. 1983), *aff’d* 734 F.2d 10 (4th Cir. 1984), *cert. denied* 105 S. Ct. 275, 83 L. Ed. 2d 211; *Marshall v. Glass/Metal Ass’n and Glaziers and Glass Workers Pension plan*, 507 F. Supp. 378 (D.C. Hawaii, 1980); *Donovan v. Walton*, 609 F.Supp 1221 (S.D. Fla. 1985), *aff’d* 794 F. 2d 586 (11th Cir. 1986); *Katsaros v. Cody*, 744 F. 2d 270 (2nd Cir. 1984); *GIW Industries v. Trevor, Stewart, Burton & Jacobsen, Inc.* 10 EBC 2290 (S.D. Ga. 1989), *aff’d* 895 F. 2d 729 (11th Cir. 1990).]

The prudent selection of investment managers can be best accomplished with the assistance of a competent Financial Advisor. Specifically, there are Financial Advisors who serve as “managers of professional money managers.” Such an advisor can assist the fiduciary in developing the written Investment Policy Statement and then identifying those investment managers and/or mutual funds most appropriate to the investment objectives of the policy. The use of a Financial Advisor should allow the fiduciary to

adequately address issues as broad as expected asset class returns over time, and as specific as who will vote proxies for holdings in the plan. It is imperative that appropriate procedures be documented and followed in selecting investment managers. If these procedures are not followed, liability will be present. [See *Whitfield v. Cohen*, 682 F. Supp. 188 (S. D. N.Y. 1988).]

The fiduciary who attempts to select investment managers or mutual funds without the assistance of a Financial Advisor should be aware of several pitfalls. First, the marketing material of managers may not provide sufficient information, and the available information in some cases may not even be accurate. The Securities and Exchange Commission (SEC), which oversees all federally registered investment managers, has not enforced a uniform format which must be used by managers when reporting performance. As a result, it may be difficult to compare one manager’s reported performance with that of another manager. The Chartered Financial Analyst Institute has adopted uniform standards to be used by investment managers. However, the managers still have broad discretion about composite calculations and the level of verification of results. In addition, some returns may not be net of fees and transaction costs, whereas other reported returns may be net of such costs. Likewise, mutual funds may have broad latitude in their overall investment approach. Items that become important are style adherence (or drift), expense ratios, peer performance, illiquid investments, manager tenure and stability and sufficient fee disclosure.

Another pitfall the fiduciary faces is that it is very difficult to identify those managers who achieved out-performance as a result of mere luck. Most fiduciaries lack the time, experience, and expertise to meet with an investment

Case law and prevailing industry standards strongly favor the use of investment managers for some portion or all of the plan assets, since fiduciaries will be judged according to such standards.

It is worth repeating that the fiduciary can reduce his or her liability by hiring an investment manager, but the fiduciary remains liable for failure to select a responsible investment manager(s) and for failure to monitor the performance of the selected manager(s).

manager face-to-face and determine whether the manager has the skills to seek above-average performance in the future. Obviously, the fiduciary who selects an investment manager who has the appropriate skill and knowledge stands a greater chance of achieving superior results over the long run than the fiduciary who hires a manager who is simply enjoying a streak of good luck.

In addition, prior performance in and of itself should not be the only factor by which an investment manager is measured. Equally important in the selection of an investment manager is the risk associated with achieving the disclosed performance. For example, two investment managers may report an identical 10% compounded annual rate of return over five years. Thus a \$1,000,000 investment at the beginning of the first year grew to \$1,610,510 at the end of the fifth year with each manager. However, Manager #2 achieved this result with the following respective annual rates of return: 15%, 15%, - 28%, 30%, and 30%. If Manager #1 achieved his performance with a consistent 10% return per year, then unquestionably the returns were generated with less volatility. Therefore, standard deviation, scatter diagrams, rolling time period evaluations, etc., may be necessary in order to truly evaluate an investment manager's performance. Rate-of-return performance alone may be misleading.

Procedures for selecting and evaluating investment managers and/or mutual funds should be stated in the plan's Investment Policy Statement. Suggested criteria include:

1. Selecting only those managers who have been managing portfolios for at least 10 to 15 years. This criterion is more likely to reveal the manager's ability to manage funds in both rising and falling markets;

2. Selecting only those managers who have specific, realistic investment strategies and have followed these strategies consistently throughout the firm's history. The fiduciary should avoid managers who are chasing investment fads. Furthermore, the fiduciary will find it impossible to monitor performance if the manager is not committed to a specific investment strategy.
3. Providing additional information that should also be considered such as: research procedures, decision making guidelines, control disciplines, transaction guidelines, background and turnover of key individuals, reference accounts, fee variations, performance deviation, composite performance returns, and (if individually managed) the means for review of sample portfolios to ensure that the manager employs the strategies described in the firm's marketing material.

Diversify, Diversify, Diversify

ERISA states that a fiduciary must diversify the plan's assets. While the DOL has established certain standards for diversification, no specific limits have been set. However, informal limits do exist and have been utilized by enforcement officials. In determining whether the assets have been properly diversified, the DOL will use the objectives outlined in the plan's Investment Policy Statement. This standard of measurement again underscores the importance of drafting a realistic, comprehensive Investment Policy Statement.

"[... a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and ...] (C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so ..."

(ERISA Sec. 404[a][1][c]. 29 U.S.C.A. 11094 [a][1][c].)

The Conference Report on ERISA makes clear that once a plaintiff proves a failure to diversify, the burden shifts to the defendant to demonstrate that non-diversification was prudent under the circumstances (H. Rep. No. 93-1280, 93rd Cong., 2d Sess. at p. 304). This is supported by case law. (*Metzler v. Graham*, 112 F. 3d. 207 (5th Cir. 1997) and *Reich v. King*, 867 F. Supp. 341 (D. Md. 1994).)

The courts have been quick to find fiduciary liability when it was apparent that diversification did not exist and a loss occurred. [See *Marshall v. Glass/Metals Ass'n and Glaziers and Glass Workers Pension Plan*, 507 F. Supp. 378 (D.C. Hawaii 1980) (23% of the plan's assets were invested in a single real estate project). *Freund v. Marshall & Ilsley Bank*, 485 F. Supp. 629 (W.D. Wisc. 1979) (unsecured promissory notes, even though

high interest bearing). *Donovan v. Guaranty National Bank*, 4 EBC 1686 (S.D. W.Va. 1983) (80% of plan assets in mortgage loans). *Brock v. Berman*, 673 F.Supp. 634 (D.C. Mass. 1987) (28% in oil and gas exploration and 17% in oil and gas concerns). *Donovan v. Mazzola*, 716 F.2d 1226 (Ca. Ct. App. 1983) *cert. denied* 104 S. Ct. 704, 79 L. Ed. 2d 169 (too large a proportion of the plan's assets in loans when other investment alternatives were available including stocks, bonds and real estate).

Editorial note: The DOL expert witness in the Donovan case testified the DOL's position to be "... investment diversification requires the identification of different classes of investments, that is, categories of investments with different characteristics and opportunities for risk and return." *Marshall v. Teamsters Local 282 Pension Trust Fund*, 485 F. Supp. 986 (E.D.N.Y. 1978) (high-risk real estate venture began with 15% of plan assets and would increase to 36% of current plan assets upon conclusion of project). *GIW Industries Inc. v. Trevor, Stewart, Burton & Jacobsen, Inc.*, 10 EBC 2290 (S.D.Ga. 1989), *aff'd* 845 F.2d 729 (11th Cir. 1990) (investment of 70% of plan assets in government bonds was inappropriate and imprudent diversification) but *cf. Withers v. Teachers' Retirement System of the City of New York*, 447 F. Supp. 1248 (S.D.N.Y. 1978) (purchase of New York City bonds to stave off city bankruptcy was acceptable). *Sandoval v. Simmons*, 622 F. Supp. 1174 (D.C. Ill. 1985) (investment manager's corporate stock holdings, although in high percentages, did not necessarily reflect imprudence); and *Meinhardt v. Unisys Corp.*, 1994 U.S. Dist. LEXIS 12713 (E.D. Pa. 1994) and *In re Unisys Savings plan Litigation*, 74 F. 3d 420 (3rd Cir.), *cert. denied*, 117 S. Ct. 56 (1996) (non-performing GIC investments held in participant-directed plan were acceptable given facts and circumstances).]

The Conference Report on ERISA makes clear that once a plaintiff proves a failure to diversify, the burden shifts to the defendant to demonstrate that non-diversification was prudent under the circumstances.

Some court decisions would lead one to believe that the word “diversification” means both asset allocation and diversification. However, the two are not synonymous. Asset allocation guidelines determine the distribution of assets among various investment classes to attempt to yield the greatest possible return consistent with the portfolio’s risk parameters. Diversification is the risk-reduction process of choosing a broad range of different individual investments within a particular investment class. For example, if a fiduciary determines that 30% of the assets should be placed in equities, then within that equity portfolio, assets should be diversified among a range of equity issues.

An analysis of the proper diversification of assets would consider the following criteria:

- Plan design
- Plan size
- Current market and financial conditions
- Existing economic conditions relative to any given investment
- Geographic distribution of assets and investments
- Dates of maturity (fixed income, cash portfolios)
- Volatility and correlation of each asset class
- Liquidity of assets in light of plan liquidity needs
- Potential portfolio return compared with the funding objectives of the plan.

This analysis should be plan-specific; two plans holding the same assets may be evaluated differently. The goals and the objectives and the return and risk parameters of the two plans will determine which is more prudently diversified and managed.

If there are sufficient assets, the fiduciary should also consider the advantages of diversifying assets among several different investment managers within the same investment class. In other words, two or three different equity managers would manage the equities portion. Again, the prudent fiduciary would realize that no single investment style is going to be in favor with the market all the time and that managers with different strategies can complement one another. The fiduciary should consider that:

1. Dividing the assets among different investment objectives may lower overall investment risk without lowering potential long-term returns;
2. Managers skilled in different strategies can be selected, e.g., value or growth-oriented, top-down, bottom-up, global, etc.; and
3. Managers who fail to perform can be terminated more easily when they are managing only a portion of the assets.

The drawback is that investment managers may have set high minimum account sizes (\$10 million or more) to reduce the number of portfolios they must actively manage. Certain Financial Advisors, however, have been able to negotiate lower account size minimums because of the administrative and client support services they can provide. Using these Financial Advisors would not only facilitate the selection of investment managers, but also give the fiduciary access to managers who may not otherwise be available.

Diversification does not ensure a profit or guarantee against a loss. Investing involves risk and you may incur a profit or a loss.

Monitor Plan Investments

A fiduciary has an ERISA-mandated responsibility to manage plan assets prudently. ERISA promotes the development of an Investment Policy Statement, provides for the use of investment managers, and requires the diversification of plan assets. If the above tenets are followed, a fiduciary's exposure to liability can be significantly reduced – assuming the fiduciary continually monitors the activities of selected managers or the performance of assets managed by the fiduciary.

The courts have interpreted this continuing duty liberally when invoking fiduciary liability. [See e.g., *Brink v. DaLesio*, 496 F. Supp. 1350 (D.C. Md. 1980) (a union pension and welfare trustee was held jointly liable with a consultant for improper receipt of commissions because the trustee failed to monitor the consultant's compensation and performance). See also *Whitfield v. Cohen*, 682 F. Supp. 188 (S.D.N.Y. 1988); *Leigh v. Engle*, 727 F.2d. 113 (7th Cir. 1984); *Atwood v. Burlington Industries*, 18 EBC 2009 (M. D. N. C. 1994); *Newton v. Van Otterloo*, 756 F. Supp. 1121 (N. D. Ind. 1991).] Given the appointment of an investment manager, the plan trustee retains oversight responsibility for the performance of the manager. The fiduciary must put in place a reporting, monitoring and evaluation procedure. Reliance on IRS Form 5500 as a monitoring device has been judged insufficient for this purpose. [See e.g., *Brock v. Berman*, 673 F. Supp. 634 (D.C. Mass. 1987)]

Most investment managers will supply quarterly performance reports. Coupled with these reports may be a statement about the portfolio's calculated rate of return. Simply reviewing this information, however, does not fulfill the ERISA requirement that portfolio performance be monitored; the analysis must go deeper.

Effective monitoring of an investment manager will be facilitated if the fiduciary utilizes a Financial Advisor. A competent Financial Advisor should be able to monitor and evaluate the activities of an investment manager and report the following objective measurements:

- What was the time-weighted return of the portfolio?
- What effect did the market have on return?
- How did asset allocation impact the return?
- How much risk is the manager taking?
- What was the manager's contribution to return (selection and timing)?
- How do the results compare with appropriate market indices?
- How does the manager's performance compare with the results obtained by managers of similar investment style?
- Are performance results, levels of risk, and asset allocations consistent with the plan's investment policy?
- Are the fees charged reasonable and adequately disclosed?

Most importantly, however, the following question must be asked: Has the manager followed his or her stated investment strategy or methodology? If not, then by implication the written Investment Policy Statement is not being adhered to and the fiduciary significantly increases his/her exposure to personal liability.

Most important is the question: Has the manager followed his or her stated investment strategy or methodology?

One question that often arises is, “When is it prudent to replace an investment manager or mutual fund?” First of all, one quarter, six months, or even one year of poor performance would not in itself necessitate the firing of a manager. In fact, most Financial Advisors would agree that a manager should be given at least two years to perform, assuming the other investment policy criteria used in the manager selection have not been violated.

When poor performance is observed, the initial prudent course of action would be to note and acknowledge the performance data, and then document explanations for such performance. An analysis will demonstrate whether the manager made bad investment decisions or whether the market has not yet reflected the manager’s good decisions. It would be advisable to place such a manager on a “watch list” to continue to determine if the plan objectives will be met.

There are times, however, when it may be prudent to fire a professional investment manager or replace a mutual fund immediately. The most common reason would be a change in the manager’s investment style, methodology, strategy, or personnel – such as key decision-makers are no longer in place. Particularly, those managers suffering from performance anemia have a tendency to undergo an evolutionary change to a new strategy. A fiduciary does not want to be an experimental tool for a manager’s new program, nor can a fiduciary effectively monitor the activities of the manager if the manager is not following a specific strategy or methodology. Similarly, a manager who sees performance sinking relative to the market may try to redeem himself and his performance by taking inordinate risks. This can compound investment errors and degrade performance.

Avoid Prohibited Transactions: No Current Benefits for Fiduciaries

With large dollar amounts accumulating for retirement years, it is only natural that certain individuals would devise ways of making these dollars work for them today. The government seeks to ensure that fiduciaries receive no such current benefit. This forms the basis for the rules relating to prohibited transactions.

Under ERISA, prohibited transactions always involve a party-in-interest and/or fiduciary; under the Code, prohibited transactions involve “disqualified persons,” which includes fiduciaries. In general, both these terms refer to any person who directly or indirectly controls or is controlled by a fiduciary; any officer, director, partner, or employee of the firm sponsoring the plan; and any close relatives of the foregoing. Obviously, a fiduciary must not direct services of the plan to a friend in exchange for other consideration. To the extent a fiduciary does hire a friend to perform a service, the fiduciary cannot pay higher rates for services than he/she would to competitors, and the friend’s quality of service must not be inferior to that offered by competitors; i.e., the engagement must be an “arms-length” arrangement.

Both ERISA and the Code are specific in dealing with these types of prohibited arrangements:

“Except as provided in ERISA Section 408 (almost identical “prohibited transaction” provisions can be found in Code section 4975):

(a)(1.) A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such a transaction constitutes a direct or indirect:

(a) sale or exchange, or leasing, of any property between the plan and a party-in-interest,

(b) lending of money or other extension of credit between the plan and a party-in-interest,

(c) *furnishing of goods, services or facilities between the plan and a party-in-interest, or*

(d) *transfer to, or use by or for the benefit of, a party-in-interest, of any assets of the plan.”*

(ERISA Sec. 406[a]. 20 U.S.C.A. 1106[a].)

ERISA continues with general items a fiduciary cannot undertake:

(b)(1). *“A fiduciary with respect to a plan shall not:*

(a) *Deal with the assets of the plan in his own interest or for his own account,*

(b) *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*

(c) *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.”*

(ERISA, Sec. 406[b]. 29 U.S.C.A. 1106[b].)

Like many legislative enactments, there are exceptions to the prohibited transaction rules. These consist of 11 “statutory exemptions,” which are identified in both ERISA and the Code as being permissible, as well as numerous “class exemptions” and individual exemptions. Two of the statutory exemptions are as follows:

“1. Contracting or making reasonable arrangements with a party-in-interest for office space, legal, accounting, or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefore, and

2. The investment of all or part of a plan’s assets in deposits which bear a reasonable interest rate in a bank or similar financial institution supervised by the United States or a State, if such bank or other institution is a fiduciary of such plan and if [such investment is expressly authorized.]”

(ERISA Sec. 408[b]. 29 U.S.C.A. 1108[b].)

Although not a prohibited transaction under ERISA Section 406, it can be mentioned here that it is prohibited under the fiduciary responsibility section (Section 404) to take plan assets out of the country. It is, however, permissible to buy foreign investments through a U.S. intermediary such as a mutual fund or a bank.

“Except as authorized by the Secretary by regulation, no fiduciary may maintain the indicia of ownership of any assets of a plan outside the jurisdiction of the district courts of the United States.”

(ERISA Sec. 404[a][2][b]. 29 U.S.C.A. 1104[a][2][b].)

Because of the high standard to which a fiduciary is held, the courts have been quick to find prohibited transactions when the fiduciary of a plan has received current economic benefit. [See *Lowen v. Tower Asset Management, Inc.*, 829 F.2d 1209 (2nd Cir. 1987) (fiduciaries invested in companies in which they owned substantial equity interests). *Donovan v. Dillingham*, (D.C. Ga. 1-17-84) (administrator’s retention of excess between contributions paid in and cost of Guaranteed Investment Contract was prohibited compensation). *Lambos v. Commissioner*, 88 T. C. 80 (1987) (leases between profit sharing plan and sponsor’s majority shareholder and wife are prohibited transactions). *Marshall v. Carroll*, 2 EBC 2491 (N.D. Cal. 1980) aff’d without op. 673 F.2d. 1337 (9th Cir. 1981) (plan assets placed on deposit in a financial institution to procure

loans for president of financial company).] Even though an investment would qualify as prudent when judged by the highest fiduciary standard, this does not exempt the transaction from being prohibited, even if the plan benefited from the transaction. Internal Revenue Code Sec. 4975 does not incorporate a prudent investment standard. [See *Lieb v. Commissioner*, 88 T. C. 83 (1987). See also *Rutland v. Commissioner*, 89 T.C. 80 (1987) (one transaction led to two prohibited transactions for purposes of the 5% excise tax and the tax applied regardless of the good faith action by the disqualified person acting on the advice of attorneys and investment counselors). Note the excise tax rates were increased in 1997. Currently, the initial excise tax on a prohibited transaction is 15% of the amount involved in the transaction; this may rise to 100% if not corrected in a timely manner.]

With smaller pension plans (assets less than \$2 million), there is a tendency for the fiduciary to play several different roles – agent of the plan, administrator, trustee, plan sponsor, and/or plan participant. A prohibited transaction is likely to ensue when the fiduciary attempts to play these roles simultaneously.

The more common prohibited transactions

For small plans, these include:

1. The sale, exchange, or leasing of land between the plan and the fiduciary. An example would be a doctor who owns his own professional building and sells the building property to the plan, or where the plan buys the building from a third party, and then has the plan lease an office back to the doctor. Other transactions involving the real estate include using plan assets to buy rental property where the sponsor or family member plans to collect the rent and otherwise manage the property.
2. Engaging in plan investment transactions with family members, such as having the plan execute a promissory note with a family member or purchase a mortgage to be held by the plan for a family member's residence or business investments.
3. Engaging in a prohibited loan. Loans from a plan to a plan participant may be permitted, but will always be carefully scrutinized in an audit. For a loan to pass inspection, the plan documents must authorize participant loans, the loan must be in writing, it must be at a reasonable interest rate, and it must be backed by sufficient collateral (at least one half of the participant's vested plan benefit) and it must not exceed the maximum dollar limit for loans. Loans must be made on the same terms and on the same basis to all participants (e.g., not just for executives or officers). In addition, to avoid adverse tax consequences, such loans must comply with the stringent provisions of the Code Section 72(p) and the regulations thereunder.

For fiduciaries of large plans, perhaps one of the more complicated prohibited transaction issues is the relationship of service providers (independent versus affiliated) to the plans and the payment of fees.

In 1997, the DOL issued guidance in the form of two Advisory Letters (DOL Adv. Op Ltrs 97-15A and 97-16A) in which it stated essentially that if a fiduciary receiving a fee had any investment discretion with respect to selection of the mutual fund paying the fee, it could not retain the fee and must credit any fee received from the fund back to the plan. This principle would equally apply to the selection of an investment manager by a fiduciary.

In 2001, the DOL issued another Advisory Opinion, (DOL Adv. Op Ltr. 2001-09A), in

which it somewhat liberalized the position it took in 1997. In its 2001 opinion the DOL indicated that the fiduciary could retain the fees it received from the funds it offered as part of a discretionary asset allocation arrangement, provided that the asset allocation models used were designed by an independent investment fiduciary. Key to the opinion was the fact that the fiduciary did not have discretionary authority over investment decisions or programs made by the independent investment fiduciary, so that it was deemed not to be engaging in a prohibited transaction.

In Advisory Opinion Letter 2003-09A, the DOL extended the position it took in Advisory Opinion Letter 97-15A. In this case, a directed trustee offered a bundled mutual fund arrangement for plans which included both affiliated and nonaffiliated mutual funds, where a plan fiduciary customer was required to select at least one affiliated fund and where the trustee was paid fees from that fund as well as from the nonaffiliated fund. The DOL took the position in this Opinion Letter that the requirement to include an affiliated fund did not cause the trustee to have discretionary authority with respect to selecting that fund because the Plan Sponsor had the option of rejecting the bundled product altogether. It also took the position that, as long as the appropriate notice and disclosure requirements were satisfied, there was no reason to treat fees paid from affiliated funds differently from the fees paid from nonaffiliated funds; i.e., the DOL determined that the fees received by the trustee from the affiliated fund did not constitute a prohibited transaction.

Of all the ERISA standards mentioned in this text, the prohibited transaction area in particular may require additional legal and accounting expertise. A fiduciary should always be able to answer in the negative when asking: “As

the plan fiduciary, do I stand to benefit or gain personally, either directly or indirectly, by the handling of the plan assets?”

Transaction Costs, Fees and Other Services

The fiduciary is responsible not only for developing an investment policy and selecting “prudent experts” to implement that policy, but he/she is also responsible for ensuring that investment transactions receive best execution, and that commission dollars pay for services that benefit the plan and participants. ERISA deals with this issue and states:

“... a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries] [for the exclusive purpose of:] (ii) defraying reasonable expenses of administering the plan.”

(ERISA Sec. 404[a][1]. 20 U.S.C.A. 1104[a][1].)

In ERISA Technical Release 86-1, the Pension and Welfare Benefits Administrator addressed the issue of brokerage commissions and their use to provide other services:

“Where an investment manager directs brokerage transactions through designated broker-dealers to provide goods and services on behalf of the plan and for which the plan would otherwise be obligated to pay, such use of brokerage commissions ordinarily would not violate the fiduciary provisions of ERISA provided that the amount paid for the brokerage and other goods and services is reasonable and the investment manager has fulfilled its duty to obtain the best execution for the plan’s securities transactions.”

When commissions are used to pay for investment advisory services, the appropriate term is “soft dollars.” It is an accepted industry practice that these consulting fees be paid with “soft dollar” or “commission recapture” arrangements. This is not, however, to be confused with “soft dollar” arrangements whereby a money manager accumulates credits for the placement of brokerage business with a brokerage firm that can be used for publications, quote services, to make up for trading errors or be used for other questionable services. This area has come under increasing SEC and DOL scrutiny and has become the subject of enforcement action because of its abuse. Fortunately, the competitive nature of the brokerage business has allowed for these advisory services to be part of the bundle of services received through a brokerage commission arrangement or a wrap fee arrangement (fee in lieu of commission), provided the arrangements are within the confines of permissible SEC, DOL and NASD guidelines. SEC regulations require that appropriate disclosure information be provided to clients under these arrangements. This is satisfied by delivering a “Schedule H Brochure” disclosure document to the client.

The requirement that transactions be done at best execution does not necessarily mean lowest commission cost. A fiduciary must take into account whether the brokerage firm offering the deepest discount has the capacity to offer the best market prices for the plan’s securities, and whether the firm offers eligible ancillary services such as security research/analysis and investment advice.

The fiduciary is responsible for evaluating the fees and expenses of all elements of the plan including not only transaction costs, but administrative expenses and the fees associated

with the investment options themselves. While these non-transaction expenses may or may not make up a majority of a plan’s costs, their amounts and the manner in which they are disclosed are receiving increased attention.

Fees can be charged in a number of ways – asset-based, transaction-based, per person or flat rate – and can vary with the services employed by a plan. Further, different fee structures can be used by competing firms for the same services – and some may involve more than one fee, such as a mutual fund on which the plan pays a transaction charge and also internal expenses charged against the assets of the fund.

Cost is not expected to be the only criterion in evaluating competing services. The quality and type of services provided – anticipated performance, specialized services and other factors specific to a plan’s needs – all play a significant role. The service provider offering the lowest cost services is not necessarily the best choice; however, a fiduciary will be expected to have considered these variables and to have appropriate documentation.

Regulators can be expected to make specific inquiries into plan selections, fees and expenses:

- Has the range of services, and associated fees and expenses, of competing providers been given sufficient consideration?
- Are plan participants being furnished with sufficient information regarding the fees and expenses associated with the options offered under their plan?
- Is the disclosure of plan fees and expenses made in language understandable to participants?

Conclusion

Both the DOL and the IRS have increased their auditing and enforcement efforts of employee benefit plans. With concerns over appropriate employee build-up of retirement assets and the push towards federal fiscal responsibility, employee benefit plans have become logical targets. The government is very interested that plans be administered correctly given the dollars involved, the impact on financial markets, and the ability plans have to lessen the dependence of retirees on the Social Security system. A plan that is disqualified for compliance reasons would cause its assets to be taxed as if disbursed.

When one considers the size of the assets held for retirement and the complexities of properly maintaining an employee benefit plan, plan fiduciaries will increasingly find themselves a target for litigation. When a fiduciary is called into court, the fiduciary's accountant, attorney, plan administrator and Financial Advisor are likely to be included in the litigation. Plan participants are becoming more sophisticated about "appropriate investment results." This expectation of competitive returns carries a heavy responsibility (and liability) on the part of the fiduciary. It is prudent, therefore, that the fiduciary reduce exposure to liability while increasing the likelihood of meeting or exceeding the plan's objectives by securing a professional, competent investment team and following the prudent procedures mandated by the marketplace. The risks are too great to not follow a prudent course of action.

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