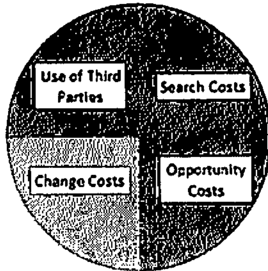
We have discussed some of the costs of investment monitoring, and Figure 1 provides a simplified illustration of some high-level categories of these costs.

Figure 1: Investment Monitoring Costs



In reality, costs are seldom compartmentalized and likely to be additive in nature. For example, an investment committee may decide to replace a fund at the urging of its outside consultant. On top of the fees already paid to that advising third party, the plan will incur search costs as well as transition costs to effect the change after an appropriate choice has been made. When calculating damages, an economist will need to account for when each expense was incurred or should have been incurred.

Economic Damages

Economic damages are "the difference between the value the plaintiff would have received if the harmful event had not occurred and the value the plaintiff has or will receive, given the harmful event."[6] As one of us has written elsewhere, this definition accords with the remedy of plan losses in ERISA litigation.[7]

The computation of economic damages from allegedly imprudent monitoring is complicated by the range of possible actions that a fiduciary might have taken "but for" the alleged failure to monitor. The monitoring process generally involves multiple steps. Some or all of these steps can vary with situational specifics including any changes in circumstances. For instance, the actions that an investment committee might take include:

- subjecting an investment to additional scrutiny,
- talking to the investment manager about the committee's dissatisfaction in hopes that this manager can come up with a plan to improve,
- retaining an advisor, consultant, or delegated fiduciary to examine whether a change is needed;
- researching and identifying potential replacements,
- removing the investment and having to possibly pay wind-up costs,
- selecting a replacement, and
- executing the necessary legal, financial, and operational action steps to replace or retain the investment.

In addition to the wide array of "but for" actions, there may be substantial variation to when prudent fiduciaries would act let alone how long it would take an investment committee to complete each action. Together, these complexities make it more difficult to determine the time period over which to calculate damages from allegedly imprudent monitoring. In some situations, there may not be a single date at which appropriate monitoring would have led to a change in investments, and it may be necessary to compute damages for multiple scenarios.

Wrap Up

The Supreme Court's recent decision in *Tibble* makes clear that fiduciaries have an ongoing duty to monitor investments. While this concept is straightforward, what constitutes appropriate monitoring is influenced by factors specific to the plan and investments (or services) at issue. The multi-dimensional nature of actions that might have been taken "but-for" an alleged failure to monitor complicates the assessment of economic damages. Variation in the timing as to when prudent fiduciaries would have made "but-for" decisions and how long each step would take to complete adds further intricacies. Clearly, these are important issues that lawyers and experts will have to address if, as expected, further challenges to fiduciary monitoring of investments emerge, post *Tibble*.

[6] Mark A. Allen, Robert E. Hall, and Victoria A. Lazear, *Reference Guide on Estimation of Economic Damages*, in REFERENCE MANUAL ON SCIENTIFIC EVIDENCE (3d ed. 2011), at 430.

[7] D. Lee Heavner, "Expert Analysis of Plan Losses in ERISA Class Action Litigation" (39 BPR 876, 5/1/12).

- fees,
- regulatory oversight of the investment, and
- compensation paid to asset managers.

Consider, for example, the differences between the monitoring of a private equity investment held by a defined benefit plan and the monitoring of a domestic large cap value mutual fund included as part of a 401(k) plan's investment menu. The defined benefit plan's fiduciaries may need to monitor how the private equity firm values relatively illiquid holdings, changes in the drawdown schedule, and the manager's evolving track record in exiting positions by selling or taking companies public.

In contrast, these factors would not apply to the large cap value mutual fund. Instead, it may be appropriate for the 401(k) investment committee to monitor the mutual fund manager's adherence to the fund's stated strategy,[3] use of derivatives and how the fund's portfolio differs from its benchmark index.

Changed Circumstances and Investment Monitoring

The Supreme Court's decision in *Tibble* stated that the appropriate monitoring is circumstance-specific and can be affected by changes in relevant circumstances:[4]

> *The Ninth Circuit did not recognize that under trust law a fiduciary is required to conduct a regular review of its investment with the nature and timing of the review contingent on the circumstances. Of course, after the Ninth Circuit considers trust-law principles, it is possible that it will conclude that respondents did indeed conduct the sort of review that a prudent fiduciary would have conducted absent a significant change in circumstances.*

Economists evaluate the implications of "changed circumstances" in a variety of contexts. Time is almost always included as a key dimension of rational decision-making and related analyses. In the world of dispute resolutions, every complaint, expert report, and decision by a trier of fact is specific to a date or period of time. Time is no less a crucial variable with regard to the creation and implementation of an adequate investment monitoring program. A plan sponsor involved in a merger or divestiture may choose to defer changing service providers until after the legal deal dust has settled rather than incur the risk of implementation errors that could disrupt the payment of benefits during the interim. Restrictions such as the lock-up periods that some hedge fund and private equity fund managers require may be another consideration in determining the frequency of investment monitoring and whether circumstances have changed sufficiently to warrant a ramped-up assessment.

What constitutes "changed circumstances" can vary with plan design, existing investment mix, participant composition, market volatility, and much more. Manager-specific news is a possible trigger. The departure of a key executive, a large loss, or a government investigation for malfeasance are a few of the events that may lead plan fiduciaries to subject an investment to enhanced scrutiny.

Costs of Investment Monitoring

As Milton Friedman coined "There is no free lunch" and so it is with investment monitoring. Every decision taken by an investment committee involves costs. These costs may be front-loaded or back-loaded, direct or indirect. Moreover, some costs are not immediately obvious nor incurred at one time. For example, when monitoring leads to a change in vendor or investment that in turn results in participant confusion, blackout dates, account errors, or a lengthy delay in setting up a new reporting system, the true costs may not be known until well after the transition is completed. Besides product-specific costs, there are search costs associated with creating some type of interview and review protocol. Third parties such as advisors, consultants, auditors, attorneys and independent fiduciaries charge a fee. Similarly, funds of funds and other types of intermediaries expect to be compensated for the monitoring assistance that they provide.

Doing nothing may impose costs in the form of lost opportunities. Courtroom dockets are replete with complaints alleging that "but-for" fiduciaries' failure to take an action, the plan would have been better off. The allegations include, but are not limited to, the failure to do the following:

- change the asset allocation mix,
- sell an investment,
- terminate an asset manager, and
- hedge against certain risks.

Although many plan fiduciaries already engage in an ongoing monitoring of investments,[5] the *Tibble* decision will likely lead some plan fiduciaries to reassess their investment monitoring activities and conclude that the benefits of enhanced monitoring activities outweigh the cost to the plan. In other situations, plan fiduciaries may reasonably conclude that the costs of incremental monitoring outweigh the expected benefits of the heightened reviews.

Post *Tibble*, sponsors may seek to go on the offensive with respect to making sure that participants understand that investment monitoring is occurring on their behalf and then elaborate about the form of monitoring. Here too, there are costs to the plan and plan participants of more frequent and detailed communication, and plan fiduciaries will need to assess whether it makes sense to provide the additional communication.

[3] In "Ad Exams Will Also Review Style Drift" (May 8, 2000), *Money Market Executive* reporter Mike Garrity explained that the U.S. Securities and Exchange Commission includes style drift assessment as part of regulatory exams. See http://www.mmexecutive.com/issues/20000507/61662-1.html.

[4] http://www2.bloomberglaw.com/public/desktop/document/Tibble_v_Edison_Intl_No_13550_US_May_18_2015_Court_Opinion.

[5] According to a 2013-2014 Deloitte survey, sixty-five percent of respondents reported that they benchmark and evaluate investments on a quarterly basis, and thirty percent reported doing so on either a semi-annual or annual basis. These results may be influenced by the prevalence of large plans in the survey. More than half of the 2013 respondents were from companies with more than 1,000 employees whereas only ten percent were from companies with one hundred or fewer employees. (Deloitte, *Annual Defined Contribution Benchmarking Survey*, Exhibits 1.13 and 5.13).

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BNA Insights

Economic Analysis in Fiduciary Monitoring Disputes Following the Supreme Court's 'Tibble' Ruling

By D. Lee Heavner, Ph.D. and Susan Mangiero, Ph.D.

The topic of fiduciary monitoring is receiving a lot of attention in the aftermath of the U.S. Supreme Court decision in *Tibble v. Edison* ("*Tibble*"). In this decision, the Court ruled that plan fiduciaries have a "continuing duty of some kind to monitor investments and remove imprudent ones."[1] However, the Court chose not to rule on whether the fiduciaries breached this duty, and it will take time before the lower court opines on the investment fiduciary monitoring at issue in *Tibble*. Nevertheless, this decision has important implications for other disputes.[2]

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Our objectives in writing this article are twofold. First, we explain that an economic assessment as to whether plan fiduciaries have engaged in appropriate monitoring must be performed through a case-specific lens. We discuss some of the limitations of trying to use a "one size fits all" approach to ascertain whether an investment fiduciary performed appropriate monitoring. Second, we discuss some of the complexities involved in calculating economic damages from allegedly imprudent monitoring.

The Evaluation of Fiduciary Monitoring Is Case Specific

The monitoring of investments is a broad and complex topic. There is no uniform process that is appropriate in every situation. To the contrary, the list of potentially relevant risk factors is long and subject to revision as circumstances change. One way to think about the exercise of investment monitoring is to imagine looking into a microscope.

At a high level, the appropriate monitoring process may be influenced by plan sponsor creditworthiness, plan design, and global market conditions as well as the demographics, wealth, income, and financial literacy of plan participants. Who bears the risk and the ability to sustain a loss can influence decisions such as the portfolio risk targets and investment complexity. Pretend now that the microscope is adjusted for a more detailed view of each investment. At this micro-level perspective, depending on the specifics of the investment and plan, fiduciary monitoring may involve scrutiny of some or all of the following:

- portfolio manager experience,
- whether the investment is traded on an exchange,
- use of derivatives,
- stability of the investment manager's organization,

[1] http://www2.bloomberglaw.com/public/desktop/document/Tibble_v_Edison_Intl_No_13550_US_May_18_2015_Court_Opinion.

[2] Dr. Susan Mangiero addressed some of the core risk management implications of *Tibble* and investing more generally in "An Economist's Perspective of Fiduciary Monitoring of Investments" (42 BPR 991, 6/2/15).