ESOP Fiduciaries and the Asset Management Role of an Institutional Trustee

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ESOP fiduciaries serving in a specific trustee role typically have numerous responsibilities with regard to the successful operation of an ESOP and the related trust. In addition to the administrative and legal aspects of the ESOP that should be managed, institutional trustees are also responsible for managing trust assets. The effectiveness of such management generally is measured pursuant to the legal standard of prudence, or exercising the level of "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."[1]

Introduction

Recently published statistics indicate that more than 6,700 employee stock ownership plans ("ESOPs"), covering over 14 million participants, currently operate in the country.[2]

Roughly 5,500, or 82 percent, of the identified ESOPs represent stand-alone ESOPs, with the remaining 1,200 being represented by KSOPs, or ESOPs with a 401(k) plan feature.

While the number of ESOPs has declined from approximately 8,900 in 2002 to approximately 6,700 currently, or at an annual rate approximating 2.3 percent, the number of ESOP participants has increased from 10.2 million to 14.1 million over the same period, or at an annual rate approximating 2.7 percent.[3]

Further, data indicate that approximately 229 new ESOPs were created annually between 2010 and 2014.

The estimated total value of the ESOP assets exceeds $1.3 trillion, with employer securities representing approximately $270 million, or slightly less than 21 percent of total ESOP assets. Based on these statistics, ESOP trustees—whether internal or institutional—are responsible for the management of over $1 trillion of plan assets on behalf of ESOP participants that are independent of the employer securities owned. As a result, ESOP trustees make recurring, responsible decisions with regard to the management of ESOP assets—in order to protect and advance the economic interests of over 14 million individuals.

The following discussion identifies several of the responsibilities of parties who serve as ESOP trustees, with particular emphasis on an institutional trustee's responsibility to manage trust assets in a manner that produces reasonable returns for the ESOP participants.

ESOP Fiduciary versus ESOP Trustee versus ESOP Administrator

The successful management and operation of an ESOP and related trust typically requires the skills and expertise of numerous individuals and professionals, including executive management, attorneys, financial advisers, ESOP administrators, and institutional trustees.

This fact is due to the general complexity of ESOPs, and is particularly the case with regard to larger ESOPs that operate in a circumstance in which there are a number of shareholders in the sponsor company (i.e., the entity in which the ESOP trust owns equity) in addition to the ESOP trust, and other structural specifics with regard to the ESOP trust and sponsoring company.

It is beyond the scope of this discussion to identify and explore the various structural and operating circumstances under which an ESOP can operate. Examples of complicating, structural specifics that add to the complexity of an ESOP circumstance include the following:

1. A capital structure that includes multiple equity owners and potential owners (e.g., outstanding options and warrants, and convertible debt) in addition to the ESOP owner
2. A pass-through tax structure (e.g., S corporation status) for the sponsor company
3. A trustee, or a trustee group or committee, comprised of members of management at the sponsor company

Based on the fact that numerous individuals may be involved in the ultimate formation and operation of an ESOP, it is important to understand some of the broad terms that are used to describe these individuals and their specific roles. Three ESOP terms relevant to this discussion—and to the roles that individuals perform with regard to an ESOP—are (1) fiduciary, (2) trustee, and (3) administrator.

ESOP Fiduciary

Generally, any individual or entity that makes decisions for the ESOP, or authorizes or causes someone else to make decisions for the ESOP, is a fiduciary to the ESOP. Within the ESOP arena, this definition is widely recognized regardless of the title or position an individual or entity maintains.

Specifically, the Employee Retirement Income Security Act of 1974 ("ERISA") defines a *fiduciary* as any person who, with respect to an employee benefit plan:

1. exercises any discretionary authority or control over the management of the plan,
2. exercises any authority or control over the management or disposition of the assets of the plan,
3. renders investment advice for a fee or other compensation with respect to plan funds or property, or
4. has any discretionary authority or responsibility regarding the administration of the plan.[4]

Based on this definition, it is clear that numerous parties potentially could find themselves fulfilling the role of ESOP fiduciary. Parties typically encompassed in the ESOP fiduciary category include executive management of the sponsor company, internal trustees and ESOP advisory or administrative committee members, institutional trustees, ESOP administrators, or any individual responsible for identifying and appointing other fiduciaries.

ESOP Trustee

By definition, a *trustee* of an ESOP will always be viewed under ERISA as a fiduciary. This is based on the fact that a trustee can exercise authority and control over plan assets.

As required by ERISA, every ESOP should have one or more trustees. The trustees of an ESOP are named in the plan document or are appointed by another named fiduciary.[5]

Unless one of the following two circumstances exists, trustees should have exclusive authority and discretion over the management and control of the assets of the ESOP:

1. When the trustee operates as a directed trustee, subject to the proper directions of another named fiduciary that are made in accordance with the terms of the plan and are not contrary to the provisions of ERISA
2. When the trustee, or another fiduciary, delegates the authority to manage, acquire, or dispose of the assets of the plan to an investment manager

ESOP Administrator

As suggested by the title, an ESOP administrator is responsible for the day-to-day administration, or management, of the plan. Based on the discretionary authority typically granted to the role, a plan administrator is generally considered to be a fiduciary as defined by ERISA.

The plan typically designates both the administrator and the specific authority granted to an administrator, which may include the following responsibilities:

1. Hiring qualified professionals, such as accountants, actuaries, appraisers, and attorneys
2. Determining the rights of plan participants

3. Preparing and issuing required reports to governmental agencies and plan participants
4. Maintaining plan records

Institutional Trustee Management

Published sources indicate that slightly more than 8 of 10 closely held ESOP companies operate with inside fiduciaries as trustees. These fiduciaries typically are officers of the sponsor company.

However, most publicly traded companies, and roughly 2 of 10 closely held ESOP companies, operate with outside fiduciaries, most of which are independent. The use of an independent trustee to fulfill certain fiduciary roles and responsibilities typically adds to the overall administrative cost of operating an ESOP.

Such practice, however, serves to help avoid conflicts inherent in executive management of the sponsor company fulfilling fiduciary responsibilities, thereby providing a higher level of assurance that the ESOP is being managed in the best interests of plan participants.

The remaining focus of this discussion addresses the fiduciary duties fulfilled by institutional trustees with regard to the management of ESOP trust assets. As previously discussed, the effectiveness of such management typically is evaluated based on the "prudent man" standard.

With regard to the management of ESOP trust assets, such a standard requires that the trustee exercises the level of care and judgment that a similarly qualified, prudent expert, rather than a prudent layperson, would exercise when making financial investment decisions for a similar entity in similar circumstances.

In many instances, institutional trustees providing their services to an ESOP in a corporate capacity through a trust company or division of a bank often are staffed with a wide range of business and legal professionals. These professionals typically include financial advisers.

In such instances, institutional trustees can rely on internal experts, or the advice of independent financial advisers to fulfill the responsibility of managing ESOP trust assets. However, even if the investment advice required to manage ESOP trust assets is delegated by an institutional trustee to an independent investment adviser, the ultimate fiduciary responsibility with regard to the effective management of the ESOP trust assets rests with the institutional trustee.

One of the most significant asset management decisions a trustee will play a role in is the decision of the ESOP trust to either purchase or sell sponsor company shares. Once again, while an institutional trustee may employ professionals fully capable of providing the requisite financial advisory services, such trustees typically rely on the advice and counsel of independent financial advisers to make stock purchase and sale decisions.

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And while an institutional trustee may rely on the advice and counsel of independent financial advisers to assist in rendering such decisions, the trustee is still expected to verify the following:

1. Qualifications of the independent adviser
2. Reasonableness of the independent adviser's analytical process and key assumptions
3. That the independent adviser relied on sufficient and appropriate information and data
4. Reasonableness of the independent adviser's conclusions based on the facts and circumstances existing at the time the conclusions were rendered

In addition to purchase and sale decisions regarding sponsor company shares, institutional trustees typically manage ESOP trust assets in a manner that addresses both reasonable return considerations and liquidity considerations. In essence, while managing ESOP trust assets to generate a reasonable annual return to participants, trustees should also maintain the liquidity necessary for the trust to address any diversification needs.

To be clear, the original intent of ESOP legislation was to provide a tax-advantaged mechanism to motivate investments *primarily* in stock of sponsoring companies. Through an ESOP, shareholders are afforded the opportunity to sell shares to an ESOP, thereby transferring ownership to employees. In effect, the motivating factors of ownership, including involvement in decision making and wealth creation, are transferred to employees.

The above factors are widely credited with creating an environment that often results in better performance for ESOP companies relative to non-ESOP companies.

Further, the tax-advantaged nature of ESOPs, including the tax deductibility of ESOP contributions and the ability of the ESOP to borrow to acquire the stock of sponsoring companies, generally provides potential for higher cash flow generation. This increased cash flow can be directed toward acquisitions and capital investments that spur growth.

While ESOPs are designed to invest primarily in the qualifying stock of sponsor companies, the assets of an ESOP trust can be represented by substantial investments in other assets, including cash and securities.

In order to reduce the risk to ESOP participants, particularly in circumstances in which the sponsor company stock reflects a declining value trend, trustees often consider diversifying plan investments by selling sponsor company stock and purchasing other assets. While not prescribed, alternative investments can include mortgages, bonds, and the stock of other corporations.

In order to achieve reasonable returns for plan participants, trustees typically adhere to a defined, rational investment process—consistent with professional standards—that generally includes the following:

1. A statement of investment objectives and policies
2. An investment strategy that includes relevant guidelines regarding allowable investments, investment horizons, acceptable risk levels, targeted asset allocations, and liquidity needs
3. Investment performance measurement—including appropriate benchmarking—and regular reporting periods

Of course, significant detail can, and typically is, reflected in a formal statement of investment objectives and policies. Such detail is beyond the scope of this discussion, which now focuses on trustee management of the ESOP trust assets based on the prudent man standard and consideration of the general process delineated above.

Trustee Management of the ESOP Trust Assets

Published statistics indicate that the DJIA, the S&P 500, and the Nasdaq increased approximately 25 percent, 19 percent, and 28 percent, respectively, in 2017. While each of these equity-based indexes reflects significant growth in the most recent year, it would be unreasonable for a trustee to assume that such high returns could be achievable over a long-term investment horizon.

However, ESOP participants aware of the performance levels achieved by the major indexes in 2017 may measure the performance of the trust, generally, against the performance of the major indexes. Such a comparison, though clearly unreasonable from a long-term performance perspective, demonstrates the need for a defined, rational investment process that clearly explains investment objectives and strategies that will be employed to achieve reasonable, long-term returns.

Statement of Investment Objectives and Policies

By their nature—that is, assets represented primarily by investments in sponsor company securities—ESOP trust assets generally are recognized to represent investments with inherently higher risk than a pool of diversified investments serving as the foundation for a pension fund.

As a result, a general statement of investment objectives and policies provides clarity regarding:

1. the desired or targeted performance level for trust assets and
2. the guidelines and practices that will be followed to achieve the targeted performance level.

Based on the prudent man principle, it likely would not be considered unreasonable for a trustee to establish return objectives for ESOP participants consistent with the historical rates of return represented by the combined dividend and stock appreciation returns realized by investors in the sponsor company stock. This, of course, can be readily determined if the sponsor company stock is publicly traded, but is more challenging if the sponsor company is privately owned.

Other foundations for establishing reasonable return objectives can include published rates of return for:

1. the relevant, broad industry category in which the sponsor company operates or
2. selected guideline publicly traded companies operating within the relevant sponsor company industry.

Investment policies serve as the investment guidelines that will be followed to ensure that established investment objectives are pursued strategically and consistently, and monitored appropriately. Common investment policies address the following:

1. Investment strategy
2. Investment performance measurement and reporting

Investment Strategy

An investment strategy is a defined process through which investment objectives are pursued. While an ESOP trust may be comprised primarily of sponsor company securities, the trust may also include substantial investments in other assets, including cash and nonsponsor company investments.

As previously discussed, an investment strategy typically addresses the following:

1. Guidelines regarding allowable investments—potential investments are defined by categories, often with restrictions on certain investment types (e.g., adult entertainment, tobacco and alcohol products, guns and munitions).
2. Investment horizons—targeted holding periods may be identified for certain investment types.
3. Acceptable risk levels—investment concentrations and/or certain investment exposures may be limited (e.g., hedge funds, derivatives, development-stage companies, or emerging markets).
4. Targeted asset allocations—asset allocations are intended to balance risk among different asset investment categories, producing a targeted, "weighted" investment risk level commensurate with the targeted overall investment return level.
5. Liquidity needs—cash or near-cash investment levels must be maintained to meet trust liquidity needs in a timely fashion, thereby avoiding untimely investment liquidations.

Investment Performance Measurement

Investment performance measurement requires periodic review of the investment portfolio and related reporting. Such reviews include evaluating the actual performance of the portfolio—often on a quarterly basis—in relation to established performance objectives.

Further, it is not unusual to establish both long-term and interim measurement periods (e.g., analyzing performance based on three-year or five-year measurement periods with interim evaluations based on quarterly or year-to-date measurements).

Investment performance measurement also typically includes evaluating asset performance categories, based on asset allocations employed, in relation to relevant capital market benchmarks. For example, the portion of the total portfolio allocated to domestic equities can be evaluated based on comparison with certain domestic equity indexes (e.g., the BlackRock Russell 1000 or Fidelity Investments funds).

Similarly, the portion of the total portfolio allocated to domestic fixed income investments can be evaluated based on comparison with certain domestic fixed income indexes (e.g., Fidelity Fixed Income & Bond Funds or Vanguard Bond Funds).

Figure 1 provides data regarding historical returns on U.S. Treasury bills, U.S. Treasury bonds, and stocks (as measured by the S&P 500 Index) for 2003 through 2017. The return on U.S. Treasury bills, U.S. Treasury bonds, and stocks averaged 1.25 percent, 4.19 percent and 11.18 percent, respectively, between 2003 and 2017.

However, between 2013 and 2017, the average returns averaged 0.45 percent, 1.28 percent, and 16.09 percent for U.S. Treasury bills, U.S. Treasury bonds, and stocks, respectively.

As indicated, average U.S. Treasury bill and U.S. Treasury bond returns declined in the most recent 5-year period through 2017 relative to average U.S. Treasury bill and U.S. Treasury bond returns based on the most recent 15-year period through 2017.

However, average stock returns have increased over the same comparative periods. Both U.S. Treasury bond returns and stock returns experienced significant volatility over the 15-year period presented.

Exhibit 1 provides additional data regarding historical stock and bond returns and inflation statistics covering the 1926 through 2016 period, as published by Duff & Phelps in the *2017 Valuation Handbook*.

Consistent with the data previously discussed, equity returns have increased considerably and bond returns have remained relatively flat in the most recent years (i.e., 2010 through 2016) in comparison to return periods from 2000 forward, which include the impact of the Great Recession in 2008.

Further, the inflation rate in the most recent years is down relative to all other periods presented.

Figure 2 presents the data summarized in Exhibit 1 graphically, once again demonstrating the significant volatility in stock returns relative to inflation and bond returns.

The data presented in Exhibit 1 and the graphs presented in Figure 1 and Figure 2 present inflation, bond return, and stock return information that may be considered by trustees for the purposes of:

1. establishing target returns for ESOP trust assets and
2. evaluating actual returns realized on ESOP trust assets.

Figure 1
Annual Returns on Treasury Bills, Treasury Bonds, and Common Stocks
2003 through 2017

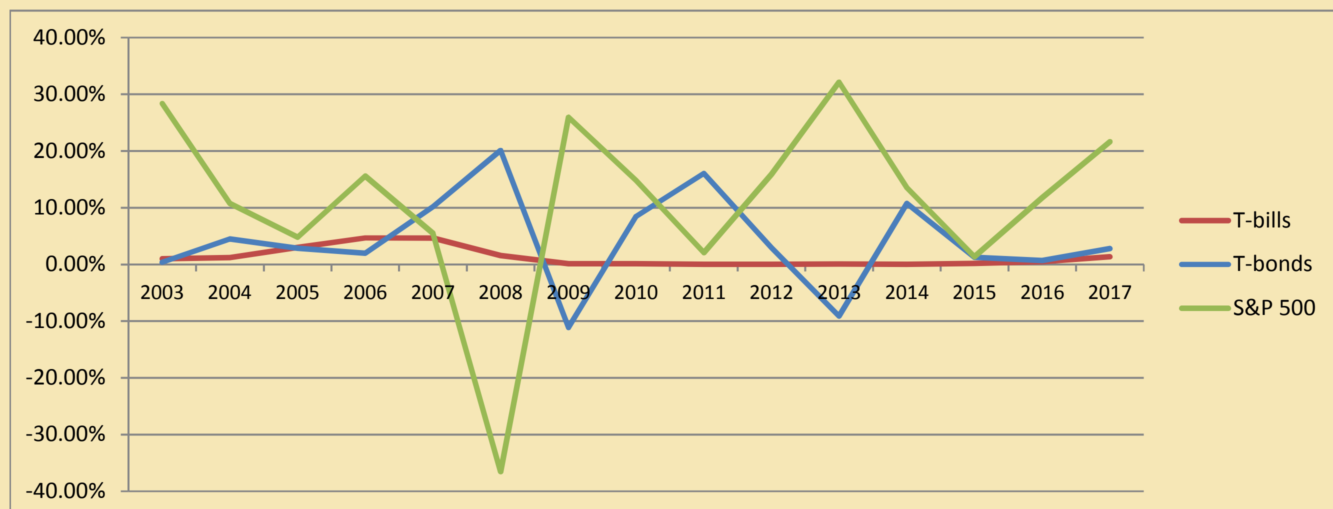


Exhibit 1
SBBI Series: Large-Cap Stocks, Small-Cap Stocks, LT Corporate Bonds, LT Government Bonds, Inflation
Average Annual Compound Rates of Return: 1926 through 2016

	1926 - 2016	2007 - 2016	2000s	2010s
Inflation (U.S. Consumer Price Index)	2.90%	1.80%	2.50%	1.60%
LT Gov't Bonds (20-year maturity yield)	5.50%	6.50%	7.70%	6.90%
LT Corp Bonds (20-year maturity yield)	6.00%	6.90%	7.60%	7.80%
Large-Cap Stocks (S&P 500 Total Return Index)	10.00%	6.90%	-0.90%	12.80%
Small-Cap Stocks	12.10%	7.60%	6.30%	15.30%

Source: *2017 Valuation Handbook: U.S. Guide to Cost of Capital* (New York: Johy Wiley & Sons, 2017).

However, it is important to note that the data presented represent broad index measures that likely require deeper analysis and possible adjustment to render them reliable comparatives for the purpose of evaluating the performance of ESOP trust assets.

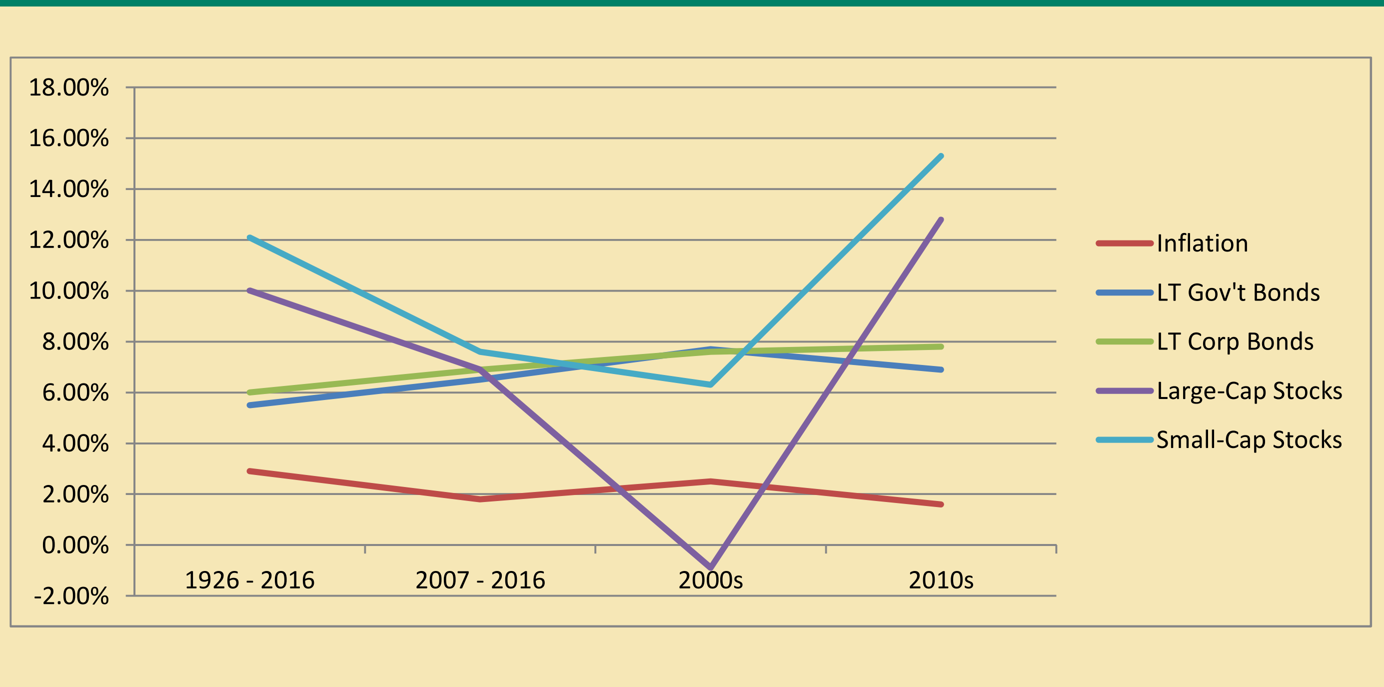
Further, the composition of the ESOP trust asset base should be considered in order to develop a reasonable, weighted expected return. That expected return should be based on the investment allocation structure of the trust.

The weighted expected return can then be analyzed based on the application of trust investment allocation weights to comparable, market-based investment returns.

Summary and Conclusion

ESOP fiduciaries serving as trustees and responsible for the management of trust asserts are held to the prudent man standard. This standard requires a

Figure 2
SBBI Series: Large-Cap Stocks, Small-Cap Stocks, LT Corporate Bonds, LT Government Bonds, Inflation
Average Annual Compound Rates of Return: 1926 through 2016



trustee to act as a prudent expert would act under similar circumstances.

The objective, of course, is for the trustee to manage trust assets in a manner that safeguards trust assets and provides reasonable returns to ESOP participants.

Because ESOPs are not intended to guarantee retirement benefits, and investments primarily in sponsor company securities necessarily expose ESOP participants to greater risk than more diversified investments, trustees typically rely on defined processes to fulfill their fiduciary responsibilities.

Such processes typically include developing the following:

1. A statement of investment objectives and policies
2. An investment strategy that includes relevant guidelines regarding allowable investments, investment horizons, acceptable risk levels, targeted asset allocations, and liquidity needs
3. Investment performance measurement—including appropriate benchmarking—and regular reporting periods

Generally, judicial precedent indicate that the reasonableness of investment decisions made by fiduciaries based on the circumstances, rather than the ultimate results of investment decisions, is of primary concern.

Notes:

1. ERISA Section 404(a)(1)(B).
2. National Center for Employee Ownership "ESOPs by the Numbers," updated March 2017, https://www.nceo.org/articles/esops-by-the-numbers. The statistics are based on data maintained by the U.S. Department of Labor, effective as of 2014.
3. Ibid.
4. ERISA, Public Law 93-406.
5. ERISA Section 403(a)
6. U.S. Treasury bills are based on the 3-month Treasury bill rate; U.S. Treasury bonds are based on the 10-year Treasury bond rate; and stocks are represented by the S&P 500 Index, and include both price appreciation and dividends. Source: http://pages.stern.nye.edu/~adamodar/New_Home_Page/datafile/histretSP.html.

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