

Understanding the Role of the ***INVESTMENT FIDUCIARY***

*A guide for those responsible for a 401(k), 403(b),
or profit sharing plan's investments*

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The world of defined contribution plan investments is one where plan sponsors are seldom fully equipped to fulfill their obligations under ERISA. As a result, those who control a plan's investments often have significant concerns about their liabilities as fiduciaries.

The Employee Retirement Income Security Act of 1974 (ERISA) contains a clear set of responsibilities and duties for those who act as plan fiduciaries. It is important that these requirements are taken seriously and the responsibilities involved are understood. Fiduciaries should be aware of limits and gaps in their knowledge, and, when lacking the proper expertise, engage someone who can ensure their responsibilities are properly met.

This writing is designed to help those responsible for a defined contribution plan's investments to understand their various options in fulfilling fiduciary obligations. It does not constitute a legal opinion, nor is it a substitute for personalized advice.


Who is considered a fiduciary with respect to a plan's investments?

Whether you are a fiduciary is determined by what you do, and not necessarily who you are. According to Section 3(21) of ERISA, anyone who has discretionary control over managing a plan or its assets or over its administration is considered a fiduciary. While a plan will have all of the usual suspects on its list of fiduciaries, such as the Plan Sponsor, Named Fiduciary, and Trustee, there may be others who fall under this definition. The definition of a fiduciary would naturally include anyone who chooses and monitors a plan's investments, whether or not that person or entity is named as a fiduciary in the plan's documents. For example, if there is an informal committee choosing the plan's investments or ratifying a broker's recommendations, that committee has fiduciary responsibility, even if they are not named in the plan's document, trust agreement, or investment policy statement.

What are the basic responsibilities of a plan's investment fiduciaries?

The law subjects plan fiduciaries to a distinct set of standards. A plan fiduciary, as defined by ERISA, must always do the following:

- Act solely in the interest of plan participants and their beneficiaries, for the exclusive purpose of providing benefits for them;
- Carry out his or her duties in a prudent manner;
- Follow the plan's legal documents (unless inconsistent with ERISA);
- Diversify plan investments to minimize the risk of large losses; and
- Pay only reasonable plan expenses.



The ERISA application of fiduciary duty is much more stringent than the common law understanding. An ERISA fiduciary must act as a prudent expert in his or her applicable area of discretion over the plan—using the care, skill, prudence, and diligence that a prudent person who is familiar with such matters would use under the prevailing circumstances. If the plan’s investment fiduciary is not equipped to act as a prudent expert in the area of choosing a plan’s investments, ERISA essentially requires that an outside professional be engaged to help. Prudence also focuses on the process followed in fulfilling one’s fiduciary duties. Any process must be documented in such a way that supports a claim of fulfilling one’s fiduciary duties. For example, a plan should have an up-to-date investment policy statement that outlines the process of periodically evaluating the plan’s investment menu, and the fiduciaries should document that this process has been followed on a regular basis. Lacking the proper expertise, it is difficult to document that a prudent process has been followed.

What happens if a fiduciary does not fulfill his or her duties?


Fiduciaries who do not follow the basic standards of conduct may be personally liable to restore any losses to the plan, or to restore any profits made through improper use of the plan’s assets resulting from their actions. In addition, the U.S. Department of Labor (DOL) may impose penalty taxes. Fiduciaries could also be liable for the actions of a fellow fiduciary, if they knowingly participate in, conceal, or have knowledge of another fiduciary’s violation and do not report it, or if they enable such a violation through their own failure to satisfy their fiduciary responsibilities. Finally, plan participants may bring civil action against fiduciaries in order to obtain equitable relief for the plan.

I am an investment fiduciary, but I am not an expert. Can I outsource my liability?

As implied above, the responsibility for a plan’s investments can be delegated to an investment advisor, assuming the procedure for doing so is clearly spelled out. However, the named fiduciary remains responsible and liable for prudently selecting and monitoring those persons to whom these responsibilities are delegated. The degree to which these responsibilities and liabilities are shared with a third party depends on the fiduciary capacity of the investment professionals who are hired.

An investment advisor may act in various capacities that differ widely in terms of how much responsibility and liability are assumed, and hence in their value to the plan sponsor who is focused on these liabilities.

- **Non-fiduciary role:** In this capacity, the outside advisor does not act as a fiduciary. This can be the case even if they say they are reducing your fiduciary liability. This provider is typically not acknowledging its status as a fiduciary in any capacity, and there is very little assumption of liability on their part. This advisor will often provide a list of funds from which the plan sponsor must still choose, rather than making a direct recommendation for including a specific investment in the plan.
- **ERISA Section 3(21) fiduciary:** As noted above, ERISA Section 3(21) outlines certain criteria that demonstrate whether someone is or is not a fiduciary. Under Section 3(21), anyone who provides investment advice for a fee or other compensation is a fiduciary. Because they have been hired to help the plan’s named fiduciary make investment decisions, Section 3(21) fiduciaries are generally acknowledging their status as fiduciaries, but this is not always the case. A 3(21) fiduciary bears responsibility for the advice provided, but not the outcome, should the advice not be followed.
- **ERISA Section 3(38) fiduciary:** An ERISA Section 3(38) fiduciary takes the role of a 3(21) fiduciary to the next level. A 3(38) fiduciary is appointed as the plan’s “investment manager” by the ERISA named fiduciary, and accepts the fiduciary role in writing. A 3(38) fiduciary must be an investment advisor registered under the Investment Advisors Act of 1940, a bank, or an insurance company. Engaging a Section 3(38) fiduciary



may provide a higher level of protection as compared to some 3(21) fiduciaries. A 3(38) fiduciary is authorized to manage, acquire, and/or dispose of the plan's assets, and is legally responsible and liable for its decisions. However, the plan's ERISA named fiduciary still has the ongoing responsibility and liability to monitor the 3(38) fiduciary.

There is no way to relieve the plan's fiduciaries of all responsibility and liability, even where a Section 3(38) fiduciary has been hired to have full discretion over a Plan's assets. Of course, if those to whom the fiduciary responsibility is delegated are experts in their respective areas of practice, and if proper procedures are followed, the risk to the plan's fiduciaries can be reduced significantly.

What type of fiduciary should I hire to help us oversee our plan?

It depends. Obviously, if the plan's fiduciaries have all of the resources and knowledge at their disposal to act as prudent experts in making plan investment decisions (for example, an investment committee comprised of retirement plan experts), then they may be just fine acting on their own. But in the more typical case where some outside guidance is needed, the choice is not as clear cut. In hiring outside expertise, some things to consider in making the fiduciary decision are as follows:

- **How much control over the process does the plan's named fiduciary desire to keep?** An investment advisor who is a 3(21) fiduciary will need to get the plan fiduciary's approval prior to making a change to the plan's investments, while a 3(38) fiduciary could act without needing to run investment recommendations past the named fiduciary. Realistically, most 3(38) fiduciaries will probably at least notify the plan's fiduciary of any actions to be taken, even if they do not require the fiduciary's approval.
- **How much liability protection is really offered?** As long as they are properly chosen and monitored, a 3(38) fiduciary will likely offer the highest level of protection. How much higher the level of protection that is offered, though, is a matter of degree. Recall that the definition of a 3(21) fiduciary includes anyone who provides investment advice to the plan for a fee. This could include both advisors who actively engage your plan in a shared fiduciary role, as well as those who try to avoid fiduciary liability as much as possible. A well-chosen, reputable firm operating at the Section 3(21) fiduciary level could offer shared liability of a very high level that may be very close to that of a 3(38) fiduciary. A lower quality arrangement could leave you holding the bag if something goes wrong.
- **What does it cost?** Of course, the cheapest route in hard dollars is to not hire someone, but then the fiduciaries are asserting that they have the full capacity to act as a prudent investment expert. This approach could seem considerably more expensive, though, if the plan's investment committee finds they need to do a lot of research and self-education, or if the plan gets caught up in a lawsuit and the fiduciaries are found liable.

When hiring an outside advisor, a 3(38) arrangement is likely to cost more than hiring a 3(21) fiduciary, but this assumes that all other things are equal. Firms vary greatly in the services offered, the flexibility of their investment menus, the degree of participant education, etc. so the best advice for the fiduciary is to consider all variables, and not just the cost. One of the fiduciary's core responsibilities is to ensure that the plan only pays reasonable costs. This does not mean the cheapest; it means the cost paid vs. the value of the services received in return is reasonable. Keep in mind that firms that are operating at a higher cost and service level likely have a lot more on the line, and therefore have a vested interest in providing excellent fiduciary services.



CONCLUSION

The world of DC plan investments is nuanced and complex. Simply sorting a list of funds by a handful of criteria and picking the “best” investment options, while well-intentioned, is probably not enough to demonstrate that a fiduciary’s full obligation has been met. Even financial services organizations may find they are best served by hiring an outside advisor when they don’t have a lot of retirement plan experience in-house. Retirement plans are a very specialized area, and there are competent experts available to help in designing an investment program with a view to meeting fiduciary obligations, often at far less cost than what it would take to do all the necessary research internally.

If you are a plan fiduciary, you no doubt have some idea of whether you can act in the capacity of a prudent expert when making investment decisions for your plan, or if you have those resources at your disposal. As is often the case, if you need to hire someone from the outside, this is a decision to be made with great care, because you can never delegate away all of your liability. Fiduciary responsibility and liability are serious concerns for the average plan sponsor. However, a successfully chosen outside advisor can ease these concerns significantly.