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The Different Flavors of ERISA Fiduciaries

by W. Scott Simon | 12-03-09

My recent four-part series on Delegation for Plan Sponsors has created some confusion among a number of readers about a certain issue. That issue involves the significance of the added protection afforded a plan sponsor when it utilizes the services of an advisor serving as a fiduciary under section 3(38) of the Employee Retirement Income Security Act of 1974 as opposed to an advisor serving as an ERISA section 3(21) fiduciary.

ERISA Selection, Monitoring, and Replacing Functions

The sponsor of a qualified retirement plan such as a 401(k) plan is charged with a myriad of legal duties under ERISA. A critical duty is the sponsor's legal responsibility (and therefore legal liability) to select, monitor, and (if necessary) replace the plan's investment options. This duty is so central to any ERISA-qualified retirement plan that its breach is often pleaded in the recent cases filed against plan sponsors involving plan investment options bearing costs that are not reasonable. The word "reasonable" here is not just a word but the operative word in ERISA section 404(a)(1)(A) which follows the great "sole interest" and "exclusive purpose" rules there: "defraying reasonable expenses of administering the plan." The appropriate fiduciary of a plan must (affirmatively) find costs to be reasonable in order to justify their expenditure for the corresponding services rendered.

Many, many plan sponsors, of course, haven't the foggiest idea how much their plans actually cost them and their plan participants. The reason for this is that plan providers have no duty (fiduciary or non-fiduciary) under ERISA to tell sponsors about the total all-in costs of, say, a 401(k) plan. Given that unfortunate fact of life, plan sponsors have no way to know whether the services they pay for are reasonable under ERISA section 404(a).

It's a cruel irony: non-fiduciaries (that is, plan providers) have the power to keep fiduciaries (that is, plan sponsors) from performing the job they're required to do prudently under ERISA. This irony is cruel because it leads to the creation of retirement plans that feature investment options rife with high (and hidden) costs, and risks that are entirely unnecessary. That helps in placing plan participants behind the eight ball in terms of having enough money for a comfortable retirement. Certain politicians and academics pick up on this and, in typical knee-jerk overreaction, whine about doing away with qualified retirement plans such as 401(k) plans instead of fixing a system in which non-fiduciaries can block fiduciaries from being prudent.

The fact that the selection/monitoring/replacing functions involving a retirement plan's investment options are at the very heart of much of current ERISA litigation should alert advisors, plan sponsors, and others of the central role these functions play in a plan. This fact should also alert plan sponsors to the significance of the added protection afforded them when they retain an advisor willing to assume, in writing, such functions as a fiduciary.

An ERISA Section 3(38) Fiduciary

ERISA provides that a plan sponsor can delegate the significant responsibility (and therefore significant liability) of the selection/monitoring/replacing functions to an ERISA section 3(38)-defined "investment manager" who, upon delegation, then becomes an ERISA section 405(d)(1)-defined "independent fiduciary." An ERISA section 3(38) fiduciary can only be (a) a bank, (b) an insurance company or (c) a registered investment adviser (RIA) subject to the Investment Advisers Act of 1940. This means that a stand-alone broker-dealer, for example, cannot be an ERISA section 3(38) fiduciary. If a broker-dealer has dual registration (that is, as a broker-dealer and an RIA), however, the RIA wing of this entity has the ability to become an ERISA section 3(38) fiduciary.

An ERISA 3(38) fiduciary has ERISA legally defined "discretion" that makes it a decision-maker. This means that a 3(38) fiduciary actually makes decisions for which it is legally culpable (and for which

the plan sponsor is no longer legally culpable). An ERISA 3(38) fiduciary decides what investment options such as stand-alone mutual funds or model portfolios should be placed on a plan's menu, whether to remove them from the menu and, if it does remove them, what investment options will replace them.

A good 3(38) fiduciary will always consult with the plan sponsor that appointed it and discuss its rationale for selecting and/or replacing given plan investment options before actually doing so. But at the end of the day, it is the 3(38) fiduciary that has sole legal responsibility (and therefore sole legal liability) for making such calls; the plan sponsor no longer has any such responsibilities because the sponsor has delegated them to the 3(38) fiduciary.

The sponsor, however, always retains the power to rescind such delegation at which point the responsibility (and liability) to select, monitor and replace plan investment options will be passed back to the sponsor. (Disclosure: As part of its business model, my registered investment advisory firm, is an ERISA section 3(38) fiduciary to all the retirement plans it advises.)

An ERISA Section 3(21) Fiduciary

In sharp contrast to the legally culpable, discretionary decisions made by an ERISA section 3(38) fiduciary are the legally blameless, nondiscretionary recommendations made by an ERISA section 3 (21) fiduciary. To the extent that an advisor is even named as any kind of fiduciary in an investment management agreement between a plan sponsor and an advisor, in most cases the advisor is an ERISA 3(21) fiduciary tasked with "recommending," "assisting," "helping," or "advising" the sponsor as the sponsor itself goes about making selection/monitoring/replacement decisions.

Such contracts make clear that an advisor who is a 3(21) has no legally defined "discretion" to actually make decisions about plan investment options but only to be a helpful gnome to the plan sponsor who continues to retain the significant responsibility (and therefore the significant liability) to select, monitor and (if necessary) replace plan investment options. I wrote a four-part series on this phenomenon in mid-2006 that examined an actual investment management agreement (still governing more than $100 million in plan assets) between a plan sponsor and its broker-dealer/RIA advisor.

In that agreement, the advisor is named as the ERISA 3(21) fiduciary. This allowed the advisor to say that it is a "fiduciary," an "ERISA fiduciary" or even an "ERISA 3(21) fiduciary." A plan sponsor hearing that kind of language relies on it by assuming that it has the warm arms of a "fiduciary" advisor wrapped around it for protection. Such reliance on the part of the sponsor can, however, turn out to be detrimental when, for example, a participant sues the sponsor over imprudent investment options in a plan.

At that point, the sponsor naturally turns to the warm arms of its advisor only to find that the advisor has gone cold as it points to the agreement where it says that the only role of the advisor is to make nondiscretionary "recommendations" (as a 3(21)) but not to make discretionary "decisions" (as a 3 (38)). In many such cases, the plan sponsor and/or its legal counsel failed to read the agreement closely enough to understand such a distinction.

In many agreements, of course, the advisor is not even named as a fiduciary and its roles are simply described as "assisting," the plan sponsor in making investment option selections (for which the sponsor is legally responsible and liable).

Summing Up

In a nutshell, here is the difference between ERISA section 3(38) fiduciaries and ERISA section 3(21) fiduciaries:

* An ERISA section 3(38) fiduciary must make decisions for which it has legal responsibility (and therefore legal liability), because such a fiduciary is charged with ERISA-defined "discretion." Under ERISA, if an entity has discretion to make a decision, that entity is responsible for that decision, not the entity that appointed it. This gives a plan sponsor significant cover from fiduciary risk.

* An ERISA section 3(21) fiduciary makes only recommendations for which it has no legal responsibility (and therefore no legal liability), because such a fiduciary has no ERISA-defined "discretion." This does not give plan sponsors cover from fiduciary risk.

An Important Caveat

It's important to understand that the part of the preceding discussion referring to an ERISA section 3 (21) fiduciary concerns what can be described as a "limited scope" 3(21). That discussion was one referring to a specific context and role in which a limited scope 3(21) fiduciary simply "recommends" plan investment options. Another role for a limited scope 3(21) fiduciary in a specific context could be where it is brought in by a plan sponsor to render decisions about the prudence of retaining (or discarding) the stock of the company sponsoring a plan.

Distinct from a limited-scope 3(21) fiduciary (the kind which is almost always discussed in the investment media) is what can be described as a "full scope" ERISA section 3(21) fiduciary. The full scope 3(21) is the "named fiduciary" of a plan; that is, the person who has ultimate authority over a plan. All qualified retirement plans governed by ERISA have a named fiduciary, and that person is always a 3(21) fiduciary, representing the plan sponsor. The plan sponsor, as the originating full scope 3(21) fiduciary of the plan, can delegate all the duties associated with same to an entity that will assume them. That entity--now being the full scope 3(21) fiduciary--can then, in turn, delegate certain carefully restricted duties to a limited-scope 3(21) fiduciary (or a number of limited-scope 3 (21) fiduciaries).

Note: On Thanksgiving Eve, the U.S. Eighth Circuit Court of Appeals reversed and remanded the district court's decision in Braden v. Wal-Mart that had dismissed the plaintiff's complaint. The complaint alleged that Wal-Mart had selected retail-priced mutual funds as the Wal-Mart 401(k) plan's (purportedly the largest in the world) investment options rather than institutional-priced funds, which are much lower in cost. Most of the selected investment options bore 12b-1 fees and paid revenue-sharing to the trustee of the Wal-Mart 401(k) plan. The appeals court noted in particular that the plaintiff's allegations raised at least the possibility that Wal-Mart's process in selecting and monitoring the plan's investment options was "tainted by failure of effort, competence, or loyalty."

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W. Scott Simon is an expert on the Uniform Prudent Investor Act and the Restatement 3rd of Trusts (Prudent Investor Rule). He is the author of two books, one of which, *The Prudent Investor Act: A Guide to Understanding* is the definitive work on modern prudent fiduciary investing.

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