ARE INVESTMENT PROVIDERS FINALLY STEPPING UP TO THE PLATE AS PLAN FIDUCIARIES?

Investment providers have historically resisted characterization as retirement plan fiduciaries even when it was clear that their activities cast them in that role. To this end, investment contracts contained elaborate denials of fiduciary status. Recently, a counter trend has emerged which entails an apparent acknowledgement of fiduciary responsibility with respect to the selection of investment menus for 401(k) plans. This is certainly a welcome development. But is it a real change or merely a sophisticated attempt to limit liability? In this white paper, we will examine some of the new programs and attempt to identify their advantages and disadvantages.

GENERAL FIDUCIARY STANDARDS

The Employee Retirement Income Security Act ("ERISA") establishes comprehensive standards governing fiduciary conduct in the management of retirement plan assets. Thus, a fiduciary, such as a plan sponsor, must discharge its duties solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits to plan participants and beneficiaries and defraying the reasonable expenses of administering the plan.[1] In essence, a fiduciary must be completely loyal to the plan and its participants.

In addition, ERISA requires plan fiduciaries to act with the care, skill, prudence and diligence that a prudent person 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.[2] In a plan that permits participants to direct investments, plan sponsors are responsible not only for the prudent selection and monitoring of the plan's investment offerings but also for the prudent utilization of those investments by participants. The standard of care is very high and requires a level of expertise beyond that of a prudent lay person.

Fiduciary responsibility goes beyond matters of loyalty and prudence. For example, the investment of plan assets must be diversified so as to minimize the risk of large losses.[3] Fiduciaries must also avoid conflicts of interest and acts of self-dealing that are known as prohibited transactions.[4] Finally, a plan fiduciary must discharge its duties in accordance with the plan and trust documents insofar as they are consistent with the law.[5]

A fiduciary that violates any of the duties discussed above is liable to the plan for any losses resulting from such a breach and for the restoration of profits made by the fiduciary

[1] ERISA Sections 403(c) and 404(a)(1)(A).
[2] ERISA Section 404(a)(1)(B).
[3] ERISA Section 404(a)(1)(C).
[4] ERISA Section 406.
[5] ERISA Section 404(a)(1)(D).

through the use of plan assets.[6] Such violations can also bring hefty statutory penalties imposed on fiduciaries.[7]

HOW FIDUCIARIES ARE IDENTIFIED

Given the responsibilities and liability exposure described above, the question naturally arises as to what makes a person a fiduciary. As described below, ERISA fiduciaries are either named in the plan document or are identified by the function they perform for the plan.

Named Fiduciary. The term, "named fiduciary" refers to a person who has the ultimate control or management power over plan assets. The named fiduciary is something like a fiduciary-in-chief and has the authority to appoint and give instructions to the plan trustee.[8] The named fiduciary is either specified in the plan document or identified pursuant to a procedure specified in the plan document.[9] Thus, there is generally no question as to the named fiduciary's identity. Frequently, the named fiduciary will be the employer or an officer of the employer.

Investment Advice Fiduciary (ERISA § 3(21)). ERISA's definition of a fiduciary includes any person who exercises any authority or control respecting the management or disposition of plan assets.[10] Assuming that an investment provider lacks such control, it could also be a fiduciary as a result of rendering investment advice for a fee or other compensation with respect to any moneys or other property of a plan, or if the provider has any authority or responsibility to do so.[11] Thus, fiduciary status may be based on a person's conduct rather than his title and without regard to whether the person acknowledges or accepts such status. Accordingly, it is possible to be a fiduciary without being aware of it.

Department of Labor ("DOL") regulations amplify the statutory definition of an investment advice fiduciary by stating that a person will be viewed as rendering investment advice if both of the following conditions are met:

> (1) the advice relates to the value of securities or other property or constitutes a recommendation as to the advisability of investing in, purchasing, or selling securities or other property, and
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> (2) either (a) the person has discretionary authority or control with respect to purchasing or selling securities or other property for the plan, or (b) the person renders advice to the plan on a regular basis under an agreement or understanding (written or

[6] ERISA Section 409(a).
[7] See ERISA Section 502(l) requiring the DOL to assess a 20% civil penalty on recovered amounts in fiduciary breach cases.
[8] ERISA Sections 402(c) and 403(a).
[9] ERISA Section 402(a)(2)
[10] ERISA Section 3(21)(A)(i).
[11] ERISA Section 3(21)(A)(ii). The statute indicates that it does not matter whether the fee is received directly or indirectly. The receipt by a broker of a commission may be sufficient for this purpose, even though no payment has been specifically allocated to the provision of investment advice. Indirect forms of compensation, such as soft-dollar arrangements and revenue sharing, pursuant to which an adviser receives something of value from an investment provider are likely to be taken into account for purposes of determining fiduciary status.

otherwise) that the advice will be a primary basis for investment decisions with respect to plan assets, and that it will consist of individualized investment advice to the plan based on its particular needs.

The particularized needs of the plan include such matters as investment policies or strategy, overall portfolio composition, and diversification of investments but would not necessarily cover advice of a more general nature, such as which asset classes are consistent with long-term investing.[12] The Department of Labor takes the view that providing investment advice to a participant in an individual account plan that allows participants to direct the investment of their accounts (as opposed to providing plan level advice) may also come within this definition.[13]

Registered Investment Advisers (RIAs). The primary role of most registered investment advisers is to provide guidance as to how plan assets should be invested or as to what investment alternatives should be made available to participants in a self-directed plan. An adviser that assists a plan in selecting an investment menu from the numerous investment options available from the plan's vendor will generally be providing individualized advice. Activities such as this will result in the adviser's legal classification as an investment advice fiduciary.

Brokers. On the other hand, a broker-dealer or its registered representative performing services in the ordinary course of its business is generally paid for executing a purchase or sale of securities, not for providing advice. Given this fact, a broker will not be an investment advice fiduciary merely because it receives a commission, although the receipt of asset-based fees may be another matter.[14]

Rendering investment advice tailored to a plan will make it difficult to contest fiduciary status. An example of a broker-dealer whose pattern of conduct crossed the threshold that made it investment advice occurred in the recent case of *Ellis v. Rycenga Homes, Inc.*, No. 1:04-cv-694, 2007 WL 837224 (W.D. Mich. 2007). In that case, periodic meetings between a broker and a plan trustee over the course of a 20 year relationship for the purpose of reviewing plan investments led to the court's holding that the broker and its broker-dealer were fiduciaries where the meetings were the plan's only source of investment advice and resulted in the plan consistently following the broker's suggestions. The Rycenga case illustrates that if it is important to avoid fiduciary status, care should be taken to avoid providing individualized services to a plan, particularly where a relationship of trust and reliance has been formed with plan representatives.

Mutual Funds and Other Investment Providers – Programs Providing Fiduciary Assistance. Having applied the definition of an investment advice fiduciary to RIAs and brokers, the question then arises as to whether it can also apply to a mutual fund company. Initially, the answer is that a statutory exemption relieves the mutual fund and its investment adviser from

[12] DOL Regulation Section 2510.3-21(c)(1).
[13] DOL Regulation Section 2509.96-1(c), ERISA Advisory Opinion 2005-23A.
[14] DOL Regulation Section 2510.3-21(d) provides a safe harbor under which a broker does not become a fiduciary merely because it executes securities transactions on behalf of a plan pursuant to directions that limit its discretion.

fiduciary status.[15] The exemption could be lost if the mutual fund were to do more than accept money from the plan. Since mutual fund companies have been very reluctant to relinquish the benefits of the exemption, they have generally declined to provide help in selecting investment options or to acknowledge any kind of fiduciary responsibility. Despite initial appearances, this has not changed, even under new programs ostensibly designed to assist plan sponsors with their fiduciary duties.

FIDUCIARY RELIEF MADE AVAILABLE BY INVESTMENT PROVIDERS

Analysis of Guarantees. New programs offered by investment providers purporting to share or relieve fiduciary responsibilities of a plan sponsor focus on guiding a plan sponsor in choosing an investment line-up for a participant-directed 401(k) plan and generally take one of two approaches. The first approach is to utilize the services of a well-known, independent investment management or consulting firm that prepares a “suggested” or “premier” list of funds culled from the investment platform maintained by the mutual fund company or other investment provider. Provided that the plan sponsor selects the plan’s investment menu from this restricted list, the investment management or consulting firm either agrees to be a co-fiduciary or otherwise acknowledges its fiduciary status with respect to the funds on the list. This is probably unnecessary, since the investment management or consulting firm has, in effect, recommended the funds on the restricted list to the plan sponsor for which it is paid by the mutual fund house or other investment provider. The investment management/consulting firm has, therefore, met the requirements for being an investment advice fiduciary under the DOL regulations.

The fine print in such arrangements should be examined closely, because, in some cases, the inclusion of a single investment option not appearing on the approved list (or the deletion of a recommended investment option) purportedly renders the benefits of the program inapplicable. Further, even when all the requirements of the arrangement are met, the plan sponsor or other plan fiduciary may continue to bear exclusive responsibility for other fiduciary issues, including the determination as to whether the adoption of the program itself is well-suited to the plan. The program documentation may include a vaguely worded indemnification for claims arising out of a fiduciary breach, but the enforcement of such an indemnity may prove problematic. Moreover, some of the agreements provide for a cross-indemnity under which the plan sponsor could find itself indemnifying the investment management or consulting firm.

The other approach to assisting plan sponsors with their fiduciary duties also involves providing a model list of investment options that includes investment vehicles from a broad range of investment categories. If the plan sponsor selects an investment line-up with representative investment vehicles from each of the recommended categories, the investment provider will guarantee that the plan sponsor’s choice meets certain (but not all) aspects of

[15] ERISA §3(21)(B) states: “If any money or other property of an employee benefit plan is invested in securities issued by an investment company registered under the Investment Company Act of 1940 [i.e., a mutual fund], such investment shall not *by itself* cause such investment company or such investment company’s investment adviser or principal underwriter to be deemed to be a fiduciary …” Italics added.

ERISA's prudence requirement. The appropriate balance of risk and potential return, the exclusive benefit rule, diversification and numerous other fiduciary matters are not covered. These programs may also guarantee that the plan meets the broad range of investments requirement necessary to assert the Section 404(c) defense which relieves fiduciaries of liability where loss results from a participant's exercise of direction and control of the investment of his own account. This guarantee is very limited and does not apply to other structural conditions of the 404(c) defense or to its numerous operational requirements.

In the end, the new programs provide some assurance that if the recommendations are followed, a plan sponsor will have constructed a well balanced menu of investment options. Further, since the investment management or consulting firm, periodically monitors the funds on the approved list and reports its findings on a website, the plan sponsor receives assistance in meeting its ongoing fiduciary responsibilities. However, the transfer or sharing of fiduciary responsibility is somewhat illusory. As has been noted, fiduciary status depends on what the investment firm does, not on what it says. In that sense, the promises of the new programs do not add to the rights that a plan already possesses with respect to an investment provider. Moreover, the documentation of the new programs could actually have the effect of limiting liability resulting from the actions of an investment firm in recommending plan investment options.

Questions to Ask with Regard to Fiduciary Relief Programs. In light of their restrictions and the less than fully transparent nature of how they are paid for, plan sponsors and their advisers should consider asking the following questions of those offering guarantees of a fiduciary nature:

- Can you explain the standards by which your conduct will be governed when you state that you will act as a fiduciary?

- Please specify those aspects of ERISA's prudence requirement that are not covered by this program.

- Will you reimburse the plan for investment losses incurred as a result of the imprudent inclusion of an investment option on the recommended list? Are there any other circumstances under which you would assume liability for a fiduciary breach?

- Are there any circumstances under which you will assert the right to be indemnified by the plan or plan sponsor?

- Explain how your fees for providing services under this program are determined?

- What fees do you or your affiliates receive with respect to investment products that are included on the recommended list?

- What arrangements have been made to notify the plan sponsor between quarterly reporting periods that events have occurred warranting the removal of an investment option from a plan's investment line-up?

THE ROLE OF INVESTMENT MANAGERS (ERISA § 3(38))

Appointment of Investment Managers. If a plan so provides, ERISA authorizes the plan's named fiduciary to appoint an investment manager that will have responsibility for investment matters, including the power to acquire and dispose of plan assets.[16] If an investment manager is properly appointed and duly monitored by the named fiduciary, ERISA provides that the plan trustee, the party that normally has direct responsibility for managing plan assets, will not be liable for the acts or omissions of the investment manager and will not be required to invest or otherwise manage any asset of the plan which is subject to the authority of the investment manager.[17] When such a delegation has occurred, the investment manager becomes responsible for all aspects of the investment process and is required to act prudently when it decides to buy or sell securities on behalf of a plan. The investment manager is also responsible for related investment matters such as the designation of the party that will execute a transaction (i.e., picking brokers).

Unlike an investment advice fiduciary whose actions control its status as a fiduciary and determine its responsibility, an investment manager must be formally appointed. Further, the investment manager must satisfy certain substantive and procedural requirements in order to qualify as an investment manager. Thus, an investment manager must be a registered investment adviser under federal or state law, a bank as defined under the Investment Advisers Act of 1940, or an insurance company that is qualified to perform investment services under the laws of more than one state.[18] Finally, the investment manager must acknowledge, in writing, that it is a fiduciary with respect to the plan in question.[19]

Only those persons who meet each of these requirements will qualify as an investment manager. Where a plan retains the services of a person who fails to qualify as an investment manager, the appointing party may be held responsible for imprudent investment decisions that result in loss to the plan. This is not to say that a defectively designated investment manager will not be a plan fiduciary. However, other plan fiduciaries will not be protected from the consequences of such an investment manager's actions.[20]

While the named fiduciary of a plan that has appointed the investment manager is not liable for the particular acts or omissions of the manager, such an appointing fiduciary always retains oversight responsibility and, therefore, must periodically review the investment manager's performance including, but not limited to, evaluating whether the investment manager's fees are reasonable.

[16] ERISA Section 402(c)(3).
[17] ERISA Section 405(d)(1).
[18] ERISA Section 3(38)(B).
[19] ERISA Section 3(38)(C).
[20] In Whitfield v. Cohen, 682 F. Supp. 188 (SDNY 1988), the president of a plan sponsor who served as a co-trustee as well as named fiduciary of the plan acquiesced in the appointment of an investment manager that was not registered under the Investment Advisers Act of 1940 and that also failed to provide written acknowledgement that it was a plan fiduciary. When the plan suffered investment losses, the DOL successfully sued the president for breach of fiduciary duty. The court deciding the case noted that, as a result of the failed appointment, the president was not shielded from fiduciary liability.

Services Rendered by Investment Managers. The basic duty of an investment manager is to manage plan assets which includes providing direction as to the acquisition and disposition of investment securities. It includes the selection of appropriate investments that have a level of risk commensurate with the anticipated return, monitoring investments and investment providers, seeing to it that risk is minimized through diversification, and ensuring that a plan has sufficient liquidity to meet its cash flow requirements. These duties may cover the plan's entire portfolio or be restricted to only a portion of the portfolio. For example, separate investment managers could be appointed for a plan's fixed income and equity investments.

The nature of the plan will also determine the character of the services rendered by an investment manager. Under a defined benefit plan, the investment manager's duties may require giving consideration to the demographic profile of the plan's participants. Liquidity and projected return on investments relative to anticipated cash flow are likely to play a larger role in a defined benefit plan than they would in the typical defined contribution plan. Defined benefit plans, in particular, may seek to establish investment policies and guidelines that, among other things, define investment return objectives, allocate plan assets among investment classes, and establish percentage limits for particular kinds of investments.

Under the typical 401(k) plan, there is less need for an investment manager since participants direct the investment of their accounts. However, an investment manager may be called on to select the particular funds that are to be made available as investment options. An investment manager may also be hired to run one or more funds that are made available as plan investment options and that consist entirely of the assets of a single 401(k) plan. For example, an investment manager may be in charge of a plan's in-house bond fund. As discussed below, the Pension Protection Act of 2006 QDIA rules added a new dimension to this role.

Management of QDIAs. Section 404(c) of ERISA provides an affirmative defense to claims for investment losses under an individual account plan resulting from fiduciary breach, provided that extensive regulatory requirements are met. This defense may be asserted only where a participant has exercised control over his or her plan account.[21] However, before 2006, there was no explicit protection for plan a fiduciary with respect to such investment losses where a participant did not exercise control over the investment of his account. The Pension Protection Act of 2006 amended ERISA to authorize the issuance of regulations by the DOL providing that participants who fail to make affirmative investment elections will be treated as exercising such control if certain requirements entailing the investment of the participants' account in qualified

[21] Under ERISA Section 404(c), if a plan is properly structured and a fiduciary, such as an investment manager fulfills its responsibility to choose investment options in a manner consistent with the duties of prudence and loyalty, the fiduciary will be relieved from responsibility for a participant's exercise of authority over his or her own account. However, the Department of Labor takes the position that the act of selecting investment alternatives is a fiduciary function to which this relief does not apply. Thus, even though a participant makes the final choice as to how to invest his or her account, an investment manager or other fiduciary has a duty not only to prudently select investment options, but also to evaluate their performance to determine whether they should continue to be made available as investment options. The Department has stated that this duty includes ensuring that the fees charged to the plan by those investments are reasonable. See Preamble to DOL Regulation Section 2550.404c-1 at 57 Fed. Reg. 46922 (Oct. 13, 1992) and Amended Brief of the Secretary of Labor, Elaine L. Chao, As Amicus Curiae in Support of Plaintiffs-Appellants in *Hecker v. Deere & Company*.

default investment alternatives ("QDIAs") are met.[22] The scope of this relief is the same as that provided by Section 404(c).

While QDIA relief primarily affects plans that provide for automatic enrollment, it also applies to a plan's default investment provisions that become operative when an investment election is determined by the plan administrator to be ineffective. This may happen if a participant has failed to complete an investment election form, the form is illegible or the participant does not provide the information necessary for an effective election.[23]

Apart from certain grandfathered and short-term investment alternatives, QDIAs made available by a plan must generally consist of one of three types of investment products or investment allocation services. The three basic QDIA forms are: (i) age-based funds or models (e.g., lifecycle or target date mutual funds), (ii) balanced or risk-based funds or models (e.g., a lifestyle fund), and (iii) managed accounts under which allocation of assets consisting of investment alternatives already available under the plan is based on an employee's age, target retirement date or life expectancy.

In addition, the DOL regulations provide that if a QDIA is not a mutual fund, it must be managed by certain specified parties. There are three forms of management that are acceptable. The first of these requires the services of an investment manager meeting the requirements discussed above. Thus, the potential role of an investment manager has been expanded and the manager may be called on to manage a QDIA that, in essence, is an in-house fund. However, this category limits fund management to investment advisers registered under the 1940 Act or under state law, banks as defined in that Act and insurance companies. A broker would ordinarily be excluded from acting as an investment manager in these circumstances. Nevertheless, as explained below, brokers and other advisers that do not qualify as investment managers have a potential role in advising employers that are willing to retain fiduciary responsibility with regard to the management of a QDIA.

An investment management service or product may also be managed by a plan trustee that would otherwise meet the requirements for being an investment manager. This opens the way for banks and insurance companies that acknowledge their fiduciary status to manage a QDIA without the need to be specifically appointed as an investment manager by a plan's named fiduciary. However, they are at somewhat of a competitive disadvantage compared to a mutual fund which is not required to make such an acknowledgment.

Lastly, a plan sponsor that is a named fiduciary identified by the plan may manage a QDIA. One would expect that most plan sponsors willing to assume this responsibility would arrange to receive advice from an investment adviser or broker. DOL regulations do not contain any rules regarding such an adviser and there do not appear to be any qualifications for this role as there are in the case of an investment manager. However, since the advice rendered would, of

[22] ERISA Section 404(c)(5).

[23] Other examples of situations where default investments may be appropriate include the failure of a participant to provide investment direction following the elimination of an investment option or a change in a service provider, and the failure of a participant to provide investment instruction following a rollover. See preamble to final regulations on default investment alternatives at 72 Fed. Reg. 60453 (2007).

necessity, be geared to the needs of the plan, the adviser would be an investment advice fiduciary for purposes of ERISA. The adviser, as well as the plan sponsor, would be subject to all of ERISA's fiduciary duties in managing the QDIA. According to the DOL, such a "fiduciary must engage in an objective, thorough, and analytical process that involves consideration of the quality of competing providers and investment products, as appropriate."[24]

QUESTIONS TO ASK WITH REGARD TO QDIA SUITABILITY

An adviser charged with determining the suitability of a QDIA for a particular plan should consider asking the provider or manager to respond to certain questions. The topics covered should include the following matters:

Cost. Ask for the estimated annual cost of the QDIA for a plan similar in size to the plan which proposes to make the QDIA available to its participants. Ask whether any indirect expenses will be charged against investment results.

Availability of Transfers. In order to comply with operational requirements for QDIAs which condition fiduciary relief on transferability of the investment, ask what process is in place to elect another investment option in place of the QDIA. Also, can the QDIA be transferred as frequently as other plan investments and are there any restrictions or fees to transfer out of the QDIA?

Notice to Employees. Ask for a sample of the notice that will be used to inform employees of the QDIA as well as information about the process for delivering such notices. Make sure that the notice can be understood by the ordinary employee and that it explains the circumstances in which the QDIA will be used.

Characteristics of the QDIA. What is the generally accepted investment theory used by the QDIA and is it diversified so as to minimize the risk of large losses? Also ask for a recent listing of the QDIAs portfolio and an explanation of its investment objectives and risk vs. return characteristics.

Type of Management. Does the QDIA manager qualify as a registered investment company (i.e., a mutual fund) or an ERISA Section 3(38) manager?

CONCLUSION

We have posed the question whether investment providers that are involved in selecting plan investment line-ups or offering default investment in the form of QDIAs have assumed fiduciary responsibility in any meaningful way. We believe that progress is being made and that services are being made available to plan sponsors that help them to meet their fiduciary duties. However, promises to share fiduciary responsibility are more apparent than real, and in that regard there is a long way to go.

[24] Preamble to the final QDIA regulations at 72 Fed. Reg. 60453 (2007).