

ERISA 3(21) and 3(38) Fiduciary Roles

Choosing the right level of investment liability:
5 questions for plan sponsors**Kirk S. Paulsen**

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Investment Selection :

***Plan sponsors must decide “Can I Do it Myself” or
“Do I Need Help” just like their participants***

Plan sponsors wear many hats. One of the most uncomfortable may be fiduciary responsibility for the selection of retirement plan investments. While the Employee Retirement Income Security Act of 1974 (ERISA) guidelines designate two different types of investment fiduciaries in sections 3(21) and 3(38), it's difficult for many plan sponsors to determine which is the best fit for their retirement plans.

Uncertainty about investment selection and monitoring is familiar to plan sponsors because their participants have the same questions. Can I do this myself? or Do I need help? Plan sponsors must decide whether they prefer a “Do it Myself,” “Help Me” or “Do it for Me” investment selection approach.

This paper helps plan sponsors make this decision by defining three common investment fiduciary roles. It then suggests plan sponsors review five questions to determine the level of investment fiduciary liability they want to keep or transfer. Securian believes that once a plan sponsor identifies with one of these roles and answers these questions, the decision to retain or transfer investment fiduciary liability becomes easier, perhaps even obvious.

ERISA high standards require a fiduciary to manage the investment array with:

“the care, skill, prudence, and diligence, under the circumstances then prevailing, 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.”

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ERISA Section 3(21)

defines the broad duties of a plan fiduciary. For the purposes of investment selection, ERISA allows for plan sponsors to complete the investment selection process on their own or hire an advisor or investment manager to assist them. In either case, the plan sponsor is still a 3(21) fiduciary. The hired entity may also be a 3(21) fiduciary along with the plan sponsor under this arrangement.

ERISA Section 3(38)

is the origin for the term “3(38) investment manager.” A 3(38) investment manager is hired by the plan to make all investment array decisions. Here, the plan sponsor's fiduciary responsibility for the selection and monitoring of plan investment options relates to the choosing and monitoring a 3(38) investment manager.

This statement goes beyond the traditional “prudent person rule” for their other fiduciary responsibilities. It requires fiduciaries to have a certain level of investment knowledge and skill when selecting plan investments. Many plan sponsors are uncomfortable with these responsibilities, and wish to transfer them to a qualified investment professional. Before they do this, they should understand the differences between 3(21) and 3(38) fiduciary assistance.

Three Investment Fiduciary Roles

Some plan sponsors feel confident enough to perform investment fiduciary duties themselves. Others find that they need assistance from a qualified investment manager. Still others conclude the best approach is to hire an investment manager to do everything – to select the plan’s investment array from start to finish.

Below are three common fiduciary roles for investment array selection. Each succeeding role requires less involvement from the plan sponsor and a greater responsibility by a chosen, outside investment manager.

Role 1: Sole Responsibility – “Do it Myself”

In this role, the plan sponsor selects the investment array without assistance from any outside source. Doing so, the plan sponsor acts as a 3(21) investment fiduciary to the plan with full liability for investment option selection and no outside party to share it with.

Role 2: 3(21) Co-Fiduciary Assistance – “Help Me”

Note: Before we define co-fiduciary assistance we need to outline the distinctions between a Registered Representative and a Registered Investment Advisor/Manager for a qualified retirement plan.

Plan sponsors may hire someone who is a **Registered Representative** to provide a variety of administrative, educational and consultative services, both at the plan and participant level. But, by law, Registered Representatives are not allowed to provide investment advice to either the plan or its participants. *They generally provide services which keep them from being 3(21) co-fiduciaries to the plan.* Registered Representatives work for broker-dealers registered with the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA). When Registered Representatives are hired as reps of record on the plan, plan sponsors must fulfill their fiduciary investment selection responsibilities on their own or hire a separate party.

Once plan sponsors identify with one of these investment fiduciary roles, they can better determine if they should keep or transfer these responsibilities.

Insuring the Sole Responsibility Role –

Some plan sponsors (especially those who choose the “Do it Myself” role) elect to purchase fiduciary liability insurance, which could include coverage for the liability of investment option selection. Such an arrangement may help a plan sponsor feel more comfortable retaining their investment fiduciary obligations. Plan sponsors must weigh the cost of the coverage with the potential benefits provided under the arrangement.

For 3(21) co-fiduciary assistance, plan sponsors may choose to hire a **Registered Investment Advisor (RIA)**. RIAs may provide investment services only or they may also provide administrative, educational and consultative services. Their fiduciary assistance usually takes the form of independent analysis, reports and/or specialized tools.

While an RIA serves as a 3(21) co-fiduciary to the plan, this does not relieve the plan sponsor of fiduciary responsibility for the selection and monitoring of the investment array.

The RIA is responsible for the analysis and tools he provides. The important distinction is that the RIA is not ultimately responsible for the actual outcomes that arise from using them. If an investment option in the RIA's recommended array is deemed inappropriate for the plan under ERISA, the plan sponsor may still be responsible because he still retains fiduciary liability. Under such a co-fiduciary arrangement, the RIA, if anything, is simply joining the plan sponsor at the fiduciary table.

Role 3: 3(38) Investment Manager - "Do it for Me"

In this role, a plan sponsor hires an RIA (investment manager) to select and monitor the investment array. Under this arrangement, the investment manager accepts the authority to manage, acquire and dispose of investment options. The investment manager acknowledges, *in writing*, that he is a fiduciary with responsibility and accountability for the selection of the investment array.

Here, the investment manager serves as a 3(38) fiduciary to the plan. **Structured properly, ERISA would view the liability for investment selection as residing with the investment manager.** While this does not completely absolve the plan sponsor, liability is defined much more narrowly.

ERISA Section 405(d) provides that under a 3(38) arrangement "the plan sponsor and/or trustees of the plan are not liable for acts or omissions of the 3(38) investment manager, and are under no obligation to invest or otherwise manage any asset of the plan which is subject to the management of that investment manager." **A 3(38) arrangement represents the highest level of investment liability transfer possible under ERISA.**

Under a "Help Me" arrangement, the RIA shares the fiduciary responsibility with the plan sponsor. While the RIA may be relied upon for investment decisions, the plan sponsor still makes the investment array selection and completes the monitoring.

Under a "Do it for Me" arrangement, the plan sponsor must provide for the appropriate selection and monitoring of the 3(38) investment manager hired, but the investment selection and monitoring (and any resultant liability) are in the hands of the 3(38) investment manager.

Five questions to help plan sponsors determine what level of investment fiduciary liability to keep or transfer

1. Do conflicts of interest exist?

Are you and your plan provider free of these conflicts of interest?			
Conflict of Interest	Yes	No	Don't Know
Requirement to use proprietary funds			
Investment options that provide varying levels of compensation to investment manager			
Varying levels of fee offsets			

Regardless of the way a plan sponsor selects plan investments, they must first determine if conflicts of interest exist. Some of the most common include: proprietary fund use restrictions, the existence of investment options that provide varying levels of compensation to the investment manager, and the existence of varying levels of fee offsets for the plan.

Proprietary fund requirements, or any requirements for use of a particular investment option, should be avoided. In particular, plan sponsors should be sure to consider any requirements around target date funds since they often function as a Qualified Default Investment Alternative (QDIA) option.

The interests of the investment manager should be revenue-neutral. Consider that 12(b)1 fees and sub-transfer agent (sub-TA) fees will, by definition, vary by investment option. If these variances affect investment manager compensation, a conflict of interest may exist. For example, if the investment manager is paid 0.25% on one investment option and 0.50% on another, there is no guarantee the investment manager will select the options on merit rather than on compensation.

Despite the inherent variation in 12(b)1 and sub-TA fees between investment options, there are several ways a plan provider can create a conflict-free position. One method is to pass these fees back directly to participant accounts in the form of an expense reduction. Another is to aggregate these fees and spread them out in a way that benefits all participants. A healthy foundation for either 3(21) or 3(38) fiduciary status relies on the absence of such conflicts of interest.

1. Do conflicts of interest exist?
2. What's my investment knowledge?
3. How much time do I have - what's my preferred level of involvement?
4. What's my liability comfort level?
5. What's my price point?

2. What's my investment knowledge?

Some plan sponsors have the expertise to feel confident about selecting the investment array for their plan, while others feel they do not have enough knowledge to do the best job. This review naturally influences the decision to hire an outside provider. Those with more knowledge usually lean towards performing these duties themselves; while those with less knowledge often feel more comfortable with a 3(21) or 3(38) arrangement.

It's important to note that there are some plan sponsors who are confident about investment selection but still work with a 3(38) investment manager to reduce their liability or to save time.

3. What's my preferred level of involvement?

The plan sponsor retains complete control over investment selection in the "Do it Myself" role. This is the most time-consuming role.

While the 3(21) co-fiduciary arrangement described in the "Help Me" role involves significant assistance from an investment manager, under 3(21) the plan sponsor still makes the ultimate investment decisions. Sponsors who wish to retain this control may be best served by a co-fiduciary arrangement.

For plan sponsors who wish to completely transfer investment selection to another party, hiring a 3(38) investment manager is the best approach. Structured properly, a 3(38) investment manager completely removes the investment selection process from the plan sponsor's responsibilities.



Once plan sponsors assess their investment knowledge, it helps them decide how much investment fiduciary liability to keep or transfer.



Likewise, once plan sponsors assess their preferred level of involvement, it helps them decide how much investment fiduciary liability to keep or transfer.

4. What's my liability comfort level?

Under either a “Do it Myself” or “Help Me” approach, the plan sponsor is responsible for all investment fiduciary discussions and outcomes. In these roles, plan sponsors should be comfortable with owning these responsibilities. **Again, it is particularly important to note that while a 3(21) co-fiduciary arrangement brings another party to the fiduciary table, it does not in any way relieve the plan sponsor of ultimate responsibility for appropriate investment selection.**

Under a properly structured “Do it for Me” arrangement, ERISA Investment Fiduciary responsibilities are transferred to the 3(38) investment manager. The manager is responsible for investment selection and its ultimate outcomes while the plan sponsor is responsible for the appropriate selection and monitoring of the 3(38) investment manager.

What if a plan sponsor wants to transfer liability through a 3(38) arrangement, but wishes to retain “veto” power over investment selections?

This is not possible. Using a 3(38) investment manager means that all investment selection decisions are the responsibility of that manager. If a plan sponsor enters a 3(38) arrangement and then overrules one of the investment decisions made by the manager, by definition they would no longer be in a 3(38) arrangement.

Remember, hiring a 3(38) investment manager moves all investment decisions from the plan sponsor to the investment manager. Trying to create a “hybrid” option of 3(38) and 3(21) effectively moves the arrangement to 3(21) status.

5. What's my price point?

3(21) or 3(38) fiduciary assistance comes with a price. Plan sponsors ultimately need to determine how much they are willing to pay for the services rendered. They should remember these services include not only those under a 3(21) arrangement, or complete investment selection under a 3(38) arrangement, but also the assumption of ERISA liability levels inherent with those arrangements.

While price is likely to increase moving from the “Do it Myself” to “Do it For Me” roles, so do the potential benefits. Plan sponsors benefit from reduced time commitment, expert advice, narrowing of liability etc. Participants benefit from the availability of investment options that are managed by professionals with the necessary financial acumen to evaluate and make investment decisions.

As with any purchase decision, a plan sponsor must decide the right balance between costs and benefits.



Finally, once plan sponsors assess their liability comfort level, it also helps them determine how much investment fiduciary assistance they need.

Conclusion

Plan sponsors must understand all of their fiduciary responsibilities under ERISA. It provides for certain levels of relief from investment selection decisions through its sections 3(21) and 3(38). As with other laws and regulations, ignorance of the ERISA sections governing these responsibilities is not a valid defense. Plan sponsors must carefully consider their circumstances and select the fiduciary role that is best for their particular situation.

For plan sponsors who feel they have the knowledge and expertise to select and monitor investments on their own or with some limited assistance, and are comfortable with the liability with making those decisions, a “Do it Myself” approach or a “Help Me” co-fiduciary approach (as outlined in this paper) work. In either case, the plan sponsor is a fiduciary under ERISA section 3(21).

Plan sponsors who are uncomfortable with making investment decisions may be best served by transferring those duties to an investment manager through a 3(38) arrangement (the “Do it for Me” approach). This removes the lion’s share of the liability for those decisions from an ERISA standpoint. However, it does not move the liability risk to zero. There are still risks relative to the selection of the investment manager and the oversight of this manager.

Regardless of the choice, ERISA is clear that plan sponsors must always act in the best interest of the participants covered by the plan. They must discharge their duties as a fiduciary with the care, skill and diligence that would be exercised by a prudent person familiar with such matters.



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