Insights for fiduciaries

Hiring an investment fiduciary—issues and considerations for plan sponsors

The Employee Retirement Income Security Act of 1974 ("ERISA"), the federal law that governs privately sponsored U.S. retirement plans, imposes a number of fiduciary duties on those who administer and manage such plans. Ultimate responsibility for ensuring that those duties, including investment responsibilities, are carried out can fall on the plan sponsor. To assist plan sponsors in meeting their fiduciary responsibilities for plan investments, the sponsors may delegate or outsource certain of those responsibilities to third parties. This paper provides an overview of issues and considerations for plan sponsors when hiring a fiduciary consultant on investment matters.

I. Fiduciary duties and liability—A primer

Fiduciary status

Individuals or entities can become fiduciaries to a plan either by (1) being "named" or appointed as a fiduciary in the plan document or by another plan fiduciary, or (2) if their conduct or actions fall within the functions described in the definition of what it means to be a fiduciary under ERISA—a so-called "functional" fiduciary—without regard to formalities such as appointments or titles.

When a person is a fiduciary to a plan, whether a "named" or "functional" fiduciary, it does not mean that the person is a fiduciary for all plan purposes. In fact, ERISA specifically states that a person is a fiduciary only "to the extent" that the person carries out fiduciary functions, such as exercising discretion over the management of the plan or the disposition of plan assets.[1] Thus, the scope of a person's fiduciary status may be limited to specific responsibilities—in the case of named fiduciaries, to the extent specified in the plan document and not otherwise delegated out; or, for functional fiduciaries, to the extent of their role with respect to the plan.[2]

Fiduciary duties

An ERISA fiduciary is subject to, and must act in accordance with, high standards of conduct in carrying out its responsibilities to a plan. These standards require that a fiduciary:

- Act solely in the interest of the plan participants and beneficiaries, and for the exclusive purpose of providing benefits to plan participants and their beneficiaries and defraying reasonable expenses of administering the plan—a duty of loyalty;
- Act with the "care, skill, prudence and diligence under the circumstances then prevailing" as a "prudent man acting in a like capacity and familiar with such matters would use" in like circumstances—a duty to act prudently;
- Diversify plan investments so as to minimize the risk of large losses, unless under the circumstances it is "clearly prudent" not to do so (this rule does not apply to investments by a 401(k) or other individual account plan in employer stock); and
- Act in accordance with the plan's governing documents (interpreted to include investment policies and guidelines), insofar as such documents are consistent with ERISA.[3]

ERISA's fiduciary standards, which are supplemented by prohibited transaction rules intended to protect plans against potential conflicts of interest, have been described by some as "the highest known to the law."[4]

Fiduciary liability

It is important for fiduciaries to understand their duties under ERISA because of the risk of personal liability if they breach these duties. Individual fiduciaries may be held financially accountable for restoring losses to a plan that result from such a breach, and to disgorge profits the fiduciary received in connection with the breach. In addition, a fiduciary may be subject to civil penalties as well as other remedies that a court deems appropriate, including the removal of the fiduciary, and possibly excise taxes in the event the breach involved a prohibited transaction.[5]

This liability can also extend beyond the breaching fiduciary to its "co"-fiduciaries. Under the applicable ERISA provision, plan fiduciaries can be liable for a breach of fiduciary duty by a second plan fiduciary, if either: (1) they knowingly participate in, or knowingly undertake to conceal, the second fiduciary's breach; (2) through failure to comply with their own fiduciary duties, they enable the second fiduciary to commit the breach; or (3) once aware of the second fiduciary's breach, they fail to make reasonable efforts under the circumstances to remedy the breach.[6] This means that even if a fiduciary did not itself

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breach its fiduciary duties, under these circumstances the fiduciary may be subject to the same liability as the breaching fiduciary.

II. Fiduciary delegation

Delegating fiduciary duties

ERISA permits fiduciaries to delegate fiduciary duties, including investment management responsibilities, to others, to the extent permitted by the plan's governing document. A plan document may allow a fiduciary to hire others to render advice to the fiduciary with respect to its fiduciary responsibilities to a plan,[7] or may permit a named fiduciary responsible for the control or management of plan assets to appoint investment managers to manage part or all of the plan assets on a discretionary basis.[8] As a shorthand, the terms "3(21) fiduciary" and "3(38) fiduciary" have been used to distinguish between a person hired as a fiduciary investment adviser versus a fiduciary investment manager.

Comparing the 3(21) and 3(38) fiduciary models

There is a difference in the level of investment responsibility retained by the delegating plan fiduciary following a 3(21) or 3(38) delegation, which in turn is based on what responsibilities are actually delegated.

Under the 3(38) fiduciary model, the 3(38) fiduciary is responsible for making the final investment decisions with respect to the assets under its management—in the 401(k) plan context, generally meaning the decisions whether to add or remove investment options. If the 3(38) fiduciary has been properly appointed in accordance with the plan document and ERISA, the delegating plan fiduciary only has direct responsibility for carrying out its oversight role, and not for making investment decisions. In other words, the delegating plan fiduciary is responsible for the prudent oversight of the 3(38) fiduciary's performance, but generally not for the 3(38) fiduciary's day-to-day investment activities.

By contrast, under the 3(21) fiduciary model, the delegating plan fiduciary is receiving advice from the 3(21) fiduciary, but retains the responsibility to make all final investment decisions. Thus, the delegating fiduciary is responsible for evaluating the 3(21) fiduciary's advice, and for making investment decisions based on that advice in accordance with its ERISA fiduciary duties of loyalty and prudence. Courts have emphasized that the delegating fiduciary cannot rely blindly on the advice given, but rather has the further responsibility under the prudence requirement to make an informed decision based on that advice and should ask questions or secure additional advice, if necessary, to be able to make such decisions prudently. Thus, as would be expected, a plan fiduciary overseeing a 3(21) fiduciary retains a higher degree of control and oversight, and has a higher degree of fiduciary responsibility and potential liability exposure, for the investment decisions being made. For these reasons, a 3(21) fiduciary is often referred to as a "co-fiduciary" who shares investment responsibilities rather than fully assuming them.

III. Why hire a fiduciary?

The reason to delegate

Many plan sponsors may have only limited knowledge of investments or, even if they have investment expertise, may have limited time to spend on plan matters. Department of Labor ("DOL") guidance and case law have emphasized that if a plan fiduciary lacks the knowledge or resources to make investment decisions for the plan, the plan fiduciary should seek advice or other assistance in making those decisions.[9]

The effect of delegation

Hiring a 3(21) or 3(38) fiduciary has the effect of reducing the plan fiduciary's level of responsibility for plan investment decisions, and thus also the plan fiduciary's exposure to potential liability for breach of fiduciary duty. But, despite a common misconception, ERISA does not allow a plan fiduciary to entirely eliminate its investment responsibilities to a plan. While a plan fiduciary can, through a proper delegation, reduce the scope of its responsibilities, the plan fiduciary remains responsible for the prudent selection and monitoring of the service provider to whom the delegation is made and, if necessary, the removal or replacement of the service provider if it fails to perform as expected. This is the case regardless of whether the provider is a 3(21) or 3(38) fiduciary.[10]

Co-fiduciary liability

Plan fiduciaries should be aware that they can be liable as co-fiduciaries for the fiduciary breaches of either a

3(21) or 3(38) fiduciary. For this reason, plan fiduciaries should, among other things, take steps to meet their oversight responsibilities—following a prudent process in the selection and periodic monitoring of the fiduciary (as discussed below), and documenting these steps in case future questions arise—and to make reasonable efforts under the circumstances to remedy any breach by the 3(21) or 3(38) fiduciary of which they become aware.

IV. Important considerations in selecting a fiduciary

Follow a prudent process in selecting a fiduciary consultant

A plan fiduciary should follow a prudent process in hiring a fiduciary consultant (or, for that matter, any service provider) for a plan. Such a process may include determining whether hiring investment consultants is permitted under the plan document(s) and the extent to which the plan fiduciary may delegate its responsibilities; developing a formal request for proposal (RFP) that discusses the needs of the plan and plan participants and sending it to potential providers of the desired services; conducting interviews of the providers that respond to the RFP; making a final selection decision based on the information collected; and negotiating a service agreement with the selected provider. The plan fiduciary should document the rationale for its decisions and keep an accurate record throughout the entire process.

Follow a prudent process in conducting ongoing monitoring of the fiduciary consultant

The plan fiduciary's responsibility does not end with the selection. According to DOL guidance and case law, the plan fiduciary also has a responsibility to conduct ongoing monitoring to ensure that using the fiduciary consultant's services continues to be prudent. The plan fiduciary should have a process for conducting such monitoring on a periodic basis (such as annually or biannually), and more frequently in the event that, for example, there are concerns about the quality of the services, the reasonableness of the fees being charged or a change in personnel. The same criteria that were considered in connection with the initial selection should be part of the periodic review.

Clearly define roles of the plan fiduciary and provider

An important consideration in hiring either a 3(21) or 3(38) fiduciary service provider is to clearly define the roles and responsibilities of the provider and the plan fiduciary. A plan fiduciary should consider, among other things, whether the provider is willing to expressly acknowledge its fiduciary status under ERISA, supply a detailed schedule of services it will provide to the plan, and agree to specified service standards. In the case of a 3(38) fiduciary, a formal written acknowledgement of the 3(38) fiduciary's fiduciary status is required under ERISA.

Consider the scope of services

Investment service providers are not one-size-fits-all—the range of services can vary from provider to provider. This means that a plan fiduciary should not assume that all providers acknowledging fiduciary status are offering the same level of service. For example, in the 3(21) fiduciary space, one firm may provide general advice to a plan fiduciary only on investment philosophies and the development of an investment policy, while another may offer more detailed analysis and advice with respect to specific investments or investment vehicles.

Be sure to evaluate fees

A plan fiduciary is responsible for ensuring that the plan pays no more than reasonable fees or other compensation for necessary services, an issue that continues to be a target of regulators and plaintiff-side law firms. As such, the plan fiduciary should determine whether the fees that a provider proposes to charge are reasonable for the level and quality of services that it has agreed to provide. Reasonableness of fees is generally measured by what other similarly-situated providers charge for comparable services. But even for the same types of services, different providers may charge different fees based on their particular experience, resources, level of service, amount of protection and exposure to risk, among other factors, which can justify paying more to certain providers as compared to others.

Fee benchmarking services can be helpful in assessing whether fees are reasonable, both initially and for purposes of ongoing monitoring, by providing a basis of comparison to what other firms are charging for the same types of services, subject to considerations of any special circumstances or unique services involved. If an RFP is conducted or multiple providers are considered, the plan fiduciary should carefully evaluate each response to compare what the plan would be receiving from each provider and at what cost, to make sure it recognizes those differences in service levels or other relevant factors that may affect the provider's fees and can ascertain whether the plan would receive additional value for any increased cost.

Other forms of fiduciary protections

What is fiduciary liability insurance?
Individuals and firms that serve as fiduciaries, or provide fiduciary services, can obtain fiduciary liability insurance as a protection for themselves and their fiduciary clients, but there are a number of limitations that may apply.

As a general matter, many standard types of insurance policies that businesses obtain—such as "directors and officers" (D&O), professional liability and "errors and omissions" (E&O)—exclude coverage of fiduciary liability under ERISA. This coverage thus has to be separately purchased, either through a rider to the main policy or, in many instances, via a stand-alone policy with another insurer (not all insurers provide this type of coverage).

Where an insurance policy does provide such coverage, the coverage generally extends to both plan losses and the costs and expenses of defending against a claim (such as attorneys' fees), but may be subject to caps on the coverage amount, as well as a deductible. In addition, the policy may exclude a plan fiduciary's acts that constitute gross negligence, willful misconduct or lack of good faith.

In many cases, the insurer will pay losses and certain expenses only after the fiduciary defends against the claim, and any settlement requires the insurer's approval. While the insurer may have the ability to participate in any legal action or investigation, insurers generally have no responsibility to do so. This means that the fiduciary must seek and pay for its own counsel, and then request reimbursement from the insurer. To ensure that the terms of the policy are met, the fiduciary will want to provide notice to the insurer of a potentially covered claim, or of circumstances that may lead to the assertion of such a claim, as soon as possible after it becomes aware of the claim or circumstances.

For these reasons, while fiduciary liability insurance on the part of the plan fiduciary or 3(21)/3(38) fiduciary may protect the plan and the plan fiduciary against loss in certain circumstances, there are many instances in which it may not fully protect either the plan or the plan fiduciary from losses or liabilities that result from a breach, or alleged breach, of fiduciary duty by a 3(21) or 3(38) fiduciary.

What is the ERISA fidelity bonding requirement?
Many plan fiduciaries believe that they are protected by the 3(21) or 3(38) fiduciary purchasing a fidelity bond as required by Section 412 of ERISA. The reality is that the bond only covers the plan for losses in connection with wrongful acts of fraud or dishonesty, such as misappropriation or embezzlement. Fidelity bonds do not cover a fiduciary for personal liability that may result from imprudence or other acts that constitute a breach of fiduciary liability under ERISA. Also, a fiduciary whose role is limited to providing investment advice may not be subject to the bonding requirement.

What are fiduciary warranties?
Fiduciary warranties tend to be included in some bundled products and services, and offer a limited scope of guarantees in connection with the purchase. For example, many fiduciary warranties provide a guarantee that the menu of investments offered under the product constitutes a broad range of investment options as required for compliance with Section 404(c) of ERISA (the exception to the ERISA fiduciary responsibility rules for participant-directed plans), but do not extend beyond that specific issue. Thus, the warranty may not cover whether the investments are otherwise prudent at the time of selection or on an ongoing basis. For this reason, it is important to ascertain what is being guaranteed and, in light of any limitations, whether the scope of the guaranty provides any protection to the plan fiduciary or otherwise adds value to the service relationship.

Beware of indemnification, limitations on liability, and caps

Fiduciary service agreements may include provisions requiring the plan or plan sponsor to indemnify the service provider for any liabilities the provider incurs as a result of providing its services (generally subject to exceptions for the provider's fraud or willful misconduct), or possibly limitations on the provider's potential liability to the plan or plan participants. While ERISA prohibits a fiduciary from disclaiming liability for a breach of fiduciary duty, for which reason these types of provisions are often made subject to compliance with ERISA, ERISA has been interpreted not to limit indemnification from the plan sponsor (as opposed to the plan itself), and other facts and circumstances may affect how these provisions are applied in different circumstances. In addition, DOL guidance has indicated that a fiduciary must act prudently in agreeing to a liability cap for plan services, adding that it would not be prudent or reasonable to agree to any limitation on liability for fraud or willful misconduct.[12] For these reasons, plan fiduciaries will want to closely scrutinize and evaluate those types of provisions, both for legal compliance and for reasonableness, and this can be an additional factor to use in comparing different providers and their costs.

Consider the provider's process and documentation

Because the appointing plan fiduciary remains responsible for the selection and monitoring of the provider, it should examine the provider's process and documentation and whether its process would be consistent with ERISA's requirements and the needs of the plan. Among other things, the plan fiduciary should inquire about how the provider documents its advice or decision-making and what reporting is provided back to the plan fiduciary. Given the greater level of delegation and reliance involved in utilizing a 3(38) fiduciary, it is all the more important for the plan fiduciary to be comfortable it can rely on the 3(38) fiduciary's investment process and will be able to oversee the 3(38) fiduciary's provision of its services.

Regulatory oversight and firm governance

A relevant consideration is how the provider is regulated, both externally and internally. To the extent the provider is subject to the oversight of a federal regulator such as the SEC or OCC, a self-regulatory organization such as FINRA, or other federal or state regulatory authority, that provides additional protections for the plan and can serve to supplement the plan fiduciary's own monitoring activities. Depending on the regulator, the provider may be subject to reporting obligations and periodic examinations, which can detect issues that may have escaped the plan fiduciary's notice. In the case of registered investment advisers, for example, relevant information about the firm's business and disciplinary history should be available in the firm's disclosure brochure intended to meet the requirements of the SEC's Form ADV-Part 2A, which must be provided to clients prior to or at the time of entering into an advisory agreement, and on the SEC's Investment Adviser Public Disclosure (IAPD) website. Additionally, a provider with strong internal firm governance may be preferred to a firm with only self-regulation and internal accountability, as that will help ensure that the provider's personnel are complying with their obligations under ERISA and applicable rules and regulations, which in turn protects the plan and the appointing plan fiduciary.

Experience

Another important factor is the provider's collective experience—including the length of time the provider has been providing the relevant types of services, and the industry experience of the firm's principals and staff. A plan fiduciary should consider requesting references from both existing and former clients of the provider. For a registered investment adviser, some of this information may be available in the firm's Form ADV-Part 2.

Financial strength, insurance and bonding

Also relevant is whether the provider has the financial strength to support the costs involved in defending, settling or paying a claim, in the event of litigation alleging a breach of fiduciary duty. In addition, ERISA requires discretionary fiduciaries (other than banks and broker-dealers) to be covered by a fidelity bond,[13] and most providers also have fiduciary liability insurance coverage. [See side bar.]

It is advisable to ask up front whether a firm maintains insurance for ERISA fiduciary liability, and to require providers to include commitments in their agreement(s) with the plan to maintain certain minimum levels of insurance coverage (in addition to any required fidelity bond), which can be based on the size of the plan or the size of the assets under advice or management by the fiduciary. The plan fiduciary may ask for proof of coverage, and also to be notified in the event that the firm loses its coverage or is no longer able to maintain the requisite level of coverage. While loss of coverage may not be the result of any particular problem with the plan's engagement, it may signal that the firm has had issues with other clients and is no longer considered an insurable risk.

However, plan fiduciaries should keep in mind that fidelity bonding only covers certain losses triggered by fraud or dishonesty, not a fiduciary breach, and that fiduciary liability insurance may be subject to coverage limitations and exceptions (as well as a deductible). Thus, a strong balance sheet remains an important consideration even where such other protections are in place.

Resources and technology

An additional consideration is the scale of the provider in terms of access to resources and technology. For example, does the provider assign a specific person to the account, and are there procedures in place for that person's absence? Or does the firm assign a team to each relationship? The provider's access to the most recent technology for investment monitoring and modeling may also be an important consideration.

Litigations and sanctions

As part of its due diligence on the provider, a plan fiduciary should consider any current or past litigation, investigations or other exposure the provider may have to legal claims, fines, penalties or other sanctions, particularly in performing the services that would be covered under the particular engagement, as that may indicate the level of risk in dealing with that provider. For disputes or investigations that have been settled or resolved, the plan fiduciary should request a description of the outcome of the dispute. For firms that are registered investment advisers, this type of information may be available in the firm's Form ADV-Part 2A and on the SEC's IAPD website.

A non-fiduciary adviser

While becoming less and less common, there are still some providers in the marketplace that offer investment-related services without specifically committing to take on fiduciary responsibility. For example, there are providers offering retirement plan consulting services that purport to be limited in a manner intended not to trigger ERISA fiduciary status, or that may seek in their service agreements to disclaim ERISA fiduciary status. When engaging with such providers, a plan fiduciary should carefully review the services to be provided and understand whether or not such providers are acknowledging fiduciary status under ERISA, to be able to evaluate whether the plan would be sufficiently protected, under ERISA or otherwise, in the event of the provider's misconduct or failure to perform.

V. Conclusion

Retaining a fiduciary consultant to advise on plan investments, or to assume discretionary responsibility for all or a portion of those investments, can help protect the plan sponsor from exposure to fiduciary liability under ERISA, particularly if the plan sponsor does not have sufficient expertise or resources to carry out the investment responsibilities itself. However, the selection and oversight of such a fiduciary is itself a fiduciary function that, if done improperly, can trigger fiduciary liability. Therefore, it is important for plan sponsors and plan fiduciaries to follow a prudent process in accordance with the plan documents, taking into account the issues and considerations described in this paper, when selecting and hiring an investment fiduciary, determining the scope of that fiduciary's services, and conducting ongoing oversight of the fiduciary's performance of its services and the reasonableness of its fees.

[1] ERISA § 3(21)(A).

[2] *See, e.g., Beddall v. State St. Bank & Trust, Co.,* 137 F.3d 12, 18 (1st Cir. 1998); *Johnson v. Georgia-Pacific Corp., 19 F.3d 1184* (7th Cir. 1994); *Leigh v. Engle,* 727 F.2d 113, 134 (2nd Cir. 1984).

[3] ERISA § 404(a)(1).

[4] Donovan v. Bierwirth, 680 F.2d 263, 271-72 n.8 (2d Cir.), cert. denied, 459 U.S. 1069 (1982). This statement has been quoted in many subsequent court decisions.

[5] ERISA §§ 409(a), 502(l); Internal Revenue Code § 4975.

[6] ERISA § 405(a).

[7] ERISA § 402(c)(2).

[8] ERISA § 402(c)(3).

[9] *See, e.g., Katsaros v. Cody, 744 F.2d 270, 279 (2d Cir.), cert. denied, 464 U.S. 1040 (1984)* (trustees violated their duty to act prudently because, "being ill-equipped to evaluate the soundness of the proposed loan, [they] failed to observe their duty to seek outside assistance"); *In re Unisys Sav. Plan Litig., 74 F.3d 420, 435 (3d Cir.), cert. denied,* 519 U.S. 810 (1996) (court "would encourage fiduciaries to retain the services of consultants when they need outside assistance to make prudent investments"); *see also Sacerdote v. New York University,* No. 16-cv-6284 (KBF), at 16 (S.D.N.Y. July 31, 2018) ("Certainly, a fiduciary is within its rights—and likely well-advised—to seek advice from experts).

[10] *See generally* ERISA § 405(c)(2)(A); Interpretive Bulletin 75-8, 29 C.F.R. § 2509.75-8, D-4 (members of an employer's board of directors are fiduciaries to the extent they are responsible for the selection and retention of plan fiduciaries); *Leigh v. Engle,* 727 F.2d 113, 134-35 (7th Cir. 1984) (persons controlling plan sponsor had only limited responsibilities for selecting and retaining plan administrators, but that did not mean they had no responsibilities whatsoever—they could not abdicate their ERISA duties merely through giving others primary responsibility for the plan). See also Interpretive Bulletin 96-1(e), which describes the responsibility of plan sponsors to act prudently and solely in the interest of plan participants and beneficiaries in selecting and monitoring plan service providers such as investment advisors.

[11] *See, e.g., In re Unisys Sav. Plan Litig.,* 74 F.3d 420, 435 (3d Cir.), cert. denied, 519 U.S. 810 (1996) ("ERISA's duty to investigate requires fiduciaries to review the data a consultant gathers, to assess its significance and to supplement it where necessary"); *Donovan v. Cunningham,* 716 F.2d 1455 (5th Cir. 1983) (plan fiduciaries are entitled to rely on the expertise of others on valuation matters, but by failing to ensure that the information provided by valuation consultants was complete and up-to-date, plan fiduciaries violated their duty to act prudently); *see also Sacerdote v. New York University,* No. 16-cv-6284 (KBF), at 14-16 (S.D.N.Y. July 31, 2018) (plan fiduciary cannot rely passively on information provided by an expert or co-fiduciary, but must determine whether reliance on the advice is reasonably justified and make its own independent decision).

[12] DOL Advisory Opinion 2002-08A (Aug. 20, 2002).

[13] ERISA § 412.

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