Investment Advisor vs. Investment Manager? No Contest (Really)

As a lawyer advising sponsors of employee benefit plans that are subject to the Employee Retirement Income Security Act (ERISA), I am often asked to help address questions of fiduciary governance. Over the years, I have learned that identifying plan decision-makers and assigning fiduciary responsibilities—which is the heart of good fiduciary governance—requires a robust understanding of both the culture of that organization and the people who drive it.

Put simply, in order for legal best practices to actually reduce liability, increase efficiency, and encourage (or at least not stifle) innovation, the fiduciary structure put in place has to work with the organization, not against it.

In connection with fiduciary governance, I am frequently asked whether it is better for a plan sponsor to hire a third-party fiduciary to advise on plan investment or to manage those investments directly. These two types of fiduciary relationships are often described using shorthand versions of statutory citations. A *3(21) fiduciary* is an investment advisor and *3(38) fiduciary* is an investment manager.

Below, I briefly outline the legal differences and similarities of these two approaches and discuss some additional considerations relevant to selecting an investment fiduciary for your company's retirement plan.

What the Numbers Mean

While it is common to label fiduciaries who provide advice as 3(21) fiduciaries and those whoexercise investment discretion as 3(38) fiduciaries, both types of fiduciaries are actually described insection 3(21) of ERISA. This section defines a fiduciary as *both*:

- a person who has or exercises discretionary authority over the assets or administration of the plan (that is, the actual decisionmakers); and
- a person who provides investment advice for a fee with respect to the assets of the plan (that is, people who are not decision-makers but who recommend investments to decisionmakers).

One important distinction between the two types of fiduciaries is that they do different things—one advises a plan decisionmaker, and the other *is* the plan decisionmaker.

Another distinction arises from the way ERISA apportions legal liability. ERISA permits a named fiduciary to appoint an investment manager (as defined in section 3(38) of ERISA) to manage plan assets. This investment manager must be a discretionary fiduciary who is also registered as an investment advisor, is a bank or insurance company, and who has acknowledged in writing that it is a fiduciary with respect to the plan.

The appointment of an investment manager is advantageous for the named fiduciary because it relieves them and the plan's trustee of fiduciary responsibilities for the investment of all assets that are under management of the investment manager, and for the manager's acts or omissions in doing so. However, as discussed below, knowing the differences does not end the analysis.

There Is No Right Answer

While the additional liability relief that comes along with the appointment of a named fiduciary can be important, the specific needs of the plan and the services that the fiduciary is expected to provide are critical to the selection decision. For instance, appointing a 3(38) investment manager won't be effective to relieve the appointing fiduciary of liability, unless the manager is actually given the power to manage the plan's assets.

Any person who provides advice to a plan but does not exercise investment discretion is a fiduciary by reason of providing investment advice but is *not* considered that plan's investment manager, regardless of how the parties decide to privately characterize their relationship). Status as an ERISA investment manager is functional. It is possible that certain activities such as monitoring of investment options and performance reporting may not be viewed as part of that fiduciary's power to manage assets and thus not viewed as investment manager responsibilities.

Additionally, while fiduciary advisors and discretionary investment managers have different roles, the standards of care and loyalty that are imposed by ERISA on the two types of fiduciaries are identical—and exacting. For instance, each type of fiduciary must act in accordance with ERISA's prudent expert standard and must avoid prohibited transactions.

And the plan sponsor that is appointing an investment manager or hiring a fiduciary advisor must monitor the fiduciary to ensure that the plan's needs continue to be met.

In my practice, I find that like any other fiduciary governance decision, deciding how to structure a plan's relationship with an outside fiduciary works best if informed by both legal and practical considerations. In selecting an outside fiduciary, the plan sponsor should understand the legal differences and similarities between 3(21) and 3(38) fiduciaries. But they must also consider the particular needs of the plan, its participants best interests, and the plan's existing fiduciary governance structure.