NEED HELP NAVIGATING INVESTMENT RESPONSIBILITIES?

Five Questions for Defined Contribution Plan Sponsors

SUMMARY

These days, plan sponsor resources are stretched thin — employees are expected to do more with less. Managing a defined contribution retirement plan — like a 401(k) or a 403(b) plan — is not typically a top priority despite the fact that a number of functions must be effectively managed for the plan to work well. And of course these demands are further complicated by ever-changing capital markets, regulatory complexity, and participant anxiety over how best to save for retirement.

The demands on plan sponsors are many, but they may be relieved to know that they don't have to go it alone when it comes to investment decisions for their retirement plans. The Employee Retirement Income Security Act (ERISA) identifies several types of fiduciaries to whom they may outsource some or all of their investment-related responsibilities. Identified by the sections of ERISA — 3(21) and 3(38) — that define them, these fiduciary roles provide different levels of support.

In this paper, we identify three approaches a plan sponsor may take for selecting and managing plan investments. Along the way, we outline five important questions to consider as they contemplate engaging a 3(21) or 3(38) fiduciary to manage their plans more effectively or outsource some of their fiduciary risk. Our hope is that plan sponsors, armed with this perspective, feel empowered to make educated choices for their plans and participants.

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At CAPTRUST, we believe that a well-constructed investment lineup with ongoing oversight is a critically important part of managing a defined contribution plan. Some plan sponsors may feel they have the knowledge and expertise to select and monitor plan investments on their own or with limited assistance from a fiduciary — and may be comfortable with the associated liability. Others, either uncomfortable making investment decisions or interested in outsourcing the work or liability, may be best served by hiring a 3(38) investment manager. Regardless of the approach, we welcome the opportunity to help plan sponsors discharge their duties with the care, skill, prudence, and diligence required under ERISA.

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Five Questions for Defined Contribution Plan Sponsors

INTRODUCTION

Defined contribution plan sponsors wear many hats. One of the most uncomfortable may be fiduciary responsibility over the selection of retirement plan investment options. While Employee Retirement Income Security Act of 1974 (ERISA) guidelines designate two different types of investment fiduciaries in sections 3(21) and 3(38), it is 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 face the same question: can I do this myself, or do I need help?

Plan sponsors similarly must decide whether they prefer to take a *do it myself*, *help me do it*, or *do it for me* investment approach. Plan sponsors can make this decision only after they understand the three common investment fiduciary roles. We suggest that once plan sponsors understand the roles, they consider five important questions to determine the level of investment fiduciary liability they wish to keep—or how much they choose to outsource. Once a plan sponsor identifies with one of these roles and answers these questions, the decision to retain or outsource investment fiduciary liability becomes easier—perhaps even obvious.

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ERISA's high standards as defined in 29 U.S.C. § 1104(a)(1)(B) require a fiduciary to manage a plan's investment menu 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."

This statement goes beyond the traditional "prudent person rule" applicable to 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 outsource them to a qualified investment professional. Before they do this, they should understand the differences between taking sole responsibility, sharing responsibility with a 3(21) investment advisor, and outsourcing to a 3(38) investment manager.

FIDUCIARY LABELS—TERMS TO REMEMBER

3(21) FIDUCIARY

Section 3(21) defines the broad duties of a plan fiduciary. For the purposes of investment selection, ERISA allows plan sponsors to complete the investment selection process on their own or hire an advisor 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.

3(38) INVESTMENT MANAGER

Section 3(38) of ERISA is the origin of the term 3(38) investment manager. A 3(38) investment manager is hired by a plan sponsor to make all plan investment decisions. Here, the plan sponsor's singular investment-related fiduciary responsibility is the selection and monitoring of the 3(38) investment manager.

The important distinction between the two types of fiduciaries is simply that they do different things—a 3(21) fiduciary advises a plan decision-maker, and a 3(38) fiduciary is the plan decision-maker—including those decisions surrounding investment selection and monitoring.

INVESTMENT FIDUCIARY ROLES

Some plan sponsors feel confident enough to perform investment fiduciary duties themselves. Others find that they need or want assistance from a qualified investment advisor, or conclude that their best approach is to hire an investment manager to select and manage the plan's investment menu on an ongoing basis.

The three common fiduciary roles for investment selection are described below. Each succeeding role requires less involvement from the plan sponsor and a greater responsibility by an objective, third-party investment professional:

1. DO IT MYSELF: Plan Sponsor Retains Sole Responsibility

In the *do it myself* role, the plan sponsor selects the investment menu without advice from any outside source. In doing so, the plan sponsor acts as the sole named investment fiduciary to the plan with full liability for investment option selection without an outside party to share the responsibility with.

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2. HELP ME DO IT:
3(21) Investment Advisor Provides Fiduciary Assistance

For 3(21) fiduciary assistance, plan sponsors hire a registered investment advisor (or RIA) to assist with plan decisions. An RIA's fiduciary assistance related to investments usually takes the form of independent analysis, plan-level reporting, and specialized investment analytical tools.

When an RIA serves as a 3(21) fiduciary to the plan, the plan sponsor is not fully relieved of fiduciary responsibility for the selection and monitoring of the plan's investment options.

The RIA is responsible for the analysis, tools, and advice it provides. The important distinction is that the RIA is not ultimately responsible for the actual decision to use them. In other words, if an investment option in the RIA's recommended menu is deemed inappropriate for the plan under ERISA, the plan sponsor still retains fiduciary liability. Under such a fiduciary arrangement, the RIA is simply joining the plan sponsor at the table in a fiduciary capacity.

3. DO IT FOR ME:
3(38) Investment Manager Relieves Certain Fiduciary Duties and Related Liability

In this role, a plan sponsor hires an RIA as an investment manager to select and monitor the plan's investment options on an ongoing basis. The investment manager accepts discretionary authority to manage, acquire, and replace or dispose of investment options over time. The investment manager acknowledges in writing that it is acting as a fiduciary with responsibility and accountability for the selection of the investment menu.

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.

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FIVE QUESTIONS FOR PLAN SPONSORS

The five questions listed in the following section are intended to draw attention to major considerations for plan sponsors regarding the level of investment responsibility (and associated liability) that makes sense for them. While the issues described are not the only ones to be considered, the questions are intended to provide a process of self-assessment for plan sponsors considering some level of fiduciary risk-sharing.

1. DO CONFLICTS OF INTEREST EXIST?

Regardless of the way plan sponsors select plan investments, they must first determine if conflicts of interest exist. Some of the most common include: proprietary fund restrictions, the existence of investment options that provide varying levels of compensation to the service provider or advisor, and the existence of varying levels of fee offsets for the plan.

Proprietary fund requirements, or any requirements to use a particular investment option, should be carefully considered. In particular, plan sponsors should be sure to understand any requirements to use target date funds, since they often function as a plan's qualified default investment alternative (QDIA) option. Proprietary stable value or capital preservation options are another area of consideration.

The interests of the investment advisor should be revenue-neutral. Consider that 12b-1 fees and sub-transfer agent (sub-TA) fees will, by

Are the plan and provider free of these conflicts of interest?

1. Requirement to use proprietary funds

   ☐ Yes ☐ No ☐ Not Sure

2. Investment options that provide varying levels of compensation to service provider or advisor

   ☐ Yes ☐ No ☐ Not Sure

3. Expense reimbursements

   ☐ Yes ☐ No ☐ Not Sure

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definition, vary by investment option. If these variances affect investment advisor compensation, a conflict of interest may exist. For example, if the investment professional is paid 25 bps (0.25%) on one investment option and 50 bps (0.50%) on another, there is no guarantee the investment professional will select the options based on merit rather than on compensation. Ensuring that advisor and provider fees are appropriate and documented in a contract is imperative.

Despite the inherent variation in 12b-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 or reimbursement. 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 or mitigation of such conflicts of interest.

2. HOW CONFIDENT ARE YOU WITH YOUR INVESTMENT KNOWLEDGE?

Some plan sponsors have the expertise to feel confident about selecting the investment options for their plan, while others may feel they do not have enough knowledge to do an adequate job. This issue naturally influences the decision to hire an outside provider. Those with more knowledge usually lean toward performing these duties themselves while those with less knowledge often feel more comfortable with a 3(21) or 3(38) fiduciary 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, save time, or both.

3. HOW INVOLVED DO YOU WANT TO BE IN THE INVESTMENT PROCESS?

The plan sponsor retains complete control over investment selection in the *do it myself* role. This approach, if done correctly, can be quite time consuming.

While a 3(21) fiduciary or *help me do it* arrangement involves significant assistance and reliance on expertise from an investment advisor, under 3(21) the plan sponsor still takes ultimate responsibility for the investment decisions. Sponsors who need help but wish to retain this control may be best served by a fiduciary arrangement.

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

4. WHAT LEVEL OF RISK ARE YOU COMFORTABLE ASSUMING?

Under either a *do it myself* or *help me do it* approach, the plan sponsor is responsible for all investment fiduciary decisions, process, documentation, 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) fiduciary arrangement brings another party to the fiduciary table, it does not relieve the plan sponsor of ultimate responsibility for appropriate investment selection.

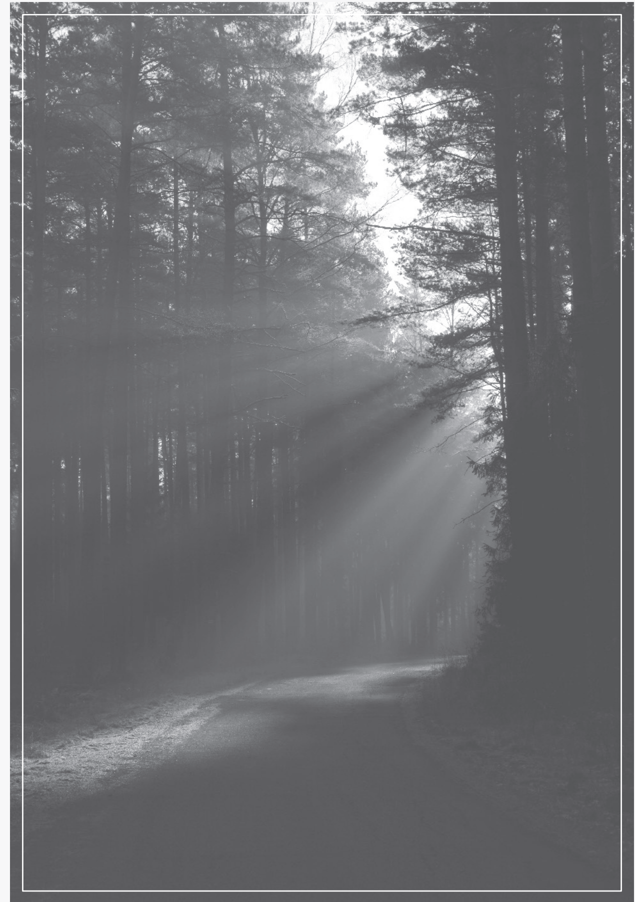
Under a properly structured *do it for me* arrangement, ERISA investment fiduciary responsibilities are transferred to the 3(38) investment manager. The

investment manager is responsible for investment selection 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 into a 3(38) arrangement and subsequently overrules 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 outsources all plan sponsor investment decisions to the investment manager. Trying to create a hybrid option, combining 3(38) and 3(21), effectively turns the relationship into a 3(21) arrangement.



5. HOW MUCH ARE YOU WILLING TO PAY FOR THESE SERVICES?

Plan sponsors ultimately need to determine how much they are willing to pay for the services rendered. 3(21) or 3(38) fiduciary assistance comes with a price. They should remember these services include not only those responsibilities 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 when moving from the *do it myself* to *do it for me* role, so do the potential benefits. Plan sponsors benefit from reduced time commitment, access to expert advice, and narrowing of liability. Participants benefit from the availability of investment options managed by professionals with the necessary financial acumen to evaluate and make investment decisions without conflict of interest.

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

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CONCLUSION

Plan sponsors must understand all of their fiduciary responsibilities, including those related to investments. ERISA 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 for non-compliance. 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 associated liability, a *do it myself* approach or a *help me do it* fiduciary approach as described in this paper may work. In either case, the plan sponsor is a fiduciary under ERISA section 3(21).

Plan sponsors who are either uncomfortable making investment decisions or who want to save time and outsource the associated risk may be best served by hiring a 3(38) investment manager—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 entirely eliminate the liability. There are still risks relative to the selection and oversight of the investment manager hired.

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, prudence, and diligence that would be exercised by a prudent person familiar with such matters. ■

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