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# Legal Considerations When Engaging an Investment Professional for an ERISA Pension Plan

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*This is the first in a series of articles about legal considerations under ERISA for pension plan fiduciaries in selecting and monitoring investment professionals to assist with the investment of plan assets.*

The prudent investment of plan assets is one of the most basic duties facing pension plan fiduciaries under the Employee Retirement Income Security Act. Under Section 404(a) of ERISA, fiduciaries must invest 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 a like enterprise of a like character and with like aims, and must diversify the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to.[1]

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The stakes for plan fiduciaries when investing plan assets are high. Large losses from investments could harm the ability of a defined benefit plan to meet its benefits obligations or drastically reduce employees' individual bookkeeping account balances in a defined contribution plan.

On a more personal note, ERISA makes fiduciaries personally liable to make good to the plan any losses resulting from their fiduciary breach.[2] Not only are fiduciaries so liable for their own breaches, but they may also be held liable for the breach of a co-fiduciary if they knowingly participated in the breach, enabled the breach, or knew about the breach and did not make reasonable efforts to remedy it.[3] In the investment context, this liability could be implicated by advocating that the plan make a specific investment or by merely voting to go along with another fiduciary's proposal.

## A. Limiting Investment Liability Under ERISA

To encourage prudent investment, ERISA sets forth a framework that allows plan fiduciaries to obtain some protection from potential liability by hiring investment professionals. However, the extent of that protection varies greatly depending on the legal status of the professional in respect of the plan. How the arrangement with the professional is negotiated and established makes the difference whether the professional shields the plan fiduciary from a fiduciary breach claim or merely stands beside her in court when such a claim is brought. The main distinction involves how much discretion is ceded to and accepted by the professional, which determines whether the professional is a mere non-discretionary fiduciary consultant or a liability-shielding ''named fiduciary'' or ''investment manager.''

**1. Non-Discretionary Fiduciary.** The non-discretionary fiduciary under ERISA is occasionally referred to as a plan's ''investment advisor'' or ''investment consultant.'' The consultant may be engaged to make recom-

[1] 29 U.S.C. § 1104(a).
[2] 29 U.S.C. § 1109.
[3] 29 U.S.C. § 1105(a).

mendations to the responsible plan fiduciaries with respect to the plan's asset allocation, the specific investments to be made, or the underlying investment managers to be engaged. In these circumstances, the plan fiduciaries remain responsible for making the ultimate decisions based on the consultant's recommendations.

The consultant is generally a fiduciary under ERISA—either expressly by agreement or functionally by operation of law—by its rendering investment advice to the plan for a fee.[4] Under the relevant regulations, fiduciary status will apply when the consultant provides investment recommendations or advice on property values on a regular basis pursuant to a mutual agreement, arrangement, or understanding with the plan that the advice will serve as a primary basis for plan investment decisions and that the advice will be individualized based on the particular needs of the plan.[5]

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Engaging this type of consultant can be beneficial to plan fiduciaries because it can be evidence that the fiduciaries acted prudently in ultimately deciding the underlying asset allocation, investment, or manager (i.e. by obtaining and relying on professional advice). However, because the plan fiduciaries maintain ultimate responsibility for the investment decision, the fiduciary remains susceptible against claims by participants or the U.S. Department of Labor (''Department'') concerning imprudent investments.

**2. Discretionary Fiduciary.** If the plan fiduciaries desire more protection from potential liability with respect to their investment duties, ERISA provides procedures for delegating responsibility to ''investment managers'' and ''named fiduciaries.'' In either case, the delegating fiduciaries are no longer responsible for the decisions delegated to the professional, and ERISA Section 405 insulates the fiduciaries from potential co-fiduciary liability in certain circumstances.

***a. Investment Manager.***

Section 3(38) of ERISA defines an ''investment manager'' as a fiduciary (other than a trustee or named fiduciary) who (1) has the power to manage, acquire, or dispose of any asset of the plan; (2) is a registered investment adviser under the Investment Advisers Act of 1940 or state law, a bank, or an insurance company, and (3) has acknowledged in writing that it is a fiduciary with respect to the plan.[6] An investment manager can be distinguished from a non-discretionary consultant by the fact that the investment manager takes responsibility for investing the plan's assets, as opposed to merely recommending how the plan fiduciary invests. In addition, while a non-discretionary consultant can become a fiduciary by operation of law, the investment manager must acknowledge fiduciary status in writing.

If the plan fiduciaries appoint an investment manager that meets this definition, ERISA Section 405(d) insulates the fiduciaries from liability for the acts or omissions of the investment manager, and provides that the fiduciaries are no longer obligated to invest the assets allocated to the manager.[7] While the fiduciaries remain liable to monitor the investment manager and the delegation of authority, this protection effectively absolves the fiduciaries from having to play an active role in the day-to-day management of the plan's underlying investments (i.e. what has been delegated to the investment manager).

***b. Named Fiduciary.***

Plan fiduciaries can obtain similar protection with respect to the act of selecting the investment managers to have discretion over all or a portion of the plan's assets. Section 402(a) of ERISA defines a ''named fiduciary'' as a fiduciary named in the plan instrument or appointed pursuant to a procedure specified in the plan.[8] Section 402(c)(3) of ERISA permits the plan to provide that a named fiduciary may appoint investment managers to manage any plan assets.[9]

Section 405(c) of ERISA permits fiduciaries to allocate this responsibility among named fiduciaries and, upon doing so, they are not liable for an act or omission of the named fiduciary in appointing the investment manager, so long as the allocation of authority itself was prudent.[10] In practice, this can occur when a plan engages a professional to serve as a ''named fiduciary'' in connection with its taking full discretion over hiring investment managers, whether through a direct arrangement with the plan or investment in a pooled ''fund of funds'' vehicle. The fiduciary protection under ERISA Section 405(c) makes distinguishing between non-discretionary investment consultants and discretionary ''named fiduciaries'' vital in this context, as often in practice the lines are blurred as to which service a professional is performing when the plan is engaging underlying investment managers.

## B. Engaging an Investment Professional

Regardless of which type of investment professional the plan fiduciaries seek to engage, the hiring itself (and any attendant discretion being allocated) must be prudent under the circumstances. In addition, the arrangement (including the compensation) must be reasonable for it to comply with ERISA Section 408(b)(2) to avoid prohibited transaction issues.[11]

**1. Market Survey.** In order to confirm that the prospective arrangement with the investment professional is prudent and reasonable, and that no more than rea-

[4] 29 U.S.C. § 1002(21)(A)(ii).
[5] 29 C.F.R. § 2510.3-21(c).
[6] 29 U.S.C. § 1002(38).
[7] 29 U.S.C. § 1105(d).
[8] 29 U.S.C. § 1102(a).
[9] 29 U.S.C. § 1102(c)(3).
[10] 29 U.S.C. § 1105(c).
[11] 29 U.S.C. § 1108(b)(2).

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sonable compensation will be paid, it is often necessary for plan fiduciaries to confirm that the terms are better than or consistent with what is offered in the marketplace. The extent to which plan fiduciaries need to send a request for proposals (''RFP'') to obtain this information depends on the circumstances.

***a. RFP Process.***

As noted in guidance published by the Department, hiring an investment professional is in and of itself a fiduciary function, and thus must be done in accordance with the standard of care under ERISA Section 404(a).[12] To ensure that the hire is prudent and in the sole interest of participants and beneficiaries, it is often necessary for the fiduciary to go through the RFP process to survey the marketplace for potential service providers and the terms they offer.

The Department notes that the RFP process should involve the plan sending the prospective service providers sufficient identical information so that a meaningful, side by side comparison can be made as to the prudence of entering into the engagement.[13] While the proposed fee to be charged by the investment professional is an important consideration, it is just one of the factors to be considered, and should not form the sole basis of the plan fiduciaries' decision.[14] This is reflected in the relevant Department regulations, which provide that ''reasonable compensation'' in this context ''depends on the particular facts and circumstances of each case.''[15] Thus, paying more for one investment professional than what a competing professional would have charged may nevertheless be appropriate if the quality or quantity of the services to be received justifies the higher fee.

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Additional information to request from investment professionals as part of the process may include, among other things, a review of the professional's experience in the particular area of investments under consideration and with other ERISA plans, the educational credentials and professional registrations of the key individuals who would act on behalf of the professional, past performance with investments of the type contemplated, and client references.

Plan fiduciaries should also request information about what terms the professional would or would not be amenable to in a prospective contract. For instance, the Department has opined that, before agreeing to a burdensome limitation on the service provider's liability or to indemnify the service provider, the fiduciaries should assess (either as part of the RFP or otherwise) whether the plan could obtain comparable services at comparable costs with no or less burdensome provisions of that sort.[16]

***b. Circumstances Where RFP May Not Be Needed.***

Although in most circumstances plan fiduciaries will want the comfort of undergoing the full RFP process, there are some situations when doing so is likely not necessary. For instance, an official from the Department recently told the ERISA Advisory Council that the Department might not insist on a full RFP in situations where the plan fiduciaries know the players in the market through past experience and due diligence.[17] Examples in which the plan fiduciaries may have obtained such experience are where the fiduciaries have become familiar with the professional through its work with another plan or have undergone a recent RFP process that searched the market for a professional of the type being sought. In these circumstances, a full RFP may not be needed and the plan fiduciary may be able to rely on this past experience and due diligence.

**2. Steps to Take Whenever an Investment Professional is Hired.** Regardless of whether the plan goes through a full RFP process when engaging an investment professional, there are certain steps the plan fiduciaries should always take. First, the plan's fiduciaries must receive and review the professional's 408(b)(2) fee disclosure prior to entering into an agreement.[18] This is true regardless of whether the professional will serve as a discretionary manager or named fiduciary or as a non-discretionary consultant. The regulations require that the disclosure contain certain information about the professional's status and compensation, including whether the professional reasonably expects to receive indirect compensation in connection with the engagement.[19] The plan fiduciary may then use the disclosed information to determine whether the terms of the proffered arrangement are reasonable under the circumstances.

Although it may seem intuitive, plan fiduciaries need to take into account the roles of the key parties when reviewing proposals and fee disclosures furnished by prospective investment professionals. The professional to be hired should be considered merely a salesperson, because the professional has not agreed to serve as a fiduciary at this point and the professional could nevertheless not use its position as a fiduciary to earn compensation from the plan (i.e. by getting hired) without raising issues under the ERISA prohibited transaction rules. Therefore, the plan fiduciaries must be able to conclude that hiring the professional is prudent, and that the potential terms (including the fees) are reasonable, independent of any opinions the prospective professional may give.

If the plan has previously engaged a non-discretionary investment consultant and is seeking to

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[12] *See Meeting Your Fiduciary Responsibilities*, United States Department of Labor, Employee Benefits Security Administration, http://www.dol.gov/ebsa/publications/fiduciaryresponsibility.html.

[13] *Id.*

[14] *Id.*

[15] 29 C.F.R. § 2550.408b-2(d); 29 C.F.R. § 2550.408c-2(b)(1).

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

[17] Forbes, Sean, *Request-for-Proposal Key for Fiduciaries, but not Always Necessary, DOL Official Says*, BNA Bloomberg Pension & Benefits Daily, August 20, 2014.

[18] *See* 29 C.F.R. § 2550.408b-2(c)(1).

[19] *Id.*

engage an investment manager, the plan fiduciaries should obtain investment opinions and recommendations from the consultant. Specifically, the consultant should review the 408(b)(2) fee disclosures of the prospective manager(s) and opine whether the proposed terms are reasonable from an investment perspective. However, unless the consultant has accepted ''named fiduciary'' status with respect to choosing investment managers, the plan fiduciaries need to be aware that they are making the final decision on the prospective investment manager and remain liable with the consultant as co-fiduciaries if the decision is imprudent.

Finally, no matter what process is used to engage an investment professional, it should be documented by the plan fiduciaries. Doing so, whether in minutes of meetings or otherwise, gives the plan fiduciaries an objective way to demonstrate that a prudent process was used in the event of a later challenge or regulatory audit. If an investment consultant provided a recommendation in connection with the plan fiduciary's decision, this recommendation should also be documented.

## C. Conclusion

It is important that the plan fiduciaries have a general idea of the types of investment-related professionals that could be engaged and the legal implications under ERISA of engaging each type. There are stark differences between the remaining duties and corresponding potential liability the fiduciaries face depending on the arrangement entered into with the professional, and such differences have a direct relationship with the extent the fiduciaries remain in control of the ultimate investment of plan assets.



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# INVESTMENT CONSULTANT VS INVESTMENT MANAGER

The stakes for plan fiduciaries when investing plan assets are high. The law sets forth a framework that allows plan fiduciaries to obtain some protection from potential liability by hiring investment professionals. There are various types of investment professionals, including investment consultants and investment managers. Let's take a look at what each type of investment professional brings to the table.

## Investment Consultant

### SERVICE

Recommends asset allocation, investments, and investment managers and monitors the foregoing.

### DISCRETION

No investment discretion.

### DECISION MAKER

No, plan fiduciary remains responsible for making the ultimate investment related decisions.

### QUOTED SAYING

"Here are three potential asset allocations. Based on the liquidity needs of your pension plan we recommend asset allocation #2."

### FIDUCIARY STATUS

Generally a fiduciary but left to the operation of law and for a court to decide. Best practice is to obtain written acknowledgement of fiduciary status.

### LIABILITY

Plan fiduciaries remain liable for all investment actions with the investment consultant having co-fiduciary liability.

## Investment Manager

### SERVICE

Invests plan assets.

### DISCRETION

Full investment discretion over the assets within its control.

### DECISION MAKER

Yes, has full decision making authority within the parameters of the authority delegated through the investment guidelines.

### QUOTED SAYING

"We sold XYZ stock because it reached its full valuation and purchased ABC stock because it is substantially undervalued."

### FIDUCIARY STATUS

A fiduciary and must acknowledge same in writing.

### LIABILITY

Plan fiduciaries are insulated from liability for the acts or omissions of the investment manager but remain responsible for the prudent delegation of authority and for monitoring the manager.

## THE TAKE HOME

Plan fiduciaries should understand the types of investment-related professionals available for hire and the legal consequences of engaging each type. Stark differences exist between the duties and liability that plan fiduciaries face depending on the arrangement entered into with the professional, and such differences have a direct relationship with the extent the plan fiduciaries remain in control of the ultimate investment of plan assets.

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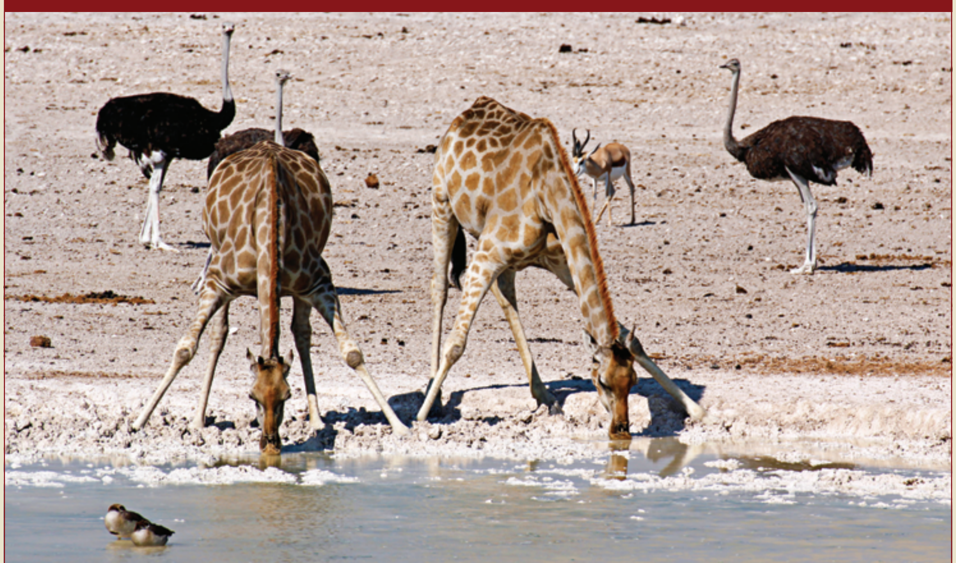
# What's the difference in fiduciary liability between hiring an investment manager versus an investment consultant?

An Investment Manager Stands in Front of You in Court



An Investment Consultant Stands Next to You...

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