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Legal Considerations When Engaging an Investment Professional for a Participant-Directed Defined Contribution Plan

BY JONATHAN M. CERRITO AND MICHAEL R. DAUM

This is the third 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.

Much has been made about the shift in the retirement landscape away from defined benefit pension plans and to defined contribution plans. With respect to such defined contribution plans, the Employee Retirement Income Security Act of 1974, as amended (''ERISA'') and regulations thereunder incentivize giving participants and beneficiaries control over the investment of their plan accounts by insulating plan fiduciaries from fiduciary liability with respect to exercises of that control. Therefore, it should come as no surprise that such participant-directed defined contribution plans continue to grow in number.

Jonathan M. Cerrito (jmcerrito@bklawyers.com) is a partner in Blitman & King LLP in New York, where he concentrates his practice on employee benefits and executive compensation matters, including the fiduciary aspects of investing plan assets and defending fiduciaries in investigations by the U.S. Department of Labor under Title I. Michael R. Daum (mrdaum@bklawyers.com) is an associate with Blitman & King LLP, Syracuse, New York, where he concentrates his work on various employment and employee benefits matters, including the fiduciary aspects of investing plan assets and investigations by the U.S. Department of Labor.

Responsible fiduciaries of these plans, such as the plan's board of trustees or investment committee, need to be aware that their duties with respect to the plan's investment lineup are not limited to ''set it and forget it.'' Instead, as recently confirmed by the U.S. Supreme Court in *Tibble v. Edison International*,[1] fiduciaries are required to satisfy their fiduciary duties under ERISA with respect to both the selection and monitoring of the lineup to ensure that it is and remains prudent.

In establishing and maintaining the plan's investment lineup, fiduciaries often engage a panoply of service providers, which may include an investment platform provider, a non-discretionary investment consultant or a discretionary investment manager. Doing so is often desirable to give the fiduciaries protection both with the overall prudence of the lineup and for compliance with the highly technical liability-reducing Section 404(c) of ERISA. However, the amount of fiduciary protection that these service providers give the plan fiduciaries can vary greatly depending on the technical status of the provider under ERISA and the structure of the arrangement. Therefore, the plan fiduciaries need to be aware of the legal status of the arrangement before entering into it and relying on the materials furnished by the provider that in all cases tend to seem like standard investment advice.

I. Investment Rules for Participant-Directed Plans

Subject to certain narrow exceptions,[2] Section 404(c) of ERISA provides fiduciaries with protection from some fiduciary liability where the plan is a defined con-

[1] 135 S.Ct. 1823, 59 EBC 2461 (U.S. 2015)(96 PBD, 5/19/15;

[2] These exceptions include situations where the participant's investment instructions are not in accordance with the documents and instruments governing the plan, would cause a fiduciary to maintain the indicia of ownership of any assets of the plan outside the jurisdiction of the district courts of the United States (except where permitted by Section 404(b) of ERISA), would jeopardize the plan's tax-qualified status, could result in a loss in excess of the participant's plan account balance, or would, absent certain circumstances, constitute a prohibited transaction. 29 C.F.R. § 2550.404c-1(d)(2)(ii).

tribution plan that permits participants and beneficiaries to exercise control over assets in their respective accounts.[3] If the plan is structured to comply with Section 404(c) and the regulations thereunder, which generally require giving participants the ability to choose from a broad range of investment alternatives to exercise control over the investment of their individual accounts, then (1) the participant will not be deemed to be a ''fiduciary'' under ERISA by reason of his or her exercise of control; and (2) no person who is otherwise a fiduciary (i.e. the trustees or investment committee) will be liable for any loss, or by reason of any breach, which results from such exercise of control.[4] In short, if the rules are complied with, the plan fiduciaries will not be responsible for the investment decisions of the plan participants.

More specifically, these rules require fiduciaries to construct the plan's investment lineup to offer a ''broad range of investment alternatives.'' Among other things, this requires that the participant have a reasonable opportunity to materially affect the potential investment return on his or her account and the degree of risk in the investments, choose from at least three investment alternatives with various characteristics set forth in the regulations,[5] and diversify the investments in his or her account.[6]

In addition, the plan must provide participants with sufficient information to make informed investment decisions with respect to the investment options offered by the plan.[7] This includes an explanation that the plan is intended to constitute a plan described in Section 404(c) of ERISA and the fiduciary consequences thereof, and the fee disclosures required under the U.S. Department of Labor's (''Department'') participant-level fee disclosure regulations.[8]

The protection afforded to plan fiduciaries by Section 404(c) of ERISAgenerally applies only where a participant has actually exercised independent control with respect to the investment of the assets in his or her account or with respect to similar rights appurtenant to the ownership in the investment fund (i.e. voting, tender, or similar rights).[9] There are also detailed rules that can extend the protection in the case of participants who fail to affirmatively direct their investment and are defaulted into an investment that qualifies under the Department's regulations as a ''qualified default investment alternative''[10] and in the case of a transfer of assets from an investment option formerly offered under the plan to its replacement.[11]

However, despite the fiduciary protection offered by Section 404(c) of ERISA, the rules explicitly do not serve to relieve a plan fiduciary from its duty to prudently select and monitor any service provider or investment option offered under the plan.[12] Plan fiduciaries are still required to fully comply with ERISA's fiduciary investment duties as it relates to choosing the investment options to be made available to participants, and for monitoring their continued appropriateness. As such, plan fiduciaries of participant directed plans not only need to be concerned with complying with the technical rules underlying Section 404(c) of ERISA but also the general fiduciary standards with respect to the plan's investment lineup.

II. Considerations When Engaging Investment Service Providers

In light of the potential costs associated with a breach of fiduciary duty under ERISA,[13] fiduciaries often look to assistance from service providers with respect to the plan's investment lineup. These service providers generally include some combination of investment platform providers/recordkeepers, investment consultants and investment managers. In taking purported advice or recommendations from these entities, the plan fiduciaries need to be aware of the role of the service providers under ERISA, as the fiduciary protection that applies to reliance on the advice or recommendations can vary greatly. This is important because the structure of the arrangement between the plan and the service provider could determine whether the provider stands beside or in front of the plan fiduciaries in a breach claim concerning the plan's investment options, or whether the service provider is insulated as not being a fiduciary of the plan at all.

A. Investment Platform Providers. The first type of service provider that can be engaged by plan fiduciaries is the investment platform provider. This service provider generally makes the investment lineup available to the plan and often performs other recordkeeping and administrative services. This entity often attempts to specifically disclaim any fiduciary liability with respect to its making the lineup of options available and to represent that it only performs ministerial, non-fiduciary functions with respect to recordkeeping and administration. Despite these fiduciary disclaimers, the provider may still present the fiduciaries of the plan with detailed information about potential investment options that could be offered that includes analysis and commentary about the options or a grade or score assigned by the provider (or its investment management affiliate) to each particular option.

If the plan's fiduciaries are challenged under ERISA for improper selection or maintenance of the plan's investment lineup, the fiduciaries will only be able to in-

[3] A ''defined contribution plan,'' or an ''individual account plan,'' is a pension plan that provides for an individual account for each participant and for benefits based solely upon the amount contributed to the participant's account, and any income, expenses, gains, and losses attributable thereto. 29 U.S.C. § 1002(34). The most common example of an individual account plan where participants can direct the investment of their accounts is a 401(k) plan, but this can also include certain other annuity funds.

[4] 29 U.S.C. § 1104(c)(1)(A); 29 C.F.R. § 2550.404c-1(b)(1).

[5] Under the regulations, the investment alternatives each must (1) be diversified and have materially different risk and return characteristics, (2) in the aggregate, enable the participant to achieve a portfolio with aggregate risk and return characteristics, and (3) when combined with investments in the plan's other investment alternatives, tend to minimize through diversification the overall risk of the participant's portfolio. 29 C.F.R. § 2550.404c-1(b)(3)(i)(B).

[6] 29 C.F.R. § 2550.404c-1(b)(3)(i).

[7] 29 C.F.R. § 2550.404c-1(b)(2)(i).

[8] *Id.*

[9] 29 C.F.R. § 2550.404c-1(c).

[10] 29 U.S.C. § 1104(c)(5); 29 C.F.R. § 2550.404c-5(b)-(c).

[11] 29 U.S.C. § 1104(c)(4)(A)-(C).

[12] 29 C.F.R. § 2550.404c-1(d)(2)(iv).

[13] ERISA makes plan fiduciaries personally liable to the plan to make good for any losses based on their fiduciary breaches. 29 U.S.C. § 1109.

volve the provider as a co-fiduciary under ERISA if its distribution of these materials and purported recommendations and analyses result in the provider being deemed a functional fiduciary under ERISA. Under current Department regulations, an entity will be providing fiduciary investment advice only if:

- the entity provides asset valuations or makes recommendations as to the advisability of investing in, selling or purchasing of assets or other property,
- the advice is provided on a regular basis,
- the advice is provided pursuant to a mutual agreement, arrangement or understanding with the plan or a fiduciary thereof,
- the advice will serve as a primary basis for investment decisions for plan assets, and
- the advice is individualized based on the particular needs of the plan.

[14]

In this context, and depending on the nature of the information furnished by the provider, the plan's fiduciaries may have arguments that the information meets the above criteria. However, the provider will likely argue that all such information, even to the extent it purports to recommend certain investment options over others (either directly or through a scoring system), is, among other things, not individualized based on the needs of the plan or provided pursuant to a mutual agreement, arrangement or understanding. The latter point may be especially pertinent to the extent the plan's agreement with the service provider indicates that any such information furnished is general and for education only, and is not to be relied on by the plan fiduciaries in making investment decisions.

Even though the service provider's actions and arrangement may not make it a fiduciary under ERISA with respect to the plan, the plan fiduciaries may still be able to point to any general investment materials furnished to and reviewed by them as part of a prudent decision-making process with respect to selecting and monitoring the plan's investment lineup. However, they should be aware of the nature of the service provider's relationship to the plan and understand that the provider may not be acting pursuant to ERISA's strict fiduciary duties and prohibited transaction rules against conflicts of interest and self-dealing. Further, in the event the plan fiduciaries' investment decisions are later challenged under ERISA, they may have no co-fiduciary recourse against the provider solely on the basis of those materials.

B. Non-Discretionary Investment Consultants. The second type of provider is the non-discretionary investment consultant. This provider generally acknowledges its status as a ''fiduciary'' under Section 3(21) of ERISA and agrees to provide the plan fiduciaries with recommendations as to the selection and maintenance of the investment lineup. In addition to an express acknowledgement of the consultant's status, the arrangement with the consultant should also be structured to make certain that the advice given meets the definition of fiduciary ''investment advice'' in the Department's regulations, as discussed above.

The consultant is generally asked to review and report on the plan's investment options and make recommendations regarding the potential addition, subtraction, or replacement of options from time to time and whether the fees charged by the respective investment options are reasonable. In addition, because of the importance to fiduciaries of structuring the lineup to comply with Section 404(c) of ERISA, the plan fiduciaries should consistently solicit opinions and assistance from the consultant as to whether the lineup is appropriately structured to obtain the maximum protection from that section, including with respect to its initial establishment, the plan's default investment options, and any changes to the lineup and transfers in connection therewith.

However, the plan fiduciaries need to be aware that in this type of arrangement they retain the final authority for the plan's investment decisions. The consultant is merely providing opinions and recommendations that the fiduciaries must accept or reject. While, unlike a non-fiduciary provider, the consultant can be subject to co-fiduciary liability under ERISA with respect to purported fiduciary breaches by the plan fiduciaries based on their following the consultant's advice and recommendations,[15] the consultant merely stands beside the plan fiduciaries in the action. The plan fiduciaries remain subject to that same co-fiduciary liability based on their ultimate discretion with respect to the acceptance of such advice and recommendations.

C. Discretionary Investment Managers. As an alternative, the plan fiduciaries can obtain even more protection under ERISA by engaging a service provider willing to serve as an ''investment manager'' under Section 3(38) of ERISA with respect to the plan's investment lineup. Under that section, an ''investment manager'' is a fiduciary (other than a trustee or named fiduciary) who:

- has the power to manage, acquire, or dispose of any asset of the plan;
- is a registered investment adviser under the Investment Advisers Act of 1940 or state law, a bank, or an insurance company, and
- has acknowledged in writing that it is a fiduciary with respect to the plan. [16]

Upon delegation of investment duties to an entity that qualifies as an ''investment manager'' under ERISA, the plan fiduciaries are not liable for the acts or omissions of the entity with respect to its management of the plan's assets.[17] In other words, the provider serves as a discretionary manager to whom authority is delegated to set and monitor the plan's lineup without further approval needed by the plan fiduciaries, and the fiduciaries get some protection from liability with respect to the investment manager's actions.

The plan's contract with the investment manager should clearly set forth the delegated duties with respect to the plan's investment lineup, including the establishment and monitoring functions. The plan fiduciaries may also want to require that the investment manager comply with Section 404(c) of ERISA with respect

[14] 29 C.F.R. § 2510.3-21(c)(1).

[15] 29 U.S.C. § 1105(a).
[16] 29 U.S.C. § 1002(38).
[17] 29 U.S.C. § 1105(d)(1).

to its establishment and maintenance of the investment lineup to provide added fiduciary protection both through the delegation to the investment manager and the insulation created by that ERISA section. In addition, because the plan fiduciaries remain responsible for monitoring the investment manager and the delegation of authority, they should require and review periodic reports concerning the manager's decisions and performance with respect to the plan's lineup.

III. Conclusion

Considering the potential liability that fiduciaries of ERISA plans face with respect to plan investments, it makes sense to structure a participant-directed defined contribution plan in accordance with Section 404(c) of ERISA. While doing so shifts some of the burden of investing the plan's assets onto the plan participants, the plan's fiduciaries nevertheless retain liability with respect to the selection and maintenance of the plan's investment lineup and the responsibility to comply with Section 404(c). As a result, plan fiduciaries often engage investment-related service providers to assist them in doing so. However, given that the legal status of the service provider under ERISA creates stark differences in the retained duties and liabilities of the plan fiduciaries, fiduciaries need to understand the provider's status and which scenario applies to their specific arrangement.

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