Concerning a Third-Party ERISA Section 3(38) Investment Manager

Retaining a third-party 3(38) that is not independent of a record-keeper can result in an inferior and conflicted process.

W. Scott Simon, 03/06/2014

W. Scott Simon is a principal at Prudent Investor Advisors, a registered investment advisory firm. He also provides services as a consultant and expert witness on fiduciary issues in litigation and arbitrations. Simon is the recipient of the 2012 Tamar Frankel Fiduciary of the Year Award.

Last month's column generated some blowback concerning my comments about third-party investment managers that are retained pursuant to section 3(38) of the Employee Retirement Income Security Act of 1974 (ERISA). I contended that such investment managers typically deliver services that are inferior in value and protection compared to independent (i.e., non-third party) 3(38) investment managers.

This month's column will delve into the contractual language drafted by a well-known third-party 3(38) to help underscore my contention. Analysis of that language shows how a plan sponsor deciding to retain this third-party 3(38), which is not independent of a record-keeper--instead of a 3(38) that has no dependence on any record-keeper--could subject the plan participants (and their beneficiaries) for which it has fiduciary responsibility to an inferior and conflicted process. Before engaging in that analysis, though, let's get back to some basics about ERISA section 3(38).

Fiduciary Status Pursuant to ERISA Section 3(38)

The text of ERISA section 3(38) reads, in part: "The term 'investment manager' means any fiduciary other than a trustee or a named fiduciary, as defined in [ERISA] § 402(a)(2)…(A) who has the power to manage, acquire, or dispose of any asset of the plan; (B) who (i) is registered as an investment adviser under the Investment Advisers Act of 1940; (ii) is... registered as an investment adviser under the laws of the State... in which it maintains its principal office and place of business...; (iii) is a bank, as defined in that Act; or (iv) is an insurance company

qualified to perform services...under the laws of more than one State; and (C) has acknowledged in writing that he is a fiduciary with respect to the plan."

ERISA states that a trustee, a named fiduciary, the plan administrator, an investment manager, or anyone else (as relevant) will be deemed to be a fiduciary of a qualified retirement plan to the extent that the person (1) exercises any discretionary authority or control in the management of the plan or disposition of the plan's assets (ERISA section 3(21)(A)(i)), (2) can or does render investment advice for a fee (section 3(21)(A)(ii)) or (3) has any discretionary authority or control in administering the plan (section 3(21)(A)(iii)).

The assessment of whether or not an entity that deals with a qualified retirement plan is to be deemed a fiduciary under ERISA requires such entity, in effect, to fit through at least one of the three preceding funnels contained in ERISA section 3(21)(A). This is also true even in cases where a particular ERISA statute actually specifies that an entity is a fiduciary. By relevant example, section 3(38) identifies an investment manager as a fiduciary. Nonetheless, an investment manager must first qualify as a fiduciary under ERISA section 3(21)(A)(i) by assuming duties concerning discretionary authority or control in the management of a plan or disposition of the plan's assets.

The Contract

A review of the contract drafted by a well-known third-party 3(38) investment manager between it and a plan sponsor reveals some germane issues that follow.

Suitability of the Guidelines

I have contended that the real value in retaining an investment manager pursuant to ERISA section 3(38) lies in having a truly independent firm make the same types of decisions that a well-informed plan sponsor would. That kind of 3(38) would, among other things, have unfettered access to all investment options and be free from constraining outside influences to select whatever options it deemed to be prudent.

The contract at hand reveals the existence of some subtle fetters that are likely to be missed by many plan sponsors. It states, in part, that a plan sponsor has determined that the plan's investment options will be subject to the investment guidelines, which consist primarily of a list of asset classes. To assist the plan

sponsor in determining the suitability of these guidelines, the third-party 3(38) has provided general information to the sponsor concerning typical plan demographics that may be appropriate for the guidelines. As a result, the plan sponsor acknowledges that it has reviewed the guidelines and that they are appropriate for the plan.

So instead of having unfettered access to all investment options in order to select whatever options it deems to be prudent, the third-party 3(38) is limited to only those asset classes listed in the attachment to the contract. Because the contract requires that the plan sponsor be solely responsible for the selection of the asset classes being offered to plan participants, the third-party 3(38) is not on the hook for selecting any imprudent asset classes. So if it turns out that an asset class heads south, the third-party 3(38) gets to legally deny any accountability for it, thereby limiting its fiduciary responsibility. In any event, the burden to determine the suitability/appropriateness of the investment guidelines (which, again, consist primarily of the asset classes) falls on the plan sponsor, not the third-party 3(38).

Another area where the third-party 3(38) limits its fiduciary responsibility in the contract--and a plan sponsor is therefore forced to retain it--involves the language in the investment guidelines. It notes, in part, that the asset classes are best suited for plans where participants have above-average investment experience and an above-average understanding of the risks involved with the various asset classes. But other than, say, an investment firm, what kind of entity fits such criteria? This language allows the third-party 3(38) a way to limit its fiduciary responsibility if anything goes wrong: "Hey, it's not our fault that things turned sour. We had to provide a fund in this asset class because the plan sponsor wanted the asset class." This kind of contractual language helps protect the third-party 3(38), but it's at the cost of reducing protection for a plan sponsor that would otherwise be available had a truly independent 3(38) been retained instead.

How Independent Is a Third-Party 3(38)?

The contract at hand is between a plan sponsor and the third-party 3(38) investment manager, but itself references a second contract between a plan sponsor and the record-keeper.

The contract at hand also appears to reference a third contract that is between the third-party 3(38) and the record-keeper. The plan sponsor/third-party 3(38) contract

states that the third-party 3(38) may provide consulting and other services to the plan's record-keeper with respect to various matters for which the third-party 3(38) receives compensation from the record-keeper. This compensation is presumably separate and apart from compensation that the third-party 3(38) would receive from a plan sponsor in exchange for performance of 3(38) services. The existence of this third contract would seem necessary in order to facilitate payment of compensation by the record-keeper to the third-party 3(38) in exchange for the 3(38) rendering non-3(38) services to the record-keeper.

The receipt by the third-party 3(38) of compensation from the record-keeper for rendering non-3(38) services to the record-keeper calls into question the very independence of the third-party 3(38) and raises doubts about whether the 3(38) is free from constraining outside influences. The subtlety of the language concerning this apparent conflict of interest raises no red flags that would indicate any independence issue; it is simply language buried in the middle of the contract. It's akin to the Wizard of Oz telling Dorothy and her merry band to pay no attention to that man behind the curtain.

Still, the language is there, and it's a good bet that the Easter Bunny didn't insert it. In fact, its presence signals that the third-party 3(38) can/will receive additional compensation from the record-keeper. Not only does that compensation appear to be conflicted, but it also illustrates the limitations of disclosures: The typical plan sponsor will not understand the subtlety of this (disclosure?) language. In any event, though, a sponsor will not know the nature or actual amount of the compensation received by the third-party 3(38) for non-3(38) services.

Some might say that receipt by the third-party 3(38) of compensation from the record-keeper for rendering non-3(38) services to the record-keeper is of no consequence, especially since apparently neither the plan sponsor nor the plan is paying the third-party 3(38) under the third contract. But payment of undisclosed revenue that may affect the motivations of a third-party 3(38) in providing plan investments is the business of a plan sponsor. The inability of the typical plan sponsor to ascertain and understand the nature of this revenue stream is troubling.

Many record-keepers that provide plan sponsors with third-party 3(38) investment managers follow a business model that offers up proprietary mutual funds and revenue-sharing. Plan sponsors should be alert to, and careful about, the opaque

nature of this model. During the Watergate scandal, Deep Throat purportedly told Woodward and Bernstein to "Follow the money." That's good advice for any plan sponsor, especially one considering the retention of a third-party 3(38). And if a third-party 3(38) doesn't understand the nuances of this model--especially the revenue needs of a record-keeper--it will soon see a decline in its business from the record-keeper.

Deep Pockets

The limitations of fiduciary responsibility that a third-party 3(38) places on itself are, as noted, real and significant. But perhaps the deep pockets of a third-party 3(38) would offer an advantage over an independent 3(38) investment manager such as a registered investment advisory firm in cases where lawsuits could arise. But the leading, well-known third-party purveyor of 3(38) investment manager services whose contract has been analyzed in this month's column limits its fiduciary responsibility in this area as well by contractually reducing its liability for damages.

There is a limitation of liability provision in the contract where the damages for which the third-party 3(38) is liable will be limited to two times the total annual fee paid to the 3(38) on behalf of the plan pursuant to the record-keeper's contract with the third-party 3(38).

To illustrate this provision, suppose that a plan sponsor has a retirement plan with $20 million in assets. Further suppose that a third-party 3(38) earns $10,000 per year for the 3(38) services it provides to the plan. According to the contract, this provides the $20 million plan with $20,000 worth of protection (i.e., damages limited to two times the $10,000 annual fee paid to the 3(38)). This presumes, of course, the plan sponsor can prove that the asset classes it selected were suitable/appropriate for the plan participants. Hopefully, the plan sponsor has detailed records of the process it followed in selecting plan asset classes and developing the investment guidelines provided to the third-party 3(38). ERISA litigation can be very expensive, sometimes running $100,000 or more for a simple case. A lawsuit involving a $20 million plan will generate a lot more costs than only $20,000--whether the plan sponsor wins or loses.

A prudent independent 3(38) investment manager, in contrast, would carry an insurance policy that has coverage limits in the millions of dollars. So much for the

deep pockets of this third-party 3(38) whose contract provides yet another instance whereby it limits its fiduciary liability at the expense of plan sponsors--with few sponsors even understanding what really happened.