

The need for an experienced intermediary

The following addresses the potential benefits of retaining a financial intermediary for retirement plans, specifically as an adviser to the plan sponsor or those designated by the plan sponsor, and legal issues and considerations related to the use of a financial intermediary.

The basic role of a financial intermediary

is to advise and otherwise assist the plan sponsor and plan fiduciaries in selecting and monitoring retirement plan investments and in obtaining the types of products and services necessary for the plan's operation. Key points in this regard are:

- Plan sponsor or plan fiduciaries may be required to seek qualified outside assistance to meet their legal obligations.
- Using a financial intermediary that works regularly with retirement plans can help decrease the risk to the plan sponsor or plan fiduciaries of liability for acting imprudently. An experienced financial intermediary should know what process to follow, the right questions to ask and how best to document the process.
- A plan sponsor or fiduciary is better protected from liability risk when it has sought, obtained and considered expert advice.
- The level of protection from liability risk depends in part on the role of the financial intermediary—whether it is retained as a non-fiduciary (least protection), a “3(21)” investment adviser (mid-range) or a “3(38)” investment manager (most protection). In all cases, plan sponsors and fiduciaries will retain certain responsibilities relating to oversight and retention of the intermediary.

Legal foundation—the ERISA Prudence Rule

The Employee Retirement Income Security Act of 1974, or ERISA, is a federal law that regulates privately-sponsored U.S. employee benefit plans (as opposed to governmental plans or foreign plans). ERISA-governed retirement plans—including defined benefit pension plans, profit-sharing plans, 401(k) plans and certain 403(b) plans—are subject to ERISA's fiduciary responsibility rules. Retirement plan sponsors or fiduciaries who violate these rules are subject to personal liability for the plan's resulting losses, as well as other liabilities and sanctions.

The persons responsible for the administration and investment management of a retirement plan are typically the plan sponsor or a committee designated by the plan sponsor (or, in some instances, individuals designated by the plan sponsor to serve as plan trustees). The ERISA fiduciary responsibility rules require such persons to act solely in the interest of the plan and its participants and beneficiaries, and “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man 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.” Some courts have labeled these fiduciary duties of loyalty and prudence under ERISA as the “highest known to the law.” Most relevant here is the prudence rule.

The ERISA “prudent man” rule has been interpreted by the U.S. Department of Labor (“DOL”) and the courts as imposing a responsibility to act in a procedurally proper manner, based on an objective standard. This requires plan fiduciaries to employ appropriate methods to independently investigate the merits of an investment decision (such as selecting plan investment options), act in a manner as would others who are familiar with such matters, and exercise independent judgment in making the decision. Under these interpretations, a fiduciary who follows proper procedures in making an investment decision should not be liable for violating the rule, even if the investment results in a loss to the plan. The standards against which a fiduciary's behavior is measured are those of the investment industry.

Thus, if a fiduciary fails to conduct any investigation whatsoever of, for example, whether there are lower-fee share classes available of the mutual funds used as plan investment options, the fiduciary has, according to this authority, breached its duty to act prudently. Even if the fiduciary has clearly considered the relevant factors, the fiduciary may still breach its prudence obligation if it fails to give those factors “appropriate consideration” in making its investment decision. This could occur, for example, if the fiduciary makes an illiquid investment for a plan that has short-term liquidity needs. Furthermore, a fiduciary's responsibilities do not end with the initial investment decision. The fiduciary has an ongoing responsibility to monitor the investment with reasonable diligence, and to consider terminating the investment if it is no longer appropriate for the plan.

Some have suggested that ERISA creates a “prudent expert” rule, thereby requiring that a fiduciary have at least a certain level of expertise regardless of the circumstances. Generally, the courts have rejected a strict “prudent expert” test in favor of a “flexible standard” that depends on the circumstances. Accordingly, the level of knowledge required on the part of the fiduciary varies with the nature of the plan, considering such factors as the size, character and aims of the particular plan. Within this framework, a fiduciary is judged according to the standard of others “acting in a like capacity and familiar with such matters,” i.e., prudent fiduciaries with experience dealing with a similar enterprise (such as a similarly-sized plan).

Under this standard, lack of familiarity with investments is no excuse for failing to act prudently. A fiduciary who commits pension plan assets to investments he or she does not fully understand will nonetheless be judged by comparison to others “acting in a like capacity and familiar with such matters.” The fiduciary is thus responsible for obtaining

sufficient information to understand a proposed investment, and for possessing the requisite expertise and knowledge to analyze the nature of any potential risks.

If the fiduciary does not have the expertise to appropriately analyze an investment in accordance with this standard, then, according to DOL guidance and several court decisions, the fiduciary has a duty to seek qualified outside assistance. However, the mere retention of an expert is not sufficient. The fiduciary cannot simply follow the advice as given, regardless of the qualifications of the adviser, but must make its own decision based on that advice, considering the advice as carefully as any other available information.

While a fiduciary thus may not be able to rely without question on the advice it receives, the fiduciary is better protected under the prudence standard where it has sought, obtained and considered expert advice.

Application to the role of financial intermediaries

Under the ERISA prudence framework, there can be several advantages to using the services of a financial intermediary, such as a broker-dealer or investment adviser representative, in connection with managing and operating an ERISA-governed retirement plan.

First, for a plan sponsor or plan fiduciary that has limited investment or retirement plan expertise, retaining a financial intermediary can be a way to access that type of expertise. Financial intermediaries often have extensive experience in working with retirement plans and assisting in the selection of plan investments, and may be able to offer sample fund lineups designed to meet different plan participant needs.

Second, even if the plan sponsor or plan fiduciary has expertise in these areas, it may not be familiar with the types of processes and procedures that are viewed as sufficient to meet the ERISA prudence standard or current industry practices in this regard (which have continually evolved over the past 40 years, based on DOL guidance and litigation as well as changes in the industry and financial markets). An experienced financial intermediary should know what process to follow and what questions to ask—both in making the initial investment decisions and developing an ongoing monitoring procedure—as well as how best to document that process (which can be important later in the event of threatened or actual litigation).

Third, in addition to helping make better decisions for the plan sponsor’s retirement plan, using the services of a financial intermediary may provide the plan sponsor or other plan fiduciary with protection from the risk of fiduciary liability under ERISA. Part of the protection comes from being in a better position to demonstrate having followed a prudent process in making investment decisions, for the reasons described above. This should follow from retaining an experienced financial intermediary as an adviser.

If the intermediary specifically acknowledges its role as making it a fiduciary under ERISA (not all will do so, although this is becoming more common), then there is additional protection, given that the intermediary would be held to ERISA fiduciary standards and could be sued for not meeting those standards. If the intermediary takes on the additional fiduciary role of not just advising as a so-called “3(21)” investment adviser but actually making the investment decisions as a so-called “3(38)” investment manager, then there is even further protection because the plan sponsor and plan fiduciary’s role is limited to the prudent selection of and oversight of the intermediary rather than responsibility for the individual investment decisions themselves. (For further explanation of the differences between the “3(21)” and “3(38)” roles, see Federated Investor’s “Comparative Chart of Fiduciary Roles for 401(k) Plan Investment Matters.”)

Additional considerations

While there can be many advantages to using the services of a financial intermediary, plan sponsors and fiduciaries should keep in mind they still have certain responsibilities under ERISA in connection with retaining and overseeing the intermediary.

According to DOL and most court decisions, the plan sponsor and plan fiduciary would have a responsibility to prudently select the intermediary. This involves due diligence on the intermediary’s qualifications to perform the role as an adviser or fiduciary to the plan, including education, past experience, checking regulatory filings for disciplinary history, obtaining and checking references, and evaluating the reasonableness of proposed fees (particularly if they are to be paid out of the assets of the plan). Some suggest that a diligence process, to meet ERISA standards, should

include going out to several different firms with a formal request for proposal (an “RFP”), although others take the view that whether an RFP or contacting multiple firms is appropriate depends on the particular circumstances.

In addition to diligence in the initial selection, the plan sponsor and plan fiduciary would be expected to employ a prudent process to oversee the intermediary on an ongoing basis. This includes monitoring the quality of the services, changes in key personnel, changes in disciplinary history and other factors relevant to the intermediary’s role. Failure to properly oversee the intermediary could result in liability in the event that the intermediary is not properly performing its services.

Important considerations in this process are fees and potential conflicts of interest. In advance of entering into a service agreement, service providers to retirement plans are required to provide extensive fee information—so-called “408(b)(2)” disclosures—describing the fees they would charge directly to the plan and any compensation they may receive from other sources in connection with the services arrangement, such as mutual fund 12b-1 fees or even gifts (above a certain threshold). In addition, service providers that rely on a DOL prohibited transaction exemption for investment advice fiduciaries (PTE 2020-02) are required to provide disclosures relating to services they provide and material conflicts of interests. It is important for plan sponsors and plan fiduciaries to obtain and review these disclosures to meet their fiduciary responsibilities and as part of their due diligence process.

The disclosures may suggest potential conflicts of interest. In fact, a DOL enforcement initiative involves a review of arrangements in which plan consultants receive fees or other benefits from investment managers or funds they recommend, because of conflict concerns. If the intermediary’s fee disclosures indicate receipt of such fees or benefits, it would be important to assess whether those are at a level that could affect the intermediary’s best judgment in recommending funds or in providing other services to the plan or whether they otherwise raise ERISA prohibited transaction issues. A potential conflict is not necessarily a complete disqualification so long as it has been disclosed, a prohibited transaction exemption is available (if necessary) and the plan sponsor and plan fiduciary can determine that the conflict will not have a material effect on the intermediary’s services.

Conclusion

In sum, subject to the additional considerations described above, using a financial intermediary has several benefits for plan sponsors and plan fiduciaries. The main advantage is to help protect the plan sponsors and fiduciaries from the risk of fiduciary liability under ERISA by providing access to investment and retirement plan expertise that should help them to make better decisions for the retirement plan and document their decision-making process. While there are no guarantees, simply being in a better position to demonstrate having followed a prudent process is beneficial in the event any of the decisions made with respect to the plan are later challenged.

ERISA and the responsibilities of a plan sponsor