Novel Coronavirus and Novel Opportunity for Fiduciary Review

*Michael J. Merriman**

There are so many titles floating around the retirement plan community that many plan sponsors have become numb to the differences and roles of their advisors. Clients of The Waterford Group utilize our services as an Employee Retirement Income Security Act of 1974 (ERISA) § 3(38) fiduciary, and there is a reason we believe there is an important distinction that needs to be reinforced. This is especially critical as we learn more about the circumstances and future of the novel coronavirus (COVID-19), and the result may be that we actually know less about the future. As such, it is a critical time for plan sponsors to understand the pressure that participant-directed accounts feel about the future, which in turn puts additional focus on the plan sponsor's actions. More fiduciary awareness on the plan sponsor's part is thus necessary, not only because we all need to do more for plan participants, but also there is a continuing trend of more fiduciary litigation against plan sponsors for high fees, poor performing investments, and other potential fiduciary issues.

To that end, this is the first of a two-part series outlining the importance of hiring an investment advisor, how to do so within the appropriate fiduciary process, and the benefits for both the plan sponsor and the participants. In this first article, the focus is on the plan sponsor, and how to avoid some common errors. The next installment will address the partnership with the participant, and how powerful the partnership between the plan sponsor and the investment advisor is in the overall success of the participant.

INVESTMENT MANAGER

A brief review of the definition of "investment manager" (IM) under ERISA § 3(38) is the appropriate place to begin. To that end:

> An investment manager is any fiduciary, other than a trustee or a named fiduciary, who has the power to manage, acquire, or dispose of any as set of a plan, and who is:
>
> (1) registered as an investment adviser under the Investment Advisers Act of 1940;
> (2) a bank, as defined in the Investment Advisers Act; or
> (3) an insurance company qualified to manage, acquire, or dispose of any asset of a plan under the laws of more than one state, and who has acknowledged in writing that he is a fiduciary of the plan.

Accordingly, the IM accepts full discretion and legal responsibility for the following investment areas of the plan, thus "standing in the shoes" of the plan sponsor for the following actions:

**MICHAEL J. MERRIMAN*, AIF®, CPFA® is the Managing Director of The Waterford Group in Rochester, NY. Mr. Merriman focuses on managing Waterford's retirement practice, and holds the Accredited Investment Fiduciary® designation, as well as the Certified Plan Fiduciary Advisor (CPFA®) credential. As Managing Director, he advises clients on company retirement plans and consults with owners and plan sponsors to deliver a "best in class" 401(k) plan. In 2019, he was named a Financial Times 401 Top Financial Adviser.

1. Asset class selections.
2. Investment policy structure.
3. Tactical asset allocation.
4. Funds' managers selection and replacement.
5. Implementation of the investments selected.

COMPARE: CONVENTIONAL INVESTMENT CONSULTANT AND 3(38) INVESTMENT MANAGER

The inherent danger for plan sponsors is believing that it has hired a 3(38) IM but rather hired "only" an investment consultant (IC). IMs can contractually assume legal liability for the investment decisions for the plan, whereas ICs just recommend investments that the plan sponsor implements. The term "implements" can be confusing, however because of the lack of a clear process. For example, ICs do not necessarily ask specifically if the plan committee votes in favor of the investment selection suggestion, an action that should take place. Rather there might be a discussion and a vote, with the plan fiduciaries not understanding that the vote was a required step in order to bring the investments into the plan. Committee members must understand that the IC does not have the discretion to make the investments on behalf of the plan sponsor; the plan thus retains the potential liability. Simply put, follow the discretion and it arrives at the party with fiduciary responsibility. To the contrary, the IM has investment discretion thus the fiduciary responsibility for selecting the investments, etc.

Further, understand that an IC is limited to recommendations, and then only in the following investment areas of the plan:

1. Time horizon (the length of time over which an investment is made or held before it is liquidated).
2. Risk/return profile of the portfolio.
3. Asset class selections.
4. Investment policy structure.
5. Tactical asset allocation.
6. Funds' managers selection and replacement.
7. Implementation of the investments selected.

Because they are just recommendations, the plan sponsor or its committee has final responsibility for all of these decisions, and has the freedom to accept or reject the IC's recommendations. Again, these rules need to be communicated to the committee, including to any new members as the roster changes over.

It is critical that the plan sponsor understand that a plan trustee that delegates investment and management duties to other parties who do not satisfy ERISA § 3(38)'s definition of "investment manager" is not shielded from liability for acts or omissions of those parties by ERISA § 405(d)(1). From this comes the first "must do" for plan sponsors at this time: plan sponsors must check and recheck that their purported "investment managers" still fulfill the statutory requirements. Because a 3(38) IM was hired does not necessarily mean that it is still a 3(38) IM! While a plan sponsor should have been notified of any such change, assuming that this is the case will not protect a plan from potential liability. It is not a common occurrence, but absolutely should not be ignored. Of course, when hiring a new group, it is not enough to see that the company represents it is an "investment manager," and the plan sponsor should not be shy in asking to see proof. In fact, it is safe to say that it is the sponsor's fiduciary duty to do so.

The Waterford Group serves as a 3(38) fiduciary and utilizes external and proprietary tools to create a best in class investment menu, which is exactly what the plan sponsor should require for any IM. This proven institutional approach to researching and evaluating investments should clearly be reflected in the Investment Policy Statement (IPS), which is too often overlooked. Keep in mind that in the event of a lawsuit or a Department of Labor (DOL) audit (which may be a thing of the past), the IPS is the first document requested and reviewed. It should be included that the investment manager utilizes qualitative and quantitative screening, which is an ERISA requirement.

A further step is that the contract with the independent fiduciary should specify its precise status. For example, if the independent fiduciary is the IM under ERISA § 3(38), the named fiduciaries may still have a statutory duty to monitor its performance. On the other hand, the parties may delegate named fiduciary responsibility to the independent fiduciary, pursuant to ERISA § 402(a). This is not a belt and suspenders issue, but a fiduciary issue that the contract contain the appropriate language to ensure the desired delegated duties are reflected in the reality of a legally enforceable agreement.

For responsible plan fiduciaries, a complex financial environment usually brings with it a barrage of investment opinions from external advisors. All too frequently we see responsible plan fiduciaries slip into over dependency on their ERISA § 3(21) and ERISA § 3(38) investment advisors. Without a formal system of internal controls, complacency can develop, and investment fiduciary risk grows. Fortunately, there are tangible steps plan sponsors can take to help keep them on a steady path, regardless of turbulent external factors.

ON THE HOOK

Despite how helpful hiring an IM under Section 3(38) is—and even more helpful if the plan sponsor understands the partnership—it does not mean that the plan sponsor can breathe a complete sigh of relief and go on its merry way. Rather, ERISA requires that the manager's actions be vigorously monitored, including and perhaps especially the investment recommendations.

Specifically, because the IM has responsibility for investment selection, the plan sponsor should not simply accept those choices and not worry about potential liability. Instead, the plan sponsor remains responsible for monitoring the investment selection process to ensure it is in the best interest of the plan and its participants. Perhaps more critical, based upon recent litigation trends, is ensuring the costs of the investments (as well as the advisor and all third-party administrators) are reasonable. Many of the over 20 colleges and universities that were sued under ERISA for maintaining costly funds were working with 3(38) fiduciaries . . . and that did not protect those institutions from multi-million dollar settlements in many cases. Plan sponsors must, therefore, adhere to a "best practice" process in order to ensure that the protection remains as broad as possible.

The significant difference from a practical (not fiduciary) standpoint is that IMs are experts in selecting investment menus for participant directed and defined benefit retirement plans. To the contrary, ICs may hold security licenses to sell mutual funds, but that is not the same as understanding diversification, selection, and the like, for qualified plans.

Why Should IMs Be Vigorously Supervised?

The DOL requires retirement plan sponsors to select and monitor service providers prudently. Prudence requires that each class of provider pass through a diligent screening process before being hired and be subject to a robust supervision process ongoing. The requirement of prudent monitoring is a safeguard against predatory vendor pricing and other practices that could potentially harm the interests of the plan participants. As the primary fiduciary, a plan sponsor is the party under ERISA legally responsible for acting in a role as steward of the plan participants. Therefore, diligent monitoring of the plan's service providers fits neatly under the umbrella of this function.

Supervising the IM

A plan sponsor must be aware of qualitative and quantitative factors in order to ensure it is meeting its fiduciary duty. The qualitative factors for a plan sponsor to determine if an IM is acting appropriately include whether the IM:

1. Utilizes a quality management system for monitoring investment selections and measuring ROI;
2. Provides online tools and/or other resources to assist the plan sponsor in its supervisory role;
3. Gives quality service compared with its competitors;
4. Provides the appropriate service for the hiring plan sponsor;
5. Develops investment strategies that are aligned with the level of education, expertise, etc. of the plan participants.

The quantitative factors for a plan sponsor to consider include its:

1. Investment performance of its selected investment. This includes analyzing a number of factors including but not limited to peer to peer benchmarking, deciding upon and benchmarking against appropriate measures, and ensuring adequate processes are in place to determine when an investment should be more closely watched and/or removed.
2. Fiduciary rating and ongoing education.
3. Costs compared with industry standards and in light of the services provided.

As witnessed by recent litigation, cost has clearly become the most important measure to potential plaintiffs (and their lawyers). Obviously it is important to benchmark not only to ensure the plan and/or the plan sponsor is spending wisely, but also to be able to defend against any breach of fiduciary claims.

CONCLUSION

Whether to hire an IM that meets the requirements of ERISA § 3(38) should not solely be based upon cost; it is just not that simple. There are many moving parts, including savings on the cost of funds, higher returns, lessening fiduciary responsibility of the plan sponsor, and treating the retirement plans as an area in the business where an outside content expert is necessary. As Part 2 will discuss, hiring an IM is in the best interest of the plan participants for a number of reasons.