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Fiduciary FAQs

What you need to know about selecting a 401(k) plan provider

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Like you, our goal is to minimize disruption as we work to understand the impact of the Department of Labor's fiduciary regulation.

We want to help separate the facts from the myths in this changing environment, so we've partnered with **Groom Law Group** to answer some frequently asked questions about the regulation.

This white paper dives into common questions we're hearing from advisors on the 900+ page regulation, including:

We're here to help you navigate the changes ahead. As we continue our analysis of the regulation, you'll receive updates from us and the experts we work with.

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Fiduciary FAQs
What you need to know about selecting a 401(k) plan provider

By Jason Lee and Steve Saxon, Groom Law Group

Providing advice is one of the ways a person may become a fiduciary under the Employee Retirement Income Security Act (ERISA) of 1974, as amended. Under a sweeping new regulation, the U.S. Department of Labor (DOL) has broadly redefined the meaning of providing investment advice under ERISA. This represents the largest change in the 40-year history of ERISA. As a result, financial advisors are more likely to become an ERISA fiduciary.

While the circumstances under which an advisor becomes a fiduciary have changed, many services which may be offered by advisors remain untouched.[1] Understandably, advisors want to know which situations will trigger the new fiduciary rules. Moreover, there are many myths regarding what recommendations an advisor must make in order to provide advice in the best interest of retirement plan clients and participants.

Many advisors want a better understanding of how ERISA applies when a plan sponsor, with the assistance of an advisor, selects a new 401(k) plan provider/recordkeeper. For example, does an advisor have to recommend the lowest cost provider or certain types of investment options? Below are frequently asked questions:

- Does a plan sponsor face a higher risk in selecting a plan recordkeeper that is not the lowest-cost recordkeeper?
- Does a plan sponsor face a higher risk in selecting investments managed by the plan recordkeeper's affiliates?
- Can advisors (if they choose) avoid providing investment advice that would make them an ERISA fiduciary while recommending that the plan sponsor change the plan's recordkeeper?
- Does ERISA favor passively managed investments, which typically have lower fees than actively managed investments?

We'll address these questions, but we'll start with background on the typical fiduciary governance structure for a 401(k) plan. We'll then talk about the circumstances under which an advisor will become an ERISA fiduciary followed by a brief overview of the DOL's new fiduciary regulation.

[1] Even if an advisor were to become a fiduciary by providing investment advice, the advisor should not be a fiduciary in performing non-fiduciary activities (such as providing non-investment advice). Fiduciary status is not "an all-or-nothing concept," such that a person is a fiduciary "only as to the activities which bring the person within the [fiduciary] definition." *Coleman v. Nationwide Life Ins. Co.*, 969 F.2d 54, 61 (4th Cir. 1992), *as amended* (July 17, 1992).

Fiduciary governance and what's changing with the new rule

Before we elaborate on the new DOL regulation and what it means, it's important to understand some foundational concepts of ERISA.

Q. What is a typical plan governance structure for a plan sponsor?

Every employee benefit plan must have one or more "named fiduciaries who jointly … have the authority to control and manage the operation and administration of the plan."[2]

A common plan governance arrangement is for a retirement plan to have two named fiduciaries, including:

- a fiduciary responsible for administering the plan (including the hiring of a plan recordkeeper)[3]; and
- a fiduciary responsible for investing the plan's assets (including the hiring of investment managers).

It's common for a named fiduciary—typically, the employer (plan sponsor) or a committee of employees of the plan sponsor—to work with an advisor in addressing plan investment duties and responsibilities. It's important to note that the selection of an advisor is a fiduciary act, along with monitoring him/her, as well as decisions to retain or terminate their services.

Q. Under what circumstances will an advisor be a fiduciary?

Whether an advisor is a fiduciary depends on whether he/she would meet ERISA's functional definition of a "fiduciary." A person is a fiduciary with respect to a retirement plan to the extent he/she:

- Exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets;
- Renders investment advice for a fee or other compensation, direct or indirect, with respect to any money or other property of such plan, or has any authority or responsibility to do so; or
- Has any discretionary authority or discretionary responsibility in the administration of such plan.[4]

For example, an advisor who recommends a service provider to provide plan recordkeeping services would be acting in relation to "the administration of [the] plan." But the advisor would likely not be viewed as acting as a fiduciary because the advisor does not have "discretion" (i.e., final authority) to select the service provider.[4] An advisor who recommends investments, however, would be a fiduciary if he/she is deemed to provide "investment advice for a fee or other compensation."[5]

[2] ERISA § 402(a)(1).

[3] This may be the plan's "administrator" as defined in section 3(16) of ERISA. Plan administrators have certain disclosure and reporting obligations under ERISA and may perform other plan administrative duties.

[4] ERISA §3(21)(A).

[5] See ERISA § 3(21)(A)(ii).

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Q. What is the DOL's "fiduciary" rule?

Over the years, the DOL has confessed great difficulty in establishing that an advisor acted as a fiduciary in providing investment advice. Under a regulation that the DOL itself issued in 1975, a person was not deemed to be providing investment advice as a fiduciary unless the advice was provided under a five-part test, which included whether the advice was provided under a mutual understanding that the recipient was using the advice as a primary basis for making an investment decision and certain other conditions were satisfied.[6] For example, in one case, a stockbroker who recommended "a few securities" and proposed that the plan trustees "purchase from th[e] select group [of securities]" was not viewed as a fiduciary because there was no "agreement for [the stockbroker] to provide individualized advice upon which the trustees would rely as a primary basis for the [p]lan's investment decisions." [7]

The DOL has now issued a new regulation redefining when a person would be deemed to be providing investment advice as a fiduciary.[8]

> This regulation makes it substantially easier for a person to be deemed to be providing investment advice as a fiduciary. In fact, merely suggesting that a plan participant consider an investment could make an advisor a fiduciary.[9]

In proposing the new regulation, the DOL had claimed that advisors were taking advantage of the alleged difficulty in establishing fiduciary status by recommending investments that maximize the advisors' compensation, but were not in the best interest of the plan or plan participants. In making this claim, the DOL asserted that advisors were recommending investments with excessive fees to plan participants.

While the DOL's new fiduciary regulation does not apply to non-investment advice, the regulation has led many advisors to seek more information on how ERISA fiduciary rules apply to a plan sponsor's selection of a new 401(k) plan provider/recordkeeper.

[6] Previous regulation at 29 C.F.R. § 2510.3-21(c)(1)(ii)(B).

[7] *Farm King Supply, Inc. Integrated Profit Sharing Plan & Trust v. Edward D. Jones & Co.*, 884 F.2d 288, 292-94 (7th Cir. 1989).

[8] 29 C.F.R. § 2510.3-21, as amended by the Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice ("Fiduciary Regulation"), 81 Fed. Reg. 20946 (Apr. 8, 2016).

[9] 29 C.F.R. § 2510.3-2(b)(1).

Impacts to 401(k) plan provider selection

In this section, we'll break down the risks for advisors and plan sponsors in selecting a plan provider/recordkeeper and investments.

Q. Do plan sponsors face a higher liability risk in selecting a plan provider/recordkeeper that is not the lowest-cost provider?

No. In selecting a plan recordkeeper, the plan sponsor (acting as a plan fiduciary) must consider all relevant factors and not just fees.

In selecting a plan service provider, plan fiduciaries should "engage in an objective process designed to elicit information necessary to assess the qualifications of the provider, the quality of services offered, and the reasonableness of the fees charged in light of the services provided."[10] "[T]he fiduciary need not select the lowest bidder . . . although the fiduciary must ensure that the compensation paid to a service provider is reasonable in light of the services provided to the plan."[11]

The DOL has identified key factors that plan fiduciaries should consider in selecting service providers to a plan, such as the:

- Needs of the plan and the particular services to be provided;
- Experience and/or past performance of similarly situated plans handled by the service provider, and the identity, experience, and qualifications of principal staff that will be handling the plan's account or assets;
- Direct and indirect fees charged for the services;
- Existence of any conflicts of interest; and
- Service provider's ability to provide information necessary for reporting purposes.[12]

Additionally, in times of significant regulatory changes, plan fiduciaries—and their advisors—should consider the capabilities of a service provider to assist and support them in fiduciary governance and compliance.

Importantly, in comparing multiple recordkeepers, the plan fiduciaries should consider recordkeeping fees together with investment expenses if a portion of the investment expenses will be used to pay for recordkeeping services.[13]

[10] DOL Field Assistance Bulletin 2007-01 (Feb. 2, 2007).

[11] DOL Information Letter to Diana Ceresi (Feb. 19, 1998).

[12] Getting It Right – Know Your Fiduciary Responsibilities: Tips for Selecting and Monitoring Service Providers for Your Employee Benefit Plan (http://www.dol.gov/ebsa/newsroom/fs052505.html); Meeting Your Fiduciary Responsibilities (http://www.dol.gov/ebsa/publications/fiduciaryresponsibility.html).

[13] The same principle would apply in selecting an investment. Selecting an investment fund with a higher expense ratio than another investment may make sense if a portion of the fees collected on the higher-expense investment (but not the lower-expense investment) can be used to offset recordkeeping expenses. Plan fiduciaries should be mindful of the overall plan fees.

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Q. Do plan sponsors face a higher risk in selecting investments managed by the plan recordkeeper's affiliates?

No. Plan sponsors are not precluded from selecting investments managed by the plan recordkeeper's affiliates. In fact, the DOL's new "fiduciary" regulation contemplates that plan fiduciaries may select investments managed by the plan recordkeeper's affiliates.[14]

In addition, courts have found that there is nothing inherently imprudent about a plan sponsor's decision to select investments managed by the plan recordkeeper's affiliates. Courts have concluded that:

- "bundling of investment management and recordkeeping services through a single provider" is a common and acceptable investment industry practice that "frequently works to the benefit of ERISA plans"[15]; and
- there is "no statute or regulation prohibiting a fiduciary from selecting investments from one management company" and that "many prudent investors limit themselves to investments offered by one company."[16]

Thus, it's unlikely that the selection by a plan fiduciary (who may be the plan sponsor or an investment fiduciary hired by the plan sponsor) of investments that are managed by affiliates of the plan's recordkeeper would constitute a fiduciary breach without the presence of other facts establishing imprudence or a conflict of interest.[17]

Q. Can advisors (if they choose) avoid providing investment advice that would make them ERISA fiduciaries while recommending that the plan sponsor change the plan's recordkeeper?

We believe so. An advisor should be able to recommend a plan provider/recordkeeper without becoming a fiduciary, even if the recordkeeping services are bundled with a platform of investment options available to the plan.

Assuming that a plan already exists,[18] selecting a plan service provider — such as a plan recordkeeper — is a fiduciary act.[19] However, an advisor who recommends a service provider for recordkeeping services is not a fiduciary. While the exercise of "discretionary authority or

[14] *See* Fiduciary Regulation, 81 Fed. Reg. 20946, 20973 (Apr. 8, 2016) (noting that it is common for a "platform" provider to have "financial or other relationships with the offered investment alternatives").

[15] *Tussey v. ABB, Inc.*, 746 F.3d 327, 336 (8th Cir. 2014).

[16] *Hecker v. Deere & Co.*, 556 F.3d 575, 586 (7th Cir. 2009).

[17] *See, e.g., In re Honda of America Mfg., Ing. ERISA Fees Litigation*, 661 F.Supp. 2d 861 (S.D. Ohio 2009) (concluding that plaintiffs failed to state a fiduciary breach claim by simply alleging that nine out of twenty-four plan investment options were mutual funds managed by affiliates of the plan's recordkeeper and directed trustee).

[18] If an advisor recommends that an employer adopt a new plan bundled with a recordkeeping arrangement, the advisor may not be acting as a fiduciary for the additional reason that, for there to be a plan fiduciary, there must first be a plan. *See Woodworker's Supply, Inc. v. Principal Mut. Life Ins. Co.*, 170 F.3d 985, 991 (10th Cir. 1999) ("[B]y definition, the insurance professional cannot act as a plan fiduciary before the plan exists. . . ."); *Coyne & Delany Co. v. Selman*, 98 F.3d 1457, 1471 (4th Cir. 1996) ("Defendants' malpractice, if any, occurred before the faulty plan went into effect and before defendants began to act as Plan Administrator and Plan Supervisor.").

[19] *See* DOL Field Assistance Bulletin 2002-3; Liss v. Smith, 991 F. Supp. 278, 300 (S.D.N.Y. 1998).

discretionary control respecting management of . . . [a] plan" makes a person a fiduciary,[20] the advisor cannot exercise "discretion" to cause the recordkeeping services to be purchased. Thus, courts have concluded that a person is not a fiduciary as to the hiring of a plan service provider unless the person exercised the "final authority" to hire the service provider.[21]

Courts have also concluded that a recordkeeper does not act as a fiduciary in limiting the universe of investments made available on an investment platform if another person has the final decision-making authority over the selection of plan investment options.[22] Even if an advisor is viewed as limiting the universe of investments made available to a plan by recommending that the plan engage a particular recordkeeper, it's unlikely that the advisor will be viewed as exercising discretion or control over management or disposition of plan assets to make the advisor a fiduciary.

> Although the new DOL "fiduciary" regulation makes it easier for a person to be deemed a fiduciary by providing investment advice, there is no reason that an advisor could not recommend a recordkeeper for plan administrative services without necessarily also recommending the investments made available on the recordkeeper's investment platform.[23]

The platform provider exception in the new regulation supports this view. The exception says that a person could avoid recommending investments made available on a recordkeeper's platform by disclosing that the person "is not undertaking to . . . give advice in a fiduciary capacity."[24] This exception is consistent with existing case law, which recognizes that a platform provider can clarify that it is not providing investment advice as to the selection of plan investment options from those made available on the platform.[25]

That said, regardless of whether an advisor would act as an ERISA fiduciary in recommending a plan recordkeeper, the advisor should consider the needs of his or her client. As a best practice, the advisor should consider the factors discussed above for the selection of plan service providers, including the capabilities of the recordkeeper and the reasonableness of fees.[26]

[20] *See* ERISA § 3(21)(A)(i).

[21] *See, e.g., Santomenno ex rel. John Hancock Trust v. John Hancock Life Ins. Co. (U.S.A)*, 768 F.3d 284, 293 (3d Cir. 2014) ("[A] service provider owes no fiduciary duty to a plan with respect to the terms of its service agreement if the plan trustee exercised final authority in deciding whether to accept or reject those terms.").

[22] *See, e.g., Hecker v. Deere & Co.*, 556 F.3d 575, 583 (7th Cir. 2009) ("Plaintiffs point to no authority that holds that limiting funds [made available on a recordkeeping platform] to [funds managed by] a sister company automatically creates discretionary control sufficient for fiduciary status."); *F.W. Webb Co. v. State St. Bank & Trust Co.*, 2010 WL 3219284, at *5 (S.D.N.Y. Aug. 12, 2010) (finding *Hecker* persuasive while noting that the degree of "control" that defendants could exercise is "inversely proportional" to the size of the universe of available funds).

[23] If an advisor provides investment advice in recommending a plan recordkeeper, the advisor will likely need exemptive relief from the prohibited transaction provisions of ERISA, and the related excise tax provisions under the Internal Revenue Code, if the advisor will receive compensation if the plan sponsor selects the recommended recordkeeper.

[24] 29 C.F.R. § 2510.3-21(b)(2)(i).

[25] For example, in a case brought against a platform provider, the court concluded that the platform provider did not provide investment advice as to the selection of plan investment options. *Zang & others similarly situated v. Paychex, Inc.*, 728 F. Supp. 2d 261, 274 (W.D.N.Y. 2010). The court noted that the contract between the platform provider and the plan sponsor stated that the platform provider "has not provided investment advice with regard to any such selections." *Id.* Similarly, in a case brought against another platform provider and affiliated companies, the court explained that "an ERISA provider does not have [an] . . . obligation to provide a service it specifically contracted not to provide." *F.W. Webb Co. v. State St. Bank & Trust Co.*, 2010 WL 3219284, at *10. Thus, the court recognized that a platform provider could avoid providing investment advice, although it could voluntarily provide investment advice and assume fiduciary status. *See id.*

[26] Regardless of whether an advisor acted as a fiduciary in recommending a plan recordkeeper, the recordkeeper may face potential excise tax liability under the Internal Revenue Code if the recordkeeping fees are determined to be excessive in light of the services provided. This is another reason that an advisor plays an important role in evaluating the reasonableness of fees.

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ERISA's take on active vs. passive investment management

Below, we explain why ERISA does not favor passively managed investments over actively managed investments.

Q. Does ERISA mandate any particular investment as necessarily prudent or imprudent?

No, ERISA requires plan fiduciaries to act prudently based on the particular facts and circumstances and does not mandate any type of investment as necessarily prudent or imprudent. In fact, Congress could not have intended to disfavor the use of actively managed investments in retirement plans because index investments were generally not yet in existence when Congress enacted ERISA.

ERISA requires plan fiduciaries to act in the sole interest of the plan's participants and to act as a prudent person would act under the same circumstances.[27] This prudent-person rule is based on trust law principles, which do not characterize any particular investment type as necessarily prudent or imprudent.[28] Notably, in issuing a new exemption (the Best Interest Contract Exemption) in connection with the new fiduciary advice regulation, the DOL explained that it has not specified "any particular investment product or category" as "illegal" or, per se "imprudent."

Q. Has the DOL ever taken a position that actively managed investments are necessarily less appropriate for a 401(k) plan than passively managed investments?

No. In fact, several official acts taken by the DOL show that it has remained neutral on the active versus passive management issue:

- The DOL opposed proposed legislation by Representative George Miller (D. CA) — the 401(k) Fair Disclosure for Retirement Security Act of 2007 — that would have required 401(k) plans to offer at least one index fund as an investment option.
- In the participant disclosure regulation, the DOL included a model disclosure chart that included both index and actively managed investments.[29]
- The DOL has opined that, "[w]hether a particular fund or investment alternative satisfies the [prudence] requirement[] … is an inherently factual question, and … [t]he appropriate plan fiduciaries must make this determination, based on all the facts and circumstances of the individual situation."
- The DOL's "QDIA" regulation allows a managed account option (which involves active management) to be used as a default investment.[30]
- The DOL's 2015 guidance on economically targeted investments provides that plan fiduciaries "need not treat commercially reasonable [economically targeted] investments," which typically are not broad market index based investments, "as inherently suspect or in need of special scrutiny."[31]

[27] ERISA § 404(a).

[28] *See* Restatement (Third) of Trusts, § 90 cmt. e(1) ("The prudent investor rule . . . does not classify specific investments or courses of action prudent or imprudent in the abstract.").

[29] 29 C.F.R. § 2550.404a-5.

[30] 29 C.F.R. § 2550.404c-5(e)(4)(iii).

[31] Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments, 80 Fed. Reg. 80 Fed. Reg. 65135, 65136-37 (Oct. 26, 2015).

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Q. Has a court ever ruled that actively managed investments are necessarily inappropriate for a 401(k) plan?

No. We are not aware of any such court decisions. In fact, plaintiffs have failed to prevail on the argument that the higher fees of actively managed investments necessarily make the investments inappropriate for use in 401(k) plans.[32]

The DOL's regulations provide that fees charged to a plan should be considered in light of the "particular facts and circumstances of each case." [33] And in the context of investments, plan fiduciaries "must consider, among other factors, the availability, riskiness, and *potential return* of alternative investments for his plan." [34] Indeed, the courts have held that plan fiduciaries should consider "performance net of fees" rather than mere fees.[35]

Q. Can plan fiduciaries reasonably conclude that a particular actively managed investment that they are selecting for the plan could be expected to outperform a comparable passively managed investment?

We believe so. While there may be an academic debate about the effectiveness of active management strategies, many plan fiduciaries believe that carefully selected actively managed investments could outperform comparable passively managed investments net of fees, especially in a down market. This is evidenced by most 401(k) plans including, actively managed investments.

Some active managers have outperformed comparable passive managed investments. Additionally some investment professionals believe that actively managed investments have an advantage in down markets as they have greater latitude in investment selection.

Importantly, many plan fiduciaries believe that plan participants should be provided with an opportunity to build an investment portfolio with both passively managed and actively managed investments. Although some commenters view that plan fiduciaries could reduce their monitoring responsibility (and associated risk) by offering only passively managed investments, many plan fiduciaries believe that plan participants would benefit from having the opportunity to seek to outperform the market through actively managed investments.

[32] *See Taylor v. United Techs. Corp.*, 2009 WL 535779, at *10 (D. Conn. Mar. 3, 2000).

[33] 29 C.F.R. § 408c-2(b)(1).

[34] DOL Advisory Opinion 85-36A (emphasis added).

[35] *See, e.g., Taylor v. United Techs. Corp.*, 2009 WL 535779, at *10 (noting that the "selection process [for actively managed mutual funds] included appropriate consideration of the fees charged on the mutual fund options, and of the returns of each mutual fund net of its management expenses"); *Laboy v. Bd. of Trustees of Bldg. Serv.*, 2012 WL 3191961, at *2 (S.D.N.Y. Aug. 7, 2012) ("[I]t is performance net of fees rather than mere fees that courts have used to find that a claim for breach of fiduciary duty had been stated.").

Q. Because actively managed investments could significantly underperform their benchmark indexes, plan fiduciaries would face a higher risk in offering actively managed investments than passively managed investments, right?

No. While it may be true that selecting and monitoring an actively managed investment would require more effort than selecting and monitoring a passively managed investment, plan fiduciaries who prudently select and monitor investments (whether active or passive) are not liable for the underperformance of the investments.

The prudence test under ERISA is whether the plan fiduciaries used a prudent process in reaching an investment decision.[36] "The focus of the inquiry is how the fiduciary acted in his/her selection of the investment, and not whether his/her investment succeeded or failed." [37] In other words, plan fiduciaries' "actions are not to be judged from the vantage point of hindsight." [38]

While plan fiduciaries who prudently select an investment would have a continuing duty to monitor the investment,[39] plan fiduciaries who satisfy their monitoring responsibility should not be liable if an actively managed investment fails to beat (on a net of fees basis) a comparable passively managed investment managed to the same benchmark. As noted above, "[t]he ultimate outcome of an investment is not proof of imprudence."[40]

Conclusion

ERISA's fiduciary duties have been described as the highest known to the law. By understanding their clients' fiduciary responsibilities, and understanding when they themselves would be considered fiduciaries, advisors can offer superior services in a changing regulatory environment.

[36] *Bussian v. RJR Nabisco Inc.*, 223 F.3d 286, 299 (5th Cir. 2000) ("ERISA's test of prudence is one of conduct, and not a test of performance of the investment."); *Jenkins v. Yager*, 444 F.3d 916, 926 (7th Cir. 2006) ("We have stated that investment losses are not proof that [a fiduciary] violated his duty of care.").

[37] *Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir. 1983).

[38] *Chao v. Merino*, 425 F.3d 174, 182 (2d Cir. 2006). *See also DiFelice v. U.S. Airways, Inc.*, 497 F.3d 410, 424 (4th Cir. 2007) ("First and foremost, whether a fiduciary's actions are prudent cannot be measured in hindsight . . . .").

[39] *Tibble v. Edison Int'l*, 135 S. Ct. 1823, 1828-29 (2015).

[40] *DeBruyne v. Equitable Life Assur. Soc. of the U.S.*, 920 F.2d 457, 465 (7th Cir. 1990).