3(21) versus 3(38) ERISA Investment Fiduciaries:

Decoding the Numbers

Introduction

What is the difference between a 3(21) and a 3(38) investment fiduciary? This question is being asked with increasing frequency, and the answer provides a host of planning opportunities for both the plan sponsor of a retirement plan and the producer providing investment services to the plan. Despite the popularity of the question, many remain confused about the differences between these important numbers.

Definitions

A 3(21) investment fiduciary is a paid professional who provides investment recommendations to the plan sponsor/trustee. The plan sponsor/trustee retains ultimate decision-making authority for the investments and may accept or reject the recommendations being made by the 3(21). Both share the fiduciary responsibility in this case, since one is making recommendations and the other is investing on the basis of those recommendations. By properly appointing and monitoring an authorized 3(38) investment manager, a plan sponsor/trustee is relieved of most fiduciary responsibility for the investment choices made by the 3(38). The 3(38) alone will direct the investment of the plan assets.

Analysis

Decoding 3(21) versus 3(38) fiduciaries starts with understanding the section numbers of the law itself. The Employee Retirement Income

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Security Act of 1974 ("ERISA") is the major law governing the operation of employee benefit plans. Section 3 of ERISA contains the definitions of terms used in the act. The twenty-first definition (ERISA Section 3(21)) defines a fiduciary as:

- anyone who makes decisions about managing the plan or its investments, such as selecting the investment choices for participants or hiring persons who provide services to the plan,
- anyone who makes decisions about administering the plan, such as determining eligibility of participants, providing benefits statements and ruling on benefits claims, or
- anyone who is paid to provide investment advice to a plan.

Typically, the plan sponsor/trustee makes all decisions relating to the first category, while the plan administrator makes decisions falling in the second category. An outside investment advisor would share in fiduciary responsibility thanks to the third category. To meet the third category's criteria, one must provide investment advice, which currently[1] includes recommendations to invest in, purchase or sell securities:

- On a regular basis to the plan.
- Pursuant to a mutual agreement, arrangement or understanding, written or otherwise.
- With the expectation that the services will serve as a primary basis for investment decisions.
- Individualized to the needs of the plan.
- For a fee.

The definitions under 3(21) connect plan sponsors (or trustees), administrators and investment advisory professionals through fiduciary duty for the plan, each being responsible for the functions they perform. Fiduciaries bear a high level of responsibility in their duties, some of which are to:

- Operate the plan only in the interest of participants and beneficiaries, for the sole purpose of providing benefits and paying plan expenses.
- Act "prudently", meaning in the manner a professional would perform under similar circumstances.
- Diversify the plan's investments in order to minimize the risk of large losses.
- Follow the terms of plan documents that govern the plan.
- Avoid conflicts of interests with the plan.

Anyone who is a fiduciary is a 3(21) fiduciary because that is simply the number of the section in ERISA that contains the overall definition. This includes the plan sponsor, trustee, plan administrator and investment fiduciary. While investment fiduciaries are paid service providers who give investment recommendations, they do not necessarily have discretionary authority to make the actual investment decisions. Instead, the 3(21) investment fiduciary typically provides

[1] DOL Reg. Section 2510.3-21(c). This definition will likely be changed in the near future, based upon proposals submitted by the DOL.

suggestions to the plan sponsor, who is free to accept or reject those recommendations, and who must then execute the investment decisions for the plan. The plan sponsor and the 3(21) investment fiduciary therefore share fiduciary responsibility, along with the plan administrator.

The thirty-eighth definition in the act (ERISA Section 3(38)) is the definition of investment manager. An investment manager is a special type of fiduciary who has been specifically appointed to have full discretionary authority and control over actual investment decisions. The manager may select, monitor, remove and replace the investment options offered under the plan. Only certain types of financial institutions may be appointed as a 3(38) investment manager. The 3(38) must be a registered investment adviser, bank or insurance company and must acknowledge its fiduciary status in writing. It is therefore important that service agreements be carefully drafted to provide for both the appointment of a 3(38) and for the acknowledgement of fiduciary status by the 3(38).

Once properly appointed, the 3(38) investment manager has full fiduciary responsibility for its investment decisions, subject to the terms of the plan documents and its investment policy statement. The plan sponsor and all other plan fiduciaries are relieved of all fiduciary responsibility for the investment decisions made by the investment manager. The plan sponsor must exercise proper due diligence in appointing the 3(38) manager and does have a continuing responsibility to monitor whether or not the investment manager is actually performing the services it is supposed to be providing but need not second guess the investment decisions made by the 3(38) fiduciary.

This shifting of fiduciary responsibility is the key distinction -- and core advantage -- of using a 3(38) investment manager. In the face of ever-increasing litigation and heightened regulatory scrutiny, many plan sponsors want this extra layer of protection, especially if they are not comfortable making the plan's investment decisions themselves.

In the next installment of our ERISA series, we will examine the division of accountability associated with three different models to deliver investments to retirement plans so that plan sponsors may better select whether they wish to work with a non-fiduciary registered representative, a 3(21) investment fiduciary or a 3(38) investment manager.

About The Author

Kimberly Shaw Elliott represents broker dealers, investment advisers, insurance companies and others nationwide, providing in-the-trenches counsel about how financial organizations deliver services and products to investors, including retirement plans, as well as general securities compliance and regulation. Her practical guidance helps clients successfully navigate the complex intersection of rules founded in ERISA/employee benefits, securities law, broker dealer regulation and tax, with a focus on fiduciary responsibility.

Kim is a three-time graduate of Washington University in St. Louis, having earned her JD, LLM, and executive MBA there. She holds the Fellow, Life Management Institute designation, is a member of the Compliance and Legal Division of the Securities Industry and Financial Markets Association, was named President Emeritus of the Association of Corporate Counsel (St. Louis), chaired the Employee Benefits Committee of the Missouri Bar, and is a frequent speaker and author about employee benefits and securities-related topics.

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