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A seismic shift: what regulatory reform means for your retirement plan business model

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Key takeaways

- As a result of pending regulatory changes, all brokers and advisors rendering investment advice are expected to be held to a fiduciary standard of care, regardless of the focus areas of each advisor's practice.
- In this environment, the ability of retirement plan advisors to differentiate their services could disappear.
- Before the regulations take effect, advisors have a unique opportunity to reposition their value proposition and market their services to plan sponsor clients and prospects, influential attorneys and accountants, and other advisors and brokers who do not wish to operate as fiduciaries.

Executive summary

Over the last decade, fiduciary services have become an increasingly important part of the value proposition for financial advisors specializing in retirement plan business. But rule changes proposed by the U.S. Department of Labor (DOL) may erode the key role that these services can play in differentiating a professional retirement plan advisor's practice. These rules may mean that all brokers and advisors rendering any form of advice to retirement plans, participants, former participants, or individual retirement accounts will be held to a fiduciary standard of care under the Employee Retirement Income Security Act (ERISA). A proposal by the Securities and Exchange Commission (SEC) could also result in a uniform fiduciary standard applying equally to brokers and advisors.

If these widely expected changes are adopted and everyone is potentially a fiduciary, will the retirement plan advisor's ability to differentiate suddenly disappear? Even if advisors believe that they will still be able to make the case for their services above those of competitors, they need to think about the next 10 years, make a plan, and act now.

The fact that no rules have changed so far makes this an opportune time for professional retirement plan advisors to talk about this issue with clients and prospects, as well as with other influential lawyers and accountants. Advisors have a unique opportunity to speak to the marketplace in advance of these changes and simultaneously reposition their value proposition for the next decade.

Many brokers and advisors who suddenly face both the responsibilities and potential liabilities of a fiduciary may not want to change their business models to meet the new requirements. In addition, advisors whose primary business is in wealth management may wish to consider whether they are willing to assume added liability if they retain a handful of retirement plan clients. Retirement plan specialists will have new opportunities to market their services to other advisors and brokers who do not want to operate as fiduciaries.

The broader goal of this paper is to help advisors make informed decisions about why they might choose to be a Limited-Scope 3(21) or 3(38) Fiduciary, and why they might not want to choose to be either a Full-Scope 3(21) or a 3(16) Fiduciary.

Confusion about the evolving regulatory environment

Regulators are changing the rules because plan sponsors, participants, and investors are confused about the types and roles of financial professionals, the service models in which each group operates, and the standard of care that applies to each. There are currently gaps between the perceptions of plan sponsors, participants, and investors, as well as misunderstanding about the realities that exist in the marketplace. The DOL and the SEC intend to close these gaps by creating certainty, and by instituting higher standards of care for brokers and consultants. Although implementing these rule changes is a top priority for both agencies, neither rule change was imminent at the time that this paper was updated in September 2015. The DOL issued a revised version of its proposed fiduciary rule in April 2015, triggering a subsequent public comment period and hearings. While the DOL considered whether to move forward with a final rule, the SEC continued to work on its own proposal.

> *"Advisors have a unique opportunity to speak to the marketplace and be heard now. But first they must clarify their value proposition!"*

Time to clarify your value proposition

The fact that no rules have changed to date makes this an opportune time for professional retirement plan advisors to start talking about this issue with their plan sponsor clients, prospects, lawyers, accountants, and other influential parties. When the rule changes eventually take effect, broker-dealers, registered investment advisors, and trust companies will crowd the stage to talk about this issue. Advisors have a unique opportunity to speak to the marketplace and be heard now. But first they must clarify their value proposition!

What are your choices?

To provide a framework for differentiating their value propositions, professional retirement plan advisors should consider the choices for positioning their practice over the next decade. Here's a look at the options under ERISA, which specifies many formal fiduciary roles by statute:

Fiduciary role	Section of ERISA
Plan Sponsor	3(16)(B)
Named Fiduciary	402(a)
Discretionary Trustee	403(a)
Directed Trustee	403(a)(1)
Administrator	3(16)(A)
Investment Manager	3(38)
Advising Fiduciary	3(21)(A)(ii)

From a practical standpoint, the spectrum of advisor fiduciary business model solutions currently available in the marketplace includes:

- Limited-Scope 3(21) Fiduciary—Advisors have been expanding the kinds of fiduciary roles they are willing to assume. Over the last decade, an increasing number of advisors have signed on as a Limited-Scope 3(21) Fiduciary, rendering investment advice for a fee. This was, and still is, a significant value proposition with plan sponsors and participants.
- 3(38) Discretionary Investment Manager—More recently, other advisors have stepped up the competition by taking on a 3(38) discretionary investment management role. Again, this represents a different, but very significant, value proposition with plan sponsors and participants.
- 3(16) Plan Administrator—In the past few years, some service providers have begun to consider the fiduciary roles of a 3(16) Plan Administrator.
- Full-Scope 3(21) Fiduciary—Similarly, some service providers, but very few advisors, have begun to consider the fiduciary role of a Full-Scope 3(21) Fiduciary, including all three levels of fiduciary services.
- Outsourcing to a third-party administrator operating in perhaps a dual 3(38) and 3(16) fiduciary capacity.

As to why an advisor might choose one role over another, it's important to understand that someone is a fiduciary to the extent that he or she:

- exercises discretionary authority or discretionary control over management of the plan or the disposition of its assets;
- renders investment advice for a fee with respect to plan assets; or
- has any discretionary authority or responsibility in the administration of the plan.

The determination of fiduciary status is based on the functions that an individual performs rather than that person's job title. For instance, in discretionary roles, the person (or group) must have discretionary authority or control over the management (primarily related to plan assets) or administration of the plan (primarily the operation of the plan). These management and administration responsibilities can frequently overlap.

Examining three fiduciary roles

Common option: Limited-Scope 3(21) Fiduciary

Under ERISA Section 3(21)(A)(ii), an advisor is appointed by a "named fiduciary" to render investment advice to the plan participants. The advice must be rendered in accordance with ERISA's fiduciary duties and solely in the interest of the plan participants and beneficiaries. The decision to act on this advice or not remains with the plan's "named fiduciary," or participant.

To date, most advisors have chosen to serve as a Limited-Scope 3(21) Fiduciary. Typically, advisors choose this path for several reasons, but primarily because plan sponsors do not want to give up control over plan investments. Also, many advisors already possess the knowledge, capabilities, and confidence to provide advisory services to plan sponsors, and, where it makes sense, to serve the participants themselves.

The plan sponsor decision-making process

Of course, plan sponsors will want to conduct proper due diligence to review and select a 3(21) advisor for their 401(k) savings plan. Some plan sponsors have gone to the extreme, setting up a full-scale request-for-proposal process to select a Limited-Scope 3(21) Fiduciary. Regardless of the approach taken, the plan sponsor should document the selection process and review the organization behind the advisor. If the advisor is independent, other areas to review include the individual's errors and omissions (E&O) insurance coverage and ERISA bonding. As a result, an advisor should create a written statement of his or her value proposition that includes all of this information.

"… an advisor should create a written statement of his or her value proposition …"

It is also advisable to include a clear discussion of the advisor's experience and qualifications. If the advisor is part of an advisor team, this exercise should speak to the experience, qualifications, and background of the other members as well as the team structure and the specific role of each member. Advisors will want to illustrate the quality and scope of services, and perhaps provide a preliminary proposal outlining the terms of the contract.

Determining a reasonable fee structure

There is an old adage that fees are only an issue in the absence of value. ERISA and new fee disclosure regulations that DOL adopted require that services must be necessary and fees must be reasonable. The reasonableness of fees is determined in light of services offered. In the end, the plan sponsor and the investment committee will need to document and demonstrate their understanding of the justification for the advisor's fee and service structure. So the advisor will want to provide fees and services in a format that supports the plan sponsor's due diligence file on the selection process.

A reasonable fee structure might consist of a flat fee, an asset-based fee, or some combination. Many advisors continue to charge asset-based fees but recognize that this approach may lead to unreasonable fees as assets grow. To mitigate this problem, many advisors now charge an asset-based fee with a flat dollar cap when the assets grow to a predetermined level.

Scope of services that a Limited-Scope 3(21) Fiduciary can get paid for

All 3(21) advisors should make it clear that their overall goal is to help the plan sponsor establish a prudent process for managing plan assets. To demonstrate value, however, it may be equally important for advisors to communicate to the sponsor the full breadth of services that they perform toward that goal, and the expertise they bring to the table to help avoid potential pitfalls. 3(21) advisors are likely to advise on menu construction, help establish a prudent selection process for the asset classes to be included, and identify candidates for the specific underlying funds. This process usually begins with the creation of an Investment Policy Statement (IPS). Displaying a sample draft IPS is one way to immediately demonstrate value. Advisors should also emphasize that they can provide expertise for prudent selection of all investment options, including target-date funds if they are to be part of the plan's investment menu. Many advisors also assist in the platform provider search process and serve as the ongoing relationship manager and troubleshooter.

Comparing ERISA roles and responsibilities

ERISA responsibility	3(21) Advising Fiduciary	3(38) Investment Manager
Duty of loyalty: Must act solely in the interest of plan participants, and for the exclusive purpose of providing benefits to participants and defraying reasonable expenses of the plan	■ Helps plan sponsor establish an oversight process for benchmarking investment fees and evaluating revenue-sharing arrangements **FYI:** Plan sponsors do not have to choose the least expensive options, but must ensure that fees are reasonable in light of services rendered.	Along with plan sponsors and other fiduciaries: ■ Develops an ongoing process for determining whether plan fees are reasonable ■ Documents the basis for all investment decisions **FYI:** Contracts, share classes, and revenue-sharing arrangements must be reasonable, the services must be necessary, and no more than reasonable fees may be paid for these services.
Duty of prudence: Must act with the care, skill, prudence, and diligence, under the circumstances then prevailing, that a prudent expert would use	■ Helps the plan sponsor choose the plan investment menu ■ Provides services to help make investment recommendations ■ Provides analytics for initial due diligence and for ongoing performance and portfolio reviews ■ Ensures that the plan sponsor and other fiduciaries act prudently when selecting, removing, and replacing investments ■ Final investment decisions are made solely by the plan sponsor and the investment committee	■ Chooses the plan investment menu ■ Provides services to evaluate and make investments ■ Provides proper analytics for initial due diligence and for ongoing performance and portfolio reviews ■ Acts prudently when selecting, removing, and replacing investments ■ Makes all investment-related decisions
Duty to diversify: Must diversify plan assets to minimize the risk of large losses unless it is clearly prudent not to do so	■ Ensures that the plan sponsor has selected a broad range of investment options allowing participants to properly diversify their accounts ■ Helps monitor investment options to prevent portfolio drift, overlaps, and duplication among holdings	■ Along with plan sponsors and other fiduciaries, selects a broad range of investment options, allowing participants to properly diversify their accounts

Duty to follow plan documents: Must follow the plan and other documents governing the plan to the extent consistent with ERISA	■ Uses the plan's Investment Policy Statement (IPS) to ensure that plan fiduciaries are fulfilling their obligations and duties under ERISA
	■ Refers to the IPS when the plan sponsor and other fiduciaries select, remove, or replace investments
	■ Helps the plan sponsor follow the IPS and other documents governing the plan to the extent consistent with ERISA
		Along with the plan sponsor:
		■ Consistently refers to the plan and trust
		■ Creates and maintains an IPS
		■ Refers to the IPS when making, selecting, removing, or replacing investments
		■ Reviews the IPS at least annually to ensure that:
		  ■ fiduciary actions are consistent with policies in the IPS;
		  ■ the IPS is up to date and reflects both the plan sponsor's intent and the current regulatory environment; and
		  ■ the IPS reflects the need to monitor fees to ensure they are reasonable.
		
		FYI: The IPS should be complete but not so detailed and restrictive as to cause unintended liability.

Duty to refrain from prohibited transactions: Must not engage in prohibited transactions, such as transactions with parties in interest, and self-dealing	■ Stays alert for any transaction that is not solely in the interest of participants or beneficiaries ■ Ensures that plan sponsors and other fiduciaries do not engage in prohibited transactions with related parties, as such transactions might not be arm's-length transactions ■ Avoids prohibited self-dealing	■ Avoids engaging in prohibited transactions with related parties ■ Avoids prohibited self-dealing

3(16) Plan Administrator
Normally, plan sponsors and other fiduciaries, rather than the 3(16) Plan Administrator: ▪ develop an ongoing process for determining whether plan fees are reasonable; and ▪ thoroughly document the basis for all investment decisions. **FYI:** Contracts must be reasonable, the services must be necessary, and no more than reasonable fees may be paid for these services. A plan sponsor may want to delegate these responsibilities to a 3(16) Plan Administrator.
▪ Does not normally have investment-related responsibilities **FYI:** Recently, however, some 3(16) Plan Administrators have been bundling investment management fiduciary services along with their administrative and operations services.
▪ Does not normally have investment-related responsibilities
▪ Reviews the plan, trust, and IPS to ensure that the administrative and operational processes align with the provisions of these documents ▪ Does not normally have investment-related responsibilities **FYI:** 3(16) Plan Administrators who bundle investment management fiduciary services along with administrative and operations services should ensure that their investment management fiduciary actions are consistent with the policies in the IPS.
▪ When responsibilities include the selection, evaluation, and monitoring of other plan service providers, the 3(16) Plan Administrator stays alert for any transaction that is not solely in the interest of participants or beneficiaries

3(21) advisors can also highlight that they will assist the plan sponsor in establishing the investment committee. Certainly, the quarterly investment review gives the advisor an ongoing role to advise and help run the committee. To further demonstrate value, many advisors create the minutes for the investment committee, and follow up by ensuring that the plan actually carries out any actions reflected in the minutes. Of course, the first order of business at the next meeting is to have the committee approve the minutes from the previous meeting.

Many 3(21) advisors emphasize the protection that their services provide to plan sponsors and other plan fiduciaries. Prudence is a matter of process, and it is the advisor's role to help the plan sponsor establish and maintain that process. But beyond the process itself, advisors can provide value by educating fiduciaries and providing fiduciary checklists. These services provide peace of mind for the plan sponsor and their fiduciaries, and help advisors demonstrate ongoing value to the plan sponsor's key decision makers.

Demonstrating the value of participant-level services

While these plan investment advisory services are critical, many advisors will want their value proposition to speak to the improved participant outcomes that result from the services they provide. A detailed description of their participant education process and sample materials may suffice, but the advisor might also include a description of the impact of participant investment advisory services. Statistical data on other plans that the advisor serves can bolster the case for the advisor's capabilities to improve participant outcomes.

Benchmarking fees

The role of the 3(21) advisor in analyzing service provider fees has become more important because recently adopted DOL fee disclosure rules create the risk of noncompliance. To limit such risk, an advisor can provide benchmarking services to ensure that fees are reasonable in light of services rendered. The advisor can also assist the plan sponsor in reviewing both the reasonableness of the fees charged and the quality of fee disclosure by service providers. The advisor can use established industry tools to produce detailed benchmarking reports and then review findings with plan sponsor clients. The advisor can also explain to the plan's fiduciaries that the most inexpensive option will not necessarily prove to be the best or the most prudent. In the end, prudence will demand a proper deliberation

process, a clear explanation of how the choices were made, and documentation of the proceedings.

A 3(21) Advising Fiduciary business model creates a significant value proposition and provides the advisor flexibility as to the scope of services offered. What's more, this model almost ensures that the advisor will continue to be paid well in an environment where margins are contracting for other service providers.

3(38) Discretionary Investment Manager

Another role that many professional retirement plan advisors have taken on in recent years is signing on as a 3(38) Discretionary Investment Manager. In this capacity, an advisor exercises discretionary authority and control of specific plan assets and has acknowledged in writing that he or she is a fiduciary with respect to the plan. Plan sponsors and their fiduciaries can limit liability by delegating responsibility of selecting, monitoring, and replacing investments to an advisor acting as a 3(38) Discretionary Investment Manager. However, the plan sponsor and other plan fiduciaries remain responsible for the due diligence, prudent selection, and ongoing monitoring of the 3(38) Discretionary Investment Manager. Plan sponsors always have a duty to monitor the 3(38) Discretionary Investment Manager and to remove and replace him or her when necessary.

Offering 3(38) Discretionary Investment Manager services is an excellent way for an advisor to differentiate versus the competition. But it's necessary to understand the complexities of this role before either the advisor or the plan sponsor can fully grasp the value of a 3(38) Discretionary Investment Manager in the context of a participant-directed 401(k) plan.

Practical reasons for becoming a 3(38) Discretionary Investment Manager

While 3(38) discretionary investment management services have been around since ERISA's inception, an increasing number of advisors are now marketing this service. Some claim 3(38) expertise as a way to differentiate themselves in the competitive environment for fiduciary services. The noise that this competition creates can make it difficult for a plan sponsor to identify a qualified 3(38) Discretionary Investment Manager. Plan sponsors will need to establish criteria for their own prudent selection process, taking into account the 3(38) advisor's qualifications and performance record. They may also conduct background due diligence, check references, and assess the advisor's business continuity and succession plan. Scrutiny may also extend to assessing the 3(38) advisor's investment expertise and approach to retirement plan investment management. How robust is the advisor's process for selecting funds?

Plan sponsors will also want to remain aware that their responsibility does not end with the appointment of a fiduciary. Whoever appoints a fiduciary is also a fiduciary, and remains responsible for monitoring that fiduciary. The appointing/monitoring fiduciary is subject to the "prudent man" rule for initial selection and ongoing monitoring, with contracts dictating the scope of services and responsibilities. A monitoring fiduciary is not liable for losses as long as selection and monitoring have been conducted prudently.

> *"If fiduciary risk management is a key objective, plan sponsors need to remain vigilant and not give way to complacency."*

What are the plan sponsor's objectives?

Some plan sponsors wish to give up control and unload as much fiduciary responsibility as possible, hoping to improve fiduciary risk management for the plan. If fiduciary risk management is a key objective, plan sponsors need to remain vigilant and not give way to complacency.

To make informed decisions about the plan investment management and the value of a 3(38) advisor, plan sponsors as well as advisors need to ask several questions. Among them:

- What does it mean to be a 3(38) advisor for a participant-directed 401(k) plan?
- Is the advisor selecting, monitoring, removing, and replacing investment options in the plan's core menu of funds?
- Is the advisor recommending and implementing an overall investment structure:
  - for the plan?
  - for the participant's managed account?
  - for structuring asset allocation models?
- What is the real value of these services?
- Will plan sponsors and their fiduciaries understand the value proposition?

Advisors should also ask themselves if providing 3(38) investment management services around just the core menu of funds is enough to get paid a premium fee. For example,

suppose the plan also offers a series of target-date funds and the bulk of the participants are invested in these default investment alternatives. That means that the plan fiduciaries are already protected under this provision from the Pension Protection Act. So how do the advisor and the plan sponsor quantify the added fiduciary protection from the advisor's 3(38) investment management services?

> *"Advisors should also ask themselves if providing 3(38) investment management services around just the core menu of funds is enough to get paid a premium fee."*

Other considerations: What is the advisor's track record for improved investment performance, and how does that translate into improved participant outcomes? What is the level of due diligence, and do the plan sponsor and the other plan fiduciaries have the expertise to prudently select and monitor an advisor acting as a 3(38) Discretionary Investment Manager? What is the value of these services over those offered by a sophisticated 3(21) Advising Fiduciary business model?

Other advisors are acting as 3(38) Discretionary Investment Managers either running participant-managed accounts or structuring asset allocation models for participants. The value proposition is improving participant outcomes. How do plan sponsors and other plan fiduciaries conduct their due diligence, selection, and ongoing monitoring process around these 3(38) investment management services? Do they have the necessary expertise, or do they need to hire a 3(21) Advising Fiduciary as the prudent expert to assist them?

Advisors seeking to offer 3(38) investment management services must be able to satisfy these inquiries. The written value proposition and supporting data and materials need to satisfy ERISA's prudent selection standard. The advisor will also need to put the plan's decision makers in a position where they will have sufficient information to make an informed and prudent decision. The advisor will also need to show how the plan sponsor will be able to perform his or her ongoing monitoring, removal, and replacement responsibilities once the decision to hire the advisor as a 3(38) Discretionary Investment Manager has been made.

3(16) Plan Administrator

There is yet a third fiduciary role under ERISA Section 3(16) for an individual who is a plan administrator. This individual assumes discretionary authority and responsibility for all of the daily operations of the plan, or agrees to take responsibility for only certain functions. ERISA does not require the plan administrator to be named or designated pursuant to a procedure specified in the plan document, and the plan sponsor can become the plan administrator by default. In the absence of any language identifying the plan administrator, the plan sponsor is presumed to be the administrator.

Several administrative firms and some investment firms have begun to offer packaged fiduciary services as part of their bundled offerings. Serving as a 3(16) Plan Administrator involves much more than recordkeeping or even the services offered by a third-party administrator. Few advisors, however, have chosen to be 3(16) fiduciaries. One reason may be that most litigation tends to focus on administrative failures. The technical knowledge and execution bar is too high for the advisor to overcome. Failure to execute would subject the advisor to open-ended fiduciary liability. For these reasons, it does not make sense for an advisor to consider this as a real option.

> *"Few advisors, however, have chosen to be 3(16) fiduciaries. One reason may be that most litigation tends to focus on administrative failures."*

Value-added option: plan management

Several providers now offer services as a fiduciary under ERISA 3(16). A plan administrator's plan management and administrative responsibilities might include the selection, evaluation, and monitoring of other plan service providers. These include trustee(s), unbundled or bundled services, investments offered under the plan, investment advisor to the plan, fiduciaries, or participants.

When ERISA 3(16) Plan Administrators wear more than one fiduciary hat, does this present conflicts of interest? For example, when a firm offers a recordkeeping platform and also takes on a 3(16) Plan Administrator role, how can the firm independently monitor and evaluate its own bundled services? Can these conflicts be resolved? This is crucial when the 3(16) Plan Administrator takes on investment management responsibilities such as the selection and evaluation of plan investments.

Another option: plan operation

When hiring a fiduciary plan administrator, plan sponsors are effectively outsourcing roles that are considered hands-on responsibilities to other parties: overseeing selection and monitoring of service providers, making participant disclosures, and handling regulatory filings. An ERISA 3(16) Plan Administrator's plan operational responsibilities generally include interpreting the plan document and executing reporting and disclosure in a timely and accurate manner. These latter responsibilities include:

- Form 5500;
- distribution of summary plan description/summary of material modifications;
- participant fee disclosure;
- benefit statements;
- qualified default investment alternative notices; and
- other required participant disclosures.

These 3(16) Plan Administrators might also take on other operational responsibilities, including managing the process and procedures for distributions, qualified domestic relations orders, and loans. Additional tasks include evaluating plan fees and disclosing fees charged by service providers.

The growth of packaged fiduciary services offered by firms raises the question: Are firms offering these services as part of their bundled offerings, diluting the value proposition of investment advisors who are offering some of the same services? For instance, are these firms pricing their fiduciary services well below market?

The growing importance of process

The outcomes of recent court cases (see the next page, "Recent court decisions can inform your advisory process") make it clear that plan sponsors and their fiduciary advisors must develop a much tighter fiduciary process. This includes monitoring for fees and revenue-sharing arrangements in the following areas:

- Fiduciaries must prudently select, monitor, and remove and replace investment options.
- Fiduciaries must follow the plan's IPS.
- Fiduciaries must monitor plan fees.
- Plan assets cannot be used to subsidize other plans.

These cases also reveal the critical importance of the consultant's/advisor's role and illustrate the importance of the IPS as the plan's governing document. The cases also speak clearly to the need for plan sponsors to formalize their due diligence, evaluation, and selection process. Proper documentation of the consultant's/advisor's specific recommendations to the investment committee is an essential part of this process as well.

It is important to be aware that ERISA prescribes specific monetary penalties, in addition to a breach of fiduciary duty, for a 3(16) Plan Administrator who fails to fulfill these administrative obligations.

A plan fiduciary must ensure that plan sponsor clients own and operate a prudent selection process. ERISA demands that the plan's investment committee must exercise the "care, skill, prudence, and diligence under the circumstances" that a prudent expert would use in selecting funds.

The advisor's specific recommendations to the investment committee regarding the funds should include the scope of the review, whether retail and institutional share classes were considered, and what questions/steps the investment committee should pursue to further evaluate these recommendations.

In the end, plan fiduciaries should strive to document the central ingredients that went into the deliberation process:

- What was the due diligence process?
- What factors were considered?
- What are the expense ratios of the investment funds?
- What asset classes were included and why?
- What share classes were considered?
- Was revenue sharing just a factor, or was it the driver of the decision to choose a particular fund?
- How do new asset classes compare with the plan's existing investment menu?
- What was the universe of investment companies considered?
- Why were particular investment funds chosen over others offered in the marketplace?

Fiduciary risk management

The problem: Most plan sponsors lack the time and inclination to manage a tight fiduciary process. The result is a haphazard approach to investment selection, ongoing management, and oversight. This presents a dual risk of litigation from disgruntled participants and enforcement from the DOL.

Recent court decisions can inform your advisory process

The federal courts have recently decided two cases that focus on the failure of plan sponsors and their fiduciaries to demonstrate a prudent process when making investment decisions. These cases, *Tibble v. Edison International* and *Tussey v. ABB, Inc.*, can inform your own process for advising plan sponsors. They also provide a painful lesson of the consequences of inattention to fiduciary obligations and the value that a prudent advisor can offer by avoiding such outcomes.

In the *Tibble* case, a federal appeals court found that the plan sponsor and other fiduciaries had imprudently selected more expensive retail mutual fund share classes for certain funds over available less expensive institutional share classes of the same funds. The court found that the institutional funds offered lower fees "with no salient differences in investment quality or management …"

The court observed that "this might have been a different case" had plan fiduciaries shown that their consultant/advisor "engaged in a prudent process" by presenting evidence of the consultant's/advisor's recommendations to the investment committee. The evidence showed that an experienced investor would have reviewed all available share classes and the relative costs of each when selecting a mutual fund.

However, the court did not hold that the use of retail mutual funds was categorically imprudent. The court recognized that such funds offer benefits over their institutional funds, and that fiduciaries are not required to simply offer only institutional funds.

Nevertheless, a federal district court found no evidence that Edison and its fiduciaries properly considered the possibility of institutional classes for the funds selected. The court called this "a startling fact considering that supposedly the 'expense ratio' was a core investment criterion." In a subsequent May 2015 ruling, the U.S. Supreme Court unanimously ruled that plan fiduciaries have an ongoing duty to review investments in retirement plans and to remove imprudent ones.

In *Tussey v. ABB, Inc.*, a federal district court judge ordered ABB, Inc. and other defendants to pay a combined $36.9 million in damages for:

- failure to follow the plan's Investment Policy Statement (IPS);
- failure to monitor recordkeeping costs and revenue sharing;
- failure to negotiate rebates for the plans;
- failure to prudently deliberate prior to removing and replacing investments;
- selection of expensive share classes when less expensive classes were available; and
- use of plan revenue sharing to subsidize other corporate services.

The importance of the IPS

The ABB plan's IPS specifically required that recordkeeping reimbursements from plan investments would offset or reduce plan administrative service costs. Instead, all revenue sharing was paid directly to the service provider.

The court found that the plan sponsor and its fiduciaries acted imprudently by failing to follow specific IPS criteria for selection and removal of funds. These include:

- replacing an existing investment fund with a target-date fund;
- selecting and retaining more costly classes of investments when other less expensive classes of the same investments were available; and
- after removing another fund from the plans, choosing replacement funds with share classes that provided more revenue sharing to avoid paying per-month participant charges.

The court found that ABB's fiduciaries had also ignored an outside consultant's/advisor's evaluation report on the service provider's fee structure. The report clearly showed that ABB was overpaying for recordkeeping services. Revenue sharing from the 401(k) plan appeared to be subsidizing other corporate services provided to ABB by the service provider. This was a clear violation of ERISA's requirement to act solely in the interests of plan participants.

The solution: Advisors acting as either 3(21) or 3(38) fiduciaries can create a strong value proposition by helping the plan sponsors establish and maintain a disciplined fiduciary risk management process.

Prudence is a matter of process

Plan sponsors and their fiduciaries need to establish and maintain a prudent process around all plan decisions. They should conduct an annual review of all fiduciary appointments to ensure that those who serve as fiduciaries continue to be prudent choices. Plan sponsors need to conduct at least annual training for fiduciaries who serve on the investment committee. There should be an annual review of the written investment policy to ensure that it is current with the plan's goals and objectives as well as the legal and regulatory environment. The investment committee should review the quarterly investment performance of the plan's menu options. The IPS should stipulate periodic investment committee meetings. If the IPS were to

require quarterly meetings, there could easily be gaps of time when no meetings were held, resulting in a violation of the IPS.

Perhaps the most important part of a prudent process is documentation. A proper document trail provides a path for plan fiduciaries to substantiate their actions and decisions. A key ingredient is the minutes for the committee meetings. Advisors often assume responsibility for keeping the minutes, and they need to ensure that the committee always ratifies the minutes.

It is clear that fiduciary positioning is an important differentiator in the competition for developing plan sponsor relationships. It is equally clear that it is a significant value proposition and can lead to a sustained long-term relationship with the plan sponsor and the investment committee members. Advisors will want to target market segments with tailored approaches to offering these services.

Fiduciary liability insurance: a critical consideration

Plans—Around three-quarters of small plans and many midsize plans lack proper fiduciary insurance, even though primary insurance for plans in this size range is relatively inexpensive.

Advisors—Most advisors lack what is referred to as affirmative fiduciary coverage in their existing errors and omissions (E&O) policies. In other words, fiduciary coverage needs to be specifically stated in the E&O policy or in a special rider to that policy.

Broker-dealers—Many broker-dealer E&O policies do not provide fiduciary coverage at all or specifically place limits on such coverage. Broker-dealer policies may exclude the advisor's particular entity, and activities outside the scope of the broker-dealer are generally subject to the aggregate limits for all registered representatives. Broker-dealer policies often limit prior coverage and they are not portable.

Retirement plan specialist programs—Several of the large broker-dealers are providing fiduciary E&O coverage for qualified advisors who are part of their newly created Retirement Plan Specialist Programs. Many of these programs allow the specialist to act as a 3(21) Advising Fiduciary for the plan. The specialist program also becomes the foundation for strategic partnering relationships with other advisors at the firms.

A new category: Accidental Fiduciary

With the advent of new fiduciary rule changes from the DOL, many more advisors will be considered to be fiduciaries, either by virtue of the advice they render to plans and their participants or by the advice they render regarding distributions and IRA rollovers. The result will be a new category of advisor that we might call the Accidental Fiduciary.

Advisors who find themselves in this new category might not want the responsibilities or the liability that will result. The specialist programs at the large broker-dealers will allow Accidental Fiduciaries to partner with a specialist to insulate themselves from these unwanted exposures. These rule changes will provide the retirement plan specialist with a new opportunity to market his or her services within the firm.

Appendix and checklist

A good checklist for documenting a tight fiduciary process is the typical DOL audit appointment letter request for copies of various key documents, including:

- copies of the plan and trust;
- a copy of the IRS determination letter;
- copies of the last three years of Form 5500 reports;
- a copy of the plan's Investment Policy Statement;
- a copy of the most recent plan valuation;
- copies of the plan's correspondence file;
- copies of the plan's service provider contracts;
- copies of the investment due diligence and performance reports; and
- copies of the minutes from the committee meetings describing the investment review, deliberation process, and rationale for investment selection, removal, and replacement, including share class and fee considerations, and a list of all parties in attendance.

Depending on the particular jurisdiction, the list will vary, but the documents identified above are generally the focus of most audit requests.

Conclusion

New rule changes proposed by the SEC and the DOL may mean that all brokers and advisors will be held to a fiduciary standard of care under both ERISA and the securities laws. Becoming an ERISA fiduciary should always be an intentional action, whether the advisor is providing 3(21) Advising Fiduciary services or 3(38) Investment Manager services.

The time has come for advisors to understand and make the case for their fiduciary services above those of others and to begin thinking about how to be effective in the new regulatory environment. The advisor should make a plan now and act on it!

The fact that no rules have changed to date makes this the perfect time for advisors to be talking about this issue with their clients and prospects, and with other influential parties. There is a unique opportunity for advisors to take center stage and speak to the marketplace now, in advance of these rule changes, and to clearly reposition their fiduciary value proposition for the next decade!

About the authors

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Bob is a lawyer and a frequent author and public speaker on retirement plans, fiduciary standards, risk management, investment advice, and related subjects. Prior to founding RJR Consulting, Bob served as director of institutional corporate retirement services for Smith Barney, where he spent 22 years with the firm and its predecessors. Before joining Smith Barney, he worked as a pension consultant for Peat Marwick Mitchell and served as an ERISA lawyer for Equitable Life Assurance Corporation. He is a graduate of the University of California at Berkeley and the Fordham University School of Law, and is a member of the New York and Federal Bar.

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