Why Advisors Will Benefit and Add Value Using a 3(38) Investment Fiduciary

Defining the roles between a 3(38) Investment Fiduciary and a Plan Advisor offering non-fiduciary services. Protecting both the Plan Sponsor and the Advisor.
Introduction

Sweeping reforms introduced by the Department of Labor ("DOL"), which will become effective in 2012, are expected to pose significant challenges for retirement plan sponsors and their advisers. The convergence of new regulations, increasing examinations and enforcement and ongoing litigation could lead to significant exposure for those who have not adequately prepared for and adapted to confront these challenges. At the same time, however, heightened expectations and regulatory scrutiny will provide considerable opportunities for advisers who are first-movers in developing compliant, forward-looking solutions for their clients.

This white paper explains the applicable rules and describes how a 3(38) Investment Fiduciary solution shifts the responsibility to prudently select and monitor the plan’s designated investment alternatives from the plan sponsor to an independent third-party fiduciary under the Employee Retirement Income Security Act of 1974 ("ERISA"). In addition to mitigating fiduciary liability for plan sponsors, an ERISA 3(38) Fiduciary allows the adviser to support clients by providing investment education and other non-fiduciary services and work more holistically with plan participants (e.g., providing financial planning and IRA rollover services) without the constraints imposed upon fiduciaries under ERISA. This paper concludes by providing examples of non-fiduciary services for advisers to consider that are designed to help Plan Fiduciaries respond to the challenges presented by the new regulations.

Background

An area that will be particularly acute for plan sponsors and advisers relates to the selection and monitoring of the plan’s designated investment alternatives ("DIAs") in participant-directed individual account plans (e.g., 401(k), 403(b), etc.). ERISA requires plan sponsors to manage these investments prudently. If they do not have the necessary expertise, they are required to engage investment professionals. Consequently, most plan sponsors look to the broker or agent who sold them the plan for advice in this regard.

If the advice provided is determined to be fiduciary "investment advice" under ERISA, the adviser will be required to act solely in the best interest of participants, and he/she may be held personally liable for violating his/her duties. Employees of the plan sponsor who perform fiduciary functions ("Plan Fiduciaries") can also be held personally liable for facilitating or otherwise failing to detect a violation or conflict of interest when entering into an arrangement with their adviser. Personal liability means that the personal assets (i.e., homes, bank accounts, etc.) of the fiduciary may be used to restore any losses resulting from a fiduciary breach.
Background

ERISA also prohibits fiduciaries from engaging in certain transactions. For example, it is a prohibited transaction to provide investment advice that results in additional compensation being paid to the broker/adviser and/or an affiliate (e.g., broker-dealer, insurance company, etc.). Registered representatives of broker-dealers and insurance agents typically receive compensation in the form of commissions and/or 12b-1 fees that may vary from fund-to-fund or among product manufacturers. If the adviser provides investment advice and receives compensation that is not level across all investments or if he/she is affiliated with an investment manager or broker-dealer that receives additional compensation (i.e., management fees, revenue sharing, markups, etc.), the rendering of such advice would be a prohibited transaction.

The DOL has also issued guidance cautioning advisers that serve in a fiduciary capacity while soliciting IRA rollovers from and/or “cross-selling” additional products to plan participants. If the adviser uses the authority that makes him/her a fiduciary to cause the participant to take a distribution and invest the proceeds with the adviser that results in additional compensation to the adviser (or an affiliate), it may trigger a prohibited transaction under ERISA and could subject the adviser to significant penalties (e.g., disgorgement, excise taxes, etc.).

ERISA allows Plan Fiduciaries to delegate responsibility for managing, acquiring and disposing of plan assets (e.g., the plan’s DIAs) to an “investment manager” that meets the requirements of Section 3(38) of ERISA. If an investment manager is properly appointed, then “no trustee shall be liable for the acts or omissions of such investment manager or managers, or be under an obligation to invest or otherwise manage any asset of the plan which is subject to the management of such investment manager.” In other words, so long as the Plan Fiduciaries prudently select and monitor a 3(38) manager, they are not liable for any losses in investments that are managed by the 3(38) manager.

Because the IRON 3(38) Service provides discretionary investment management over the DIAs and model portfolios offered to plan participants, plan advisers are less likely to be considered to be fiduciaries under ERISA. Moreover, IRON provides its services remotely and does not interact directly with plan participants, leaving the adviser as the primary source for participants to receive non-fiduciary investment education on their investments within the plan and investment advice on assets held outside of the plan. Understanding the difference between fiduciary investment advice and non-fiduciary education is, therefore, fundamental for advisers who provide services to ERISA-covered retirement plans and plan participants.
Fiduciary Status

Fiduciaries of an employee benefit plan are charged with carrying out their duties prudently and solely in the interest of participants and beneficiaries of the plan, and as discussed, are subject to personal liability to, among other things, make good any losses to the plan resulting from a breach of their fiduciary duties. Section 3(21) of ERISA defines a fiduciary as one whom: a) exercises any discretionary authority over the management of the plan or its assets; b) renders investment advice for a fee or other compensation; or c) has any discretionary authority over the administration of such plan.

Most advisers will not be in a position to exercise discretionary authority or control over the management or administration of a plan or plan assets,4 so the most common way for an adviser to become an ERISA fiduciary is by the rendering of investment advice to the plan’s investment committee and/or participants. For purposes of ERISA, investment advice is defined as: i) advice or recommendations as to the advisability of investing in securities or other property; ii) individualized to the needs of the client; iii) rendered on a regular basis; iv) pursuant to a mutual understanding; and v) that the advice will serve as a primary basis for investment decisions.5 Because this test is predicated upon the functions one performs, it is possible that an adviser can be held to a fiduciary standard even when he/she disclaims fiduciary status in their disclosures or agreements.6

Your “Non-Fiduciary” Role

<table>
<thead>
<tr>
<th>Responsibility</th>
<th>Tasks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Participant Services</td>
<td>• Conduct enrollment meetings</td>
</tr>
<tr>
<td></td>
<td>• On-site education seminars;</td>
</tr>
<tr>
<td></td>
<td>o Rick Tolerance Day</td>
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<tr>
<td></td>
<td>o Employee Gap Analysis</td>
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<tr>
<td>Plan Sponsor Services</td>
<td>• Plan Sponsor guidance on appropriate asset class model</td>
</tr>
<tr>
<td></td>
<td>• Creation and monitoring of a “Fiduciary file”</td>
</tr>
<tr>
<td></td>
<td>o Benchmarking the plan</td>
</tr>
<tr>
<td></td>
<td>o Review of quarterly performance reports</td>
</tr>
<tr>
<td></td>
<td>o Committee meetings</td>
</tr>
<tr>
<td></td>
<td>o Service Provider reviews</td>
</tr>
<tr>
<td></td>
<td>• Assist the Plan Sponsor in complying with new 408(b)(2) regulations</td>
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<tr>
<td></td>
<td>o Determination of service providers, compensation reasonableness and</td>
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<tr>
<td></td>
<td>value for service</td>
</tr>
<tr>
<td>Wealth Management Services</td>
<td>• Executive wealth management</td>
</tr>
<tr>
<td></td>
<td>• IRA rollovers</td>
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1 The majority of errors and omissions policies do not cover fiduciary services rendered by registered representatives or insurance agents to ERSIA-covered clients for these reasons. Even if coverage is available, services outside of the supervising firm’s policies and procedures are typically excluded, and most broker-dealers and insurance companies prohibit advisers and agents from acting as ERISA fiduciaries.
2 See ERISA 402(c)(3). The term “investment manager” means any fiduciary (other than a trustee or named fiduciary) that has the power to manage, acquire, or dispose of any asset of a plan; is registered as an investment adviser, bank or certain types of insurance companies; and has acknowledged in writing that he is a fiduciary with respect to the plan.
3 See ERISA 405(d)(1).
4 Some courts have found that advisers exercised actual control over the management and disposition of plan assets when clients merely “rubber stamped” or followed automatically or without consideration, the adviser’s investment recommendations.
5 See Regulation 29 C.F.R. 2510-3.21(c).
New Regulatory Pressures on Retirement Plan Advisers

Since the passage of the Pension Protection Act in 2006, the DOL has proposed and finalized a number of regulations designed to protect plan participants and provide plan sponsors with greater information from which to assess their arrangements with plan service providers, including advisers.

Proposed Expansion of the Scope of Fiduciary Status and Renewed Discussion of IRA Rollovers

Noting the evolution in ‘relationships between advisers and their plan clients,” in October 2010, the DOL issued a proposal to redefine the term “investment advice” by eliminating some of the requirements of the aforementioned five-part test.7 For example, advice would no longer be required to be rendered on regular basis or that there be a mutual understanding that the advice will serve as the primary basis for investment decisions. Not only has the DOL proposed to make it easier for advisers to satisfy the test for fiduciary status, point to concerns expressed that “plan participants may not be adequately protected from advisers who provide distribution recommendations (regarding IRA rollovers, for example) that subordinate participants’ interests to the advisers' own interests,” the DOL requested comments as to whether the final regulation should cover such recommendations.” At a minimum, the proposal highlights the fact that advisers will be subject to greater scrutiny in their interactions with plan sponsors and participants. Advisers should evaluate their practices in light of these concerns, and those who may have provided investment advice in the past may be required to “outsource” the advice to third-parties and redefine their value proposition through more robust non-fiduciary services.

Plan-Level Fee Disclosure under ERISA 408(b)(2).

The DOL’s Final Rule under ERISA 408(b)(2) will further compound the challenges to plan advisers. By January 2012, broker-dealers, insurance companies and registered investment advisers (among others) will be required to provide written disclosures to plan sponsors setting forth the following information:

- All services to be rendered to the plan and/or plan participants;
- All direct and indirect fees (i.e., commissions, 12b-1 fees, etc.) received in connection with the services, including any compensation received by affiliates of the adviser (e.g., revenue sharing, management fees, etc.); and
- An acknowledgment of fiduciary status if any of the services are considered to be fiduciary under ERISA and/or the Investment Advisers Act.8

These details are meant to help plan sponsors (and the DOL) evaluate the reasonableness of arrangements with service providers, and the disclosures will be used to benchmark plan advisers against other advisers that may be able to render services as ERISA fiduciaries. For most advisers, these disclosures will be prepared by their supervising firms. Consequently, plan sponsors will be on notice of any limitations imposed upon the adviser, and affected advisers should be prepared to offer up solutions to plan sponsors that seek specific guidance on plan investments and to demonstrate the value of the adviser’s non-fiduciary services.
New Regulatory Pressures on Retirement Plan Advisers

Participant Disclosures under ERISA 404(a)(5)

Lastly, the DOL’s Final Rule for Participant Disclosures will require plan sponsors to provide detailed disclosures of fees and services to plan participants in the first quarter of 2012. Numerous studies show that most participants are not aware that they pay fees to maintain their 401(k) accounts. Given that commission-based advisers receive compensation indirectly from plan investment providers, it is anticipated that the new disclosures will create “bottom-up” pressure for advisers to defend their value propositions to plan participants.

In addition, participant inquiries and complaints that are not properly handled may lead to DOL examination and enforcement. While participants will likely focus on the amount of the adviser’s compensation the standard documents and information requested by DOL examiners will reveal the nature and source of that compensation. As such, advisers should begin to educate plan participants on the fees charged to their accounts and the value of the services provided. Indeed, offering to prepare plan sponsors for the participant disclosures and educating plan participants on this information can be another way for an adviser to provide meaningful non-fiduciary service and further justify their compensation.

Shifting Fiduciary Risk with a 3(38) Manager

The combined effects of the plan- and participant-level disclosures will serve as a guide not only for plan sponsors and participants but also for regulators and potential plaintiffs. It is, therefore, imperative that advisers begin to assess the compensation they receive in light of the value of their services. At the same time, many supervising firms are beginning to pull back on approved services making it more difficult for advisers to provide investment-related support.

Advisers that cannot provide investment advice will be faced with the following options: 1) continue to provide fiduciary services and risk personal liability for fiduciary breaches, causing a prohibited transactions and being uninsured for providing services outside of home office policies; 2) providing only non-fiduciary services and risk losing the client to fiduciary advisers; or 3) provide information to their plan sponsors on third-party, remote solutions and demonstrating their ongoing value through the provision of non-fiduciary services. Given the aforementioned regulatory scrutiny and retirement plan litigation, the first option is not advisable.

The second option is problematic also, as many registered investment advisers are prospecting further “down market” and looking to take business away from advisers that cannot provide fiduciary services. The third option is, therefore, the most effective way for non-fiduciary advisers to retain and attract clients going forward, and using a remote solution (i.e., IRON’s 3(38) Investment Fiduciary Service) will ensure that the adviser remains that primary source of in-person support and guidance for their clients.

Shifting Fiduciary Risk with a 3(38) Manager

Not only does this solution shift investment-related fiduciary responsibilities from the adviser (and the plan sponsor) to the 3(38) manager – freeing up the adviser to solicit cross-selling opportunities and IRA rollovers – the IRON 3(38) Investment Fiduciary Service does not include any services provided to plan participants regarding investments held outside of the plan. Advisers that elect to pursue this option should conduct due diligence to ensure that the 3(38) manager is experienced in servicing ERISA-covered plans and has sufficient credentials and policies. Recommending an inexperienced or unsuitable 3(38) manager to a plan sponsor could jeopardize the adviser’s relationship with the client and subject him/her to liability for the recommendation.

Effectively evaluating a 3(38) manager, however, is a formidable task for an adviser; it requires the adviser to become familiar with the investment processes of the 3(38) manager as well as legal and regulatory requirements imposed upon ERISA fiduciaries. To facilitate this process, IRON Financial voluntarily subjected itself to examination by the Center for Fiduciary Excellence (“CEFEX”). CEFEX is an independent global assessment and certification organization. It works closely with investment fiduciaries and industry experts to provide comprehensive assessment programs to improve risk management for institutional and retail investors. A CEFEX certification helps determine the trustworthiness of investment fiduciaries.

In 2011, IRON Financial became one of first registered investment advisors globally to successfully complete the independent certification process for discretionary investment and ERISA 3(38) investment advisory services for ERISA plans. The CEFEX certification provides the recommending adviser (and his/her plan sponsor clients) with an independent recognition of IRON Financial’s conformity to a defined standards and adherence to best practices. Advisers can, therefore, demonstrate additional value to their clients by recommending the IRON 3(38) Service and leveraging the rigorous processes of CEFEX to help the Plan Fiduciaries demonstrate that the plan’s 3(38) manager was prudently selected.

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11 For more information, see http://www.cefex.org/.
12 See Certification of Registration available at: http://www.cefex.org/rmark/CefexRegistration.aspx?qryRegistrationNumber=hRiHScb00%2f8%3d.
Adding Value through Non-Fiduciary Solutions

In addition to the compliance-related challenges facing commission-based retirement plan advisers, competitive forces are also at play. Filling the advice “gap” with an experienced 3(38) manager is only part of the solution, however; many advisers will be forced to defend or redefine their value proposition in light of any perceived or actual reduction in services. The following concepts are meant to serve as a guide for advisers to consider in developing non-fiduciary solutions for their clients that align with the challenges presented by the new regulations:

Disclosure Support and Fee Benchmarking

The new plan-level disclosures under ERISA 408(b)(2) will require Plan Fiduciaries to develop and implement procedures relating to the intake and evaluation of service provider disclosures; ERISA requires prudent processes to be used to select and monitor the plan’s covered service providers. While the DOL expects that Plan Fiduciaries will use the information contained in the service provider disclosures to meet their obligations to report to the DOL (via the Form 5500 and Schedule C, if applicable) and plan participants under the new participant disclosure rule (ERISA 404(a)(5)), many plan sponsors do not have the time or inclination to stay abreast of new requirements.

Others may not have the expertise to assess the completeness and reasonableness of the disclosures. By educating the Plan Fiduciaries on their obligations under ERISA 408(b)(2) and assisting with establishing and maintaining procedures to evaluate the plan’s service arrangements, advisers can not only add additional value but can “insert” themselves in that process and ensure that there is an ongoing need for their services.14

Participant Education and Inquiry Support

With respect to investment education, Department of Labor Interpretative Bulletin 96-1 sets forth examples of services that are considered to be non-fiduciary investment education versus fiduciary investment advice.15 Many advisers may be surprised to learn how much latitude they are afforded with respect to participant investment education. For example, interactive questionnaires, information and materials that provide participants the means to estimate future retirement income needs and assess the impact of different asset allocations on retirement income, would be considered education if certain conditions are met.

Most providers currently offer such tools free of charge, and incorporating these resources into more robust participant education will help adviser’s demonstrate additional value. Investment education is also a way for non-fiduciary plan advisers to become more familiar with the needs of plan participants and increase the opportunity to discuss products and services offered outside of the plan, including IRA rollover programs.
Many non-fiduciary advisers have also reported recent successes retaining and prospecting clients by offering support to Plan Fiduciaries in creating policies around and offering to assist with participant inquiries stemming from the enhanced disclosures. Many routine inquiries can be easily resolved by demonstrating that a prudent selection process was in place and that the plan would not exist but for the support provided by and the fees paid to the plan’s service providers. Plan sponsors will value the adviser’s foresight and willingness to “run interference” on their behalf by providing information and explanations designed to resolve routine participant inquiries.

**Compliance Support and Exam Readiness**

Plan audits are on the rise, and the DOL has recently vowed to commit to “a better and smarter enforcement of the law.” Knowledgeable retirement plan advisers can demonstrate value by educating clients on these initiatives and proactively preparing them for routine audits of their fiduciary processes. In addition, it is in the interest of the plan adviser to mitigate the risk that the plan will be in violation, as most sponsors look to their advisers to keep them informed and in compliance.

There are a number of publically-available resources that advisers can leverage to educate plan sponsors on their fiduciary obligations and ERISA compliance. The following are a few examples of publications designed for Plan Fiduciaries:

- DOL Retirement Security Initiatives
- Top Ten Issues Found in IRS Audits
- DOL Reporting and Disclosure Guidelines for Employee Benefit Plans
- IRS 401(k) Plan Checklist
- PRI Fiduciary Education Resource Guide *

Assisting Plan Fiduciaries in establishing prudent processes designed to detect and prevent fiduciary breaches is an excellent way for advisers to differentiate their services from those less specialized that do not offer comprehensive non-fiduciary support.

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14 Advisers, while perhaps prohibited from rendering “investment advice,” will often be the most knowledgeable person to assist the Plan Fiduciaries in locating and examining investment-related information (e.g., fees, share classes, etc.) and conflicts of interest. By proactively drawing upon this expertise to support Plan Fiduciaries (through the creation of checklists, monitoring procedures, etc.), advisors can help to ensure that they are ahead of the curve and will be part of the required solution. See e.g., supporting materials available at: www.pension-resources.com/resources/adviserresourceseries/disclosuremanagement.

Summary

Increasing scrutiny, litigation and the pulling back of services by broker-dealers and supervising firms will present challenges for many commission-based advisers. Affected advisers will need to assess how to respond to these challenges and develop competitive and compliant solutions. The IRON 3(38) Service provides advisers and Plan Fiduciaries with a proven partner to fulfill the fiduciary obligations to prudently manage the plan’s investments and allows the adviser to interact with the plan sponsor and participants in a way that does not implicate fiduciary liabilities under ERISA.

This white paper explains the applicable rules and describes the solution offered by IRON Financial that shifts the responsibility to prudently select and monitor the plan’s designated investment alternatives from the plan sponsor to IRON - an independent third-party fiduciary under the Employee Retirement Income Security Act of 1974 (“ERISA”). In addition to protecting plan sponsors and advisers from fiduciary liability, IRON Financial’s ERISA Fiduciary 3(38) Investment Management Service (the “IRON 3(38) Service”) allows the adviser to support clients by providing investment education and other non-fiduciary services and work more holistically with plan participants (e.g., providing financial planning and IRA rollover services) without the constraints imposed upon fiduciaries under ERISA.

IRON’s Added Value

- Independent investment selection, monitoring and replacement in accordance with the plan Investment Policy Statement
- Communication with the broker of record and plan sponsor from the point of sale forward
- Quarterly newsletter with educational materials and plan investment performance, if requested

Custodial Platform Value

- Fund window that allows participants to access all available mutual funds
- Self directed brokerage – employees can direct their own accounts as they see fit
- Web-based educational and fiduciary tools
- Quarterly and annual plan fiduciary reviews
- Complete transparency with fee disclosure

*The Pension Resource Institute (PRI) provides strategic and compliance consulting, education and sales support to broker-dealers and RIAs on securities- and ERISA-related matters. Incorporating guidance and analysis ranging from due diligence, operations and supervision to product development and distribution, PRI is able assist clients in the development and deployment of profitable and sustainable solutions for the retirement plan marketplace.

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