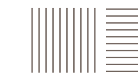
ERISA AND THE RESPONSIBILITIES OF A PLAN SPONSOR:

THE NEED FOR AN EXPERIENCED INTERMEDIARY



The following addresses the potential benefits of retaining a financial intermediary for retirement plans, specifically as an adviser to the plan sponsor or those designated by the plan sponsor, and legal issues and considerations related to the use of a financial intermediary.

The basic role of a financial intermediary is to advise and otherwise assist the plan sponsor and plan fiduciaries in structuring retirement plan investments and in obtaining the types of products and services necessary for the plan's operation. Key points in this regard are:

- Plan sponsor or plan fiduciaries may be required to seek qualified outside assistance to meet their legal obligations.
- Using a financial intermediary that works regularly with retirement plans can help decrease the risk to the plan sponsor or plan fiduciaries of liability for acting imprudently. An experienced financial intermediary should know what process to follow, the right questions to ask and how best to document the process.
- A plan sponsor or fiduciary is better protected from liability risk when it has sought, obtained and considered expert advice.
- The level of protection from liability risk depends in part on the role of the financial intermediary—whether it is retained as a non-fiduciary (least protection), a "3(21)" investment adviser (mid-range) or a "3(38)" investment manager (most protection).

LEGAL FOUNDATION—THE ERISA PRUDENCE RULE

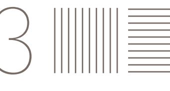
The Employee Retirement Income Security Act of 1974, or ERISA, is a federal law that regulates privately-sponsored U.S. employee benefit plans (as opposed to governmental plans or foreign plans). ERISA-governed retirement plans—including defined benefit pension plans, profit-sharing plans, 401(k) plans and certain 403(b) plans—are subject to ERISA's fiduciary responsibility rules. Retirement plan sponsors or fiduciaries who violate these rules are subject to personal liability for the plan's resulting losses, as well as other liabilities and sanctions.

The persons responsible for the administration and investment management of a retirement plan are typically the plan sponsor or a committee designated by the plan sponsor (or, in some instances, individuals designated by the plan sponsor to serve as plan trustees). The ERISA fiduciary responsibility rules require such persons to act solely in the interest of the plan and its participants and beneficiaries, and "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." Some courts have labeled these fiduciary duties of loyalty and prudence under ERISA as the "highest known to the law." Most relevant here is the prudence rule.

The ERISA "prudent man" rule has been interpreted by the U.S. Department of Labor ("DOL") and the courts as imposing a responsibility to act in a procedurally proper manner, based on an objective standard. This requires plan fiduciaries to employ appropriate methods to independently investigate the merits of an investment decision (such as selecting plan investment options), act in a manner as would others who are familiar with such matters, and exercise independent judgment in making the decision. Under these interpretations, a fiduciary who follows proper procedures in making an investment decision should not be liable for violating the rule, even if the investment results in a loss to the plan. The standards against which a fiduciary's behavior is measured are those of the investment industry.

Thus, if a fiduciary fails to conduct any investigation whatsoever of, for example, whether there are lower-fee share classes available of the mutual funds used as plan investment options, the fiduciary has, according to this authority, breached its duty to act prudently. Even if the fiduciary has clearly considered the relevant factors, the fiduciary may still breach its prudence obligation if it fails to give those

factors “appropriate consideration” in making its investment decision. This could occur, for example, if the fiduciary makes an illiquid investment for a plan that has short-term liquidity needs. Furthermore, a fiduciary’s responsibilities do not end with the initial investment decision. The fiduciary has an ongoing responsibility to monitor the investment with reasonable diligence, and to consider terminating the investment if it is no longer appropriate for the plan.



Some have suggested that ERISA creates a “prudent expert” rule, thereby requiring that a fiduciary have at least a certain level of expertise regardless of the circumstances. Generally, the courts have rejected a strict “prudent expert” test in favor of a “flexible standard” that depends on the circumstances. Accordingly, the level of knowledge required on the part of the fiduciary varies with the nature of the plan, considering such factors as the size, character and aims of the particular plan. Within this framework, a fiduciary is judged according to the standard of others “acting in a like capacity and familiar with such matters,” *i.e.*, prudent fiduciaries with experience dealing with a similar enterprise (such as a similarly-sized plan).

Under this standard, lack of familiarity with investments is no excuse for failing to act prudently. A fiduciary who commits pension plan assets to investments he or she does not fully understand will nonetheless be judged by comparison to others “acting in a like capacity and familiar with such matters.” The fiduciary is thus responsible for obtaining sufficient information to understand a proposed investment, and for possessing the requisite expertise and knowledge to analyze the nature of any potential risks.

If the fiduciary does not have the expertise to appropriately analyze an investment in accordance with this standard, then, according to DOL guidance and several court decisions, the fiduciary has a duty to seek qualified outside assistance. However, the mere retention of an expert is not sufficient. The fiduciary cannot simply follow the advice as given, regardless of the qualifications of the adviser, but must make its own decision based on that advice, considering the advice as carefully as any other available information.

While a fiduciary thus may not be able to rely without question on the advice it receives, the fiduciary is better protected under the prudence standard where it has sought, obtained and considered expert advice.

APPLICATION TO THE ROLE OF FINANCIAL INTERMEDIARIES

Under the ERISA prudence framework, there can be several advantages to using the services of a financial intermediary, such as a broker-dealer or investment adviser representative, in connection with managing and operating an ERISA-governed retirement plan.

First, for a plan sponsor or plan fiduciary that has limited investment or retirement plan expertise, retaining a financial intermediary can be a way to access that type of expertise. Financial intermediaries often have extensive experience in working with retirement plans and assisting in the selection of plan investments, and may be able to offer sample fund lineups designed to meet different plan participant needs.

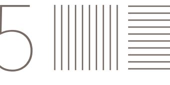
Second, even if the plan sponsor or plan fiduciary has expertise in these areas, it may not be familiar with the types of processes and procedures that are viewed as sufficient to meet the ERISA prudence standard or current industry practices in this regard (which have continually evolved over the past 40 years, based on DOL guidance and litigation as well as changes in the industry and financial markets). An experienced financial intermediary should know what process to follow and what questions to ask—both in making the initial investment decisions and developing an ongoing monitoring procedure—as well as how best to document that process (which can be important later in the event of threatened or actual litigation).

Third, in addition to helping make better decisions for the plan sponsor's retirement plan, using the services of a financial intermediary may provide the plan sponsor or other plan fiduciary with protection from the risk of fiduciary liability under ERISA. Part of the protection comes from being in a better position to demonstrate having followed a prudent process in making investment decisions, for the reasons described above. This should follow from retaining an experienced financial intermediary as an adviser.

If the intermediary specifically acknowledges its role as making it a fiduciary under ERISA (not all will do so, although this is becoming more common), then there is additional protection, given that the intermediary would be held to ERISA fiduciary standards and could be sued for not meeting those standards. If the intermediary takes on the additional fiduciary role of not just advising as a so-called "3(21)" investment adviser but actually making the investment decisions as a so-called "3(38)" investment manager, then there is even further protection because the plan sponsor and plan fiduciary's role is limited to oversight of the intermediary

rather than responsibility for the investment decisions themselves. *(For further explanation of the differences between the "3(21)" and "3(38)" roles, see Federated Investor's "Comparative Chart of Fiduciary Roles for 401(k) Plan Investment Matters.")*

ADDITIONAL CONSIDERATIONS



While there can be many advantages to using the services of a financial intermediary, plan sponsors and fiduciaries should keep in mind they still have certain responsibilities under ERISA in connection with retaining and overseeing the intermediary.

According to DOL and most court decisions, the plan sponsor and plan fiduciary would have a responsibility to prudently select the intermediary. This involves due diligence on the intermediary's qualifications to perform the role as an adviser or fiduciary to the plan, including education, past experience, checking regulatory filings for disciplinary history, obtaining and checking references, and evaluating the reasonableness of proposed fees (particularly if they are to be paid out of the assets of the plan). Some suggest that a diligence process, to meet ERISA standards, should include going out to several different firms with a formal request for proposal (an "RFP"), although others take the view that whether an RFP or contacting multiple firms is appropriate depends on the particular circumstances.

In addition to diligence in the initial selection, the plan sponsor and plan fiduciary would be expected to employ a prudent process to oversee the intermediary on an ongoing basis. This includes monitoring the quality of the services, changes in key personnel, changes in disciplinary history and other factors relevant to the intermediary's role. Failure to properly oversee the intermediary could result in liability in the event that the intermediary is not properly performing its services.

Important considerations in this process are fees and potential conflicts of interest. In advance of entering into a service agreement, service providers to retirement plans are required to provide extensive fee information—so-called "408(b)(2)" disclosures—describing the fees they would charge directly to the plan and any compensation they may receive from other sources in connection with the services arrangement, such as mutual fund 12b-1 fees or even gifts (above a certain threshold). It is important for plan sponsors and plan fiduciaries to obtain and review these disclosures to meet their fiduciary responsibilities and as part of their due diligence process.

The fee disclosures may suggest potential conflicts of interest. In fact, a DOL enforcement initiative involves a review of arrangements in which plan consultants receive fees or other benefits from investment managers or funds they recommend, because of conflict concerns. If the intermediary's fee disclosures indicate receipt of such fees or benefits, it would be important to assess whether those are at a level that could affect the intermediary's best judgment in recommending funds or in providing other services to the plan or whether they otherwise raise ERISA prohibited transaction issues. A potential conflict is not necessarily a complete disqualification so long as it has been disclosed, a prohibited transaction exemption is available (if necessary) and the plan sponsor and plan fiduciary can determine that the conflict will not have a material effect on the intermediary's services.

CONCLUSION

In sum, subject to the additional considerations described above, using a financial intermediary has several benefits for plan sponsors and plan fiduciaries. The main advantage is to help protect the plan sponsors and fiduciaries from the risk of fiduciary liability under ERISA by providing access to investment and retirement plan expertise that should help them to make better decisions for the retirement plan and document their decision-making process. While there are no guarantees, simply being in a better position to demonstrate having followed a prudent process is beneficial in the event any of the decisions made with respect to the plan are later challenged.

Eugene F. Maloney
Executive Vice President and Corporate Counsel

Mr. Maloney is Executive Vice President and Corporate Counsel of Federated Investors, Inc., a member of the Executive Committee, and has been employed by the firm for forty-two years.

Mr. Maloney was a member of the Board of Directors of the Foundation for Fiduciary Studies and was appointed by the U.S. House of Representatives and Senate as a member of the Industry Sector Working Group on Financial Services. He was an instructor in trust and securities law at Boston University School of Law, has been a visiting instructor at the Federal Financial Institutions Examination Council and the American Bankers Association's National Graduate Trust School at Northwestern University, and participates in programs leading to the designation of Certified Trust and Financial Advisor. Mr. Maloney has also served as an expert witness in both judicial and legislative settings on matters relating to fiduciary compensation, will construction, and prudent investing. Mr. Maloney is a member of the Advisory Board for the David Berg Center for Leadership and Ethics at the Katz Graduate School of Business, University of Pittsburgh.

Mr. Maloney has authored and co-authored a number of articles appearing in various financial and legal publications regarding the investment responsibilities of corporate fiduciaries. He has also been the architect of various educational videos and memoranda having to do with the Uniform Prudent Investor Act, the implications for trust banks of functional regulation under the Gramm-Leach-Bliley Act, asset allocation in a trust context, the prudence of international investing, fiduciary compensation, and the propriety of a corporate fiduciary utilizing a mutual fund to which it provides discrete services.

Mr. Maloney was honored by the Trust Education Foundation, which established and funded the Eugene Maloney Trust Scholarship at Campbell University in North Carolina. In April 2013, Gene received the Fiduciary of the Year Award from fi360 at their annual conference; fi360 is one of the top fiduciary oversight groups in the United States, and they are responsible for implementing the AIF (Accredited Investment Fiduciary) designation.

Mr. Maloney received his B.A. from Holy Cross College in Worcester, Massachusetts, and his J.D. from Fordham Law School in New York City. He attended Wharton School of the University of Pennsylvania focusing on the financial management of commercial banks. He was an officer in the United States Army from 1969 to 1972 and served as an infantry officer for one year in the Republic of Vietnam.

Michael B. Richman

Morgan Lewis, of counsel

Michael B. Richman is of counsel in Morgan Lewis's Employee Benefits and Executive Compensation Practice. Mr. Richman's principal focus is on matters under the ERISA fiduciary responsibility rules. He advises plan sponsors on investment matters for defined benefit and defined contribution plans, and investment adviser firms on ERISA compliance for ERISA plan separately managed accounts, collective investment funds, and private funds. In addition, he counsels clients on fiduciary governance of ERISA plans, prohibited transaction issues in proposed transactions and transactions under government investigation, and preparing requests to the U.S. Department of Labor for prohibited transaction exemptions and advisory opinions. His practice also includes advising IRA custodians on permissible IRA investment and investment restrictions.

Prior to joining Morgan Lewis, Mr. Richman was counsel in the benefits and executive compensation and investment management groups at one of the 15 largest global law firms.

Mr. Richman earned his J.D. from Columbia University School of Law in 1988, where he was managing editor for the *Columbia Journal of Transnational Law*. He earned his A.B., magna cum laude, in history from Princeton University in 1985.

Mr. Richman has authored or co-authored a number of articles on ERISA, benefits, and securities issues. He is the co-author of the book *ERISA Class Exemptions* and of chapters on the ERISA class exemptions and trustee responsibility in the book *ERISA Fiduciary Law*, as well as of an overview of the ERISA-prohibited transaction rules for the online *Bloomberg BNA Benefits Practice Resource Center.*

Mr. Richman is admitted to practice in the District of Columbia and Maryland and before the U.S. District Court for the District of Maryland.

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Federated Investors, Inc.

Federated Investors Tower | 1001 Liberty Avenue | Pittsburgh, PA 15222-3779

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