

Unblurring the Lines: Understanding the Roles of Investment Providers

Workshop 32

Monday, October 19, 2015 2:15 p.m. – 3:30 p.m.

Speaker: Virginia Sutton, QKA



Investment Provider Roles

- This session will explore the various roles of bundled and unbundled Investment Providers
- Learning objectives:
 - List the different types of services that investment providers can offer.
 - Distinguish between a 3(21), 3(38) and 3(16) provider.
 - Recognize when an investment provider is or is not acting in a fiduciary capacity.



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Fiduciaries and Service Provider Roles

FIRST, SOME CONTEXT...

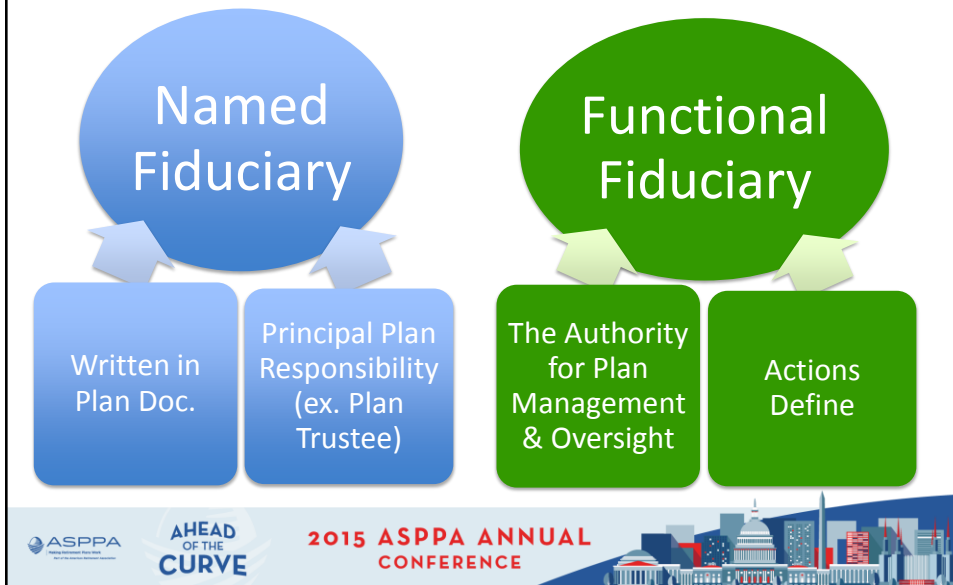


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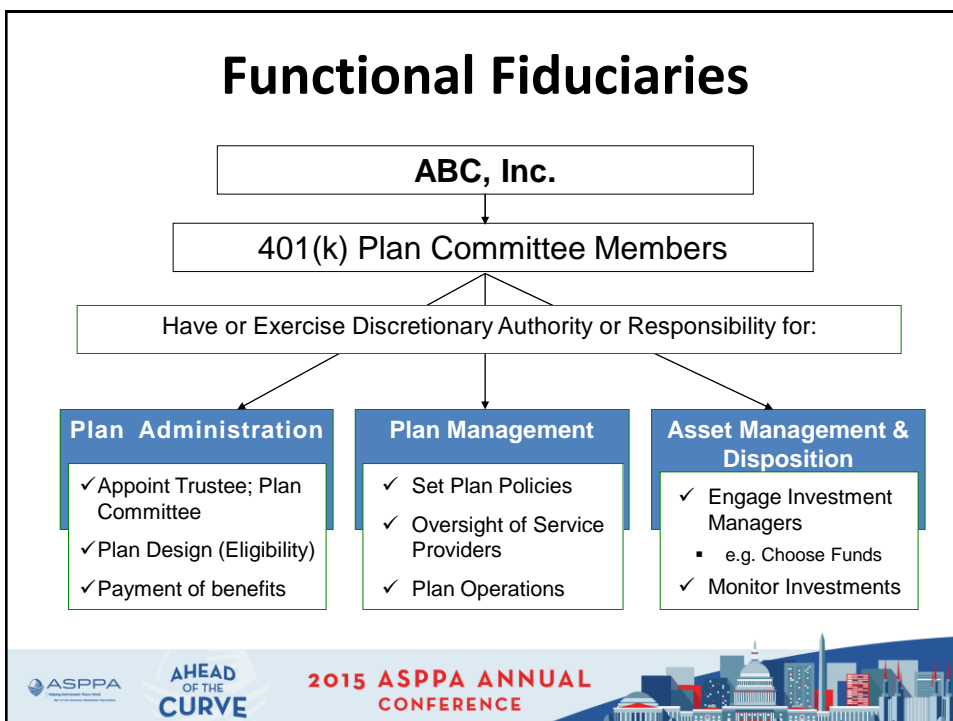
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Who is a Fiduciary?



Functional Fiduciaries



A Plan Fiduciary must be Loyal to a Plan and its Participants/Beneficiaries

- A fiduciary, such as a plan sponsor, must discharge its duties solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits to plan participants and beneficiaries and defraying the reasonable expenses of administering the plan. (ERISA Sections 403(c) and 404(a)(1)(A))



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Fiduciaries Must Act Prudently

- ...with the care, skill, prudence and diligence that a prudent person 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 (ERISA 404(a)(1)(B))
 - For plans that permit participants to direct investments, plan sponsors are responsible not only for the prudent selection and monitoring of the plan's investment offerings but also for the prudent utilization of those investments by participants.
 - The standard of care is very high and requires a level of expertise beyond that of a prudent lay person.



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Fiduciaries Must Diversify Plan Assets

- Investment of plan assets must be diversified so as to minimize the risk of large losses. (ERISA Section 404(a)(1)(C))
- Fiduciaries must also avoid conflicts of interest and acts of self-dealing that are known as prohibited transactions. (ERISA Section 406)



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Give the Money Back! And Pay a Fine

- A fiduciary that violates any of the duties discussed above is liable to the plan for any losses resulting from such a breach and for the restoration of profits made by the fiduciary through the use of plan assets. (ERISA Section 409(a))
- The DOL can also impose statutory penalties (ERISA Section 502(l))



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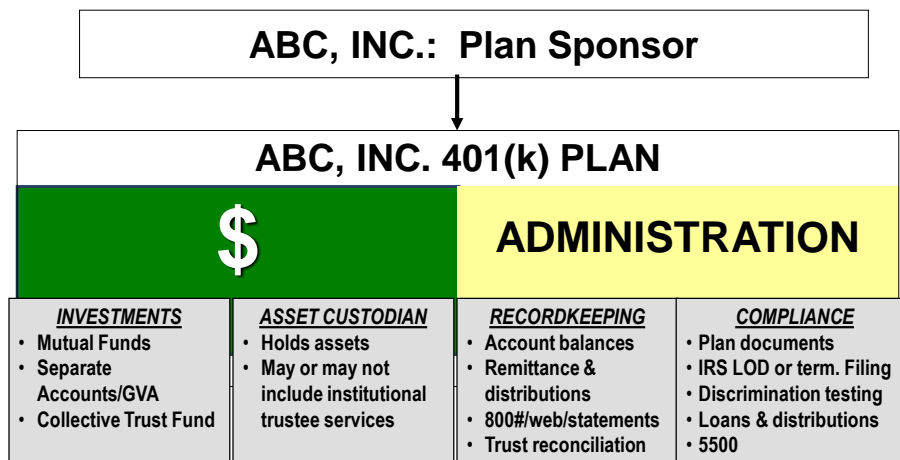


Investment Providers: Who Are They?

Company Types	Plan Services/Function
<ul style="list-style-type: none"> Insurance Companies Mutual Fund Companies Banks Brokerage Firms <ul style="list-style-type: none"> Schwab, Merrill Lynch, etc. Trust Companies Independent Recordkeepers <ul style="list-style-type: none"> Partner to provide investments Designated Investment Managers (3(38)Fiduciaries) 	<ul style="list-style-type: none"> Recordkeeping Compliance Services Asset Custody Plan Trustee Asset Management <ul style="list-style-type: none"> Mutual Fund Separate Accounts/Group Annuity Collective Trusts Annuities



Typical 401(k) Structure



What/Who is a Trustee

➤ The Designated Plan Trustee is a Named Fiduciary

➤ In the absence of an appointed trustee, the Plan Sponsor is the plan trustee

- ✓ A trustee of a qualified retirement plan is the entity or group of individuals who hold the assets of the plan in trust.
- ✓ Trustees are either designated in the plan document or appointed by another fiduciary, typically the employer who sponsors the plan.
- ✓ The trustees will have exclusive authority and discretion over the management and control of plan assets unless the plan document provides otherwise:
 - Control over investment decisions is delegated to an "investment manager"
 - For 401(k) Plans: participants in self-directed plans are responsible for investment decisions.



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Institutional Trustee Services

- A plan can be self-trusteed or a registered Trust company can be named as the plan trustee
 - ERISA requires that a trustee be named by the plan
 - The Trustee by definition is a fiduciary of the plan
- A "Passive" institutional trustee is most commonly named, because this means the plan sponsor retains fiduciary responsibility for disposition & investment of trust assets
- The plan's passive trustee is frequently an affiliated bank or strategic bank/trust company partner of the recordkeeper.
 - Plan Trustee services are highly specialized to qualified plans in contrast to trust companies who may provide services for IRAs or real estate transactions, etc.



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Fiduciaries and Service Provider Roles

PLAN ADMINISTRATION



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To the Extent an Investment
Provider is engaged to provide Plan
Administration, their services
agreement will need to clarify their
status as a 3(16) Fiduciary



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What is a 3(16) Fiduciary

3(16) offers a fiduciary definition for individuals who serve as plan administrators.

**3(16)
Is
an
“Administrative
Fiduciary”**

- Under this definition, these individuals agree to take full responsibility for the daily operation of the plan — or, in some cases, only specific functions.



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3(16) Fiduciary Defined:

- “The person specifically designated by the terms of the the instrument under which the plan is operated”
- If an administrator is not so designated, the plan sponsor...



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If Investment Providers will be a 3(16) Fiduciary

- It will be in writing in their services agreement and the plan document will reference
- Specific services for which the entity is a 3(16) will be named:
 - Determination on Loans, Hardship or QDROs & directing the trustee to make distributions
 - Filings (e.g. 5500) on behalf of plan sponsor
 - Disclosures



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3(16) Administrative Fiduciary: Caution

- Service Providers who offer 3(16) Administrative Fiduciary Services will frequently identify only those services for which they are a fiduciary:
 - the plan sponsor may not understand it is not “all or nothing”
- The service standard for 3(16) services is highly skilled and by extension, personnel concerns over quality control must be considered when offering 3(16) services
- It is unusual for large investment advisor institutions to offer 3(16) services



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Read The Service Agreement

- When service providers are NOT acting in a Fiduciary Capacity they will use language that indicates that the plan sponsor or participant retains the control over the process
- Look for key phrases like:
 - “Directed Record-keeper”
 - Compliance or Administration “Outsourcing” or “Support Service”
 - Asset Allocation Funds are offered as an “Education Service”



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The Case for A Multiple Employer Plan

- A plan sponsor can shift 3(16) responsibility to the sponsor of an MEP by adopting the MEP instead
 - Form 5500, audit, etc. is the responsibility of the MEP provider/plan sponsor
- The monitoring of the MEP’s investment options fall to the MEP plan sponsor
 - Investment options may still be mutual funds or may be provided by a 3(38) investment manager
- A BD/Registered Rep does not need to be named as the plan’s investment advisor
 - No conflict if use an MEP and become investment advisor to participants’ rollover IRAs



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Investment Provider Roles:

ASSET MANAGEMENT & ADVICE



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Asset Custody

Who holds the Plan's Money?

- Asset custody depends on the type of institution and the plan's investment options:
- Asset custody by an insurance company can be through an insurance contract
- Asset custody of mutual funds is typically through a registered broker-dealer or banking institution

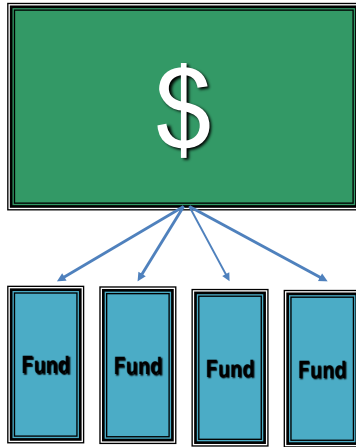


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Common 401(k) Investment Types



■ Mutual Funds

- Transparent & Independently verifiable
 - Prospectus Requirement
 - Net Asset Value (NAV) in newspaper; shares valued daily
 - Retail or Institutional

■ Separate Accounts

- Insurance Company/ Group Variable Annuity
- Unit Pricing: may or may not track underlying mutual fund

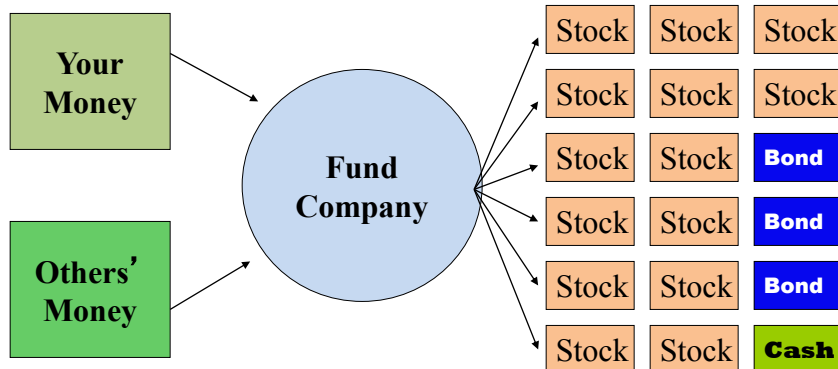
■ Collective Pooled Trust

- Institutional Management
- Fund is Fiduciary; Fund is Plan Asset
- Less expensive; less transparent

Pooled Investment Funds

Mutual Funds, Separate Accounts, Collective Trust Accounts

These investment structures pool investor dollars and buy assets types



What is a 3(21) Fiduciary

Under ERISA Section 3(21)(A), a plan fiduciary is defined as anyone who:

- Has discretionary authority or control regarding management of the plan or disposition of plan assets;
- Renders investment advice for a fee; or
- Has discretionary authority or responsibility for the administration of the plan.



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§3(21)(B) Provides Exception:

- Typically Registered Mutual Fund Managers are not considered Fiduciaries to the Plan or Participants
 - Most often, a mutual fund's manager will have a fiduciary duty to its shareholders, but not the investors in the fund unless the investors of the fund are considered fund shareholders
 - There can be exception to this:
 - Ex: Vanguard sets up its funds so that investors in their funds are the funds' shareholders



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Mutual Fund Company Fiduciary Exception under ERISA:

- ERISA §3(21)(B) states: “If any money or other property of an employee benefit plan is invested in securities issued by an investment company registered under the Investment Company Act of 1940 [i.e., a mutual fund], such investment shall not by itself cause such investment company or such investment company’s investment adviser or principal underwriter to be deemed to be a fiduciary ...”



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Mutual Fund Companies Hold Exemption Dear

- Mutual Funds or insurance companies may offer services to 401(k) plan sponsors to remain competitive as a service provider, but will most often provide these services as an outsourcing function, not as a fiduciary service
 - Since investment management & disposition of assets in a 401(k) account is delegated to the participant, the fund company is not compelled to be a fiduciary
 - Plan sponsor may engage a 3(21) investment advisor for help with the set up and review of their plan’s investment menu or
 - Plan sponsor can delegate investment decision-making to a 3(38) investment manager



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3(21) Limited Scope Fiduciary

**3(21)
Is
an
“Investment
Advisor”**

- While 3(21) Defines who is a Fiduciary under ERISA, the marketplace most frequently identifies a Limited Scope Investment Fiduciary as a 3(21) Fiduciary Advisor
- A registered investment advisor provides investment advice for a fee



Shared Investment Fiduciary Responsibility

- An investment fiduciary is a paid service provider that gives investment recommendations but does not necessarily have discretionary authority to make the actual investment decisions.
- Instead, the 3(21) investment fiduciary typically provides 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.



The Rise of the Retirement Plan Investment Advisor

- Post-Fee Litigation and implementation of the DOL's fee disclosure rules, Plan Sponsors have increasingly engaged plan advisors to help them assess service providers and monitor plan investments
 - Increasing acceptance by many traditionally "direct" sold 401(k) plans providers to acknowledge the Advisor's role
 - Ability for Retirement Plan investment advisors to drop their BD affiliation and still work with most recordkeeper platforms



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The Investment Fiduciary Fight

- Registered Investment Advisors and their representatives will have an agreement that states their fiduciary standing
 - The RIA Agreement will state the services and fee structure
 - The plan sponsor can pay the fee or it can be assessed to the plan/participant accounts
- The registered representatives of Broker-Dealers who work with plan sponsors may want to be aligned with their clients' (the plan sponsor) interests, but the other business that the BD supports may be in conflict
 - Broker-Dealers have a suitability standard
 - BD may mandate that they do not have fiduciary status
 - The Proposed Fiduciary Regulations seek to mandate that services provided to a plan or participants in retirement accounts must adhere to a fiduciary standard



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Who/What is a 3(38) Fiduciary

3(38) defines a fiduciary as someone who agrees in writing to be an investment manager for the plan, having the power to manage, acquire or dispose of any assets of the plan.

**3(38)
Is
an
“Investment
Manager”**

- This individual must be a registered investment advisor under the 1940 Act.
- If not registered under the Act, individuals must be registered with the state.
- A fiduciary can also be a bank or an insurance company.



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Designated Investment Manager: A 3(38) Fiduciary

Can Be Engaged by the PLAN

- Engaged by the Plan Sponsor and designated in the Plan Document:
 - Determine and oversee the investment line-up and make changes without plan sponsor consent
 - Manage individual funds within the plan
 - E.g. Collective Trusts

Can Be Engaged by Participants

- Appointment by the Participants in writing to manage all or a portion of their accounts
 - “Managed Portfolios/Accounts”
 - Discretionary authority over participant’s balance
 - May or may not be able to invest participant assets in funds outside of Plan’s funds



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Investment Asset Allocation Programs

Not A 3(38) Service

- Recordkeeping function:
 - Asset allocation is an “Education” service for participants
- Asset allocation pulls from a core fund line up that was determined by the plan sponsor
- Asset Allocation funds are not “Designated Investment Alternatives” (“DIA”)

3(38) Investment Service

- Investment Provider or Firm that is registered or governed by banking or insurance law
- Appointed formerly by plan sponsor via the plan document or associated plan service agreement
- Discretionary authority to change the investment positions. May or may not use the plan’s “core” fund options
- Can apply to management of a 401(k) line up or asset allocation fund offered within a 401(k) lineup



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Read the Services Agreement

- Fiduciary status will be used as a competitive advantage; marketing material will be explicit
- If acting in a fiduciary capacity, the services agreement will be specific as to which services provide fiduciary status
 - For 3(16) the Administration Services Agreement will typically require the plan sponsor to agree to provide necessary data in a timely fashion
 - For 3(38) the Investment Manager will provide their credentials and indicate their status as such



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What Role do they play?

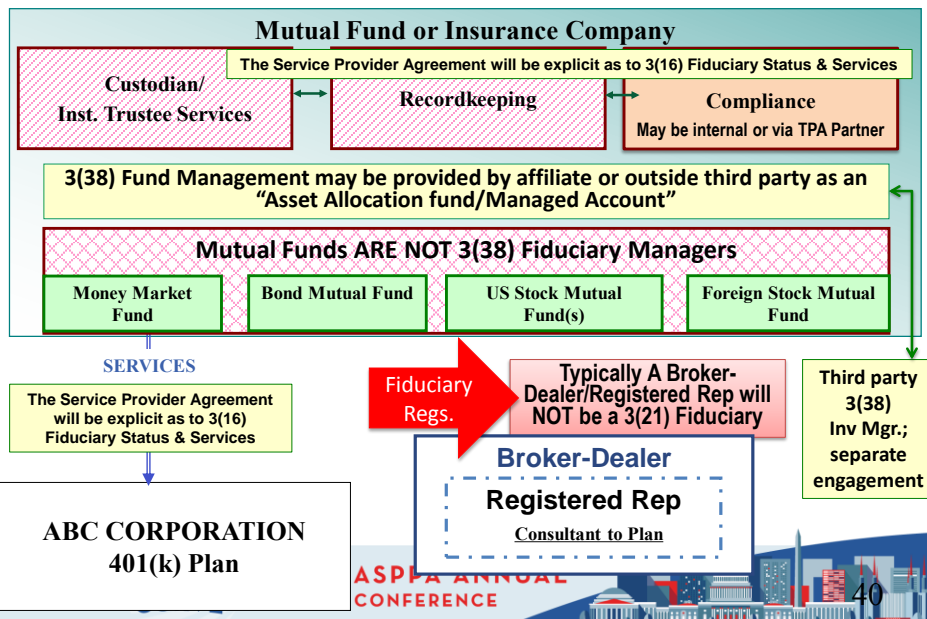
SAMPLE INVESTMENT PROVIDER/ SERVICE PROVIDER PARADIGMS



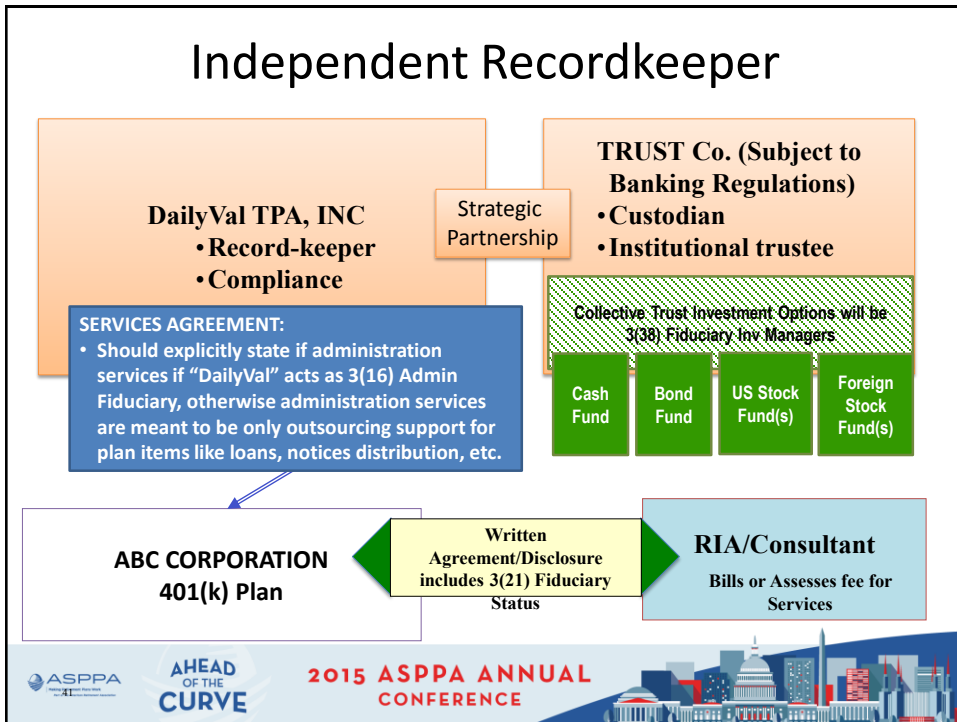
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Bundled or Partner Mutual Fund/Insurance Co.



Independent Recordkeeper



Trending now...

IN CONCLUSION



How Much Discretionary Control?

- The degree to which an institution provides and retains discretionary control over plan assets or administration, determines whether or not they take on a designated fiduciary role under ERISA
- If the investment provider takes control of plan administration, investment decisions, or money management, they take a fiduciary role for that function
- *The big service provider fear is whether or not they are an accidental fiduciary*



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Look For It In Writing— The Plan Document or Trust Agreement

- The Plan Document must name appointed Fiduciaries:
 - Trustee
 - 3(38) Investment Manager
- In the absence of a named entity or person in a fiduciary role, the plan sponsor is has the fiduciary responsibility



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Look For it in Writing— The Services Agreement

- For Investment Providers, look for their acceptance of fiduciary responsibility in writing in their services agreements
 - ✓ Investment advisory agreement (3(21) Status)
 - ✓ Investment Manager (3(38) Status)
 - ✓ Administrative Fiduciary (3(16)) status or named services



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Investment Providers

- Must evaluate their ability to provide fiduciary services:
 - Can the service be competently provided or will it add disproportionate liability for the service provider?
 - Will the marketplace pay the price that they feel can be charged for such services?
 - Will the marketplace pay for outsourcing of services that do not take on fiduciary standing?



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Plan Sponsors: All About Risk Management

- Plan Sponsors truly concerned about risk management and fiduciary liability will seek to designate third party fiduciaries and will be willing to:
 - Pay more for the fiduciary services
 - Relinquish control to eliminate liability



Thank you

Questions?

