# Deconstructing the Discretionary Fiduciary Models: ERISA Section 3(38) Investment Managers vs. Discretionary Trustees

By Jason E. Grantz and Michael Samford



**Jason E. Grantz, QKA, AIF®,** is an Institutional Consultant in the Retirement Plan Consulting Group with Unified Trust Company. Jason has over 15 years of experience serving, selling and consulting to the retirement plan marketplace. Jason is also a board member for the Greater Philadelphia Chapter of the American Society of Pension Professionals and Actuaries and the co-author of The 401(k) Plan Blog, www.the401kplanblog.blogspot.com.

**Michael Samford, AIF®,** is an Internal Consultant in the Retirement Plan Consulting Group with Unified Trust Company. Michael is responsible for helping 401(k) advisors with fiduciary, compliance, investment, and operational issues relating to Unified Trust's retirement plan services. He is also co-author of The 401(k) Plan Blog.

*Over the last several years, awareness surrounding the various fiduciary roles that retirement-plan advisors and consultants play when serving their clients has been on the rise. Contributing to this awareness are organizations dedicated to promoting fiduciary best practices and the increased exposure to content available via an ever-growing number of industry conferences. Not surprisingly, the observed result is the selling of expertise through the creation of new credentials.*

The sections of ERISA dealing with fiduciary responsibility, in name, have evolved into little more than marketing terminology or street credibility for those who define their business model this way. An unfortunate side effect of this trend, however, is the wide disparity in the quality of the delivery system. In other words, some purport to be ERISA fiduciary "experts," when really they are better portrayed as expert fiduciary "marketers." Even among genuine experts, there are many who lack the basic understanding of the true responsibilities and nuances that distinguish the roles.

While we observe an uptick in the use and discussion of the various appointed fiduciary roles, we still see many inappropriate or plainly incorrect assumptions being made. For example, a firm may be appointed as a Discretionary Trustee under ERISA Section 403(a)(1); however, when using the word "discretionary," a common response observed is "oh, so your firm is a Section 3(38) fiduciary." This response is not surprising. Many retirement plan consultants commonly associate the discretionary trustee role with that of an ERISA Section 3(38) Investment Manager (IM), another investment fiduciary who can be appointed on a discretionary basis. The remark is incorrect, however. This unnecessarily diminishes the laundry list of other responsibilities—in addition to investment discretion—required of a Discretionary Trustee but not necessarily of an investment manager.

In this article, we provide a comparison of these two outsourced fiduciary roles that can serve as a valid reference for those considering engaging one, the other, or both of these types of appointed fiduciaries. While there are a number of fiduciary capacities that arise in qualified plan governance, we will discuss these two fiduciary roles in isolation rather than expanding the discussion to other named or functional fiduciaries

such as limited or broad scope fiduciary investment advisors under ERISA Section 3(21).

In this article, we will explore

- The practical roles of a trustee,
- The types of corporate trustees that may be hired, and the differences between them,
- The role of an ERISA Section 3(38) Investment Manager vs. that of a Discretionary Trustee, and
- The general differences between full delegation (broad) and restricted delegation (limited) and the implications of each.

Finally, while there may be some overlap between some functions of a Discretionary Trustee and those of an ERISA Section 3(38) Investment Manager, there is no presence of any "fatal flaw" that would keep them from being able to work together when it is sensible for them to do so. In fact, when structured properly, these two fiduciaries can form an efficient, complementary partnership. We will, therefore, introduce a new model for fiduciary governance, called "The Two Party System." This model serves plan and participant interests effectively, and permits seemingly duplicative service providers to harmoniously work in conjunction with each other.

## Not All Trustees Are Created Equal

There are three types of trustees under ERISA. The most common is the "self–trustee," in which the plan sponsor names itself or an individual such as the business owner or a committee/board as the plan trustee. The two remaining trustee types fall under the category of appointed "corporate trustee." These are appointed under ERISA Section 403(a)(1). Depending on what types of services are available, a corporate trustee will be identified as either a Directed Trustee or as a Discretionary Trustee. There is considerable confusion surrounding the terms "Discretionary Trustee" and "Directed Trustee," and, in some cases, practitioners are unaware that there are even two types.

The most important distinction for plan sponsors and plan advisors to understand is fiduciary responsibility. Both a Discretionary Trustee and a Directed Trustee can act as fiduciaries to retirement plans; however, the critical distinction is that fiduciary risk and responsibility follow discretion. In other words, whoever has the final say with regard to selection, retention, and replacement of plan investments assumes fiduciary responsibility and the subsequent risk or liability for their decisions and actions.

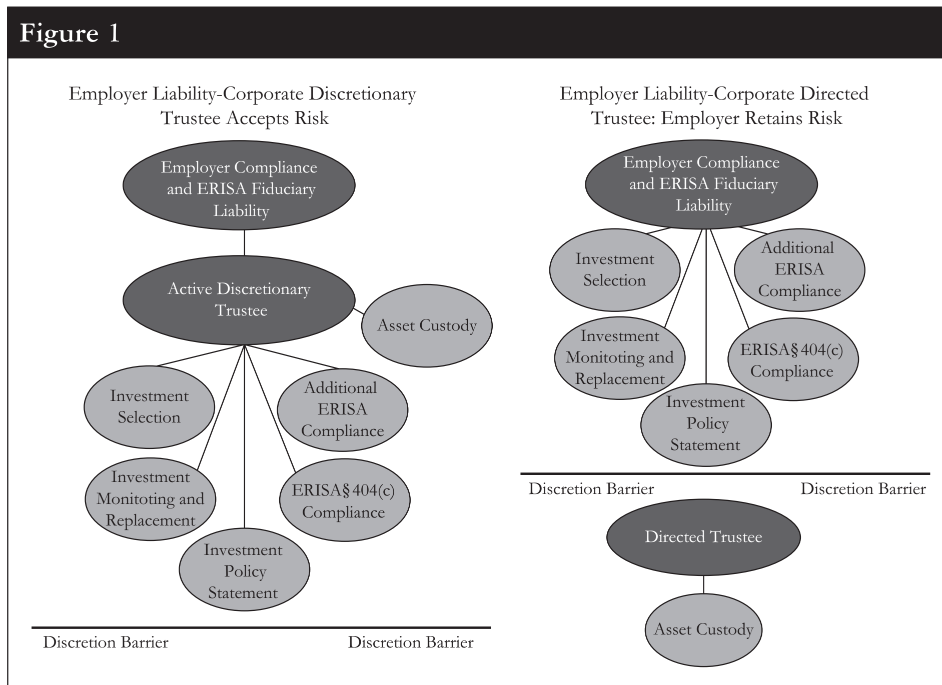
## Directed Trustee

The typical Directed Trustee is synonymous with Passive Trustee, Custodial Trustee, or even, plainly Custodian. The custodial function is to safeguard or hold plan assets and to do what the plan sponsor instructs, although ensuring that only directions from the plan sponsor that are consistent with ERISA and the plan document are executed. Most Directed Trustees disavow fiduciary status. They do not give advice to the other plan fiduciaries regarding the assets in their custody, nor are they afforded discretion to make investment decisions. However, there are a few Directed Trustees who may function in a carefully-crafted, limited fiduciary-advice capacity. They may provide nondiscretionary investment recommendations and ongoing data to the plan sponsor in this role. However, in such cases, the final discretionary authority and ultimate fiduciary risk still belongs to the plan sponsor.

## Discretionary Trustee

Unlike a Directed Trustees, Discretionary Trustees take responsibility for the selection, monitoring, and retention of plan investments. They must always follow the ERISA prudent-expert rules and maintain well-documented records on behalf of the plan and the participants. Because Discretionary Trustees control investment choices, they are held to a higher standard of fee disclosure and good faith than the potentially nonfiduciary Directed Trustees. The Department of Labor (DOL) requires a Discretionary Trustee to apply revenue they receive from mutual funds for the benefit of plan participants (known as the "Frost Model" after DOL Advisory Opinion 97-15A). This does not apply to nonfiduciary Directed Trustees. In addition, a Discretionary Trustee must make "un-conflicted" decisions regarding the funds used in a retirement plan. In other words, decisions must be made without regard to the amount of revenue the Discretionary Trustee receives from a fund company for any investment selection. Non-fiduciary Directed Trustees can, and commonly do, make their decisions about the breadth of the product they provide based on the amount of revenue they receive from a fund company.

To illustrate the differences between Directed and Discretionary trustees see **Figure** 1 highlighting an imaginary bright line we call "The Discretion Barrier" [excerpted from *Retirement Success* by Dr. Gregory W. Kasten].




## ERISA Section 3(38) Investment Manager

Under ERISA Sections 402(c)(3) and 403(a)(2), a named fiduciary, such as the trustee or plan sponsor, may formally delegate certain responsibilities to an investment manager. ERISA Section 3(38) discusses becoming a plan fiduciary by way of having discretion over investment decisions. Thus, the term ERISA Section 3(38) Investment Manager was born. This party is any fiduciary (other than the trustee or a named fiduciary) who has the power to manage, acquire, or dispose of any asset of a plan, is a Registered Investment Advisor, bank, or insurance company, and has acknowledged in writing that he or she is a fiduciary with respect to the plan. This appointed fiduciary may have full or partial discretion for investment selection and monitoring. The plan sponsor or other appointing fiduciary is relieved from fiduciary liability for the actions and behavior of the Investment Manager pursuant to ERISA Section 405(d)(1), provided the appointment was prudent and the performance of the investment manager is monitored on an ongoing basis.

## ERISA Trustee vs. ERISA Section 3(38) Investment Manager

We have determined that most Plan Sponsors are not taught the basics of how plans should be structured, or what the roles and responsibilities are for each party to the plan. This is a fundamental problem embedded in ERISA, itself. If one were to look at the complete body of law and regulations that govern this area and compare them to other areas of law, a fair conclusion to draw is that there are similarities between ERISA and general trust law. As a practical matter, however, ERISA plans, and specifically 401(k) plans, operate very differently from other types of trusts.

A good way to illustrate this is to think about the three primary parties to any trust, the administrator, the trustee, and the beneficiary. When discussing a charitable trust or a family trust, it would be uncommon for a single person or entity to play all three roles. It allows for too many conflicts of interest. However, 401(k) Plans are also trusts, and the same three parties exist. Yet, it is quite common for plans to be structured so that the plan sponsor names itself as the plan administrator and then also names itself (or the majority owner) as the trustee who, in turn, will also be the biggest beneficiary. While this structure is very common, it presents clear conflicts of interest. It is this structure that often leads to poor plan governance, often also the result of a "sales" process that loses sight of the plan as a trust. The natural side effect of the same party playing all of the major roles is that such person is commonly unaware when he or she is acting as the plan sponsor versus plan administrator or the trustee, or even that there is a difference. The party only knows that he or she makes 100 percent of the decisions. It would be fair to refer

to most of these parties as *amateur fiduciaries*—that is, they engage in these fiduciary activities only because the plan is sponsored by their own companies. Their main business activities are to be manufacturers, professionals, and other business owners.

When in front of clients, we often try to illustrate that there are different roles and that these can be outsourced when prudent. The simplest "lay person" explanation we use is that the trustee is responsible for everything related to the assets, and the administrator is responsible for everything else. Now, we know that, in reality, it is more complicated than that, but we want our amateur fiduciary to gain a basic understanding that there are different roles that have different responsibilities.

In order for the comparison of a Discretionary Trustee to an ERISA Section 3(38) Investment Manager to be fair, one needs to know the basic duties for which a trustee is responsible. The following discussion is meant to be thorough, albeit not necessarily exhaustive.

### General Requirements

Plan trustees have complete authority over the management and control of plan assets. In general, all trustees must adhere to these general minimum guidelines:

- Obey the rules of the plan's documents and other instruments that govern the plan;
- Follow the Exclusive Benefit Rule, by always acting solely in the best interest of the participants and beneficiaries;
- Follow the Prudent Man/Prudent Expert rule (or as we like to call it, "The Good Idea Rule"): Would someone who is not an amateur fiduciary believe this decision to be a good idea or not?
- Adhere to minimum investment diversification requirements unless it is imprudent to do so;
- Protect the plan from prohibited transactions (PTs); and
- Determine the fair market value of the assets of the plan at least annually.

The aforementioned guidelines are a great start but are intentionally vague and interpretive. When consulting in this area, clients must be asked some basic questions before decisions are made. For Example: If we take this action, will it be in the best interest of the participants? If the answer is yes, ask more questions. If the answer is no, do not proceed.

### The Investments

Ultimately, the primary duty that trustees have is the prudent selection, monitoring, and replacement of investments offered inside the plan. This is also commonly the area associated with the word "discretionary," and many of these duties can be delegated to either an ERISA Section 3(38) Investment Manager or to a corporate Discretionary Trustee. It would be fair to say that this primary trustee function is well-served by having a formal written process that governs how decisions are made.

This document, commonly referred to as an Investment Policy Statement or IPS, will outline what asset classes are considered for inclusion in the plan, the criteria used to determine how specific investments are selected to fill these asset classes, and what the criteria is for monitoring and, if necessary, replacing previously selected investments. DOL Interpretive Bulletin 94-2 defines an IPS as "a written statement that provides the fiduciaries who are responsible for plan investments with guidelines or general instructions concerning various types or categories of investment management decisions." This is the most common trustee function and the one that gets the most attention from well-trained investment advisors and retirement-plan consultants.

There are other lesser-known trustee functions that have a relationship to the investments but have very little to do with how the investments are selected and monitored. These duties fall outside the domain of what most ERISA Section 3(38) Investment Managers will do but are within the domain of Discretionary Trustees appointed under Section 403(a)(1).

### Participant Investment Decisions

The trustee is fully responsible for all aspects of plan management, *including* participant investment choices, subject to the conditional relief offered under ERISA Section 404(c). Thus, it would follow that, if a trustee wants Section 404(c) protection, compliance with Section 404(c) is the trustee's responsibility. With an ERISA Section 3(38) Investment Manager, unless specifically (contractually) accepting responsibility for participant investment choices (which no Investment Manager that we've encountered would agree to do) the plan sponsor remains potentially culpable for the consequences of poor participant choices and still needs to ensure Section 404(c) compliance themselves. With this in mind, the natural question to ask is, "How many plan sponsors can actually do this?" We estimate, not very many.

## Broad Duties of a Trustee

A trustee also has a number of other duties that would not apply to most ERISA Section 3(38) Investment Managers.

Examples:

- Pursuing contributions owed to the trust, such as late deferral remissions or pension contributions, as well as Sub-TA fees, 12(b)-1 fees, or other revenue sharing dollars
- Following an overall process reasonably designed to prevent prohibited transactions, in addition ensuring that the trustee, him- or herself, does not commit prohibited transactions
- Safekeeping or providing for the safekeeping of plan assets, i.e., custody
- Maintaining the indicia of ownership in the jurisdiction of U.S. courts
- For larger plans, adhering to mandatory third party audit requirements

## Philosophical Advantage

An advantage of the Discretionary Trustee that is not structural, i.e., not related to the trustee/Investment Manager status itself, but practical, has to do with the area of expertise that most Investment Managers have relative to professional ERISA discretionary trustees. Most ERISA Section 3(38) Investment Managers are well-equipped inside their areas of core expertise, usually investments. Conversely, many are ill-equipped to handle those aspects of ERISA plan management outside of investment management. Some areas of failure we've observed are basic, such as the inability to distinguish between the ERISA fiduciary, the SEC fiduciary standard, or the common-law fiduciary standards of care. Many, while operating well as SEC RIA firms, cannot articulate the primary duty under ERISA, which is the duty of loyalty to the participants and their beneficiaries. And finally, many do not distinguish between their core investment philosophy for accredited investors or wealthy individuals vs. ERISA plans that benefit many participants, who are often emotionally sensitive and unsophisticated investors. Excluding behavioral finance or participant decision-making behavior, such as performance chasing, when making investment decisions on behalf of the plans they serve, often leads to poor decisions, such as including inappropriate asset classes in the available investment options.

However, even after considering the aforementioned philosophical advantage, most ERISA Section 3(38) Investment Managers are very comfortable with, and are even good at, fund selection and monitoring. Most are good at setting asset allocations for advice models or QDIAs. But few that we've met are knowledgeable enough or have proper systems in place to ensure that the administrative aspects of ERISA-fiduciary, asset-management are handled properly. Below are some examples and questions to consider:

- Who is responsible for distributing QDIA notices to participants? Who suffers the consequences of nondistribution? Which rules govern these things, ERISA or contract law? Is the Investment Manager prepared to be responsible for notices or know what questions to ask?
- Who is responsible for 404(c) notices and compliance? How does noncompliance affect the Investment Manager? The plan sponsor?
- What due diligence is the Investment Manager responsible to perform with respect to SEC Rule 22c-2 issues (the issues surrounding Day Trading)? These include redemption fees, protective holds, or short-turn trades. Does the Investment Manager understand the operational issues surrounding trading policies, where these documents are found, and what to look for?
- Who is responsible for voting proxies? What are the procedures for doing so? Where will they be mailed? Who will maintain the file to show it's been done properly? Are the legal documents properly reflective of the roles and responsibilities?
- Who is responsible for Automatic Contribution Arrangement (ACA), Eligible Automatic Contribution Arrangement (EACA), and Qualified Automatic Contribution Arrangement (QACA) notices, and why might an Investment Manager need to be involved with them?
- What special due diligence is required with respect to Collective Investment Trusts/Funds (CIFs), such as stable value funds? What questions need to be asked and where does one find the information? Better, if they can't get the information, what is the investment decision process?

A great example of a mistake we see made in this area is related to the most recent trend towards using Exchange-Traded Funds (ETFs) as investment alternatives inside of 401(k) plans. Without respect to whether these are appropriate or inappropriate, we've

observed that the desire for them usually stems from how they are used when constructing model portfolios or managed accounts. The mistake that we see is that these models are being used as Qualified Default Investment Alternatives (QDIAs) when the ETF will administratively cause certain problems. How?

When a participant's contributions are invested in a QDIA, those contributions cannot be subject to any fees, restrictions, or expenses during the first 90 days [ERISA Reg. § 2550.404c-5(c)(5)(ii)]. ETFs trade similarly to stocks and, therefore, have a commission for both buying and selling them. This commission, even if very small, could create an unintentional violation of the QDIA no-fee requirement. This issue creates problems when using ETFs in a model that would be a QDIA for a plan and has nothing to do with the merits of the ETF as a stand-alone investment. Yet, without deep knowledge of the ERISA rules governing QDIAs, it would be easy to see how a Section 3(38) Investment Manager who is in favor of using passive money management to fill asset classes in a model, may unknowingly create an issue for a plan.

## By Definition or by Contract

Finally, the biggest distinguishing feature between the Discretionary Trustee and the Section 3(38) Investment Manager is the nature of the appointment and its implications. Once a plan is established, the plan instrument that governs its operation is called the "plan document." It is in this document that the named fiduciaries are identified.

Generally, there are three named fiduciaries: the plan sponsor, the plan administrator (who is usually the Plan Sponsor), and the trustee. Once these parties are appointed, with the exception of a Directed Trustee (as described earlier), the appointment comes with broad authority and defined roles and responsibilities. It follows that an individual or Discretionary Corporate Trustee's authority is comprehensive with respect to plan assets.

Under ERISA Section 402(c)(3), a named fiduciary, such as the plan sponsor or the trustee (whether individual or corporate Discretionary), can delegate certain functions to an Investment Manager. This appointment is made by contract. The scope of that contract can be broad or limited to some extent.

Example 1: Investment Manager contracted to score, select, monitor, and replace the investments exclusively at the plan level, even if the pool of available vehicles is restricted. Many refer to these functions as "fishing in a small pond," and, therefore, describe the Manager as a "small pond fiduciary."

Example 2: Investment Manager contracted is responsible for selecting, monitoring, and replacing sub-advisors of Collective Investment Funds or Insurance Sub-Accounts exclusively at the product level and is not responsible for how plans use these vehicles.

Example 3: Investment Manager contracted to create model portfolios from available funds in the plan. The Manager has no discretion over what funds are filling the asset classes, but only over how the asset classes are weighted within the models and when they need to be rebalanced or changed.

Conversely, an appointed Discretionary Trustee cannot limit its responsibilities by contract and cannot exculpate itself from ERISA duties. Once appointed in this role, it is unconditionally responsible to manage and control the assets of the Plan in accordance with ERISA.

A Discretionary Trustee appointment is all-encompassing, whereas the Investment Manager appointment requires additional knowledge and effort by the plan sponsor or trustee to know how broad or narrow the appointment is, and to assess the contract for fee fairness, necessity, and reasonableness. Our observation is that most ERISA Section 3(38) Investment Managers' contracts are very specific as to the boundaries of the service. This additional burden can be a challenge to most Plan Sponsors.

See **Figure 2**, to illustrate the various responsibilities that have been discussed and who could or would be responsible for performing them in their roles.

## The Two-Party System

Based on the previous explanation of the various fiduciary functions, there are distinguishable roles that Discretionary Trustees and ERISA Section 3(38) Investment Managers may play in a plan's total fiduciary governance. The two-party system is an arrangement in which a plan sponsor legally allocates certain fiduciary functions or responsibilities to one entity, and then hires a second entity to monitor the actions of the first. Simply stated, one fiduciary is hired by the plan sponsor to make decisions, and the second fiduciary is hired to monitor those decisions and the process for decision-making. Critical to this system is that both appointed fiduciaries are independent of each other and of the plan sponsor. Both must have the expertise and be capable of playing either the role of decision maker or monitoring agent.

**Figure 2**

| Category | Corporate Discretionary Trustee | ERISA § 3(38) Investment Manageer |
|---|---|---|
| Responsible for Selection, Monitoring, and Replacement of Plan Investments | √ | √ |
| Supplies and Follows IPS | √ | √ |
| Named Fiduciary in Plan Document | √ | |
| Naturally Responsible for § 404(c) Compliance | √ | |
| Pursues Contributions to the Trust | √ | |
| Follow Process Designed to Prevent Prohibited Transactions | √ | |
| Construct Model Portfolios Which May BE Used As QDIAs | √ | √ |
| Custody of Plan Assets | √ | |
| Maintain Indica of Ownership in the Jurisdiction of U.S. Courts | √ | |
| Adhering to Mandatory Third Party Audit Requirements | √ | |
| Familiarity with ERISA Fiduciary Standard of Care | √ | √ |
| Additional Concerns: Voting Proxies, QDIA Notice Distribution, § 404(c) Notice, ACA, EACA, QACA Notices, SEC Rule 22c2 | √ | |

Each of the fiduciary functions described in this article—ERISA Section 3(38) investment manager and discretionary trustee—represent unique and highly specialized areas of expertise. In some capacity, their duties overlap. In others, they do not. The purpose of the two-party system is to weave each of these high-level, fiduciary roles into a web that offers the greatest benefit to plan participants with the least amount of risk, liability, cost, and administrative burden to the plan sponsor.

The first player in the two-party system, the corporate Discretionary Trustee, is positioned to service a retirement plan in various capacities beyond the expertise offered by discretionary Section 3(38) Investment Managers. As previously discussed, there are many instances of exclusive trustee duties that most discretionary investment managers cannot, or frankly, would not want or be able to execute. Additionally, while the investment selection aspect of a Discretionary Trustee's duties may be valuable, they are not essential to the Discretionary Trustee's value proposition. The trustee may still employ its fiduciary process to oversee the monitoring and replacement of assets when selected. On the other hand, Investment Managers operating with discretion under ERISA Section 3(38) would suggest that their primary competitive advantage is within the arena of investment selection, monitoring, and replacement or setting asset allocation models and QDIA portfolios.

Implementing the two-party system for a plan would require several steps. In the plan document, the Plan Sponsor appoints the Discretionary Trustee. The Discretionary Trustee or Plan Sponsor appoints by contract an ERISA Section 3(38) Investment Manager

to write the IPS for the plan. Upon approval of the IPS by the Discretionary Trustee, the Investment Manager follows the IPS to prudently select investments for the plan. The Investment Manager then monitors the investments and replaces them when necessary. The Discretionary Trustee monitors the Investment Manager to ensure the IPS is followed correctly and that any changes are implemented properly. All of this occurs at the full appointment by the Plan Sponsor, who is not required to approve the specific investment processes as they occur. This shelters the Plan Sponsor from taking part in the investment process. The Discretionary Trustee continues to perform all of its other duties, as discussed earlier.

This partnership between a Discretionary Trustee and an ERISA Section 3(38) Investment Manager is one that offers the potential for holistic qualified-plan fiduciary governance. Participants and employers can benefit from the consultation of two expert fiduciaries operating within the domain of their expertise. Thus, the plan gains the benefit of the ERISA knowledge from the Discretionary Trustee's noninvestment selection duties and also gains the benefit from having an independent, qualified investment manager making prudent investment decisions on its behalf. Because the Discretionary Trustee has expertise in the same area as the Investment Manager, it is also in the best position to monitor that the Investment Manager is performing its duties well and within the boundaries of the plan's Investment Policy.

Under this type of structure, it would be fair to say that the plan sponsor is effectively shielded from the bulk of its exposure to fiduciary liability. Remember that ERISA Section 405(d)(1) specifically states that named fiduciaries are not liable for the acts or omissions of other named fiduciaries if those fiduciaries have been prudently appointed, retained, and monitored. This "shielding" is accomplished under the two-party system and tends to result in better fiduciary governance and better outcomes for the plan and the participants.

## Conclusions

The retirement-plan-services industry is riddled with ERISA-referencing, marketing lingo. As representatives of a professional fiduciary who uses similar marketing language, on some level this is exciting. The use of the terminology is beneficial if it enhances the awareness and understanding of how to apply these rules to achieve better participant outcomes.

The drawback of the terminology as used for marketing, however, is that the portrayal of the responsibilities is not always in line with the statutory duties. In such instances, it presents false comfort and is detrimental to the very intent and purpose of that fiduciary's role. So, while the marketing dialogue is useful for expanding the knowledge and understanding of these fiduciary roles, it is essential for service providers (platforms and consultants alike), plan sponsors, and even participants to understand what they really entail.

The Discretionary Trustee and the ERISA Section 3(38) Investment Manager are the two predominant fiduciaries servicing plans in an appointed discretionary capacity. While these two discretionary fiduciaries seem to be similar, they are quite different. As described, these differences can be used in a complimentary way by instituting a new model for fiduciary governance called the two-party system.

Under this arrangement, the Plan sits cradled between two professional fiduciaries working harmoniously with one another for the exclusive benefit of the participants and their beneficiaries. Together, a Discretionary Trustee, acting loyally for participants, who fulfills its broad obligations for the caretaking and management of plan assets under ERISA, and a discretionary investment manager acting within the scope of its mandate from the plan sponsor make a model for exemplary plan fiduciary governance. Under this model, the Plan Sponsor gains the benefits from prudent outsourcing of named fiduciaries and outsourcing of monitoring and oversight. ■