Third Party Fiduciaries—Myth and Reality

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In previous publications, we have discussed the nuances between various types of fiduciaries that exist and have even gone over a few of the iterations available in the marketplace as services. Some of these fiduciary services are very good and others are less effective.

Over the last few years, we have seen phrases such as 3(38), 3(21), and Discretionary Investment Manager become commonly used industry jargon. On one hand, as a professional fiduciary, trustee and discretionary investment manager, that is very exciting to us. On the other hand, we see lesser services than those we provide being touted as equivalent or superior to hiring a Discretionary Trustee as a professional Named Fiduciary.

A recent trend we have encountered is the so-called "Third Party Fiduciary" service. These are embedded relationships between two different companies. One company acts in their historically normal fashion, as a non-fiduciary retirement plan service provider offering recordkeeping, investments and third party administration. Often this is an insurance company, an independent record keeper or a mutual fund provider.

The company then partners with an investment management firm, which operates as a third party to provide fiduciary advice or 3(38) Investment Manager services. These third party fiduciary services are typically very inexpensive at a few additional basis points or a low flat fee.

The well-known adage 'You get what you pay for' should serve as a caveat in these circumstances.

Practitioners selling these programs say "you can tack fiduciary protection onto their program". This sounds eerily similar to the way Fiduciary Warrantees were marketed and sold in the past. Here is what we see as the most common iteration of third party fiduciary services, our view of its limitations and what you NEED to know that they do not tell you.

CASE STUDY

Insurance Company provider markets a Third Party Investment Manager as part of the overall suite of services for a few basis points. The marketing materials state this provider will act as a 3(38) Investment Manager and be responsible for fund selection. This represents a good deal for the Insurance Company because they can sell fiduciary protection without necessarily becoming one (maybe, maybe not *). This is appealing to the Broker-Dealer because it gives their rep the ability to sell a retirement plan product without stepping into the investment advice space, enabling them to walk the fiduciary tightrope. The Insurance Company has a steeply narrowed list of investments available through their product; 400 total options - many of which are proprietary. This "small pond" is the boundaries in which the 3(38) must operate.

This is most problematic with group annuity contracts. Large providers might have less than 200 funds. The shallow option pool becomes most glaring with Target Date Funds, where they should arguably be devoting their greatest resources.

Questions should also arise on whether delegation to the 3(38) was prudent. If so, is there any documentation of a prudent process?

THE CONTRACT

Under the above fact pattern, this arrangement will be governed by the contract held between the 3(38) Investment Manager and Plan Sponsor. This contract is typically drafted with a narrow scope of services, responsibility and limitations. Upon scrutiny, these arrangements are not even necessarily 3(38) services, but rather advice marketed as discretionary authority.

Several such contracts we have reviewed state that the 3(38) will draft and provide an Investment Policy Statement for signature, then select the initial set of funds FOR APPROVAL (advice, not discretion) and finally provide ongoing reporting to the plan trustees on which they can base decisions.

PROBLEMS

MYTH: The Plan Sponsor is sold on the idea that they are relieved from fiduciary risk under this arrangement because someone else is making investment decisions.
REALITY: The arrangement is a disguised advice relationship better described under ERISA §3(21)(a)ii, not delegated discretion. The plan trustee still makes 100 percent of the decisions and thus is responsible for those decisions in totality.

MYTH: The 3(38) is completely liable for the investments in the plan.
REALITY: The contract narrowly defines the scope.

- They are working within a "small pond" and thus are only responsible for advice specific to the pond's inhabitants. The 3(38) is not responsible if all the investments are bad, only for advising the client on selecting the best of the bad.
- They are only providing advice because the trustee must approve all investment decisions. That is not discretionary authority, but rather recommendations.

MYTH: The plan sponsor and/or participants can sue the 3(38) if they select poor investments or make poor recommendations.
REALITY: The contract will stipulate, specifically, that the 3(38) is NOT responsible for the quality of the investments available to them, the investment results of their recommendations, or any actions or behaviors of other fiduciaries to the plan. They are ONLY liable if found to be guilty of gross negligence.

For the non-lawyers reading this, Gross Negligence is different than mere negligence. In layman's terms, negligence is failure to exercise a reasonable amount of care and can be applied to many circumstances. The word 'Gross' elevates the threshold to acting in a manner that is reckless or willfully disregards the safety of others. **In other words, they can only be liable if they are found to be willfully harmful or intentionally harmful.**

CONCLUSION

Having any advice is better than none even when dealing with limited choices. These arrangements are inexpensive and, in our opinion, fairly priced since they are not worth very much to the client. Unfortunately, they are being marketed and sold with an inflated value, which lends a false sense of security to plan sponsors. It requires a keen advisor or client to vet the real details and limitations.

*Final thoughts: These arrangements are set up by companies that provide their own money management – typically Insurance Companies or Mutual fund companies. They do this because they want to offer a fiduciary service in their product that makes them more marketable. But they cannot and will not be acknowledged fiduciaries to the plan because they have so many conflicts of interest that they would invariably violate the Prohibited Transaction rules of ERISA for virtually every plan they serve.

This is what creates the need for the party rendering discretion or advice to be different from the product manufacturer. However, because they are wedded in these arrangements, even if no money passes directly between the two organizations, one can make an argument that both entities are acting in a fiduciary capacity and thus, have fiduciary status. Subsequently both should be subject to the prohibited transaction rules of ERISA.

They both benefit financially from the arrangement because both market and sell it and that would arguably be affecting their own compensation a.k.a. self-dealing. These arrangements will come under close scrutiny and most likely be the subject of future litigation and lawmaking. Ironically, by trying to avoid litigation and liability, they may actually be taking on additional risk and that could become a harmful arrangement for clients.

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