



What You Should Know About Fiduciary Status Under ERISA

Foreword

Compliance with ERISA's fiduciary responsibility and prohibited transaction provisions starts with an understanding of whether a person is serving in a fiduciary capacity. To a large extent, the application of ERISA's prudence and general fiduciary duties and prohibited transaction provisions as well as ERISA's civil enforcement and liability provisions all depend on one's status as a fiduciary. Accordingly, the determination of fiduciary status is critical.

The following presentation prepared by the Principal Financial Group® concisely describes the basic concepts of fiduciary status under ERISA, as well as the implications of being a fiduciary. Equally importantly, the presentation focuses on the differences in the types of investment fiduciaries — both investment advisory fiduciaries under Section 3(21) and investment manager fiduciaries under Section 3(38).

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INTRODUCTION

Understanding the role of plan fiduciaries in the selection and ongoing monitoring of investment options for retirement plans can be a challenge. However, having a firm grasp of the different roles of an ERISA¹ fiduciary is critical given the ramifications of assuming fiduciary status (whether assumed intentionally, or not).

At the Principal Financial Group®, we recognize the challenge and have developed this guide that plan sponsors and their financial professionals can use to help them understand:

- Under ERISA, who is a fiduciary?
- What does it mean to be an ERISA fiduciary?
- What are the differences in the types of ERISA fiduciary roles?
- What are the implications of holding fiduciary status?

Note: In October 2010, the U.S. Department of Labor (DOL) proposed a regulation that would broaden the range of circumstances under which a person would be considered an ERISA fiduciary due to providing investment advice to a sponsor of an employee benefit plan or the plan’s participants or beneficiaries. While the final regulation — which is expected to be finalized in the near future — will broaden the scope of specific activities triggering fiduciary status, the existing definitions of 3(21) and 3(38) fiduciaries will likely remain intact.

¹Employee Retirement Income Security Act of 1974

ERISA DEFINITION OF FIDUCIARY

Who is an ERISA fiduciary?

Before exploring the specific roles or functions of an ERISA fiduciary, it is important to understand what causes a person or entity to become an ERISA fiduciary in the first place.

Congress constructed ERISA based on its perspective that certain critical relationships to a plan and functions on the behalf of a plan should require heightened duties (and corresponding heightened scrutiny). Congress, therefore, defined who could be considered an ERISA fiduciary based not on the particular title a person (or entity) holds, but rather on what that person or entity does or has the authority to do relative to the plan. Thus, with the exception of the plan's named fiduciary and trustee, it is the functions undertaken rather than the title held that will be determinative of fiduciary status.

The starting point for all discussions of what it means to be an ERISA fiduciary is Section 3(21)(A) of ERISA. Section 3(21)(A) states that a person is a fiduciary "to the extent" that the person:

- Exercises any discretionary authority or control over plan management or disposition of a plan's assets
- Provides investment advice for a fee (or other direct or indirect compensation) or has any authority or responsibility to do so, *or*
- Has any discretionary authority or responsibility over plan administration

What does "to the extent" mean?

ERISA states a person is a fiduciary "to the extent" the person performs any of the functions listed above. "To the extent" means that a person could be a fiduciary regarding some aspects of the administration of the plan or its investments, but not others. In other words, the "extent" of fiduciary status can vary from person to person, depending on the specific plan duties each person undertakes. For example, an investment manager will be a fiduciary for purposes of the assets under its discretionary control but would not be a fiduciary regarding benefit claim decisions.

Actions drive fiduciary status

To better grasp what does and doesn't trigger fiduciary status, it is helpful to remember the following:

- A person's fiduciary status is determined *solely* by whether any of the fiduciary activities listed above are performed, or not.
- With the exception of the plan's named fiduciary and trustee, neither a person's actual title, nor whether the person has acknowledged fiduciary status, drives fiduciary status.

Note: Non-investment professional service providers (e.g., attorneys, accountants, actuaries) are not considered ERISA fiduciaries if they are providing only their normal professional services to a plan but may be fiduciaries with fiduciary obligations arising under other laws. Non-fiduciary status also applies when a person (or entity) performs administrative functions for the plan that do not fall under the types of actions that trigger fiduciary status (listed above, under "Who is an ERISA fiduciary?").

Categories of ERISA fiduciaries

As mentioned earlier, any person who carries out any of the functions listed in **ERISA Section 3(21)(A)** is a fiduciary. Within this broad definition of fiduciary, however, ERISA recognizes four categories of fiduciaries: Named Fiduciary, Investment Manager, Trustee and Investment Adviser.

- **Named Fiduciary** — ERISA requires each plan designate at least one fiduciary by name as having control over the plan’s operation. The named fiduciary can be identified by office or by name. Typically, the named fiduciary is the employer sponsoring the plan, but it does not need to be.
- **Investment Manager** — ERISA Section 3(38) defines the term “investment manager” to mean a 3(21) fiduciary (other than a trustee or named fiduciary) who:
 1. Has the power to manage, acquire or dispose of any asset of a plan;
 2. Is either a registered investment adviser (RIA) under the Investment Advisers Act of 1940, a bank or an insurance company; and
 3. Has acknowledged in writing that he or she is a fiduciary with respect to a plan.

Note: Only the named fiduciary or its delegates can appoint an investment manager, and the investment manager has fiduciary responsibility only for the portion of a plan’s investments that the named fiduciary or plan trustee delegates to the investment manager.

- **Trustee** — ERISA requires (with certain limited exceptions) that a plan’s assets be held in trust by one or more trustees. Unless the trustee is subject to the direction of another party, such as plan participants, the plan trustee is the person recognized as having exclusive authority and discretion over the management and control of plan assets.
- **Investment Adviser** — ERISA Section 3(21) provides that a person will be deemed an investment adviser fiduciary where such person renders advice or provides recommendations for a fee regarding the purchase or sale of securities or other property for a plan. Under DOL regulations, a five-part test must be satisfied.

Also, as is defined under **ERISA Section 3(16)**, the plan administrator generally has discretion over the administration and, as such, is a fiduciary.

FIDUCIARY RESPONSIBILITIES

ERISA fiduciaries are subject to heightened standards of conduct. A fiduciary’s duties include:

- Acting solely in the interest of plan participants and their beneficiaries and with the exclusive purpose of providing benefits to them
- Carrying out their duties prudently
- Following the plan documents (unless inconsistent with ERISA)
- Diversifying plan investments, and
- Paying only reasonable plan expenses

ERISA imposes significant responsibilities on fiduciaries who manage, control or otherwise have the authority to invest plan assets. For example, virtually every aspect of ERISA's fiduciary duty requirements — including the prudence, exclusive benefit and diversification requirements, and the obligation to follow plan documents — impact how a plan's investments are managed.

The duty to act prudently is one of a fiduciary's central responsibilities under ERISA. It requires expertise in a variety of areas, such as investments. Lacking that expertise, a fiduciary will want to hire someone with that professional expertise to assist in carrying out the investment and other functions. Prudence also focuses on the *process followed* in making investment decisions. It is therefore critical that the appropriate level of due diligence is conducted (e.g., meetings, performance reviews, minutes) in making fiduciary decisions.

A fiduciary should be aware of others who serve as fiduciaries to the same plan, because all fiduciaries have potential liability for the actions of their co-fiduciaries. For example, if a fiduciary knowingly participates in another fiduciary's breach of responsibility, conceals the breach or does not act to correct it while having reason to know that a breach is occurring or has occurred, that fiduciary is liable as well.

Certain transactions are prohibited under the law to prevent dealings with parties who may be in a position to exercise improper influence over the plan. In addition, fiduciaries are prohibited from engaging in self-dealing and must avoid conflicts of interest that could harm the plan. (*Self-dealing* means taking advantage of the fiduciary position or acting in one's self-interest rather than in the best interest of the plan.)

Fiduciaries can be held personally liable for their actions.

HOW ARE ERISA SECTIONS 3(21) AND 3(38) FIDUCIARIES DIFFERENT?

A great deal of discussion has surrounded the differences between what are commonly referred to as ERISA Section 3(38) and 3(21) fiduciaries.

Who is a Section 3(21) fiduciary?

As noted earlier, ERISA Section 3(21) broadly and clearly identifies actions that trigger fiduciary status under ERISA: Anyone who exercises any discretionary authority or control over management of a plan's assets, or who renders investment advice for a fee regarding a plan's assets, is a fiduciary.

For the purposes of this guide, the specific actions triggering 3(21) fiduciary status are narrowed in scope to the selection and monitoring of the investment options for investment of a plan's assets; in this situation, 3(21) fiduciary status is understood to mean a person renders non-discretionary investment advice regarding the plan's investment options for a fee.

When the named fiduciary engages a 3(21) fiduciary or advisor, the named fiduciary is not relieved of fiduciary responsibility. Rather, the 3(21) fiduciary has been engaged to help the named fiduciary, who ultimately makes the decision regarding investment options. Though the 3(21) fiduciary generally makes a recommendation, it is up to the named fiduciary whether or not to follow that advice. In this scenario, the 3(21) fiduciary bears responsibility for the advice he or she provides, but generally not for the outcome should the named fiduciary not follow that advice. The DOL and federal courts have held that the engagement of a 3(21) fiduciary is an indication of prudence.

Determining whether someone is functioning as a 3(21) fiduciary involves a “facts and circumstances” analysis. Just because someone holds himself or herself out to be a 3(21) fiduciary does not trigger 3(21) status; as stated earlier, a person’s fiduciary status is determined solely by whether any fiduciary activities (spelled out in ERISA Section 3(21)) are performed. The DOL recently issued a proposed regulation redefining the circumstances under which a person will be deemed to be a fiduciary by reason of providing investment advice. In the proposal, the DOL expanded broadly on the types of activities that will trigger fiduciary status.

Note: A 3(21) fiduciary also could be anyone who exercises any discretionary authority or control over management of a plan’s assets, without ever acknowledging in writing that he/she is an investment manager (as defined in ERISA Section 3(38)).

Who is a Section 3(38) fiduciary?

3(38) fiduciary status is attained by:

1. Meeting the 3(38) requirements listed previously *and*
2. Being appointed as the “investment manager” to a plan by the plan’s named fiduciary and accepting the appointment in writing.

A 3(38) fiduciary also is by definition a 3(21) fiduciary, because a 3(38) fiduciary has discretion, authority and control over a plan’s assets. The 3(38) fiduciary therefore assumes legal responsibility and liability for the decisions it makes.

Note: The named fiduciary cannot completely eliminate its fiduciary liability regarding investment decisions. Even after appointing a 3(38) fiduciary, the named fiduciary still retains ongoing responsibility for the prudent selection, monitoring and evaluation of the 3(38) fiduciary.

It is also important to understand that the act of managing a mutual fund does not confer fiduciary status under ERISA. In fact, ERISA states that the assets of a mutual fund are not plan assets and an advisor to a mutual fund is not a fiduciary in managing the mutual fund’s investment portfolio. As a result, the investment manager of a mutual fund, in buying or selling underlying securities or selecting a sub-advisor, cannot take on an ERISA 3(38) role. In contrast, the act of buying or selling shares in a mutual fund on behalf of the plan in a discretionary fashion can be covered under ERISA Section 3(38).



A person is a Section 3(21) fiduciary *to the extent* the person:

- Controls plan management or management of plan assets
- Provides investment advice for a fee (or other direct or indirect compensation)
- Has any responsibility over plan administration

Four categories of Section 3(21) fiduciaries:

- 1. Named fiduciary** — Plan must identify at least one fiduciary that controls plan operations (usually the plan sponsor).
- 2. Investment manager** — Appointed by named fiduciary and has acknowledged fiduciary status in writing (example could be a registered investment advisor).
- 3. Trustee** — Unless directed otherwise, trustees hold title to and manage the assets of the plan. Most 401(k) and other defined contribution plans have “directed” trustees who have no investment management responsibilities.
- 4. Investment Adviser** — SEC registered investment advisers or others providing non-discretionary recommendations.

Key points — ERISA Section 3(38) Investment Manager:

- An RIA, bank or insurance company
- Appointed by named fiduciary and has acknowledged fiduciary status in writing
- Has fiduciary responsibility for delegated plan investments
- Authorized to manage, acquire or dispose of any delegated plan asset
- Legally responsible and liable for decisions it makes
- Also a 3(21) fiduciary (due to control over plan assets)

Potential liabilities of holding fiduciary status:

- A fiduciary who breaches any of the responsibilities, obligations or duties imposed under ERISA can be personally liable for reimbursing the plan for any losses resulting from the breach.
- Even if a fiduciary delegates fiduciary duties to others, the delegating fiduciary retains fiduciary responsibility for prudently monitoring the performance of those to whom duties have been delegated.
- A fiduciary who breaches his or her obligation can be required to disgorge any profits made as a result of the breach and may be subject to additional equitable relief.

The named fiduciary is responsible and liable for the resulting outcome should it override any decision made by the 3(38) fiduciary.

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References to prudence mean compliance with the prudent standard described in §404(a)(1)(b) of ERISA, including following prevailing industry standards and generally accepted investment theories. ERISA imposes on the plan administrator ongoing accountability for the selection and monitoring of those to whom specific fiduciary responsibilities have been delegated or on whom the plan administrator is depending for help in meeting its own fiduciary obligations.

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