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Evaluating ERISA 3(38) investment managers

A guide for plan sponsors

Fiduciary duties

Loyalty

Prudence

Provide a diversified investment menu for plan participants

Administering the plan in accordance with plan documents

Paying reasonable expenses and avoiding conflicts of interest

Fiduciary responsibility

As a plan sponsor of a 401(k) plan you are considered a fiduciary, which means that you are responsible for making decisions that are in the best interest of the plan's participants. The Employee Retirement Income Security Act of 1974 (ERISA) requires plan fiduciaries to satisfy a number of obligations. Because fiduciary responsibilities are complex, plan sponsors frequently look to experts to help satisfy these responsibilities and mitigate liability.

Managing liability

Plan sponsors can never fully absolve themselves of fiduciary responsibilities, but they can and should seek help when needed. One of the core fiduciary responsibilities for a 401(k) plan is the prudent selection, monitoring and diversification of the plan's investment offerings. This standard of care is very high and requires investment expertise. Employers and investment committee members may not be investment professionals, and may lack the experience and expertise to make investment decisions. If this is true of your organization, consider hiring an investment manager.

Selecting an investment manager

With respect to the selection and monitoring of investments, the appointment of an investment manager under ERISA 3(38) provides the ability to narrow the scope of your fiduciary responsibilities. The plan sponsor would retain fiduciary responsibility for the selection and monitoring of the performance of an investment manager, but would not have responsibility for the selection and monitoring of the specific investment options made by the investment manager.

Weighing the pros and cons of a 3(38) investment manager

Pros

Access to expertise
Outsourcing can allocate the responsibility of investment related decision-making to those who have more knowledge of the applicable rules, and may have better technology to support the process.

Limiting fiduciary responsibilities
By appointing a competent investment manager, plan sponsors can limit the scope of their fiduciary responsibilities.

Ability to focus on core business
While plan sponsors may have a desire to assist employees in becoming financially able to retire, their focus and energy may be needed elsewhere.

Cons

Loss of control
The fiduciaries who were handling the investment-related decisions prior to the appointment may be concerned over the loss of control.

Cost
There will be a cost incurred for the outsourcing of investment management responsibilities to an investment manager.

Monitoring
The fiduciary who appoints the investment manager also has the responsibility to monitor its performance.

3(38) Investment Manager evaluation checklist

Selecting and monitoring the plan's investment manager is a fiduciary function. Below is a non-exhaustive list of considerations you may want to evaluate as you review providers and determine the best fit for your plan.

Initial screening

Depending on plan size, the plan sponsor may want to focus their search on investment managers that exceed minimum requirements related to:

- Overall assets under management, or assets in a particular product area
- Years in business
- Number of similar clients

After initial screening[1]

Once the list is narrowed through a screening process, a more in-depth review of providers is a prudent next step before hiring an investment manager. The following information may serve as a baseline for what may be assessed during the investment manager vetting process. A plan sponsor may want to verify information provided by the investment manager through independent sources.

1 In a 1991 settlement with the trustees of a multiemployer pension plan in Martin v. Towers Asset Management, the DOL set forth criterion that a named fiduciary should take into account in appointing an investment manager. The checklist expands upon those criteria.

Firm

Organizational structure and stability

- [ ] Is the firm reputable, with proven capabilities and experience?
- [ ] Have there been any recent changes in the organization that could impact service?

Resources and staffing

- [ ] Does the investment management team have the proper resources to succeed?
- [ ] Are the investment professionals distracted by other responsibilities?

Education and credentials

- [ ] What is the education and certification level of key personnel?[2]
- [ ] Is there significant experience and complementary skills among the professionals as a team?

Financial condition and protection

- [ ] Are the firm's growth prospects and capital base sufficient to maintain a healthy business?
- [ ] Does the firm hold sufficient Fiduciary Liability Insurance? Error or Omission Insurance?[3] Fidelity Bond?[4]

Experience

- [ ] What is the organization's experience with plans of similar size and complexity?
- [ ] How many clients do they have and how long have they been doing this?

Legal considerations

- [ ] Is there litigation (settled, pending and/or threatened) or enforcement activity against the firm?
- [ ] Is the firm routinely examined by regulators or independent auditors?
- [ ] Does the manager qualify as a qualified professional asset manager?[5]

Investment process

Investment philosophy

- [ ] Is the manager's approach to selecting and monitoring plan investments clearly defined and consistently applied?
- [ ] Is the process repeatable and capable of adding similar value in the future?

Performance

- [ ] What benchmarks are in place and how has performance compared to those benchmarks?
- [ ] Consider the value of any unique data sources, modeling capabilities, and depth/quality of resources.

Risk control and compliance

- [ ] Are compliance and back office systems adequate?
- [ ] Has the firm or investment team's prior funds effectively mitigated real and apparent risk?

2 Certification by CEFEX (Center for Fiduciary Excellence), DALBAR or other such organization would be an example. **3** Because an investment manager is an ERISA fiduciary, it needs to have coverage with respect to breaches of fiduciary duty under ERISA. There are various ways in which E&O coverage treats breaches of fiduciary duty generally (including absolute exclusion), and plan sponsor wants to confirm that policy will cover ERISA breach of fiduciary duty. **4** Most investment managers will be required to have an ERISA bond. Depending upon the size of the plan, plan sponsor may wish coverage in excess of statutory requirements. **5** For an investment manager to be a QPAM if it is a bank, it must have equity capital in excess of $1,000,000. If it is an insurance company, it must have net worth in excess of $1,000,000 and if it is a registered investment adviser, it must have total client assets under its management and control in excess of $85,000,000 and either have shareholders or partners equity in excess of $1,000,000 own unconditional guaranties by certain parties with a net worth in excess of $1,000,000. If the investment manager qualifies as a qualified plan asset manager or QPAM, numerous prohibited transactions can be addressed.

Service and value

Fees

- [ ] Do the fees fall in a reasonable range?
- [ ] Will any affiliates be involved in or compensated for servicing their client?

Client service and satisfaction

- [ ] Can the firm provide client lists and references?[6]
- [ ] Are there periodic meetings to review performance?

Participant communication

- [ ] Does the investment manager provide education to plan participants?
- [ ] Is the education provided on a level that is suited both for the beginning and advanced investor?

6 One of the factors that a plan sponsor needs to consider is the quality of services. Reaching out to existing or prior clients of the candidate helps satisfy this requirement.

Want to know more?

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