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3(21) versus 3(38) ERISA Investment Fiduciaries- Decoding the Numbers

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What is the difference between a 3(21) and a 3(38) investment fiduciary? This question is being asked with increasing frequency and the answer provides a host of planning opportunities for both the plan sponsor and the producer providing investment services to the plan. Despite the popularity of the question, many remain confused about the distinctions relating to these important numbers.

Executive Summary:

A 3(21) investment fiduciary is a paid professional who provides investment recommendations to the plan sponsor/trustee. The plan sponsor/trustee retains ultimate decision-making authority for the investments and may accept or reject the recommendations. Both share the fiduciary responsibility. A 3(38) fiduciary is also a paid professional, but with full authority to manage the investments in the plan. By properly appointing and monitoring an authorized 3(38) investment manager, a plan sponsor/trustee is relieved of all fiduciary responsibility for the investment decisions made by the investment professional.

Analysis:

Decoding 3(21) versus 3(38) fiduciaries is found in the section numbers of the law itself. The Employee Retirement Income Security Act of 1974 ("ERISA") is the major law governing the operation of employee benefit plans. Section 3 of ERISA contains the definitions of the terms used in the act. The twenty-first definition (ERISA Section 3(21)) is the definition of fiduciary. A fiduciary is:

1. anyone who makes decisions about managing the plan or its investments, such as selecting the investment choices for participants or hiring persons who provide services to the plan,
2. anyone who makes decisions about administering the plan, such as determining eligibility of participants, providing benefits statements and ruling on benefits claims, or
3. anyone who is paid to provide investment advice to a plan

Typically, the plan sponsor/trustee makes the first category of decisions while the plan administrator makes the second category of decisions. To meet the third category, one must provide investment advice, which currently[1] includes recommendations to invest in, purchase or sell securities:

Fiduciaries bear a high level of responsibility. A fiduciary has the duty to:

- Operate the plan only in the interest of participants and beneficiaries, for the sole purpose of providing benefits and paying plan expenses
- Act "prudently", meaning how a professional would perform under similar circumstances
- Diversify the plan's investments in order to minimize the risk of large losses
- Follow the terms of documents written to govern the plan
- Avoid conflicts of interests with the plan.

Anyone who is a fiduciary is a 3(21) fiduciary because that is simply the number of the section in ERISA that contains the overall definition. This includes the plan sponsor, trustee, plan administrator and investment fiduciary. 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.

[1] DOL Reg. Section 2510.3-21(c). This definition will likely be changed in the near future, based upon proposals submitted by the DOL.

The thirty-eighth definition in the act (ERISA Section 3(38)) is the definition of investment manager. An investment manager is special type of fiduciary, one who has been specifically appointed to have full discretionary authority and control to make the actual investment decisions. The manager may select, monitor, remove and replace the investment options offered under the plan. Only certain types of financial institutions may be appointed as a 3(38) investment manager. The 3(38) must be a registered investment adviser, bank or insurance company and must acknowledge its fiduciary status in writing. It is therefore important that service agreements be carefully drafted to provide for both the appointment of a 3(38) and for the acknowledgement of fiduciary status.

Once properly appointed, the 3(38) investment manager has full fiduciary responsibility for its investment decisions, subject to the terms of the plan documents and its investment policy statement. The plan sponsor and all other plan fiduciaries are relieved of all fiduciary responsibility for the investment decisions made by the investment manager. The plan sponsor does have a continuing responsibility to monitor whether the investment manager is actually performing the services but need not second guess its investment decisions.

This shifting of fiduciary responsibility is the key distinction- and core advantage- of using a 3(38) investment manager. In the face of ever-increasing litigation and heightened regulatory scrutiny, many plan sponsors want this extra layer of protection, especially if they are not comfortable making the plan's investment decisions themselves.

About the author:

Kim Shaw Elliott is President of IFP Plan Advisors, a division of Independent Financial Partners ("IFP"), a registered investment advisor. Kim helps investment advisors and their plan sponsor clients successfully navigate the complex rules founded in ERISA/employee benefits, securities law, broker dealer regulation and tax. She defines IFPs risk management strategies for retirement programs, provides thought leadership and training, and delivers solutions-based guidance to support IFP's advisory business. She also serves as the firm's ERISA counsel.

A three-time graduate of Washington University in St. Louis, Kim earned her JD, LLM, and executive MBA there. Her bachelor's degree in Mass Communication- Radio Television was awarded by Southern Illinois University at Edwardsville. She holds the Fellow, Life Management Institute and Associate- Customer Service designations. Kim is a frequent speaker on employee benefits and securities-related topics.