

**ERISA FIDUCIARY RESPONSIBILITY:
FIDUCIARY RELIANCE ON REGISTERED
INVESTMENT ADVISORS**

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Plan sponsors have become more concerned about the investments in their plans--due to the bear market, biased advice from Wall Street analysts, the mutual fund scandals and increased fiduciary litigation (for example, the Enron case). The legal responsibility for the investments falls on the persons who make those decisions, for example, the members of the plan committee. The conduct of these investment fiduciaries is governed by the Employee Retirement Security Income Act--ERISA.

In performing their duties, the fiduciaries are measured by ERISA's "prudent man" rule which requires that they perform at the level of a hypothetical person who is knowledgeable about investment matters.¹ If the fiduciaries lack the knowledge and experience to choose investments to be used by employees, they must obtain the necessary expertise through independent investigation or through the use of experts.² This paper examines the duties of investment fiduciaries and their use of, and reliance on, advisors.

(For ease of reference, this paper uses the term "advisor" to refer to any person giving advice on retirement plan investments. Thus, as used in this paper, the scope is broader than "registered investment advisors" or "RIAs." "Advisors," for our purposes, include RIAs, investment consultants, brokers, and others who give advice on plan investments.)

Fiduciary Duties and Standards of Conduct

Under ERISA, the fundamental duties of investment fiduciaries are:

- the duty to prudently select, monitor, remove and replace investment options;³
- the duty to provide investment options, which in the aggregate, constitute a broad range of investments;⁴ and
- the duty to provide investment options and related services which are suitable and appropriate for the particular needs and abilities of the employees covered by the plan.⁵

Fiduciaries are held to high standards when managing their plan's investment options. As one court has said, and many have repeated: "The fiduciary obligations of the trustees [and other ERISA fiduciaries] to the participants and beneficiaries of the plan are . . . the highest known to the law."⁶

ERISA requires fiduciaries to perform their duties solely in the interests of participants and for the exclusive purpose of providing participants with retirement benefits.⁷

Fiduciaries must also manage their plan's investments in accordance with the "prudent man rule."⁸ Under this requirement, they must use "the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."⁹ This

measures the conduct of fiduciaries by the standard of a hypothetical knowledgeable investor--the so-called “prudent expert” standard. In *Donovan v. Cunningham*, the court explained “a pure heart and an empty head are not enough.”¹⁰ Another court noted that ERISA’s prudence standard “is not that of a prudent layperson, but rather that of a prudent fiduciary with experience dealing with a similar enterprise.”¹¹ In the context of participant-directed 401(k) plans, this means that the standard is that of an investor who is knowledgeable about selecting investments for others to direct for the purpose of accumulating retirement benefits.

The prudent man rule requires that fiduciaries engage in a prudent process when selecting and monitoring a plan’s investments.¹² Fiduciaries should engage in both substantive and procedural prudence--that is, they should determine what information is material and relevant to their job; they should examine and understand that information; and then they should make an informed and reasoned decision.¹³

Under the prudent man rule, fiduciaries must understand and apply generally accepted investment theories, such as the modern portfolio theory.¹⁴ As a result, they should understand concepts and terminology, such as asset classes and investment styles, correlation of different investments, volatility and expense ratios. The court in *Katsaros v. Cody* stated that a fiduciary’s “lack of familiarity with investments is no excuse. . . .”¹⁵

Courts have found that, to meet these standards, fiduciaries have a legal duty to investigate the merits of any investments. In *Howard v. Shay*, the court said, “To enforce [ERISA’s fiduciary duties], the court focuses not only on the merits of the transaction, but also on the thoroughness of the investigation into the merits of the transaction.”¹⁶ In another case, the court stated that “[T]he most basic of ERISA’s investment fiduciary duties [is] the duty to conduct an independent investigation into the merits of a particular investment.”¹⁷

Use of Experts

While ERISA fiduciaries are held to the standard of a hypothetical knowledgeable investor, the law “does not impose a rule that fiduciaries be ‘experts’ on all types of investments they make.”¹⁸ U.S. Department of Labor (DOL), as well as a number of courts, have taken the position that, if the fiduciaries are not qualified to fulfill their duties, they are required to seek help. The DOL stated “Unless they possess the necessary expertise to evaluate such factors, fiduciaries would need to obtain the advice of a qualified, independent expert.”¹⁹ In *Liss v. Smith*, the court said: “where the trustees lack the requisite knowledge, experience and expertise to make the necessary decisions with respect to investments, their fiduciary obligations require them to hire independent professional advisors.”²⁰

Consistent with the requirement that fiduciaries use outside advisors where needed, courts give credit to fiduciaries who use advisors. As stated in *Martin v. Feilen*, “courts should look closely at whether the fiduciaries investigated alternative actions and relied on outside advisors before implementing a challenged transaction.”²¹ In the case of *Bisceglia v. Bisceglia*, the court stated, “Although reliance on an adviser will not immunize a trustee’s [or other fiduciary’s] actions, it is a factor to be weighed in determining whether a trustee breached his or her duty.”²²

However, fiduciaries may not rely blindly on the investment advice they receive. Instead, they must review, evaluate and understand the advice, and then decide whether to accept and implement it. As stated in a leading case, “The fiduciary must (1) investigate the expert’s qualifications . . . (2) provide the expert with complete and accurate information . . . and (3) make certain that reliance on the expert’s advice is reasonably justified under the circumstances.”²³ The court, in another well-known case, held that a fiduciary “is not justified . . . in relying wholly upon the advice of others, since it is his duty to exercise his own judgment in light of the information and advice which he receives.”²⁴ However, fiduciaries are not required to have the same level of expertise as their consultants or to duplicate their work. As one court has said, “we would encounter fiduciaries to retain the services of consultants when they need outside assistance to make prudent investments and do not expect fiduciaries to duplicate their advisers’ investigative efforts. . . .”²⁵

In order to obtain the greatest protection, fiduciaries should obtain written acknowledgment that the advisor is a fiduciary and regular written reports concerning the selection and monitoring of investments. As one case reported, “Moreover, [the advisor/broker] did not provide the subcommittee members with written material upon which they could base a meaningful decision with respect to his choices.”²⁶

Other criteria fiduciaries should consider when selecting a source for investment advice are:

- ***Is the advisor independent?*** Courts have emphasized the importance of the independence of the advisor. The court in *Gregg v. Transportation Workers of America International* stated “One extremely important factor is whether the expert advisor truly offers independent and impartial advice.”²⁷ Later in the same case, the court said “Fiduciaries need not become experts in employee benefits, and may rely on independent expert advice. . . .”²⁸

In *Liss v. Smith*, the court found “there is no genuine issue of fact as to whether the trustees fulfilled their fiduciary obligations to investigate the merit, structure and prudence of the various investments they made. Indeed, their modus operandi--blind reliance on the broker whose livelihood was derived from the commissions he was able to garner--is the antithesis of such independent investigation.”²⁹

Based on these court decisions, fiduciaries are entitled to place greater reliance on the advice of independent investment advisors, whose compensation is not affected by the advice given. In fact, ERISA section 406(b) specifically prohibits a person from giving investment advice where that person will receive compensation as a result of the acceptance of the advice by the plan fiduciaries.

- ***Does the advisor provide full disclosure, including expenses, for all funds?*** Fiduciaries are required to know all expenses that are being paid by the plan (directly or indirectly) and to determine if they are reasonable (that is, if the plan and its participants receive value commensurate to the cost).³⁰ In explaining this requirement, the DOL has said, “employers must . . . ensure that fees paid to service providers and other expenses of the plan are reasonable in light of the level and quality of services provided. . . .”³¹

Unfortunately, some advisors do not disclose all of the investment expenses; including their compensation and other payments. As a result, those advisors place the fiduciaries in jeopardy of breaching their fiduciary duties. To ensure compliance, fiduciaries should insist on written full disclosure of all compensation and other payments, direct or indirect, related to the investments being recommended.

- ***Is the advisor qualified?*** Fiduciaries are required to prudently select and monitor advisors. As stated in *Liss v. Smith*, “Failure to utilize due care in selecting and monitoring a fund’s service providers constitutes a breach of the trustee’s [*i.e.*, the appointing fiduciary’s] fiduciary duty.”³²

Fiduciaries should consider whether the advisor has the investment credentials, experience and expertise to warrant being considered an expert. That is, are the fiduciaries justified in relying on the expertise of the advisor based on the nature and extent of the advisor’s education and experience? Also, does the advisor have the resources (*e.g.*, databases, computer software and staffing) to properly perform his job and to warrant reliance by the fiduciaries? As stated by the *Liss v. Smith* court, “At the very least, trustees have an obligation to (i) determine the needs of a fund’s participants, (ii) review the services provided and fees charged by a number of different providers and (iii) select the provider whose service level, quality and fees best matches the fund’s needs and financial situation.”³³

In *Whitfield v. Cohen*, the court held that the trustees violated the “prudent man” standard.³⁴ In *Whitfield*, a plan trustee, the plan fiduciary relied on an investment advisor who had been recommended by a business associate. The fiduciary “failed to conduct an independent investigation into (1) the qualifications and past performance of the investment advisor, (2) the educational credentials of the advisor or his employees, (3) the identities of the advisor’s other clients, (4) the nature of the advisor’s proposed investments, (5) the fees to be paid under the agreement or (6) the advisor’s registration status with the SEC.”³⁵ As a result, the court found that the fiduciary breached his fiduciary duties under ERISA.

In *Liss v. Smith*, the court was critical of the fiduciaries for not investigating the advisor’s credentials: “The trustees repeatedly made investments--sometimes totaling over 25% of the Pension Fund’s assets--without any independent investigation, but based solely on the advice of a broker, whose credentials they never reviewed.”³⁶

- ***Does the advisor provide quality services that are tailored to your plan?*** Fiduciaries are required to determine whether the investments are suitable and appropriate for the needs of the plan and its participants.³⁷ In performing that task, the fiduciaries and their advisor should consider the investment abilities of the participants and the needs of the plan relative to those abilities. Depending on the participants’ investment abilities, the plan’s investments and services may vary. For example, if the average participant lacks basic investment skills, the plan may need to offer a limited lineup of funds, lifestyle funds, robust investment education or even investment advice. In making those decisions, fiduciaries should ensure that their advisor takes into account the investment abilities of the participants and gives proper consideration to the issues and possible solutions.

- ***What services are being received for the fees charged?*** Fiduciaries are required to understand the value that is being received by the plan for the fees paid.³⁸ They are not required to choose the least expensive services, but rather should ensure that they are getting value for the plan's money.

Approximately 75% to 90% of the expenses of a typical 401(k) plan are related to the investments (e.g., the expense ratios for the mutual funds).³⁹ As a result, fiduciaries and their advisor need to focus on the reasonableness of those expenses and their impact on the investment results for the participants. Fiduciaries should expect their advisor to provide a written analysis of the fees relative to appropriate fee benchmarks.

Fiduciaries should also be aware that the fees charged will vary, depending on the size of the plan. An issue often arises where a plan's assets increase in value over time. Fiduciaries are often unaware that the costs and available services are related to the size of the plan. As a result, they should be able to get additional services or reduced fees (or both) as the plan grows. A qualified advisor can educate the fiduciaries on the services and expenses that are appropriate for a plan of a given size and can advise the fiduciaries on opportunities as the plan grows.

Of course, the fiduciaries must also evaluate the expenses associated with the investment services of the person advising about the investments--who may be an investment advisor, broker or consultant. The first step is for the fiduciaries to obtain complete information about all payments, direct or indirect, being made to that person, whether by the plan or a third party (e.g., the mutual fund complex, and insurance company or a broker-dealer). (One court criticized the plan fiduciaries' failure to learn of the commissions and fees as follows: "All the while the trustees never monitored [the advisor's/broker's] performance nor did they question, inquire into or know the extent of the commissions he was earning."⁴⁰ The second step is to evaluate that information and determine whether the plan is receiving adequate value for the cost. The key factor for that analysis is the cost of a similar service in the marketplace. For example, it would normally be imprudent to pay significantly more than the price of comparable investments or services from another source.

- ***How is the advisor being paid for its services?*** Fiduciaries should make sure that a prohibited transaction does not occur as a result of the manner in which the advisor is paid. Fiduciaries also have a duty to avoid prohibited transactions.⁴¹ Under ERISA, the two most likely prohibited transactions are that the compensation of an investment consultant (for example, a broker or an investment advisor) is unreasonably high,⁴² and that the consultant gives conflicted advice (that is, advice that results in the payment of additional, and often unknown, compensation).⁴³

In order to avoid these prohibited transaction issues, the consultant should be independent (that is, not affiliated with, or compensated by, a provider) or, alternatively, the advisor should receive only a single fee based on the advice given (that is, its compensation should not vary based on the funds recommended by the advisor).

- ***Have you engaged in a prudent process to select the advisor?*** A number of court cases have analyzed the process and criteria for selecting investment advisors and managers under

ERISA.⁴⁴ Exhibit A lists many of the most important factors for selecting an investment advisor.

Conclusion

It is important for fiduciaries to understand their legal responsibilities for their plan's investments and advisors, the degree of reliance that can be placed on the advice given to the fiduciaries, and the added burden of inquiry when advice may potentially be influenced by the compensation being paid. Fiduciaries must prudently select and monitor their advisors and consultants. They may not blindly rely on advice (but may rely more heavily on independent investment advice). Fiduciaries must understand and evaluate the advice and information provided--and, if they agree with that advice, embrace it as their own.

Additionally, to protect themselves and to maintain the records required by ERISA, fiduciaries should insist on a written report of the conclusions and recommended actions of the advice given on the investments.

Exhibit A

Selection of Investment Advisor

In selecting an investment advisor, plan sponsors and fiduciaries are required to engage in a prudent process. That process involves asking the right questions and carefully evaluating the answers. The following is a list of important information that should be obtained and reviewed:

- The candidate's qualification for the position in terms of:
 - education;
 - experience in advising plans;
 - professional designations; and
 - securities law registration (or similar licensing).

- References from other plans for whom the candidate has provided investment advisory services.

- Acknowledgement in writing by the candidate that he or she is an ERISA fiduciary as an investment advisor.

- A description of the investment advice process to be followed by the candidate, including:
 - the providers for the databases and software used to formulate the advice;
 - whether and how often written reports are provided to the fiduciaries; and
 - whether the processes and advice are based on generally accepted investment theories, including modern portfolio theory.

- Whether the candidate's advice is potentially conflicted:
 - Does the candidate's compensation (or other payments) vary depending on the advice given?
 - Does any affiliated entity or person receive payments that varies based on the advice given?
 - If the payments vary, are those payments offset against consulting fees?

- Is the compensation transparent (*i.e.*, fully disclosed)? That includes:
 - all compensation or other payments to, or for the benefit of, the candidate, directly or indirectly?
 - all payments, direct or indirect to, or for, the benefit of, any person or entity affiliated with the candidate?

- Whether the candidate has, and would propose to use, an affiliated broker/dealer and, if so, the transactions and financial arrangements with the broker/dealer.

- The number of ERISA plans advised by the candidate and the amount of assets in ERISA plans for which the candidate provides investment advice.

- Whether the candidate has fiduciary liability or other insurance that would protect the plan and its fiduciaries.

Footnotes

¹ ERISA § 404(a)(1)(B).

² DOL Reg. § 2509.95-1(c)(6).

³ ERISA § 404(a)(1)(B). *See, e.g.*, the Department of Labor’s Preamble to the Final 404(c) Regulation, 57 FR 46906, 46922 (1992) (“The Department emphasizes, however, that the act of designating investment alternatives (including look-through investment vehicles and investment managers) in an ERISA section 404(c) plan is a fiduciary function to which the limitation on liability provided by section 404(c) is not applicable. All of the fiduciary provisions of ERISA remain applicable to both the initial designation of investment alternatives and investment managers and the ongoing determination that such alternatives and managers remain suitable and prudent investment alternatives for the plan. Therefore, the particular plan fiduciaries responsible for performing these functions must do so in accordance with ERISA.”)

⁴ ERISA § 404(a)(1)(C). *See also*, the Department of Labor’s Preamble to the Final 404(c) Regulation, 57 FR 46906, 46918-46922 (1992), which discusses the “broad range” requirement for 404(c) protection for fiduciaries. While the 404(c) fiduciary rules do not require compliance with 404(c), the logic of requiring a broad range of investment options in participant-directed plans applies equally to both sections.

⁵ *See, e.g.*, the Department of Labor’s Preamble to the Final 404(c) Regulation, 57 FR 46906, 46922 (1992) (the investment alternatives must be “suitable and prudent investment alternatives for the plan”).

⁶ *Donovan v. Bierwirth*, 680 F.2d 263, 272 (2d Cir. 1982).

⁷ ERISA § 404(a)(1)(A)(i).

⁸ ERISA § 404(a)(1)(B).

⁹ ERISA section 404(a)(1)(B).

¹⁰ 716 F.2d 1455, 1467 (5th Cir. 1983), *cert. denied*, 467 U.S. 1251 (1984).

¹¹ *Marshall v. Snyder*, 572 F.2d 894 (2d Cir. 1978).

¹² *Bevel v. Higginbottom*, 2001 WL 1352896, at *15 (E.D. Okla.) (*See also, Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir. 1983), *cert. denied*, 467 U.S. 1251 (1984).)

¹³ *See, e.g.*, DOL Reg. §2550.404a-1(b).

¹⁴ *See, e.g., Laborers Nat’l. Pension Fund v. Trust Quantitative Advisors, Inc.*, 173 F.3d 313 (5th Cir. 1999).

¹⁵ 744 F.2d 270, 279 (2d Cir. 1984) (citing *Marshall v. Glass/Metal Association*, 507 F.Supp. 378, 384 (D.Haw.1980)).

¹⁶ 100 F.3d 1484, 1488 (9th Cir. 1996).

¹⁷ *Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir. 1983).

¹⁸ *Harley v. Minnesota Mining and Manufacturing Company*, 42 F.Supp. 2d 898, 907 (D. Minn. 1999).

¹⁹ DOL Reg. § 2509.95-1(c)(6).

²⁰ 991 F.Supp. 278, 297 (S.D.N.Y. 1998); *see also United States v. Mason Tenders Dist. Council of Greater New York*, 909 F.Supp. 882, 886 (S.D.N.Y. 1995); *Trapani v. Consolidated Edison Employees’ Mutual Aid Society*, 693 F.Supp. 1509, 1516 (S.D.N.Y. 1988).

²¹ 965 F.2d 660, 671 (8th Cir. 1992).

²² 17 F.3d 393 (9th Cir. 1994).

²³ *Howard v. Shay*, 100 F.3d 1484, 1489 (9th Cir. 1996).

²⁴ *Donovan v. Mazzola*, 716 F.2d 1226 (9th Cir. 1983).

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- ²⁵ In re *Unisys Sav. Plan Litig.*, 74 F.3d 420, 435 (3d Cir. 1996).
- ²⁶ *Liss v. Smith*, 991 F.Supp. 278, 299 (S.D.N.Y. 1998).
- ²⁷ 343 F.3d 833, 841 (6th Cir. 2003).
- ²⁸ 343 F.3d at 843.
- ²⁹ 991 F.Supp. 278, 299 (S.D.N.Y. 1998).
- ³⁰ ERISA §§ 404(a)(1)(A)(ii), 406(a)(1)(C) and 408(b)(2).
- ³¹ *A Look at 401(k) Plan Fees*, U.S. Department of Labor, Employee Benefits Security Administration.
- ³² 991 F.Supp. 278, 297 (S.D.N.Y. 1998).
- ³³ 991 F.Supp. 278, 300 (S.D.N.Y. 1998).
- ³⁴ 682 F.Supp. 188 (S.D.N.Y. 1988).
- ³⁵ In re *Masters, Mates and Pilots Pension Plan*, 90 WL 10010495 (S.D.N.Y. 1990) (describing *Whitfield v. Cohen*, 682 F.Supp. 188 (S.D.N.Y. 1988)).
- ³⁶ 991 F.Supp. 278, 298 (S.D.N.Y. 1998).
- ³⁷ *Whitfield v. Tomasso*, 682 F.Supp. 1287, 1304. (E.D.N.Y. 1988).
- ³⁸ ERISA § 404(a)(1)(A)(ii); DOL Advisory Opinion 2001-01A. *See also*, DOL Field Assistance Bulletin 2003-3.
- ³⁹ Study of 401(k) Plan Fees and Expenses, Economic Systems, Inc., Section 3.b, 1998 (prepared for the U.S. Department of Labor).
- ⁴⁰ *Liss v. Smith*, 991 F.Supp. 278, 299 (S.D.N.Y. 1998).
- ⁴¹ ERISA § 406.
- ⁴² ERISA §§ 406(A)(1)(C) and 408(b)(2).
- ⁴³ ERISA § 406(b).
- ⁴⁴ *Whitfield v. Cohen*, 682 F.Supp. 188, 193 (S.D.N.Y. 1988); *Arizona State Carpenters Pension Trust Fund*, D. Ariz., No. CIV 89-0693 PHX RGS, *settlement* 1/2/94; *Chao v. Legino*, D. Ore., No. 02-440, *settlement* 4/4/02.