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Investment Advisor vs. Investment Manager? — No Contest (Really)

No one way of utilizing investment advisory services will be a good fit for all. To clarify some of the considerations involved in selecting the ideal approach, we asked Jennifer Eller, a principal with the Groom Law Group, to author this position piece on the differences between advising and managing a company's retirement plan as described by ERISA.

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As a lawyer advising sponsors of employee benefit plans subject to the Employee Retirement Income Security Act of 1974 (ERISA), I am often asked to help address questions of fiduciary governance. Over the years I have learned that identifying plan decision-makers and assigning fiduciary responsibilities—the heart of plan "fiduciary governance"—requires an understanding of the culture of the organization and the people who drive it. Put simply, in order for legal "best practices" to actually reduce liability, increase efficiency and encourage (or at least not stifle) innovation, the fiduciary structure put in place has to work with the organization, not against it. In connection with fiduciary governance, I am frequently asked whether it is "better" for a plan to hire a fiduciary to "advise" on plan investments or a fiduciary to "manage" plan investments. The two types of fiduciaries are often described using shorthand versions of statutory citations (i.e., a "3(21) fiduciary" vs. a "3(38) fiduciary"). Below, I briefly outline the legal differences and similarities of these two approaches, and discuss some additional considerations relevant to selecting an investment fiduciary.

What the Numbers Mean

While it is common to label fiduciaries who provide advice as "3(21) fiduciaries" and those who exercise investment discretion as "3(38) fiduciaries," both types of fiduciaries are actually described in section 3(21) of ERISA, which defines a fiduciary to include both:

- a person who has or exercises discretionary authority over the assets or administration of the plan (actual decision-makers); and
- a person who provides investment advice for a fee with respect to the assets of the plan (not decision-makers but persons who recommend investments to decision-makers).

Of course, one important distinction between the two types of fiduciaries is simply that they do different things—one advises a plan decision-maker and one is the plan decision-maker. The other distinction arises from the way ERISA apportions legal liability. ERISA permits a named fiduciary to appoint an investment manager (as defined in section 3(38) of ERISA) to manage plan assets. An "investment manager" must be a discretionary fiduciary who is also registered as an investment adviser, is a bank or insurance company, and who has acknowledged in writing that it is a fiduciary with respect to the plan. The appointment of an investment manager is advantageous for the named fiduciary because it relieves them and the plan's trustee of fiduciary responsibility for the investment of the assets under management by the investment manager (and for the manager's acts or omissions in doing so). However, as discussed below, knowing the differences does not end the analysis.

There Is No "Right Answer"

While the additional liability relief that accompanies the appointment of a named fiduciary can be very important, the specific needs of the plan and the services the fiduciary is actually expected to provide are critical to the selection decision. For instance, appointing a 3(38) investment manager won't be effective to relieve the appointing fiduciary of liability unless the manager is actually given the power to manage the plan's assets. Any person who provides advice to a plan, but does not exercise investment discretion is a fiduciary by reason of providing investment advice is not an "investment manager" (regardless of how the parties characterize the relationship). In addition, status as an ERISA investment manager is functional. It is possible that certain activities (e.g., monitoring of investment options and performance reporting) may not be viewed as part of the "power to manage" assets and thus not "investment manager" responsibilities.

In addition, while fiduciary advisors and discretionary investment managers have different roles, the standards of care and loyalty imposed by ERISA on the two types of fiduciaries are identical—and exacting. For instance, each type of fiduciary must act in accordance with ERISA's prudent expert standard, and must avoid prohibited transactions. And the Plan Sponsor appointing any investment manager or hiring a fiduciary advisor must monitor the fiduciary to ensure that the plan's needs continue to be met.

In my practice, I find that like any other fiduciary governance decision, deciding how to structure a plan's relationship with an outside fiduciary works best if informed by both legal and practical considerations. In selecting an outside fiduciary, the Plan Sponsor should understand the legal differences and similarities between 3(21) and 3(38) fiduciaries, and consider the particular needs of the plan and the plan's existing fiduciary governance structure.

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