



AN EMERGING DIFFERENTIATOR

DC Edge spoke with Jeff Gratton, Bob Cross and Jim O'Shaughnessy about offering 3(21) and 3(38) fiduciary capabilities to clients and the impact it has on their business.

Jennifer Kelly & Heather Ross

With changing regulations and increased litigation, plan sponsors are increasingly concerned about their fiduciary responsibilities. In response, a growing number of retirement plan advisors have expanded their capabilities, building the infrastructure to take on these responsibilities for clients.

In some cases, they are structuring their business as **3(21) investment advisors**, offering advice and consultation to clients on all investment and plan design decisions, though deferring the ultimate decision to the sponsor. Or, they are going further, offering discretionary advice as **3(38) investment managers**, where they take on sole responsibility, and liability, for any individual investment decisions. *For an overview, see “Who Does What” on page 9.*

“Fiduciary capabilities have become a litmus test for plan sponsors,” says Jeff Gratton, Managing Director of SageView Advisory Group, an Irvine, California-based RIA firm focused on offering 3(38) services. “It’s a differentiator for us that we can act in either a 3(21) or 3(38) capacity, based on a plan sponsor’s needs.”

Plan sponsors often do not understand the nuances of these fiduciary relationships. However, that uncertainty provides an opening for recommendation, it’s ultimately the investment committee or another decision maker that approves it. As a 3(38), I’d have full authority to make decisions.”

Bob Cross, president of the Southeast and Midwest divisions of the USI Consulting Group, a full service pension consultant and employee benefits firm, and an investment advisory representative of USI Advisors,* says that many of his firm’s relationships are 3(21) fiduciary partnerships. “We don’t really feel that we have the need, given the marketplace that we serve, to be the 3(38) investment manager with specialized advisors to explain the alternatives and, in the process, demonstrate their value-added capabilities.



Jeff Gratton

MBA

*Managing Director,
SageView Advisory Group*

- Team manages 88 plans with \$3B AUM
- Focuses on mid- to-large plans between \$20M and \$500M
- Named one of “Most Successful Retirement Plan Advisors” by *PLANADVISER* in 2009 and 2010



Bob Cross

MAAA®, ASAA®, FCA®

President, Southeast and Midwest Regions, USI Consulting Group, and Investment Advisory Rep., USI Advisors Inc.

- Oversees 31 plans with \$2B AUM
- Focuses on plans between \$25M and \$75M
- Has more than 25 years of experience in all aspects of employee benefits, with special emphasis on the design, funding, security and administration of qualified and non-qualified retirement programs



Jim O'Shaughnessy

AIF®, PRP®

Co-founder and Managing Partner, Sheridan Road

- Manages 100+ plans with \$1.5B+ AUM
- Focuses on plans between \$5 and \$250M
- Elected to the Executive Council for Defined Contribution Plan Investment Council
- Named “Top 40 Most Influential Advisors in DC” by *401kWire*, a Top 20 Rising Star of Retirement Plan Advisors by *Institutional Investor News*, a finalist for the ASPPA/Morningstar 2011 401(k) Advisor Leadership Award and in Top 5 for *PLANADVISER* Adviser of the Year

* USI Advisors Inc. is a federally registered investment advisor and wholly owned subsidiary of USI Consulting Group.

Service agreements are a key part of educating clients because they make it absolutely clear what the advisor's fiduciary role is

Jim O'Shaughnessy, a managing partner at Sheridan Road in Chicago, is the third generation of his family to advise retirement plans and has, in the last decade, made the transition from primarily broker, non-fiduciary relationships to 3(21) and, occasionally, 3(38) status.

O'Shaughnessy says that it's important to keep initial discussions simple. "The main idea that I emphasize is that it's a question of how much control you want to delegate to us as the advisor," he explains. "The major difference between 3(21) and 3(38) is that as a 3(21), if I make a recommendation, it's ultimately the investment committee or another decision maker that approves it. As a 3(38), I'd have full authority to make decisions."

Bob Cross, president of the Southeast and Midwest divisions of the USI Consulting Group, a full service pension consultant and employee benefits firm, and an investment advisory representative of USI Advisors, says that many of his firm's relationships are 3(21) fiduciary partnerships. "We don't really feel that we have the need, given the marketplace that we serve, to be the 3(38) investment manager with discretion over investment decisions," says Cross, explaining that his clients range in asset size from \$5M to over \$300M.

In many cases, Cross and O'Shaughnessy do not take on a fiduciary role, instead acting as a non-fiduciary to the plan, based on the client's needs.

3(21)

**GIVING ADVICE,
SHARING
RESPONSIBILITY**

"As a firm, we have been able to really differentiate ourselves from most of our competition the last three or four years by offering a 3(21) model and communicating the value of that model to plans in the \$50M and under segment of the market," says O'Shaughnessy. After his firm joined the National Retirement Partners (NRP) network in 2006, he met with nearly all of his 80 clients to explain the 3(21) services that his firm could offer. Most midsize plans

made the change right away with a few of his smaller plan clients—those with assets under \$10M—making the change once they realized that they alone were bearing the full fiduciary responsibility. "Service agreements are a key part of educating clients because they make it absolutely clear what the advisor's fiduciary role is," he says. "The discussion provides an opportunity to emphasize the services provided and strengthen the client relationship."

"We now break out our investment advisory services into two schedules—where we are acting as a fiduciary and where we're not acting as a fiduciary," says O'Shaughnessy. "We clearly state we're acting as a fiduciary in the investment monitoring and selection process, the implementation of investment options and the monitoring of the QDIA. We then state that we're not operating in a fiduciary capacity in areas like writing investment policy statements, plan benchmarking, fee benchmarking and disclosure, plan design and employee education."

Bob Cross also relies on service agreements to clarify 3(21) responsibilities, but he says that face-to-face meetings are equally critical. "I meet with clients quarterly, regardless of the size of the relationship," he notes. He presents each client with a formal report with information about each investment choice within the plan, and the firm's recommendations with respect to various funds—whether they should be kept, be replaced or put on watch. "We don't believe in chasing performance. We're very methodical and are extremely focused on process."

Cross always approaches clients with USI Consulting's value proposition, as opposed to scare tactics. "We talk about all the things that we can do as a firm, all the services we provide. The fiduciary responsibility we assume is all part of that package."

3(38)

**TAKING ON
DISCRETION,
MAKING DECISIONS**

Jeff Gratton has made fiduciary partnership a cornerstone of the SageView Advisory Group's business. He takes pride in his firm's becoming one of the first investment advisors to be certified by the Centre for Fiduciary Excellence (CEFEX) for meeting the highest standards of fiduciary excellence. The CEFEX logo is displayed prominently on his firm's website, which he says has been an important differentiator.

Gratton joined SageView three years ago and, soon after, began spearheading its effort to attain 3(38) fiduciary status. "ERISA 3(38) was introduced shortly after ERISA was written, but historically, it has mostly been applied in the defined benefit space," he explains. "We put a lot of time, effort

and money into researching whether it made sense for us to be able to act in an ERISA 3(38) capacity in the defined contribution arena, and we found that there was a need for that. We saw that DC plans were looking to employ much more automated processes to mitigate the plan sponsor's liability."

Gratton emphasizes that his firm's basic function, the services they provide and the analysis they perform is essentially identical, whether they are acting in a 3(21) or 3(38) capacity. "The only difference is this: Do plan sponsors want to relieve themselves of the liabilities around the investment selection monitoring process, or do they want to share in them?"

Today about a quarter of SageView's new clients hire the firm in a 3(38) capacity, and that number is growing. Moreover, a number of the clients that initially opted for 3(21) services have switched to 3(38). "We've had sponsors

who have gone through a couple of meetings as a 3(21) relationship and said, 'You know what, Jeff, you're doing everything anyway and we're going with all your recommendations. Perhaps this is a great risk mitigation tool for us, just to engage you as a 3(38).'

WHAT'S INVOLVED IN BECOMING A 3(38)?

Establishing 3(38) capabilities requires an investment of time and money. For instance, SageView supports its 3(38) relationships with a 12-member committee that makes all investment decisions for the plans. The committee is headed by economist Dr. Frank Sortino, Ph.D., who has developed a risk metric ratio employed by Morningstar in its mutual fund analysis. Other members of the committee include certified financial analysts and certified investment management advisors.

WHO DOES WHAT

	NON-FIDUCIARY BROKER	3(21) INVESTMENT ADVISOR	3(38) INVESTMENT MANAGER
ADVISOR RESPONSIBILITIES	Advises sponsor by making investment recommendations and providing related assistance. To avoid fiduciary status, advice generally must not serve as primary basis for sponsor's decision.	Advises sponsor by making investment recommendations and assist sponsor in monitoring and replacing investments, as necessary.	Advisor has discretion to make all investment decisions, including fund selection, monitoring and replacement without plan sponsor approval.
PLAN SPONSOR RESPONSIBILITIES	Takes into consideration advisor recommendations but makes final decision on any plan changes. Sponsor should independently evaluate advice from advisor, who is not a fiduciary.	Takes into consideration advisor recommendations but makes final decision on any plan changes. Sponsor may rely on advice from advisor who is a co-fiduciary.	Responsible for prudently selecting a qualified 3(38) manager, then monitoring and replacing manager as necessary.
CONSIDERATIONS	<ul style="list-style-type: none"> Services are typically provided without written agreement. Recommendations from advisor to client must meet suitability standard under securities laws. No fiduciary liability under ERISA as long as advisor does not provide fiduciary "investment advice." 	<ul style="list-style-type: none"> Service agreement defines advisor's role. Education ensures sponsor understands they have final say. 	<ul style="list-style-type: none"> Service agreement clearly spells out scope of advisor's management responsibilities. Advisor needs experienced investment team to make investment decisions. Additional fiduciary insurance required.

Source: CFDD, *What Type of ERISA Fiduciary Are You and Why It Matters*, January 2010; Marcia Wagner, The Wagner Law Group.

A RECENT PLAN SPONSOR STUDY FOUND THAT:

56%

were working with a 3(21) investment advisor

19%

did not work with a third-party advisor

14%

were working with a 3(38) advisor

11%

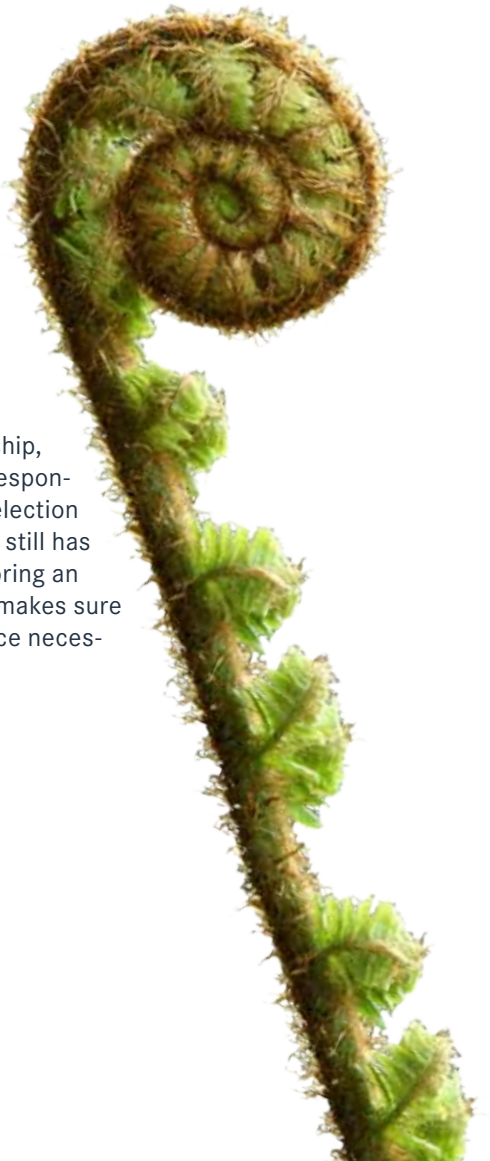
were working with a non-fiduciary advisor

In addition, the shift to 3(38) status requires revised service agreements and enhanced communication. Even though the committee can make changes to plans autonomously, Gratton says that they work closely with plan sponsors to make sure they understand any actions taken on their behalf. So far, no plan sponsors have ever objected to the committee's recommendations. "If that happened," says Gratton, "the firm would have to revisit its agreement with the sponsor and move back to a 3(21) relationship."

Specialists who take on 3(38) relationships take on greater risk, so they require higher levels of fiduciary insurance coverage than either non-fiduciary or 3(21) advisors. Gratton explains that his firm must be fully bonded under ERISA for each individual 3(38) relationship. Many firms also increase their Errors & Omissions coverage to protect themselves against potential claims relating to fiduciary liability, and certain plan sponsors want the firm to have a minimum level of coverage. For this reason, and because of all the other resources that must be devoted to a 3(38) relationship, Gratton says that his advisory fees run about 25% higher for 3(38) clients than for 3(21) clients.

A 3(38) fiduciary can offer all the usual services to plan sponsors—from plan design to investment selection and monitoring to fee analysis and benchmarking to participant communication and education. Yet firms with 3(38) status can also offer additional services, such as providing investment management for target date portfolios serving as a qualified default investment alternative (QDIA) for the plan.

By opting for a 3(38) fiduciary partnership, the plan sponsor delegates fiduciary responsibility for all aspects of investment selection and monitoring. However, the sponsor still has responsibility for selecting and monitoring an appropriate 3(38) fiduciary. SageView makes sure to provide clients with any due diligence necessary to back up the client's decision.



"Trends and Insights Focusing on the Fiduciary Agenda," Retirement Plan Survey 2011, Grant Thornton, Drinker Biddle & Reath, and PlanSponsor Advisors, March 2011, page 5.

O'Shaughnessy, whose firm acts almost entirely in a 3(21) capacity, says that he has been retained occasionally to evaluate 3(38) providers for a sponsor. "We'll create the RFI to select an advisor, we'll do the interviews with the advisors, and then, together with the committee, we'll help them select who will be the ongoing advisor," he explains. O'Shaughnessy says that the selection process for 3(38) and 3(21) advisors is not very different; however, the pool of potential 3(38) advisors is smaller. "There are not many companies out there that can act truly as a 3(38). They tend to be larger, more specialized consulting firms."

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Gratton, Cross and O'Shaughnessy agreed that there is growing demand for fiduciary services among plan sponsors, even if they are not yet fully aware of the differences in fiduciary status. The possible change in the definition of fiduciary will only increase the spotlight on who does what, an advisors' value proposition, and fees associated.


All agree that education is a critical part of the process, enabling sponsors to grasp the basic benefits and differences between a non-fiduciary broker, a 3(21) investment advisor or a 3(38) investment manager, choosing the one that best fits their needs. When included as a regular part of the annual or quarterly meeting, fiduciary discussions can reinforce the value of the services that the advisor is currently offering and determine whether the client might benefit from additional fiduciary partnership. In addition, just demonstrating an understanding of fiduciary issues can enhance the advisor's perceived value to clients. Gratton says that even when new clients choose not to engage them as a 3(38), his firm's ability to offer that service can be a differentiator for SageView.

Yet, he also cautions that not all firms have the resources to develop 3(38) capabilities. SageView already had a team of economic and legal experts when it developed the capability, but many smaller firms don't have the expertise in place. It costs more to act in a fiduciary role, given the need for

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more extensive fiduciary insurance coverage. Advisors and consultants should think carefully about their resources and their clients' needs before making the change. As well, they should plan for extensive communication and education with clients so that they can communicate the value of these new services. And finally, they will need to think about the fees they charge and how much extra they will need to charge for enhanced fiduciary capabilities.

Still, for advisors and consultants who can offer 3(21) or 3(38) fiduciary partnership, these services can be an important part of an overall package. In today's volatile markets, the demand for these services appears to be growing. "There's certainly anxiety in the marketplace about fiduciary responsibility and roles, and with market turmoil, that anxiety only increases," says Cross.

"However, I think it's critical that we go about this from an educational perspective and a communication perspective, not from the perspective of creating unnecessary fear to generate business. It has to be done in a professional way." 

WE WANT TO
HEAR
FROM YOU

- What do you think?
- What advice do you have for your peers?
- Do you act in a non-fiduciary, 3(21) or 3(38) capacity? How has it impacted your business?

Send us an email at blackrockDC@blackrock.com. For more information, access our advisor Fiduciary Toolkit at www.blackrock.com/dcedge. It features seven guides and videos by ERISA attorney Marcia Wagner on topics such as fiduciary status, plan fees, investment duties, due diligence, investment menu, fiduciary liability and rollover assets.