A decorative graphic at the top of the page featuring a compass rose with cardinal and ordinal directions (N, NNW, NNE, NE) and a central arrow pointing upwards. The background is a dark purple color.

# CLS ADVISOR IQ SERIES

A PRIMER ON **ERISA** FIDUCIARY  
STANDARDS AND TYPES



CLS INVESTMENTS

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## Introduction

The Employee Retirement Income Security Act (“ERISA”) was enacted to provide minimum standards for retirement plans in private industry and to protect the interests of participants and beneficiaries of those plans. Many of ERISA’s rules are grounded in common sense concepts, the most familiar of which is the fiduciary status requirement. However, application of the fiduciary requirements can become quite complex in the ERISA framework.

Many sponsors of plans that qualify for special tax treatment under ERISA (“plan sponsors”) may not have the necessary experience to navigate the complicated fiduciary standards under ERISA. This whitepaper is intended as an introductory primer on the interactions between CLS Investments LLC’s (“CLS”) qualified plan service offerings and the various fiduciary standards under ERISA, as well as a brief explanation of how CLS’s offerings can be used to satisfy different ERISA fiduciary standards.

## General Fiduciary Standards Under Securities Law

Before diving into the various code sections of ERISA, it may be helpful to go over the general fiduciary standard that ERISA borrowed from SEC rules and regulations in building its own fiduciary frameworks. At the margins, the standards are different for registered investment advisers (“RIA”) and broker-dealers. A summary of both is included below, as CLS works with both.

### RIAs

The SEC has made it clear that RIAs are fiduciaries whose duty is to serve the best interests of their clients, including an obligation to not subordinate clients’ interests to their own. Included in the fiduciary standard are the duties of loyalty and care. An RIA with a material conflict of interest must either eliminate that conflict or fully disclose all material facts to his or her clients relating to the conflict. In addition, the Investment Advisers Act of 1940 expressly prohibits an RIA, acting as principal for his or its own account, from effecting any sale or purchase of any security for the account of a client without disclosing certain information to the client in writing before the completion of the transaction and obtaining the client’s consent.

### Broker-Dealers

Generally, broker-dealers that do business with the public must become members of FINRA. Under the antifraud provisions of the federal securities laws and self-regulatory organization rules, including those relating to just and equitable principles of trade and high standards of commercial honor, broker-dealers are required to deal fairly with their customers. While broker-dealers are generally not subject to a fiduciary duty under the federal securities laws, courts have found broker-dealers to have a fiduciary duty under certain circumstances. Moreover, broker-dealers are subject to statutory, SEC, and self-regulatory organization requirements that are designed to promote business conduct that protects customers from abusive practices, including those that may be unethical but not necessarily fraudulent.

CLS, as an SEC-registered investment adviser, is held to the higher fiduciary standard imposed on RIAs.

## ERISA Fiduciary Standards

If a service provider undertakes certain activities, ERISA has higher fiduciary requirements than the ones set forth above. Generally, service providers may be ERISA fiduciaries if they:

- exercise authority or control over the management or disposition of employee benefit plans that are covered by ERISA
- provide investment advice for a fee with respect to plan assets, or have authority or responsibility to do so
- have discretionary responsibility or authority to administer a plan

In general, an ERISA fiduciary must act with care, skill, prudence, and diligence under the circumstances that a reasonably prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character with like aims. ERISA requires, among other things, that a fiduciary must diversify a plan’s investments so as to minimize the risk of large losses, unless, under the circumstances, it is clearly prudent to not do so. ERISA also prohibits a number of transactions, particularly those involving conflicts of interest

between the plan and certain parties in interest.

This fiduciary standard goes above and beyond the securities laws standards because they require a measurable level of skill, prudence, and diligence, while the securities laws generally only require that the fiduciary act in the client's best interests and eliminate or disclose conflicts of interest. Courts have generally been very willing to judge an ERISA fiduciary performance in light of these heightened standards. While many service providers have the necessary grounding in securities law fiduciary concepts to comply with those fiduciary laws, the technical nature of ERISA can trap many unwary advisers and plan sponsors. Given the fairly low regulatory thresholds to becoming a representative of an RIA or a broker-dealer, CLS believes it is in the best interests of plan sponsors and the professionals who interact with plan sponsors to ensure that the adviser to the plan is a qualified fiduciary with an in-depth understanding of ERISA issues.

Additionally, the "prohibited transaction" elements of the fiduciary rules can be very complex. We'll address the prohibited transaction elements later in this whitepaper. However, prior to doing so, it's important to recognize that even within ERISA, there are various levels of fiduciary status and it's important to correctly categorize the services being provided into the correct one.

## Types of ERISA Fiduciaries

As the industry matures and regulations become increasingly complex, demand for qualified fiduciary adviser services has increased, and the industry is experiencing a rising number of advisers offering fiduciary services that have not previously done so. This increase in demand is prompting many advisers in the industry to assume a fiduciary role they have not fully explored. However, CLS has been providing services as an ERISA fiduciary for almost a full decade.

There are two code sections of ERISA that specifically define types of fiduciaries. Both are referred to in shorthand by the code sections of ERISA in which they are found. Accordingly, a "3(21)" fiduciary is a fiduciary of the type described in ERISA code section 3(21) and a "3(38)" fiduciary is a fiduciary of the type described in ERISA code section 3(38). We'll examine each of these types of fiduciaries in detail below.

### 3(21) Fiduciary

Section 3(21) of the ERISA code states that a person is a fiduciary with respect to a plan to the extent:

- i. he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets;
- ii. he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or;
- iii. he has any discretionary authority or discretionary responsibility in the administration of the plan.

It's important to note how broad subsection (i) is. To the extent that an individual or entity

exercises any authority or control respecting plan assets, they become a fiduciary to the plan. Additionally, if a party does not have “authority” or “discretion” but would otherwise receive compensation for only rendering “advice,” the service provider also becomes a fiduciary.

Accordingly, Section 3(21) of ERISA takes a very expansive view of who can be a fiduciary. Many investment professionals unwittingly become 3(21) fiduciaries to plans either because they make decisions on behalf of the plan or render investment advice to the plan. This is why 3(21) is referred to as a “functional” fiduciary – because, by performing various functions, an investment professional can be deemed a fiduciary without agreeing to serve in a fiduciary capacity.

### **3(38) Fiduciary**

In contrast to 3(21) fiduciaries, 3(38) fiduciary status attaches only when a service provider is formally appointed by the plan sponsor. Section 3(38) of ERISA defines a 3(38) fiduciary (or “3(38) investment manager”) as a fiduciary who:

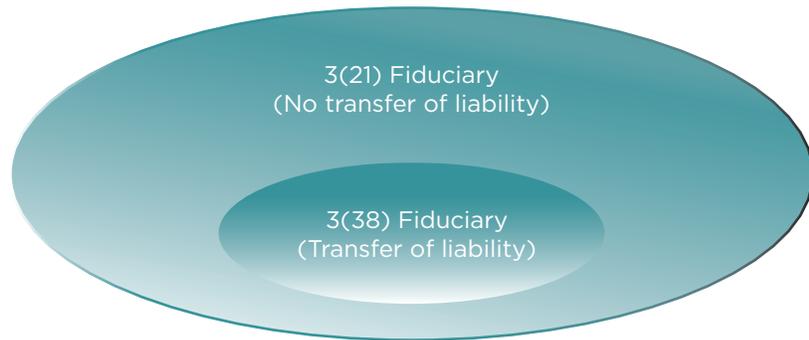
- A. has the power to manage, acquire, or dispose of any assets of a plan;
- B. who (i) is registered as an registered investment adviser under the Investment Advisers Act of 1940, (ii) is a bank, or (iii) an insurance company;
- C. has acknowledged in writing that he is a fiduciary with respect to the plan.

As a practical matter, item (C) means that, in order to be a 3(38) fiduciary, the service provider must formally agree in writing to act as such. After the 3(38) is named (usually in the plan sponsor agreement), the plan sponsor turns over authority to the 3(38) fiduciary to make investment decisions on behalf of the plan. The 3(38) fiduciary, in turn, assumes legal responsibility and liability for the decisions it makes, which enables the plan sponsor to manage and mitigate its own fiduciary risk.

This does not mean that the plan sponsor can completely mitigate its fiduciary risk. The plan sponsor still retains responsibility for the prudent selection of the 3(38) investment manager and must monitor that 3(38) investment manager. This means that the plan sponsor must select an appropriate 3(38) investment manager with experience acting as such, and take appropriate steps to replace the 3(38) investment manager if they do not provide the promised services.

## Overlap of 3(21) and 3(38)

3(21) and 3(38) fiduciary status are not mutually exclusive. Because 3(38) is more focused, it's appropriate to think of 3(38) as a subset of 3(21) fiduciary status. In other words, whenever an investment professional has agreed to act as a (38) fiduciary, they are automatically acting as a 3(21) fiduciary as well.



From a plan sponsor's perspective, the most practical difference between 3(21) and 3(38) fiduciary status is the extent, and degree, to which fiduciary liability issues are transferred from the plan sponsor to the investment professional.

The following chart is a shortcut reference on the difference between 3(21) and 3(38) fiduciary status.

	<b>3(21)</b>	<b>3(38)</b>
<b>Actions taken</b>	Can be limited to provision of "advice."	Has "discretionary control" over plan assets.
<b>Liability of plan sponsor</b>	Selection of the provider and for actions taken by the provider.	Selection and monitoring of the advisor.
<b>How appointed</b>	No formal appointment needed. Can exist by action alone.	Provider needs to acknowledge in writing that they are a fiduciary.
<b>Type of provider</b>	Can be any person or entity.	Needs to be an RIA, bank, or insurance company.

## What Type of Fiduciary is CLS?

CLS serves as both a 3(21) and a 3(38) fiduciary. We tailor our service offerings to each plan. Accordingly, we have various service offerings spanning both the 3(21) and 3(38) space depending on the services chosen by the plan sponsor and the capabilities of the platform and the custodian. Because of the fiduciary risk we assume on our 3(38) offerings, we reserve the right to limit our 3(38) offerings, as we deem necessary.

We partner with independent broker-dealer and investment adviser representatives to provide money management services, leaving the representative to focus on plan sponsor education and assistance. By utilizing CLS to provide fiduciary services, representatives can devote more of their time to the following client services:

- Establishing and evaluating goals to ensure the plan meets objectives
- Providing investment-related communications to participants
- Ensuring plan-related recordkeeping and other administrative functions are completed
- Supporting fiduciary monitoring requirements
- Offering plan cost benchmarking
- Guiding plan participants as they near and enter retirement

CLS strongly believes that plan participants and plan sponsors can benefit from representatives focusing on the above services, while leaving the day-to-day investment decisions, and the resulting investment liability, to CLS.



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17605 Wright Street  
Omaha, NE 68130  
888.455.4244  
CLSinvest.com