As discussed in our February 20, 2018, article, the Division of Enforcement of the Securities and Exchange Commission (the “Division”) released an announcement on February 2 that launched the Division’s Share Class Selection Disclosure Initiative (the “Initiative”). The Initiative continues the SEC’s focus on investment advisers who receive compensation or financial incentives in connection with their selection or recommendation of mutual fund share classes. For employers that sponsor retirement plans, the Initiative also raises the issue of whether plan fiduciaries, who engage the services of an investment adviser, have the appropriate information to fulfill their fiduciary obligations.

Under ERISA’s exclusive benefit rule, a fiduciary must discharge his or her duties with respect to a plan solely in the interest of participants and beneficiaries, which includes defraying reasonable plan expenses. In addition, ERISA’s prudent expert rule requires that a fiduciary discharge his or her duties with respect to a plan “with 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.”

Because prudence under the prudent expert rule is contextual, fiduciaries have a duty to understand the market, take current conditions into consideration, and stay informed or seek help (if needed) when engaging plan service providers, including investment advisers. In addition, the exclusive benefit rule requires, in part, that plan fiduciaries understand the compensation that service providers receive in order to determine whether such compensation is reasonable. Fiduciaries, however, may encounter challenges when trying to obtain sufficient information to fulfill these obligations.

For example, the SEC states in its Announcement that it has identified numerous arrangements in which an investment adviser, its affiliated broker-dealer, or its supervised persons received compensation pursuant to Rule 12b-1 of the Investment Company Act of 1940 (“12b-1 fees”) from a higher-cost mutual fund the adviser recommended to, or selected for, a client when a lower-cost share class of the same fund was available, without explicitly disclosing such conflicts of interest to the client.

As reflected in a series of questions previously issued by the Department of Labor, the DOL and SEC have consistently expressed concerns that investment advisers may not be adequately disclosing conflicts of interest to their clients. As a result, plan fiduciaries may not be able to properly evaluate and monitor an investment adviser’s conflicts, thereby creating risk for themselves. Thus, plan fiduciaries may need to dig deeper to fully understand an investment adviser’s compensation and where potential conflicts of interest exist. By actively researching and questioning an adviser’s direct and indirect compensation, as well as its alliances and relationships with other entities, plan fiduciaries can help mitigate their potential fiduciary risk.

This blog post was drafted by Beth Miller, an attorney in the Spencer Fane LLP Overland Park, KS office. For more information, visit spencerfane.com.

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