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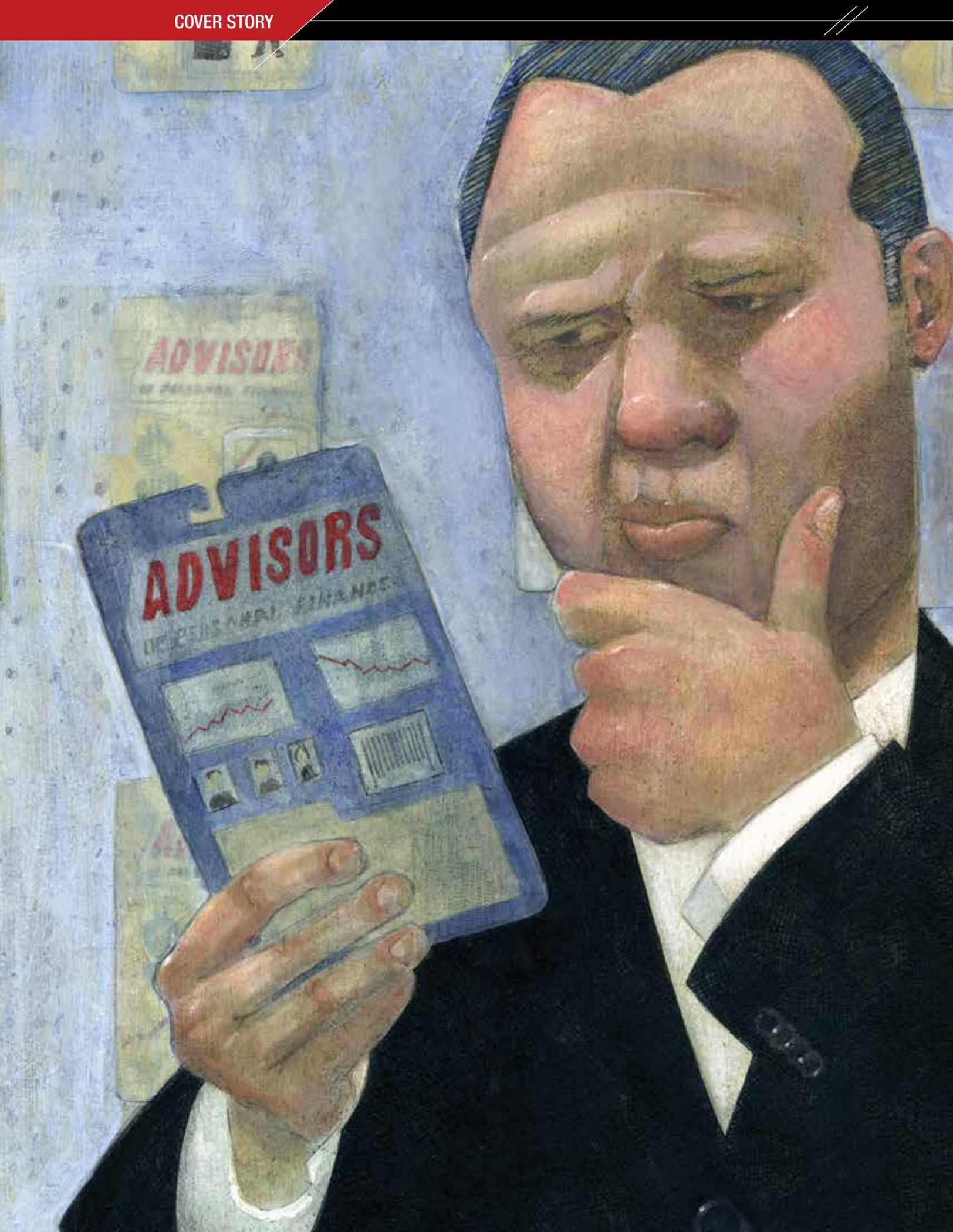
## Buyer Beware

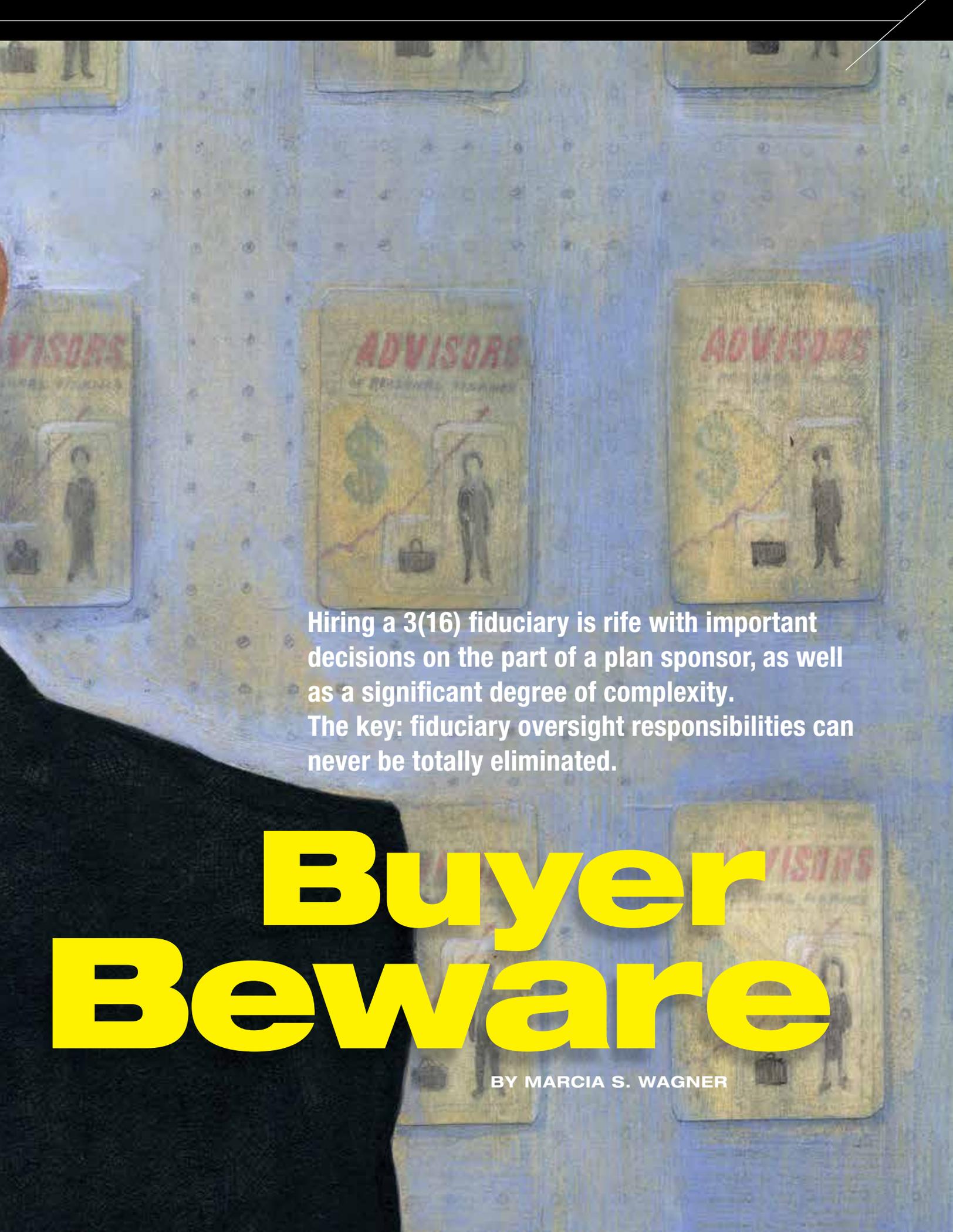
Hiring a 3(16) fiduciary won't eliminate a plan sponsor's fiduciary oversight responsibility.

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Hiring a 3(16) fiduciary is rife with important decisions on the part of a plan sponsor, as well as a significant degree of complexity. The key: fiduciary oversight responsibilities can never be totally eliminated.

# Buyer Beware

BY MARCIA S. WAGNER



Although a plan sponsor may hire various service providers, the sponsor typically retains primary responsibility for the management of the plan as a fiduciary under ERISA. However, a number of providers are now willing to accept certain plan management responsibilities as so-called “3(16) fiduciaries.” In this article, we will examine the implications of this development.

### **DEFINITION AND DUTIES OF 3(16) FIDUCIARY**

The term “3(16) fiduciary” is derived from Section 3(16) of ERISA, which provides that the term “administrator” means either the person “specifically so designated” by the plan terms or if an administrator is not so designated, the plan sponsor. Every plan must have a person who serves as its administrator for ERISA purposes, and this person is required to fulfill certain reporting and disclosure obligations under ERISA that are not imposed on other types of plan service providers. These functions make such an administrator a unique ERISA fiduciary.

The administrator’s duties include providing summary plan descriptions (SPDs) to participants and ensuring that they receive quarterly benefit statements. In addition, the administrator must furnish participant-level fee disclosures in accordance with the DOL’s new participant-level disclosure regulations. A copy of the plan document must be provided by the administrator to participants upon request.

Furthermore, the administrator has a duty to sign and file a plan’s Form 5500, and must engage an accountant to conduct audits of the plan’s financial statements where necessary for purposes of these annual filings. The administrator has a duty to maintain the tax-qualified status of the plan and ensure that it is operated in accordance with its terms.

In addition to being subject to the aforementioned obligations, a plan’s administrator is also subject to a unique set of sanctions that only apply to administrators and their reporting and disclosure duties. Specifically, the administrator’s failure to file a Form 5500 on a timely basis may result in a penalty of up to \$1,100 per day. Upon a failure to furnish certain required information (e.g., the plan’s SPD, Form 5500 or plan document) to a participant within 30 days of a request, the administrator may be subject to a penalty of up to \$110 per day.

The plan fiduciary responsible for these duties that come within ERISA’s definition of “administrator” should never be confused with ordinary administrative service providers. Accordingly, this statutory term should not be used to describe a TPA that does not accept any fiduciary responsibility from the plan sponsor. When the plan sponsor serves as administrator, it has the fiduciary responsibility of ensuring that the participants receive their mandatory disclosures even if as a practical matter it relies on the plan’s record keeper or TPA to deliver these materials.

Furthermore, even if the TPA prepares the Form 5500, it is the plan sponsor in its capacity as the administrator that must file the form, making it responsible for its informational content. If the record keeper or TPA makes an error, it is the plan sponsor in its capacity as the administrator that is subject to a fiduciary penalty.

### **ADVANTAGES OF HIRING A 3(16) FIDUCIARY**

To meet the desire of some plan sponsors to “outsource” fiduciary responsibilities attributable to their status as administrators, a number of third party service providers holding themselves out as “3(16) fiduciaries” are now willing to accept certain plan management responsibilities that traditionally had been performed by plan sponsors. For example, some TPA firms are now willing to perform

certain fiduciary functions as 3(16) fiduciaries. Trust companies which offer trust and custody services to plans, as well as certain registered investment advisors under federal or state securities laws, may also be willing to serve as 3(16) fiduciaries.

If a plan sponsor elects to engage a third party to serve as the plan’s 3(16) fiduciary, the plan document must be amended to designate this third party provider of fiduciary services as the plan’s administrator. When a 3(16) fiduciary is designated as the administrator, the plan sponsor ceases to be responsible for the applicable ERISA reporting and disclosure obligations.

For example, if the plan’s record keeper fails to distribute a plan document upon a participant’s request, it would be the 3(16) fiduciary (rather than the plan sponsor) that would be subject to the applicable statutory penalties. Furthermore, since the 3(16) fiduciary would be responsible for signing and filing the plan’s annual filings on the Form 5500, the 3(16) fiduciary (rather than the plan sponsor) would be liable under ERISA for any delinquent or defective filings made on behalf of the plan.

As a result of the transfer of potential liability from the plan sponsor to another 3(16) fiduciary, there are some clear benefits for the plan sponsor from a fiduciary perspective once it engages the 3(16) fiduciary. However, it should be noted that the transfer of fiduciary responsibilities from the plan sponsor to the 3(16) fiduciary may in fact be limited to the transfer of the sponsor’s fiduciary reporting and disclosure obligations. Unless the 3(16) fiduciary voluntarily agrees to accept additional fiduciary responsibilities, the plan sponsor would remain responsible for discharging all other plan management responsibilities, including the fiduciary oversight of the plan’s investment menu and management of all other benefits-related aspects of the plan.

### **SHIFTING FIDUCIARY RESPONSIBILITIES**

Some plan sponsors may

# Plan sponsors should be wary of any arrangement in which the 3(16) fiduciary has the discretion to appoint itself to serve as the plan’s investment manager.”

mistakenly believe that a 3(16) fiduciary will automatically assume all of the sponsor’s responsibilities. As noted above, it is entirely possible for a 3(16) fiduciary to genuinely claim that it has taken on the role of the plan’s administrator while limiting its fiduciary responsibility solely to the reporting and disclosure obligations imposed by ERISA on the plan’s administrator.

To illustrate this point, consider a hypothetical TPA firm that offers non-fiduciary administrative services to its plan clients, such as performing compliance testing, administering the plan’s loans and preparing a signature-ready Form 5500 for the plan sponsor’s execution. This kind of TPA firm could easily offer to serve as a 3(16) fiduciary for its plan sponsor clients by offering these incremental services:

(1) monitoring the plan’s record keeper to ensure that all required disclosures are delivered to participants, and

(2) signing the Form 5500 as the plan’s administrator.

Alternatively, a trust company offering to serve as a 3(16) fiduciary could agree to expand its traditional services to include adjudication of benefit claims and disputes with participants, manage the plan’s menu of investments, ensure that the plan operates in accordance with applicable tax qualification requirements, select and monitor the plan’s service providers and execute their service agreements on behalf of the plan, while ensuring that the plan’s fees and expenses are reasonable.

In the case of a third party which agrees to serve as a 3(16) fiduciary and accept a comprehensive level of

fiduciary oversight responsibilities, the plan document is typically amended to designate such third party as the plan’s “named fiduciary” (in addition to designating the third party as the plan’s administrator). ERISA Section 402(a) requires every plan to identify at least one named fiduciary with the “authority to control and manage the operation and administration” of the plan. Therefore, depending on the scope of the fiduciary responsibilities assumed by the 3(16) fiduciary as reflected in the plan document, the 3(16) fiduciary’s duties may be narrowly limited to the applicable reporting and disclosure obligations of the plan or they may be substantially broader.

If the 3(16) fiduciary accepts the role of named fiduciary, its fiduciary duty extends to the operation and management of the plan as a whole.

## **INABILITY TO FULLY ELIMINATE PLAN SPONSOR RESPONSIBILITY**

Unfortunately, even if a 3(16) fiduciary agrees to assume full plan management responsibilities as both named fiduciary and administrator, it cannot fully eliminate the plan sponsor’s fiduciary oversight responsibilities. This especially may be the case regarding monitoring of the timely transmission of elective deferral contributions to trust. Given the fact that it is the sponsor’s decision to hire and retain a 3(16) fiduciary, the sponsor remains responsible for the duly diligent selection and monitoring of such a service provider. The courts have held that even if a plan sponsor gives the administrator control over the plan, the sponsor remains responsible for

the administrator’s appointment.<sup>1</sup>

It is important for plan sponsors to understand that their decision to appoint a 3(16) fiduciary is itself an affirmative fiduciary act that must be made prudently in accordance with the fiduciary standards of ERISA. Moreover, plan sponsors should realize that they have an ongoing duty to monitor the performance of its 3(16) fiduciary firm at reasonable intervals (e.g., annually).

## **HOW TO PRUDENTLY SELECT A 3(16) FIDUCIARY**

A decision to hire a 3(16) fiduciary should be made prudently and solely in the interest of plan participants. As part of its decision-making process, it is important for the plan sponsor to establish and follow a procedure that satisfies the requirements of ERISA. According to the DOL, the plan sponsor must engage in an “objective process” designed to elicit the information necessary to evaluate the following three criteria:

(1) the qualifications of the service provider,

(2) the quality of services provided, and

(3) the reasonableness of the provider’s fees in light of the services provided.<sup>2</sup>

To evaluate a prospective 3(16) fiduciary, the plan sponsor should consider the qualifications of the firm and its personnel. The plan sponsor may wish to request information concerning the firm’s track record in serving as a 3(16) fiduciary as well as the educational background and experience of the firm’s employees and management team.

Given the highly technical nature of fiduciary services, it is important

<sup>1</sup> See, e.g., *Gelardi v. Pertec Computer Corp.*, 761 F.2d 1323 (9th Cir.1985) (holding that the employer and the employer’s board of directors remain liable with respect to the selection of the plan’s administrator).

<sup>2</sup> DOL Advisory Opinion 2002-08A. See also DOL Field Assistance Bulletin 2002-3.

## “When a 3(16) fiduciary is designated as the administrator, the plan sponsor ceases to be responsible for the applicable ERISA reporting and disclosure obligations.”

that the firm have sufficient expertise in ERISA as well as the fiduciary standards and requirements that are imposed on named fiduciaries and administrators under ERISA. The plan sponsor should also consider the firm's size, the total amount of client assets under administration and whether the prospective firm is a trust company, registered investment adviser or a non-regulated entity

When considering the quality of the services offered by the prospective firm, it is especially important to identify the scope of the fiduciary responsibilities that would be assumed by the 3(16) fiduciary in connection with the proposed engagement. The scope of the firm's services should be described in its upfront fee disclosures mandated under ERISA's new plan-level disclosure rules, which must be provided to the plan sponsor before the firm may be hired.

Using these disclosures and other relevant information, the plan sponsor should determine the extent to which the 3(16) fiduciary will accept fiduciary responsibilities beyond those of an administrator, and whether the firm is also willing to be named as the plan's named fiduciary. The plan sponsor should also identify which direct services the 3(16) fiduciary intends to render itself and inquire how the 3(16) fiduciary intends to monitor and evaluate other plan service providers with respect to their performance and compensation.

In order to evaluate the reasonableness of the fees of a 3(16) fiduciary, the plan sponsor may request bids or quotes from comparable 3(16) fiduciary firms to help it determine the prevailing rate for similar services.<sup>3</sup> However, the number of 3(16) fiduciary

firms (offering both fiduciary oversight and non-fiduciary administrative services) may be small in comparison to the number of firms, such as TPAs, that routinely offer non-fiduciary administrative services only.

Accordingly, if the plan sponsor is not able to obtain bids or quotes from multiple firms that are comparable to the prospective firm, it may wish to consider comparing the 3(16) fiduciary firm's quoted fee for its suite of fiduciary oversight and non-fiduciary administrative services against the quoted fees of comparable firms offering non-fiduciary administrative services only. This comparison would enable the plan sponsor to determine the fee "premium" charged by the 3(16) fiduciary firm for accepting additional fiduciary responsibilities as an administrator (or as both an administrator and named fiduciary).

In addition to evaluating the three criteria required under the DOL's guidance for prudently engaging a service provider, when considering a 3(16) fiduciary firm, the plan sponsor may also wish to consider the firm's capacity to pay any possible legal claims made by the plan sponsor or its participants in connection with any breach by the 3(16) fiduciary of its duties to the plan. For example, if a 3(16) fiduciary were to imprudently approve the hiring of a record keeper with dishonest or incompetent employees, the 3(16) fiduciary would be subject to potential liability for causing any related losses sustained by the participants.

Plan sponsors may wish to confirm that their 3(16) fiduciaries maintain a sufficient level of insurance coverage and/or have deep pockets. If not, a plan sponsor could ultimately

be liable for the misdeeds and/or negligence of a 3(16) fiduciary.

Finally, the plan sponsor will want to ensure that there is no duplication of services among the 3(16) fiduciary, the TPA and the investment advisor.

### **LIMITATIONS OF INVESTMENT MANAGER APPOINTMENTS**

Certain trust companies and registered investment advisers willing to serve as 3(16) fiduciaries may claim to be able to serve as the plan's investment manager in addition to simultaneously serving as its administrator and named fiduciary. An investment manager is defined under Section 3(38) of ERISA as a qualifying financial services firm that has investment discretion over plan assets and has acknowledged in writing that it is a fiduciary.<sup>4</sup> Despite the appeal of promotional claims made by a 3(16) fiduciary that it has the ability to take on three distinct fiduciary roles as plan administrator, named fiduciary and investment manager, the firm's claim that it will assume the responsibilities of an investment manager (in addition to those of a named fiduciary) has no value from a technical perspective under ERISA.

Ordinarily, when a plan sponsor in its capacity as a named fiduciary appoints a third party firm to serve as investment manager, the sponsor is shielded from potential ERISA liability. While the sponsor is responsible for prudently selecting the investment manager, it cannot be held liable for any losses that arise under ERISA as a result of the investment manager's acts or omissions. Thus, when the plan sponsor serves as the plan's named fiduciary, there is a substantial benefit to the sponsor from a liability perspective

<sup>3</sup> If a separate fee quote is provided, the plan sponsor should also review the compensation information included in the firm's 408(b)(2) fee disclosures.

<sup>4</sup> ERISA Section 3(38). To qualify as an investment manager, the financial services firm must be a bank, insurance company or registered investment adviser.

if the sponsor appoints a third party to serve as investment manager.

On the other hand, when a 3(16) fiduciary serving as the plan's named fiduciary appoints itself as investment manager, there is no benefit from a liability perspective to the plan sponsor. From the sponsor's perspective, there is no substantive difference between an arrangement in which the 3(16) fiduciary appoints itself to serve as an investment manager, and an arrangement in which the 3(16) fiduciary provides investment management services directly as the named fiduciary.<sup>5</sup>

Plan sponsors should be wary of any arrangement in which the 3(16) fiduciary has the discretion to appoint itself to serve as the plan's investment manager. If the unilateral exercise of such discretion results in any increase in the aggregate compensation of the

3(16) fiduciary, it would be in violation of ERISA's prohibited transaction rules, which bar fiduciary self-dealing.<sup>6</sup>

To the extent the plan sponsor considers hiring a 3(16) fiduciary that holds itself out as both named fiduciary and investment manager (in addition to being the administrator), the sponsor should ensure that it is paying a single fee for all bundled services. No prohibited self-dealing would occur under ERISA so long as the sponsor ensures that the 3(16) fiduciary is unable to unilaterally increase the compensation that it earns.

### CONCLUSION

Although a 3(16) fiduciary firm can relieve plan sponsors of a great deal of their fiduciary oversight duties under ERISA, the level of fiduciary responsibility that may be accepted from plan sponsors varies

considerably, and sponsors should focus on the nature of their remaining fiduciary duties. Even if a 3(16) fiduciary accepts a comprehensive level of fiduciary responsibility, the plan sponsor's fiduciary oversight responsibilities can never be totally eliminated. If a plan sponsor is uncomfortable with engaging a 3(16) fiduciary for any reason, it can simply retain its customary plan management responsibilities and make all plan-related decisions prudently with such technical or practical assistance from investment advisers, TPAs or plan service providers, as it deems necessary. **PC**



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<sup>5</sup> Accordingly, the investment management services do not necessarily need to be documented in a separate investment management agreement (which is separate and in addition to the main service agreement for the 3(16) fiduciary firm's services).

<sup>6</sup> ERISA Section 406(b). Section 4975 of the Internal Revenue Code includes "mirror" provisions imposing excise taxes on such prohibited transactions.