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## Separating Fact from Fiction:

The Potential Risks and Rewards of Hiring 3(16) Fiduciaries

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 **Sentinel Benefits**  
& FINANCIAL GROUP  
*Custom Solutions for Life and Wealth*

## **Important Information**

The Wagner Law Group has prepared this white paper on behalf of Sentinel Benefits & Financial Group, which is intended for employers sponsoring retirement plans that are subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), as well as service providers who work with plan sponsors. Future legislative or regulatory developments may significantly impact the matters discussed in this paper. This white paper is intended for general informational purposes only, and it does not constitute legal, tax or investment advice on the part of the Wagner Law Group, Sentinel Benefits & Financial Group or their respective affiliates.

## Executive Summary

Although Plan sponsors may hire various service providers, they typically retain primary responsibility for the management of their Plans as fiduciaries under the Employee Retirement Income Security Act of 1974, as amended (“ERISA”). However, a number of providers are now willing to accept certain Plan management responsibilities as “3(16) Fiduciaries.”

### Accepting Role of “Administrator” Under ERISA

When a Plan sponsor accepts the role of “Administrator” under its Plan document, it is responsible for certain reporting and disclosure obligations under ERISA (e.g., SPDs, benefit statements, 404a-5 Disclosures, Form 5500). But if a 3(16) Fiduciary is designated as Administrator, these reporting and disclosure obligations are transferred from the Plan sponsor to the 3(16) Fiduciary. Unless the 3(16) Fiduciary voluntarily agrees to accept additional fiduciary responsibilities, the Plan sponsor would remain responsible for all other Plan management responsibilities (excluding these reporting and disclosure duties).

### Accepting Other Fiduciary Responsibilities

A 3(16) Fiduciary may accept a comprehensive level of fiduciary management responsibilities relating to the Plan’s operation (e.g., adjudicating claims, managing Plan investments, compliance with IRS rules, monitoring Plan’s providers). If the 3(16) Fiduciary accepts the role of “Named Fiduciary” under the Plan document, it may even accept responsibility for the management of the Plan as a whole. However, even if a 3(16) Fiduciary agrees to assume full Plan management responsibilities as both the Plan’s Named Fiduciary and Administrator, it cannot fully eliminate the Plan sponsor’s fiduciary oversight responsibilities. At a minimum, the Plan sponsor is responsible for the selection and monitoring of the 3(16) Fiduciary. If the 3(16) Fiduciary narrowly assumes Administrator responsibilities only (i.e., reporting and disclosures duties only), the Plan sponsor would remain responsible for monitoring all applicable service providers to the Plan.

### Protective Practices

Any decision to hire a service provider on behalf of a Plan, including a 3(16) Fiduciary, should be made by the Plan sponsor solely in the interest of participants and in a prudent manner. As part of its decision-making process, it is important for the Plan sponsor to establish and follow a procedure that satisfies the procedural requirements of ERISA. The attached Appendix A includes a “top ten” list of protective practices that Plan sponsors should consider adopting for purposes of gathering key information and prudently evaluating the potential risks and rewards of engaging a firm to serve as the Plan’s 3(16) Fiduciary.

### Alternative to Hiring 3(16) Fiduciary

The reality is that not all 3(16) Fiduciaries are “created” equal. These firms may assume different levels of fiduciary responsibility on behalf of their Plan clients, and Plan sponsors may not appreciate the nature of the lingering fiduciary duties that remain with them. Furthermore, they may not realize that a Plan sponsor’s fiduciary oversight responsibilities can never be totally eliminated. If a Plan sponsor is uncomfortable with engaging a 3(16) Fiduciary firm in light of the information gathered or for any other reason, the Plan sponsor may simply retain all of its customary Plan management responsibilities and not hire a 3(16) Fiduciary. All Plan-related decisions should be made prudently, and if the Plan sponsor requires assistance, it may wish to consider seeking assistance from an Advisor or any of the Plan’s other existing service providers.

## **Introduction – Third Party Firms Offering to Serve as 3(16) Fiduciaries**

Because of the complex nature of 401(k) plans and other similar tax-qualified plans (“Plans”), it is customary for Plan sponsors to rely on the services of multiple providers, including recordkeeping platforms (“Recordkeepers”), third party administrators (“TPAs”), financial advisors (“Advisors”) and lawyers. However, although a Plan sponsor may hire various providers, it typically retains primary responsibility for the management of the Plan as a fiduciary for purposes of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”).

In recognition of the fact that Plan sponsors may wish to “outsource” these fiduciary responsibilities, a number of third party service providers holding themselves out as “3(16) Fiduciaries” are now willing to accept certain Plan management responsibilities which traditionally had been reserved for Plan sponsors. For example, some firms that had served Plans as TPAs in a non-fiduciary capacity are now willing to perform certain fiduciary functions as 3(16) Fiduciaries. Trust companies which offer trust and custody services to Plans may also be willing to hold themselves out as 3(16) Fiduciaries on behalf of their Plan clients. Similarly, certain registered investment advisers under federal or state securities laws (“RIAs”) may also be willing to serve as 3(16) Fiduciaries.

**Although, in certain instances, 3(16) Fiduciaries are able to relieve Plan sponsors of a great deal of their fiduciary oversight duties under ERISA, the reality is that not all 3(16) Fiduciaries are “created” equal. These firms may take on and assume different levels of fiduciary responsibility on behalf of their Plan clients, and Plan sponsors may**

not necessarily appreciate the nature of the lingering fiduciary duties that remain with them. Furthermore, they may not realize that, even if a 3(16) Fiduciary accepts a comprehensive level of fiduciary responsibility, a Plan sponsor’s fiduciary oversight responsibilities can never be totally eliminated. No Plan sponsor should be under the mistaken impression that they have no oversight duties at all once they hire a 3(16) Fiduciary.

## **ERISA Section 3(16) Definition of “Administrator”**

The term “3(16) Fiduciary” is a reference to Section 3(16) of ERISA, which describes a special kind of Plan fiduciary that is plainly referred to as the “Administrator” of a Plan.<sup>1</sup> Every Plan must have a person which serves as its Administrator for ERISA purposes, and this “Administrator” definition under ERISA (which is somewhat misleading) should never be confused with administrative service providers. Thus, this statutory term should not be used to describe a TPA which does not accept any fiduciary responsibility from the Plan sponsor.

A Plan’s Administrator has certain reporting and disclosure obligations under ERISA which are not imposed on other types of Plan fiduciaries. It is these reporting and disclosure responsibilities that make the fiduciary role of an Administrator unique under ERISA. For example, the Administrator has a duty to provide summary plan descriptions (“SPDs”) to participants.<sup>2</sup> It is also the responsibility of the Administrator to ensure that Plan participants receive quarterly benefit statements.<sup>3</sup> Similarly, the Administrator must furnish participant-level fee disclosures (“404a-5 Disclosures”) in accordance with the Section 2550.404a-5 of the DOL regulations. A copy of the Plan document must also be provided by the Administrator

<sup>1</sup> As provided in Section 2509.75-8 of the U.S. Department of Labor (the “DOL”) regulations, an Administrator by the very nature of its position has “discretionary authority or discretionary responsibility in the administration” of the Plan, which in turn makes the Administrator a fiduciary within the meaning of Section 3(21) of ERISA.

<sup>2</sup> ERISA Section 102.

<sup>3</sup> ERISA Section 105.

to participants upon request.<sup>4</sup> The Administrator also has a duty to sign and file the Plan's annual information return on the Form 5500, and it must engage an accountant to conduct audits of the Plan's financial statements as may be necessary for these annual filings.<sup>5</sup> The Administrator has a duty to maintain the tax-qualified status of the Plan and ensure 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 penalties that only apply to Administrators and their reporting and disclosure duties under ERISA.<sup>6</sup> 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., Plan's SPD, Form 5500 or Plan document) to a participant upon request within 30 days, the Administrator may be subject to a penalty of up to \$110 per day.

As defined under ERISA, a Plan's Administrator is "the person specifically so designated by the terms of" the Plan's governing document. In the case of a Plan document which does not designate a person, the Plan sponsor is automatically deemed to be the Administrator. In the absence of a 3(16) Fiduciary, Plan documents routinely designate the employer as the Administrator. Thus, when the Plan sponsor serves as Administrator, it has the fiduciary responsibility of ensuring that the Plan participants receive their mandatory disclosures (e.g., SPDs, benefit statements, 404a-5 Disclosures) even if as a practical matter it relies on the Plan's Recordkeeper or TPA to deliver these materials. Furthermore, even if the Plan's TPA prepares the Form 5500, it is the Plan sponsor in its capacity as the Administrator that must sign this annual return, making it responsible for the informational content included in its filings. If an error is made by the Recordkeeper or TPA, it is the Plan sponsor in its capacity as the Administrator that would be subject to the fiduciary penalties under ERISA.

## ***Specific Advantages of Hiring a 3(16) Fiduciary to Serve as Plan's "Administrator"***

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 reporting and disclosure obligations under ERISA. For example, if the Plan's Recordkeeper 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 the third party willing to serve as the Plan's 3(16) Fiduciary, there are some clear benefits for the Plan Sponsor from a fiduciary perspective once it engages such third party to serve as 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 Plan's sponsor's **fiduciary reporting and disclosure obligations** under ERISA. Unless the 3(16) Fiduciary voluntarily agrees to accept additional fiduciary responsibilities, including maintaining the tax-qualified status of the Plan, the Plan sponsor would remain responsible for discharging all other Plan management responsibilities, including the fiduciary oversight of the Plan's investment menu as well as the management of all other benefits-related aspects of the Plan (excluding the reporting and disclosure duties transferred to the 3(16) Fiduciary).

<sup>4</sup> ERISA Section 104(b)(4).

<sup>5</sup> ERISA Section 103.

<sup>6</sup> ERISA Section 502(c).

## ***Fiduciary Responsibilities Transferred from Plan Sponsor to 3(16) Fiduciary May Vary***

Some Plan sponsors may mistakenly believe that a 3(16) Fiduciary will automatically assume all of the Plan 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 that are imposed under ERISA on the Plan's Administrator.

For illustrative purposes, let us examine a hypothetical TPA firm that offers non-fiduciary administrative services to its Plan clients. Such services may include the performance of IRS compliance testing, administering the Plan's loans to participants, as well as the preparation of a "signature ready" Form 5500 for execution by the Plan sponsor each year. This kind of TPA firm could easily offer to serve as a 3(16) Fiduciary for its Plan sponsors clients by offering the following incremental services:

- (1) monitoring the Plan's Recordkeeper to ensure that SPDs, 404a-5 Disclosures, benefit statements and all other required disclosures are delivered to participants, and
- (2) signing the Form 5500 returns as the Plan's Administrator (and engaging an accountant, if necessary, to perform any required audits of the Plan's financial statements for such Form 5500 returns).

As illustrated above, unless a 3(16) Fiduciary accepts additional fiduciary responsibilities, the Plan sponsor will be responsible for all other Plan management responsibilities, including but not limited to the Plan's investments, and tax-qualification.

In contrast to a 3(16) Fiduciary which assumes no fiduciary

responsibilities other than the reporting and disclosure obligations that are necessarily imposed on an Administrator for ERISA purposes, a 3(16) Fiduciary could conceivably accept a comprehensive level of fiduciary management responsibilities relating to the Plan's operation and its investments. By way of example, in addition to accepting responsibility for the Plan's reporting and disclosure obligations, a trust company offering to serve as a 3(16) Fiduciary could also agree to adjudicate any benefit claims and disputes with participants, manage the Plan's menu of investments, ensure the Plan operates in accordance with all applicable tax qualification requirements under the Internal Revenue Code, select and monitor the Plan's service providers and execute their service agreements on behalf of the Plan, and ensure 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 to 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 such third party as the Plan's Administrator). ERISA Section 402(a) requires every Plan to identify at least one Named Fiduciary who has the "authority to control and manage the operation and administration" of the Plan. To designate a person as the Plan's Named Fiduciary, the Plan document merely needs to provide a "clear identification" that such person will have the authority to control and manage the operation and administration of the Plan or to expressly identify such person as the Plan's Named Fiduciary.<sup>7</sup> For this reason, it is customary for Plan documents to separately identify the Plan's Administrator as well as the Plan's Named Fiduciary, even if the same person serves in both roles.

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. On the other hand, they may be substantially broader than the limited statutory duties of an Administrator under ERISA. In fact, if the 3(16) Fiduciary accepts the role of Named Fiduciary, it is possible for the 3(16) Fiduciary to broadly accept responsibility for the operation and management of the Plan as a whole.

## **Employer’s Fiduciary Risk Can Never be Fully Eliminated by 3(16) Administrators**

Unfortunately, even if a 3(16) Fiduciary agrees to assume full Plan management responsibilities as both the Plan’s Named Fiduciary and Administrator, it cannot fully eliminate the Plan sponsor’s fiduciary oversight responsibilities. **Given the fact that it is the Plan sponsor’s decision to hire and retain a 3(16) Fiduciary to serve as the Plan’s Administrator, the Plan sponsor remains responsible for the duly diligent selection and monitoring of the 3(16) Fiduciary.** The courts have held that even if a Plan sponsor gives the Plan’s Administrator control over the Plan, the Plan sponsor remains responsible for the selection of the Administrator.<sup>8</sup>

Even if a 3(16) Fiduciary serves as the Plan’s Named Fiduciary and Administrator as designated under the Plan document, such Plan sponsor remains responsible and liable as a fiduciary to the extent it appoints or has the power to replace the Named Fiduciary or Administrator through its power to amend the Plan document.<sup>9</sup> Therefore, as part of its responsibilities as an **appointing** fiduciary, the Plan sponsor has a duty to monitor the performance of the **appointed** 3(16) Fiduciary serving as Named Fiduciary or Administrator at reasonable intervals on an ongoing basis.<sup>10</sup> Thus, 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).

If the 3(16) Provider also agrees to serve as the Plan’s Named Fiduciary and assume full control of the management and administration of the Plan, the Plan sponsor would not have a duty to oversee the Plan’s other service providers (e.g., Recordkeeper, Advisor). On the other hand, if the 3(16) Fiduciary narrowly assumes Administrator responsibilities only (i.e., fiduciary responsibilities for the Plan’s reporting and disclosures obligations only), the Plan sponsor would remain responsible for monitoring all applicable service providers to the Plan as part of its general fiduciary oversight duties regarding the management and administration of the Plan.

## **How to Prudently Select Your Plan’s 3(16) Fiduciary**

Any decision to hire or engage a service provider on behalf of a Plan, including a 3(16) Fiduciary, should be made by the Plan sponsor solely in the interest of the Plan participants and it should also be made in a prudent manner.<sup>11</sup> As part of its decision-making process, it is important for the Plan sponsor to establish and follow a procedure that satisfies the **procedural** requirements of ERISA. According to the DOL, the Plan sponsor must engage in an “objective process” which is 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>12</sup>

<sup>7</sup> Section 2509.75-5 of the DOL regulations, FR-1 Q/A.

<sup>8</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>9</sup> See, e.g., *Coyne & Delaney Co. v. Selman*, 98 F.3d 1457 (4th Cir. 1996) (holding that the employer’s power through Plan amendment to appoint and remove fiduciaries constitutes “discretionary authority” over the management or administration of plan sufficient to trigger fiduciary status).

<sup>10</sup> Section 2509.75-8 of the DOL regulations, FR-17 Q/A.

Thus, in the case of hiring a prospective firm to serve as a 3(16) Fiduciary, the Plan sponsor should consider the **qualifications** of the firm and the firm's personnel. The Plan sponsor may wish to request information concerning the firm's experience and 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 any provider of fiduciary services, it is important 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 size of the firm, the total amount of client assets under administration as well as whether the prospective firm is a trust company, RIA or a non-regulated entity.

When considering the **quality of the services** offered by the prospective firm, it is especially important for the Plan sponsor to identify the scope of the fiduciary responsibilities that would be transferred to and assumed by the 3(16) Fiduciary in connection with the proposed engagement. Although the level of detail may vary, the scope of the firm's services should be described in its upfront fee disclosures mandated under ERISA Section 408(b)(2) (the "408(b)(2) Fee Disclosures"), which must be provided to the Plan sponsor **before** the firm may be hired. Using the 408(b)(2) Fee Disclosures and other relevant information, the Plan sponsor should determine the extent to which the 3(16) Fiduciary will accept any fiduciary responsibilities beyond those of an Administrator, and whether the firm is also willing to be named as the Named Fiduciary for the Plan. The Plan sponsor should also identify which direct services the 3(16) Fiduciary intends to render itself (e.g., TPA services). With respect to any other Plan-related services that would be furnished by a separate provider, the Plan sponsor should inquire how the 3(16) Fiduciary intends to monitor and evaluate the separate provider's performance

and its compensation. For example, the 3(16) Fiduciary might perform its own formal evaluation of the separate provider's performance or engage a third party to conduct an audit of such separate provider. It could also perform a benchmarking analysis to evaluate the reasonableness of the separate provider's fees.

In order to evaluate the **reasonableness of the fees** quoted by the prospective firm willing to serve as the Plan's 3(16) Fiduciary, the Plan sponsor may request bids or quotes from other comparable 3(16) Fiduciary firms to help it determine the prevailing rate for similar services.<sup>13</sup> However, it should be noted that the number of 3(16) Fiduciary firms (offering both fiduciary oversight and non-fiduciary administrative services) may be relatively small in comparison to the number of firms, such as TPAs, that routinely offer non-fiduciary administrative services only. Thus, 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. Such 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

<sup>11</sup> ERISA Section 404(a)(1).

<sup>12</sup> DOL Advisory Opinion 2002-08A. See also DOL Field Assistance Bulletin 2002-3 and DOL Information Letters to D. Ceresi (February 19, 1998) and to T. Konshak (December 1, 1997).

<sup>13</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.



a Recordkeeper with dishonest or incompetent employees, the 3(16) Fiduciary would be subject to potential liability for causing, directly or indirectly, any related losses sustained by the participants.<sup>14</sup>

However, even if a court were to rule against the 3(16) Fiduciary, holding it liable for the harm caused by its fiduciary breach, the court's judgment would only be meaningful to the extent the 3(16) Fiduciary had sufficient assets to pay the amount owed to participants. To assure their Plan clients that they will have sufficient assets to pay any potential claims made against them, many 3(16) Fiduciary firms have purchased professional liability coverage or errors and omissions insurance ("E&O coverage"). Thus, Plan sponsors may wish to confirm that their 3(16) Fiduciaries maintain a sufficient level of E&O coverage (e.g., \$1 million) and/or have deep pockets. If not, Plan sponsors may be ultimately liable – i.e., end up "holding the bag" – for the misdeeds and/or negligence of the 3(16) Fiduciaries.

## **Restrictions on Ability of 3(16) Fiduciaries to Appoint Investment Managers**

As discussed above, a 3(16) Fiduciary may assume certain fiduciary responsibilities in its capacity as both an Administrator and a Named Fiduciary. Certain trust companies and RIAs willing to serve as 3(16) Fiduciaries may also claim to be able to serve as the Plan's "Investment Manager" in addition to simultaneously serving as the Plan's Administrator and Named Fiduciary. An Investment Manager is defined under Section 3(38) of ERISA as a qualifying financial service firm with investment discretion over Plan assets, which has acknowledged in writing that it is a fiduciary.<sup>15</sup>

Despite the appeal of any promotional claims made by a 3(16) Fiduciary that it has the ability to take on three distinct fiduciary roles as the Plan's Administrator, Named Fiduciary and Investment Manager, it should be noted that 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 its Investment Manager, the Plan sponsor is shielded from potential liability under ERISA. Although the Plan sponsor is responsible for prudently selecting the Investment Manager, the Plan sponsor cannot be held liable for any losses that arise under ERISA as a result of the individual acts or omissions of such Investment Manager.<sup>16</sup> Thus, when the Plan sponsor serves as the Plan's Named Fiduciary, there is a substantial benefit to the Plan sponsor from a liability perspective if the **Plan sponsor** appoints a **third party** to serve as the Plan's Investment Manager:

On the other hand, when a 3(16) Fiduciary serving as the Plan's Named Fiduciary appoints itself to serve as an Investment Manager, there is no benefit at all from a liability perspective to the Plan sponsor. From the Plan 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>17</sup>

In fact, Plan sponsors should be mindful 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, such 3(16) Fiduciary would be in violation of the prohibited

<sup>14</sup> ERISA Sections 405 and 409.

<sup>15</sup> ERISA Section 3(38). To qualify as an Investment Manager, the financial services firm must be a bank, insurance company or RIA.

transaction rules under ERISA, which prohibit any kind of fiduciary self-dealing.<sup>16</sup> For example, a Plan sponsor might engage a 3(16) Fiduciary to serve as the Plan's Administrator and Named Fiduciary for a **stated fee**. However, if the 3(16) Fiduciary unilaterally uses its discretionary authority as the Named Fiduciary to appoint itself as the Plan's Investment Manager, causing the Plan to pay an **additional fee** for its investment-related services, a violation of the prohibitions against self-dealing would be deemed to have occurred under ERISA.

To the extent the Plan sponsor considers hiring a 3(16) Fiduciary that holds itself out as both the Named Fiduciary and Investment Manager (in addition to the Administrator), the Plan 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 Plan 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 can be accepted from Plan sponsors can vary considerably, and Plan sponsors should focus on the nature of the fiduciary duties that remain with them. 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.

The attached **Appendix A**, *Protective Practices for Gathering Key Information Before Deciding to Engage a 3(16) Fiduciary*, includes a "top ten" list of protective practices that Plan sponsors should consider adopting for purposes of gathering

key information and prudently evaluating the potential risks and rewards of engaging a firm to serve as the Plan's 3(16) Fiduciary. These protective practices are based on the legal analysis developed in this paper, and they are designed to ensure that Plan sponsors have sufficient information to make informed decisions about the prudence of hiring a 3(16) Fiduciary for their respective Plans.

If a Plan sponsor is uncomfortable with engaging a 3(16) Fiduciary firm in light of the information gathered or for any other reason, the Plan sponsor may simply retain all of its customary Plan management responsibilities and not hire a 3(16) Fiduciary. In this situation, the Plan sponsor should be able to manage its Plan successfully by making all Plan-related decisions prudently, and if the Plan sponsor requires technical or practical assistance, it may wish to consider seeking assistance from its Advisor, TPA or any of the Plan's other existing service providers.

<sup>16</sup> ERISA Section 405(d)(1).

<sup>17</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>18</sup> ERISA Section 406(b). Section 4975 of the Internal Revenue Code includes "mirror" provisions imposing excise taxes on such prohibited transactions.

## **Appendix A: Protective Practices for Gathering Key Information Before Deciding to Engage a 3(16) Fiduciary**

Key Information	Evaluation Criteria	Protective Practices
1. Firm Experience	<b>Qualifications of Firm</b>	Request information concerning the firm's experience and track record in serving as a 3(16) Fiduciary, and the educational background and experience of the firm's employees and management team.
2. ERISA Expertise		Confirm firm's personnel have sufficient expertise in ERISA as well as the fiduciary standards and requirements that are imposed on Named Fiduciaries and Administrators under ERISA.
3. Nature of Firm		Identify the size of the firm, the total amount of client assets under administration as well as whether the prospective firm is a trust company, RIA or a non-regulated entity.
4. Level of Fiduciary Responsibility	<b>Quality of Services</b>	Determine the extent to which the firm will accept any fiduciary responsibilities beyond those of an Administrator, and whether it will also be named as the Named Fiduciary for the Plan.
5. Direct Services		The Plan sponsor should identify which direct services the 3(16) Fiduciary intends to render itself (e.g., TPA services).
6. Monitoring Services		Inquire how the firm intends to monitor and evaluate the services of other providers and their related compensation (e.g., formal evaluation, third party audit, fee benchmarking).
7. Fee Quotes for Comparable Services	<b>Reasonableness of Fees</b>	Request bids or fee quotes from other comparable 3(16) Fiduciary firms to help determine the prevailing rate for similar services.
8. Fee "Premium" for Accepting Fiduciary Role		If necessary, compare the firm's fee against the fees of comparable TPA firms offering non-fiduciary administrative services only, to determine the fee "premium" charged by the 3(16) Fiduciary firm for accepting fiduciary responsibilities.
9. Professional Liability (E&O) Coverage	<b>Other Considerations</b>	Confirm that the firm maintains a sufficient level of professional liability coverage or errors and omissions insurance (e.g., \$1 million) to ensure it will have sufficient assets to pay any potential claims made against it.
10. Compensation for Investment Manager		If the firm intends to serve as Named Fiduciary and Investment Manager (in addition to Administrator), confirm that the firm will be unable to increase its compensation for its services as Investment Manager in violation of ERISA's prohibited transaction rules.

### IMPORTANT NOTE

If a Plan sponsor is uncomfortable with engaging a 3(16) Fiduciary firm in light of the information gathered or for any other reason, the Plan sponsor may simply retain all of its customary Plan management responsibilities and not hire a 3(16) Fiduciary. All Plan-related decisions should be made prudently, and if the Plan sponsor requires technical or practical assistance, it may wish to seek assistance from its Advisor, TPA or any of the Plan's other existing service providers.

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