ETHICS

As more companies promote a third option for plan sponsors to reduce their fiduciary liabilities—the 3(16) fiduciary—it's important to remember that reality may not align with our expectations. Making the right decision comes down to critical thinking, not—like Goldilocks did—simply trusting that the third choice is "just right."

Goldilocks and the Three Fiduciaries

BY JAMES H. CULBRETH, JR. AND ANNE N. COMER

When many of us were growing up, we learned that making decisions with three options at hand meant that one of those choices would be "just right." Today, no matter what we're searching for, we subconsciously expect that one choice will be too much and another too little, but our third choice will provide us with exactly what we need.

For this, I blame Goldilocks.

As we read her tale of choices, we learned early in life that finding the perfect fit for our needs is easy if we just keep looking — particularly with three options. But in real life, sometimes the third — and last — alternative may not be the best. (Try arguing a called third strike with the umpire.) Other times, the third choice is as flawed as the first two. In the end, however, we must choose one option over the other.

Being a retirement plan sponsor is far from a fairy tale. As more companies promote a third option for plan sponsors to reduce their fiduciary liabilities — the 3(16) fiduciary — we must remember that "Goldilocks and the Three Fiduciaries" is an adult fairy tale, and reality may not align with our expectations.

GOLDILOCKS, INC.

Our story begins with Glenda Goldilocks, owner of Goldilocks, Inc. Rather than searching for the perfect porridge, chair and bed, Glenda is a plan sponsor looking to balance responsibilities with the increasing pressure on fiduciaries.

For years, Goldilocks has maintained a qualified retirement plan for its employees without any operational issues under ERISA. Glenda, however, has watched the Department of Labor step up enforcement through increased plan audits and new mandatory disclosures to plan participants — and she is concerned about fiduciary liabilities.

Glenda knows to be cautious in every action concerning the plan and recognizes that mistakes can be expensive, embarrassing, time-consuming and bad for employee morale. She fears the consequences of an operational or administrative problem but knows that Goldilocks needs the retirement plan.

THE PLAN

Goldilocks sponsors a typical DC plan with a "cash or deferred" feature under IRC §401(k) and matching contributions under IRC §401(m). Goldilocks is the plan sponsor and for years served as the "administrator" by default under ERISA §3(16)(A)(ii) simply because no one else was designated under the plan document. Three years ago, however, the company created a Retirement Plan Committee to serve the administrator role, as well as that of the plan's "named fiduciary" under ERISA §402(a).

Glenda chairs the Committee, whose members include the Director of Human Resources and the CFO. The Committee has selected the plan's investments and record keeper, reviewed ERISA's mandatory reporting and disclosures, and approved participant requests for distributions, loans and hardship withdrawals.

In light of ERISA's increased scrutiny regarding conflicts of interest, fees and prudence, the Committee has decided to engage an independent fiduciary for financial advice and is considering two options:

1. an "Investment Manager" under ERISA §3(38); and
2. an "Investment Fiduciary" as described in ERISA §3(21)(A)(ii) and DOL regulation section 2510.3-21(c).

These financial fiduciaries differ significantly, but the Committee recognizes the principal differences:

- If they select an Investment Manager, then they will have no direct say in the plan's chosen investments (or fiduciary responsibility for the investments) but will maintain fiduciary responsibility for selecting and monitoring a qualified Investment Manager.
- If they select an Investment Fiduciary, then the Committee would make the final decisions using advice received by the outside professional investment advisor — and retain fiduciary responsibility choosing investments and a qualified Investment Fiduciary.

Goldilocks provided the Committee the authority to hire other fiduciaries, and the Committee is still deciding between hiring an Investment Manager or an Investment Fiduciary when the fabled third choice appears.

THE THIRD CHOICE

Goldilocks recognizes that sponsoring a retirement plan creates fiduciary responsibilities beyond those associated with investments, such as selecting (or possibly serving as) a plan trustee, monitoring plan fees and expenses, and making fiduciary decisions regarding plan administration. Glenda and the Committee also are concerned with non-fiduciary administration issues, from confirming that ERISA §408(b)(2) and §404(c) documents are gathered and distributed to determining if a plan audit is required and then handled correctly.

With visions of additional fiduciary liabilities dancing through her head, Glenda is intrigued when the third choice appears: an appointed "administrator" under ERISA section §3(16)(A)(i) (an ERISA Administrator).

Because Goldilocks is the "administrator" by default, the company is currently responsible for all aspects of proper plan operation. But, by traveling the 3(16) route, Goldilocks is told that its only remaining responsibility is to prudently hire an ERISA Administrator.

This ERISA Administrator is entirely different than the plan's TPA. Goldilocks' contract with its TPA states very clearly that the TPA makes no discretionary administrative decisions concerning the plan unless the contract specifically delegates that decision-making power to the TPA. On the other hand, the prospective ERISA Administrator is proposing to assume as many operational and administrative decisions as Goldilocks wants to remove from itself or the Committee.

The ERISA Administrator may not only select the investment advisor and agree to its fiduciary role (like the first two choices), but also hire the record keeper, file the annual reports, see that the participant-level reporting is done properly, determine if plan fees are reasonable and fill almost any other plan-related role. All Goldilocks must do is select the ERISA Administrator prudently and monitor its performance (as best it can, given that many of the ERISA Administrator's duties can only be evaluated after the fact).

The 3(16) contract has a list of duties the ERISA Administrator may assume, with Goldilocks checking the boxes and relieving itself of the fiduciary and administrative duties for these matters.

Could the third choice be "just right" for Goldilocks?

REAL WORLD VS. FAIRY TALES

Despite knowing the fairy tale, Glenda (and by extension, Goldilocks) is hesitant when presented with this third choice—and rightfully so. While engaging an ERISA Administrator could relieve the Committee of many (or all) of its fiduciary and administrative responsibilities, this move does not mean that Goldilocks has avoided all fiduciary or administrative duties regarding the plan.

Like so many things that seem too good to be true, engaging an ERISA Administrator may result in a concentration of responsibilities without proper oversight. In at least one real-world case, this concentration has led to the collapse of a large ERISA administrator amid allegations of self-dealing—with resulting lawsuits.

Glenda knows that placing the plan's oversight in a single place with single monitoring would be simple and avoids the problems that may arise under the Committee's administration, but she also sees the difficulty in assessing how the ERISA Administrator will fulfill each delegated role. She is also concerned that using plan assets to pay for an ERISA Administrator who then directs plan assets to pay for an Investment Fiduciary (on top of the record keeper, custodian, etc., expenses that occur regardless) may create high plan administrative expenses.

If that happened, how would Goldilocks know? Would the ERISA Administrator be responsible to restore the plan assets? Ultimately, can the Committee adequately evaluate and monitor the powerful ERISA Administrator in a manner that fulfills its fiduciary responsibilities to act prudently and in the best interests of the plan participants?

THE MORAL OF THE FIDUCIARY STORY

Despite a subconscious desire to embrace the third choice and expect it to provide precisely the balance of attributes we need, Glenda sees that choosing to use an ERISA §3(16) plan administrator is trickier than it seems. Yes, these fiduciaries can simplify a plan sponsor's regular responsibilities and tasks. But they can also dispose of plan assets and concentrate duties so as to completely control the investment process — increasing the risk of errors, misappropriations and fraud. And unlike options 1 and 2, 3(16) administrators are not required to register as a financial advisor and thus may not be subject to any regulation, requirements or oversight.

Before making a decision, Glenda must consider what is best for plan participants—not for Goldilocks, its HR or finance departments, or the Committee members. She must enter the process realizing that the newly marketed "third choice" may or may not be "just right" for Goldilocks' retirement plan and participants. Should she conclude that it is, in fact, the best choice, Glenda would be wise to include two key factors when selecting Goldilocks' ERISA administrator:

1. Choose a firm with ongoing regulatory oversight, such as an independent trust company.

2. Embrace the importance of separation of duties, by independently hiring the investment advisor and CPA firm for auditing, if needed, rather than allowing the ERISA administrator to make these choices.

Because unlike in fairy tales, any one of the three choices may be best—and making the right decision comes down to critical thinking, not simply trusting that the third choice is "just right." PC

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