3(16) and the Fiduciary Plan Administrator

The Next Number to Decode

Introduction

In this increasingly high risk regulatory environment, plan sponsors are seeking new ways in which they can delegate to others some of their ERISA fiduciary responsibilities. Included among them is authorizing a delegate to assume decision-making authority for plan administration duties. These functions have traditionally been the sole purview of plan sponsors. Any service provider rising to the challenge to accept fiduciary plan administration accountabilities - and the resulting liability that goes with them - will wish to carefully consider exactly what duties he or she is capable of performing and what additional risks they present. First, a little background:

Demystifying a Language of Numbers

ERISA-speak can be difficult for the un-initiated. Communicating involves a language based on numbers and founded in distinct bodies of law. Practitioners deftly refer to 401(k) plans (a tax code provision), 408(b)(2) disclosures (a section of ERISA dealing with prohibited transactions) 12b-1s (an Investment Company Act rule) and the differences in 3(21) and 3(38) services. Added to these are now 3(16) services. Some clarity can be gained from knowing that Section 3 of Title 1 of ERISA includes the definitions used in the act and the 16th definition is that of "plan administrator." Hence, when these

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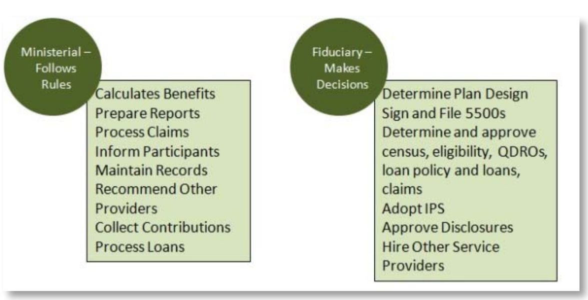
services are performed by a delegate, they are called “3(16) Services.”

The plan administrator is either named in the plan document or, if none is named, then the employer is presumed to perform this role. The plan administrator is automatically considered a plan fiduciary. As a fiduciary, a plan administrator who breaches his or her duties faces severe penalties. A fiduciary can be:

- *Personally liable* for losses suffered by the plan and lost opportunity costs.
- Required to pay attorney fees.
- Subject to Department of Labor fines or IRS excise taxes.
- Liable for breaches of other fiduciaries.

Ministerial v Fiduciary?

The plan administrator is the big “A” administrator, and is not to be confused with a third party administrator (“TPA”). The plan administrator has a wide variety of responsibilities. Some of the major categories include: plan qualification and operations, retaining experts, reporting and disclosure, investments and expenses, making contributions, overseeing distributions and recordkeeping, and determining plan coverage, discrimination testing and tax reporting.



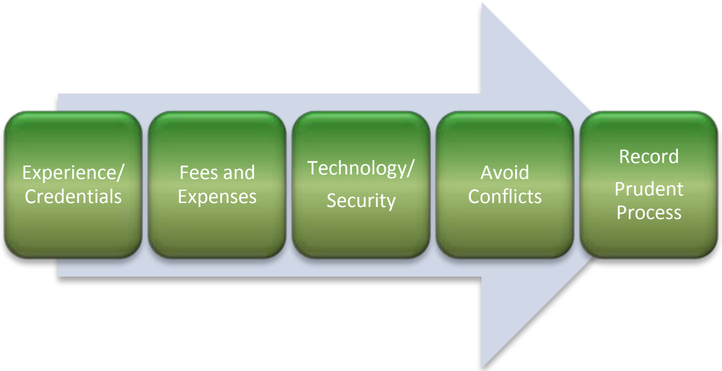
The plan administrator makes real decisions about managing the plan and is therefore considered a fiduciary. He or she might outsource some of the routine operations to a non-fiduciary, such as a TPA. The TPA’s functions are “ministerial” only, meaning that the TPA simply follows rules, while the administrator uses his or her discretion to make decisions, such as adopting and interpreting policies and establishing rules of operation. The TPA may simply follow the rules when calculating benefits, preparing reports, processing claims or collecting contributions. The administrator is charged with actually making those contributions in the proper amount and on time, resolving claims disputes and signing reports.

How to Shift Fiduciary Authority

By appointing a 3(16), the employer (the original plan administrator) can shift responsibility for its fiduciary decisions from itself to the provider. This can be accomplished only if the plan document provides a procedure for the administrator to appoint another fiduciary or a procedure to allocate its duties among the other fiduciaries. This can work for all but trustee functions (such as asset management duties), which require a special type of appointment. Anyone wishing to convey or accept these fiduciary duties is cautioned to seek the advice of a skilled attorney to make sure that this is accomplished properly. If it is not, responsibility remains with the original administrator.

This does not give the original administrator a free pass, however, as some fiduciary responsibilities can never be escaped. The employer must conduct proper due diligence in selecting the provider and provide oversight to remain confident that the services are being appropriately delivered.

You can help your plan sponsor prospects with this effort - and help them select you - by providing the information which documents the due diligence process. This information will help create an audit-ready file proving that the sponsor followed a prudent fiduciary process when selecting and retaining you.



Address each of the above due diligence criteria and package that information for the plan sponsor. The sponsor will then have an audit-ready file to support that it followed a prudent process in selecting you to provide the services.

Deciding What Duties to Assume

Generally, plan sponsors are looking for help that will save them time, limit staff and avoid liability. In deciding whether to assume duties that will meet those goals, a provider will assess how the resulting fiduciary risk can be controlled or mitigated. This is largely a determination of whether the provider has the necessary information, expertise and resources. For example, providers typically are not in control of whether payroll is paid on time and, therefore, whether salary deferrals are contributed on time to the plan. They likely will not wish to take on fiduciary responsibility for plan contributions. Alternatively, a provider who is already processing claims and producing operations manuals for plans may be comfortable also making the final claims decisions and being responsible for adopting the policy manuals. Approving the final census might best be left in the HR department's hands, because a service provider may have difficulty confirming every employee who is eligible to participate. Each of the services must be carefully assessed for risk.

Key among the considerations is whether any particular service presents a conflict of interest for the fiduciary administrator. A fiduciary may not use his or her authority to gain additional compensation or engage in self-dealing. The 3(16) cannot, therefore, appoint him or herself the 3(38) investment manager and then get paid more.

Pricing Services

TPA services offer a wide variety of fee structures. Separate charges can be assessed for each and every transaction, such as each loan approved, disclosure provided, QDRO processed, etc. This might be viewed by the employer as "nickel-and-diming." An asset-based fee grows with the assets, and presumably with the required amount of service. The Department of Labor is beginning to question whether this is really true. Combinations of fees can be bundled into a single program. In each case, the risk to the provider, and the commensurate compensation, rises with the level of assets, the volume of individual transactions and the errors and omissions risk.

Are you Covered?

Most errors and omissions insurance policies exclude coverage for acting in the capacity as a named fiduciary for others, including one serving as an outsourced 3(16). Careful attention is needed to make sure that the policy is amended by endorsement for fiduciary administration services. Do not simply rely on a certificate of insurance or a verbal representation of coverage. The full policy should be examined to document the scope or limitations of any fiduciary coverage of the outsourced vendor. Do not forget also that the plan administrator likely handles plan assets and should be covered by an ERISA fiduciary bond.

Both the plan sponsor and the outsourced vendor should have (and should maintain) their own first party fiduciary liability insurance protection and ERISA bonds. The vendor can provide evidence of its coverage to the plan sponsor.

It is critical to work with a broker knowledgeable in this area to find the right coverage for the provider.

Contracts

The primary purpose of any contract is to document what each party agrees to do, and clarifying obligations from the start will help to avoid disputes in the future. A check-the-box menu format is a great method to list easily understood descriptions of the services offered and a clear way for the plan sponsor to precisely indicate which services have been selected. Failure to check a box should be an express representation that the service provider is not performing that unchecked service, avoiding confusion - and possibly legal fees - down the road. Affirmatively state what the service provider will *not* do.

Strive for plain English. A good lawyer today should be able to write in words that the parties to the agreement can actually understand. The contract should serve as a guide to the parties for which the reader should not have to translate from “legalese.”

Beware the Newest Shiny Object

The buzz about 3(16) services is getting louder. It is likely that these services may one day be as commonly known as 3(38) services are today. Until routines are established, it is wise to beware of the newest shiny object. Despite the revenue opportunity it presents, real financial liability is possible. Do your homework and understand that this is not for everyone. Any good service is based upon a firm grasp of the required technical know-how, systems, and procedures. As in all things relating to administration, it is about Process, Process, Process.

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