



3(16) Administrative Outsourcing and Multiple Employer Plans

A WHITE PAPER BY

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Employers want more help managing their retirement plans and the industry is gearing up to deliver it. But few employers or vendors fully understand the 3(16) administrator role and the nuances of managing a multiple employer plan (MEP)—the two primary sources of relief that will be the focus of the coming boom in fiduciary outsourcing.

Executive Summary

1. Because service as an ERISA Section 3(16) administrator or as a named fiduciary in general is new to most service providers, it is necessarily the case that few have extensive experience or credentials specific to these roles.
2. There is some confusion even among pension professionals about named fiduciary roles, plan governance structures, and conflicts of interest. In particular:
 - a. Service providers are not sure how to structure multiple employer plans.
 - b. Misperceptions are common with respect to the appointment of and allocation of duties among named fiduciaries and how named fiduciaries delegate to subordinate fiduciaries.
 - c. Providers are occasionally mistaken as to when a conflict exists, believing certain arrangements to be conflicted when they are not and others to be unconflicted when perhaps they are.
3. Outsourcing arrangements can be roughly divided into three categories:
 - a. Appointment of a “principal” named fiduciary or overall plan fiduciary
 - b. Investment fiduciary outsourcing through appointment of investment advisors, investment managers, or discretionary trustees
 - c. Administrative outsourcing through appointment of a third party to serve as the administrator named in the plan document; or through various other arrangements intended to lessen administrative burdens for employers.
4. Administrative outsourcing arrangements are growing in popularity and take the following forms:
 - a. The “supervisory” administrator who hires a TPA but does no administration
 - b. The “working” administrator who is named as such in the document and does the administration itself rather than hiring a TPA (i.e., it is the TPA)
 - c. The “co-administrator” who divides the role with the employer
 - d. An administrative fiduciary who performs certain fiduciary functions on behalf of the administrator under ERISA Section 3(21)(A)(iii)
 - e. A non-fiduciary recordkeeper or TPA who expands its menu of ministerial services to provide greater assistance for the administrator



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- e. MEP fiduciaries.
 5. Employers who hire professional fiduciaries must still avoid co-fiduciary liability but this is not difficult under a plain reading of ERISA Section 405(a).
 6. Because of the potential for confusion, some modest edits to the Department's plain language guide on selecting and monitoring service providers may be helpful.
 7. Risks associated with hiring professional fiduciaries are an appropriate focus for the Department. Areas to explore include asset safety, credentials, solvency or claims- paying ability, and bonding.

Introduction to the Fiduciary Outsourcing Marketplace

Outsourcing of investment responsibility has grown in popularity over the past ten years as advisors embrace fiduciary status under either ERISA Section 3(21)(A)(ii) (investment advice fiduciary) or Section 3(38) (investment manager), and as specialist trust companies embrace the discretionary trustee role. But until recently the industry has steadfastly declined to accept the plan administrator role as defined in ERISA Section 3(16), or in general to accept broad fiduciary responsibility under ERISA Sections 402(a) or 3(21)(A)(i) and (iii). This is changing, and several variations of 3(16) and named fiduciary service are emerging. MEPs offer a cost effective way for employers to outsource and interest in them is growing rapidly.

Qualifications and experience vary but because the practice is new, few vendors have outsourcing experience, and the level of expertise can vary dramatically. Due diligence for an employer seeking to hire a professional administrator is made harder by the understandably poor credentials of most service providers. When the automobile was first invented, it was probably tough to find a good mechanic, but that didn't mean cars were a bad idea.

Confusion in the marketplace is exacerbated by a lack of understanding of basic fiduciary law and how actual plan documents are structured. For details see [15 Misconceptions about the Three Principal Fiduciary Roles in a Retirement Plan.](#)¹

Employer Responsibilities for Selecting and Monitoring

Employers cannot shed the responsibility for prudent selection and monitoring of a professional fiduciary or MEP. Existing Department guidance suggests a protocol for selection and monitoring of providers (though one must do some studying to fully define the protocol), and this protocol and the guidance from which it derives are summarized in Chapter 14 of 401(k) Fiduciary Governance: An Advisor's Guide². This protocol need not be altered, but additional information on the nature of professional fiduciaries and what to look for during a due diligence process would likely be helpful to both employers and fiduciaries. Therefore some modest edits to the Department's plain language guides may make sense.

The Different Flavors of Professional Fiduciary

The following analysis of the types of professional fiduciary is intended to capture all of the major variations available in the marketplace today. Note that actual levels of responsibility can vary widely even within each category.

¹ Article by Pete Swisher available at www.pentegra.com.

² Third Edition, Pete Swisher, American Society of Pension Professionals and Actuaries, Washington, D.C., 2011.

Three Broad Categories of Outsourcing

1. Principal named fiduciary—outsourcing to an independent fiduciary with broad responsibility for the plan
2. Investment fiduciary outsourcing—assistance with trustee investment functions
3. Administrative outsourcing—assistance with plan administrator functions.

The trustee is responsible for everything having to do with the assets and the administrator is responsible for everything else, roughly speaking. The term “principal named fiduciary” is problematic for several reasons but no better term comes to mind. The notion is that a person may be appointed to govern the plan in its entirety, and may either perform all fiduciary functions itself or make prudent choices as to outsourcing certain functions.

Principal Named Fiduciary Outsourcing


First, a word about named fiduciaries and what I mean by “principal.” There are many misperceptions even at the highest levels of the pension community about the precise nature and practical application of the named fiduciary roles. [“15 Misconceptions about the Three Principal Fiduciary Roles In a Retirement Plan”](#) discusses this problem in detail. One misperception is that every plan has a “principal” named fiduciary who has overall responsibility for the plan, and that this fiduciary appoints the trustee and administrator. This is simply not true: most documents have no separate “named fiduciary” named in the plan document: rather, there are two named fiduciaries in virtually every plan—the trustee and the administrator—and the administrator in most documents is identified as the “go to” fiduciary that interested parties should contact about the plan. This is very different from the notion of a single named fiduciary with overarching authority.

However, just because most plan documents are written this way does not mean they have to be. There is nothing wrong with appointing a “principal” named fiduciary with overall authority and placing this person over the trustee, administrator, and other service providers. This is exactly what some service providers are doing. For example, one firm describes itself as a “402(a) named fiduciary” with broad authority over all aspects of governing the plan, and the firm is appointed to this role by the plan sponsor. Interestingly, in this particular example, the firm in question is not named as a named fiduciary in the plan document, which may or may not be a problem depending on how the document and the contracts read, but it certainly seems as though being named in the document is the best approach.

To add color to the discussion of the practice of holding oneself out as a fiduciary with a broad scope of authority over ERISA plans, note that this business model was first broadly promoted at a symposium in Boise, Idaho, put on several years ago by Matthew Hutcheson, an independent fiduciary who made the news due to malfeasance with respect to plans of which he served as fiduciary. The fact that one independent fiduciary did bad things does not invalidate the value and viability of the service model, but it does raise obvious questions about due diligence and protections for participants.

As a result of the Hutcheson symposium, a number of investment advisors changed their business model to accept a broader scope of responsibility, usually described as a “full scope 3(21)”³ service. Recently,

³ A term I dislike, as discussed in Chapter 12 of 401(k) Fiduciary Governance.



additional service providers have arisen with a similar business model: some law firms, consulting firms, and TPAs now offer a service whereby they will accept broad responsibility for plan governance, to include prudent selection and monitoring of service providers and their compensation.

A few points are worth making about the “principal named fiduciary” business model:

- It has the advantage of allowing a sponsor to offload maximum responsibility (other than prudent selection and monitoring of the named fiduciary) to one person.
- It has the potential disadvantage of adding a layer of fees when the fiduciary is not a “working” fiduciary (see the discussion on administrative outsourcing below).
- There are no credentialing, reporting, or financial standards for such fiduciaries. This problem is not limited to named fiduciaries, as will be discussed below.
- Care should be taken to observe the formalities of proper ERISA appointment: named fiduciaries, with few exceptions, should be named in the plan document, and if not named in the document language the document must clearly permit the appointment according to a written procedure.
- The actual scope of authority of such a fiduciary is not set in stone, but instead depends on the details of the appointment, including both the plan document language and the fiduciary’s contract.
- There is a temptation to believe that adding an additional layer atop service providers and fiduciaries is safer or more objective than having fewer layers, but as the Hutcheson example shows this is not the case. See the “who watches the watchmen” discussion below for more on this point.

Investment Fiduciary Outsourcing

Chapter 12 of 401(k) Fiduciary Governance: An Advisor’s Guide contains a detailed description of the many forms an investment fiduciary outsourcing service can take, as summarized below.

Investment Advisor under ERISA Section 3(21)(A)(ii)

An advisor can advise on some or all aspects of plan investing, including:

- Advising on plan investments
- Advising on model portfolio allocations
- Advising participants

ERISA Section 3(38) Investment Manager

There are many flavors of manager service, including:

- Pooled account managers
- CIF⁴ and separate account managers
- Managers of individual participant accounts
- QDIA⁵ managers
- Overall plan managers

⁴ Collective Investment Fund, a bank trust for retirement plan investing.

⁵ Qualified Default Investment Alternative, a form of protection for fiduciaries with respect to monies invested on behalf of participants who do not exercise control over their investments.

Administrative Fiduciary Outsourcing

Administrative outsourcing takes five current forms in the marketplace as described below.

The “Supervisory” Administrator or Named Fiduciary

The business model of the “supervisory” administrator is to select various vendors on behalf of the sponsor. The supervisory administrator does not do any administration but rather hires a TPA according to a prudent process. This model is similar to and may be coincident with the “principal named fiduciary” model described above.

The “Working” Administrator

There is no requirement under ERISA or DOL regulations to outsource. Employers are not required to hire TPAs, they simply choose to do so, and in point of fact some employers actually handle all administration in house. Professional administrators similarly have no requirement to outsource: they can choose to do the work themselves or hire a TPA. “Working” administrators do the work themselves, thereby eliminating a layer of service providers and therefore fees, and allowing greater integration of the oversight function with the actual administration function.

The key characteristic of the “working” administrator is that the appointment is made in the plan document—the service provider takes over the role of administrator from the employer.

As with any fiduciary role, the actual scope of service is defined by a variety of factors, including the plan document language, the precise wording of any contracts, and the fiduciary’s actual performance of certain functions. It is possible for there to be wide variations in the scope of outsourced responsibility.

The typical “working” administrator is a recordkeeper or third party administrator (TPA) that accepts the ERISA Section 3(16)(A) administrator appointment rather than providing non-fiduciary or “ministerial” services only, as TPAs have historically done.

The Co-Administrator


The administrator duties can be divided. For example, the sponsor can be the primary administrator but designate a TPA as co-administrator with responsibility for approval and compliance with respect to loans and distributions or other functions.

The Administrative Fiduciary Appointee

There is no good term to describe this but “appointee” works. The idea is that a service provider might not offer to be named in the plan document as administrator or co-administrator, but is willing to accept discretionary control of specified administrative functions under ERISA Section 3(21)(A)(iii). Conceptually this is identical to the co-administrator model above, with the primary difference being the form of the appointment: the co-administrator is a named fiduciary; the appointee is not.

New, Non-Fiduciary Services in Support of Administrators

A large number of providers are adding new support services to supplement existing non-fiduciary administrative and recordkeeping services. Examples include mailing of notices, mailing of new hire enrollment kits, payroll processing, and other tasks that employers can outsource without the vendor necessarily becoming a fiduciary.



A point worth noting is that, in some cases, vendors are describing these ministerial services using terms that include “3(16).” For example, a firm might offer “3(16) services” but not serve as a fiduciary, which might be a practice prone to misinterpretation by employers.

The MEP Fiduciary

MEP fiduciaries take the form of one of the other fiduciary services, but they are worth mentioning separately since the character of outsourcing via a MEP is different than doing so in a single employer plan. The MEP approach is simpler in several ways:

- The adopting employer is responsible for prudent selection and monitoring of the MEP as a vehicle for its employees’ savings, but is otherwise generally not involved with vendor selection and oversight—a function performed by the lead employer or board.
- The adopting employer’s name does not appear on the plan document in any fiduciary capacity.
- The number of direct interactions with vendors tends to be more limited in a MEP than in single employer plans.

Co-Fiduciary Liability

Co-fiduciary liability for the acts and omissions of outsourced fiduciaries depends on a variety of factors, but is generally not hard to avoid so long as the hiring employer does not knowingly participate in or conceal the commission of breaches by co-fiduciaries or fail to take action if it knows of a breach. This is not a difficult standard: ordinary common sense would appear to suffice in most cases to protect an employer so long as the employer does a prudent job selecting and monitoring co-fiduciaries.

Negotiating Favorable Terms for Outsourced Fiduciary Services

The Department’s existing guidance contains clues that point to a hiring protocol that is applicable to professional fiduciaries without alteration. But, as mentioned above, additional information published by the Department on the nature of professional fiduciaries and suggestions for the due diligence process might be helpful. Details of what to look for in contract negotiations are included in Chapter 14 of 401(k) Fiduciary Governance, including the points of interest to the Council such as termination rights and liability caps.

Note that the emerging competitive practice among professional fiduciaries is to charge no surrender penalties or termination fees other than de minimis processing charges, and professional fiduciaries as a group are quite scrupulous about offering clear fee disclosures, as should be expected.

Conflicts of Interest

Fiduciary outsourcing providers sometimes seem prone to accusing one another of having business models that are prohibited. Similarly, respected commentators have made statements that, on their face, appear incorrect (e.g., that a 3(16) administrator must be the approval authority for the hiring of all plan providers—not true unless the plan document is structured that way). Ordinarily credible sources, when mistaken, cause confusion in the marketplace, but unfortunately this is where the fiduciary outsourcing market is today. It takes years of doing a thing repeatedly to become an expert, and genuine fiduciary outsourcing is still new to most of the industry, so our expertise is still evolving. Time will cure this.

The discussion around conflicts of interest seems to cover two main points:

A named fiduciary cannot “appoint itself”

Obviously this is true as stated: no fiduciary can appoint itself or determine its own compensation. But the gist of what some commentators mean by this statement is that any business model other than the “supervisory” form of 3(16) administrator or named fiduciary is conflicted. For example, they claim that:

- A professional 3(16) administrator cannot perform actual administration. The notion here is that the role of “third party administrator” (TPA) is necessarily distinct from the 3(16) fiduciary administrator role, and that for the fiduciary to do the actual work is somehow prohibited. Therefore a professional 3(16) firm cannot do the work of a TPA but must instead hire a TPA. This is nonsensical and adds a separate layer and therefore a separate fee while impairing efficiency, and it is an incorrect reading of law and regulation, but the view is clearly being promoted in the marketplace.
- A discretionary trustee cannot choose itself to be the investment manager. The notion here is that the trustee is choosing itself to be the ERISA Section 3(38) investment manager if it does not hire an outside manager: again, a nonsensical notion and a poor reading of basic fiduciary law, but this view has been presented publicly.
- An advisor or trustee cannot advise on or manage both participants’ accounts and the overall plan assets. This is an old misperception but still relatively common.

A clearer view of both the law and the regulations—specifically ERISA Section 408(b)(2) and DOL Reg. Sec. 408b-2(e)—is that an “independent fiduciary” must appoint an outsourced fiduciary and determine its compensation, whether direct or indirect. So long as the sponsor properly appoints a named fiduciary, it is clear under the statute that multiple roles are fine. ERISA Section 402(c)(1): “...any person or group of persons may serve in more than one fiduciary capacity with respect to the plan (including service both as trustee and administrator).” A person appointed by an independent fiduciary to fill multiple roles is not appointing itself.

A “supervising” fiduciary cannot supervise parties who refer new clients

DOL Reg. Sec. 408b-2(f)(5) contains an example of a situation that results in a prohibited transaction in the Department’s view, and the scenario is very similar to one that does occur periodically in the marketplace today. For example, if ABC is a professional fiduciary firm that holds itself out as being a named fiduciary under ERISA Sections 402(a) or 3(16), or a discretionary fiduciary with powers under Section 3(21)(A)i) or (iii), with broad discretion over plan management including appointment and monitoring of service providers, it is arguably a conflict of interest if ABC accepts referrals of new clients from an advisor when ABC will become responsible for selection and monitoring of the advisor. The fiduciary, in this circumstance, may have an interest in the transaction (the fact that it owes the advisor for the client relationship) that impairs its best judgment as a fiduciary. On the other hand, the fiduciary may not have an interest that impairs its judgment—this is a factual determination (i.e., it depends on the situation). The point is that the arrangement does appear to resemble one that the Department uses as an example of prohibited behavior.

The problem with the supervisory model is in how to grow it. From a business perspective, the way plans change vendors and arrangements is through the assistance of advisors, and advisors are therefore the primary way that a supervisory fiduciary must grow its business. Yet the act of soliciting and accepting referrals from advisors may lead to a circumstance in which it is inappropriate to select or monitor the

advisors. This problem is easily solved by leaving the appointment and monitoring of the advisor or referring party to the sponsor, but some services are not, in fact, structured this way.

Governance Structures and Conflicts of Interest in Multiple Employer Plans

MEPs are new to most service providers and fiduciaries, and because of their unique structure it is important to clarify basic roles and responsibilities. The various possible governance structures for MEPs are discussed below, including an analysis of potential prohibited transaction issues.

Quis Custodiet Ipsos Custodes? (Who Watches the Watchmen?)⁶

This line from Juvenal is often associated with Plato's discussion in *The Republic* of the structure of a just society, and it highlights an issue that can never be avoided: there must always be someone who is not being watched. If ABC appoints an advisor, ABC must watch the advisor, but who will watch ABC? If the sponsor appoints ABC, the sponsor must watch ABC, but who will watch the sponsor? No matter how many layers we add, there will always be a top layer that is essentially unsupervised and, in the retirement plan setting, self-appointed (since the sponsor chooses itself to be the sponsor).

The way ERISA is crafted, the plan sponsor is the top layer and makes its appointments through plan document language, and this is a reasonable arrangement. The problem in a multiple employer plan is that the individual employer is not the sponsor. Which begs the question: who is the sponsor? Who controls the ultimate power of appointment over the named fiduciaries via the plan document language? This is a key issue.

Possible MEP Governance Structures

1. Lead Employer Sponsorship
2. Board Sponsorship
3. Co-Sponsorship
4. Group or Association Sponsorship
5. Sponsorship by a Third Party

Sponsorship by a "Lead" Employer

Suppose twenty employers want to form a MEP. One of them can take the lead and sponsor the plan and appoint its fiduciaries. The upside is that this is simple and clean. The downsides are several:

- Continuity. What happens if the lead sponsor ceases to exist, whether through merger, acquisition, restructuring, or going out of business?
- Compensation. The lead employer cannot get paid unless an independent fiduciary can be identified to approve the services and compensation. The lead employer will be providing a valuable service, at some risk, but not benefiting from its own efforts.
- Control. One of the Department's requirements for considering a MEP to be a single plan for ERISA purposes under Advisory Opinion 2012-04A is that the adopting employers must control the plan. It may be problematic to meet this requirement under the lead employer structure in some cases.

⁶ A better translation of this Latin rendition is "who guards the guards themselves?"

Board Sponsorship

If a board of directors consisting solely of members appointed according to an objective process by adopting employers controls the plan, the Department's control requirement should easily be met. Furthermore a Board, under a plain reading of ERISA, meets the definition of a plan sponsor and employer, though the Department might disagree under its "bona fide" requirement depending on the facts and circumstances. The board in this instance can actually sponsor the plan, though it could also exist solely to appoint and monitor fiduciaries on behalf of the sponsor.

A board structure is arguably a best practice for MEP governance.

Co-Sponsorship

The plan document can be drafted in such a way that each adopting employer is a co-sponsor of the plan. This approach can be combined with a board structure to ensure control by adopting employers. Or, instead of a board, the premise of the plan's governance structure can be that each adopting employer explicitly agrees to the appointment, services, and compensation of each fiduciary and service provider not appointed by others. It is not clear whether this approach would satisfy the Department's requirement under Reg. Sec. 408b-2(e) that an independent fiduciary approve fiduciary and vendor service and compensation. Is an adopting employer an independent fiduciary for this purpose absent a mechanism for removal of appointed fiduciaries and service providers by adopters? There is no guidance and therefore no clarity on this point, and it is an important one for purposes of the prohibited transaction discussion: if the Department is not satisfied by this arrangement, it means that the service providers may be committing prohibited transactions by virtue of appointing themselves.

It may be that the Department has made just such a ruling in the case of the National Rural Electric Cooperative Association (NRECA), which entered a settlement agreement with the Department in 2012 in which it agreed to pay over \$30 million in penalties and restoration to MEPs that it serves. The details of the settlement are not public so we are left to imagine the circumstances, but the Department's press release on the issue, available at dol.gov, specifically states that it viewed the NRECA as having appointed itself.

Group or Association Sponsorship

The language of ERISA Section 3(5), the definition of "employer," says that a "group or association" of employers is an employer for ERISA purposes. In the MEP context we can simplify the use of these terms as follows: a governing body representing a group of employers can sponsor the plan per ERISA Section 3(16)(B), the definition of "plan sponsor," so "group" can be used to mean the plan is board sponsored. "Association" can be used to signify that a separate entity such as a not-for-profit association is the sponsor, though the Department has ruled that association sponsorship does not automatically confer "employer" and "sponsor" status.

An association sponsoring a plan has a problem similar to a lead employer's: how can it get paid for the work? Absent a clearly identifiable, and clearly independent, independent fiduciary, the association cannot get paid. A board structure when coupled with association sponsorship should allow the association to get paid, but this is not completely clear: after all, the association controls the ultimate appointment authority through plan document language and could theoretically remove the board. This is probably splitting hairs as a practical matter and recalls the "who watches the watchmen" conversation, but it is worth noting.

Third Party Sponsorship

Some MEPs in the past decade or so were created by advisors or professional fiduciaries who formed alliances with organizations that would sponsor the MEPs for a fee: a sort of “professional sponsor.” This is a head-scratcher. The ordinary chain of appointment in an ERISA plan is that a sponsor makes a business decision to sponsor a plan then appoints one or more named fiduciaries via plan document language to run the plan. So how can a professional fiduciary appoint a sponsor? Obviously it cannot, and the document language in these programs did not suggest anything other than that the sponsor was in control, but was there a form over substance issue here given that the fiduciary, not the sponsor, was effectively calling the shots in these business arrangements? The “professional sponsor” approach may therefore be suspect, and certainly on its face it appears to upend the standard ERISA chain of appointment.

Another approach to third party sponsorship is that a service provider, such as a recordkeeper or advisor, can be the sponsor. The problem with this arrangement is the “independent fiduciary” requirement of DOL Reg. Sec. 408b-2(e): is the service provider/sponsor appointing itself? Arguably not when there is a clearly identifiable independent fiduciary, such as a board. Again, however, it is worth pointing out that there is some uncertainty in this structure.


The Department’s “Bona Fide” Requirement

In Advisory Opinion 2012-04A and in a number of Opinions previously the Department said only a “bona fide” group or association of employers meets the ERISA definitions of “employer” and therefore “plan sponsor.” The term “bona fide” is, however, not used in the statute and the actual language of Sections 3(5) and 3(16)(B) is fairly straightforward:

The term “employer” means any person acting directly as an employer, or indirectly in the interest of an employer, in relation to an employee benefit plan; and includes a group or association of employers acting for an employer in such capacity.

The term “plan sponsor” means...in the case of a plan established or maintained by two or more employers or jointly by one or more employers and one or more employee organizations, the association, committee, joint board of trustees, or other similar group of representatives of the parties who establish or maintain the plan.

It is worth remembering that MEPs predate ERISA by many decades. Pentegra’s own Multiple Employer Defined Benefit Plan for Financial Institutions was founded by the Federal Home Loan Banks in 1943 and continues to serve hundreds of banks and credit unions. The “group or association” language of ERISA recognizes the reality that pertained in 1974—that MEPs had been around for a long time and the law needed to make allowances for them. A plain reading of the text, therefore, is that any group or association of employers may join together to sponsor a retirement plan, and that third parties may represent employers in sponsoring a plan. The point is not that DOL did wrong in ruling otherwise, but rather that public policy may be served by altering the position and finding alternate methods to protect participants from the sort of abuses that 2012-04A and decades of the Department’s predecessor guidance were crafted to prevent.



Another point worth noting is that, if the Department were to consider altering its position with respect to the “bona fide” requirement⁷, it might also wish to examine the rules surrounding the audit requirement in the Annual Report rules. An audit can be a burden and an obstacle to formation of new MEPs, especially in light of the fact that most adopting employers will have fewer than 100 eligible employees and would not otherwise need an audit. Regulatory guidance that helps keep costs down for startup MEPs by interpreting the audit requirement differently for MEPs than for single employer plans would be helpful.

Several current Bills in Congress address each of these points, but the Department may wish to consider revisiting this issue from a regulatory standpoint given the public and Congressional interest in MEPs.

Access to Plan Assets

Appointing a professional fiduciary will often mean granting control over participants’ money to a third party. As the Hutcheson case demonstrates, this can lead to problems. In the world of regulated financial institutions, banks, trust companies, and credit unions are required to follow careful protocols involving dual controls, segregation of duties, and minimum capital and insurance standards, and to submit to regular audits the purpose of which is to “follow the money.” As a result, money rarely goes missing in the banking system: it is quite safe. But the simple fact is that most professional fiduciaries are virtually unregulated other than with respect to their obligation to follow IRS and DOL rules. And some percentage of the time when people are granted unfettered access to other people’s money, bad things will happen.

One possible cure for this problem is to stipulate that only regulated financial institutions may serve as professional fiduciaries, but this would eliminate from consideration the majority of contenders today: advisory firms, law firms, consulting firms, TPAs—all would be eliminated as possible service providers. This course is therefore not recommended since it would concentrate such services in the hands of a relatively small number of firms. Pentegra Trust Company and a handful of companies like us would benefit mightily from such a rule, but it’s not the right rule.

Another possible cure is for the Department to work with the Securities and Exchange Commission and/or banking regulators to develop rules for ERISA fiduciaries similar in intent to the SEC’s custody rules, or bank rules on dual controls and segregation of duties. In brief, when a firm accepts control of assets via fiduciary privilege, it could become subject to rules intended to protect plan assets. One branch of this approach could be to have custody via ERISA fiduciary status serve as a triggering event for a requirement to register as an investment adviser (unless the fiduciary is a regulated financial institution).

Access to client funds is a serious business. Plan sponsors since before ERISA have had such access, and are not regulated as “custodians.” Some percentage of the time, these amateur fiduciaries do bad things and every year some go to jail. Similarly, professional fiduciaries are not currently subject to the sort of stringent rules that financial institutions take for granted, but perhaps it would be appropriate if they were.

⁷ Pentegra participated in previous industry discussions with the Department on this point and we recognize that, at present, it appears quite unlikely the Department will reconsider.

Solvency and Claims-Paying Ability

In some cases, professional fiduciaries are very small businesses or self-employed individuals who may or may not have the wherewithal to pay a claim if one arose. In one example I ran across a “full scope 3(21)” fiduciary whose Form ADV (investment adviser disclosure document) disclosed that the fiduciary had recently entered into negotiations with creditors—not a good sign for someone whose fiduciary status makes it relatively easy to transfer large sums of money.

Even if such firms have errors and omissions liability coverage, which surely all do, the deductibles on these policies can be quite large, the limits small, and total out of pocket expenses may exceed a fiduciary’s ability to pay. Also a firm that is the subject of a class action lawsuit would be unlikely to be covered sufficiently by a typical E&O policy since the class action would be considered a single claim.

One approach the Department could take is to include in any revisions to plain language guides a suggestion to require copies of insurance policy declaration pages and financial statements, or, in the case of individual fiduciaries or the principals of very small firms, personal financial statements as evidence of solvency and claims-paying ability. The guides might suggest questions that might be asked in order to discover bankruptcies, creditor negotiations, or other sources of concern.

Bonding

Several years ago I met a professional fiduciary holding himself out as a “full scope 3(21)” and asked him how he handled bonding. He showed me the declarations page from a fiduciary liability insurance policy, and when I pointed out that the policy was not an ERISA bond he did not know what I meant. This incident illustrates more than one point, including the fact that just because a professional fiduciary has hung out his shingle does not mean he knows what he’s doing. But in particular the issue is that control of trust assets triggers a bonding requirement, and the professional fiduciary must be conscientious about meeting the requirement.


The Form 5500 will not capture a failure by a professional fiduciary to obtain a bond: the way the annual report is written, the sponsor can be covered by a bond and no “red flag” would be raised even if other parties who should be bonded are not.

It is also worth noting that, in general, an ERISA Section 3(38) investment manager must be bonded, but awareness of the bonding rules is not high among investment advisors and a given advisor may or may not obtain a bond. Again, the Form 5500 will not capture such a failure. The Department might wish to consider amending the Form 5500 and its instructions to capture information about bonding of all parties who are required to be bonded.

Qualifications — The “Shingle” Effect

Anyone not proscribed under ERISA Section 411 (e.g., felons) can “hang out a shingle” as a professional fiduciary. The level of knowledge can therefore vary widely and, as has been observed previously, most professional fiduciaries today have minimal experience at the role simply because these services are only now becoming more popular.

A Word about Regulation and Enforcement with Respect to Professional Fiduciaries



I have mixed feelings about what the Department should do about this issue. On the one hand, perhaps professional fiduciaries should meet certain minimum requirements and register with the Department.

Perhaps they should pass a test or have certain credentials. On the other hand, the regulatory burden for qualified plans is quite heavy already, and I am reluctant to suggest that more regulation is needed. Nonetheless this is certainly a key issue, and the more plans a professional fiduciary serves, the stronger the case for increased oversight.

Perhaps the answer is enforcement. New rules may not be necessary, but a program of enforcement aimed at professional fiduciaries would help reduce or eliminate problems associated with fiduciary qualifications or the lack thereof. Professional fiduciaries should reasonably expect to be examined, and should be prepared to pass with flying colors.

Funding for an enforcement regime will doubtless be an issue, but in reality no additional funding should be necessary: the nature of professional fiduciaries is that they serve many plans. The enforcement task is therefore simplified to a degree. For example, instead of investigating the 1,000+ clients Pentegra serves as a professional fiduciary, the Department could just investigate Pentegra and accomplish almost as much. (Note: our Chief Counsel did NOT want me to include this paragraph.)

Conclusion

Fiduciary outsourcing is a powerful tool that is only now beginning to take hold in the marketplace, but interest is skyrocketing. It is not unreasonable to expect that, over the next five to ten years, the majority of employers will choose to outsource in whole or in part, either by hiring a professional fiduciary or by joining a multiple employer plan.

To help employers make good decisions about outsourcing, the Department may wish to update some of its plain language guides. And to protect participants the Department should make a careful study of the risks associated with outsourcing and make reasoned judgments about whether any additional rules or enforcement initiatives are needed.