THE EXCELLENT FIDUCIARY

When Recordkeepers Merge

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Businesses that provide recordkeeping services to defined contribution retirement plans are merging at a dizzying rate. What considerations should plan sponsors resolve when a competitor or aggregator acquires their recordkeeper or third-party administration firm?

INTRODUCTION

The number of organizations that provide recordkeeping services to defined contribution employee benefit plans has declined to less than 100 in 10 years from over 400. The merger of competitors is the primary cause of declining vendor options for fiduciary committees. Industry experts believe there is more consolidation of recordkeeping firms to come. Significant pressure to keep pace with investments in technology, product offerings, and the client experience has forced many firms into the hands of a competitor. In addition, narrow profit margins increased technology requirements, and greater client demands force recordkeeping providers to increase their scale.

HOW THE RECORDKEEPING BUSINESS GREW

While defined contribution 401(k) and 403(b) plans have been in existence for some time, significant changes have taken place since The Revenue Act of 1978 became effective. That legislation opened the door for 401(k) plans, and the change proved revolutionary. At the time, recordkeeping was a low technology need well served by quarterly paper statements. Significantly, there was no participant-directed investing during that era.

The mutual fund industry drove the next evolutionary step for defined contribution plans in the early 1990s. Recognizing a massive opportunity to capture assets, these firms moved to put control of the investments into the hands of plan participants. Once individuals made investment decisions, the demand for more frequent information and access naturally developed into daily recordkeeping and all-hour access.

In that era, the most dominant recordkeepers and third-party administration firms (collectively, RK) were the mutual fund managers and insurance companies whose primary in-

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terests were to sell their investment products. The American retirement landscape was more of a vehicle for product distribution than a well-considered program to produce retirement-ready participants.

In the early 2000s, the emergence of independent consultants to the defined contribution plan market slowly changed the industry by promoting more fee awareness. That moved the focus of investments away from each RK's proprietary products. In turn, federal regulators began enforcing a new idea called fee transparency, which ushered in so-called "open architecture" investment menus. Incidentally, open architecture can use investments provided by more than a single fund family or insurance company. Initially, only the most prominent plan sponsors could afford this luxury, but open architecture has become the prevailing norm over time.

THE CURRENT ENVIRONMENT

All of this brings us to where the retirement plan industry is today: one pieced together by product providers, growing demand, and governmental oversight. As regulation and client demand have stretched margins thin, we see RKs taking large-scale action, whether by acquiring, merging, outsourcing, or simply exiting the business. In order to increase profit margins, many are adding services and charging extra for them. Some of these new services have questionable value other than to increase RKs' profits. An example is "3(16) fiduciary" services.

While discussions of fiduciary responsibility for employee benefit plans are not new, the message from some RKs and some third-party administrators (TPAs), too, is that their 3(16) fiduciary service relieves an employer of fiduciary responsibility. Is this a boon for employers or a gimmick by savvy vendors?

THE VEIL OF AUTHENTICITY

Many service providers represent themselves to be genuine, devoted partners to retirement plan sponsors—from their brands to their marketing presentations to their detailed, regular updates to clients. By all accounts, it appears that these vendors' efforts focus on helping their clients' retirement plans to be successful. Unfortunately, while corporate fiduciaries may interpret that vendors act in their enterprise's best interest, some vendors are authentic in one thing, and only one—their desire to be profitable. Driven by consolidation, entry into the 3(16) fiduciary space is an example of how RKs have introduced expensive services to gain new revenue by capitalizing on their veil of authenticity. Due to the significant sensitivity of the 3(16) fiduciary role, and to determine the value of the claims made by RKs that offer a service so-named, let us first look at how the Employee Retirement Income Security Act of 1974 (ERISA) defines that role.

So what is a 3(16) fiduciary? Why does it seem that some RKs have abandoned their long-time non-fiduciary status by selling themselves as such?

Every ERISA plan's governance structure possesses at least four parties that share primary fiduciary responsibility: the plan sponsor, a Plan Administrator, a Named Fiduciary, and a trustee. Section 3(16) of ERISA defines the legal obligations of a Plan Administrator. Hence, the term "3(16) fiduciary." It is both a legal role and a functional title.

The Plan Administrator is the person or committee designated in the document that defines a retirement plan's features and governance structure. It is called the Plan Document. By default, if no Plan Administrator is named, the plan sponsor is the Plan Administrator.

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Generally, a Plan Administrator is responsible for interpreting the plan's governance documents, administering the plan per governance provisions, overseeing the careful handling of plan assets, managing operations including the plan's payroll interface, appointing other fiduciaries, selecting and monitoring service providers, and determining the reasonableness of their compensation initially and ongoing. As can be seen, the Plan Administrator or 3(16) fiduciary role is comprehensive and embraces a wide range of responsibilities.

The plan sponsor is the 3(16) fiduciary at a retirement plan's inception, and the vast majority of employers keep it permanently. However, employers may delegate 3(16) functions to qualified third parties as long as they have no conflicts of interest with the plan. Even though an employer may hire various service providers to assist with the operation and management of their plans, under ERISA, they retain the primary fiduciary responsibility. They are never wholly free of potential liability, no matter what savvy service marketers say or infer.

RKs are historically non-fiduciary service providers, and their services are called ministerial. That is what makes the emergence of 3(16) fiduciary services from that category of vendors noteworthy, requiring careful examination.

We have looked closely at many contracts offered by RKs' 3(16) provisions, and they reveal clever language that disguises avoidance of actual liability. While RK service agreements stipulate *support* of the 3(16) functions, they can disclaim legal responsibility for performing those functions or outcomes.

CONSOLIDATION OF RECORDKEEPERS RAISES CYBERSECURITY QUESTIONS

Without exception, challenges involving employee benefit plan supply chains that include RKs and TPAs have outstripped efforts to manage them securely because of their proprietary systems and our dependence on their marketing claims. Let us face it. It is tempting to trust big brand name providers implicitly to provide secure services without challenging their capabilities. Stark evidence in many cybersecurity lawsuits proves that no vendor is safe from an attack. If you have not subjected your plan's RK, following its merger with another firm, to an inspection that complies with the Department of Labor's guidelines, do not wait any longer to do so. Employing the most capable and innovative players in the industry allows for both diversity and resilience that builds trust based on performance, not merely slick marketing slogans.

WHY MERGE?

The executives who plot strategy among RKs face many reasons to buy or merge with a competitor. Most acquirers are looking for more market share or expansion in specific market segments. Acquiring a competitor's superior technology or systems is also a common goal. As a by-product of federal regulations and lawsuits against plan sponsors, RK fees continue to decline, requiring firms to do more with less. In today's environment, they are businesses that demand scale. It often is more successful to acquire an entire portfolio of retirement plan clients than to grow one client at a time.

The hope is that these continued transactions are favorable for the industry, leading to enhancements in technology and services, with economies of scale driving better experiences and outcomes for plan sponsors and their participants. But consolidation does not automatically mean improved innovation. The frequency of these changes and the different benefits and challenges that can come from each trans-

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action make it as important as ever for plan fiduciaries to perform periodic due diligence of the marketplace.

THE PLAN SPONSOR'S PROPER RESPONSE

What should you do if your retirement plan's RK is acquired? Plan sponsors should use news of their retirement plan RK's merger as an opportunity to assess all RK services and negotiate fees. As a fiduciary, selecting appropriate service providers is one of the most critical responsibilities. An RK merger is a vendor change, and federal law requires that fiduciaries handle that change with care, skill, and diligence. Documentation of a fiduciary committee's action must show that it pursued an informed, reasoned, and rigorous investigation.

A practical benefit of due diligence is it can help you evaluate possible changes in service levels and fees that could be on the way. And you certainly do not want to miss out on any new benefits, such as technology improvements and enhanced features that could improve plan administration and outcomes for your employees. And, if coming changes from your RK do not seem appropriate, you can take the step of expanding your committee's response.

CONCLUSION

Just going with the flow if your retirement plan's RK is acquired or merges with another organization is not a good idea. Industry best practices offer three approaches. The first is a request for a meeting with the current RK to review any service, fee, or product questions the fiduciaries may have. The second approach is a request for information or an RFI. The scope of an RFI usually involves a review of service, fee, or product-related questions with the current RK comparing them to answers to the same issues obtained from other vendors. The third and more involved approach is a request for proposal or RFP project. As the name suggests, the fiduciaries would seek bids from a group of vendors to determine which vendor would best meet the plans' current and future needs. Get help from an unbiased qualified vendor management firm to simplify an RFP and lighten the burden on the human resources group where RFPs are typically managed.

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