PENSION RIGHTS CENTER

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Statement of Norman Stein
On Behalf of the Pension Rights Center
Before the ERISA Advisory Council
On the Topic of

"Outsourcing Employee Benefit Plan Services"

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Good morning. I am Norman Stein. I am a professor at the Drexel University School of Law, where I teach and write principally in the areas of employee benefits and tax law. I also am a policy consultant for the Pension Rights Center in Washington, on whose behalf I am today testifying. The Pension Rights Center is the country's oldest consumer organization dedicated solely to protecting and promoting the retirement security of American workers, retirees, and their families. It is always a pleasure to appear before this advisory council, of which I am an alumnus, on its important work.

I very much appreciate the opportunity to testify on the topic that this work group is studying: the outsourcing of plan services. Outsourcing of benefit plan functions, administrative and otherwise, is a practice that predates ERISA by more than 100 years—that is, from the adoption of the first industrial pension plans in the late 19^{th} century—but one whose prevalence and scope has grown significantly since ERISA's passage. Part of this is due to ERISA's regulatory structure, particularly the relationship between some early regulatory rulings from 1975 and concerns about plan sponsor liability, but some of the proliferation in outsourcing reflects advances in technology, service specialization, evolution of plan design, the difficulty of any one plan sponsor keeping up with legislative and regulatory change, the ability to pass administrative fees in defined contribution plans through to participants, and new business and marketing strategies to capture the demand for plan services.

My testimony will be in two parts: the first part provides a bit of historical context and explores the definitional contours of what we mean by outsourcing; the second part is both descriptive and prescriptive and tries to set out some regulatory principles that should apply to outsourcing—both for the party contracting for services and the party providing services. In this section, I will discuss some gaps in the current regulatory framework—which as I noted date back to a part of 1975 interpretative bulletins—that could be filled by new Department of Labor guidance updating those early bulletins. I am particularly concerned about outsourcing arrangements that many people today think eliminate or at least reduce the fiduciary protections that the statute nominally purports to extend to participants. It revisits first regulatory principles for ERISA, which is appropriate as retirement and other employee benefit plans have evolved since ERISA's first decade.

Background and Definitional Overview

An initial historical question is whether there were ever plans—pre- or post-ERISA—that performed all plan functions internally, from administrative to compliance, from investment to record-keeping, from legal to accounting? In other words, is outsourcing an unanticipated byproduct of ERISA?

The simple answer to this question is of course no. Outsourcing was always common, even for large plans whose plan sponsor had mammoth-sized human resources departments. Even those plans would have been reliant on outside legal, investment, banking, and sometimes actuarial and insurance, and other outside support.

But this also is true: before and even a bit after ERISA, there were some plans—mostly small ones maintained by law firms or accounting firms—that did not contract out for any services, even record-keeping and investment management services, but kept all plan functions in house. Some attorneys my age were once covered by such plans. But today, in an era where almost all defined contribution plans provide individually directed investments and where compliance and basic administrative costs are simply too steep if not done on something like an assembly-line basis, the time of administer-it-on-your-own plans is almost certainly completely over. So ERISA did not create outsourcing but it probably did ultimately put an end to plans that were administered entirely in house.

There are different types and levels of outsourcing. Multi-employer plans and large single-employer defined benefit plans sometimes outsource investment and actuarial functions but retain at least some other core administrative and management functions in house. On the other side of the spectrum, a small firm typically outsources the administration of a 401(k) plan to its record-keeper to the greatest extent possible. As a result, the face of such a plan to the employee is generally the plan's record-keeper and not the plan sponsor. Indeed, if you ask individuals if they have a 401(k) plan, some of them will respond that their employer has a Vanguard or a T. Rowe Price or a Fidelity 401(k) plan.

And in some cases the plan sponsor believes that it has outsourced not only its administrative functions to the record-keeper, but also its fiduciary responsibilities. While this belief is never true under the statute, outsourcing can change the nature and limit the scope of the plan sponsor's fiduciary responsibilities, a topic to which I will return. And the reality that some plan sponsors may believe that outsourcing frees them of any fiduciary responsibility undermines part of the statute's structure. We want fiduciaries to be aware of their fiduciary status and prevent problems; we don't want fiduciaries to simply become unwitting insurers after problems arise.

I want to turn to the definitional scope of outsourcing, because it helps to have a common vocabulary when we apply a complicated set of rules to a particular category of activity. So what do we mean by outsourcing services or plan-related functions? What are plan-related functions that can be performed by third parties?

There are three types of plan-related services for which plans or plan sponsors contract with third-party services.

First, services to help the plan sponsor perform its settlor functions, such as plan design and plan amendments. ERISA's fiduciary rules do not apply to settlor functions, and services to assist the plan sponsor in performing such functions are outside the discussion of outsourcing under ERISA, at least to the extent that we are concerned about fiduciary rules as they are currently interpreted. (But even here we might have some policy concerns when consultants make assumptions about what plan sponsors want their plans to accomplish, such as minimizing contributions for lower-paid employees, and then push plan designs that reflect these assumptions about what plan sponsors want.)

Second, services provided to a plan fiduciary to assist the fiduciary in carrying out the fiduciary's obligations. In such cases, the fiduciary is not transferring its management, administrative, or investment functions to a third party, but is using third-party services to help the fiduciary exercise its own management, administrative, or investment activities. This is not an actual delegation of a fiduciary function. Often, but not always, the nature of the services contracted for is advice, as, for example, engaging a lawyer to help analyze plan eligibility terms.
Third, services provided to a plan to perform the plan's administrative, management, or investment activities. The third parties that perform such services will be fiduciaries to the extent the services they perform are fiduciary activities.

While ERISA has relevance to contracting for both the second and third category of service, the relevant ERISA analyses are different for the two categories.

I also note that this idea of categorizing services into three distinct types is imperfect: some services may overlap categories, and it is sometimes different to distinguish whether a service is in the second or third category. For example, under current law, an appraiser who values closely held stock may be advising the appropriate plan fiduciary on value or it may be performing a fiduciary function for the plan.

Some ERISA Fiduciary Issues Related to Outsourcing

People discuss ERISA's fiduciary duties with hushed reverence, talk about them as imposing on those who manage and administer employee benefit plans and invest their assets the highest legal standard known to law. Whether this is the case is open to dispute but that is not the focus of today's hearing and ERISA actors often try to avoid fiduciary status by any means available. And this seems true enough: ERISA's fiduciary standards, when they apply and if there are available remedies, can be a powerful corrective to wrongdoing, conflicts of interest, and serious lapses in judgment. Perhaps even more important, ERISA's fiduciary standards incentivize prudent and conflict-free conduct by ERISA actors. It is preferable to prevent fires than to have to extinguish them and clean up after them.

So I start with the notion that ERISA fiduciary standards have meaning and bite and that actors who are subject to them are more likely to act prudently and for the exclusive benefit of plan participants. The standards, of course, only apply to ERISA fiduciaries and the ERISA's definition of fiduciary is a functional one, providing that "a person is a fiduciary with respect to a plan to the extent he exercises any discretionary authority or discretionary management of such plan or exercises any authority or control respecting management or disposition of its assets . . . or has any discretionary authority of discretionary responsibility in the administration of a plan." A person is also a fiduciary to the extent that they render "investment advice for a fee or other compensation with respect" to plan money or property.

So putting investment advice aside, ERISA's fiduciary standards apply to persons to the extent they manage or dispose of plan property, whether or not they have discretion; to persons to the extent they exercise discretionary authority over plan management; and to persons to the extent they have discretionary authority over plan administration, regardless of whether they exercise it.

There are two particular regulatory outsourcing issues on which I will focus—what I will call the ministerial service issue and the expert/professional advice issue.

The Ministerial Service Issue. It is commonplace for an ERISA plan to contract with a third party to provide administrative services. In some cases, the third party will perform fiduciary services and will itself be a fiduciary. Here, so long as the plan document permits such delegation of fiduciary functions, the regulatory regime is reasonably straightforward and is not problematic. The delegating fiduciary must prudently select the fiduciary and monitor its performance, and it is probable that best practices would have the third-party fiduciary acknowledge its status. In 1975, as part of an early Interpretive Bulletin[1] on fiduciary matters, the Department of Labor explained the nature of monitoring a fiduciary appointed by another fiduciary:

> At reasonable intervals the performance of trustees and other fiduciaries should be reviewed by the appointing fiduciary in such manner as may be reasonably expected to ensure that their performance has been in compliance with the terms of the plan and statutory standards, and satisfies the needs of the plan. No single procedure will be appropriate in all cases; the procedure adopted may vary in accordance with the nature of the plan and other facts and circumstances relevant to the choice of the procedure.

While the guidance here is not as specific as it might be, it suggests a rigorous process. (The Department may want to provide examples of acceptable approaches to monitoring and to identify best practices.) There is no specific regulatory guidance on the selection process, but the selection process should consider the third-party's competence, reputation, the quality of its employees, the ability to meet any individualized needs of the plan, and cost among other factors. (Again, the Department may want to provide specific examples of acceptable approaches to appointment of a fiduciary and to identify best practices.)

In some cases, a plan fiduciary will contract with a third party to provide administrative or management services that are not fiduciary functions (or at least that the third party does not consider a fiduciary function). For example, virtually all defined contribution plans contract today with third-party record-keepers and few of those record-keepers regard themselves as fiduciaries, even though they are the primary party with whom participants will interact and rely. The notion that performing record-keeping and related activities does not result in a person being

[1] See 29 CFR § 2509.75-8.

a fiduciary has as its statutory basis that it is a non-discretionary administrative function and that a person is a fiduciary under ERISA only if they have discretionary administrative responsibility.

The 1975 Interpretative Bulletin seems to confirm this. It provides that a person who provides "ministerial" services is not a fiduciary if he had no "power to make any decisions as to plan policy, interpretations, practices or procedures," and applied rules "within a framework of policies, interpretations, rules, practices and procedures made by other persons."[2] The Bulletin goes on to provide a non-exclusive list of ministerial services, which includes record-keeping and 10 other examples.[3]

The Bulletin provides that "a plan fiduciary may rely on information, data, statistics or analyses furnished by persons performing ministerial functions for the plan, provided that he has exercised prudence in the selection and retention of such persons. The plan fiduciary will be deemed to have acted prudently in such selection and retention if, "in the exercise of ordinary care in such situation, he has no reason to doubt the competence, integrity or responsibility of such persons."

This regulatory guidance, which predates the emergence of the self-directed 401(k) as the dominant design template for retirement plans, is somewhat out of sync in today's benefit world. It is typically the record-keeper who in most important senses manages and administers a self-directed 401(k) plan. It is the record-keeper who generates most participant communications, it is the record-keeper who participants call when they have questions or problems, and it is the record-keeper that employees generally interact with to arrange for distributions when they retire or leave employment. The record-keeper largely runs the plan but the record-keeper is not typically thought to have fiduciary responsibility.

Under the Interpretive Bulletin, then, a type of contractual legerdemain occurs when a plan's named fiduciary (typically the plan sponsor) contracts with a record-keeper, which magically and mystically transforms the nature and shape of ERISA's fiduciary protections. The plan's

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[2] Id., at D2.

[3] The complete list follows:

(1) Application of rules determining eligibility for participation or benefits;

(2) Calculation of services and compensation credits for benefits;

(3) Preparation of employee communications material;

(4) Maintenance of participants' service and employment records;

(5) Preparation of reports required by government agencies;

(6) Calculation of benefits;

(7) Orientation of new participants and advising participants of their rights and options under the plan;

(8) Collection of contributions and application of contributions as provided in the plan;

(9) Preparation of reports concerning participants' benefits;

(10) Processing of claims; and

(11) Making recommendations to others for decisions with respect to plan administration.

fiduciary has shrunk its fiduciary responsibility for plan administration to a duty to use ordinary care in the selection and retention of the record-keeper and to have no reason to doubt the competence, integrity, or responsibility of the record-keeper.[4] And the record-keeper does not pick up the ERISA fiduciary responsibilities that the actual fiduciary has shed.

This framework is outdated and outmoded, and it is time that the Department expressly revisit this early guidance, which the Interpretative Bulletin itself says is good only until regulations are issued and notes that the guidance itself must be interpreted in light of subsequent legislation, interpretive bulletins, and judicial decisions.

There are two aspects of the Bulletin that are troubling. The first is that the standard of prudence for choosing a comprehensive record-keeper should set a high bar, perhaps higher than the one that fiduciaries employ when they contract with a third-party for actual fiduciary services, for in the latter cases the third-party accepts fiduciary responsibility so that such responsibility is not diluted and does not disappear. The notion that the standard for selecting and retaining a non-fiduciary third-party record-keeper is one of "ordinary care" and having "no reason to doubt competence is inappropriate" and should be expressly disclaimed. I doubt that this is in fact the standard that the Department or any court would apply today.[5] It should be conformed to the reality of today's world, in which people purporting to be non-fiduciaries are managing most of the retirement plans for American workers.

The second troubling aspect is the Bulletin's lack of clarity on what services are strictly ministerial in nature. In practice, the focus is on the Bulletin's enumerated list of "ministerial" activities.[6] But under the interpretive bulletin a provider of these services is only relieved from fiduciary status if it is performing such activities under "a framework of policies, interpretations, rules, practices and procedures made by other persons." Generally, the record keepers-themselves make these policies, rules, etc., and one can assume that few employers—especially small employers—are actively involved in helping develop this framework. The interpretive bulletin's rational seems to be that recordkeeping is an administrative function, but, if it is being done pursuant to an administrative framework developed by others, it becomes ministerial. A third-party record-keeper who adopts such a framework should be able to spare its own employees fiduciary status, but should the record-keeper be able to shed its own fiduciary status by following a framework that the record-keeper itself developed?

But perhaps the above analysis—suggesting that record-keepers and other third-party administrators are in fact fiduciaries—is reading the bulletin too narrowly, for another "ministerial activity" under the bulletin is "making recommendations with respect to plan administrators." So maybe the record-keepers are not only providing record-keeping services, but are also making recommendations to a plan fiduciary about adopting an administrative

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4 The Department's position concerning the rigor of the selection and monitoring of a record-keeper today likely requires more than what the interpretative bulletin requires: "in the exercise of ordinary care in such situation, he has no reason to doubt the competence, integrity or responsibility of such persons." See, for example, Department of Labor Fact Sheet, "Tips For Selecting And Monitoring Service Providers For Your Employee Benefit Plan," http://www.dol.gov/ebsa/newsroom/fs052505.html.

5 In this regard, see note 3.

6 See note 3.

framework. But this is somewhat circular, because under the interpretative bulletin the "recommendations" are ministerial if they are made under a framework of policies, rules, etc., made by other persons. This all suggests that record-keepers and other third-party providers of administrative services, contrary to conventional wisdom, may arguably be fiduciaries after all.

In our view, record-keepers, the most important of all plan actors in the current self-directed defined-contribution plan environment, probably should be fiduciaries. In any event, the Department might consider clarifying the issue of when record-keeping and other activities identified by the Bulletin are ministerial rather than fiduciary because they are performed under "a framework of policies, interpretations, rules, practices and procedures made by other persons."

The Expert Advice Issue. Another 1975 Interpretive Bulletin[7] considered another fiduciary issue: whether "an attorney, accountant, actuary or consultant who renders legal, accounting, actuarial or consulting services to an employee benefit plan (other than an investment adviser to the plan) [is] a fiduciary to the plan solely by virtue of the rendering of such services." The Bulletin answered the question thusly:

> No. However, while attorneys, accountants, actuaries and consultants performing their usual professional functions will ordinarily not be considered fiduciaries, if the factual situation in a particular case falls within one of the categories described in [section 3(21), defining fiduciary], such persons would be considered to be fiduciaries within the meaning of section 3(21) of the Act.

And a fiduciary, pursuant to either the already quoted "reliance" language from the companion 1975 bulletin[8] or a parallel idea, can certainly rely on the opinion of the professional.

There are at least three troubling aspects to this ruling. First, there are few ERISA cases holding that a person engaged by a plan to provide legal, accounting, actuarial or consulting services (other than financial advice) became a fiduciary by acting beyond that role. But in the real world, particularly the world of small plans, it is often the case that the lawyer, accountant, or consultant's advice will always be followed – a fact often known to the professional giving the advice. More relevant, sometimes that advice draws upon the professional's judgment and not just technical expertise. Judgment and discretion are linked if not identical concepts. While a professional offering judgment that he knows will be followed under these circumstances may be enough to turn the professional into a fiduciary in a theoretical world, it apparently only seldom turns them into a fiduciary in the real world. This is, of course, a difficult issue, but one that should at least be revisited by the Department, with a possible eye toward providing specific examples of when a professional crosses over into fiduciary activity

The second two troubling aspects parallel those raised in the discussion of the "ministerial issue" discussion. The first is the issue of diminished fiduciary responsibility when the fiduciary relies on the expert opinion of a professional (such as the appraiser of property that the plan is either purchasing or selling – most commonly closely held stock or employer real property). The

[7] 29 CFR § 2509.75-5.
[8] See note 1.

fiduciary typically rests his decision on the professional opinion, while the professional who gave the opinion disclaims fiduciary status. The fiduciary's duty in such cases, as with the fiduciary's duty with respect to ministerial duties, is one of selection of the appraiser (retention will not generally be relevant in certain one-shot deals, such as appraisal of closely-held employer stock). In effect, under ERISA no one stands directly behind the conclusions proffered by the professional.[9] This again raises the issue of whether there may be circumstances when the professional or expert should be considered a fiduciary if they know that their work is going to be the primary basis on which a fiduciary would act. The Department might consider offering guidance on this issue.[10]

The other issue involves the nature of the fiduciary's duty of prudence with respect to retention of non-fiduciary professionals. Is the duty similar to the one that the Department in 1975 said was applicable to the selection of an entity providing merely ministerial services? Should the selecting fiduciary consider the possibility of conflict if it engages a firm that is also retained by the plan sponsor? These are issues that merit space on the Department's regulatory agenda.

Conclusion

The Department of issued two 1975 Interpretative Bulletins on outsourcing issued at the dawn of the ERISA era. The benefits world, and the nature of outsourcing, has changed considerably during the last four decades and new issues that could not have been anticipated in 1975 have arisen. The Department might want to reconsider, update, and expand its guidance.

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[9] The appraiser, however, may have duties under state law.

[10] Here it should be noted that the professional may have professional liability for malpractice and might also be subject to review by its licensing or accrediting agency, outside of ERISA.