Are 401k 3(38) Services Worth the Price?

401(k) plan sponsors question if it makes sense

We're gonna go with a big yes.

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When analyzing different investment options, many 401(k) plan sponsors question if it makes sense to pay more for 3(38) investment advisory services. By selecting 3(38) services, the plan sponsor is electing to have an outside third party act as a discretionary manager for their investment lineup. In other words, the designated discretionary manager can make investment lineup changes without formal approval from the plan trustee or committee.

Designating a 3(38) investment advisor can be a beneficial choice for plan sponsors. But when reviewing this option plan sponsors need to determine if it is in the best interest of the participants to hire this type of advisor. In this article we have outlined some of the advantages and disadvantages that plan sponsors should investigate when considering this option.

Pros:

- By designating a 3(38) investment advisor, the plan sponsor has essentially shifted the fiduciary risk of the investment lineup to the Discretionary Manager.
- If the plan sponsor lacks expertise on investment processes or principles, then engaging a 3(38) investment advisor will reduce some of the risk because they are transferring discretionary authority to a qualified party.
- In general, under ERISA, if an entity has discretion to make a decision, that entity is responsible for that decision, not the entity that appointed it. By engaging a 3(38) fiduciary, the plan sponsor has reduced their legal liability because the 3(38) fiduciary is responsible for making investment decisions, not the plan sponsor.

Cons:

- Obtaining the services of a 3(38) investment advisor typically cost more. This is due to the fact that the 3(38) fiduciary is absorbing a portion of the fiduciary risk for the plan.
- By engaging a 3(38) fiduciary, the plan sponsor has not abdicated all fiduciary risk. They are still responsible for monitoring the activities of the 3(38) fiduciary to make sure they are acting prudently.
- Since a 3(38) investment advisor has discretionary authority over the investment lineup, the plan sponsor loses control on which funds are added or removed from the lineup.

Keeping in mind the pros and cons, when does it make sense for a plan sponsor to engage a 3(38) investment advisor? If the plan sponsor is unsophisticated with investment principles or does not have employees who are able to commit the time and take on the risk of acting as plan fiduciaries, it may make sense to engage a 3(38) advisor. Even if a plan sponsor is well versed on investment management skills, it can still make sense to engage a 3(38) fiduciary at a higher cost. This is because the 3(38) fiduciary can essentially act as an insurance policy for the plan sponsor.

If the plan sponsor is cost conscience and is agnostic to the risk of the plan, then the value of a 3(38) fiduciary goes down. They may be better off engaging a 3(21) investment advisor (co-fiduciary) or self-managing the risk.

If you’re exploring how to best manage the fiduciary risk of your plan and provide participants with the opportunity to meet retirement goals, it’s important to review all options. Hiring a 3(38) advisor may help your organization mitigate some of the risks of plan sponsorship and is something that should be reviewed.

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