



The Surprising Benefits of a 3(38) Fiduciary

Bill Hoover, chief financial officer at Hillcrest Convalescent Center in Durham, North Carolina, has always had an open-door policy. Twelve years ago, when he started at the company, that policy helped him get to know his colleagues and respond to their concerns. But as Hillcrest grew to nearly 500 employees, Hoover found it challenging to keep on top of all of his many responsibilities while maintaining the open-door policy that was so important to him.

Among the many responsibilities competing for Hoover's time and attention was his responsibility to monitor the company's 401(k). Although he never missed a meeting with his plan advisor, scheduling became increasingly difficult, and he found himself consistently agreeing with his advisor's every recommendation. This made him wonder if there wasn't a better way.

Hoover recognized how important it was for his team to lean on experts for guidance. He also wanted to win back some of his own time to focus on other aspects of the business. With those two things in mind, he decided to transition Hillcrest to a 3(38) investment management arrangement.

A 3(38) arrangement gets its name from the relevant Employee Retirement Income Security Act of 1974 (ERISA) section that defines it. In brief, a 3(38) arrangement is a way of outsourcing the burden of investment decision-making—and risk—to a qualified expert. 3(38) investment managers are a distinct breed of fiduciaries legally required to act in their clients' best interests when it comes to choosing funds and managing assets. Their job is to select, monitor, and benchmark retirement plan investments on a discretionary basis. And they're experts at doing so.

Smart Outsourcing

Investment advisors registered under the Investment Advisers Act of 1940 have long assumed this

role for defined benefit pension plans. But increasingly, 3(38) relationships are being extended to defined contribution plans too, primarily 401(k)s and 403(b)s.

There is good reasoning behind this choice, says [Jennifer Doss](#), senior director of CAPTRUST's defined contribution practice. Doss says an uptick in litigation regarding defined contribution plans has led to increased industry demand for 3(38) relationships.

"A 3(38) arrangement represents the highest level of investment liability transfer possible under ERISA today," says Doss. "It's pretty easy to see why there's demand in the industry for this kind of fiduciary."

Benefits attorney Mark Grushkin agrees. He has seen many defined contribution plan committees receive materials for approval right before a meeting and then rubber stamp whatever they get from their investment advisor.

That's partly because very few people have the requisite expertise to confidently make these investment decisions. "There may be one person—maybe the CEO—with some financial acumen," Grushkin says. "But that doesn't make them an expert in investing. And for those folks, I think [using a 3(38) is] really important." With the "virtual explosion of ERISA litigation," he's noticed, "Why not offload as much fiduciary responsibility as possible?"

There's also the appeal of unburdening overworked executives by having someone else manage plan investments. "If you're a smaller partnership or mid-size enterprise, one of the things you value most is time," says [Scott Matheson](#), managing director of the institutional group at CAPTRUST. For example, the business officer at a school is not only making sure everyone's benefits are in order but also running the line for carpool. "Reducing the amount of time spent on retirement plan meetings and follow-ups is a real, tangible benefit," says Matheson.

The time savings was a big draw for Bill Hoover at Hillcrest. "We were a smaller company, and we liked to have control and have our hands in everything," he says. "But as we started to grow, we realized we needed to focus on growth and put investment decisions in the hands of experts."

Faster Changes, Better Outcomes

Smaller companies are happy to reclaim time, and larger companies are often glad to unload some of the risks that aren't core to their businesses. But any size company is pleased when its investments achieve better outcomes.

"Committee members wear lots of hats, so getting all the decisionmakers in the same room can be difficult," says [John Leissner](#), CAPTRUST head of institutional client service and operations. "Considering the time needed to adequately discuss fund changes, the timeliness of these changes can pretty easily be negatively impacted."

With a 3(38) arrangement, fund changes can happen more quickly. They no longer require companies to spend time scheduling and holding committee meetings or researching and debating

proposed changes. And with quicker fund changes come compounding returns and better retirement results for employees, explains Leissner.

Reducing the expenses and logistics of plan committee meetings are additional benefits. Financial advisors at CAPTRUST have witnessed plan sponsors in a 3(38) capacity lowering company expenses by having fewer meetings. These meetings can quickly become expensive when accounting for travel costs, lost billable hours, and expert fees. One advisor reported that a plan sponsor was able to reduce its committee size from eight to two and switch from quarterly to semiannual meetings, thereby reducing costs significantly.

For many plan sponsors, committee meetings—previously filled with discussions about managing investments and selecting funds—have shifted. Now, they're more focused on participant engagement, plan design, optimization of retirement plan vendor offerings, and the fiduciary process. Advisors have also witnessed plan sponsors with a 3(38) relationship being able to spend more time on participant financial wellness, retirement readiness, and overall plan satisfaction.

“The committee spends much less time talking about the individual investment options, freeing up time for more meaningful discussions about helping their employees build a solid retirement plan,” says one CAPTRUST advisor.

The Phew Factor

What's the biggest motivator for plan sponsors to engage in a 3(38) arrangement? At first glance, it may seem like plan sponsors would want to reduce fiduciary risk. But surprisingly, many sponsors report that relief from worry was their major incentive.

“While we felt that plan sponsors would be relieved about taking on less risk as fiduciaries upon hiring a 3(38), we didn't realize that this typically results in committee members experiencing less worry and stress related to plan decisions,” says Leissner. “We realized committee members actually felt emotionally relieved to not have to make these decisions.”

For Hoover, switching to 3(38) had just that effect. “The financial world is a crazy world out there, and unless you're in it every day and know what you're looking at, it can be overwhelming,” he says. “It takes a lot of weight off my shoulders and my business partners' shoulders to know we can focus on our employees, on our business, on our growth, and know that experts are handling our 401(k).”

He's certainly not alone. Doss says that some plan sponsors may not have fully understood the liability they were accepting in their prior 3(21) advisory arrangement—a relationship that allows a fiduciary to advise the committee but not execute decisions on its behalf. After working under a 3(21) arrangement for a period of time, a 3(38) arrangement felt much more appealing.

"A lot of committee members are very happy to relieve themselves of that responsibility, understanding they do not really have the requisite knowledge base," Hoover says. Or as one CAPTRUST advisor explains it, the feeling his clients experience as part of a 3(38) arrangement could be called *the phew factor*: a sense of safety and relief.

Letting Go of the Reins

One of the primary reasons why companies might choose not to pursue a 3(38) arrangement: fear of giving up control. Often, plan sponsors say they're comfortable where they are, often with a 3(21) relationship. Or they don't feel comfortable handing over the reins to someone else. "Some folks want to stay involved in the decision-making process and don't want to feel out of the loop or caught off guard by changes being made to the plan," explains Doss.

Certainly, a 3(38) arrangement is not the right choice for every plan sponsor. For Grushkin, the benefits attorney, it comes down to the aptitude and availability of committee members. For CAPTRUST's Matheson, it's about culture. "If you're an organization that likes to be involved in all the gory details, then don't turn over the keys," he says.

But surprisingly, even plan sponsors who were once hesitant to give up control said moving to a 3(38) arrangement did not leave them craving their old responsibilities. "They are not burdened with making difficult decisions, they have time for more dialogue about participant outcomes and plan competitiveness compared to peers in industry, and the fund change process is streamlined with minimal involvement," says Leissner.

Given all those positives, and the draw on resources they had with previous arrangements, "It makes sense to us that the plan sponsor's emotional ties to the process are something that they can let go of a little more quickly than they had anticipated," he says.

Hoover was not disappointed when he switched to a 3(38) arrangement. The time saved, the risk transferred, and the improved outcomes all left him satisfied with his decision to make the change. In fact, Hoover says Hillcrest's competitive 401(k) is a big selling point in the recruitment process, and one that gets used to attract top talent.

Hoover says the switch to a 3(38) relationship has been successful because it is something he doesn't have to think about.

And, surprisingly for him, using a 3(38) has allowed him to focus his scarce time and attention on other pressing matters, like helping Hillcrest employees get in the plan and save enough for a comfortable retirement. "The fact that we have an advisor picking the funds for them, not only does it help me sleep better, but it takes away a negative," he says. "There are much more important things for me to focus on."



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