

Fiduciary Focus: Managing Accountability

W. Scott Simon | 12-04-08 |

Investment advisors to sponsors of qualified retirement plans such as 401(k) plans might wish to adapt some of the material in this month's column for use when marketing to other plan sponsors.

Two Problems Faced by Sponsors of 401(k) Plans

Are you the sponsor of a 401(k) plan? If you are, does the investment advisor to your plan acknowledge in writing its status as a section 3(38) "investment manager" operating as a section 405(d)(1) "independent fiduciary" under the Employee Retirement Income Security Act (ERISA)? If not, you face two problems. First, you subject yourself to the risk of legal liability for your investment advisor's own imprudent conduct. Second, you have missed the chance to transfer significant risk and responsibility, and hence potential liability, to your investment advisor. Both of these problems are unnecessary and both of them can be solved.

Recommendations without Accountability or Advice with Accountability

The 401(k) plan industry includes investment advisors such as brokerage firms, insurance companies, banks, trust companies, mutual fund families and other entities offering their investment services to sponsors of 401(k) plans. The persons who represent investment advisors bear such titles as advisor, consultant, financial consultant, stockbroker, insurance agent, registered representative, or vice president. Many of these are salespeople who adhere to what I term the "salesperson" standard.

There are three ways how investment advisors can become ERISA fiduciaries. The first two ways are intentional: the advisor is identified in plan documents or other formal fiduciary documents (e.g., formal delegations, assignments, agreements, etc.) as a "named fiduciary" or the advisor enters into a written agreement accepting responsibility as an "appointed fiduciary." The third way is unintentional: the advisor inadvertently becomes a "functional fiduciary" through its actions such as exercising discretionary authority or control over the management of a qualified retirement plan.

Many sales-oriented investment advisors don't want to become ERISA fiduciaries because they don't want to be personally liable for their actions. This refusal comes in two forms: (1) failing to acknowledge in writing their status as an appointed fiduciary and (2) making sure that their actions don't make them a functional fiduciary.

ERISA requires a section 3(38) investment manager to be a bank, an insurance company or a registered investment adviser. Nearly every major brokerage firm, insurance company, bank, trust company, mutual fund family and other entities offering investment services to sponsors of 401(k) plans has a registered investment adviser subsidiary so they have the ability to accept status as a fiduciary under ERISA sections 3(38) and 405(d)(1).

Yet these entities have made the business decision not to accept such fiduciary status. In doing so, they have decided to provide their clients with only legally meaningless recommendations and have therefore settled for adherence to the salesperson standard.

That decision is viewed by prudent fiduciaries to be fundamentally disloyal to plan participants. (The opposite of disloyalty, of course, is loyalty, which is the oldest fiduciary duty from which all other fiduciary duties emanate.)

Sales-oriented investment advisors to 401(k) plans (whatever the title of their representatives) have no legal obligation to plan sponsors to ensure that they get the very best products at the best price. This salesperson standard -- recommendations with meaningless legal accountability -- stands in sharp contrast to the "fiduciary" standard -- advice with meaningful legal accountability. The fiduciary standard is the one that all plan sponsors such as you should demand from their investment advisors; there's no need to settle for the clearly inferior salesperson standard.

Sales-oriented advisors that refuse to become a functional fiduciary are careful not to cross over the line to provide investment "advice" to plan sponsors because the act of rendering such advice carries real legal responsibility (and therefore the risk of real legal liability). By not straying over that line, these advisors instead provide only investment "recommendations" to plan sponsors because the act of making such recommendations carries little legal responsibility (and therefore little risk of legal liability).

Plan sponsors such as you don't even know that such a line exists. Many of you assume that your sales-oriented investment advisor provides legally meaningful investment advice to you, not legally meaningless investment recommendations. Whether or not you know it, this lulls you into a false sense of security. (The "S" in ERISA stands for "Security" so it goes without saying that a plan sponsor should be concerned primarily with enhancing the security of the "E" in ERISA (that would be "Employee") and not be fooled by investment advisors that in any way lessen that security.) That leaves you, as the plan sponsor, in an inferior legal position requiring you to prove the fiduciary status of your investment advisor.

Two Immediate Benefits Accruing to Sponsors of 401(k) Plans

If an investment advisor agrees to acknowledge in writing its status as an independent fiduciary under ERISA section 405(d)(1), a plan sponsor gets two immediate benefits. First, the sponsor can transfer to the investment advisor the responsibility (and therefore the risk of legal liability) for selecting, monitoring and replacing (if necessary) the plan's investment options. Second, the sponsor ensures that the plan (and therefore the plan's participants and beneficiaries) receives investment advice with legally meaningful accountability (the fiduciary standard) instead of investment recommendations with legally meaningless accountability (the salesperson standard).

Why should an advice-giving investment advisor need to go to the trouble of formally acknowledging its fiduciary status in writing? The reason: litigation. When plan participants file lawsuits against plan sponsors, sales-oriented advisors often escape responsibility by arguing that they made investment recommendations, not gave investment advice, to sponsors. That defense, when successful, leaves plan sponsors all alone to face the risk of legal liability.

As a plan sponsor, however, you needn't feel alone in such circumstances. An investment advisor that's an ERISA-defined independent fiduciary/investment manager stands by your side in fiduciary solidarity and accepts legal transfer -- from you as the plan sponsor to the

advisor -- of the responsibility (and therefore the risk of legal liability) for selecting, monitoring and replacing (if necessary) your plan's investment options.

Retaining an investment advisor that's an ERISA section 3(38) investment manager, operating as a section 405(d)(1) independent fiduciary, creates a positive relationship with a plan sponsor that has hired the advisor to provide unbiased investment advice. Such an advisor and the sponsor have the same interest in legally and morally doing the right thing for the participants (and their beneficiaries) in the 401(k) plan. That's the significance of providing legally meaningful investment advice to plan sponsors instead of legally meaningless investment recommendations made by sales-oriented advisors.

Few sponsors of 401(k) plans know that ERISA allows them the opportunity to transfer responsibility (and therefore the risk of legal liability) to an investment advisor because few advisors marketing their investment services to plan sponsors tell them about it. After all, why would such advisors want to tell plan sponsors about a benefit they can get at the expense of the advisors?

Conflicts of Interest with Third-Party Masters

Many sales-oriented investment advisors have significant conflicts of interest. Commissions and other fees and considerations that they receive from third parties such as insurance companies, brokerage firms and mutual fund families distort or cloud the advice they give to plan sponsors. Such advisors are often motivated by selling investment products to sponsors of 401(k) plans -- and unmotivated to provide services after these sales because their ongoing commissions are so small.

By accepting these commissions and other fees and considerations, such investment advisors become agents of third parties that pay them. The result is biased advice distorted or clouded by what benefits the investment advisor and its third party master - investment products that often have hefty fees poorly disclosed - rather than what benefits the 401(k) plan and its participants. A sales-oriented investment advisor's hidden allegiance to third parties that pay it commissions as well as the potential for payment of other fees and considerations upsets the alignment of interests that should exist between a plan sponsor such as you and your investment advisor.

An investment advisor providing investment advice to a plan sponsor is forbidden by ERISA to have the conflict of interest faced by a recommendations-making investment advisor. Many sponsors of 401(k) plans are unaware of this difference in compensation sources. They do, however, have the duty to understand what type of relationship they have entered into with their investment advisor.

Advice with Accountability Solves the Two Problems Faced by Sponsors of 401(k) Plans

Here's what you need to do as the sponsor of a 401(k) plan to solve the two problems described here:

1. Ask the investment advisor to your 401(k) plan if it has acknowledged in writing that it's an ERISA section 405(d)(1)-defined independent fiduciary/ERISA section 3(38)-defined investment manager.
2. If the advisor has, ask to see the document where that written acknowledgment appears.

3. If the advisor has not, ask the advisor if it will acknowledge in writing that it's an ERISA-defined independent fiduciary/investment manager.
4. If the advisor won't do that, find one that will acknowledge in writing its status as an ERISA-defined independent fiduciary/investment manager.
5. At a minimum, a plan sponsor should make sure that the investment advisor it retains completes satisfactorily the fact sheet issued by the Department of Labor and the SEC titled "Selecting and Monitoring Pension Consultants: Tips for Plan Fiduciaries."

As an individual fiduciary of your 401(k) plan, you are personally liable to the plan's participants (and their beneficiaries) for "any losses to the plan resulting from a breach of fiduciary duties." By settling for the outdated salesperson standard - investment recommendations with meaningless accountability -- you increase the risk that your personal net worth will be consumed by lawyers in litigation against you to ensure your compliance with ERISA standards. The receipt of investment recommendations with meaningless accountability may also increase the risk of enforcement actions against you by the Department of Labor and the Internal Revenue Service.

Plan participants deserve advice with accountability from fiduciaries that openly and fully (and yes, honorably) accept fiduciary duties and are not paid by any third parties. Plan sponsors should always try to work with an investment advisor who will accept meaningful fiduciary status with respect to the plans it advises.

At a minimum, a plan sponsor such as you needs to understand the business model and nature of the contractual relationship you have entered into with your investment advisor. An investment advisor - no matter what its business model -- should document that it has fully disclosed the nature of the relationship with its clients. These acts of disclosure -- indeed, of education -- provide clarity to all parties and help to eliminate any misunderstandings about who is responsible for what. Such transparency, the opposite of which has had a significant role in creating the troubles now being experienced by our financial and economic system, should be -- must be -- a lodestar from here on.

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Simon provides services as a consultant and expert witness on fiduciary issues in litigation and arbitrations. He is a member of the State Bar of California, a Certified Financial Planner and an Accredited Investment Fiduciary Auditor. Simon's certification as an AIFA qualifies him to conduct independent fiduciary reviews for those concerned about their responsibilities investing the assets of endowments and foundations, ERISA retirement plans, private family trusts, public employee retirement plans as well as high net worth individuals.

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