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Non-fiduciary Investment Consultants

Fiduciaries of 401(k)s can choose to favor their participants or their consultants.

by W. Scott Simon

Most fiduciaries of 401(k) plans have a service provider that in some way gives assistance to them concerning plan investment options. Such providers include brokerage firms, insurance companies, banks, trust companies, mutual fund families, financial planning firms and other entities offering their investment services. The people who represent these service providers bear such varied titles as advisor, consultant, financial consultant, stockbroker, insurance agent, financial planner, registered representative, vice president, as well as others. Service providers and the persons representing them are referred to as"investment consultants" for purposes of this article.

Investment consultants come in three basic varieties when it comes to acknowledging their fiduciary responsibilities under the Employee Retirement Income Security Act (ERISA):

- Those who don't acknowledge any fiduciary responsibility at all;
- Those who acknowledge fiduciary responsibility under ERISA section 3(21)(A); and
- Those who acknowledge fiduciary responsibility under ERISA sections 3(38) and 405(d)(1).

There are significant differences among such non-fiduciaries and fiduciaries, and those differences can have a direct bearing on the retirement lifestyles of participants in 401(k) plans. Plan fiduciaries must have a good understanding of such differences so that they can protect plan participants and their beneficiaries from the worst of the investment consultants and help them benefit from the services of the best consultants.

Non-fiduciary Investment Consultants

Some investment consultants refuse outright in the contracts they sign with fiduciaries of 401(k) plans

to acknowledge any fiduciary responsibility to such fiduciaries. [Actually, the legal entity that enters into a contract with an investment consultant is the 401(k) plan itself, but plan fiduciaries that have the legal authority to act on behalf of the plan sign the contract. It is ultimately plan participants, and their beneficiaries, of course, upon whose behalf the plan fiduciaries must act prudently.] Since these consultants are not fiduciaries, they have no duty other than a moral one to put the interests of plan participants and their beneficiaries first.

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Even with the best of intentions, non-fiduciary investment consultants simply pursue their own financial self-interests with no legal obligation to plan participants to ensure that they get the very best investment products at the very best price. For example, industry practices allow non-fiduciary consultants to collect "revenue sharing" payments. These payments pass—usually in the deep, dark, dead of night—from mutual fund companies and brokerage firms to investment consultants in exchange for having the consultants make available the companies' and firms' mutual funds for selection as 401(k) plan investment options. It's not illegal, of course, for non-fiduciary investment consultants to engage in such "pay to play" schemes.

The Beautiful World That Many Investment Consultants Create for Their Own Benefit

Other investment consultants will acknowledge ERISA section 3(21)(A) fiduciary responsibility in their contracts with plan fiduciaries. The problem is that the pre-drafted, off-the-shelf contracts that many such consultants present to plan fiduciaries (often at the last minute just before signatures are affixed with no time to negotiate terms) include language that virtually "guts"—with exquisite legal skill and precision—from a fiduciary-consultant contract significant ERISA section 3(21)(A) fiduciary duties that investment consultants would otherwise owe to plan participants (and their beneficiaries). Before examining how a real-life contract carries out this kind of gutting, let's review the relevant text of ERISA section 3(21)(A).

ERISA section 3(21)(A) provides that a person is a fiduciary with respect to a plan to the extent that:

- It exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets;
- It renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so; or
- It has any discretionary authority or discretionary responsibility in the administration of such plan. In other words, an investment consultant can become an ERISA section 3(21)(A)-defined fiduciary of, for example, a 401(k) plan in at least one of three ways:
  - Having "discretionary" authority or control to manage the plan, or actually exercising authority or control to *manage the plan or buy and sell its assets* under section 3(21)(A)(i);
  - Having authority or responsibility to render *investment advice for compensation* concerning plan assets, or actually doing so under section 3(21)(A)(ii); or
  - Having discretionary authority or responsibility for *administering* the plan under section 3(21)(A)(iii).

Now let's examine some relevant language contained in a real-life contract [common among, for example, brokerage firms, insurance companies and mutual fund families that gladly provide such contracts free of charge to unsuspecting fiduciaries of 401(k) plans] between a prominent investment consultant brokerage firm ("X") and the fiduciaries of a 401(k) plan ("Client"):

"X acknowledges that it is a fiduciary as defined under section 3(21) of the Employee Retirement Income Security Act of 1974 ("ERISA"), but only as to the services provided by X under this Agreement with respect to the following:

- X has identified for the Client one or more Managers that X deems suitable for the Client based on information provided by the Client;
- X will provide due diligence and monitoring services with respect to the Managers. As part of this process, X will periodically monitor the performance of the Managers for purposes of determining whether they should continue to remain on the Recommended List of X;
- X will provide periodic performance reports to the Client concerning the Client's Account managed by the Manager; and
- X will provide trade execution services and custody."

Does the language in this fiduciary-consultant contract give the investment consultant any discretionary authority or control to "manage the plan or buy and sell its assets" under section 3(21)(A)(i)? Here's a hint as to the correct answer: it begins with *n* and ends with *o*. At no point in this contract is the investment consultant given authority or control (discretionary or otherwise) to manage the plan or buy and sell its assets.

Does the language in this fiduciary-consultant contract give the investment consultant any discretionary authority or control to render "investment advice for compensation" concerning plan assets under section 3(21)(A)(ii)? Here's a hint as to the correct answer: in Russian, it would be *nyet*.

Department of Labor Regulation 3.21(c) provides that a person gives fiduciary "investment advice" only when:

- It makes recommendations regarding the purchase or sale of securities; and
- The advice is individualized and based on the particular needs of the retirement plan.

Note that ERISA fiduciary investment advice is deemed to be given when it pertains only to recommendations concerning *investments—not investment managers*. (See "*Thought Capital: Retirement News and Analysis*," a white paper prepared by Fred Reish and Bruce Ashton for the Principal Group in September.) Ergo, there can be no "investment advice" if a person recommends *only* investment managers.

And that's why it's no accident under the terms of this contract that the investment consultant promises to provide due diligence and monitoring services only as to *managers, not investments* offered in the 401(k) plan (and only for the purpose of determining whether the managers should stay on the recommended list, not whether the managers are prudent, or even suitable, for the client). It's also no accident that the consultant promises to provide performance reporting services, but only as to—yup, you guessed it—managers, not investments.

Does the language in this fiduciary-consultant contract give the investment consultant any discretionary authority or responsibility for "administering" the plan under section 3(21)(A)(iii)? Here's a hint as to the correct answer: The chance is somewhere between slim and none. Okay, okay, the correct answer is actually "none" since in another part of the contract, the consultant makes crystal clear that it doesn't have any such fiduciary duty: "X [is not] responsible for administration of the Plan."

Note that in this contract the consultant also promises to provide trade execution services and custody. While trade execution services can be critically important because of (high and hidden) cost issues related to directed brokerage and revenue-sharing, trading is essentially a ministerial function. Trade execution services have nothing to do with "discretionary" authority or control to manage a plan or buy and sell its assets, rendering investment advice for compensation concerning the plan's assets or administering the plan. The same is true of custodial services that the consultant promises to provide in the contract.

The quoted language contained in this fiduciary-consultant contract makes clear that X has not, in any meaningful way, taken on ERISA section 3(21)(A) fiduciary responsibility. This position is bolstered even further on the basis of other terms in the contract. For example, X selects the managers for its trading platform; the client then selects managers from that platform and directs X to follow the instructions of the selected managers. Notice the nexus: Client? Manager? X. X has very cleverly—throughout the contract—placed the manager(s) between the client and X. As a result, X has ensured, by the very terms of the contract it has drafted and presented to the client, that all "discretion" under ERISA section 3(21)(A)—*and therefore fiduciary responsibility and therefore fiduciary liability*—lies with the client, not with X.

And that, folks, is a clinic on how to gut from a fiduciary-consultant contract significant ERISA section 3(21)(A) fiduciary duties so that the consultant can claim that it is an "ERISA fiduciary" while bearing no real fiduciary responsibility—and therefore liability—to plan participants (and their beneficiaries). In such situations, many plan fiduciaries are misled because they see (assuming they read their contracts) and hear (you can be sure it's brayed repeatedly by their investment consultants whenever the plan fiduciaries are within earshot) the magical word *fiduciary*.

Investment consultants creating this kind of situation have the best of both worlds—they get to throw around the word "fiduciary" without being on the hook for any real fiduciary responsibility (and therefore liability) to plan fiduciaries.

Plan fiduciaries finding themselves in this kind of situation have the worst of both worlds—they think they are getting the protections of a fiduciary from such consultants, but when push comes to shove (as when plan participants sue plan fiduciaries) and the fiduciaries turn to the consultants for some help, the consultants simply whisper to the fiduciaries: "Read your contract, dummy. It's *you* who's responsible for the prudent selection and monitoring of the investment options in your 401(k) plan, not us. We're fiduciaries in name only, sucker."

Ah, what a beautiful world these consultants have created for their own benefit—but not so for the plan fiduciaries—or more accurately, *not so for flesh-and-blood plan participants and their beneficiaries*. With "fiduciaries" like these, who needs enemies?

The Beautiful World That Plan Fiduciaries Can Create for the Benefit of Their Participants

There is a way for the fiduciaries of 401(k) plans to create a beautiful world for the benefit of their plan participants (and their beneficiaries)—not to mention for their own benefit. That way is to locate an investment consultant that will acknowledge, in the fiduciary-consultant contract, its status as an ERISA section 3(38)-defined "investment manager" and ERISA section 405(d)(1)-defined "independent fiduciary."

The consultant's acknowledgment in the fiduciary-consultant contract as an ERISA investment manager/ independent fiduciary helps create a positive relationship in which both the plan fiduciaries and the consultant have the same incentive to legally and morally do the right thing for plan participants.

Trustees and other fiduciaries of 401(k) plans have a number of duties they owe to plan participants (and their beneficiaries). For example, they are personally liable for the selection and monitoring of a plan's investment options. Although not widely known, plan fiduciaries can transfer their selection and monitoring duties to an ERISA investment manager/independent fiduciary that will accept ERISA "discretion" over plan assets and assume full responsibility (and therefore liability) for those fiduciary functions.

This discretion can include selecting asset classes appropriate for plan participants, recommending mutual fund investment options appropriate for such asset classes and monitoring the funds periodically and replacing them whenever the consultant deems it prudent. An ERISA-defined investment manager/independent fiduciary, therefore, takes on "much of the decision-making" and removes from the shoulders of the plan fiduciaries "virtually all of the fiduciary responsibility," Reish wrote in September at *PLANSPONSOR.com*.

When plan fiduciaries make this transfer prudently, they escape liability for any selection and monitoring mistakes made subsequently by the consultant. This is a tremendous benefit for fiduciaries looking to reduce the personal liability they face as stewards of their retirement plans. Through prudent delegation, a plan also gains another steward that is a fiduciary in the true sense of what ERISA law requires: an entity that legally must act with the sole purpose of benefiting the plan participants and beneficiaries. (Note that plan fiduciaries always retain the overall responsibility to oversee plan investment options and investment consultants. These are duties that no fiduciary, whether responsible for ERISA, private trust, non-profit or public employee pools of money, can ever transfer.)

And how do plan participants (and their beneficiaries) benefit by having an investment consultant for their plan that is an ERISA investment manager/independent fiduciary? Such a consultant provides *investment advice with accountability*, which is based on the highest standard of the law (the fiduciary standard). The consultant's acknowledgment in the fiduciary-consultant contract as an ERISA investment manager/independent fiduciary helps create a positive relationship in which both the plan fiduciaries and the consultant have the same incentive to legally and morally do the right thing for plan participants.

Contrast this kind of advice with that provided by the prominent investment consultant brokerage firm discussed in this article: *investment advice without accountability*, which is based on a "phantom" fiduciary standard under which such consultants bamboozle the plan fiduciaries (hence, plan participants) they profess to serve by pretending that they are fiduciaries with real responsibilities. There's nothing inherently wrong, of course, with the business model under which such consultants otherwise provide services to retirement plans. But that model becomes perverted when it is adapted to outright fool plan fiduciaries about non-existent fiduciary responsibilities—not to mention when it is adapted to hide (high) fees from plan fiduciaries that are hard to find.

W. Scott Simon writes a monthly "Fiduciary Focus" column for MorningstarAdvisor.com, where the above article was originally published. Reprinted with permission of Morningstar.

Editor's Note:

The Department of Labor published a proposed regulation on October 22, 2010, to update the definition of a "fiduciary" under ERISA. Public comment is invited and ASPPA Government Affairs Committee (GAC) was expected to comment by the January 20, 2011 deadline. As per *ASPPA asap No. 10-35*, "The proposed regulation would modify and expand the definition of fiduciary in the context of providing investment advice to a plan fiduciary, as well as to a plan participant or beneficiary. This proposal rewrites rules that have been untouched for 35 years."

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