

Crossing the Line:
Managing Fiduciary Responsibilities of Financial Advisors
and Avoiding Prohibited Transactions



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Executive Summary

In today's climate of liability risks, stock market volatility, and mutual fund trading scandals and potential legislation, U.S. employers are reassessing their 401(k) plan priorities for 2004. Plan sponsors will most likely devote much of this year to reducing the risks of liability and lawsuits, and to finding additional ways to support employees' retirement planning efforts.

Plan Sponsors will spend considerable effort this year deciding how to handle funds that have been implicated in the mutual fund scandals. In short order, they will move beyond the knee-jerk reaction of simply eliminating funds that have been implicated. They will then move on to trying to sort through the mess and determine which fund management companies have responded in a way that they should be included in plans, and which have not. That is a more sophisticated process requiring knowledge of the changes that have been made. In other words, plan sponsors and financial advisors will go beyond the headline news to understand and respond. Employers agree universally that reducing the risks of liability and exposure to lawsuits will be a priority this year. Means cited for reducing risk include outsourcing investment manager oversight, implementing/revising the plan's investment policy statements and providing advice.

401(k) plans are the sole retirement plan savings vehicle for over 40 million participants — and an essential benefit for small and mid-sized companies. Many employers offer them without being fully aware of the responsibility and potential liability that accompanies 401(k) plans. Just as important, the advisors who try to help them may be putting themselves in jeopardy.

For many years, financial advisors have worked hard to educate their plan sponsor clients about their responsibilities as ERISA plan fiduciaries. But few financial advisors have understood their potential status as plan fiduciaries, and the risks they run as a result. In the case of advisors to 401(k) plans, these risks are significant.

The Next Litigation Battleground?

In the past, courts have struggled with determining when a broker crossed the line to become a fiduciary to an ERISA plan. There is a developing trend where the Department of Labor and the courts are more willing to determine that brokers who advise on investments are considered fiduciaries. Plaintiff's attorneys are also becoming more sophisticated about the issues, and therefore better able to prove their cases.

Financial advisors who counsel 401(k) plan sponsors are, in many instances, acting as fiduciaries. The consequences for a financial advisor to assume fiduciary status can be profound - including personal liability if the fiduciary or prohibited transaction rules are broken.

They can choose to avoid risk or manage it in one of the following ways:

- 1) Provide services to plan sponsors in a way that will not make them fiduciaries; or
- 2) Restructure their services to plan sponsors to eliminate the conflicts of interest and satisfy basic ERISA fiduciary responsibility provisions.

This paper examines these issues and provides solutions.

**Financial
advisors need
to understand
and address
the risks involved
in crossing the
line from sales
person to
fiduciary.**

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The Role of a Financial Advisor in 401(k) Plans

Mutual fund and insurance companies have long championed financial advisors as one of the most important resources a plan sponsor can have - specifically to make sense out of the staggering range of investment choices available to participants today. Mutual funds still lead as the investment of choice for the majority of plan sponsors, but there are over 7,000 funds to select among. A financial advisor has been traditionally promoted as the best resource to assist sponsors in narrowing the field of investments to help participants reach their investment goals. The act of doing so, without using specific tools or processes, may put advisors at risk.

Financial Advisors as Fiduciaries

Generally speaking, people tend to think of fiduciaries as individuals directly affiliated with the plan sponsor, such as officers, directors or plan committee members. But the law does not limit fiduciary status to those people; rather, fiduciary status is a function of a person's relationship to the plan, particularly with respect to matters concerning investments. In this context, a person is a fiduciary if he 1) has or exercises any authority or control over the assets in a plan, or 2) renders investment advice for compensation. A person is a fiduciary if he or she is assigned a fiduciary role or if they exercise fiduciary control. Either will do. As a practical matter, brokers can become functional or de facto fiduciaries.

It is specific and individualized investment advice that is most likely to trigger fiduciary status for financial advisors. Correspondingly, a recommendation on guidance that is generalized is not fiduciary advice. For example, if a financial advisor says, "Most 401(k) plans offer menus of investments in the following asset classes," it is not considered advice; whereas stating "I have selected these funds to be the right ones for your plan and participants" would be considered individualized advice.

In the past, conventional wisdom was that financial advisors engaged in a non-fiduciary sales process, and did not provide advice in such a way as to make them a fiduciary under ERISA. However, as case law has developed, and the Department of Labor (DOL) has further defined its own position on regulations and other guidance, the line is less clear between non-fiduciary selling of investment products versus fiduciary advice.

Regular, Individualized Investment Advice

While ERISA itself does not define the difference between the sale of investment products and the provision of investment advice, DOL regulations do address this topic. In essence a person is rendering investment advice as a fiduciary if that person:

- Recommends the purchase or sale of specific investments,
- Renders advice on a regular basis to the plan pursuant to a mutual agreement, written or otherwise, that such service will serve as the primary basis of investment decisions with respect to plan assets, and
- The advice is individualized to the plan based on the particular needs of the plan regarding such matters as investment policies or strategy, portfolio composition, or diversification of plan assets.

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As a practical matter, many 401(k) advisors today are meeting this definition of fiduciary when they perform their normal functions, such as:

- Recommendations to plan fiduciaries that they select a particular 401(k) package of investments and services
- Advising fiduciaries in the selection of investment funds that are offered to participants
- Developing and applying the investment policy statement
- Ongoing performance monitoring and due diligence
- Advising on the recipient funds for mapping from a prior provider

Discretionary Control

Another way for a 401(k) advisor to become a fiduciary is to exercise actual or discretionary authority or control over the assets in the plan. (Note: if a person is given discretionary control he is a fiduciary regardless of whether he exercises it or not. In fact, the failure to exercise that authority could be a fiduciary breach. Alternatively, if a person is not given discretionary authority but actually exercises control or gives advice, they can be a fiduciary as well. So, there can be both a named fiduciary and functional fiduciary with the same range of fiduciary authority.)

Some courts have found advisors to be fiduciaries under this definition in instances where, because of their professional expertise, they exerted an unusual degree of influence on the plan. As a practical matter, when trustees or plan committees are unsophisticated as investors, they are likely to rely more heavily on the representations made by financial advisors.

Responding to Market Demand

The market has insisted on offering more investment choices to plan participants. The number of investments available for plan participants has doubled from an average of 6 to more than 12 in the past decade. The number of mutual fund families available in a single plan has increased as well. The popular definition of diversification has expanded to include multiple investment managers as well as asset classes, e.g., a 401(k) package from a mutual fund company may permit a plan to offer participants 20 different funds from a total universe of 50 proprietary mutual funds and 25 "outside" mutual funds. Many plan sponsors and fiduciaries expect their financial advisors to advise or actually choose a more limited lineup of funds for their 401(k) plans. This act can cause the advisor to become a fiduciary.

As a word of caution, the compensation structure of the funds an advisor selects to create the 401(k) investment product can cause the advisor to inadvertently violate ERISA's prohibited transaction rules. The consequence of an ERISA section 406(b) violation is severe; all of the financial advisor's compensation must be paid to the plan. This is tricky terrain because most bundled mutual fund providers pay different levels of revenue on proprietary and outside funds. Indeed, the payouts vary greatly from one mutual fund family to the next...and even within a mutual fund family depending upon the share class.

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Brokers' Responsibilities and Risk as Fiduciaries

General Fiduciary Responsibilities — The Prudent Man Rule

If a financial advisor is, or may become, a fiduciary, the first step is for an advisor to perform an analysis of the plan, participants and funds and to give advice that satisfies ERISA's prudent man rule. Basically, the financial advisor must engage in a prudent process — to analyze the appropriate information (substantive prudence) in the appropriate way (procedural prudence). That process will be evaluated by the prudent man standard: What would a prudent investor or advisor - who is knowledgeable about retirement investing and whose sole purpose is providing quality retirement benefits — have done?

Selection and Monitoring of the Investment Package

The selection of the investments for a participant-directed 401(k) plan requires that the plan fiduciaries (often relying on the expertise of their advisor) consider the following:

- 1) Is each individual fund a prudent and suitable investment option for the participants?
- 2) Does the fund menu create a broad range of investment options?
- 3) Is the investment menu suitable for the abilities of the participants in the plan to understand and use appropriately, or is education or advice required?

Many 401(k) bundled providers and service companies have developed packages, methodologies and mapping systems to help identify suitable initial investments. Fiduciaries have a regular duty to monitor those investments and remove ones that regularly underperform.

Most plan sponsors will rely on their financial advisors to determine the appropriate information to gather, then to review that information and to provide them with recommendations. While it is not advice to assist the employer in putting together investment information, it **is** a fiduciary decision to determine which information is needed and to interpret that information as it applies to the investments in the plan. Morningstar, Lipper Analytics, Ibbotson Associates and many mutual fund companies, banks and insurance companies provide performance, expense and benchmark information; however it remains the responsibility of the fiduciary to regularly review the information and document their decisions about what to do with that information.

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or a similar fund that pays a smaller amount, and recommends the higher-paying fund, then a prohibited transaction has occurred. Not only must the difference between the two amounts be returned to the plan, but the advisor may also be required to pay penalties to the government.

As a practical matter, where open architecture NAV programs offer almost every mutual fund class of shares available to plan sponsors, A, B, C, I, K, L, M, N, R, and Y, the finder's fee for the investment options might vary, e.g., from 25% to 1% and the trailing commissions can range from 0.00% to 1.00%.

While it is possible to structure compensation in a manner that will eliminate this prohibited conflict of interest for 401(k) advisors as discussed below, few 401(k) advisors do so. As a result, many financial advisors continue to inadvertently commit these prohibited transactions by their continued receipt of 12b-1 and finders' fees.

Prohibited Transactions

In addition to meeting general fiduciary responsibility provisions, most 401(k) advisors acting as fiduciaries have to meet more stringent prohibited transaction and conflict of interest provisions under ERISA. These rules strictly prohibit a fiduciary from giving advice - or otherwise using his authority - to cause himself to be paid additional compensation.

Specifically, certain transactions are prohibited between a plan and so-called "parties-in-interest." For plan fiduciaries, these rules prohibit them from acting in their own best interests--as opposed to acting in the best interests of the participants. Fiduciaries have a duty of loyalty to the participants and cannot place their own interests ahead of the participants — and that is particularly true when it comes to the possibility of gaining an economic advantage. Essentially, these rules prohibit a fiduciary from dealing with plan assets in his or her own interest, or from receiving compensation in connection with a transaction involving plan assets.

Prohibited transactions become an issue for 401(k) advisors when the investment options pay different amounts of compensation (directly or indirectly), and in any form, such as a finder's fee (front-end commission) or a trailing commission (e.g., 12b-1 fees). If an advisor has the choice between recommending a fund that pays higher compensation

If an advisor has the choice between recommending a fund that pays higher compensation or a similar fund that pays a smaller amount, and recommends the higher-paying fund, then a prohibited transaction has occurred. Not only must the difference between the two amounts be returned to the plan, but the advisor may also be required to pay penalties to the government.

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There are two sets of penalties for prohibited transactions. The first is the penalty imposed by the Internal Revenue Code. That is 15% per year of the amount involved. However, the IRS can impose a 100% penalty if the transaction is not corrected once the IRS demands that it be corrected. There is also a 20% penalty that the DOL can impose. The two penalties offset each other, such that a person will never have to pay both--just the largest. The tax penalty is found under section 4975(a) of the Internal Revenue Code. The ERISA penalty is found in section 502(l) of Title I of ERISA.

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Not Stepping into the Fiduciary Trap

There are only two proven ways for 401(k) advisors to avoid the downside of being a fiduciary:

- 1) Don't become a fiduciary — be a salesperson.
- 2) Accept the responsibility of being a fiduciary and manage the risks actively by implementing, following and documenting processes that comply.

In practical terms, an advisor can structure services to a client so there is no "advice," as defined by the regulations and case law. Effectively, this means the 401(k) advisor acts purely as a salesperson by:

- 1) offering a 401(k) "package" created by a product or service provider¹, or
- 2) employing an investment selection methodology (his or her own, or preferably one from a notable third party like Ibbotson, Lipper, Morningstar, Zephyr, etc.) to provide a menu of potential investment alternatives but leaving the selection of actual investments to the plan trustees or committee.²

In the first instance, a sample investment "package" might consist of a stable value fund and a series of lifecycle funds or actively managed model portfolios. This limited option package would be constructed to offer participants a number of retirement portfolios approximately evenly spaced along the "efficient frontier."

Actively managed model portfolios can range from the lowest acceptable level of risk to the highest acceptable level of risk invested in each case to achieve the maximum return given the acceptable level of risk. These portfolios can range from a pre-mixed, registered "fund of funds" or individually tailored, unregistered, actively managed portfolios consisting of a number of mutual funds periodically rebalanced to maintain its relative position on the "efficient frontier." This basic sales package is typically designed to address 404(c) issues as well as to create a documented methodology behind selecting, evaluating and managing the on-going investments in the portfolios.

In the second instance, if the sales person uses a methodology that follows an initial investment selection process consistently, e.g. using "style boxes" to populate with multiple fund alternatives for the trustees to select from, then the sales person might still be found to have crossed the line and given advice. It would NOT be advice if the sales person's representation were generalized, for example, "many plans evaluate funds this way." In other words, it needs to be explained that this process is generally followed for plans. As a word of caution, if the 401(k) advisor is presenting investments to a

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small plan sponsor with limited investment experience to select funds for its 401(k) plan, he or she ought make sure the compensation arrangement with the investment providers is fully disclosed and as level as possible regardless of the actual funds selected. As certain investment options like guaranteed investment contracts and money market funds have very particular rates of compensation and are not possible to "level" with others, the advisor should confirm in writing that he is not making recommendations about these particular investments.

The only safe course of action is disclosure.

What if You Are a Fiduciary?

Many 401(k) advisors have difficulty rationalizing their relationships to plans if they are not providing some valuable advice and on-going service to the plan. It is for this reason that many financial advisors run the risk of becoming fiduciaries by virtue of the "advice" they provide.

There are many fiduciary potholes, but with a good roadmap, most of them can be avoided. If 401(k) advisors become fiduciaries, it is critical they:

- 1) Manage their general fiduciary responsibilities as discussed earlier; and
- 2) Structure their compensation so as to avoid prohibited conflicts of interest.

There are two ways to structure advisor compensation to avoid prohibited transaction and conflict of interest pitfalls: leveling and offsetting.

If the 401(k) advisor is presenting investments to a small plan sponsor with limited investment experience to select funds for its 401(k) plan, he or she ought make sure the compensation arrangement with the investment providers is fully disclosed and as level as possible regardless of the actual funds selected.

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The Level Fee Solution

A level fee solution is where the compensation is identical regardless of the investment option recommended to the plan sponsor. By definition, an advisor cannot commit a prohibited transaction by affecting his compensation if “advice” cannot cause the fiduciaries to acquire higher paying investment options. The level fee solution may be found in group annuity contracts offered by insurance companies or in wrap fee programs offered by many broker dealers. These arrangements generally increase the overall expense of the underlying investment to the plan participant, although the additional fee generally decreases as plan assets increase. The additional expense creates the fixed trail compensation to pay an advisor regardless of the investment selected from the program. In addition to the increased expense of these programs, other limitations include a limited number of investment alternatives available that, someone, other than the plan sponsor, selected based on some criteria. Leveling, as a solution, could also be accomplished by agreement with the plan fiduciaries. Plan fiduciaries could agree that the financial advisor only select from a universe of funds that pay a 25 basis point finders fee and 25 basis point trailing solution. While legally permissible, this solution isn't practical, leading many others to turn to the offset solution.

The offset solution allows the advisor to expand the investment type and menu far beyond the limitations found in level fee arrangements, while staying protected from prohibited transaction issues.

The Offset Solution

For advisors who serve as Registered Investment Advisors or Fee Based Consultants, there is a second solution, gaining in popularity: the offset solution. Under this arrangement the advisor charges an annual fee of 0.25%, 0.50% or even 0.75% of the plan assets (typically paid quarterly in arrears) depending on the services agreed upon. The offset solution allows the advisor to expand the investment type and menu far beyond the limitations found in level fee arrangements, while staying protected from prohibited transaction issues.

To avoid conflict of interest issues, the advisors agreement with the plan needs to provide an offset of all commissions and compensation received on the plan investments (direct and indirect) against the agreed upon advisor fee.

For example, if the advisor receives 0.25% in such fees and he has negotiated 0.50% for his services, then he would charge the plan for the remaining 0.25%. However, if the advisor receives more in compensation from the investment providers than he is charging for his services, the difference would be paid back to the plan. Offset solutions should be documented in writing between the advisor and sponsor and administered by an organization with experience in calculating fees, accounting for commissions and offsetting the difference. A small fee may be charged for this service.

Conclusion

While legal issues around fiduciary status are constantly evolving, it behooves financial advisors to understand thoroughly the rules and consequences of crossing the line from sales person to fiduciary. It is imperative to understand the status of a plan fiduciary and the inherent and significant risks associated with being in this position. The worst thing an advisor can do is ignore the risks.

Jeff Miller
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About GoldK

GoldK is focused solely on delivering a low-cost, efficient technology, investment and recordkeeping platform for third party administrators (TPAs). The GoldK platform greatly reduces the administrative burdens on TPAs by providing a feature rich, fully integrated retirement platform for financial advisors, plan sponsors and participants. In 2002, Defined Contribution News, a unit of Individual Investor, named GoldK the retirement industry's "Online Provider of the Year."

The Company's fundamental services feature a suite of fully integrated retirement plan solutions that include plan set-up and management, recordkeeping, daily valuation, open investment platform and participant education.

Jeff Miller — Jeff has been an innovator in retirement plans throughout his career. He began as an ERISA attorney in —Washington before joining Smith Barney, where he developed the retirement-services unit. He is credited with building the industry's first integrated 401(k) fiduciary management and participant advice program — 401(k) Trak — which resulted in the issuance of a groundbreaking Department of Labor exemption permitting Smith Barney to provide advice to plan participants as far back as 1992. He later moved to Putnam Investments to head advisor-sold 401(k) plans, insurance and annuities before being tapped to lead Putnam's European business development group in London, where he managed strategic joint ventures across the continent, ran an offshore fund family and built a sales and client-service organization. Returning to Boston, Mr. Miller launched Putnam's private asset management business before joining GoldK in early 2002.

Jeff is the author of *The 401(k) Plan Management Handbook*, published in the U.S. and Japan by McGraw Hill, and has written numerous articles about retirement plans in investment and pension periodicals. He is a graduate of Boston University's School of Management and American University's Washington College of Law.

Fred Reish — This White Paper was reviewed by **Fred Reish**, managing director and partner of the Los Angeles-based law firm of Reish Luftman McDaniel and Reicher. A nationally recognized expert in employee benefits law, he has written four books and more than 100 articles on ERISA, IRS and DOL audits and pension plan disputes.

¹The investment package would be presented in a way that it would not be considered advice. In other words, the financial advisor could put together a package, based on criteria that are explained to the plan sponsor/fiduciaries. The financial advisor should explain to the fiduciaries that the selection was based on criteria that are often used for retirement plans, but that was not individually designed for that specific plan and its participants. The fiduciaries must determine whether the criteria are appropriate for their plan and their participants and whether the funds selected by the criteria are appropriate for their plan and their participants. All of those representations by the broker should be in writing. The key here is that the fiduciaries understand that they are not receiving individualized investment advice based on the particular needs of their plan, but rather are receiving information about investment criteria that is commonly used, but that is neither individualized nor particularized to their situation.

Without those disclosures, it is conceivable that the fiduciaries will believe (and the DOL or a litigation attorney will believe) that the broker was representing that the investment package was specifically developed for that company.

Alternatively, the broker could use an investment package that was pre-assembled by others (with the explanation that they were put together by a third party), but that the broker believes that the criteria used and the quality of the analysis of the third party "assembler" or "packager" was of good quality. Again, though, it needs to be clear that it was put together as an offering to the marketplace and not as advice related to the particular needs of that company, its plan or its participants.

²It is important that the basis for selecting the funds in the package be explained, and that it also be explained in writing that the criteria for investment selection were generalized for the marketplace and, therefore, the criteria and selected funds are not individualized or particularized to the particular plan or its participants.