Retaining a Fiduciary Investment Advisor

Employers Need Up-front Information, Not Belated Explanation

By Sheldon M. Geller

Whether or not the government enacts the Department of Labor (DOL) fiduciary rule requiring retirement plan advisors to act in the employer's best interest, employers must be able to rely on their 401(k) plan service provider and the investment fund selection advice they receive from their advisors. Employer fiduciaries need to go beyond the spirit and intent of the DOL fiduciary rule and retain an advisor who acts as an investment manager providing discretionary investment management services. Only advisors with discretion are subject to a fiduciary duty, assume complete responsibility for the investment process, and are required to act solely in the employer's best interest.

Fiduciary Acknowledgement

It is critical for employer plan fiduciaries to understand the extent to which their investment advisors have accepted a delegation of fiduciary duty without disclaimer, and then to establish an investment review process documenting their fund selection and retention decisions. Fiduciary status depends upon what the advisor does and what the advisor service agreement states, not what the advisor says. Advisor activities or the advisor's written acknowledgment of fiduciary status will result in the advisor's legal classification as an investment advice fiduciary.

Although there are various methods to manage the complex fiduciary duties under the Employee Retirement Income Security Act of 1974 (ERISA), the most effective choice is to retain a 3(38) investment manager. A 3(38) investment manager will assume complete responsibility for fund selection and ongoing monitoring, making this the best, if not the only, way to protect employer plan fiduciaries from excessive fees and poor fund performance. Given the increase in fiduciary litigation, regulatory scrutiny, and participant awareness, many employers desire the extra layer of fiduciary protection provided by investment managers.

Unlike a 3(21) registered investment advisor, whose actions and service agreement control its status as a fiduciary and therefore determine its responsibility, a 3(38) investment manager must be formally retained as an investment fiduciary and acknowledge in writing that it is a fiduciary providing discretionary investment management services with respect to the plan. In addition, retirement plan committees retain the ultimate decision-making authority for investments and may accept or reject the 3(21) registered investment advisor's fund recommendation—whereas by properly appointing and monitoring a 3(38) investment manager, a committee is relieved of all fiduciary responsibility for investment decisions and recommendations made by the investment manager.

Registered representatives, a designation that includes stockbrokers, insurance agents, and other salespeople, are paid for executing a transaction or representing a product, not for providing advice. Brokers do not acknowledge fiduciary status and limit their activities so as not to be treated as an investment advice fiduciary. By comparison, a 3(38) investment manager who is properly appointed and duly monitored by a committee will be treated as an investment fiduciary relieving the employer from all aspects of the plan investment process.

Registered investment advisors who act as 3(38) investment managers create a fiduciary framework that enables retirement plan committees to properly carry out their governance activities and therefore make good fiduciary decisions. Investment managers have full responsibility for their investment recommendations and the application of the plan's investment policy statement; the employer and the committee are relieved of all fiduciary responsibility for the plan asset investment process. The shifting of fiduciary responsibility is the important distinction, and supreme advantage, of retaining a registered investment advisor who acknowledges fiduciary status as an investment manager.

Conflicts of Interest

The business model of many 3(21) registered investment advisors who do not also act as 3(38) investment managers approximates the business model of registered representatives and thus embraces an interpretation of the term "fiduciary" that is not in an employer's best interest. Advisor titles are often created by the industry and use "fiduciary" to suggest that the advisor will always act in the employer's best interest and maintain no conflicts. Most employers therefore mistakenly believe that their

advisors assume complete fiduciary responsibility for investment fund selection and the investment process.

The Supreme Court has found that an employer plan fiduciary has a continuing duty to monitor plan investments and remove imprudent investments, separate from the fiduciary duty to select prudent plan investments [see *Tibble v. Edison International*, 575 U.S. __(2015)]. Accordingly, employers must understand whether they have delegated the fiduciary responsibility to select investment funds and monitor investment fund performance to their advisors under the service agreement.

Simply because an advisor calls himself a fiduciary does not mean that he has no conflicts, which may result in excessive fees and poor fund performance. A review of Forms ADV—the disclosure required to be filed by a registered investment advisor with the SEC—discloses conflicts for many advisors (e.g., dually registered advisors selling insurance and annuities resulting in commissions that may not be in the plan's best interest). One such Form ADV discloses that offering advice and selling product "involve a possible conflict of interest, as commissionable products can conflict with the fiduciary duties [of loyalty and prudence] of a registered investment advisor." Brokers should include the words "investment sales representative" in their title, rather than "registered representative," to indicate nonfiduciary status.

Many brokers use the titles "financial advisor," "financial consultant," or "wealth manager," further confusing employers as to whether they are held to a fiduciary standard. Accordingly, employers need to have a clear understanding of an advisor's business model and level of fiduciary responsibility to make an informed decision. Employers should determine the extent to which they can rely on their advisor's advice; only then can they avoid breaches of their fiduciary responsibility.

Advisor Compensation

The fiduciary rule and the obligation to act in the plan's best interest is better understood by focusing on advisor compensation. Excessive advisor compensation can result from the employer not understanding how the advisor is paid, who pays the advisor, or the advisor's compensation amount.

Too many advisors earn excessive compensation, decreasing participant returns and increasing employer risk. In addition, too many advisor fee schedules are supported by self-serving benchmarks and an inflated marketplace. Nevertheless, many uninformed employers have approved the retention of these advisor fee schedules and have failed to monitor compensation amounts and the excessive fund expenses that drive them.

Advisor fee compression continues to reduce the extent to which advisors can charge for services without becoming excessive. It appears that 25 basis points is the median advisor fee benchmark, but many advisors are charging less and fixing their fees in the large-plan market.

Up-front Information

Employers need up-front information in order to make informed and defensible fiduciary decisions. Employers should retain advisors who also act as investment managers subject to the fiduciary duties of loyalty and prudence to make certain they receive unbiased advice to level the playing field between themselves and their service providers. Advisors who also act as investment managers enable employers to reduce the information gap between themselves and other types of retirement plan advisors.

Employer plan fiduciaries should implement the following best practices in the selection and retention of an advisor for their 401(k) plan:

- Demand a fixed fee or annual retainer.
- Obtain a written acknowledgement of fiduciary status.
- Require disclosure of all conflicts of interest in writing.
- Review disclaimers of fiduciary responsibility in writing.
- Require an explanation of any potential conflict of interest.
- Restrict services to the plan and avoid multiple service lines.
- Require experience, credentials, and objectivity.
- Determine advisor fee based upon expertise and value, not sales skills.
- Retain an advisor who acts as an investment manager to avoid conflicts and disclaimers.

Avoid Belated Explanation

Executives responsible for the management of 401(k) plans must make certain that their advisors earn reasonable compensation based upon services and value. Reasonable compensation and discretionary investment management often result in prudent investment fund recommendations.

Employers can avoid monetary sanctions and participant lawsuits by achieving fiduciary compliance and operational excellence through proper plan governance. Executives charged with plan governance must be able to demonstrate and communicate the basis for their decisions on selecting service providers, investment advisors, and investment funds.

Employers must take 401(k) plan stewardship seriously and properly delegate fiduciary responsibility to a retirement plan committee. A retirement plan committee is the body charged with plan governance and therefore must obtain complete information before making fiduciary decisions impacting plan participants. Retirement plan committees should engage an advisor who acts as an investment manager in order to help them properly navigate a conflicted marketplace, understand inflated benchmarks, and make good fiduciary decisions. ❑

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