MORNINGSTAR®

# Fiduciary Focus: Non-Fiduciary Investment Consultants

**This article by W. Scott Simon has been adapted and condensed.**
**To read the full article, go to: www.MorningstarAdvisor.com | 05-04-06**

Most fiduciaries of 401(k) plans have a service provider that in some way gives assistance to them concerning plan investment options. 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. (I'll lump together service providers and the persons representing them into the term "investment consultant" 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): (1) those that don't acknowledge any fiduciary responsibility at all, (2) those that acknowledge fiduciary responsibility under ERISA section 3(21)(A), and (3) those that acknowledge fiduciary responsibility under ERISA sections 3(38) and 405 (d)(1).

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. 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.

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. It's not illegal, of course, for non-fiduciary investment consultants to engage in such "pay to play" schemes.

## ERISA Sec. 3(21) Fiduciary Investment Consultants

Other investment consultants will acknowledge ERISA Section 3(21)(A) fiduciary responsibility in their contracts with plan fiduciaries. An investment consultant can become an ERISA Section 3(21)(A)-defined fiduciary of 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).

An ERISA section 3(21) fiduciary has the duty to place the interests of plan fiduciaries (who represent plan participants and their beneficiaries) ahead of its own within the context of the services for which it accepts fiduciary responsibility. To that extent, the ERISA section 3(21) fiduciary investment consultant is forbidden from having any conflicts of interest. That is, the consultant must *outright avoid all* conflicts of interest.

To determine whether (and to what extent) an investment consultant to the fiduciaries of a 401(k) plan is a "real" fiduciary is to examine the contract between the fiduciaries and consultant. If the contract spells out carefully and clearly that the consultant assumes responsibility as a real ERISA section 3(21) fiduciary, then it's easier for plan fiduciaries to mitigate their liability (by ensuring that the consultant at least shares in that liability) in situations where they are sued by plan participants.

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.

**"Phantom" Sec. 3(21) Fiduciary Investment Consultants**

Unfortunately, many investment consultants employed at large broker-dealers are particularly notorious for supplying plan fiduciaries with contracts that eviscerate any real fiduciary responsibility under ERISA section 3(21). This has to do with the simple fact that brokerage firms just don't want to be fiduciaries.

The problem is that the pre-drafted, off-the-shelf contracts that many such consultants present to plan fiduciaries 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. Such deceptive contracts allow the consultants to claim that it is an "ERISA fiduciary" while bearing no real fiduciary responsibility--and therefore liability--to plan participants. In such situations, many plan fiduciaries are misled because they see (assuming they read their contracts) and hear 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. It's *you* who's responsible for the prudent selection and monitoring of the investment options in your 401(k) plan, not us."

**ERISA Sec. 3(38) & ERISA Sec. 405(d)**
**Fiduciary Investment Managers**

There is a way for the fiduciaries of 401(k) plans to create a beautiful world for the benefit of their plan participants --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."

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, 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," attorney Fred 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.

**Conclusion**

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 nonexistent fiduciary responsibilities--not to mention when it is adapted to hide (high) fees from plan fiduciaries that are hard to find.

An entire cottage industry of consultants has sprung up that does nothing but attempt to help plan fiduciaries uncover the fees and expenses that investment consultants bury in the contracts they provide to plan fiduciaries--even in cases where the consultant professes (in the very same contract) to have a fiduciary relationship with those fiduciaries. (emphasis added)

Indeed, why is it necessary for fiduciaries of retirement plans to hire a third party to ferret out the hidden costs buried in the language of such contracts? Isn't it a bit strange that we need consultants to protect plan fiduciaries from the conduct of fiduciary investment consultants in which no fiduciary should be engaged in the first place?

If the broker-dealer fiduciary investment consultant were really thinking and acting like a true ERISA fiduciary, it wouldn't employ language in its contract that guts significant ERISA section 3(21)(A) fiduciary duties that the consultant would otherwise owe to plan fiduciaries. The consultant, however, is decidedly not acting and thinking like a true ERISA fiduciary--which is why it has shunned any real responsibility (and therefore liability) with respect to the plan fiduciaries in the contract it has prepared and presented to them.

W. Scott Simon is an expert on the Uniform Prudent Investor Act and the Restatement 3rd of Trusts (Prudent Investor Rule). He is the author of two books, one of which, *The Prudent Investor Act: A Guide to Understanding* is the definitive work on modern prudent fiduciary investing.

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.

*This information was previously published on MorningstarAdvisor.com*



**To read the full article: http://morningstaradvisor.com/articles/archive.asp?authId=500**