# *Understanding the Structure and Risk in a Co-Fiduciary Advisor Relationship*


***A White Paper by***

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## *Introduction*

The purpose of this White Paper is to educate sponsors of retirement plans about what constitutes a co-fiduciary advisor relationship, as well as the fiduciary liability which occurs as a result of such status. The discussion will show the areas where advisors may have a conflict of interest, both on the plan and participant levels, and what plan sponsors can do to avoid the potential for prohibitive transactions taking place and bring the co-fiduciary advisor relationship into compliance.

## *Table of Contents*

# Understanding the Structure and Risk in a Co-Fiduciary Advisor Relationship



What fiduciary liability might a plan sponsor have in regards to the common practice of hiring and monitoring an advisor (defined as a broker, insurance agent, consultant, or financial advisor) to serve the retirement plan and / or to provide investment education and advice to plan participants? Done correctly, plan sponsors can successfully reduce their fiduciary liability. Done incorrectly, plan sponsors may expose themselves to increased fiduciary liability, just the opposite of what they are trying to achieve by engaging the services of an advisor in the first place.

In particular, it is important to determine the existence of fiduciary status on the part of the advisor. Once established, it becomes the responsibility of the plan sponsor to ensure the advisor chosen is qualified to perform the work assigned and is able to avoid conflicts of interest that may violate the many requirements imposed upon fiduciaries under ERISA.

The following explores the importance of understanding the relationship that is established when engaging the services of an advisor and the impact that has on a plan sponsor's responsibilities under ERISA.

## Is the advisor a fiduciary?

Section 3(21)(A) of ERISA provides that a person is a fiduciary with respect to a plan to the extent (i) he 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, (ii) he 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 (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.

Advisors may or may not have the qualifications as noted in (i) and (iii) above, so for purposes of the following, Section 3(21)(A)(ii) will be explored. It is assumed in the following that the advisor is receiving compensation from the plan for his or her services.

In a U.S. Department of Labor Advisory Opinion dated December 7, 2005, the Chief of the Division of Fiduciary Interpretations was asked to give further guidance on the definition of investment advice. The Chief gave the following list of qualifiers (quoting Regulation 29 CFR § 2510-3.21(c))

- Rendering advice to the plan, for a fee, as to the value of securities or other property
- *Making recommendations as to the advisability of investing in, purchasing, or selling securities or other property*
- Having discretionary authority with respect to purchasing or selling securities or other property for the plan
- Rendering investment advice on a regular basis either to the plan or a fiduciary with respect to the plan
- *Providing advice which serves as a primary basis for investment decisions with respect to plan assets*
- *Rendering individualized investment advice to the plan based on the particular needs of the plan (ie investment policies or strategy, overall portfolio composition, or diversification of plan investments)*
- Providing investment advice to participants or beneficiaries that allow them to direct the investment of their accounts

While the Advisory Opinion speaks to the provision of investment advice on the participant level, the courts have found that the same stipulations hold for an advisor providing services at the plan level. In the recent court case of *Ellis v. Rycenga Homes*, an Edward Jones broker was rendering services to the plan trustee for the Rycenga 401(k) plan. The broker had not been identified in writing as a fiduciary, and did not have discretionary authority over the plan. The broker was quoted in his testimony as saying "We (Edward Jones) would make the recommendations and ultimately he (the plan trustee) was the one who decided what changes were to be made."

It was determined in the case that the broker **was offering investment advice** as defined in ERISA Section 3(21)(A). The court turned to the law, namely Regulation 29 CFR § 2510-3.21(c)'s qualifiers as listed above, to define investment advice as given by the broker at the plan level.

The factors italicized in the list above require more thoughtful attention due to their significance. As Regulation 29 CFR § 2510-3.21(c) lists, recommendations are enough to constitute investment advice, thus making the advisor a fiduciary and subjecting him / her to the prudent expert rule. DOL Advisory Option 84-04A further states that if a person is deemed to be giving investment advice per Regulation § 2510-3.21(c))(1)(ii)(B)'s guidelines, the presence of an unrelated second fiduciary (namely, a plan sponsor) acting on the investment advisor's recommendations on behalf of the plan is **not sufficient to insulate the investment advisor from fiduciary liability under section 406(b) of ERISA.**

Thus, the actions of the advisor subject him or her to fiduciary status under ERISA. Next, we will identify the liability tied to having an investment advisor as a co-fiduciary.

## Plan Sponsor Liability

Two of the requirements of Sections 403(c)(1) and 404(a) of ERISA are that the assets of a plan be held for the *exclusive purpose of providing benefits to participants and beneficiaries of the plan* and defraying reasonable administrative expenses of administering the plan, and that a fiduciary with respect to the plan carry out his duties for the exclusive purpose of providing benefits to participants and beneficiaries.

Furthermore, Section 405(a) of ERISA provides that a fiduciary of a plan *may be liable for a breach of fiduciary responsibility committed by another fiduciary of the plan*: (1) if he knowingly participates in, or knowingly undertakes to conceal, an act or omission of such other fiduciary, knowing such act or omission is a breach; (2) **if, by his failure to comply with section 404(a)(1) of ERISA in the exercise of his fiduciary obligations, he has enabled such other fiduciary to commit a breach;** or (3) if he has knowledge of the breach by such other fiduciary, unless he makes reasonable efforts under the circumstances to remedy the breach.

To ensure such "enabling" is not occurring, and the plan sponsor's fiduciary obligations are being met, ERISA mandates that fiduciaries determine whether the value received for the fees paid to the advisor or broker is reasonable. This requires that plan fiduciaries:
--Understand exactly what fees are being assessed against the plan
--Know where the fees are going (e.g. how much is being paid to a broker or other advisor for serving as a consultant to the plan sponsor)
--Understand if the amount received is reasonable, considering the value the plan and its participants are receiving[1]

Anyone who breaches a fiduciary duty imposed by ERISA will be "held personally liable to make good any losses to the plan resulting from each such breach and shall be subject to such other equitable or remedial relief as the court may deem appropriate." [29 USC 1109(a)] Prior to the Bankruptcy Reform Act of 2005, actual personal liability was limited by state bankruptcy laws. Many states have large bankruptcy exemptions for homes and retirement plans. However, under Section 522(q) of the Bankruptcy Reform Act these exemptions are limited to $125,000 for homesteads and $125,000 for retirement plans covered by ERISA, when the liability is "a result of fraud, deceit, or manipulation in a fiduciary capacity." Furthermore, the homestead exemption for bankruptcy in California is even less. Exemptions are afforded on a sliding scale with those over the age of 65 or who are disabled receiving a $125,000 exemption.

DOL Regulation §2509.95-1(c)(6) states that "unless a fiduciary possesses the necessary expertise to evaluate such factors, he would need to obtain the advice of a qualified, independent expert." Many

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[1] "Understanding Your Fiduciary Responsibility: An Executive Guide to Reducing Risk and Liability", 2006, Schwab Retirement Plan Services, Michael Olah.

Courts have emphasized the importance of independence in the selection of an expert. The court in *Gregg v. Transportation Workers of America International* stated, “One extremely important factor is whether the expert advisor truly offers independent and impartial advice.” [343 F.3d 841 ($6^{th}$ Cir. 2003)] This would include looking at whether the advisor has any conflicts of interest.

### Conflicts of Interest / Prohibitive Transactions at the Plan Level

What might a conflict of interest entail? Fiduciaries are prohibited from engaging in the following transactions in regards to plan assets (as outlined in Sec 406 of ERISA):

- the sale, exchange or leasing of property
- the lending of money or other extension of credit
- the furnishing of goods, services or facilities
- the transfer to, or use by or for the benefit of, the income or assets of the plan
- **in the case of a fiduciary, any act that deals with the plan’s income or assets for the fiduciary’s own interest or account.**
- **the receipt by a fiduciary of any consideration for the fiduciary’s own personal account from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.**

Among these potential conflicts, advisor compensation is an area of special concern. Advisors are commonly compensated in one of two ways: paid exclusively by the plan sponsor in the form of a flat fee or as a percentage of assets under management; or paid by product providers (mutual fund distributors, vendors, insurance companies, investment managers, etc). The former compensation arrangement is generally free of conflicts as it is neutral to the advice given, is transparent, and is not dependent upon the action taken by the plan fiduciaries. The latter comes with several potential, and sometimes unavoidable, conflicts that must be understood and avoided.

Because various product providers pay advisors and their respective firms different amounts of finder’s fees, 12(b)-1 fees, shelf space payments, revenue sharing, etc., the potential for conflicts exist. Under this arrangement, an advisor may be inclined to recommend products for which he would receive higher compensation rather than what is in the best interest of the plan, and therefore may be considered a prohibited transaction.

Acknowledgment of such circumstances has led the industry to embrace “level” compensation arrangements. These arrangements, usually administered by vendors, fix the rate of compensation paid to the advisor, with any excess retained by the vendor or returned to the plan, thereby “levelizing” advisor compensation. Although simple in theory, difficulty arises in implementation. Often, the “level” rate paid by the vendor to the advisor is dependent upon the mix of funds selected by a plan as that determines the revenue the vendor receives from the various mutual fund distributors and investment managers and in turn determine what can be passed on to the advisor. Again, the advisor may be inclined to include products in his recommendations that pay a higher rate to the vendor in order to secure a higher “level” compensation rate, rather what is in the best interest of the plan.

Furthermore, most “level” compensation arrangements focus solely on finder’s fees and 12(b)-1 fees, and ignore the other types of compensation that may be received by the advisor and his firm for recommending particular mutual funds or managers. Because all types of compensation an advisor and his firm receive must be accounted for in order for these arrangements to be effective, true “level” compensation arrangements may not exist.

The prudence standards under ERISA suggest the best course of action for plan sponsors is to avoid compensation arrangements where potential conflicts exist and choose to pay advisors directly for independent advice.

So far, advisor fiduciary status and potential conflicts of interest at the plan level have been discussed. Conflicts of interest also exist at the participant level; further exploration on this topic is next.

### Conflicts of Interest / Prohibitive Transactions at the Participant Level

Conflicts of interest in regards to participant advice can occur in a variety of ways, namely through variable compensation on the different funds within the plan, as well as directing plan assets to investment options outside the plan on which the advisor receives greater compensation.

Variable compensation, where different funds directly pay different levels of revenue to the advisor, holds obvious potential for a conflict of interest. If an advisor is directing participants to move their assets into higher revenue – generating funds, for the advisor's own interest and without basis for the plan participant, an ostensible conflict of interest occurs.

The advisor providing services at the participant level may sell other products and services outside the plan, such as annuities or IRA rollovers out of 401k plans. The compensation for selling such products would definitely be different than what the plan is paying for the advisor to perform participant communications, and in most cases, is more lucrative. Upon meeting with the participant, the advisor might suggest moving the participant's assets, currently in the plan, into an IRA, annuity, or other product. Given that the advisor is a fiduciary, this may be considered a prohibitive transaction if such a move was not in the best interest of the participant and the act is for the benefit of the advisor's own account. The U.S. Department of Labor Advisory Opinion dated December 7, 2005 states "If, for example, a fiduciary exercises control over plan assets to cause the participant to take a distribution and then to invest the proceeds in an IRA account managed by the fiduciary, the fiduciary may be using plan assets in his or her own interest, in violation of ERISA section 406(b)(1)."

What these examples illustrate is that a breach of fiduciary duty by committing a prohibitive transaction can occur at either the plan or participant level, with a variety of different compensation structures.

### Prohibitive Transaction Exemption for Participant Advice – the EIAA

On the participant side, under a new prohibited transaction exemption, qualified "Fiduciary Advisors" can offer personally tailored professional investment advice to help employees manage their 401(k) and other plans. For retirement plans, ERISA Section 408(g) (as amended by the PPA) states that fiduciary advisors may provide investment advice pursuant to an Eligible Investment Advice Arrangement (EIAA) given that the advisor either:

(i) provides that any fees (including any commission or other compensation) received by the fiduciary advisor for investment advice or with respect to the sale, holding, or acquisition of any security or other property for purposes of investment of plan assets *do not vary depending on the basis of any investment option selected*, or

(ii) uses a computer model under an investment advice program meeting the requirements of paragraph (3) in connection with the provision of investment advice by a fiduciary advisor to a participant or beneficiary, and

The EIAA also requires that the fiduciary advisor provide, in written format, the following to participants and beneficiaries:

- Specific services provided
- Compensation
- What entitles a participant to the advisory service

As far as the EIAA is concerned, it is not required in order for a plan sponsor to meet their fiduciary requirement. It is, however, required in order for the investment advisor to qualify for the prohibitive transaction exemption.

The EIAA as outlined in the Pension Protection Act gives investment advisors added protection when providing investment advice to plan participants, which is especially needed if the investment advisor is also selling products such as annuities outside the plan. In the end, however, investment advisors are still fiduciaries, and as such, are held to the "prudent expert" rule to act in the best interest of the participant.

It is the fiduciary duty of the plan sponsor to thoughtfully choose an advisor for the plan participants, avoiding conflicts of interest. The following excerpt from the U.S. Department of Labor Field Assistance Bulletin No. 2007-01 details the processes involved with the selection and monitoring of an advisor:

*With regard to the prudent selection of service providers generally, the Department has indicated that a fiduciary should engage in an objective process that is designed to elicit information necessary to assess the provider's qualifications, quality of services offered and reasonableness of fees charged for the service.* ***The process also must avoid self dealing, conflicts of interest or other improper influence.*** *In applying these standards to the selection of investment advisers for plan participants, we anticipate that the process utilized by the responsible fiduciary will take into account the experience and qualifications of the investment adviser, including the adviser's registration in accordance with applicable federal and/or state securities law, the willingness of the adviser to assume fiduciary status and responsibility under ERISA with respect to the advice provided to participants, and the extent to which advice to be furnished to participants and beneficiaries will be based upon generally accepted investment theories.*

*In monitoring investment advisers, we anticipate that fiduciaries will periodically review, among other things, the extent to which there have been any changes in the information that served as the basis for the initial selection of the investment adviser, including whether the adviser continues to meet applicable federal and state securities law requirements, and whether the advice being furnished to participants and beneficiaries was based upon generally accepted investment theories. Fiduciaries also should take into account whether the investment advice provider is complying with the contractual provisions of the engagement; utilization of the investment advice services by the participants in relation to the cost of the services to the plan; and participant comments and complaints about the quality of the furnished advice. With regard to comments and complaints, we note that to the extent that a complaint or complaints raise questions concerning the quality of advice being provided to participants, a fiduciary may have to review the specific advice at issue with the investment adviser.*

## Conclusion

In conclusion, the law defines what constitutes investment advice on both the plan level and participant level, and therefore what makes an advisor a fiduciary. Advisor acknowledgement of fiduciary status is of utmost importance. All conflicts of interest should be avoided in order to lower liability on the part of the advisor and the plan sponsor. The best way to remove a conflict of interest is to accept only flat dollar fees, so there's no motivation to move assets in any direction other than that which is most beneficial to the participant.

The plan sponsor has a fiduciary duty to go through a prudent selection and monitoring process in regards to their choice of an investment advisor for the plan and its participants. While a plan sponsor is insulated from liability tied to the actual participant advice given by the advisor, it is the duty of the plan sponsor to ensure no conflicts of interest arise when going through the monitoring of the advisor. The EIAA, as defined by the Pension Protection Act, is a great way to give the plan sponsor and investment advisor added protection against liability.

It is in the best interest of the plan, and for the plan sponsors as fiduciaries, to choose advisors who have no potential for a conflict of interest as described above. As with all issues, as a fiduciary, prudence is the best judgment.

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