Fiduciary Focus: Providing Advice to 401(k) Plans

W. Scott Simon | 4-23-04 |

This month's column is written for those of you who would like to get into the 401(k) business and provide investment advice to 401(k) plans. My hope is that this discussion will show you how to bring real value added to your clients. The discussion may also be helpful to those of you who already serve 401(k) plans.

Advising 401(k) Plans

Providing investment advice to 401(k) plans is not to be taken lightly. An advisor that really wants to bring value added to his or her retirement plan clients must be prepared to hunker down, do some homework, and learn the business.

Many in the 401(k) plan industry make it seem, however, that providing investment advice to 401(k) plans is relatively simple: "Just bring in the wholesaler to close the business." Such advice is dangerously simplistic. Many well-intentioned and seemingly well-informed investment advisors who follow this advice inadvertently expose their plan sponsor clients to added risk.

A 401(k) retirement plan conference that I attended recently provides a good example of this. The conference was attended by more than 100 investment advisors. Many of these advisors are the most sophisticated and successful in the country. One of the panels at the conference, consisting of three advisors, debated the topic of providing investment advice to 401(k) plan participants.
The discussion started harmlessly enough when someone in the audience asked the advisors on the panel if they provided investment advice to 401(k) plan participants.

(In the 401(k) world, you become a fiduciary and assume all the legal responsibilities and liabilities that go along with that status if you provide investment "advice" to participants in 401(k) plans. If you provide merely investment "education," however, you do not become a fiduciary. Informing a plan participant about the concept of asset allocation is education but telling them how to allocate the assets in their particular portfolio is advice.)

The panelists answered differently when asked if they provided investment advice to 401(k) plan participants. One panel member said that she didn't "cross the line" to provide investment advice to 401(k) plan participants; instead, she provided investment education only. Another panel member said that ordinarily he didn't provide investment advice to 401(k) plan participants but that every once in awhile he would be cornered by a participant and they would "chat" about how the participant should invest his or her money.

It was the last panel member, though, that showed how easy it is for even the most well-intentioned advisors to place their clients--sponsors of 401(k) plans--in (legal) harm's way. The panel member, who has built a large and prestigious investment advisory practice, said that he didn't provide merely investment education to participants in 401(k) plans, but he also provided investment advice to them. His attitude amounted to: "I'm not worried about providing advice; that's why I carry insurance."

The advisor-panel member had weighed the added risk of "crossing the line" to provide advice instead of just education to 401(k) plan participants and made a business decision to offer advice. That decision would be prudent if the advisor was living in a vacuum. The provisions of the Employee Retirement Income Security Act (ERISA), however, do not exist in a vacuum. (ERISA is the broad body of federal law that governs 401(k) plans including the standards that govern the fiduciary conduct of 401(k) plan sponsors and providers.)

The Road to (ERISA) Hell Is Paved with Good Intentions

Although the advisor's intentions were good, his decision to offer investment advice to participants in 401(k) plans unilaterally without obtaining the permission of plan fiduciaries increased the level of personal risk for each fiduciary exponentially. The advisor had, by giving investment advice, become a fiduciary and thereby assumed co-fiduciary status with the plan fiduciaries. Under ERISA, co-fiduciaries are jointly and severally liable for the actions of the other.

This means that when the advisor in this example provides investment advice to plan participants, liability for the prudence of that advice "sticks" not only to the advisor but also to plan fiduciaries. When the plan fiduciaries are sued by plan participants, they are exposed to greater potential liability as a result. In addition to this, the plan fiduciaries now have the duty to monitor the prudence of the advice provided by the investment advisor to plan participants. Many fiduciaries aren't in a position to evaluate the prudence, the relevance, the objectivity and the effectiveness of such advice.

What's maybe even worse is that the fiduciaries never even got the chance to decide whether or not they wanted to assume the increased risk of any potential liability. All this was caused by a well-intentioned and seemingly well-informed investment advisor, who, because of his myopic vision, really didn't understand the consequences of his actions within the realm of ERISA law.

Another example of the unintended consequences caused by well-meaning but ill-informed investment advisors to 401(k) plans came to my attention recently. A well-known 401(k) plan provider advised its plan sponsor client that the sponsor was "better than most trustees of 401(k) plans."

That kind of advice is what gets plan providers--and the plan sponsors they should be serving in a prudent way--into trouble. In fact, the standard under ERISA isn't one of "you're doing better than the average bear." Instead, the standard that 401(k) plan fiduciaries must live up to under ERISA centers on the notion of "prudence." This exacting standard is what governs all trust law. That standard was breached by the well-known 401(k) plan provider that advised its plan sponsor client that the trustee was "better" than most trustees of 401(k) plans.

Factors to Keep in Mind

Know the issues if you plan to be a retirement plan advisor.

- The retirement plan industry glosses over the fact that you need to know the rules as well as the concepts to add value to a retirement plan.
- Be careful of best intentions that can result in unexpected (bad) consequences.
- You cannot make unilateral decisions in the ERISA environment.
- Every decision you make has consequences; don't make them lightly.

Keeping these factors in mind will help you begin to understand the prudent process envisioned, and required, by ERISA.

Jeff Chang, one of the most respected ERISA attorneys in the country, observes: "The single most important thing a 401(k) plan sponsor can do when retaining a plan provider who gives investment advice to the plan is to ensure that *the provider formally assumes fiduciary liability for its investment advice*. This should be possible as long as the provider qualifies as an 'investment manager' under ERISA."

Apart from whether or not you formally assume fiduciary status under ERISA, you should always try to protect a plan sponsor. Any approach to providing 401(k) plan services, then, should be centered on the plan sponsor. And that is the topic of next month's column.

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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.

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