

Fiduciary Focus: How to Bring Value to 401(k) Sponsors

W. Scott Simon | 5-06-04 |

In last month's column, I made some suggestions to help those of you who would like to get into the 401(k) plan business (or who are already in it) as to how you can bring value to 401(k) plans when providing investment advice.

That column concluded with a quote from Jeff Chang of Chang Ruthenberg & Long, which is one of the nation's most respected ERISA law firms: "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."

Contrary to Chang's prudent advice, an overwhelming number of financial advisors that render investment advice to 401(k) plans do not embrace a fiduciary standard of care when giving that advice. Indeed, many of them do all they can to avoid such a standard. Those that fight against accepting a fiduciary standard of care for their investment advice to sponsors of 401(k) plans instead embrace what I'll dub, for purposes of this article, the "anti-fiduciary standard."

Those of you that desire to enter the 401(k) plan business and provide investment advice to plan sponsors have the choice of selecting from two business models. One model requires you to be a fiduciary and the other requires you to be an anti-fiduciary. I'll describe and explain the anti-fiduciary model first since it's by far the most prevalent today.

The Anti-Fiduciary Business Model

The anti-fiduciary business model is followed by certain "independent" consultants and consultants at certain Wall Street brokerage firms as well as others. These consultants market to sponsors of 401(k) plans and offer their services.

One such service is to conduct searches to find the "best" money managers for a sponsor's 401(k) plan. When the sponsor hires a consultant to advise it which money managers to hire or which investment options to select, it's natural to assume that the consultant will be objective in its advice. If you think that's true of these consultants, you would be wrong.

In fact, the business model that such consultants follow is riddled with inherent conflicts of interest. One such conflict involves the pay-to-play scheme. Because consultants hold so much sway over 401(k) plan sponsors in advising them which investment options (and money managers) to select, those who would benefit from such selections--certain money managers--pay consultants money and other forms of compensation to play by being included on the consultants' lists of preferred plan investment providers. This pay-to-play scheme is illustrated by industry pension conferences that are sponsored by consultants and attended by money managers who pay very large fees to attend, while others do not pay.

Another conflict of interest inherent in the anti-fiduciary model is when certain consultants direct excessively costly brokerage trades to their affiliates, thereby collecting soft dollar

fees. Soft dollar fees can cost a 401(k) plan in at least two ways: 1) high commissions and 2) possible violation of the "execution at best price" rule, which can amount to as much as 1% per year. Undisclosed soft dollar fees can add up to sums that are far larger than the disclosed fees consultants charge their 401(k) plan sponsor clients. In many cases, soft dollar revenues represent the bulk of a consulting firm's top line. That's why disclosed fees are often a kind of "loss leader" for certain consultants.

This business model has consequences that are dubious at best for plan sponsors. Imagine the power and the inequality of a poorly disclosed, misunderstood consultant-centric business model created by the same consultants who act as the all-powerful gatekeepers controlling access to it. In practical terms, this business model has created a cartel of high-powered consultants who face limited competition from outside the anointed circle. The cartel profits handsomely at the expense of participants in 401(k) plans.

The model is so effective that it allows consultants to charge admission to money managers in return for allowing the managers to "come in and sit at the table" so that they can be in the running to provide investment services. In this model, money managers aren't judged solely on their respective merits but on a willingness to pay the "independent" consultants for access to the business of 401(k) plan sponsors.

This consultant-centric business model is corrupt because it lines the pockets of those that operate under it with (non-visible) profits that are so excessive that they would make a loan shark blush. These consultants act, in effect, as "the middleman" by adding an extra layer of costs for little or no added value. What's worse is that their profits come *directly* at the expense of 401(k) plan participants.

Many commentators have diagnosed the conflicts of interest that are inherent in the anti-fiduciary business model. As with all the other recent scandals in the financial services industry, regulators have now entered the picture. In a Dec. 12, 2003, letter to a number of investment advisory firms, the Securities and Exchange Commission explained that it is "examining the practices, compensation arrangements and disclosures of consultants that provide services to sponsors of defined benefit and defined contribution pension plans or other market participants."

Given that 1) the SEC (and Elliot Spitzer, who can't be too far behind) is now zeroing in on the pension consulting industry and 2) there are rumors that any number of the biggest pension consulting firms in the country may go the way of Arthur Andersen (i.e., vanish), the anti-fiduciary business model doesn't seem to have a promising future. Nor should it, given its corrupting influences.

The Fiduciary Business Model

There is an alternative business model for those of you that desire to enter the 401(k) plan business and provide investment advice to plan sponsors the right way. That model requires you to be a fiduciary.

No entity can invest and manage the assets of a 401(k) plan unless it is an ERISA-defined investment manager. This definition encompasses a registered investment advisor. Those of you who are financial planners with an RIA can, therefore, invest and manage the assets of 401(k) plans. Doing so confers fiduciary status on you in the eyes of ERISA law. This follows ERISA attorney Chang's advice at the beginning of this article: "Ensure that the provider [that's you] formally assumes fiduciary liability for its investment advice."

Nearly every major investment firm in the country has an RIA subsidiary, so it is also able to accept status as ERISA fiduciaries. Many such firms, however, have made the conscious business decision not to accept fiduciary status. In doing so, they have decided to follow the

anti-fiduciary business model. You can distinguish yourself from the competition by adopting the fiduciary business model before regulators require it.

Following the fiduciary business model when pursuing 401(k) plan business means that you have a fiduciary relationship with the sponsors of 401(k) plans that is formally acknowledged. This is in accord with my advice in last month's column that "any approach to providing 401(k) plan services should be centered on the plan sponsor."

As a fee-based provider of investment services to 401(k) plans, you don't have the conflicts of interest that consultants following the anti-fiduciary business model have. For example, while such consultants receive undisclosed compensation from their unacknowledged cronies--third-party money managers--you receive fully disclosed compensation directly from your formally acknowledged clients--sponsors of 401(k) plans.

Under the fiduciary model, all compensation is disclosed and reported to the plan sponsor and to each individual plan participant on an annual basis. There is full and complete transparency for all compensation charged at both levels. This model aligns your interests (as provider of investment services to 401(k) plans) with those of the plan sponsor and plan participants.

The anti-fiduciary business model aligns consultants' interests with those of their third-party cronies but *subordinates* the interests of 401(k) plan sponsors and plan participants. Subordinating such interests to your own interests is the direct opposite of what it means to be a fiduciary: placing the interests of your client-beneficiary ahead of your own interests. Indeed, one of the two primary fiduciary duties under ERISA (section 404(a)) is to act for the "exclusive purpose" of providing benefits to retirement plan participants and their beneficiaries.

Following the fiduciary business model when pursuing 401(k) plan business does bring real value to sponsors of 401(k) plans and plan participants. This model provides complete clarity and simplicity and eliminates nearly all of the problems created by the anti-fiduciary business model that is followed by many consultants.

So what do you want to be: a fiduciary or an anti-fiduciary?

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.

For more information about Simon, please visit www.prudentinvestoract.com and www.prudentinvestoradvisors.com or you can e-mail him at wssimon@mindspring.com.

© Copyright 2003 Morningstar, Inc. All rights reserved. Please read our Privacy Policy.
If you have questions or comments please contact Morningstar.

Morningstar.com | Australia | Canada | Europe | Finland | Hong Kong | Japan | Korea | Netherlands | New Zealand | Norway | Sweden