SELECTING AND MONITORING AN INVESTMENT ADVISOR FOR YOUR COMPANY'S RETIREMENT PLAN:
A GUIDE FOR COMPANY FIDUCIARIES

Lance T. Studdard, J.D.

Many companies now use some sort of investment professional to help select an investment menu for their company's qualified retirement plan (typically a 401(k) plan). As qualified plan fiduciaries, it is the responsibility of the company officers, directors and key employees to select and monitor the investment advisors that provide services to their company's retirement plan. It is important that they do so with the care and prudence required by the Employee Retirement Income Security Act of 1974 (ERISA). Because in the end, the fiduciaries within the company (Company Fiduciaries) that face the prospect of being held personally liable for plan losses if they do not prudently select and monitor their plan's investment advisors.

There are several reasons why ERISA's fiduciary rules were put in to place. Qualified retirement plans collectively represent billions of dollars in savings for Americans. At the individual plan level, someone has to be responsible for the well-being of those saving within the plan. ERISA recognizes the need to have someone in charge. That is accomplished by creating a fiduciary relationship between the plan sponsor (the stewards of other peoples' savings) and those the plan sponsor represents (plan participants and beneficiaries). This stewardship has often been handed over to investment advisors due to the complexity of plan investing.

Since investment advisors play a central role in the qualified plan marketplace, the Securities and Exchange Commission (SEC) and the Department of Labor (DOL) jointly issued a guidance paper titled, "Selecting and Monitoring Pension Plan Consultants, Tips for Plan Fiduciaries" (SEC/DOL Guidance paper).

This paper is intended to supplement and reinforce the advice provided in the SEC/DOL Guidance paper—though some areas of particular importance warrant mentioning again. The SEC/DOL Guidance paper is identical and, as of the release date of this article, can be found at the following Web sites:

- http://www.dol.gov/ebsa/newsroom/
- http://www.sec.gov/

Is an investment advisor also a plan fiduciary?

The SEC/DOL Guidance paper correctly identifies the fiduciary status of the investment advisor as a key factor in the Company Fiduciaries' evaluation process. The conventional wisdom within the retirement services industry is that an overwhelming majority of investment advisors do not voluntarily serve as a fiduciary for the plans they advise. The fiduciary status of an investment advisor is generally determined by a facts and circumstances test (usually determined by a court of law) unless the advisor makes a written acknowledgement that he or she is an Investment Manager as defined by ERISA. In other words, an investment advisor's decision whether to voluntarily serve as a plan fiduciary is very much about that advisor's corporate culture.

Company Fiduciaries should view any person(s) who visit the company to review their qualified plan's investments (usually on a quarterly or semi-annual basis) as an investment advisor. The investment advisor may be an employee of the bank, mutual fund or insurance company that either provides recordkeeping services or investments to the plan. In other cases, the investment advisor may be from a third-party human resources consulting firm, a Registered Investment Advisor (RIA) or a brokerage firm that has no direct relationship with the recordkeeper or the underlying investments in the plan. However, in this second instance the advisor's indirect relationship with the recordkeeper or investment provider may be important.

Copyright © Reliance Trust Company
All Rights Reserved

For the sake of efficiency, this paper is not intended to be a complete discussion of the fiduciary status of investment advisors. However, as a summary, I have listed some of the reasons why the fiduciary status of an investment advisor is important:

- The ERISA-granted liability shield for plan investments is provided only to Company Fiduciaries that outsource the selection of a plan's investments to an Investment Manager. Non-fiduciary investment advisors provide no such protection under this statute.
- Non-fiduciary investment advisors, though they often describe themselves as "co-fiduciaries" or "trusted advisors," can actually increase the risk of Company Fiduciaries. Non-fiduciary advisors often do not feel bound by ERISA's fiduciary or reasonable compensation standards.
- Selection of a non-fiduciary advisor means that Company Fiduciaries are still considered the party actually selecting the investments for their company's retirement plan. This often comes as a surprise to Company Fiduciaries as they assume they are no longer responsible for this function. Only Investment Managers provide this service on an outsourced basis.

Company Fiduciaries need to be sure that the agreement to appoint an Investment Manager is straightforward and plainly states that the investment advisor is a fiduciary to the plan being advised. Language should also be added to the investment advisor's service contract or the plan's trust agreement and should always be reviewed by counsel for the Company Fiduciaries.

Reviewing an investment advisor's credentials

The investment advisor's credentials should be reviewed at both the entity and individual level. At the entity level, it is important that the entity has registered with the relevant governing body. Company Fiduciaries seeking to hire a RIA firm should also obtain a copy of Part II of the firm's form ADV. The form ADV is a disclosure and information form that RIAs are required to file with the SEC on an annual basis. Company Fiduciaries seeking to hire a trust company should contact the banking regulators of the state in which the trust company does business, or in the case of trustees with a national charter, with the Office of the Comptroller of the Currency.

Company Fiduciaries should also inquire as to the qualifications of the individuals that will be performing services for the plan. Certain qualifications, such as experience with retirement plans, advanced degrees and professional designations should be collected and verified by the Company Fiduciaries. It is important to note that licenses required by the SEC and the National Association of Securities Dealers (NASD) are not per se designations, but rather licenses that allow the holder to sell certain products or to trade certain securities. They also allow the holder to personally receive investment commissions—a factor that some view as more of a disadvantage rather than a credential.

Some questions a Company Fiduciary may want to ask include:

- How much experience does the advisor or advisory firm have with qualified retirement plans?
- How much of the advisory firm's/individual advisor's annual income is derived from providing advice to qualified plans (vs. from advising individuals)?
- Is the advisor's compliance department well versed in ERISA's fiduciary and prohibited transaction standards? Please demonstrate.
- Does the advisor or members of the advisory firm have a familial or business relationship with a Company Fiduciary that may involve a prohibited transaction under ERISA?
- Does the advisor or the advisory firm have a relationship with a third party involved with the plan that may cause a conflict of interest?

An advisory firm is only as good as the people it employs. It is important for Company Fiduciaries to ensure that they select and monitor competent, conflict-free advisors—both for personal liability purposes and to help preserve the protection granted under ERISA associated with outsourcing the investment function.

Copyright © Reliance Trust Company
All Rights Reserved

Investment advisors must avoid conflicts of interest

One of the most basic tenets of ERISA fiduciary law is that advice should be free of conflicts of interest. Conflicts of interest can arise in many ways, but primarily from the relationship between the advisor and the client or between the advisor and the investment provider (such as a mutual complex or an insurance company). Conflicts can arise outside the relationship between the advisor and his or her client, such as when the advisor works for a mutual fund complex or insurance company, or when there is undisclosed revenue sharing between the advisor and the investment provider. One of the reasons for the SEC/DOL Guidance paper was the finding by the SEC that many advisors placed their clients' plans in products that paid the highest compensation to the advisor.[1]

Company Fiduciaries should make sure that they have received written representations from the investment advisor addressing conflicts of interest and how the advisor and his or her firm deals with potential or real conflicts of interest. One way to combat potential advisor conflicts of interest is to require the advisor to verify in writing that he or she is an ERISA fiduciary to the plan he or she is advising.

Evaluate brand and capitalization in relation to an investment advisor's fiduciary status

The high value placed on name brand is a hallmark of American consumer behavior. However, reliance on brand is not the best way to evaluate investment advisors. Brand can be important, especially to participants who might have a comfort level with certain recognized brands. It is important for Company Fiduciaries to balance various factors when selecting an investment advisor, but they should not forget that there have been some mutual fund and trading scandals in the last decade that involved many well-known, brand-name providers.

Consumers often feel a sense of security when doing business with "the big boys" in any given industry. In the qualified plan investment advisory world, it is important for Company Fiduciaries to know that they have a partner with substantial assets standing behind the work they do. However, capitalization can be misleading in the retirement plan advisory world as the defense of choice for non-fiduciary advisors in ERISA litigation has been to disclaim any fiduciary liability for the investment recommendations they make. The result of this defense is that Company Fiduciaries are standing alone to face a lawsuit filed by plan participants and former employees. The real challenge is that these large non-fiduciary firms often earn millions of dollars in fees from advising qualified retirement plans. Predictably, non-fiduciary advisors have vigorously defended any lawsuit that alleges they violated their ERISA fiduciary duty because one lawsuit could result in an avalanche of other lawsuits. Added to this is the ability to use their "deep pockets" to hire the best law firms to defend themselves.

An advisor's insurance should be carefully evaluated

While the combination of a corporate culture that disclaims any fiduciary status and large assets is not attractive, it may be no worse than a firm that accepts fiduciary status but has little or no assets to back up their decisions. One factor Company Fiduciaries should review is the amount and type of insurance maintained by the investment advisor. Not all policies cover losses arising from ERISA-based claims. Likewise, the amount of coverage should be sufficient to cover potential losses based on an action involving your plan. The size of the firm's assets also comes into play as most of these policies have large deductibles that must be paid for losses. Advisory firms that accept fiduciary responsibility offer many benefits to a plan, but these benefits should be balanced with that firm's ability to stand behind its services.

Organizational structure may also hold clues

How does the advisory firm run its business? Are there committees for decision making? Are there multiple offices? Is the decision-making process centralized or controlled in various regional offices? These questions stem from traditional regulatory analysis. Regulators often want to see consistency throughout an organization. Exceptions to general procedure must be reconciled and documented by the advisor. One big

[1] SEC, Staff Report Concerning Examinations of Select Pension Consultants, May 2005.

Copyright © Reliance Trust Company
All Rights Reserved

"no-no" is for one advisor to have a fund on a sell list while another advisor in a separate city has the same fund on a hold, or buy list. This inconsistency is often fodder for plaintiff's attorneys and can become a problem for Company Fiduciaries who are not adequately monitoring the plan's advisor.

Strategic considerations to help fiduciaries manage liability risks

The DOL has been working on widespread reforms, but it could be years before they are issued. Company Fiduciaries should not wait on Federal regulators to affect change in this area. The ERISA fiduciary risk management implications associated with a qualified plan's investments can have a severe impact on Company Fiduciaries. It is up to Company Fiduciaries to ensure that they have documented the retirement plan investment advisor's qualifications, lack of conflicted advice, amount of fees and fee sources.

Aside from the risk management implications listed above, Company Fiduciaries should align the advice model chosen by the advisor with their objectives. For example, are the Company Fiduciaries the investment experts with enough time to carry out his or her duties as required by ERISA's prudence standard? If the answer is "yes," this person or persons may want to consider hiring a non-fiduciary advisor to assist with investment research and reporting. If the answer is "no," then this person or persons may want to consider outsourcing the plan's investment responsibilities to an ERISA-defined Investment Manager.

Once an advice model has been chosen, Company Fiduciaries should use resources such as this paper and the DOL/SEC Guidance paper to ensure that they have considered and documented a prudent advisor selection process. After selection, similar resources should be used to monitor the advisor – generally on an annual or bi-annual basis.

Copyright © Reliance Trust Company
All Rights Reserved