

Fiduciary Focus: Non-Fiduciary Investment Consultants (Part 3)

W. Scott Simon | 07-06-06

"The battle of Waterloo was won on the playing fields of Eton." This line has been attributed to Arthur Wellesley, otherwise known to history as the Duke of Wellington, Conqueror of Napoleon. Lord Wellington linked one factor--the activities of children--to another, seemingly unrelated factor--the defeat of Napoleon.

In perhaps a more certain way, one factor--the amount of income a person can expect from his or her retirement plan upon retirement--can be linked to another, seemingly unrelated (yet very harmful) factor--obscure, yet crucial language found in contracts entered into by fiduciaries of retirement plans and the investment consultants to such plans.

In my two previous columns, I examined how a real-life contract, in effect, gutted the contract of all ERISA section 3(21)(A) fiduciary duties owed to the plan's participants. The contract was drafted by a broker-dealer investment consultant to a 401(k) plan (through its RIA arm) and entered into by the consultant and the fiduciaries of the plan. This contract enabled the consultant to avoid real responsibility (and, therefore, liability) for any such duties while allowing the consultant to continue posing as a "fiduciary."

In this month's column, I'd like to continue this examination with a look at how this contract allows the broker-dealer consultant to plunder (all legally, of course) the accounts of plan participants, significantly (and unconscionably) reducing the amount of income plan participants can expect upon retirement. I'm not sure if Lord Wellington would approve of such behavior, but Blackbeard, that plundering pirate of old, certainly would. Let's see *why*.

ERISA section 404(a)(1)(A)(ii) states: "A fiduciary shall discharge his duties solely in the interest of the participants and their beneficiaries for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan."

The "fiduciary" referred to here is the fiduciary of a retirement plan that is responsible for knowing the nature and amount of the fees and expenses incurred by the plan. The "duties" referred to here make up a portion of "the core fiduciary law [of] ERISA [section] 404(a)(1) which propounds the foundational norms--the duties of loyalty and prudence--which underlie all trust fiduciary law," according to John H. Langbein, the Reporter for the Uniform Prudent Investor Act and Chancellor Kent Professor of Law and Legal History at Yale University law school.

Needless to say, then, fiduciaries of retirement plans such as 401(k) plans should have a very good idea about the costs incurred by the plans for which they are legally responsible. It's no secret, though, that precious few of them have any clue about the nature and amount of such costs. This is due in no small part to the fact that ERISA doesn't require a non-fiduciary investment consultant to disclose its fees to plan fiduciaries. Fred Reish and Bruce Ashton, in a [white paper](#) prepared by for the Principal Group in September, label this a "disconnect" under ERISA law:

[T]he plan sponsor and its key officers have a duty to know and understand the fees and expenses being paid by the plan. However, in most cases, there is no commensurate duty on a non-fiduciary financial professional to disclose his fees. That disconnect creates a potential conflict between the plan fiduciaries and the intermediary; if the professional does not fully inform the fiduciaries of its compensation, he probably has not violated ERISA, but may have caused the fiduciaries to breach their ERISA duties.

So there you have it: Plan fiduciaries must ask non-fiduciary consultants to account for their compensation so that the fiduciaries can fulfill their fiduciary duty under ERISA

section 404(a)(1)(A)(ii). The consultant, however, has no duty to (and very rarely does) answer that question. Reish and Ashton really have nailed it when they refer to this as a "disconnect."

But does a *fiduciary* investment consultant have the duty to answer that question? It would sure seem so. In the real-life contract between the fiduciaries of a 401(k) plan and what I referred to in my previous column as a "phantom" fiduciary (i.e., the broker-dealer/RIA investment consultant to the plan that poses as a fiduciary), the consultant agrees that, with respect to providing certain services, it is an ERISA section 3(21) fiduciary.

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 in this case is forbidden from having any conflicts of interest. That is, the consultant must *outright avoid all* conflicts of interest. The consultant must, therefore, avoid the "disconnect"--the failure to inform the plan fiduciaries of its compensation--that creates the potential conflict between the consultant and the plan fiduciaries.

This would seem to require the investment consultant to make it easy--not virtually impossible--for the plan fiduciaries to know the exact amount of fees the plan is being charged by the consultant to allow the fiduciaries to carry out their duties under ERISA. But the language in the real-life contract supplied to the plan fiduciaries by the investment consultant does precisely the opposite: It outright disguises the consultant's fees and expenses to get away with increasing its compensation. "Obfuscation" is too kind a word to describe the kind of double-talk in this contract about the nature and amount of the consultant's fees and expenses.

Why would any fiduciary of, say, a 401(k) plan want to have a relationship with such an investment consultant when ERISA forbids them outright from having any conflicts of interest at all? Why would any such fiduciary want to allow the consultant to place its interests ahead of those of plan participants to which the fiduciary owes the highest duties of care?

Can anyone really say with a straight face that when such an investment consultant hides its high fees from plan fiduciaries--fiduciaries that are charged by ERISA with knowing what those and other fees are--the consultant's conduct is fiduciary conduct? How can the consultant be engaged in ERISA fiduciary conduct when it's working actively to keep plan fiduciaries in the dark by hiding its high fees, so that they cannot carry out their ERISA section 404(a)(1)(A)(ii) duties?

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 such as our example where the consultant professes (in the very same contract) to have a fiduciary relationship with those fiduciaries. 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?

Far from actually hiding their fees, such consultants should serve up their fees on a silver platter to plan fiduciaries that have the legal duty to plan participants to know the nature and amount of these fees so that they can determine whether or not they are reasonable under ERISA. The investment consultant here, as an ERISA fiduciary, should not make it virtually impossible for plan fiduciaries to fulfill their own duties under ERISA. Instead, the consultant should help them make it easy.

This kind of behavior engaged in by the investment consultant isn't legally a breach of fiduciary duty. Or is it? According to Reish and Ashton, there's a case on point (*Brink v. DaLesio*, 496 F. Supp. 1350, 1376 (D.Md. 1980), 667 F.2d 420 (4th Cir. 1981)) that has actually ruled on the issue of whether or not an ERISA fiduciary investment consultant must disclose its compensation: "[T]he trustees have an obligation to ensure that insurance brokers or consultants providing services to the Funds receive only reasonable compensation and otherwise comply with the requirements of the exemption. In order for them to perform these tasks full disclosure of material information concerning the services provided and the associated costs is required. In

other words, under ERISA, [the fiduciary/broker] had a duty to disclose the amount of compensation he received from the insurer as well as an obligation to ensure that that amount was reasonable."

If the broker-dealer fiduciary investment consultant I have cited in my recent columns 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.

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