

Fiduciary Focus: Non-Fiduciary Investment Consultants (Part 4)

W. Scott Simon | 08-31-06

My column this month continues to focus on the contract between a well-known broker-dealer investment consultant and the fiduciaries of a retirement plan. I detailed previously how the consultant in the contract named itself as a fiduciary under section 3(21) of the Employee Retirement Income Security Act (ERISA), but gutted all language from the contract that would have actually made the consultant responsible (and, therefore, liable) for the duties required of an ERISA fiduciary. The contract also named the consultant as a fiduciary under the Investment Advisers Act of 1940 (1940 Advisers Act). As a result, I thought it might be interesting to examine the status of the consultant as a fiduciary under both ERISA and the 1940 Advisers Act and the issues that might arise from that.

Registered Representatives of Broker-Dealers Cannot Be Fiduciaries to Their Clients

Every stockbroker at the large broker-dealers providing advisory services to fiduciaries of retirement plans (such as the one at issue here) is a registered representative (RR) of its broker-dealer. A RR agent legally (factually is another matter, depending on the actions of the RR and how well it is supervised by management at the broker-dealer in a given fact-specific situation) cannot be a fiduciary to its investment clients. This has nothing to do with any governmental regulation but to the private contract that each RR agent enters into with its broker-dealer. That contract legally requires a RR to place the interests of its broker-dealer before the interests of the RR's clients.

As it turns out, then, a RR is a fiduciary--but only to its broker-dealer--not to its investment clients. A RR owes no legal duty of loyalty (the paramount duty owed by a fiduciary to its beneficiaries as well as the oldest one, originating in the common law of 11th century England) or any other fiduciary duties to its investment clients. (The way the brokerage industry fought tooth and nail to ensure that the Merrill Lynch rule was adopted tells you what I have been telling you for some time now: Broker-dealers will do anything to avoid having the "fiduciary" stake driven through their heart.) So even if a RR wanted to be a fiduciary to its clients, it couldn't do so legally given the contract with its broker-dealer. Some RRs assert that they feel as though they are fiduciaries to their clients. While that's a nice sentiment, it has no legal validity.

A Fiduciary Subject to the Investment Advisers Act of 1940 as Regulated by the U.S. Securities and Exchange Commission

Section 202(a)(11) of the 1940 Advisers Act defines an "investment advisor" (i.e., a registered investment advisor, or an RIA) as: "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."

If there was ever any doubt about it, the U.S. Supreme Court made clear in *S.E.C. v. Capital Gains Research Bureau, Inc.* (375 U.S. 180 (1963)) that an RIA is a fiduciary. The Supremes noted that the 1940 Advisers Act "reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship." The court also noted that the 1940 Advisers Act reflects "a congressional intent *to eliminate, or at least expose, all conflicts of interest* which might incline an investment adviser--consciously or unconsciously--to render advice which was not disinterested." (My emphasis.) Further, every RIA owes its clients a duty of "utmost good faith, and full and fair disclosure of all material facts" as well as an affirmative obligation "to employ reasonable care to avoid misleading clients."

Given the language of the court, an RIA fiduciary subject to the 1940 Advisers Act is required at the very least to disclose all conflicts of interest it may have to its beneficiary clients. (A fiduciary is deemed to have a conflict of interest when it has a financial (or personal) interest that conflicts (or appears to conflict) with its fiduciary duties to its beneficiaries.) Even in situations where a conflict of interest is disclosed,

no fiduciary should even attempt to take advantage of that conflict when discharging its fiduciary duties.

A strong argument can be made, based on other language in the court's *Capital Gains* opinion as well as that found in the congressional committee reports that helped shape enactment of the 1940 Advisers Act, that an RIA must actually avoid any conflicts of interest, whether real or perceived. For purposes of this article, though, let's just say that an RIA fiduciary subject to the 1940 Advisers Act has the duty to disclose (not avoid) all conflicts of interest.

A Fiduciary Subject to the Employee Retirement Income Security Act as Regulated by the U.S. Department of Labor

The consultant has entered into the contract as an RIA fiduciary subject to the 1940 Advisers Act. Yet it has also acknowledged in the contract that it is an ERISA fiduciary. According to the "sole interest" and "exclusive purpose" rules of ERISA section 404(a)(1), an ERISA 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." (My emphasis.)

The words "shall," "solely," and "exclusive" are clear in meaning and don't allow for any ambiguity. This is not to say that courts in some cases haven't allowed ERISA plan fiduciaries or plan sponsors to benefit from conflicts. But that was permitted only when the benefits that arose from such conflicts were minor and the primary motive of the fiduciaries involved in such conflicts was to benefit the plan. The conduct of the broker-dealer under discussion here is a far cry from that standard: the primary motive of the broker-dealer in being involved in a number of conflicts was not to benefit the plan (i.e., the plan participants) but to benefit the broker-dealer.

Unlike an RIA fiduciary that's required to *merely* disclose conflicts of interest, then, an ERISA fiduciary has the duty to outright *avoid* conflicts of interest. So an RIA fiduciary could very well have a conflict of interest vis-à-vis a client (e.g., advising the client to use an investment manager that trades through a broker-dealer affiliated with the RIA fiduciary). That's permissible as long as the RIA fiduciary discloses the conflict to the client. Yet an ERISA fiduciary is not permitted to have conflicts of interest vis-à-vis its clients according to ERISA section 404(a) and ERISA's prohibited transaction rules (unless a Prohibited Transaction Exemption applies).

Dual Registration as a Broker-Dealer and Registered Investment Advisor

The broker-dealer under discussion here is dually registered both as a (a) broker-dealer subject to the Securities Exchange Act of 1934 (as regulated by the Securities and Exchange Commission and the National Association of Securities Dealers) and (b) registered investment advisor subject to the 1940 Advisers Act (as regulated by the SEC).

Only a bank, insurance company, or registered investment advisor can become an ERISA fiduciary (see ERISA section 3(21)(A)(ii)), which makes it legally impossible for a broker-dealer to become an ERISA fiduciary. That's why a broker-dealer that wants to become an ERISA fiduciary and deal with ERISA money must enter into contracts with plan fiduciaries as a registered investment advisor (not a broker-dealer) under the RIA side of the broker-dealer. As a result, the broker-dealer consultant, through its RIA arm, is magically transformed into an ERISA fiduciary.

This alchemy allows the consultant to bootstrap itself from being a broker-dealer (subject to no fiduciary duties) into an RIA fiduciary (subject to the "must disclose conflicts" duties of the 1940 Advisers Act) and then into an ERISA fiduciary (subject to the "must avoid conflicts" duties of ERISA). Among other things, that permits the consultant to choose to become an "investment manager" in accordance with ERISA sections 3(38) and 402(c)(3) and by doing so, accept--in writing--discretion for investment and management of assets as an ERISA section 405(d)(1)-defined "independent fiduciary." The fact that virtually no (actually none, but one must always hedge a bit) broker-dealers with dual registration would--at least in our solar system--ever accept such discretion is another story.

Contract Language Concerning Conflicts of Interest

Let's examine some language in the consultant-drafted contract between the fiduciaries of the retirement plan ("Client") and the consultant ("X") that discusses conflicts of interest:

Client acknowledges that one or more conflicts of interest exists or may exist with respect to the activities of X and its affiliates. All managers in the X Program and certain of the managers in the Y Program are affiliated with X. The Client understands that X and its affiliates will receive more aggregate fees when the Client selects a Manager affiliated with X than if the Client selects a Manager that is not affiliated with X. Thus, X *and its financial consultants have a conflict of interest when identifying affiliated managers to the Client.* (My emphasis.)

This contract language makes clear that X receives more fees when the plan fiduciaries select a Manager affiliated with X than one unaffiliated with X. Equally clear is that the consultant has a conflict of interest when it "identifies" money managers that are affiliated with the consultant. In the situation at hand, nearly 40% of the value of the portfolio is being managed by consultant-affiliated money managers that the consultant has identified to the Client. The conflict is readily apparent: The consulted-identified affiliated managers charge the plan fiduciaries (really the plan participants) much higher fees (ranging from about 50% to 150% higher) than the unaffiliated managers.

As an RIA fiduciary, X has the duty to acknowledge and disclose all real or perceived conflicts of interest. This means that X is free to have as many conflicts of interest as it wants with respect to any non-ERISA clients--just as long it acknowledges and discloses them to those clients. As an ERISA fiduciary, however, X has the duty to outright avoid actual--or even potential--conflicts of interest that would place its own interests ahead of the interests of any beneficiaries of a qualified retirement plan. (Do the "sole interest" and "exclusive purpose" rules of ERISA section 404(a)(1) ring a bell?) So when the consultant is actually engaged in the kind of conduct that it describes in the very contract it drafted--"X and its financial consultants have a conflict of interest when identifying affiliated managers to the Client"--no other conclusion is possible except that X is in violation of ERISA.

There's a section elsewhere in the contract that deals specifically with ERISA plans, but it's bereft of any language about conflicts of interest. One would expect in that section there would be some discussion about the differences between the conflicts of interest standard that applies to an ERISA fiduciary and the one that applies to an RIA fiduciary. As it reads, though, the consultant-drafted contract between the plan fiduciaries and consultant holds the consultant only to the RIA "disclose" conflict of interest standard not the ERISA "avoid" conflict of interest standard. *The practical result is that the consultant violates ERISA because it's required only to disclose conflicts of interest as an RIA fiduciary, not avoid them as an ERISA fiduciary.* The consultant's answer to question 4 of "A Fact Sheet issued by the Department of Labor and Securities and Exchange Commission" with respect to "Selecting and Monitoring Pension Consultants: Tips for Plan Fiduciaries" confirms this:

4. Do you have any policies or procedures to address conflicts of interest or to prevent these payments or relationships from being a factor when you provide advice to your clients?

[Consultant X's answer:] With respect to conflicts of interest generally, X's general objective is to *disclose* to clients the potential for conflicts of interest in the various programs and services that it provides.(My emphasis.)

If consultant X was dealing only with non-ERISA money, the preceding "disclosure" language would be acceptable--legally at least. But in cases such as here, where the consultant describes itself in the very contract it has drafted and presented to the plan fiduciaries as an ERISA section 3(21) fiduciary dealing with ERISA money, the consultant must avoid--not just disclose--any conflicts of interest in its role as an ERISA fiduciary. It would appear that failure to do that ensures that such consultants face real liability under ERISA.

Of course, all this raises a number of questions: Why would any fiduciary of a retirement plan want to have a relationship with an entity such as X that violates ERISA (i.e., because it's forbidden to have conflicts of interest) by identifying money managers to the plan fiduciaries that are affiliated with X? For that matter, why would any plan fiduciary want to have a relationship with an entity such as X that can have real or perceived conflicts of interest as an RIA--as long as those conflicts are acknowledged and disclosed to plan fiduciaries? Indeed, why would any plan fiduciary

want to allow an entity such as X to place its interests (particularly an interest--disclosed or not--in getting paid more money under one investment program than another) ahead of the interests of participants in retirement plans?

These questions should lead all fiduciaries of retirement plans to ask themselves: Why would we ever place plan participants--the very beneficiaries to whom we owe the highest fiduciary duties of care--in financial jeopardy and ourselves in legal jeopardy by dealing with entities such as X? The problem, of course, is that many fiduciaries of retirement plans are not very well informed and entities such as X not only are all too happy to keep them that way but in many cases actively work to make sure that such fiduciaries never get the chance to become well informed.

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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 Analyst. 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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