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DOL: If Your Clients Have Qualified Plan Assets And You Provide Advice, You Are Held To A Fiduciary Standard

by Stephen C. Winks

If we can't rely on the NASD or the SEC to support fiduciary responsibility as a conumer protection, we can always rely on the Department of Labor. The rules are about to change for advisors helping clients with assets held in qualified plans.

Essentially, in the normal course of your business, if you advise individuals on the assets they hold in a qualified plan you are considered a fiduciary by the Department of Labor even if you have no involvement with the plan. You are not only held to a fiduciary standard of care, you are liable for imprudent investment decisions because those decisions "would not have been the direct and necessary result of the participant's exercise of control."

In a Department of Labor Advisory OpinIon dated December 7th, Louis Campagna, Chief of The DOL Division of Fiduciary Interpretations, stated, "that directing the investment of a plan constitutes the exercise of authority and control over the management or disposition of plan assets and that the person directing the investments would be a fiduciary, even if the person is chosen by the participant and has no other connection to the plan. In addition, regulation 29 CFR sub-section 2510-3.2-1© further clarifies the meaning of the term "investment advice." Under that regulation, a person will be deemed to be rendering investment advice if such person renders advice to the plan as to the value of securities or other property, or makes a recommendation as to the advisability of investing in, purchasing, or selling securities or other property and such person either directly or indirectly has discretionary authority or control, whether or not pursuant to an agreement, arrangement or understanding, with respect to purchasing or selling securities or other property for the plan; or renders any such advice on a regular basis to the plan pursuant to a mutual agreement, arrangement or understanding, written or otherwise, between such person and the plan or a fiduciary with respect to the plan, that such services will serve as a primary basis for investment decisions with respect to plan assets, and that such person will render individualized investment advice to the plan based on the particular needs of the plan regarding such matters as, among other things, investment policies or strategy, overall portfolio composition, or diversification of plan investments. The department of Labor has taken the position that this definition of fiduciary also applies to investment advice provided to a participant or beneficiary in an individual account plan that allows participants or beneficiaries to direct the investment of their accounts. 29 CFR sub-section 2509.96-1©."

> PROFITING FROM A POSITION OF TRUST ALL DEPENDS ON WHETHER THE ADVISOR AND/OR THEIR SUPPORTING FIRM TREATS TRADE EXECUTION AS A PROFIT OR COST CENTER.

Prohibited Transactions

This advisory opinion places the plan participant advisor in a fiduciary role, which precludes them from profiting from their being in a position of trust. The advisor cannot receive "any consideration for their own personal account from any party dealing with the plan in connection with a transaction involving the assets of the plan." This is the Achilles Heal of the brokerage industry serving qualified plans, as the advisor receiving brokerage commissions derived from the plan could be a prohibited transaction (profiting from a position of trust), depending upon whether the advisor and their supporting firm treats trade execution as a cost center or a profit center. This is why many RIAs dispense with their brokerage licenses, and charge a fee for their services, so there will be no question as to whether they benefit from the commissions generated from the accounts they advise. In fact it is the RIA's fiduciary responsibility to act in the consumer's best interests in managing trade execution cost on behalf of their clients. Because the lower the cost the better for the consumer, there is a conflict of interest between whether the advisor and/or the advisor's supporting brokerage firm is acting in the consumers best interest or whether the

advisor is acting in their brokerage firm's best interest when it comes to trade execution (see the July 2004 issue of SENIOR CONSULTANT, "The Third Rail of the Financial Services Industry: Trade Execution, Best Execution and Beyond"). The advisor's fiduciary charge to act in their client's best interest is in conflict with how the advisor's employer, a brokerage firm, charges for trade execution. Even if the advisor has no control over how their firm charges for trade execution, they indirectly are engaged in a prohibitive transaction, if they do not act responsibly to secure the lowest trade execution cost available. This rationale explains how Charles Schwab has become more attractive than Merrill Lynch in fiduciary circles and why Schwab's 3,000 RIAs (who have relinquished their brokerage licenses) garnered $44 billion in net new assets last year relative to Merrill's 15,000 advisors garnering $10 billion in net new assets.

Many of the DOL's concerns with conflicts of interest and creating a conflict free environment in which to work, pertain to prohibitive transactions or advisors profiting beyond the knowledge of the consumer from their being in a position of trust. Undisclosed compensation from money managers, brokerage commissions, actuarial firms, plan administration firms, referral fees, finders fees, etc are prohibitive transactions, which may or may not be resolved by disclosure. Profiting from trade execution on qualified plan assets advised is a prohibited transaction. Reasonable trading cost, as can be negotiated by a prudent expert on behalf of the consumer, are allowed. An advisor held to a fiduciary standard must treat trade execution as a cost center, not a profit center. Thus if the industry is to be supportive of their advisors acknowledging and fulfilling their fiduciary responsibilities, it must create a conflict free business environment within which advisors should work. By virtue of the advisor acting in their clients best interests and treating trade execution as a cost center not a profit center—the advisor avoids a prohibited transaction, the qualified plan keeps its tax exempt status and the advisor fulfills their fiduciary obligation. Conversely, if the advisor's brokerage firm treats trade execution as a profit center as is customary within the brokerage industry, and receives compensation from trades executed within the plan they advise, it would be considered a prohibited transaction, the plan's tax exempt status would be in jeopardy and the advisor would have put their own interest or the interest of their brokerage firm ahead of their client's. A conflict free business environment that treats trade execution as a cost center will increasingly become important strategic imperative as it serves as a bell weather for who is acting in a fiduciary capacity. Effective January 31st the new SEC disclosure statement requires brokers who cannot declare their fiduciary status to state in short—"I am acting in a sales capacity and am not obligated to act in the consumer's best interest." Consumers are finally able to discern whether advisors are acting in a sales capacity or a fiduciary capacity and it is at the peril of all brokers that their firms choose not to support fiduciary counsel. It is clear what is required to create a conflict free business environment for advisors; please see April/May 2005 issue of SENIOR CONSULTANT, Volume 8, No. 7; SEC and DOL: Ten Questions Every Advisor Must Answer.

> IF YOU CAN REDUCE TRADING COST AS A PRUDENT EXPERT ON BEHALF OF YOUR CLIENTS TO A SMALL FRACTION OF RETAIL PRICING (OMNIBUS BLOCK TRADING) YOU ARE FULFILLING YOUR FIDUCIARY OBLIGATIONS.

The Solution: Transparency, Conflict-free Business Environment and the Repricing of Services

The DOL does not require advisory services vendors to not profit from providing their services, it just requires the advisor to act as a prudent expert in acting in the best interests of the consumer. Thus, if you can reduce trading cost as a prudent expert by utilizing omnibus block trading at the advisor level, effectively managing trading cost on behalf of your clients to a small fraction of retail pricing you are fulfilling your fiduciary obligations as a prudent expert. This requires the industry to be totally transparent in all forms of compensation to include disclosure of all advisor compensation including brokerage commissions. It is not terribly disruptive to create a conflict free business environment. The industry simply must fully disclose and reprice its services. There should be a fully transparent fee for services provided. Brokerage commissions are simply recast as part of a fully disclosed advisory fee charged by the advisor, so the industry can maintain its margins and yet support their advisors in fulfilling their fiduciary obligations. The free markets will determine if the advisor's fee is in line with the services they provide and the value they add. Brokerage commissions tied to trade execution can no longer be the principle means of advisor compensation in serving accounts that are held to a fiduciary standard of care. Typically the advisor's intentions are good, their services may be able to be held to a fiduciary standard, thus, there is no reason why the advisor is not able to fulfill their fiduciary obligations simply because it is beyond their control that their supporting brokerage firm profits from executing trades within a plan the advisor advises. This structural disconnect is easily resolved so advisors can declare their fiduciary status and not have to use the new SEC disclosure statement.

Conclusion

There is a convergence of regulatory and market forces in support of fiduciary counsel. A conflict free business environment must be created, fiduciary counsel needs to be defined, a prudent investment process which can be audited back to statute, case law and regulatory opinion letters must be established, a legal construct must be established to protect the advisor in providing fiduciary counsel, a Code of Ethics must be created, a Policies and Procedures Manual must be developed—all

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are required by regulatory mandate, all constitute the foundation upon which a new profession of Fiduciary Advisors will be built. Virtually everything already exists. Thus, the conundrum—why does the industry insist upon denying its advisors have a fiduciary obligation to their clients? The DOL makes this cultural disconnect clear. Thanks to technological innovation and the transparency of the new SEC required disclosure statement, fiduciary counsel is within our reach. Advisors and RIAs have to go outside of their NASD member firms, which will not acknowledge their advisor's fiduciary obligations, and personally gain access to the enabling resources necessary to fulfill their fiduciary obligations. This is the beginning of the emergence of a new profession--the Fiduciary Advisor. The question is will the industry adapt? The DOL is keeping vigil and may leave no option. ■

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