The Changing Definition of Plan Fiduciary and Why Retirement Plan Sponsors Should Care

By Ary Rosenbaum, Esq.

In 2012, as long as the Department of Labor (DOL) doesn't further delay, there will be profound change in the world of employer sponsored retirement plans. While much has been discussed over the DOL's fee disclosure regulations that will once and for all, allow plan sponsors and participants to understand the costs involved with the administration of retirement plans, the more substantive change is the change in the definition of fiduciary. This definition of plan fiduciary as it relates to financial advisors for retirement plans will be a substantive change which can have an effect on the fee disclosure regulations as well.

There are two types of professionals that can call themselves retirement plan financial advisors: stock brokers and registered investment advisors (RIAs). Both of these types of retirement plan advisors have the same role. Their role is to work with the employers sponsoring these plans as plan sponsors and fiduciaries in managing the selection of plan investments, whether the investments are plan trustee or participant directed. This process which is the fiduciary process involves the development of an investment policy statement (IPS) which details how and why investment options are selected and replaced; the selection and review of investment options based on that IPS, and investment education to participants (if the plan intends to be a participant directed plan). The biggest difference between the two types of advisors is that the RIA is a plan fiduciary and the stock broker is not. What's the difference? Based on what is going on in the retirement plan business, a whole lot.

A fiduciary duty is the highest standard of care at either equity or law. A fiduciary is expected to be extremely loyal to the person to whom he or she owes the duty of care (the "principal"), The fiduciary must not put his or her personal interests before the duty, and must not profit from their position as a fiduciary, unless the principal consents. As a plan fiduciary, a financial advisor must put the needs of the plan sponsors first and avoid any transactions that may result in a prohibited transaction (which may be as innocuous as soliciting IRS rollover accounts from former participants moving money from the Plan).

Current law imposes a five-part test that must be satisfied in order for a person or an entity to be treated as a fiduciary by reason of rendering investment advice. Advice is considered "investment advice" if an adviser who does not have discretionary authority or control with respect to the purchase or sale of securities or other property for the plan:

1. renders advice as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing or selling securities or other property
2. on a regular basis
3. pursuant to a mutual agreement, arrangement or understanding, with the plan or a plan fiduciary, that
4. the advice will serve as a primary basis for investment decisions with respect to plan assets, and that
5. the advice will be individualized based on the particular needs of the plan.

Based on the definition, stock brokers have been able to skirt being a fiduciary. Broker were able to skirt the application of the fiduciary rule by arguing that they only rendered advice from time to time and that their advice wasn't the primary basis for the plan's investments. Some RIAs have tried to disclaim any fiduciary role and there have been third party administrators that have crossed near the current fiduciary definition. It should be noted that this definition was developed in the mid 1970s when bellbottoms, disco, and wall paneling were in style. It was drafted in a pre-historic time when dinosaurs called employer provided pension plans dominated the retirement plan landscape and where investments were not dominated by mutual funds. It was drafted at a time where there were no participant directed 401(k) plans or a wide variety of proprietary financial products that broker-dealers could sell or other financial products that they could sell and earn better commissions. Since stock brokers sell financial products and owe no fiduciary duty of care to the plan, they can sell financial products that benefit them-

selves more than it benefits the plan sponsor. This is not to suggest that brokers are unscrupulous, it is just to note that they currently do not owe the same duty of care that a RIA owes to the plan sponsor. RIAs don't have such issues since they don't sell financial products. In terms of lawsuits for fiduciary liability, an RIA will sit at the defendant's table as a co-defendant with the plan sponsor, while the broker doesn't have to be in the courtroom.

So in 2010, the DOL issued a proposed change to the definition of fiduciary. Generally, it will consider a person gives fiduciary investment advice if, for a direct or indirect fee, he or she –

Provides the requisite type of advice:

Appraisals or fairness opinions about the value of securities or other property;

Recommendations on investing in, purchasing, holding, or selling securities; or

Recommendations as to the management of securities or other property;

And meets one of the following conditions:

Represents to a plan, participant or beneficiary that the individual is acting as an ERISA fiduciary;

Is already an ERISA fiduciary to the plan by virtue of having any control over the management or disposition of plan assets, or by having discretionary authority over the administration of the plan (known as a functional fiduciary);

Is an investment adviser under the Investment Advisers Act of 1940; or

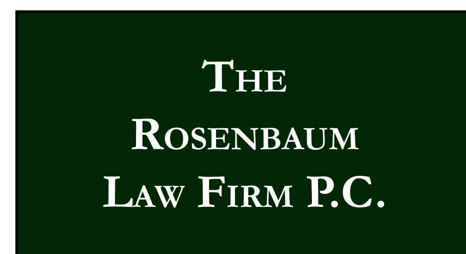
Provides the advice pursuant to an agreement or understanding that the advice may be considered in connection with investment or management decisions with respect to plan assets and will be individualized to the needs of the plan.

Democrat and Republican lawmakers don't agree on much, but many of them have protested to the DOL about this fiduciary definition change because Wall Street money does go a long way. Many broker dealers are trying to fight this change because if the new rule is implemented, brokers will have a tough choice to make. They will have to become fiduciaries, partner up with RIAs and/or ERISA §3(21) and 3(38) fiduciaries where brokers can serve in a non-fiduciary function, or leave the retirement plan advisory business because they don't want the extra liability of being a fiduciary.

While the fiduciary definition is in limbo, it should be no surprise that the DOL has postponed the §408(b)(2) fee disclosure regulations because I believe both rule changes go lock step with each other. Why? Who is a plan fiduciary is an important element in the fee disclosure rules. The fee disclosure rules will allow plan service providers to be compensated for their services without engaging in a prohibited transaction. A prohibited transaction can occur between "parties in interest" and ERISA-covered retirement plans. A party in interest includes persons providing services to such a plan such as an RIA, The ERISA prohibitions preclude the furnishing of services between a plan and a party in interest and the transfer of plan assets to a party in interest. Thus, absent an exemption, the plan could not employ the RIA or stockbroker or use plan assets to pay their fees.

If a plan engages in a prohibited transaction, the Internal Revenue Code imposes an excise tax of 15% on the amount involved in the prohibited transaction. The excise tax increases to 100% of the amount involved if the prohibited transaction is not corrected. There can also be other consequences, such as lawsuits against the parties who participate in a prohibited transaction. There are, however, exemptions from the prohibited transaction provisions. Under ERISA §408(b)(2), a prohibited transaction will not occur if the contract or arrangement between the plan and the service provider is reasonable, the services are necessary to the plan, and the plan pays only reasonable compensation for the services offered by a service provider. Under the fee disclosure regulations, service providers will have to disclose the direct and indirect compensation that they will receive to the plan's fiduciaries. Failure to provide the required disclosures causes the fiduciary and service provider to engage in a prohibited transaction. The problem? Plan sponsors are going to identify to their plan providers those individuals who are fiduciaries and to inform service providers of their identity so these plan providers can meet their disclosure obligations. Under the current fiduciary definition, this is a problem because many functional fiduciaries have denied their fiduciary role or delegated other individuals to communicate with service providers without any appointment. The new rules, if implemented, should help clear it up. So while service providers will be responsible for delivering the required disclosures to the "responsible plan fiduciary," plan sponsors still will need to identify all of the plan's fiduciaries.

If implemented, the new fiduciary definition will have a profound change on the retirement plan industry. Plan sponsors need to be aware of this change because they will have to identify their fiduciaries for disclosure rule purposes as well as whether they have to replace their financial advisor if that financial advisor decides to leave the retirement plan business because the new rules will label the financial advisor a plan fiduciary.



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