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"There are known knowns. There are things we know that we know.

There are known unknowns. That is to say, there are things that we know we don't know.

But there are also unknown unknowns. There are things we do not know we don't know."

-US Secretary of Defense, Donald Rumsfeld

A FRIGHTENING TREND: IMPROPER DUTIES FOR ADVISORS

The mistake we see far too often is this: employers have tasked non-fiduciary advisors with fiduciary duties and vice-versa.

HOW THIS HAPPENS: A TYPICAL SCENARIO

The laws that govern institutional investing are constantly in flux. The Employee Retirement Income Security Act (ERISA), having started in 1974, is relatively mature but the application and expansion of these legal constructs are ongoing. For example, Uniform Prudent Management of Institutional Funds Act (UPMIFA) and the Pension Protection Act (PPA) circulated in a wave of reform in 2006 through 2007.

On the other hand, institutional relationships with advisors and brokers may not change for decades. A complacent relationship can easily develop over the years between a plan sponsor and advisor. Over time, an institution's assets may grow beyond the level of expertise and sophistication of the advisor. Over time, prices become uncompetitive and, ultimately, abusive to the client's trust and loyalty. Without pressure, the service level may devolve and the plan's interest is no longer being served. Such relationships may operate in the advisor's interest, but not the plan sponsors and their employees.

Even the best run relationships, with fair costs and high service standards, should periodically conduct a Request-For-Proposal to ensure that the client's best interests are being served.

The lowest level of this untested relationship occurs when the long established advisor believes that the back office changes in business operations mean that the entirety of the advisor's actions has therefore conformed to the law. The unsophisticated advisor may observe updates to compliance procedures and suggest to the client that they are conforming to the changes in the law with an incomplete understanding of what the law actually requires. A casual and trusting relationship with a client can even result in inappropriate investment advice, subject to fiduciary principles & liabilities, being given by the non-fiduciary advisor with serious consequences for the client and the advisor. The advisor, without malice, continues business as usual. The client thinks: "My advisor has assured me we are following the rules so I'm protected." In reality, the client is often not protected because neither they, nor their advisor, have fully understood their duties. In other words, "they don't know what they don't know."

A BRIEF REVIEW OF FIDUCIARY VS. SUITABILITY STANDARDS

The trustees of any institution – foundation, retirement plan, union pension, and so on – are making decisions for money that does not belong to them. They are entrusted with other people's money and therefore obligated, legally and ethically, to act with the owner's best interests as the sole guiding principle. In other words, these trustees are fiduciaries.

"A fiduciary must act with care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matter would use in the conduct of an enterprise of a like character and with like aims." [ERISA Sec.404 (a)(1)(B)]

An advisor who adopts fiduciary status bears a burden similar to the institutional trustee; they must act with undivided loyalty to the interests of the owners and avoid (or disclose) any possible conflicts of interest. This is the fiduciary standard.

Conversely, non-fiduciary advisors are subject to a lesser burden: the suitability standard. Legally, this often means that the financial advisor is required to offer an individual investor options which only meet their needs based upon their particular circumstances. Advisors may select products or services that are "suitable" for the client, but not necessarily the best choice.

"A fiduciary … may employ one or more persons to render advice with regard to any responsibility such fiduciary has under the plan. [ERISA Sec. 402 (c) (2)]"

However, recent court decisions point to a more vigorous monitoring of the choices being offered by these non-fiduciaries. In other words, the investment choices being given should be more suitable for the client(s) and less self-serving to the non-fiduciaries and the companies they serve. Closer scrutiny is being paid to these transactions which both buyers and sellers should start paying closer attention to moving forward.

Example: buying a car

It might be useful to think of a car salesman as following the suitability standard. Imagine you walk onto a used car lot and talk to the salesman on duty to show you a few cars; the salesman will show cars, but they get to choose how to sell them. Do they show you a selection of sporty cars with high markups? Imagine that this particular salesman is the head of the Model Ts and they are compensated based on the number of Model Ts sold, but not Saturns; might they try and steer you towards a particular brand or model? Is there an unreliable Edsel that the car dealership is trying to get rid of, such that they are willing to give you a bargain? The car salesman will show you cars that go from point A to point B; he may show you suitable options. However, he has a vested interest in higher commissions, or perhaps moving particular models that aren't necessarily your ideal selection.

From a broader perspective, imagine that this particular used car lot has your dream car with everything you want. The only problem is a competitor's car lot across the street has the exact same vehicle for $5000 less. A salesman following the suitability standard has no obligation to tell you about the cheaper dream car across the street; his interest is selling the car from his own dealership and certainly your dream car is a suitable choice. Even more insidious, the salesman simply may not know about better options outside of their own car lot; their job is to sell cars, not to know about the entire universe of options.

WHERE IS THE HARM?

Now, apply this illustration to the context of investments. Imagine you are an employer – John Doe Computers - with a 401k retirement plan and that you're working with ABC Mutual Fund Company to run the recordkeeping, participant education, and investment management services. ABC Mutual Funds are the only allowable investments in the retirement plan. So, John Doe Computers only receives recommendations of which ABC Mutual Funds to include in the retirement plan, but with tens of thousands of investment options available, how can the employer know that ABC funds are the best options for their employees? Alternatively, imagine that the ABC investment family of products don't pass any fiduciary standard (e.g. – they're more expensive than peers, all of their portfolio managers and analysts were replaced, risk adjusted returns are terrible, etc.). Imagine that ABC is charging too much for recordkeeping, but they won't bring these issues to John Doe Computer's attention. The employer might never know about these failings because there is a conflict of interest; ABC simply won't fire themselves and it falls on the board or a fiduciary advisor to properly vet their advisors.

For non-qualified plans- the harm of operating without fiduciary coverage is more subtle. Certainly, the committee members and other fiduciaries working on behalf of the plan have been entrusted with fiduciary duty, but their advisors are not always required to share this burden. If a committee is made of lawyers and accredited fiduciaries and they have borne the responsibility for governance review, investment manager due diligence, peer review, and so on, they may have sufficient justification for working without a fiduciary advisor. For most committees, however, working with fiduciary advisors is often a best practice, designed to promote conflict-free advice and the best possible outcomes.

For retirement plans that fall under the auspices of ERISA, or foundations or endowments which follow UPMIFA, the harm is more obvious: the law is being broken. The fiduciary requirement exists for the ultimate benefit of plan participants.

"A fiduciary's independent investigation of the merits of a particular investment is at the heart of the prudent person standard. [Fink v. National Savings and Trust Company, 772 F.2d 951, 957, 6 E.B.C. 2269(DC Cir. 1985)]"

The conflict-of-interest inherent in a non-fiduciary advisor conducting fiduciary tasks can easily become the basis of a lawsuit against any decision makers or fiduciaries working for the benefit of the plan.

THE ROLES OF A FIDUCIARY ADVISOR VS. A NON-FIDUCIARY ADVISOR

Thus far, we have looked at the relative benefits of working with a fiduciary advisor and the potential hazards of working with a non-fiduciary advisor. This raises the question: is there any advantage of working with a non-fiduciary advisor?

The short answer is "yes". To begin with, a non-fiduciary advisor may be a specialist in their particular field. Returning to the car salesman example, a salesman may know the history and subtleties of every car on their lot and they could provide a lot of useful knowledge about their own products. Similarly, a spokesman for ABC's Mutual Fund Company may have accumulated a great deal of knowledge and experience about their products and how to integrate their product suite into an effective retirement plan lineup. Fiduciary advisors may take advantage of this expertise by inviting product specialists to discuss their particular suite of products. However, the fiduciary has to look at a broad pool of investment options in order to fulfill the duties set forth under ERISA. Missing options which apply to individual investors is done with a certain amount of risk for fiduciaries and the courts have upheld their liability, especially when they have failed to seek outside professional advice.

"*A trustee's lack of familiarity with investments is no excuse: under an objective standard, trustees are to be judged according to the standards of others acting in a like capacity and familiar with such matters. [Marshall v. Glass/Metal Association and Glaziers and Glassworkers Pension Plan, 507 F. Supp. 378, 2 E.B.C. 1006 (D. Hawaii 1980)]"*

The non-fiduciary, subject to the lesser suitability standard can become a greater expert on certain specific investment options due solely on the fact that they do not have a duty to find the best option and can therefore limit their search. Ironically, the limited search may actually yield the best option for the investor client!

For employer retirement plans, like a 401(k), there is another area where the roles of fiduciary and non-fiduciary advisors are distinct: investment advice vs. education. Imagine an employee at John Doe Computers, Bob, wants to know how to invest his 401(k) savings. Specific recommendations given to the employee (i.e. – "Bob, we've had a one-on-one discussion and I think you should put 50% of your money in this equity fund, and 50% in this other fixed income fund") is considered investment advice. Investment advice given to employees (i.e. plan participants) is solely the purview of a fiduciary advisor, and the recommendation a fiduciary advisor provides to employees is subject to fiduciary responsibility and potential liability.

A non-fiduciary advisor cannot give specific recommendations to employees. On the other hand, a non-fiduciary advisor can provide education and guidance. So, Bob can call up the investment hotline at ABC Mutual Funds and get investment education. Bob can receive general information about types of risk (market, inflation), compounding interest, risk tolerance levels & hypothetical asset allocation models, and so on. This general education gives tools to employees to make their own investment decisions, so is not subject to the fiduciary standard. As a result, the liability to the employer is significantly less.

Another perceived benefit non-fiduciaries have which fiduciaries do not possess is with regard to the perception of "self-serving" transactions under ERISA and therefore the non-fiduciaries are exposing the employers to less liability than the fiduciaries.

"A fiduciary with respect to a plan shall not –

1. *Deal with the assets of the plan in his own interest or for his own account;*

2. *In his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, or*

3. *Receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan." [ERISA Sec. 406(b)]"*

Let's go back to our car salesman illustration to demonstrate how a "self-serving" transaction might still work in the client's benefit. Imagine that you are ready to buy your car, but you don't have enough money to purchase your car outright; you'll need some short term financing options. A car salesman would be happy to offer you financing, but no fiduciary could ever offer loan you money to purchase a product. A fiduciary might be able to research different loan offers and recommend a particular deal, but the car dealership could actually provide the financing directly and they may even offer a competitive rate given their desire to sell the car.

Let's apply this illustration back to the world of investing: imagine you run a foundation with a high annual spending requirement to maintain a favorable tax status. Now, imagine it's 2008 and the stock market just crashed. A non-fiduciary advisor could offer the foundation a loan, collateralized against the remaining assets, which could support ongoing spending requirement, so the foundation wouldn't have to immediately sell their assets at depressed market prices. A fiduciary advisor could recommend getting a loan, but the non-fiduciary advisor could actually provide it directly.

THE SOLUTION: DIFFERENT ROLES FOR DIFFERENT ADVISORS

These revelations may feel new to some institutional fiduciaries and, as we've suggested, even some consultants. It is important to understand the different duties, responsibilities and liabilities of both the fiduciary and non-fiduciary plan advisors, and the benefits and the risks to the individual investors and the companies who employ them.

Understanding the structure of the decision making and the incentives of the advisors is key to recognizing the limitations of certain types of advisors. If you would like to review your current structure or simply gain some clarity on the rules that govern behavior, please feel free to call our offices anytime and we will be happy to discuss it with you.

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