THE ASPPA Journal

ASPPA's Quarterly Journal for Actuaries, Consultants, Administrators and Other Retirement Plan Professionals

Ethics and Professionalism: How Do We Know?

Assembling and Monitoring a Plan's Investment Team

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Every day, each of us forms opinions regarding our friends, family, coworkers and every person we encounter. Can they be trusted? Who is dependable? For most of us, it is a trial and error process. Psychologists tell us that, at the most basic level, we form bonds of trust by receiving a variety of visual, auditory and olfactory cues. These clues combine to make us either comfortable, or wary, of others. But how do *entities* learn to form bonds of reliance and trust—especially when the consequences of being wrong make trial and error an unacceptable process?

The difficulty of this question is compounded when the bonds of reliance and trust are formed through business and financial guidance instead of personal advice. It is made even more complicated when the trust involves the well-being of others. This situation occurs when a plan sponsor reaches out to investment advisors to assist with a qualified retirement plan. The consequences of forming unreliable relationships fall on both the plan sponsor and the plan participants.

What to Look For

When a plan sponsor is seeking an advisor, one substitute for the sights, smells or sounds of a trusted advisor is to consider the academic and professional licenses held by the individual. However, unlike the legal, medical and accountancy professions, the investment advisory industry requires no defined criteria or specific educational requirements. Instead, a person can attain a license to sell investments or insurance products by qualifying for and passing one of the three licensing tests. Three of the most common securities licenses are:

- Insurance license, permitting the licensee to sell insurance products from authorized and regulated vendors;
- Stockbrokers, who are regulated by FINRA, hold a Series 7 license, which permits the licensee to sell stocks, bonds, mutual funds, etc., or a Series 6 license for which activities are limited to the sale of mutual funds and annuities; and

- Investment Adviser Representative (Series 65), which is regulated by US Securities and Exchange Commission (or, in the case of smaller firms, regulated by the state) and can provide investment advice on stocks, bonds mutual funds, etc.

The long-term value of relying upon the securities license is limited because once an individual becomes licensed as an Investment Adviser Representative, no formal continuing education or professional ethic updates are required.

Some plan sponsors rely upon the myriad of financial and professional designations that can be attained by financial advisors. There are more than 100 financial designations, most with at least academic or exam requirements but few providing ongoing oversight. The variety of professional designations, coupled with the lack of structured oversight among the designations, make it difficult for an investor to know who is qualified to manage money in any specific situation, including qualified retirement plans.

Within the unstructured context of the available designations, a person holding one or more of the following designations indicates that he or she is knowledgeable and has demonstrated commitment to the investment advisory profession:

- Certified Financial Planner ("CFP®") – advisers with three years of experience and a bachelor's degree, or five years of experience with no college degree. Requires passage of an exam, along with 30 hours of additional coursework every two years. [The CFP is conferred by the Certified Financial Planner Board of Standards, Inc. (CFP Board) in the United States.]
- Certified Financial Adviser ("CFA") – three six-hour exams, a bachelor's degree from an accredited institution and with four years of qualified, professional work experience. Must adhere to the CFA Code of Ethics governing their professional conduct. [The CFA is offered by the CFA Institute (formerly AIMR).]
- Certified Public Accountant ("CPA") – awarded by each state's board of accountancy requiring passage of the Uniform Certified Public Accountant Examination plus additional education (most states now require a masters degree) and experience requirements. A CPA can become a Personal Financial Specialist ("PFS"), a designation from the American Institute of Certified Public Accountants, by passing an additional exam. A minimum of 40 hours each year of professional education is required. CPAs must adhere to a strict Code of Ethics and Standards governing their professional conduct. [The Uniform CPA Exam is developed and maintained by the American Institute of Certified Public Accountants (AICPA) and is administered by the National Association of State Boards of Accountancy (NASBA).]
- Certified Investment Management Analyst ("CIMA") – two exams and independent study coursework is required. Three years of experience with no criminal history, regulatory violations, civil actions or formal customer complaints. [CIMA is conferred by the Investment Management Consultants Association (IMCA).]
- Chartered Financial Consultant ("ChFC®") – 75 hours of coursework and an exam on topics such as estates, taxes, portfolio management and financial planning. Commonly held by individuals working in the insurance industry. [The ChFC is conferred by The American College.]
- Accredited Investment Fiduciary ("AIF®") and Accredited Investment Fiduciary Analyst ("AIFA®") – focus on a comprehensive investment process, related fiduciary standards of care. Two-day course (one week of course work for the AIFA® designation), examination and ten hours of continuing education. [The AIF and AIFA marks are held by the Center for Fiduciary Studies, LLC, a Fiduciary360 (fi360) company.]

If a person holding one or more of the above licenses also obtains ASPPA's Qualified Plan Financial Consultant (QPFC) credential, that person shows a strong commitment not just to the investment consulting field, but also to the qualified plan industry. The QPFC credential focuses on plan design and consulting issues for qualified plans as well as fiduciary issues, investment issues and fee analysis. To obtain the QPFC, a candidate must pass two online open-book exams (unless waivers apply) and two proctored exams. QPFCs must also meet ASPPA's Continuing Professional Education requirements.

Is it Enough to Have a License or Professional Accreditations?

What a plan sponsor may not know is that the majority of those who hold themselves out as "financial advisors" or "financial planners" are not actually subject to a *fiduciary* obligation to the plan sponsor or plan participants[1]. Moving beyond the license and professional accreditations, the most important question a plan sponsor can ask of anyone offering to provide the plan with financial advice is, "Do you have a legal obligation to act in the best interests of the plan and its participants?"

What About Using a Standard That Transcends Licensing and Designations?

Under current rules, financial advisors operate under one of two broad standards of care: suitability standard and fiduciary standard. Plan sponsors and the investing public may not be aware of the difference and can be unpleasantly surprised to discover that the difference is significant.

Suitability Standard

This standard requires investment recommendations that are appropriate to a client's circumstances, without a requirement to put the client's interests first or an obligation to disclose conflicts of interest. Stockbrokers and insurance agents typically are held to the suitability standard. Even if this is disclosed, the stockbroker or insurance agent can sell products that maximize commissions if the product is suitable for the client, even though not in the client's overall best interest. This conflict is made clear if the financial advisor markets securities to a client that, although suitable, may primarily serve the interests of issuers rather than those of the client.

1 Investment Adviser Representatives have a fiduciary obligation to put their client's interests ahead of their own interests.

Fiduciary Standard

This standard obligates the advisor to act in the client's own best interest, not his or her own. Among the professional designations, Registered Investment Advisers are required to follow this standard. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) gave the Securities and Exchange Commission ("SEC") the authority to extend the fiduciary standard of care to brokers or dealers who give personalized investment advice to retail customers. The fiduciary standard would require broker-dealers to act in the best interest of their clients, a higher standard than the suitability standard.

What is a Fiduciary?

Even after the fiduciary standard is applied, the plan sponsor needs to know exactly what constitutes a fiduciary. The fiduciary role, as it currently exists, can be found in several areas, including the "common law," demonstrated by case law and the multiple state laws codifying the role of a fiduciary. Another source is federal laws such as the Investment Advisers Act of 1940 ("Advisers Act"), whose Section 206 prohibits an adviser from engaging in any practice that is "fraudulent, deceptive or manipulative," and federal litigation such as SEC v Capital Gains, which identified a duty to act with utmost good faith, full and fair disclosure of all material facts and reasonable care to avoid misleading clients.

In defining the fiduciary role, plan sponsors have a valuable ally in the Employee Retirement Income Security Act of 1974 ("ERISA"), which through statute, regulation and case law have created a fiduciary standard that is considered stricter than under the Advisers Act. For example, ERISA's Exclusive Benefit Rule under §404(a)(1)(B) requires a fiduciary to discharge his or her duties with respect to the plan *solely* in the interests of the participants and the beneficiaries. ERISA goes on to require that fiduciaries must use "the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims" (sometimes referred to as the "prudent expert rule").

Almost any person can be a fiduciary under the ERISA standard, including (depending upon state law) a bank or other financial institution. Regardless of whether the person or entity agrees to be a fiduciary, ERISA supplies a functional test, making a fiduciary anyone who: (i) exercises discretionary authority over the management of the plan or disposition of plan assets, or (ii) provides investment advice for compensation. In addition, ERISA provides that a plan sponsor and plan trustees are always considered fiduciaries to the related plan. The ERISA definition is a functional one, so even if a person is not specifically named in the plan document, he or she will be considered a fiduciary if he or she performs a fiduciary function.

Why a Plan Sponsor Should Engage a Fiduciary to Manage the Plan Investments

The plan sponsor is a fiduciary and therefore under ERISA must:

- Act solely in the interest of the plan participants and their beneficiaries;
- Carry out his or her duties prudently;
- Follow plan document unless inconsistent with ERISA;
- Diversify plan investments; and
- Pay only reasonable plan expenses.

Although fiduciaries are held to the standard of a knowledgeable investor, they are not required to have the experience or qualifications. The ERISA regulations state: "Unless they possess the necessary expertise to evaluate such factors, fiduciaries would need to obtain the advice of a qualified, independent expert." [DOL Reg. § 2509.95-1(c)(6)] In Liss v. Smith, the federal court said, "where the trustees lack the requisite knowledge, experience and expertise to make the necessary decisions with respect to investments, their fiduciary obligations require them to hire independent professional advisors."

Hiring a plan's investment advisor should be considered a fiduciary function. The process used for selection of the investment advisor should be documented. The advisor must be prudently selected and monitored, and the advice must be carefully evaluated before being relied upon. The courts have weighed in on this issue, as in Howard v. Shay, in which the court stated "The fiduciary must: (1) investigate the expert's qualifications ... (2) provide the expert with complete and accurate information ... and (3) make certain that reliance on the expert's advice is reasonably justified under the circumstances."

Asking Questions Permits the Plan Sponsor to Know

Plan sponsors need to have an adequate process and clearly document the selection and monitoring of advisers. In selecting service providers, the plan sponsor must engage in an objective process designed to assess the qualifications of the service provider, the quality of the work product and the reasonableness of the fees charged in light of the services provided. A plan sponsor demonstrates the deliberative process by asking questions that may be as broad as licensing, professional credentials, client references, past performance and fees. This process should also be as specific as the frequency of meetings, the level of errors and omissions insurance coverage. A plan sponsor can learn much from a financial advisor's sample documents, which may include a model Investment Policy Statement, a representative investment portfolio for a similar plan and a copy of recent quarterly reports. Finally, the plan sponsor can review the advisor at **www.sec.gov** and look at the investment adviser's: (i) ADV Part 1, (ii) ADV Part 2 and (iii) FINRA Broker Check Reports for firms and individuals.

What a Plan Sponsor Should Expect from the Investment Fiduciary

A plan sponsor is required to monitor the fiduciary to assure that the investment advisor is performing in accordance with the terms of the Investment Advisory Agreement. The plan sponsor should also establish a formal review process and monitor the fiduciary to assure the agreed upon services are being provided.

The Investment Advisory Agreement should clearly establish if the investment advisor is a "Limited Scope" fiduciary under ERISA §3(21), which requires the fiduciary to: (i) have a written agreement, (ii) render advice for a fee and (iii) select & monitor investments, but does not provide the investment fiduciary with investment "discretion." The limited scope fiduciary is contracted with the role of "Investment Manager" as that term is defined in ERISA §3(38) as a fiduciary who: (i) manages investments and is *solely responsible* for the selection, monitoring and replacement, (ii) acknowledges fiduciary status in writing and (iii) must be a Registered Investment Adviser, bank or insurance company.

What Should a Plan Sponsor do if a Fiduciary Fails to Perform His or Her Duties?

The plan sponsor should review, on a periodic basis, the performance of the plan's service providers to ensure that they are providing the services required by, and at a cost consistent with, the agreements. Part of this process involves reviewing participant comments or any complaints about the services. If there is a problem with a fiduciary, the plan sponsor, as the plan fiduciary, is compelled to act and is breaching its own fiduciary obligation by not doing so.

For example, the Employee Benefit Security Administration (EBSA) of the DOL monitors plan fiduciaries and advised in the case of the Madoff scandal that sponsors "… should address [potential Madoff-related losses] in a manner consistent with their fiduciary duties of prudence and loyalty to the plan's participants and beneficiaries." This recent statement further underscores the duty of a plan sponsor to be both involved in monitoring its appointed fiduciaries and active in correcting or replacing plan fiduciaries that fall short of their obligations.

The widespread increase in class actions and litigation involving corporate employee benefit plans reinforces the need for plan sponsors and fiduciaries to be vigilant in ensuring that employee benefit plans, and the governance of those plans, comply with ERISA, securities laws and tax laws. For example, the DOL recently brought suit against a business owner for failure to carry out his fiduciary duty to *monitor* the service provider of the company's 401(k) plan, in violation of ERISA. "Company executives are obligated by law to properly monitor the actions of those who provide services to employee benefit plans and to deter preventable losses to plans," said Paul Baumann, director of the Cincinnati Regional Office of the EBSA, which conducted the investigation leading to the EBSA lawsuit.

So, How Does a Plan Sponsor Know?

Obtaining financial advice for a retirement plan is not a "fire-and-forget" exercise in which the plan sponsor can be diligent in the selection process and detached thereafter. As President Reagan noted in his description of the Strategic Arms Limitation Treaty, a prudent person learns to "trust, but verify." A plan sponsor who first learns what to look for, and then follows President Reagan's adage throughout the selection and retention process and ongoing monitoring of the plan's financial advisors, will come to know what is best for the plan and its participants. Like in most human relationships, however, such knowledge is a process and not an event. For plan sponsors, a well documented process and monitoring of the investment advisor provides a level of risk management in these litigious times.

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