How Financial Advisors Can Use the New 401(k) Advice Rules to Their Competitive Advantage

By Ary Rosenbaum, Esq.

Years ago, the term retirement plan financial advisor was a vague term and really didn't mean that the advisor had any retirement plan knowledge. The term could have fit the broker who had a just a handful of retirement clients, who rarely saw or serviced the clients, and got an extra trail of basis points for recommending a specific platform or set of investments. While this practice felt short of what a retirement plan advisor was supposed to do, it was tolerated as long as the stock market was booming. Thanks to a lost decade for investing and the retirement crisis that a flat stock market has created, the Department of Labor (DOL) has tried to change the role of retirement plan advisors and make sure that they fulfill a role to help 401(k) plan participants and help limit a plan sponsor's liability in the fiduciary process of selecting plan investments.

This is why the DOL has asked on plan audits for the investment policy statement (IPS) that too many plans don't have and why they have tried to change the definition of fiduciary to make sure that all financial advisors who work on retirement plans have the same duty of care to the plan they work on. This is also why the DOL has recently implemented regulations that created an exemption on 401(k) advice so that plan providers could offer it without creating a prohibited transaction.

Before the new regulations, which are effective on Dec. 27, 2011, 401(k) retirement plan providers could not give advice to participants so either the provider or the plan sponsor was required to hire an independent provider to provide advice. That's because ERISA (the Employee Retirement Income Security Act) prohibited advisers from recommending investments to plan participants. Advisors have been able to provide investment education consisting of generic asset allocation models that are not tailored to a particular individual. So advisors could give education, but not advice. This was to avoid conflicts of interest because some advisors were receiving extra compensation by pushing specific investments. There was also concern about bundled providers namely mutual fund companies like Fidelity, Vanguard, and T. Rowe Price who were paid for plan administration but also were deriving revenue from their mutual funds that they offered on the investment menu for the plans they administered.

The reason for this rule change by the DOL is rather simple. Only the largest retirement plans could have afforded to hire independent third party providers to give individual investment advice to participants. So participants of smaller to medium sized plans didn't get advice which is a problem since they were the most likely ones making the investment choices in their 401(k) plan. The DOL claimed that there was evidence that many participants in these retirement accounts make costly investment errors because of flawed information or reasoning. They often don't optimize their investment mix in accordance with generally accepted financial theories. I'll never forget the one former co-worker who put all his money in the mid-cap fund our 401(k) plan has because it was the middle of the market. This is a reason why the DOL felt it had to do what it had to do.

This rule change is a win-win for almost everybody. For the 401(k) participant, they will get much needed investment advice to help them in their selection of their plan investments (when they have that role in their plan). It will also be a coup for 401(k) plan sponsors as more educated participants will probably lead to less litigation against them for losses from participant direction,. In addition, it is a plus for financial advisors who take their role as a retirement plan advisor seriously because the addition of being able to provide advice can augment their practice and allow them to stand out among the competition. A retirement plan advisor who understands the change that is going on in their industry can use that to their own advantage.

The statutory exemption created by the DOL allows investment advisers to receive compensation from investment options they recommend if either (1) the investment advice they provide is based on a computer model certified as unbiased and as applying generally accepted investment theories, or (2) the adviser is compensated on a "level-fee" basis (i.e., fees do not vary based on investments selected by the participant). While it seems easy for a financial advisor to comply with either prong of the exemption, it is not as the DOL estimates that compliance with this exemption will be $2 to $5 billion, with much of it coming from auditing and expert fees.

The final regulation provides detailed guidance to advisors on how to comply with the conditions of this exemption. First off, the regulation requires that a plan fiduciary (independent of the investment adviser or its affiliates) authorize the advice arrangement. It also imposes extra recordkeeping requirements for investment advisers relying on the exemption whether they select the level fee or computer model option. It also imposes the duty of a being a fiduciary financial advisor for the advisor who abides by this exemption, so any financial advisor needs to ensure whether their errors & omissions carrier allows them to be considered a fiduciary, especially if the advisor is employed by a broker-dealer.

If an investment advisor chooses an arrangements utilizing a computer model must ensure, that the model is designed and operated to apply or account for: generally accepted investment theories; investment management and related fees; personal information, to the extent provided, from participants; objective criteria to provide asset allocation portfolios; appropriately weighing factors used in estimating future returns; and avoiding recommendations that inappropriately favor options offered by the fiduciary advisor or that generate greater income for the fiduciary advisor. The computer model will require a written certification from an eligible investment expert (as defined under the regulations) that the computer model satisfies the regulatory requirements

If the investment advisor is using the fee-leveling choice of the exemption require that fees or other compensation for investment advice or investment activity received directly or indirectly by an employee, agent or registered representative who provides advice on behalf of fiduciary adviser; or by the fiduciary adviser may not vary depending on the investment option selected by participant. So a financial advisor who charges a flat fee or a flat advisory fee (regardless of the investment) will have an easier time to comply than the broker who has been receiving different levels of remuneration for different securities they sell.

Regardless of the approach that the financial advisor chooses, the regulations also require the fiduciary advisor to (1) engage an independent auditor, at least annually, to audit the investment advice arrangement, and within 60 days of the audit, issue a written report to the fiduciary advisor and each fiduciary authorizing use of the arrangement; and (2) provide certain written disclosures to the participants and beneficiaries, without charge (the rules contain a model disclosure form).

The costs to provide financial advice under this exemption can be prohibitive and the regulations make it clear that there is no obligation on a plan fiduciary to offer, provide or otherwise make available any investment advice to a participant. So while a financial advisor does not have to offer advice to plan participants because of its cost, an advisor should make that option available as a marketing tool to maintain and increase their base of retirement plan costs. So if an advisor cannot afford to abide by this exemption, a financial advisor would be wise to use the way advice was used before these new regulations, by having a third party perform that function. Using an on-line advice tool company like the folks at rj20 (rj20.com) can make sure that the financial advisor is getting participants the financial advice they need to make informed investment decisions. This will help participants get a better return on their retirement savings as well as help plan sponsors minimize their potential liability for sponsoring a participant directed plan.

Regardless of the approach a financial advisor takes, it would smart for them to seize the opportunity that this new regulation gives them in letting them stand out among the competition. Things that come to those who wait were left there by those that got there first. Whether a financial advisor decides to offer advice themselves or engage the services of a third party, the use of financial advice is a win-win for all the parties involved (plan participants, plan sponsors, and financial advisors.

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