The Role of Investment Consultant

Defined Benefit Plans

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ZINGLE AND ASSOCIATES, INC.

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How to achieve superior investment results with less risk and smaller expense loads?

There probably isn't a pension investment professional alive who hasn't thought long and hard about that since 2008. Many pension plans have positioned and repositioned themselves since then. Some also have considered the role of the investment advisor or consultant, a topic explored by this paper.

Although the following pages will not turn you into an expert, we trust this report will reveal both opportunities and risks associated with the position of investment consultant. If you are interested in learning more about this evolving subject, we would like to hear from you.

1. BACKGROUND

Defined benefit plans accumulate assets which are not allocated to individual participants. In fact, it is the employer, not the participants, who reaps the benefit of superior investment performance, and who suffers the consequence of underperforming plan assets.

The Issue

Since the market crash of 2008-2009, most employers have sought to reposition their pension investment portfolios. They wish to take advantage of attractive returns, but want to protect their plans from future uncertainties. Additionally, there is the inevitable danger of inflation which is sure to return at some point.

The result in some plans has been an unusually high degree of cash flow volatility. This can be particularly acute among small plans, including:

- Uncertainty: Both high gains and high losses, depending on the year and industry sector.
- Expense load: Significant plan expenses associated with investment fees and functions associated with them.
- Liquidity needs: Unpredictable lump sum distributions triggered by early retirement or looming deferred retirement among key participants.

The Opportunity

Consequently, trustees of some plans consider it both necessary and prudent to formalize the function of investment advice and consultation. This function is separate from investment management concerning trades and administration. Since defined benefit plans are responsible for investment risk, it is common for them to secure the investment services of brokerage firms, insurance companies, banks, trust companies, mutual fund families, financial planning firms, and other entities offering their investment services. According to the Foundation for Fiduciary Studies, "the overwhelming majority of the nation's pension plans, foundations, endowments, private trusts, and wealthy families are advised by investment consultants." [Press release, January 16, 2004]

Those who represent these service providers use such varied titles as advisor, consultant, financial consultant, stockbroker, insurance agent, financial planner, registered representative, vice president, and others. For consistency reasons, this paper will refer to the duties of such service providers and the persons representing them as investment consultant ("Consultant").

Many plan documents allow such formalization, and permit the plan to hire an investment consultant, as it does for legal counsel, actuarial, and plan administration services. The function of investment consultant is subject to the Employee Retirement Income Security Act of 1974 ("ERISA"), and the terms of the Plan document also should provide structure and limitation on such function.

2. ERISA

Market Breakdown

Investment consultants tend to fall into three general categories concerning their degree of fiduciary responsibilities under ERISA. In practice, significant differences can be found among fiduciary and non-fiduciary investment consultants. What's more, those differences can directly affect a plan's solvency, return, and liquidity on behalf of its participating employees.

- Those who do not acknowledge any such responsibility.

  These non-fiduciary consultants have no legal duty to put plan participants' first. Consequently, industry practices allow non-fiduciary consultants to collect revenue sharing payments (sometimes negatively referred to as "pay to play"). Actions of certain investment consultants in this category were the subject of a Securities and Exchange Commission investigation concerning the possibility of compromised objectivity.

- Those who acknowledge such responsibility under §3(21)(A).

  Other investment consultants acknowledge ERISA §3(21)(A) fiduciary responsibilities, but are not held to them contractually. Consequently, these consultants are not required to act with respect to the plan in the following ways under ERISA:

  1. Exercises discretionary authority / control respecting management of the plan or disposition of plan assets. [§3(21)(A)(i)]
  2. Compensated to render investment advice respecting plan assets, or has the authority / responsibility to do so. [§3(21)(A)(ii)]
  3. Has discretionary authority / responsibility for plan administration. [§3(21)(A)(iii)]

- Those who acknowledge fiduciary responsibility under §3(38) ("investment manager") and §405(d)(1) ("independent fiduciary").

  Consequently, they legally must act with the sole purpose of benefiting the plan participants and beneficiaries.

  Note that plan fiduciaries – for example, the plan trustees – continue to be responsible for overseeing plan investment options and investment consultants. These are duties that no fiduciary can transfer. ("A fiduciary shall discharge his duties solely in the interest of the participants and their beneficiaries for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan." [ERISA §404(a)(1)(A)(ii)])

An additional consideration is the U.S. Department of Labor (DOL). According to DOL Reg. 3.21(c), a person gives fiduciary "investment advice" only when both of the following are true:

- Recommends purchase and/or sales of securities.
- The advice is individualized and based on the particular needs of the retirement plan.

(Under ERISA, fiduciary investment advice is deemed given when it pertains only to recommendations concerning *investments,* not investment *managers*. In this way, there is no "investment advice" if a person recommends *only* investment managers.)

3. PROHIBITED TRANSACTION RULES

Internal Revenue Code

Under the Internal Revenue Code, it is a prohibited transaction for a disqualified person to receive consideration for his own personal account from a party dealing with the plan in connection with a transaction involving plan income or assets [ERISA §406(b)(2)]. For this purpose, "disqualified person" includes a fiduciary (a) with discretion over plan administration or asset disposition, or (b) who is compensated for rendering investment advice to the plan.

Pension Protection Act of 2006

Beginning in 2007, the Pension Protection Act of 2006 (PPA '06) exempts from the prohibited transaction rules certain "fiduciary advisers" providing investment advice under an "eligible investment advise arrangement". [IRC §4975(d)(17) and §4975(f)(8)]

- In order to qualify as such an arrangement, fees (including commissions or other compensation) received by the fiduciary for investment advice must not vary depending on the basis of any investment option selected. As an alternative, a detailed computer model may be constructed to accomplish the same thing.
- Generally, as defined by law a fiduciary adviser is (a) a registered investment advisor, (b) a financial institution, (c) an insurer, (d) an SEC-registered registered broker or dealer, or (e) an employee or affiliate of one of them. [IRC §4975(f)(8)(J)(i)].

4. U. S. DEPARTMENT OF LABOR

Consultant / Adviser Project

The most recent national focus of the DOL's EBSA division is called the Consultant / Adviser Project. Its focus is the receipt of improper, undisclosed compensation by pension consultants and other investment advisors. Investigations will seek to determine whether the receipt of such compensation violates ERISA because the advisor / consultant used its position with a benefit plan improperly to generate additional fees for itself or its affiliates. In doing so, EBSA has indicated that it may need to investigate individual plans in order to address such potential violations as (a) failure to adhere to investment guidelines,

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and (b) improper selection or monitoring of the consultant or advisor.

Identification of potential criminal violations, such as kickbacks or fraud, will also come within the scope of the project. While such strategies appear to result from improperly maintained defined contribution plans, defined benefit plans are not exempt from review, either.

[Source: http://www.dol.gov/ebsa/erisa_enforcement.html].

5. Fundamental Distinction

Letter Ruling 9252029

A fundamental distinction exists according to Letter Ruling 9252029:

- Brokers' fees are directly related to the purchase of an asset and thus are considered part of the cost of the securities.

- Investment consultants' fees (as well as legal, accounting, and trustee fees) are recurring administrative expenses which do not vary with the number or volume of investment transactions.

It is possible for an advisor who is a fiduciary also to be compensated for trades. In that event, the plan must address possible conflicts of interest.

6. Conclusion

There can be opportunity and benefits associated with an investment consultant. However, plan executives should be careful to watch out for the pitfalls. In particular, plans must take precautions to avoid a prohibited transaction if advisory remuneration is paid to a disqualified person. As well, accountability metrics are a good idea.

Above all, decision makers must keep abreast with legal changes and trends, both before and after establishing an investment consultant role. Finally, a second opinion is always a good idea before launching something this significant. We would be pleased to discuss the matter with you.

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We would be pleased to hear from you by contacting us as shown below.