

# ADVISOR REPORT

A NEWSLETTER FOR RETIREMENT PLAN ADVISORS

## Message From The Firm

Welcome to the first edition of our Advisor newsletter.

This newsletter is written for retirement plan advisors, such as investment advisors, financial advisors (i.e., brokers), and consultants. The purpose of the newsletter is to provide timely information to advisors, together with legal and practical commentary to help them in their work with plan sponsors and fiduciaries.

However, while this newsletter is written from the perspective of the advisor, the information is also valuable to plan sponsors, fiduciaries, benefits attorneys, providers, and others in the 401(k) community. (Our primary focus will be on 401(k) and other participant-directed plans—like 403(b)s and 457s, but we will also, from time to time, comment on significant issues for other types of retirement plans.)

In our view, the advisor community is maturing—in the sense that most plan sponsors already have experience with 401(k) plans. As a result, they are looking for help from advisors who are knowledgeable about the investment, design and operation of 401(k) plans. In other words, plan sponsors are “forcing” the advisor community to bring greater expertise and consulting to the table. That means that advisors need to see themselves as plan consultants, with their investment knowledge being just one part of the equation.

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## Safe Investments: Part 1



By Fred Reish ([FredReish@Reish.com](mailto:FredReish@Reish.com))

The Department of Labor has completed drafting a proposed regulation to create a fiduciary safe harbor for default investments.

“Default” investments are used where participants fail or refuse to direct the investments of their accounts. Under ERISA’s fiduciary responsibility rules, if a participant does not direct the investment of his account, the fiduciaries are duty-bound to prudently invest the money on behalf of the participant. To simplify that process, the 401(k) community has come up with the concept that a plan would have a default investment choice, which is used for any and all participants who do not direct their investments.

The most common default investment is a money market account. Unfortunately, in most cases it is arguable that the fiduciaries who use a money market account are breaching their responsibilities under ERISA, since a default investment must be consistent with the plan’s purpose of providing retirement benefits. Arguably, a money market account is not a prudent vehicle for long-term investing. That is because, due to the low rate of return, participants would have a difficult time accruing sufficient retirement benefits.

Further, ERISA’s investment principles are based on modern portfolio theory, which contemplates the use of a variety of investments, including equities, bonds, and cash, to create a balance of risk and reward. A money market account, standing alone, is obviously inconsistent with that principle.

While the DOL proposed regulation has not yet been released for comment (but is anticipated to be in the next 30 to 60 days), our understanding is that the Department will create a fiduciary safe harbor where a plan uses a multi-asset class vehicle as the default investment for a plan. Those vehicles would include, for example, age-based lifecycle funds, risk-based lifestyle funds, age- or risk-based asset allocation models, managed accounts, and balanced funds.

In a sense, fiduciaries who had previously used a money market default account are being told that, if they do not put the participants’ money at risk (that is, with some allocation to stocks), then the fiduciaries will be at risk. Correspondingly, if fiduciaries put the participants at risk in a proper way (for example, through a multi-asset class vehicle), then the fiduciaries will not be at risk.

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## Advisor Do's and Don'ts



By Bruce Ashton ([BruceAshton@Reish.com](mailto:BruceAshton@Reish.com))

This will be a recurring column. We will address practices we believe advisors should adopt – the “Do’s” – and others they should avoid – the “Don’ts.” Our focus will be on issues arising under ERISA and generally will not touch on investment or securities law matters, except to the extent they are relevant. In this column, we discuss issues we have dealt with in drafting service agreements for brokers, broker/dealers and RIAs; and we divide our comments between situations where the advisor takes on a fiduciary role and those where they don’t.

**Do #1:** Whether you are a financial consultant/broker or investment advisor, you should have an agreement (or letter or memo) with your fiduciary client that explains your services.

For fiduciaries: If you act as a fiduciary for the plan (for example, an investment advisor), you should separately describe the services for which you are acting in that capacity and those that are not fiduciary services. For example, if you advise on the selection of the investment options from the provider platform, that is often a fiduciary function. If you are conducting enrollment or educational meetings – but are not giving advice to the participants about how to allocate their accounts – those are non-fiduciary activities.

For non-fiduciaries: Even if you don’t act as a fiduciary, you should still have an agreement. Among other things, it should say that you are not taking on a fiduciary role and should explain your services in a way to support that.

**Don’t #1:** Don’t over-state your role. For fiduciaries: Under ERISA, you can

be a fiduciary for some purposes but not others – e.g., a fiduciary for dealing with investment issues but not for purposes of administering the plan. So don’t just say you will serve as a fiduciary. For example, your agreement could say that you are a fiduciary only for the purpose of advising on the selection and monitoring of the mutual fund investments options, but that you are not a fiduciary (*i.e.*, do not provide advice) for company stock or individual brokerage accounts. An agreement could provide that you give plan-level advice, but not participant-level advice. The key is that you clearly state what you do and don’t do.

For both: In all events, whether or not you are a fiduciary, don’t say that you will “oversee all aspects of the plan’s investments” unless you actually do that.

A well-crafted service agreement may be the best tool for managing your risk – regardless of whether or not you are a fiduciary. ❖

## Excessive Commissions

By Fred Reish ([FredReish@Reish.com](mailto:FredReish@Reish.com))

On May 15th, a NASD arbitration panel awarded \$22,000,000 to retired Exxon Mobil employees in a matter related to excessive compensation and variable annuities and B-share and C-share mutual funds.

Based on reported stories, the commissions in the variable annuities were 5% and higher and, of course,

the commissions in the B-share and C-share mutual funds were higher than other share classes (and apparently were inappropriate for the particular situation).

The employee money resulted from distributions from the Exxon Mobil Thrift Plan and Defined Benefit Pension Plan.

While the arbitration was apparently decided on issues related to the securities laws, there would also be significant issues under the tax laws for investment advice for individual

retirement account and individual retirement annuities. While it is not well known, the prohibited transaction rules under the Internal Revenue Code would preclude an advisor from giving fiduciary investment advice to an IRA which resulted in the advisor, in effect, setting his own compensation. That would typically occur where the advisor would make recommendations that would impact the level of the advisor’s compensation. We will discuss this issue in future newsletters. ❖

# Disclosure of Fees



By Fred Reish ([FredReish@Reish.com](mailto:FredReish@Reish.com))

The DOL is working on a regulatory project, the so-called “408(b)(2) project,” to require full disclosure of fees and expenses by advisors and plan providers. It is possible that a proposed regulation, together with a disclosure form, could be published by the end of this year.

Our understanding is that the disclosure requirements would apply equally to all advisors and providers, regardless of whether their investment products are otherwise governed by the securities laws, insurance laws, or banking laws. We also understand that the disclosures would need to be provided, reviewed and approved by the plan’s fiduciaries prior to or at the point of sale. That is, the disclosure would need to be made before the plan sponsor/fiduciary agrees to “purchase” the package of investments and services.

With regard to advisors, we expect that the proposed regulation will require disclosure of all sources of compensation (including any items of value), whether direct or indirect. That is, advisors will have to disclose everything that they are receiving that is in any way, directly or indirectly, fixed or contingent, related to the sale of investments to the plan. For example, that might include finder’s fees, expense reimbursements, allowances, bonus payments, and so on.

Similarly, providers (such as recordkeepers) will need to disclose all revenue and other consideration, including revenue sharing.

Under the current state of the law, fiduciaries are required to obtain, understand and evaluate all of that information. However, ERISA does not impose a corresponding duty of disclosure on advisors—and particularly non-fiduciary advisors and consultants—on providers.

While this will be a dramatic change for some advisors and providers, our belief is that full disclosure will ultimately benefit high quality advisors and providers. Further, we believe that it will accelerate the trend towards specialization among advisors because it will require greater knowledge and understanding of the marketplace and will impose additional compliance complexity.

While additional compliance burdens may have some negative aspects (such as adding some expense), we believe that, in the aggregate, the news is good. That is because, when equipped with better information, fiduciaries will be in a position

## Lifetime Achievement Award

Each year the editors of PLANSPONSOR magazine acknowledge significant individual career contributions to the field of employee benefit plans with its Lifetime Achievement Award. Lifetime Achievement Award recipients will have demonstrated a commitment that both sustains and expands the ability of employee benefit plans to serve the national interest in providing employee benefit plans in the workplace through:

- thought leadership,
- a demonstrable expertise in both the technical nuances and practical application of that knowledge, and
- a willingness to share those ideas and expertise with the employee benefits community at large.

In bestowing this year’s award to Fred Reish, managing director and partner of the Los Angeles-based law firm of Reish Luftman Reicher & Cohen, PLANSPONSOR Editor-in-Chief Nevin Adams noted, “Fred has been teaching me—and the industry—about ERISA for longer than any of us probably want to admit. Fred is, of course, a prodigious writer—four books and a conservatively estimated 250 articles, and he generously shares his thoughtful expertise with the industry at large on a regular basis.”

“In fact,” Adams noted, “I am persuaded that he is the most-quoted ERISA expert of our time.”

Also acknowledged this year with PLANSPONSOR’s Lifetime Achievement Award was GM Asset Management Corp.’s President and CEO Allen Reed.

Previous award recipients include Dallas Salisbury, President and CEO of the Employee Benefit Research Institute (EBRI) and Bob Reynolds, Vice Chairman and Chief Operating Officer of Fidelity.

### Message from the Firm

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*Through this newsletter, we hope to contribute to the advisor community by discussing a wide range of plan investment, design and operational issues, including issues that affect advisors directly, as well as ideas for successful plans. With the help of the advisor community, we can accomplish that. Please give us your ideas on how we can help. Working together, we can improve the retirement benefits for working Americans.*

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## Safe Investments: Part 2



By Fred Reish ([FredReish@Reish.com](mailto:FredReish@Reish.com))

As Part 1 of this article (earlier in this newsletter) explains, fiduciaries will be given a safe harbor for the use of multi-asset class investment vehicles where participants do not direct the investment of their 401(k) money. (As explained in Part 1, examples of multi-asset class investments would include age-based lifecycle funds and models, risk-based lifestyle funds and models, managed accounts and balanced funds.)

We believe that the initial consequence of the new guidance will be to increase the use of multi-asset class investments for default accounts. We also believe that, once fiduciaries become familiar with the legal benefits of safe harbor

default accounts, they will embrace the concept of default accounts generally—in order to expand their protections under the safe harbor concepts. As a result, we anticipate that plan sponsors will embrace the concept of allowing employees to default, rather than encouraging them to direct their investments. After all, fiduciaries will be protected in safe harbor defaults, but will not have the same level of protection for participant-directed investments (unless a plan complies with the 20 to 25 requirements in the 404(c) regulation).

Fiduciaries may even manage the plan in a way that increases the use of the default investment by participants. For example, when fiduciaries change providers, they may map the funds to the new provider in a way that encourages

safe harbor default investments. In that situation, the fiduciaries could require that, unless the participants direct the investments in the new options prior to the conversion, the participants will be “defaulted” into, for example, age-based lifecycle funds or into managed accounts. In addition, fiduciaries may work with their advisors and providers to re-design their enrollment forms so that those forms provide that, if a participant does not direct the investment of his account, the plan will place them in a safe harbor “default” investment vehicle.

In other words, we believe that many fiduciaries will look for ways to increase the use of multi-asset class investing for their participants, while also protecting themselves through the use of the safe harbor concept.

The role of advisors will be to understand these rules and opportunities and to educate the fiduciaries on their benefits. ❖

## Personalized Retirement Advice and Managed Accounts

Behavior finance research can be invaluable in understanding participant-directed retirement plans. To that end, our firm is supportive of behavioral finance research by academics concerning investment behavior in participant-directed plans, such as 401(k) plans. For example, we support the research of Professor Shlomo Benartzi, a leading academic in behavioral finance at UCLA.

Additionally, we have established a library on our web site of significant studies into participant behavior. The most recent addition to that library is a paper by Julie Agnew of William & Mary entitled “Personalized Retirement Advice and Managed Accounts: Who Uses Them and How Does Advice Affect Behavior in 401(k) Plans?”

In part, the abstract for the study describes the work as follows:

“This paper investigates two methods for improving participants’ asset allocations in their 401(k) plans: personalized online advice and managed account services. . . Preliminary results suggest that online advice and the managed account service appeal to different populations. Managed accounts tend to be attractive to individuals across most demographic groups, while online advice appeals more to higher salaried, full-time workers. . . Finally, although a causal relationship cannot be determined, trading activity is higher for those using the online advice system compared to those who do nothing.”

Professor Agnew contemplates additional research about how portfolio allocations and trading are influenced by the use of the two systems.

As a comment, it appears to us that the research suggests that online advice is used by more sophisticated and motivated investors, perhaps for investment ideas and for validation, as well as for the advice itself. On the other hand, managed accounts appear to have more universal appeal to participants. From a legal perspective, when management services are implemented by participants, the primary plan fiduciaries receive substantial protection under ERISA’s rules.

A copy of the study is located at [www.reish.com/practice\\_areas/empbenefits.cfm#row1](http://www.reish.com/practice_areas/empbenefits.cfm#row1).

## Investments: Part 1

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Of course, fiduciaries will need to prudently select and monitor the default investment—as they currently have to do with every investment in the plan. However, once prudently selected, fiduciaries will be able to invest the participant default accounts with safe harbor protection.

We believe that, once fiduciaries understand the value of a fiduciary safe harbor, they will nearly universally embrace the concept and, within a short period of time, multi-asset class investments will become the default investment for almost all 401(k) plans.

At this point, advisors should work with all of their plan sponsors and fiduciaries to ensure that plans have appropriate safe harbor investment vehicles. That is,

the multi-asset class vehicles should be reasonably priced and should be based on generally accepted investment theories, such as modern portfolio theory, strategic asset allocation, and so on. ❖

## Disclosure of Fees

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to make informed and prudent decisions on behalf of their participants—thereby driving down plan expenses and increasing participant investment earnings.

From the advisors' perspective, we recommend that, if they are not already using disclosure forms, they should be created and put to use immediately. If an advisor is already using a form, it should be reviewed to ensure reporting of all sources of revenue and other consideration. ❖

## Lawyers Honored in the Best Lawyers in America

Fred Reish and Bruce Ashton were recently selected by their peers for inclusion in *The Best Lawyers in America 2007*. Celebrating over 20 years of research and publication, *The Best Lawyers in America* has been regarded as the preeminent referral guide for the legal profession. The lists are compiled through a confidential peerreview survey in which thousands of lawyers in the U.S. evaluate their professional peers.

## Around the Firm

**Speeches:** In May, Fred Reish presented "Where Are We Going? The Retirement Industry Five to 10 Years From Now" to the AIF/ AIFA Conference in Savannah. In June, Nick White co-presented "It's Finally Here! EPCRS Updated: Employee Plans Compliance Resolution System (EPCRS) Revenue Procedure 2006-27" as part of the ASPPA 2006 Webcast Series. In July, Fred presented "Top Fiduciary Issues in 401(k)" at the Western Benefits Conference in Las Vegas. In addition, Nick presented "Case Studies in Correction Under EPCRS- Practical Advice from the Experts" at the conference.

**Quotes:** Fred was quoted in the July article "Fiduciary Protection: It's All About Documentation" in PlanSponsor.com. Bruce Ashton and Fred were quoted in the article "Fiduciary Focus: Non-Fiduciary Investment Consultants" in Morningstar.com.

**Articles:** Fred's column in the June issue of *Plan Sponsor* magazine addressed the topic "The Starting Point: A Shift in Focus for the 401(k)."

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