Avoiding conflicts of interest as your business grows

By Marcia S. Wagner, Esq.

Cross-selling can be an effective means to growing a firm's retirement business, largely because selling new services to existing clients is easier and less costly than approaching new clients. Accordingly, many financial advisors that sell both retirement and nonretirement products and services are prospecting for new retirement plan business from their existing nonretirement client base. In addition, financial advisors at investment and service providers to defined contribution (DC) plans are cross-selling these and other related services to their existing plan clients.

Cross-selling can be an especially effective way to gather assets in the rollover IRA market. In fact, a number of retirement plan providers are making an organized push to capture rollover business in light of the unprecedented number of Americans retiring, many of whom have yet to take a distribution from their 401(k) plan accounts. The U.S. Department of Labor is also scrutinizing the manner in which advisors to DC plans are cross-selling their firms' IRA products and services.

Cross-selling practices by their nature create potential conflicts of interest. From a policy perspective, it is easy to see the potential abuse that can arise when a financial advisor exploits the trust it has developed with a client through a longstanding relationship in order to sell additional products and services at unfavorable terms to the client. However, in the context of retirement plans, the potential for abuse is even greater because individual plan participants (and not merely the plan sponsor) can be harmed. In theory, a plan sponsor could agree to investments or services that result in excessive fees for plan participants in order to secure for itself free or discounted services or other personal benefits from the plan's provider.

The fiduciary standards under ERISA, which include prohibitions against transactions involving conflicts of interest, are regarded as "the highest known to the law." [*See* Donovan v. Bierwirth, 680 F.3d 263 (2d Cir.), *cert. denied*, 459 U.S. 1069 (1982).] The cross-selling practices of fiduciaries and nonfiduciary parties alike must comply with the strict requirements of ERISA to the extent any of the applicable services directly or indirectly involve plan assets.

Best practices concerning IRA rollover advice. If an advisor is not providing "investment advice" or any other fiduciary investment services for the plan or its participants, the advisor is permitted to provide advice and recommendation to participants regarding when they should take distributions from the plan and how they should invest the proceeds in an IRA outside of the plan. However, ERISA's conflict of interest rules prohibit an investment professional advising a plan sponsor or plan participants from recommending an IRA that will generate fees or other compensation for that investment professional. Such an advisor may provide investment education about availability—not advisability—of a rollover, even if the advisor will earn fees or other compensation from the participant's rollover IRA assets. This approach of restricting services to investment education about rollovers would be consistent with the guidance under DOL Advisory Opinion 2005-23A and Interpretative Bulletin 96-1.

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Therefore, if an advisor is already providing investment advice to a retirement plan sponsor or participants, the advisor cannot recommend an affiliated IRA. However, the advisor could educate (and not advise) participants with respect to rollovers in general and describe the ability (and not advisability) to withdraw funds from the retirement plan and to roll them over into affiliated and nonaffiliated IRAs generally. As a best practice, the advisor should also disclose to the participant that if a participant elects to contact the advisor after taking a distribution from the plan, the advisor may recommend IRA investments to the participant for which the advisor will receive fees or other compensation.

In the DOL's interpretive bulletin relating to participant education, the Department has indicated that certain information and materials are not "advice" or "recommendations." This includes information regarding the terms of the plan, for example, and the circumstances under which the plan allows distributions. It also includes information relating to the benefits of plan participation and the impact of preretirement withdrawals on retirement income. To avoid providing "investment advice" to a participant with regard to IRA rollovers, the key would be to avoid any reference to a proper or desirable course of action, including the appropriateness of any particular investment option. Although an advisor would be prohibited from making a "hard sell" to participants, a neutral presentation of rollover investment information may be appreciated by many participants.

The current DOL guidance does not specifically state whether an advisor can present asset allocation models that are available outside the plan. Obviously, this would assist the participant in assessing whether he or she should take

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a distribution in order to access such investment alternatives. This would be particularly true for a participant nearing retirement if the model portfolios are for hypothetical individuals with a short time horizon. This should not be treated as a recommendation or advice, provided that the model is accompanied by a statement that other investment alternatives with similar risk and return characteristics may be available and the advisor identifies where the participant may find information on other investment alternatives. Staying out of trouble requires an advisor to avoid making a recommendation, and the best way to do this is to make a balanced and neutral presentation.

DOL/SEC's tips for reviewing conflicts of pension consultants. When considering or implementing policies and procedures to address cross-selling practices and the related conflicts of interest, it may be helpful to bear in mind the guidance provided by both the DOL and the U.S. Securities and Exchange Commission (SEC) with respect to pension consultants and their potential conflicts.

In a joint release published on June 1, 2005, the DOL and SEC issued a fact sheet of "tips" to help plan fiduciaries determine if pension consultants have conflicts of interest when it comes to advising the plan. The tips comprise 10 questions that plan fiduciaries should ask to assist them in evaluating the objectivity of the recommendations provided by a pension consultant. Below are questions that plan sponsors can ask pension consultants (as well as any other plan providers) with respect to conflicts and indirect compensation. Providers should be prepared to answer and address these types of inquiries from plan clients.

1. Are you registered with the SEC or a state securities regulator as an investment advisor? If so, have you provided me with all the disclosures required under those laws?
2. Do you or a related company have relationships with money managers that you recommend, consider for recommendation, or otherwise mention to the plan for our consideration? If so, describe those relationships.
3. Do you or a related company receive any payments from money managers you recommend, consider for recommendation, or otherwise mention to the plan for our consideration? If so, what is the extent of these payments in relation to your income (revenue)?
4. Do you have any policies or procedures to address conflicts of interest or to prevent these payments or relationships from being considered when you provide advice to your clients?
5. If you allow plans to pay your consulting fees using the plan's brokerage commissions, do you monitor the amount of commissions paid and alert plans when consulting fees have been paid in full? If not, how can a plan make sure it does not overpay for its consulting fees?
6. If you allow plans to pay your consulting fees using the plan's brokerage commissions, what steps do you take to ensure that the plan receives the best execution for its securities trades?
7. Do you have any arrangements with brokers-dealers under which you or a related company will benefit if money managers place trades for their clients with such broker-dealers?
8. If you are hired, will you acknowledge in writing that you have a fiduciary obligation as an investment advisor to the plan while providing the consulting services we are seeking?
9. Do you consider yourself a fiduciary under ERISA with respect to the recommendations you provide the plan?
10. What percentage of your plan clients utilize money managers, investment funds, brokerage services, or other service providers from whom you receive fees?

Although cross-selling new services to current clients is a relatively easy way to grow a business, financial advisors should be aware of potential pitfalls when undertaking a cross-selling strategy. ❖

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