TOP TEN FAQS FOR PROVIDING INVESTMENT ADVICE TO 401(K) PARTICIPANTS

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Many investment advisers provide investment advice to 401(k) Plans. In these instances, the 401(k) Plan itself is the client. In other words, the adviser is hired by the employer to design or manage the Plan itself. In other cases, the adviser may simply be hired by the employer to assist the employees in selecting the funds from the available choices or to provide educational seminars to the employees. In each of these situations, however, the client is still the Plan itself. Oftentimes, however, individual employees will ask the adviser for additional assistance. It is often the case that the employees may feel more comfortable with the adviser who is managing their 401(k) Plan because they feel that their employer must have performed some due diligence before hiring him or her or they may have developed a relationship via the educational seminars the adviser presented or the assistance he or she provided in helping the employee select the funds. In any event, you may be the first investment adviser many of these individuals have met and they may therefore feel you are more trustworthy than someone they would pick out of a phone book.

The question then arises: Can you, as the adviser to the employees' 401(k) Plan, also serve as an investment adviser for the individuals themselves?

The short answer is yes, and, while you can't charge fees to "manage" those 401(k) assets, you can charge a fee (typically a flat, or hourly, fee) to provide advice as to those assets. Any service you would provide to the individual employees above and beyond what you were hired to provide by the employer itself, is individualized investment advice and the employee becomes your client separate and apart from the 401(k) Plan. You would need the individual to sign an investment advisory contract with you in their own right. Whether managing other assets, financial planning or simply financial consulting, these services are separate and apart from those you're providing to the Plan. Consequently, each individual must also receive a copy of your Form ADV Part 2A Brochure and 2B Supplement as well as a copy of your privacy notice.

At this point you would treat the individual as you would any other client. However, there are some frequently asked questions ("FAQs") that arise in these situations, which we have attempted to answer below.

1. Are there any current ERISA regulations that would prevent a broker-dealer representative, registered investment advisor, or registered investment adviser representative from providing investment advice to an individual company 401(k) retirement plan participant?

In broad terms, the answer is No. However, there are aspects of ERISA (such as the prohibited transactions provisions) that may apply. So, for example, you can't "double dip" as they say. You can't charge the Plan Participant for advice that the 401(k) Plan itself may be paying you to provide. In other words, if you're getting paid to manage a 401(k) Plan and you're being paid on those Plan assets, you should not include the individual Plan participant's portion…his or her 401(k) Plan…in the total assets of the individual that you're charging a fee on.

Example 1: XYZ Corp. hires you to manage their company 401(k) Plan. Maybe you design the Plan yourself or perhaps XYZ hired another adviser to design the Plan. Regardless, for this example, you manage the Plan assets. You decide what funds to buy and sell or what individual securities within a model portfolio to buy and sell. There are likely multiple funds or multiple models for employees with different goals.

Employee Mary Smith hires you. Mary has a 401(k) account with XYZ Corp. in which she has $25,000 invested and she also has $50,000 that she and her spouse have saved up over the years. Mary initially contacted you to ask what funds or model she should invest in in XYZ Corp.'s 401(k) Plan, and also wants you to manage the $50,000 and give her advice on 529 plans for her children's college.

Since you're already being paid to manage the 401(k) Plan account, you should not charge a fee on Mary's $25,000. However, you can charge Mary a fee on the $50,000 you're managing for her, and you could also charge a fee (typically hourly or a flat fee) for the financial consulting advice relating to the 529 Plans.

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Example 2: XYZ Corp. hires you to assist with plan participant enrollment. As part of that, you help the Plan to select funds from a list of available options and then put on an educational seminar for the employees and assist them in completing the necessary paperwork.

John Jones wants to hire you separately. John inherited $100,000 from his recently deceased father and has no idea how to invest it. Additionally, John still isn't sure what funds or models to allocate his 401(k) money to and wants some advice on that as well.

In this case, you can charge John (typically a percentage of the Assets Under Management) to manage the $100,000 inheritance. However, you can also charge him (typically a fixed fee or an hourly fee) to provide advice on how to allocate his 401(k).

2. How does an investment adviser calculate individual company 401(k) retirement Plan accounts as Regulatory Assets Under Management or Assets Under Advisement?

Your total Regulatory Assets Under Management (RAUM) that you report in your Form ADV are calculated by looking at your discretionary and non-discretionary assets. All of your discretionary assets (that is, assets over which you have authority to buy and sell without asking the client's permission before each transaction) are considered RAUM. Ongoing management of those assets is also a critical factor. Non-Discretionary assets are only considered RAUM if you have the responsibility to make recommendations as to those assets AND, if the client accepts that recommendation, you have the responsibility of effectuating that transaction.

Typically, when we're talking about Plan Participant's 401(k) assets, you don't have the authority to effectuate the trade. In other words, Mary Smith might ask you what funds or models she should be invested in, but once you give her that recommendation, it's her job, not yours, to call it in to the 401(k) Plan manager. Consequently, you would not include Mary's $25,000 in your calculation of RAUM.

Additionally, it should be noted that many advisers have adopted the term "assets under advisement" to distinguish these assets from "assets under management" (since the adviser can't personally effect the transactions). However, some regulatory authorities have expressed disapproval of that phrase as they feel it can be misleading. In their eyes most clients don't understand the difference between assets under management and assets under advisement. Consequently, consider being more specific in describing these assets in your disclosure brochure and simply state that "We also provide investment advice on an additional [$X amount] of assets which we do not directly manage."

3. Does using an individual client's 401(k) Plan log-in and password trigger the SEC Custody Rule?

Yes. This is the least preferable option for an investment adviser to provide individual Plan Participant investment advice.

The SEC has indicated that they consider the adviser to have custody if password access provides the adviser with the ability to withdraw funds or securities or transfer them to an account not in the client's name at a qualified custodian. Note that in some cases, clients may not be able to withdraw funds directly from the 401(k) account without further documentation being provided, but if the client has other accounts linked to that 401(k) account, and if the client can withdraw funds from those other accounts, then, by logging in as the client, you effectively can access those other accounts and would be deemed to have custody. Having custody will, in most cases, require that you have a surprise annual audit conducted on those funds over which you have custody.

An adviser with custody would also need to provide appropriate disclosures on Form ADV, which can heighten an adviser's risk level resulting in more frequent visits from the regulatory authorities. Additionally, for state registered advisers, they may be required to maintain a higher net capital (in most scenarios tens of thousands of additional net capital), and provide annual audited balance sheets to the state.

Additionally, it should be noted that, on November 6, 2017, the North American Securities Administrators Association, Inc. ("NASAA") adopted an amendment to NASAA's Unethical Business Practices of Investment Advisers, Investment Adviser Representatives, and Federal Covered Advisers Model Rule to prohibit investment advisers from accessing clients' electronic accounts through the clients' own unique identifying information (the "Account Access Model Rule"). Since this is only a Model Rule at this point it may not be applicable in all states. As of this writing, only a couple of states have adopted part or all of the model rule while over a dozen have adopted it as a best practice. Advisers should check their state's law to ensure they are in compliance.

4. Does providing fiduciary investment advice to an individual 401(k) retirement plan participant make an investment adviser a fiduciary to the entire company 401(k) retirement Plan?

No. The services you provide to individual plan participants is separate and apart from any other services you're providing. If you haven't been hired by the employer to provide services to the Plan, then the fact that an individual plan participant hired you only makes you a fiduciary to that individual.

It's important to note, however, that in instances where an investment adviser is engaged by the Plan to provide educational and/or enrollment services to plan participants, the investment adviser is a fiduciary to the Plan and not the individual Plan Participants so long as the investment adviser does not provide specific investment advice to the plan participant(s).

5. What kind of disclosure or acknowledgment forms are required when a Plan Participant hires an investment adviser to individually provide advisory services as to their 401(k) assets?

When providing advisory services to both individual Plan Participants and the 401(k) Plan itself the focus should, as always, be centered on the conflicts of interest, particularly in regard to 401(k) Rollovers. These types of scenarios often create conflicts of interest in that respect. As part of your investment advisory services to the Plan Participant, you may recommend that they withdraw the assets from their employer's retirement plan and roll the assets over to an individual retirement account ("IRA") that you will manage. If the Plan Participant elects to roll the assets to an IRA that is subject to your management, you will, almost certainly, charge the client an asset based fee. This practice presents a conflict of interest because you have a financial incentive to recommend the rollover to the client based on the potential revenues rather than solely based on the client's needs. Consequently, you should advise clients of this conflict and the fact that they are not obligated to rollover their 401(k) nor to roll it over to you specifically.

Remember, however, that under ERISA, many conflicts of interest cannot simply be disclosed away. More often than not, the conflict results in a prohibited transaction that you simply can't engage in absent an exemption.

Clients should also be advised to weigh the costs and benefits of leaving the funds in their employer's (or former employer's) Plan as opposed to moving the funds to a new employer's retirement Plan or cashing out and taking a taxable distribution from the Plan or rolling the funds into an IRA rollover account.

The client should be encouraged to speak with their CPA and/or tax attorney. A good disclosure will also alert the client to consider other factors as well, including, but not limited to, the fact that: 401(k) Plans typically have a more limited investment menu than IRAs; 401(k) Plans may have unique investment options not available to the public; the 401(k) Plan may have lower fees than your fees; mutual fund share classes may be less expensive than share classes available in an IRA; your strategy may have higher risk than the option(s) available in the 401(k) Plan; the 401(k) Plan may also offer financial advice; the client may be able to delay their required minimum distribution beyond age 70.5 if they keep their assets in the 401(k); the 401(k) may offer more liability protection than a rollover IRA; (depending on the state law); the 401(k) may offer loan features that aren't available in an IRA; there may be differences in creditors protection; there may be differences in the tax consequences of early withdrawals; the client may be able to liquidate shares of company stock they may own at a lower capital gains tax rate; and, the 401(k) Plan may allow the client to hire you as the manager and keep the assets titled in the Plan name.

6. What are the differences between advising an individual 401(k) retirement Plan Participant who is currently an active Participant in a company 401(k) retirement Plan versus the same individual investor who is about to separate from service in that Plan?

From a fiduciary liability standpoint, there is no difference. Providing investment advice to an individual client is the same regardless of the custodian of the assets. However, see FAQ #5 in regards to advice to rollover a 401(k) into an IRA or another employer's retirement Plan.

7. If an individual client pays his or her investment advisory fees directly from their own 401(k) retirement Plan account held with their employer, is there the potential for a prohibited transaction to occur?

If you, as the RIA, are also providing advisory services to the Plan, you may, in some cases, be able to deduct your fee for the services you provide to an individual plan participant (services which may be unrelated to the Plan itself or to the individual's participation in the Plan). However, this can be a complex issue that could possibly result in a taxable distribution. Since the answer can change depending on the particular facts and circumstances, you should consult with an experienced ERISA attorney before attempting to structure your billing in this way.

8. What are the best practices in regard to allowing investment advisors to charge investment advisory fees on client assets currently held in a company 401(k) retirement Plan?

If an investment adviser is providing advice on "held away" assets, a simple solution to billing on those assets is to charge a consulting fee in the form of hourly or fixed fee compensation. While it is possible to bill on non-managed assets based on a percentage of such assets (so-called "assets under advisement"), consideration should be given to how that fee will be collected, calculated, and how a regulator might view the arrangement.

Since the amount of time spent on such assets is usually less than what is spent on actively managed assets, regulators might see a fee based on a percentage of those assets to be excessive. Consider charging either a lower percentage that would be more reflective of the time spent on reviewing and consulting on those assets or, more appropriately, billing based on an hourly or fixed fee basis. Even then, it's possible that a fixed fee could be considered excessive when compared to the percentage of the Participant's assets.

In instances where an investment adviser representative is dually registered with a broker- dealer, the representative should be mindful of the broker-dealer's internal policies and procedures prior to establishing a particular payment arrangement.

9. What is the main difference in an ERISA 3(21) fiduciary investment adviser versus an ERISA 3(38) Investment Manager?

An individual is a 3(21) fiduciary if he or she exercises any authority or control with respect to the management or disposition of Plan assets. Typically, a 3(21) fiduciary serves in a co-fiduciary capacity making investment recommendations to the Plan sponsor or trustee, but does not have the discretionary authority to unilaterally make investment decisions on behalf of the Plan. The 3(21) fiduciary may also provide services such as education and enrollment assistance to Plan Participants on behalf of the Plan.

On the other hand, a 3(38) fiduciary is formally appointed by the Plan (typically, the Plan sponsor, Plan trustee or named fiduciary) as an "investment manager" having full discretionary authority over all aspects of the investment process, including the ability to control and manage the fund lineup. Generally, the 3(38) fiduciary capacity takes on additional liability as being the investment manager responsible for the Plan investments and options. In addition, unlike the 3(21) fiduciary, the 3(38) fiduciary, as the investment manager, typically reports the Plan's assets on its Form ADV as regulatory assets under management.

It's important to note that the 3(21) and 3(38) fiduciaries serve in the capacity as a retirement Plan adviser at the Plan level where the client is the Plan itself, and not the individual Plan Participant.

10. Can a registered investment adviser or registered investment adviser representative provide periodically updated investment performance reports on company 401(k) retirement Plan mutual funds from commercially provided databases, such as Morningstar, Zacks, NASDAQ Dorsey Wright or The Sherman Sheet?

Yes. However, investment advisers should consider the recent amendments to SEC Rule 204-2(a)(7) and (a) (16) requiring advisers to maintain records necessary to form the basis for or demonstrate the calculation of the performance rate of return of any or all managed accounts or securities recommendations in any notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication that the investment adviser distributes.

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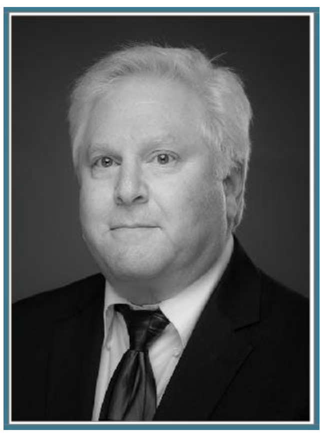

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