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The Cost of Advising One's Own Plan

To charge a fee is prohibited

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ADVISER QUESTION: *We are an RIA [registered investment adviser] firm that provides investment advisory services to ERISA [Employee Retirement Income Security Act] clients. Our firm also maintains a 401(k) plan for our employees. We provide ongoing investment advice to the plan. Are we permitted to charge the plan an advisory fee for these services as long as it is reasonable and comparable to the fee we charge other similar plans?*

ANSWER: No. The receipt of a fee for services to your plan is a prohibited transaction. However, you can avoid a prohibited transaction by providing the services to the plan without charge.

In your capacity as the employer plan sponsor, you are a discretionary fiduciary under ERISA—or, more technically, a 3(21)(A)(i) management fiduciary and a 3(21)(A)(iii) administrative fiduciary. As the plan sponsor, you have a fiduciary duty to prudently select your plan's service providers. The selection of yourself as investment adviser is not, on its own, prohibited. However, it is prohibited to cause the plan to pay an advisory fee to itself.

Here's why. One of the prohibitions under ERISA is self-dealing. Under the self-dealing prohibited transaction rule, a fiduciary may not use its fiduciary authority to cause itself to receive compensation from its own plan. Here, you, as plan sponsor, are using your fiduciary authority to require your plan to pay you an advisory fee. If, on the other hand, no fee is charged for your investment advisory services, there will not be a prohibited transaction.

In our experience, Department of Labor (DOL) investigators are particularly interested in finding self-dealing prohibited transactions. In one instance, an RIA's plan sponsor hired an affiliated RIA to provide investment advisory services and believed this would enable it to avoid the prohibited transaction. Unfortunately, it does not because the self-dealing rule also applies to additional compensation paid by the plan to "a person in which the fiduciary has an interest, which may affect the exercise of such fiduciary's best judgment as a fiduciary." The rule identifies a "person in which the fiduciary has an interest" as including entities that share certain ownership relationships with the employer fiduciary.

For instance, an entity in which the employer owns 50% or more is a person in which the employer has an interest. Similarly, the rule applies to an owner of 50% of more of the employer. Additionally, an employee, officer, director or 10% or more direct or indirect shareholder of the employer is considered a person in which the employer has an interest.

The rule also identifies a "relative" as a person in which the fiduciary has an interest. For this purpose, a relative is defined as a fiduciary's spouse, ancestor (e.g., parent or grandparent), lineal descendant (e.g., child or grandchild) and any spouse of a lineal descendant. If, for example, plan decisions are made by the chief financial officer (CFO) of the plan sponsor and the CFO hires his spouse as investment adviser, the payment of the advisory fee will be a prohibited transaction.

It should be noted that the definition of a person in which the fiduciary has an interest is very broad. While it may seem obvious that it includes children, parents and others in the bloodline, we have seen the DOL assert that a cousin is such a person.

Even if no advisory fee is charged for the investment advisory services, a prohibited transaction could arise if the RIA receives third-party payments in connection with the investment advisory services it provides to its plan. For example, let's assume that the RIA decides to offer a proprietary fund as an investment option to be made available to plan participants. The fund is managed by an affiliate of the RIA—a wholly owned subsidiary—and the affiliate receives a management fee for overseeing the fund. The receipt by the affiliate of that management fee in connection with plan assets would be prohibited unless a prohibited transaction exemption (PTE) can be used.

Fortunately, there is a prohibited transaction exemption that can be employed if the fund is a mutual fund. PTE 77-3 provides relief for utilizing proprietary open-end mutual funds in one's own plan providing certain conditions are satisfied. Other payments such as revenue sharing from custodians or investment providers are also forms of prohibited compensation.

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