Was That a Prohibited Transaction?

By Editor Test *Wed, Mar 20, 2013*

We all think we know right from wrong. But in the ERISA world, it's not always so easy tell the difference. Listen to these war stories and decide for yourself.

A thickset man in an open collar shirt, who advises a small-plan 401(k) sponsor, approached the microphone stand during the Q&A portion of a breakout session on ERISA litigation at the recent ASPPA/NAPA Summit at Caesar's Palace in Las Vegas.

His question was this: Twenty years ago, he sold his client a retirement plan. The plan was worth $300,000 at the time, and his one percent annual fee yielded $3,000. He considered himself paid fairly for the hours he put in.

Since then, the plan assets have swollen to $2 million, and his 1% now yields $20,000 a year. He feels a responsibility to tell the plan sponsor that it could buy the same services elsewhere for $5,000, but that would reveal the fact that he was being overpaid.

Should he inform the sponsor? he asked the panel on the dais, which included David Cohen of Evercore Trust, Michael Kozemchak of Institutional Investment Consulting and David Wolfe of Drinker, Biddle & Reath.

"Well, it goes against human nature," observed Wolfe. "But it makes sense." Laughter burst from the audience, helping to relieve a perceptible buildup of tension in the room.

Such is the type of dilemma in which many professionals in the retirement plan industry find themselves since the Labor Department's Employee Benefits Security Administration began crusading for greater fee transparency and higher fiduciary standards among providers.

Several anecdotes in the spirit of the one related above could be heard at the ASPPA/NAPA conference. It didn't take much digging to elicit ERISA war stories from attendees, who spoke on the assumption that their names wouldn't appear in print.

For instance, after the same breakout session, a somewhat distressed plan advisor from Tennessee approached one of the panelists and began telling a complex tale that had no obvious beginning, middle or end but was compelling nonetheless.

The young man had just begun advising a plan sponsor who several years ago had bought a group variable annuity from a registered rep associated with a major life insurance company. A few years later, the rep exchanged the annuity for a new contract, netting a $45,000 commission.

The plan sponsor wasn't happy with the new contract, and asked the rep if the company could back out of it. The rep reported that a surrender charge would apply.

The new plan advisor and his client are both unhappy with the situation. Part of the problem is that neither the plan sponsor nor the advisor fully understands the exact costs or benefits of the contract.

They are under the impression that even the youngest participants are locked into a lifetime of fees for a lifetime income guarantee. They also don't know whether or not the new contract was better than the old one, or if it might even be valuable enough to hang onto. (It was purchased before the financial crisis, when VA riders were rich.)

The point here is that neither the plan sponsor nor advisor knows what to do next.

Here's another tale, this one from a worried 401(k) broker. Like many of his brethren, he often used creativity to help close a deal. Given the new environment, he's wondering if he may have transgressed in the past.

For instance, he described a negotiation where he offered the plan sponsor certain discounts on services if the plan sponsor would let him run the plan's money and some of the sponsor's corporate money as well. Is that OK, he asked?

It depends, said Evercore Trust's Cohen: "You can offer to manage the plan assets for less if the sponsor also hires you to manage the corporate assets for the regular price. But it doesn't work the other way. You can't offer to manage the corporate assets for less if the sponsor also hires you to manage the plan assets."

When brokering a 401(k) deal, which might involve a five-figure commission, intermediaries may overlook such subtleties, said one consultant who audits and advises broker-dealers on ERISA fiduciary matters. He trains brokers to recognize and avoid what ERISA regulations call "prohibited transactions."

These are transactions that involve conflicts of interest and/or revenue-sharing arrangements that are indistinguishable from kickbacks, to use a quaint expression. Such arrangements can easily occur, for instance, in the provision of "bundled services" where there's not always a clear and direct link between a fee and the service it covers.

Does the typical broker have a voice inside his head, or a tiny angel who sits figuratively on his shoulder, that helps him distinguish between prohibited and fiduciary actions at such moments, the consultant was asked. No, the consultant said. Usually not.

Indeed, a broker-dealer whose reps have been mis-selling 401(k) plans for years may have hundreds of toxic contracts on its books, each of them tainted with actionable, prohibited transactions and each of them a fiduciary liability time bomb, the consultant suggested. (Under ERISA, there is a six-year and a three-year statute of limitations on such violations, depending on the situation, David Levine of Groom Law Group told *RIJ*. But a deal made 10 years ago, for instance, may still be questionable if a recurring payment was recently received under the terms of the deal, he said.)

It's not all gloom and doom on the moral front, however, Most people in the 401(k) services business want to do the right thing, a woman who has worked in the retirement industry in a variety of capacities for 25 years told *RIJ* during a cab ride from Caesar's Palace to McCarran Airport after the ASPPA/NAPA conference adjourned.

Many of them consciously avoid both the opportunity and the temptation to commit conflicted transactions simply by advising plans without selling products to them or selling products to them without advising them. But a few try to do both, and when deep in the weeds of a complex bundled deal they may forget that they're working both sides of the street—and that they may be headed toward a prohibited transaction.