

Brokers as Fiduciaries

By Fred Reish

I am often asked whether there are any lawsuits against brokers as fiduciaries for retirement plans. The answer is, yes, there are lawsuits and NASD arbitrations claiming that brokers have become ERISA fiduciaries. They are, in the main, based on allegations that the brokers gave investment advice. The cases are usually filed by the plan sponsor or its fiduciaries (e.g., the responsible officers, the committee or the trustee) to recover investment losses. Some of those cases are won by the plans and others are won by the brokers.

The legal issue is whether the broker made investment recommendations that rose to the level of ERISA-defined "investment advice," which is different than either the securities law definition or the conversational meaning of those words. Stated slightly differently, ERISA did not make every broker a fiduciary, nor did it turn every investment recommendation into fiduciary advice. Instead, ERISA and the DOL regulations crafted a specific and limited definition of fiduciary investment advice.

In a recent case, *Ellis v. Rycenga Homes*, the court found that the broker, and his broker-dealer, Edward Jones, had become fiduciaries because of ERISA investment advice. (The case was decided by a trial court—the U.S. District Court for the Western District of Michigan, Southern Division.)

Rather than restating the facts and conclusions in my words, I will, for the most part, let the court speak for itself:

The Facts

[I]n 1984, the plan opened an account with Edward Jones by executing a standard retirement trust form and corporate account form. These forms authorized Edward Jones to open an account in the name of the plan and authorized Retsema, as the trustee, to issue instructions to Edward Jones regarding the purchase of securities for the account. No document identifies Edward Jones as a plan fiduciary.

The plan's account at Edward Jones had two components—a securities account and a money market checking account. Both of these accounts were "nondiscretionary," that is, the customer rather than the securities broker had sole discretion to decide which purchases and sales to make. The testimony establishes that all decisions to buy or sell securities on behalf of the plan were made by the plan trustee and not by Edward Jones, and that Edward Jones had no authority to trade on behalf of the account.

The Rycenga 401(k) plan was a "pooled-asset" plan, meaning that the participants did not have the ability to direct the investment

of their individual accounts. Rather, the plan trustee selected the investments, and each participant had a percentage share of the whole.

Baetens [the broker] regularly rendered to the trustee advice concerning the investment of plan assets over the relevant twenty-year period.

The advice rendered by Baetens involved strategy as well as individual investments. . . .

Baetens's advice came unsolicited or in response to Retsema's inquiries:

If we had money that we were accumulating in our cash account, I might call him and he would say "Well, I think you should invest here or there." If he saw something, he might call me and say, "Well, hey. I think you ought to do this," but generally it was Tom Baetens that advised us.

A typical occasion for Baetens to call was his perception that too much cash was accumulated in the account. Baetens might recommend immediate investment or suggest holding back for a month, because he anticipated a market correction.

[The broker] confirmed that he and Retsema "would sit down periodically to review the assets in the plan and to do the asset allocation. . . ." He testified that the cash contributions and disbursements from the plan accounts would require periodic rebalancing of the portfolio.

Baetens based his advice on general guidelines for retirement funds that Edward Jones generated through the Investment Policy Committee or "IPC." The guidelines addressed the balance of the investment of retirement funds among cash, income and "growth and income" investments within "wide parameters." Baetens would periodically review the plan's holdings against these guidelines, and make investment recommendations: [The court then quoted from Baetens' testimony . . .] "It's reviewed on a quarterly basis and then it's adjusted mainly for the economic conditions. And so periodically we would meet, and may have been twice a year, in some cases it may have been after the annual reports came out, to review that, and then I would do a printout on this is the asset allocation of the funds and see if we should make any rebalancing positions. And once again this was usually from, say, a Putnam stock fund to a bond fund, or a bond fund to a stock fund to try to

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stay within these Edward Jones parameters. So we would make the recommendations and ultimately he was the one who decided what changes were to be made.”

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The record does not identify any instance in which the plan trustee failed to accept a recommendation from Edward Jones concerning a plan investment.

Edward Jones was compensated for its services in a number of ways. The principal source of compensation was the receipt of commissions at the time each security was purchased. The firm also charged service fees on a quarterly basis, calculated on the size of the investment portfolio. Edward Jones also received revenue-sharing fees and shareholder accounting fees on all Putnam funds held by the plan.

The Law

With that factual background, the court turned to the law. The definition of “fiduciary” is found in ERISA section 3(21)(A). While that section provides three distinct definitions, the court focused on the investment advice definition. To better understand the rule, the court looked at the underlying DOL regulation:

The ERISA statute, however, is not the only source of law in this area. The Department of Labor, acting pursuant to a statutory grant of authority, has adopted regulations defining when a person is deemed to be providing investment advice for purposes of section 3(21)(A)(ii) of ERISA. These regulations significantly narrow the class of stockbrokers who might otherwise fall within the statutory definition.

The regulation’s definition of the term “fiduciary,” as applied to stockbrokers, therefore includes two classes. The regulation includes stockbrokers who actually have discretionary authority with regard to buying and selling securities, a situation not present in this case. The second alternative, however, does not require that the stockbroker have discretion or control. It merely requires rendering of investment advice pursuant to a mutual agreement that the stockbroker’s advice will serve as a primary basis for investment decisions and that the broker will render “individualized investment advice” as defined by the regulation.

The law, as implemented by the regulation, requires only that the stockbroker (1) render investment advice to the plan on a regular basis (2) pursuant to a mutual agreement, arrangement, or understanding, written or otherwise between the broker and a plan fiduciary (3) that such services will serve as a primary basis for investment decisions with respect to plan assets, and (4) that the broker will render “individualized investment advice” to the plan based on the particular needs of the plan.

The Court’s Conclusion

Edward Jones clearly rendered “individualized investment advice” regarding investment policies or strategy, overall portfolio

composition, and diversification of plan investments. The testimony of Baetens himself establishes this fact beyond genuine issue. . . .

To be “individualized” within the meaning of the regulation, advice must pertain to investment policies or strategy or portfolio composition or diversification. 29 C.F.R. § 2510.3-21(c)(1)(ii)(B). In other words, the advice must address the individual needs of the plan.

Obviously, the writers of the regulation were attempting to differentiate individualized investment advice, which is based upon the particular needs of the plan, from the general promotion of a product or service, pursuant to which a stockbroker might “recommend” a security to its customers at large.

Afterthoughts

In analyzing the opinion, I want to focus on the requirement that the advice be “individualized.” That requirement significantly limits the fiduciary exposure of brokers and broker-dealers. The relevant language in the regulation is:

. . . that such person will render individualized investment advice to the plan based on the particular needs of the plan regarding such matters as, among other things, investment policies or strategy, overall portfolio composition, or diversification of plan investments.

In other words, to be fiduciary advice, the broker’s recommendations must contemplate, among other things, investment policies and strategies, portfolio composition, diversification or similar overarching factors. That is, investment recommendations alone are not fiduciary advice.

While the court did not analyze the regulatory language in detail, it did make factual findings that the broker’s recommendations went beyond just the stocks and mutual funds that were approved or reviewed by the brokerage firm. For example, the court commented on the broker’s intimate and long-term involvement in strategic matters, such as asset allocation, re-balancing, and investment strategy.

Thus, ERISA’s definition of fiduciary investment advice is more akin to the combination of the services offered by investment advisers, where the overall needs of a plan are considered and where the advice contemplates investment policies and strategies that are individualized to the needs of the plan and the participants.

As an aside, while the court noted, in the statement of facts, that Edward Jones received service fees in addition to the commissions, the compensation of the broker and broker-dealer were not discussed in the legal analysis. As a result, it is impossible to know what, if any, importance the court attached to that fact. It is conceivable, though, that the judge perceived those payments as compensation for services above and beyond the traditional brokerage services.

Stated simply, an investment recommendation- standing alone- is not a fiduciary act.

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