

## Brokers As Fiduciaries: The Reality and the Issues

By Fred Reish and Bruce Ashton

The White House has proposed fiduciary status for broker-dealers and their registered representatives—and has sent legislation to Congress to accomplish that result. Congressional leaders have endorsed the concept and legislation is working its way through Congress. In addition, the leadership of the SEC and FINRA, which oversee registered investment advisers (RIAs) and broker-dealers, respectively, have endorsed the concept, as has SIFMA—the primary trade association for broker-dealers. So, it seems almost certain that broker-dealers and their registered representatives will become fiduciaries. However, that raises as many questions as it answers. The key questions are: Why? When? For what?

### Key Questions

To fully answer “Why?” requires a complex and a lengthy discussion. Simply stated, however, it is because broker-dealers and their registered representatives (commonly called “financial advisers”) frequently provide investment advice to individuals, trusts, charities, businesses and other retail investors. The concept is that, when advice is provided to non-institutional investors, it is different from brokering a transaction, and the potential impact on the investor is so great that the advice needs to be measured by a higher standard.

Turning to “When?”, the easy answer is that the fiduciary standard would apply whenever advice is given to buy, sell or hold a particular investment or to pursue a particular investment strategy. However, the issue may be more difficult than that because—as some argue—generic or generalized information or recommendations should not be measured by the fiduciary standard. Arguably, the fiduciary standard should only apply to individualized (or “personalized”) investment advice based on the particular needs of the investor. But that begs the question: what is the difference between generalized information and individualized advice?

In our view, the best way to answer this is to look to ERISA, where similar concepts apply. (While these proposed changes have standards that are similar to ERISA’s, those rules would not supplant the ERISA fiduciary and prohibited transaction requirements. Thus, if these proposed changes to the securities laws are enacted, broker-dealers would need to satisfy both bodies of law when working with ERISA-governed plans.) Under ERISA, determining the risk tolerance of an investor or the asset allocation appropriate for, *e.g.*, a hypothetical 45 year old, is treated as generalized information, or investor education, and not advice. Similarly, when a financial advisor is providing a “preferred” list of mutual funds or other securities, this is considered generalized information.

Contrast this with the concept of individualized advice in ERISA. For example, fiduciary advice at the plan level is defined, in relevant part, as an investment recommendation that is based on

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the particular needs of the plan. Similarly for participants, fiduciary advice is defined as individualized advice that is based on the particular needs of the participant.

Applying these principles, the gathering of data about an investor, including spouses’ assets, benefits in retirement plans, other investments, income, and so on, would be individualized information and would be suggestive of individualized rather than generalized advice.

The third question, “For what?”, is the most difficult. Under ERISA, and under most bodies of fiduciary law, the acceptance of fiduciary status does not automatically include all fiduciary functions. For example, when an investment manager agrees to manage a separate

account in international stocks, the investment manager does not have fiduciary responsibility for other decisions, such as asset allocation or the management of other investment styles. Thus, a fiduciary is only a fiduciary, and only has fiduciary responsibility, “to the extent” that he either (1) accepts fiduciary responsibility or (2) functions as a fiduciary (for example, provides individualized advice even though he does not acknowledge that he is a fiduciary). In those cases, the adviser is either an acknowledged or a functional fiduciary, but a fiduciary nonetheless. However, the fiduciary status and responsibility do not extend beyond that function. (The only exception would be ERISA’s co-fiduciary responsibility rules.)

### Impact on Procedures and Documentation

Assuming that fiduciary status is mandated for broker-dealers and their registered representatives, it will significantly change the procedures and documentation used by broker-dealers. That is, different investors may hire financial advisers (and, therefore, their broker-dealers) for different fiduciary and non-fiduciary purposes. The internal procedures of broker-dealers, and the service agreements with the investors, will need to reflect that.

For example, an investor may engage a financial adviser to assist in the development of a portfolio of mutual funds, but may not want to pay for ongoing monitoring. In that case, the financial adviser would be a fiduciary at the outset for the individualized advice on the portfolio—for the asset allocation and the individual mutual funds—but would not be a fiduciary for monitoring purposes. Alternatively, another investor may want the financial adviser to provide the ongoing monitoring services as well and, in that case, the adviser would be a fiduciary for both purposes.

The fee structure should provide reasonable compensation in both cases; that is, the financial adviser in the second case would be entitled to both greater and continuing compensation than the adviser in the first case.

It is also conceivable that an investor will engage a broker to provide only brokerage services. For example, an investor may make all of his own investment decisions, but be supplied with research and investment reports by the broker. For these situations, the issue would be whether the research and investment information could be viewed as individualized investment advice or, alternatively, whether it is clear that the information is generic and is not based on any individualized needs of the investor. If the latter, it should not be viewed as individualized advice, and fiduciary status should not attach. As a result, broker-dealers will need to be attentive to the origination, nature and purpose of the delivery of such information.

Broker-dealers will also need to have internal procedures and policies for those non-fiduciary services, as well as service agreements that are consistent with the non-fiduciary services that are being provided.

### Legal Requirements

Let’s look at one more question . . . “What will the legal requirements be for financial advisers and broker-dealers who act in a fiduciary capacity?”

Before answering that question, though, let’s take a look at the relevant language from the proposed legislation—the Investor Protection Act of 2009:

**SEC. 913. ESTABLISHMENT OF A FIDUCIARY DUTY FOR BROKERS, DEALERS, AND INVESTMENT ADVISERS, AND HARMONIZATION OF THE REGULATION OF BROKERS, DEALERS, AND INVESTMENT ADVISERS.**

...

“(k) STANDARDS OF CONDUCT.—Notwithstanding any other provision of this Act or the Investment Advisers Act of 1940, the Commission may promulgate rules to provide, in substance, that the standards of conduct for all brokers, dealers, and investment advisers, in providing investment advice about securities to retail customers or clients (and such other customers or clients as the Commission may by rule provide), shall be to act solely in the interest of the customer or client without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice.

“(l) OTHER MATTERS.—The Commission shall—

“(1) take steps to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with investment professionals; and

“(2) examine and, where appropriate, promulgate rules prohibiting sales practices, conflicts of interest, and compensation schemes for financial intermediaries (including brokers, dealers, and investment advisers) that it deems contrary to the public interest and the interests of investors.”.

It appears that there will be at least three requirements. The first is the fiduciary standard; the second is a duty of loyalty to the investor; and the third is disclosure of material conflicts of interest. (While the statutory language does not reference fiduciary status, the heading refers to “establishment of a fiduciary duty.” That presentation is unusual and leaves room for argument about its meaning. However, it appears that the intent is to create a fiduciary standard since the plain language should be given reasonable meaning.)

In addition, the legislation proposes to give the SEC the power to prohibit broker-dealer compensation arrangements that are inconsistent with the duty of loyalty to the investor.

### *Fiduciary Status*

With regard to fiduciary status, the most common standard of care is the “prudent man rule.” While RIAs have been subject to a fiduciary standard under the securities laws and, therefore, have experience with that standard—there is much more guidance and experience with the fiduciary standard under ERISA. For example, under ERISA, the fiduciary standard and the prudent man rule are included in the statute; have been amplified by DOL guidance (including regulations, advisory opinions, and other guidance); have been the subject of considerable litigation (thereby further defining the standard); and have been exhaustively analyzed through a variety of publications by lawyers, law students, academics and investment advisers. The result is a robust body of thinking that can be used by Congress, the SEC and the courts in developing and applying the new standards to broker-dealers and registered representatives.

The prudent man rule under ERISA provides that fiduciaries shall act:

“. . . with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. . . .”

In effect, when advice is given in the ERISA context, it requires that the financial adviser and broker-dealer, as fiduciaries, provide investment advice at the level of a hypothetical knowledgeable investor. In addition, it requires that the objectives of the investor be determined and that the advice be consistent with those objectives. For example, in a retirement plan, the objectives are fairly obvious, that is, to develop a

balanced portfolio that is consistent with the accumulation and payment of retirement benefits. As a result, it would be an unusual case where highly aggressive and speculative portfolios could be consistent with the objectives of a retirement plan. Similarly, individual investors have objectives, as do trusts and charitable organizations.

The DOL and the courts have commonly interpreted the prudent man rule to require that fiduciaries engage in a prudent process to make decisions. Similarly, a financial adviser and/or the broker-dealer would need to engage in a prudent process to develop fiduciary investment advice for the investor. In that case, broker-dealers would want to have internal practices, including software and databases, that assist in the development and documentation of the process.

#### *Duty of Loyalty*

The next requirement—the duty of loyalty—would require that the financial adviser and the broker-dealer put the interests of the investor ahead of their own. In most cases, that would apply to compensation. That is, the compensation must be reasonable as compared to the services, and the costs of the investments must be prudently evaluated (*e.g.*, for all mutual funds, but particularly for proprietary funds). (While ERISA prohibits many of these transactions, it is likely that the securities rules—for non-ERISA advice—will rely on prudence, reasonableness and disclosure.) However, the duty of loyalty also extends to other practices.

Subsumed in the duty of loyalty, but treated separately in the proposed legislation, is a duty to disclose conflicts and the duty to receive no more than reasonable compensation.

#### *Disclosure of Conflicts*

Both ERISA and the securities laws governing RIAs impose on fiduciaries a duty to disclose material conflicts. So, from a conceptual perspective, there is nothing new about this approach. However, it may require a change in policies and procedures, agreements and disclosure statements for some broker-dealers, depending on their current practices. For guidance, broker-dealers can look to the Form ADV Part II and to the proposed regulation under section 408(b)(2) of ERISA (and other guidance under ERISA).

These changes present issues for broker-dealers who are affiliated with insurance companies, mutual fund complexes and other investment providers. That is because, there is a conflict of interest if the financial adviser gives advice about affiliated investments.

While it is appropriate to have reasonable safeguards against conflicts, not every potential conflict is harmful. For example, the sale of a high quality, reasonably-priced insurance contract from an affiliated insurance company to an investor may be to the advantage of the investor notwithstanding the potential conflict. The interesting legal issue is whether those transactions will be prohibited when accompanied by fiduciary advice, whether they will be excepted from the fiduciary standards with appropriate notices, or whether, with proper disclosures, the fiduciary standard will be deemed to be satisfied. As a practical matter, we doubt that the new rules will prohibit the sales of products of affiliates.

#### *Reasonableness of Compensation*

With regard to the reasonableness of compensation, that will be determined, by and large, by the specific services that are rendered (both fiduciary and non-fiduciary) and by industry practices concerning fees and commissions for the services. However, it will create some meaningful changes. For example, the mutual fund 12b-1 fees paid to a broker-dealer and financial adviser who provide substantial ongoing services (and particularly fiduciary services) should be more than the fees that are paid to a broker-dealer and financial adviser who do not provide material ongoing services. At the current time, 12b-1 fees are the same regardless of whether any continuing services are provided. While some may argue that, in all cases, there are at least minimal continuing services, that argument seems more theoretical than practical.

It is likely that the approach under the new rules will be to evaluate the aggregate services of the broker-dealer and the financial adviser in determining the reasonableness of the fees. At the very least, these changes will likely increase the inquiry into whether the 12b-1 fees (and other fees, as well) and the services that the broker-dealer and the financial adviser provide in exchange for that compensation are reasonable.

In addition, where broker-dealers receive profit sharing or “bonus” payments (or other payments from mutual funds, mutual fund complexes, insurance companies or others), that compensation will need to be disclosed as well. It is also possible that the broker-dealers will need to explain the services that they provide as consideration for that additional compensation.

#### **Conclusion**

This bulletin describes a possible—and perhaps likely—outcome of the current initiative concerning fiduciary status for broker-dealers and financial advisers who provide advice to investors. Those changes will materially affect current practices of broker-dealers. Because of the likelihood that this, or similar, legislation will be adopted, broker-dealers are well advised to begin examining the consequences, and the changes in practices, procedures and agreements, that will be required under the new regime. It does not make sense to be spending money and effort developing programs that are inconsistent with these contemplated changes or that would conflict with the common understanding of fiduciary practices.

Furthermore, broker-dealers are well advised to begin developing an understanding of fiduciary responsibilities and commonly accepted fiduciary practices. It is a different approach and will require a re-thinking of many everyday practices at broker-dealers.

On the other hand, some services of broker-dealers will continue to be non-fiduciary services. Part of the initial analysis will be to distinguish between fiduciary and non-fiduciary services and treat each in a manner that is consistent with its status.

In doing this analysis, broker-dealers should look to fiduciary guidance elsewhere in the law. In that process, we believe they will inevitably look to ERISA, which has the best developed and most comprehensive body of guidance on fiduciary status and responsibility. ❖

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