

Fiduciary Status for Broker-Dealers

By Fred Reish

The President's proposal for reform of the financial services industry was described in a Department of Treasury publication—or White Paper—entitled “Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation.” As a part of that proposal, the Administration included a provision to establish a fiduciary duty for broker-dealers who offer investment advice and to harmonize the regulation of investment advisers and broker-dealers. While the proposal was written from the perspective of the retail investor, we believe that it will have a significant impact on investment advice for 401(k) plans—particularly in the mid-sized and small plan market.

This bulletin quotes from the Department of Treasury White Paper and then describes my initial reaction to the proposed change.

The President's proposal:

Retail investors face a large array of investment products and often turn to financial intermediaries – whether investment advisors or brokers-dealers – to help them manage their investments. However, investment advisers and broker-dealers are regulated under different statutory and regulatory frameworks, even though the services they provide often are virtually identical from a retail investor's perspective.

Retail investors are often confused about the differences between investment advisers and broker-dealers. Meanwhile, the distinction is no longer meaningful between a disinterested investment advisor and a broker who acts as an agent for an investor; the current laws and regulations are based on antiquated distinctions between the two types of financial professionals that date back to the early 20th century. Brokers are allowed to give “incidental advice” in the course of their business, and yet retail investors rely on a trusted relationship that is often not matched by the legal responsibility of the securities broker. In general, a broker-dealer's relationship with a customer is not legally a fiduciary relationship, while an investment adviser is legally its customer's fiduciary.

From the vantage point of the retail customer, however, an investment adviser and a broker-dealer providing “incidental advice” appear in all respects identical. In the retail context, the legal distinction between the two is no longer meaningful. Retail customers repose the same degree of trust in their brokers as they do in investment advisers, but the legal responsibilities of the intermediaries may not be the same.

The SEC should be permitted to align duties for intermediaries across financial products. Standards of care for all broker-dealers when providing investment advice about securities to retail investors should be raised to the fiduciary standard to align the legal framework with investment advisers. In addition, the SEC should be empowered to examine and ban forms of compensation that encourage intermediaries to put investors into products that are profitable to the intermediary, but are not in the investors' best interest.

New legislation should bolster investor protections and bring important consistency to the regulation of these two types of financial professionals by:

- *requiring that broker-dealers who provide investment advice about securities to investors have the same fiduciary obligations as registered investment advisers;*
- *providing simple and clear disclosure to investors regarding the scope of the terms of their relationships with investment professionals; and*
- *prohibiting certain conflict of interests and sales practices that are contrary to the interests of investors.*

Comments:

The primary investment advisers to 401(k) plans in the mid- and small-market space are broker-dealers, RIAs (or registered investment advisers), and benefits brokers. The individuals who work under the supervision of the broker-dealers are commonly called financial advisers, financial consultants, financial representatives, registered representatives and/or brokers. From a legal perspective, they are treated as salespeople who may give incidental advice related to investments. However, in many cases, they are highly knowledgeable about investments and give sophisticated and individualized advice.

Under current securities law, if the advice is “incidental” to the sale of investments, they may act as representatives of broker-dealers. However, under ERISA, if the advice is individualized and based on the particular needs of the plan (or of a participant), they become functional fiduciaries. So, there is a difference between ERISA and the securities law. Under the securities laws, incidental advice is viewed as part of the sales function, but even incidental advice can result in fiduciary status under ERISA. It appears that the President's proposal would reconcile

that difference, in the sense that incidental advice would result in fiduciary status under the securities laws as well.

Registered investment advisers, or RIAs, are fiduciaries under the securities laws. In addition, with regard to retirement plans, their advice is usually individualized and based on the particular needs of the plan or the participants and, as a result, they are fiduciaries under ERISA.

Benefits brokers are almost always licensed under state insurance laws, which do not have a concept of fiduciary responsibility. Benefits brokers may also be licensed under the securities laws as registered representatives of broker-dealers. Typically, however, they are not RIAs and, therefore, are not fiduciaries under the securities laws. However, if they provide 401(k) plans with individualized advice based on the particular needs of the plan or the participants, they will become functional fiduciaries under ERISA. The President's proposal apparently does not address the status of benefits brokers who are operating solely under state insurance laws.

If the President's proposal is adopted, and broker-dealers become fiduciaries under the securities laws when they provide any advice (and particularly individualized or customized advice), the impact will be more than it appears on the surface. That is because fiduciary status carries meaning beyond the obvious.

In my opinion, the two greatest changes would be the standard of care and disclosures of conflicts of interest. With regard to the standard of care under current securities laws, a broker-dealer needs only to determine that an investment is suitable for the client. However, the fiduciary standard of care requires that the adviser take into account a number of considerations, such as whether the fees are reasonable, whether the investments are adequately diversified, whether there are conflicts of interest, whether the investments are consistent with the provisions of the trust or other governing document, and so on. Furthermore, the process that the adviser uses in developing the recommendation is measured by a prudent and reasonable hypothetical person who is knowledgeable about investments, about portfolio concepts and about the purpose of the investments. In some cases, the suitability and fiduciary standards can produce the same result. However, in other cases the recommendations may be different.

Equally as important, though, is the requirement for disclosures and management of conflicts of interest. Once an adviser representative of a broker-dealer has determined that an investment is suitable, the adviser may offer the recommendation even if certain aspects of it may be in the adviser's best interest, *e.g.*, because of conflicts of interest or higher compensation. On the other hand, fiduciaries are generally required to disclose all conflicts and to operate in the best interest of the investor. That is because fiduciary status carries with it a "duty of loyalty." The duty of loyalty to the investor requires that the adviser put the investor's interest ahead of the adviser's interest.

To do so, a fiduciary generally has to avoid conflicts of interest and, where they cannot be avoided, the adviser must inform the investor of the nature and scope of the conflict. In fact, in some cases, a fiduciary may be precluded from making a recommendation where the conflict is so great as to materially impair the advice.

Keep in mind that this is a discussion about the legal standards. In our experience, many broker-dealers and financial advisers operate at a standard that equals or exceeds the fiduciary standard, even though they do not affirmatively embrace fiduciary status. As a result, while a comparison of the two standards from the perspective of the investor obviously favors fiduciary status, many broker-dealers and advisers have been loyal to their customers and have avoided the potential negative effects of conflicts of interest.

We believe that the President's proposal will have a significant, unique impact on retirement plans. First, this change, and even the debate leading up to the legislation, will educate the 401(k) marketplace about the difference between the suitability standard and the fiduciary standard and about many of the existing conflicts of interest. From the perspective of plan sponsors and plan fiduciaries, it is likely that the fiduciary standard will seem more attractive—if, for no other reason, because it imposes a duty of loyalty on the adviser, requiring that the adviser put the investor's interest ahead of its own and requiring that the adviser disclose all material conflicts of interest.

Secondly, ERISA has the best-developed body of law concerning fiduciary status and conflicts of interest . . . by far. As a result, it is likely that, in the short term, Congress and the regulators will look to ERISA for guidance and, in the long term, the courts will look to ERISA decisions for guidance. I believe a consequence will be that the expectations of advisers will be better defined and will probably be at a higher standard. While that will be problematic for less sophisticated advisers and for those of less integrity, it should ultimately benefit both the advisory community and investors, including 401(k) plans. For example, we believe the change will result in more advice that is based on modern portfolio theory, including the use of well-diversified investments to create diversified portfolios. As greater awareness of the fiduciary standard causes that approach to become more popular, it should be helpful to plan fiduciaries in the selection of appropriate investments and in the management of investments at the participant account level.

Even though this is just a proposal, it carries change with it. That is, the proposal alone will cause change—because it will require that broker-dealers, RIAs, politicians, government officials, 401(k) plan sponsors and fiduciaries, and others, engage in a discussion about the meaning of fiduciary responsibility.

It will be interesting to watch the progress of this proposal and, if it is enacted into law, to see its long-term effect. ❖

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