THE UNIFORM FIDUCIARY STANDARD AND ERISA PLANS

A New Kind of Status Quo Is Emerging for Brokers

By Charles G. Humphrey, Esq.

Those who work in the financial services industry, particularly those who work with 401(k) plans, are awaiting new rules that may significantly change how brokers and investment advisors work with plans and how they are compensated. The driving force of these yet-to-be-proposed rules is a yet-to-be-created fiduciary standard of care for brokers.

As of this writing the United States Department of Labor (DOL) has delayed its fiduciary definition or “conflicted advice” re-proposal to January 2015. The Securities and Exchange Commission (SEC), already in no hurry to issue a uniform fiduciary standard rule for advisors and brokers, may be subject to legislation that would prohibit it from issuing rules that apply a uniform fiduciary standard to both brokers and advisors. Where all of this may go in the next 12 months one would be foolish to predict.

The dawning reality, however, is that major regulatory changes may not come and that advisors and brokers likely may continue to do business under the existing two separate sets of rules applicable to them under the securities law and a third set of existing rules under the Employee Retirement Income Security Act (ERISA).

This does not mean that it will be business as usual for the industry. DOL issued service provider fee disclosure rules in 2012 that have sparked plan sponsor awareness of service provider fees and conflicts of interest. These rules have forced significant changes in financial service industry and plan sponsor behaviors and have led to lower fees. The Financial Industry Regulatory Authority (FINRA) also has gotten into the game with a modification of its suitability rule. It is these rules that all stakeholders will be ordering themselves around now and not the proposals that may never come.

SEC and FINRA Rules

Brokers and advisors operate under separate sets of rules and regulations.

Brokers are regulated under the Securities Exchange Act of 1934 ('34 Act), which defines a broker as a “person engaged in the business of effecting transactions in securities for the account of others.”

Members of FINRA must follow the suitability rule, which states that brokers must have a "reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer.” This means, for example, that a broker can recommend a higher-expense mutual fund share to a client that pays the broker more than a lower-cost institutional share, as long as the investment itself is appropriate to the plan's needs, and completely satisfy the suitability rule.

Investment advisors and money managers are regulated under the Investment Advisers Act of 1940 ('40 Act or Advisers Act). The '40 Act defines an investment advisor as "any person who for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the value of investing in, purchasing or selling securities …" The '40 Act does not provide a comprehensive regulatory regime for advisors; rather, it imposes a broad fiduciary duty on advisors to act in the best interest of their clients. As SEC staff explained in a report on the SEC regulation of advisors:

Unlike the laws of many other countries, the U.S. federal securities laws do not prescribe minimum experience or qualification requirements for persons providing investment advice. They do not establish maximum fees that advisers may charge. Nor do they preclude advisers from having substantial conflicts of interest that might adversely affect the objectivity of the advice they provide. Rather, investors have the responsibility, based on disclosure they receive, for selecting their own advisers, negotiating their own fee arrangements, and evaluating their advisers' conflicts.

Fundamental to the Advisers Act is the notion that an adviser is a fiduciary. As a fiduciary, an adviser must avoid conflicts of interest with clients and is prohibited from overreaching or taking unfair advantage of a client's trust. A fiduciary means more than mere honesty and good faith to its clients. A fiduciary must be sensitive to the conscious and unconscious possibility of providing less than disinterested advice, and it may be faulted even when it does not intend to injure a client and even if the client does not suffer a monetary loss.

The advisers’ duty then is to avoid conflicts wherever possible and manage unavoidable conflicts in the investor's interest.
Controlling investor costs and revealing all costs to the investor are essential components of this duty, but not sufficient alone to fulfill one's fiduciary duty. If an adviser makes disclosures and then proceeds in a way that is not in the client's best interest, he or she has violated this duty.7

Brokers may also be subject to the '40 Act, but only if:

- They give advice that is not solely incidental to their business as a broker.
- The broker receives special compensation for providing the advice.8

The SEC says that a broker receiving asset-based fees can provide investment advice “solely incidental to its business” without registering as an investment advisor as long as it discloses the nature of its services. In other words, the receipt of asset-based fees does not constitute special compensation subjecting the broker to the '40 Act.

In sum, the following pertain under existing regulatory authority:

1. Brokers are subject to the suitability standard that does not include a requirement to act in the best interest of the client.
2. Investment advisors are required to act according to the fiduciary standard, that is, they are required “to act in the best interests of their clients,” but that does not necessarily preclude conflicts of interest. An advisor’s duty is to avoid conflicts wherever possible and manage unavoidable conflicts in the investor’s interest. Controlling investor costs and revealing all costs to the investor are essential components of this duty but not alone sufficient if the advisor otherwise acts in a way that is contrary to the investor’s interest.
3. These obligations are less protective of clients than those under the fiduciary standards of ERISA.

**ERISA Standards and Conflict of Interest Rules**

**General Fiduciary Duties**

ERISA applies to fiduciaries obligations of loyalty and duties of care that do not apply to brokers or advisors under the securities laws. Under common-law standards, a fiduciary “steps into the shoes of another person and applies all of her or his knowledge and skill to benefit that person as if he or she were that person.” ERISA adds that a fiduciary’s conduct will be measured against what is expected of a “prudent expert.” This means that under ERISA the fiduciary must act in accordance with a very high standard of care and for the exclusive benefit of plan participants and beneficiaries and no others.10

**Prohibited Transaction Rules**

ERISA fiduciaries are also subject to a set of prohibitions under the prohibited transactions rules that are designed to prevent them from self-dealing for their own benefit. For example, fiduciaries are forbidden from (1) dealing with the assets of a plan for their own accounts; (2) acting on behalf of another whose interests are adverse to the interests of the plan; or (3) receiving any consideration from a party dealing with the plan in connection with a transaction involving the assets of the plan.11 These rules have no equivalent under the securities laws.

**Who Is a Fiduciary Subject to These Rules?**

ERISA generally defines these fiduciaries, insofar as investment advisors and securities brokers are concerned, as those (1) managing plan assets or (2) providing investment advice for a fee.12 DOL rules narrowly define investment advice for purposes of determining whether an individual or entity is an ERISA fiduciary.

To be considered an investment fiduciary, an advisor’s advice must have all the following elements. If only one of these elements is missing, the advice provided by the broker or advisor will not make that person or entity an ERISA fiduciary.

1. The individual makes recommendations on investing in, purchasing, or selling securities or other property,
2. on a regular basis,
3. pursuant to a mutual understanding that the advice will
4. serve as the primary basis for investment decisions and
5. be individualized to the particular needs of the plan.

Most brokers providing investment advice have been able to structure their business practices around this rule (the so-called “five-prong test”) so as not to be considered ERISA fiduciaries. This has been a sore point for DOL regulators because it hampers their ability to take actions against brokers that are providing misleading or inaccurate advice to plan sponsors in order to increase their fees.

**Withdrawn DOL Proposed Rule**

In 2010, DOL proposed then withdrew a rule intended to close the loophole the brokerage industry has used quite effectively to avoid fiduciary status under ERISA for the advice its brokers provide.13

The withdrawn rule has caused great concern among investment advisors and brokers because it generally says that any person who is an investment advisor under the Investment Advisers Act of 1940 will be a fiduciary as long as he or she provides investment advice for a fee.14 It includes as fiduciaries anyone who provides advice or recommendations about investments or recommendations according to an agreement or plan.15

A key difference between the current rule and the withdrawn rule is how hard it is to become an investment fiduciary under the current rule and how easy it will be to become one under the withdrawn rule.

Under the current rule, described above, a broker providing investment advice to a plan can become an investment advice fiduciary only if all of its conditions are met. Brokers generally get around the definition by disclaiming any intention that their advice will serve as the primary basis for investment decisions or that it is individualized to the particular needs of the plan. In other words, there is not a “mutual understanding” between the plan and the broker that makes the broker a fiduciary because the broker never agrees to do that.

The withdrawn rule, if re-proposed, would knock the legs out from typical industry...
would be subject to ERISA’s prohibited transactions rules as plan fiduciary. Rather than operating under the looser suitability standard described above, a broker would be required to act in the exclusive interests of the plan participants and beneficiaries, and would be subject to ERISA prohibited arrangements. This is because the rule, among other things, does not include the requirement of a mutual understanding about the investment advice that is being provided. As long as the plan sponsor thinks the investment advice is being provided, the broker becomes an ERISA fiduciary. Rather than operating under the looser suitability standard described above, a broker would be required to act in the exclusive interests of the plan participants and beneficiaries, and would be subject to ERISA prohibited transactions rules as plan fiduciary. This means the broker could not recommend investments that pay the broker higher fees. Industry practices that have been in place for nearly 30 years would come undone and have to be substantially re-ordered.

In May 2014, DOL announced its delay until 2015 of the re-proposal of the rule. If that action is taken in 2015, it will be only a proposal. How closely it will track the original proposed rule is a matter of conjecture, although it is expected to change to some degree.

Public hearings and a comment period will precede any final rule. DOL attempts to change the rule also face the headwind of congressional resistance. The Retail Investor Protection Act would prevent DOL from issuing a rule until the SEC issues a final rule and after a determination by SEC that customers are being systematically harmed under the current rules. This process could take some time.

Enter Dodd-Frank

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) created authority in the SEC to create a single standard for brokers and advisors. This standard, if proposed by the SEC, “shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment advisor providing the advice.”

SEC staff issued a study in 2011 that recommends that the SEC adopt such a uniform standard. The study suggested a general framework for such a standard, which includes the following:

- Issuance of a uniform standard should apply to broker–dealers and investment advisors when personalized investment advice is provided.
- Issuance of interpretative guidance addressing the components of a uniform fiduciary standard.
- The uniform standard will obligate both investment advisors and broker–dealers to eliminate or disclose conflicts of interest.

The study had no specific details about the breadth or scope of the standard, and the SEC rejected the staff recommendation saying it was provided “without adequate articulation or substantiation of the problems that would be purportedly addressed via the regulations.” Subsequently, in 2013, the SEC requested and received comments from the regulated community. As previously stated, there is no certainty as to whether or when the SEC will issue a proposal.

FINRA Developments and ERISA Service Provider Disclosure Requirements

Although neither the uniform fiduciary standard nor the DOL conflicted advice rule may ever be realized, the door to a true fiduciary standard has been pushed open by developments brokers must take notice of.

FINRA Developments

In 2012, FINRA issued a statement that says the suitability requirement contains an obligation to “act in the best interests of the clients.” This modification of the requirement was effective July 2012. This statement was followed in 2013 by the FINRA-issued Report on Conflicts of Interest, which states: “[an] effective practice is the adoption of a best interests of the customer standard in a firm’s code of conduct.”

The FINRA Conflicts Report introduces a watered down uniform fiduciary standard under the suitability rule that moves the bar a bit higher. FINRA is careful to state that it supports a rule that “respects the purpose of the enabling legislation and allows for differences between the investment advisor and the broker models.” In other words, it does not want brokers to be regulated under the current same scheme.

The report suggests, however, that brokers must consider managing conflict of interest issues in the following three critical areas:

- Establishment of enterprise-level frameworks to identify and manage conflicts of interest
- Approaches to handling conflicts of interest in manufacturing and distributing new financial products
- Approaches to compensating associates that diminish conflict situations

Impact of ERISA Service Provider Disclosure Requirements

In 2012, DOL rules became effective requiring “covered service providers,” including brokers, to provide sufficient information to plan sponsors so they can understand the services being provided, the provider’s fiduciary status, and the related parties to whom fees are paid.

These rules have made plan sponsors smarter about plan fees and relationships. Indeed, evidence suggests that plan fees have been reduced as a result. This is a significant change, the importance of which is already being amplified by DOL’s tougher enforcement of these rules beginning this year. Both brokers and plan sponsors must now be on their toes or risk the consequences.

What Brokers and Advisors Should Do in the Interim

These developments mean that brokers must consider their practices and modify them as necessary.

The following are important considerations suggested by the FINRA report:

1. Deciding whether to sell financial products, provide investment advice, or act as an investment manager. The decision made will determine the regulatory scheme that applies.
2. Understanding that, whether a broker (non-fiduciary under ERISA) or an advisor (fiduciary), fee and service description disclosures are required under ERISA.
3. As an investment advisor or investment management fiduciary under ERISA,
learning what potential conflict of interest situations exist under ERISA and avoiding them.
4. Defining conflicts of interest in a way that is relevant to the broker/advisor’s business and helps staff identify conflict situations.
5. Articulating employees’ roles and responsibilities for identifying and managing conflicts and establishing mechanisms to identify conflicts across business lines.
6. Avoiding severe conflicts, even if that avoidance means foregoing otherwise attractive business opportunities.
7. Training staff to identify and manage conflicts in accordance with firm policies and procedures.
8. Disclosing potential conflicts to plan sponsors.

The result of the foregoing considerations should be clearly articulated in written structures, policies, and processes.

Conclusion
Until new rules are proposed and finalized, brokers that work with 401(k) and other benefit plans fall under the modified version of the status quo described in this article. Those that wish to continue to be brokers may without being considered ERISA fiduciaries if they order their affairs under the five-prong test. They will, however, have to adjust to the FINRA modified suitability rule, the scope of which is not clear at this point. The higher-standard fiduciary rule under ERISA and the uniform fiduciary standard authorized under Dodd-Frank, however, have not arrived yet.

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Endnotes
1. DOL exercises its authority in this area through its Employee Benefits Security Administration (EBSA).
2. The regulatory agenda for the 2014 fiscal year the SEC views the issuance of the rule a long-term action and 40 out of 43 items in terms of priority.
3. DOL Reg. section 2550.408(b)-2(c), Federal Register, February 3, 2012 (Vol. 75, No. 23), page 5,655-5,658.
4. Section 3(a)(4).
5. FINRA Rule 2111.
8. Section 202(a)(1)(C) of the Advisers Act.
10. ERISA Section 402.
11. ERISA section 406(b).
12. ERISA section 301.
15. Definition of the Term “Fiduciary”; 75 Fed Reg. 65223.
16. ERISA sections 403 and 406. Corresponding Internal Revenue Code section 4975 applies excise taxes to prohibited transactions as defined in ERISA and the Internal Revenue Code.
17. Labor Department Semiannual Regulatory Agenda, May 2014.
20. Act section 913(b).
22. Statement by two SEC commissioners in response to the SEC Study on Investment Advisers and Broker- Dealers.
26. ERISA sections 403 and 406. Corresponding Internal Revenue Code section 4975 applies excise taxes to prohibited transactions as defined in ERISA and the Internal Revenue Code.
27. ERISA Reg. Section 2550.408b-2. The failure to provide the required information to plan sponsors can result in prohibited transaction excise taxes to the service provider/broker.