Commentary: ERISA's Fiduciary Standard Is Applied to Broker-Dealers

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Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act authorized the SEC to adopt rules that would impose the fiduciary standards of the Investment Advisers Act of 1940 on broker-dealers that provide personalized advice to retail customers. Although Chairperson Schapiro has expressed her support for adopting this standard, the SEC has not yet promulgated any such proposal. To be fair, the SEC has a lot on its plate right now.

Meanwhile, the Department of Labor (DOL), which was not affected by Dodd-Frank, moved the issue to center stage on October 21 by proposing to amend its 1975 regulation defining when a person providing investment advice becomes a fiduciary under the Employee Retirement Income Security Act (ERISA). The DOL's regulations also affect Individual Retirement Accounts (IRAs), even though IRAs are not generally subject to DOL oversight, because the Department of Treasury applies DOL's ERISA interpretations to the substantially identical fiduciary duty rules contained in the Internal Revenue Code, which are applicable to IRAs.

The primary change would categorize a broker-dealer as a fiduciary any time it provides advice to an ERISA plan and receives a fee, directly or indirectly, for the advice. Broker-dealers do nothing for free; advice is generally provided in order to obtain an order.

The prior rule required fiduciary status only when the advice-giving was provided on a regular basis on the understanding that it would serve as the primary basis for the plan's investment decisions. Broker-dealers generally could avoid the application of the rule by arguing that they only rendered advice from time to time and that their advice wasn't the primary basis for the plan's investments. The new rule, by contrast, will be very difficult for broker-dealers to avoid if they provide investment advice to ERISA plans or to customers with IRA accounts. It is worth noting that the proposed rule does not distinguish the advice rendered to retail accounts from that given to institutions managing pension plans. In either case, the account can claim that the broker-dealer has fiduciary liability for the advice it renders.

Some broker-dealer business with ERISA plans may fall under an exemption. A transaction would be exempt if the broker-dealer makes clear to another fiduciary for the plan that it is acting as an agent for someone else in selling securities to the plan; or if the broker-dealer is selling securities on a principal basis to the plan, and therefore is not acting as a fiduciary to the plan, and discloses this role to another plan fiduciary. Keeping registered representatives within this exemption will cause compliance officers to reach for their Pepcid bottles.

Fiduciary duties under ERISA present a much heavier burden that the fiduciary responsibilities imposed on investment advisers under the Investment Advisers Act. Entire volumes have been devoted to the complexities of fiduciary duty. Here, we will describe one illustrative example.

Both ERISA and the Investment Advisers Act prohibit their respective fiduciaries from buying or selling property from their own account to the ERISA plan or IRA. As a result, it is difficult for broker-dealers that also are investment advisers to sell over-the-counter securities to their clients, because over-the-counter securities generally are traded on a principal basis. However, investment advisers can sell securities to their clients if they receive the consent of their clients after full disclosure. So, while the Investment Advisers Act imposes some inconveniences, it does not prohibit the ordinary business activities of a broker-dealer. However, broker-dealers that are fiduciaries under ERISA cannot purchase or sell securities from their own accounts to an ERISA plan or IRA. Period. This is a prohibited transaction, and there are no exceptions. Broker-dealers that engage in a prohibited transaction are required to disclose this misdeed to the ERISA plan's participants, but disclosure does not excuse the transaction.

And the penalties under ERISA are much more severe than under the Investment Advisers Act.

An investment adviser's clients have no private right of action under the Investment Advisers Act. Only the SEC can sue an investment adviser. While the SEC's enforcement division must be taken seriously, its ability to investigate complaints and prosecute breaches very much depends on the amount of funding received from Congress. Under past administrations, the SEC was starved for funding, forcing its enforcement division generally to limit its attention to the largest and most noteworthy cases. When the SEC does seek redress, the remedy for breach is to restore the funds lost to the client as a result of the transaction, although the SEC also can impose fines. In especially egregious cases, the persons responsible for the breach can be suspended or barred from the securities industry.

Under ERISA, plan participants, other fiduciaries for the plan, the DOL and the Internal Revenue Service can investigate and bring actions to remedy prohibited transactions. The transaction must be reversed, which in many cases is something like putting Humpty-Dumpty back together again. Moreover, the offending fiduciary broker-dealer must pay a prohibited transactions excise tax amounting to 15% of the amount of the transaction, which increases to an eye-watering 100% if it is not corrected immediately. It should be noted that this is not a tax on the amount of the loss, but on the entire amount of the transaction. If the Congress ever gives the IRS the funding it needs to enforce the federal tax laws, the collection of prohibited transactions taxes, without more, might cure the federal deficit. Last but not least, willful violations of ERISA are punishable by 10 years in jail.

Some commentators will no doubt complain that the DOL's proposed fiduciary regulations will cause broker-dealers to refrain from doing business with ERISA plans and IRAs. This is foolish. Most of the investment money in the world belongs to ERISA plans and IRAs, with a nod in the direction of state pension plans, which are likely in my view to adopt ERISA standards in the near future. Broker-dealers will simply make the best of it and find a way to live within the regulations. But, compliance will be one more blow to industry profits.

In a famous case, Justice Cardozo described fiduciary duty as "[n]ot honesty alone, but the punctilio of an honor the most sensitive." Perhaps. However, the sensitivity of that honor for transactions in securities depends on whether the broker-dealers engaged in them are governed by the Investment Advisers Act or ERISA.

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