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A Matter of Trust: Standards of Conduct under ERISA, the Exchange Act, and the Advisers Act: Part 1 of 2

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While most broker-dealers and investment advisers know whether they are supposed to be registered under the Securities Exchange Act of 1934 (Exchange Act) or the Investment Advisers Act of 1940 (Advisers Act), they are not aware of their fiduciary status under the Employee Retirement Income Security Act of 1974 (ERISA). Or, even if they do in fact know that they are fiduciaries for purposes of ERISA, they are unaware that there are substantial differences between how the securities laws and ERISA govern transactions involving employee benefit plan assets and the assets of an entity that are deemed to be employee benefit plan assets for purposes of ERISA.

The purpose of this article is to help a broker or dealer registered under the Exchange Act (BD) and an investment adviser registered under the Advisers Act (RIA) better determine at what point he or she is acting as a fiduciary for purposes of ERISA and the applicable standards of conduct under ERISA by comparing and contrasting the corresponding requirements under the Exchange Act and the Advisers Act. The importance of understanding the differences will grow in the near future

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as the Department of Labor (DOL) works to revise its regulations identifying fiduciaries that provide investment advice and the SEC looks to coordinate the conduct standards under the Exchange Act and Advisers Act.

The article is divided into two parts. Part 1 focuses on when each of the respective statutes applies and the standards of conduct under the Exchange Act and the Advisers Act. Part 2, which will be published in an upcoming issue of *The Investment Lawyer*, addresses the standards of conduct under ERISA and how they compare to those under the Exchange Act and Advisers Act.

Coverage by the Exchange Act, Advisers Act, and ERISA

In order to determine whether a BD or RIA is subject to ERISA and thus impacted by ERISA's requirements, it is helpful to compare when a broker-dealer or adviser is subject to the Exchange Act or the Advisers Act versus when he or she is subject to ERISA. The following is a summary of when the Exchange Act, Advisers Act, or ERISA applies.

1. Exchange Act

The Exchange Act imposes certain registration and conduct standards on brokers and dealers. Unless an exemption applies, a broker or dealer of securities involved in interstate commerce may not effect securities transactions or induce another party to enter into the purchase or sale of securities unless such broker or dealer is registered as required under the Exchange Act.[1] A "broker" is a person engaged in the business of effecting transactions in securities for the account of others,[2] while a "dealer" is a person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise.[3]

The conduct of a BD is governed through a combination of the provisions of the Exchange Act and its underlying regulations and the rules established by the applicable self-regulatory organization (SRO), such as the Financial Industry Regulatory Authority (FINRA). For purposes of this article, we will assume FINRA is the applicable SRO.

2. Advisers Act

The Advisers Act establishes registration and business conduct requirements for certain investment advisers. An "investment adviser" is, in the absence of an exemption, a person who:

- For compensation;
- Engages in the business of;
- (i) Advising others as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or (ii) who issues or promulgates analyses or reports concerning securities.[4]

The Advisers Act specifically exempts certain persons from the definition of "investment adviser" including brokers and dealers whose performance of the above-described services is solely incidental to the conduct of his or her business as a broker or dealer and who receives no special compensation for such incidental services.[5] However, an adviser may also be a dual-registrant under both the Advisers Act and the Exchange Act and thus subject to both regimes.

The registration requirements, and thus the conduct standards, only apply to advisers that are required to register with the SEC because they meet or exceed certain assets under management thresholds or, if applicable, do not have a principal place of business in a state that requires registration and examination by such state.[6] In addition, some advisers can voluntarily register with the SEC, including pension consultants that advise benefit plans with at least $200 million under management.[7] For purposes of this article, we will assume an adviser is subject to registration with the SEC and thus the Advisers Act applies.

3. ERISA

ERISA establishes extensive fiduciary duty and prohibited transaction provisions that apply to any person who is a "fiduciary" with respect to a "benefit plan" as defined in Section 3(3) of ERISA or a portion of the assets of that plan as long as the plan is subject to the fiduciary duty provisions of ERISA. A party may also be a fiduciary with respect to an entity the assets of which are deemed to be "plan assets" as defined in Section 3(42) of ERISA and as

determined under DOL Regulation section 2510.3-101 (as amended by Section 3(42) of ERISA). Both "benefit plans" and "plan asset" entities will be referred to as "plans" throughout this article.

A determination of fiduciary status under ERISA is based upon (i) a functional definition found in Section 3(21) of ERISA (commonly referred to as a "3(21) fiduciary") and (ii) the delegation of investment authority to an "investment manager" as defined in ERISA (commonly referred to as a "3(38) fiduciary"). A person is a 3(21) fiduciary if he or she does any of the following:

- Exercises any discretionary authority or discretionary control respecting management of the plan;
- Exercises any authority or control respecting management or disposition of the plan's assets;
- Renders investment advice with respect to plan assets for a fee or other compensation, or has any authority or responsibility to do so; or
- Has any discretionary authority or discretionary responsibility in the administration of the plan.

As noted above, this is a functional definition of fiduciary. As such, a person is a fiduciary only if it performs one of the functions described above and only to the extent it performs such functions.

For purposes of the aforementioned functional definition, a person will be a fiduciary by reason of giving investment advice if the person receives compensation for conducting the following services:

- He or she makes recommendations regarding the advisability of buying, selling, or retaining securities;
- He or she does so on a "regular basis" pursuant to an agreement that "such services shall serve as the primary basis for investment decisions with respect to plan assets"; and
- Such advice is individualized to the plan taking into account factors such as investment policies, investment strategies, the plan's overall portfolio, or diversification of plan investments.[8]

Importantly, the DOL is in the process of revising the regulation establishing when a person is providing "investment advice" for purposes of determining fiduciary status.[9] The result of the rulemaking process will likely be a broadening of the definition of "fiduciary" for purposes of ERISA. The impact of fiduciary status on BDs and RIAs is discussed below.

A 3(38) fiduciary is an "investment manager" as defined in Section 3(38) of ERISA to whom investment discretion with respect to all or a portion of a plan's assets has been delegated by another plan fiduciary pursuant to Section 405(c)(1)(B) of ERISA. An "investment manager" for this purpose is a person who (i) has the "power to manage, acquire, or dispose of any asset of a plan"; (ii) falls into one of several specifically listed financial institutions including an adviser registered under the Advisers Act (but does not include a BD); and (iii) acknowledges in writing that it is a fiduciary. Section 405 allows the delegating fiduciary to shift a significant portion of its potential liability regarding investment management decisions to the investment manager.

4. BDs and RIAs as ERISA Fiduciaries

For any financial professional or institution, many of which are well aware of their registration obligations under the Exchange Act and the Advisers Act, a key determination is whether they are, or whether they want to be, acting as a fiduciary for purposes of ERISA. While a 3(38) fiduciary relationship will be obvious because it is intentionally established as such, a determination with respect to 3(21) can be much more nuanced.

In many cases, a BD does not intend to be a fiduciary for ERISA purposes. This will be the case if a BD is simply making trades at the direction of another plan fiduciary (such as the employer, an investment committee, or an investment manager) or a plan participant (such as in the case of a 401(k) plan in which the participant can direct account investments). DOL regulations specifically provide that a registered BD is not a fiduciary under these circumstances as long as the BD is not affiliated (that is, not in common control with) a fiduciary to the plan

and the trade orders are very specific.[10] However, the BD may become a fiduciary if it (i) assumes too much discretion in making trades on behalf of a plan (or a participant's plan account) or (ii) in making recommendations to a plan (or a participant with an account in the plan) the BD provides "investment advice." A BD should carefully review its trading operations to assure that it is not becoming an ERISA fiduciary inadvertently.

BDs are also advised to consider the impact of any "investment advice" regulations proposed by the DOL as those regulations will likely be broadened in a way that will cause BDs to become plan fiduciaries for purposes of ERISA. Those regulations, for example, may eliminate language from the current regulation requiring the advice to be given on a "regular basis"[11] or serve as the "primary basis."[12] Such regulation may also overturn current DOL guidance that the recommendation to rollover plan assets to an IRA is not a fiduciary act.[13]

RIAs, on the other hand, often operate as ERISA fiduciaries. This is particularly so when the RIA has discretion to manage plan assets. However, ERISA fiduciary status may not always be desired or intended even though the RIA is otherwise subject to the Advisers Act. For instance, if an RIA offers a standard investment platform to all of its plan clients, some RIAs may take the position that they are not acting as a fiduciary for purposes of ERISA because they do not have investment discretion and do not provide advice as defined under current DOL regulations. In fact, there is case law that may support this position as long as another fiduciary (such as the plan sponsor) approves the use of the platform without receiving any advice from the RIA.[14] However, it is not clear whether a platform provider that is an RIA would be able to successfully take this position in all circumstances. Furthermore, any changes to the fiduciary regulation under ERISA may result in some RIAs being fiduciaries in circumstances where they may not be so under current law.

The following table illustrates the applicability of the respective statutes:

Registered Investment Adviser	**Registered Broker Dealer**	**ERISA Fiduciary**
In the absence of exemption, the Advisers Act applies to an "investment adviser," who is 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 advisability of investing in, purchasing, or selling securities, or issues analyses or reports concerning securities. Specific exclusion for BD if advice is incidental and no special compensation is paid. Small and some mid-sized advisers subject to registration at state level, thus state law governs conduct.	In the absence of an exemption, the Exchange Act applies to a broker or dealer of securities involved in interstate commerce when effecting securities transactions or inducing another party to enter into the purchase or sale of securities. "Broker"—person engaged in the business of effecting transactions in securities for the account of others. "Dealer"—person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise.	ERISA applies to any person who does any of the following: • Exercises any discretionary authority or discretionary control respecting management of a plan; • Exercises any authority or control respecting management or disposition of the plan's assets; • Renders investment advice with respect to plan assets for a fee or other compensation; or • Has any discretionary authority or discretionary responsibility in the administration of the plan. "Plan" is an employee benefit plan subject to Part 4 of Title I of ERISA and "plan asset" entities with such benefit plans as investors.

Standards of Conduct under the Exchange Act and the Advisers Act

Once a determination is made that a BD or RIA is acting as an ERISA fiduciary, such BD or RIA needs to understand the impact of that status on how it makes trading or investment decisions on behalf of its clients. In so doing, an understanding of how the standards of conduct under the Exchange Act and the Advisers Act compare to ERISA is helpful.

1. Exchange Act

The Exchange Act prohibits fraud, manipulative, and similar kind of conduct in operating as a BD. Such provisions have been interpreted broadly by the courts and FINRA to encompass extensive duties and responsibilities applicable to BDs though federal law does not create a fiduciary relationship between a BD and its client. More specifically, a BD subject to registration under the Exchange Act is prohibited from causing a client to enter into a securities transaction "by means of any manipulative, deceptive, or other fraudulent device or contrivance."[15] The Exchange Act also prohibits the use by a BD of "any manipulative or deceptive device or contrivance" contrary to the rules established by the SEC or FINRA designed to protect the interest of investors engaging in securities transactions.[16]

From the above antifraud provisions in the Exchange Act, the courts and FINRA have developed what is commonly referred to as a "duty of fair dealing" applicable to a BD's activities. According to the Second Circuit, the Exchange Act establishes a "special relationship" between the BD and the client whereby the BD is in a position of trust such that the client should be able to assume statements made by the BD are thoughtful and accurate. FINRA Rule 2010 also provides that a BD "in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade." Inherent in this duty of fair dealing is a requirement that a BD make a "suitability" determination with respect to securities transactions it recommends to its customers.

FINRA Rule 2111 provides for three suitability determinations including (i) "reasonable-basis suitability," (ii) "customer-specific suitability," and (iii) "quantitative suitability," each of which is described below:

- *Reasonable-Basis Suitability:* With respect to "reasonable-basis suitability," the BD must have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors. Effectively, FINRA establishes a type of threshold test that should be made before a recommendation is made to any client.
- *Customer-Specific Suitability:* As the name implies, "customer-specific suitability" requires the BD to make a determination whether the recommendation is suitable for the specific client given the specific client's investment profile. In making such suitability determination, the BD should look to facts such as the client's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and other relevant factors.
- *Quantitative Suitability:* Even if any single recommendation with respect to a securities transaction would pass muster under the "client-specific suitability" standard, a BD who has actual or de facto control over a customer account must also comply with the "quantitative suitability" requirement. As such, the BD must have a reasonable basis for believing that a series of recommended transactions is not excessive or otherwise unsuitable for the client based upon the client's investment profile. For example, excessive buy-sell transactions in a short period of time (often referenced in the negative as "churning") may not be suitable for many clients upon considerations of turnover ratio and the sophistication level of the client.

While the courts, SEC, or FINRA do not suggest that a BD is acting as a fiduciary when it recommends securities transactions to clients, the duty of fair dealing and the underlying suitability requirements certainly hold BDs to a standard higher than merely not defrauding their clients when making recommendations with respect to securities transactions. Rather, the BD must have a reasonable

basis on which to make a recommendation based upon the surrounding facts and circumstances.

The SEC and FINRA have also long-recognized a duty of best execution, which is derived "from common law agency principles and fiduciary obligations."[17] The SEC has taken the position that this duty requires the BD to "seek the most favorable terms reasonably available under the circumstances for a customer's transaction."[18] Among other things, this duty requires the BD to (i) regularly examine execution quality likely to be obtained from the different markets or market makers, (ii) determine if different markets may be more suitable for different types of orders or particular securities, (iii) account for any material differences between the price improvement opportunities offered by markets or market makers, and (iv) account for any material differences in execution quality among the various markets or market centers to which limit orders may be routed. BDs should also not allow payments to it as an inducement for order flow to interfere with its obligation to seek best execution.[19] FINRA Rule 5310 also sets forth the duty of best execution and provides that a BD must "use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions." The rule further establishes what constitutes "reasonable diligence" and other aspects of this duty.

The SEC and FINRA, through their authority under the Exchange Act, regulate several other areas of BD operations to assure fraudulent, manipulative or deceitful conduct does not occur and to otherwise uphold the principles of fairness and truthfulness in the profession discussed above. For example, BDs may not engage in securities transactions, or must make disclosures to clients before doing so, when certain conflicts specified in FINRA Rules are present. Such regulations include Exchange Act Rule 15c1-5, which requires a BD to disclose in writing any control relationship or affiliation between the issuer of a security and the BD, and Exchange Act Rule 15c1-6, which requires a BD to disclose in writing if it owns a security or has a financial interest in a security that the BD is recommending. FINRA has also implemented similar rules including FINRA Rule 2262 (Disclosure of Control Relationship with Issuer) and FINRA Rule 2269 (Disclosure of Participation or Interest in Primary or Secondary Distribution).

In summary, in addition to a general prohibition against fraud, the Exchange Act, SEC regulations, and FINRA establish a code of conduct applicable to BDs that includes the following:

- Duty to deal fairly with clients;
- Duty to make a suitability determination;
- Duty of best execution; and
- Duty to disclose conflicts in certain situations.

The Exchange Act does not create a fiduciary relationship between the BD and client or an underlying duty of loyalty. Rather, a BD is bound by a standard that requires it to act honorably and fairly in its dealings with his or her clients.

2. Advisers Act

The Advisers Act, as interpreted by the Supreme Court and the SEC, imposes a fiduciary duty on RIAs in dealing with clients and prospective clients. Section 206 of the Advisers Act provides that an RIA cannot (i) act in a manner designed to manipulate, defraud, or deceive its clients or prospective clients, or (ii) engage in any course of conduct that will have the effect of manipulating, defrauding, or deceiving a client or prospective client. After reviewing the legislative history, the US Supreme Court interpreted the language in the statute broadly to impose a fiduciary duty on an RIA.[20] Therefore, the Court concluded that the Advisers Act establishes that the RIA must "eliminate, or at least expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which is not disinterested."[21]

In addition, the SEC has taken a similar position and requires that as a fiduciary, an RIA "must not put himself into a position where his or her own interests may come in conflict with those of his [client],"

though there is an exception to this general prohibition "where the [client] gives informed consent to such dealings."[22] Part and parcel to its fiduciary duty under the Advisers Act is, according to the SEC, a duty of loyalty. As such, an RIA must "serve the interests of his client with undivided loyalty."[23] The RIA should not make investment decisions, including trades in securities, in a manner that will benefit the RIA without first disclosing the existence of the conflict to the client. The content and frequency of such disclosure varies based upon the facts and circumstances of the situation. In effect, informed consent given by a client to the RIA is permitted by the Advisers Act and will overcome a breach of the duty of loyalty owed by the RIA to the client.[24]

The SEC has also concluded that the fiduciary duty requirements impose additional duties on RIAs. One such duty is a determination of "suitability" in delivering investment advice to a client.[25] The SEC takes the position that an RIA has a duty to make a reasonable determination that investment advice is suitable for the client based upon the client's financial situation, investment experience, and investment objectives. Inherent in this suitability requirement is that the RIA has a duty to inquire as to the financial situation and financial goals of the client and to periodically update this information to assure that the advice is appropriate initially and throughout the term of the investment. According to the SEC, suitability determinations should be made with respect to each piece of advice and in the context of the client's entire portfolio.[26] Seemingly connected to this suitability requirement and its underlying duty of inquiry is the SEC requirement that the RIA have a reasonable independent basis for the investment recommendations he or she makes to his or her clients.[27]

The SEC has also taken the position that the fiduciary duty provisions of the Advisers Act impose standards on RIAs when they have the discretion to engage in brokerage transactions on behalf of client accounts and they have discretion to select the broker-dealers. Specifically, the SEC states that RIAs who have such discretion are required to seek "best execution," which means they are required to seek the best price at which client account trades could be executed in light of factors such as dealer mark ups and mark downs, brokerage commissions, and compensation paid to the RIA by reason of its use of a particular broker or dealer (including the receipt of soft dollar payments).[28]

Regulations promulgated under Section 206 of the Advisers Act address specific instances in which an RIA's conduct will be considered in compliance with Section 206 of the Advisers Act. Such regulations include the following:

- Conduct of agency cross transactions;[29]
- Conduct of principal trades;[30]
- Custody of client funds or securities;[31] and
- Proxy voting.[32]

Furthermore, while the Advisers Act does not address the use of performance fees in Section 206, the provisions in Section 205 addressing investment advisory agreements generally prohibit any compensation arrangement whereby the RIA's compensation is based upon "a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client."[33] Notwithstanding this general prohibition, the SEC's regulations provide that an RIA will not violate Section 205 by including in an investment advisory agreement an arrangement whereby compensation is determined on the basis of a share of the capital gains upon, or the capital appreciation of, the funds, or any portion of the funds, of a client if the client is a "qualified client."[34]

In summary, Section 206 of the Advisers Act prohibits conduct by an RIA that is manipulative, fraudulent, or deceitful with respect to a client or a prospective client. The Supreme Court and the SEC have interpreted Section 206 to establish a fiduciary relationship between the RIA and its clients and prospective clients. The following duties are derived from that fiduciary relationship:

- Duty to disclose material facts;
- Duty to not engage in transactions involving a conflict of interest unless such conflicts are disclosed;
- Duty to determine suitability (including a duty to inquire);

- Duty of best execution; and
- Duty of loyalty.

The SEC has also promulgated regulations under Section 206 of the Advisers Act that address how certain transactions that raise conflict of interest issues can be undertaken without violating the Advisers Act.

Summary

As discussed above, the Exchange Act and Advisers Act each provide for rigorous standards of conduct that govern the activities of BDs and RIAs, as applicable. Both BDs and RIAs are required to act fairly and honestly with their clients. However, the Advisers Act's fiduciary requirements appear to impose a heavier burden on RIAs particularly with respect to disclosure of conflicts of interest and other aspects of their operations.

Part 2 of this article will explain that ERISA, the regulations thereunder, and guidance issued by the DOL establish an extensive and strict standard of conduct pursuant to which ERISA fiduciaries must operate. Such standard of conduct essentially can be broken down into three parts: (i) the general fiduciary duty provisions, (ii) prohibitions against self-dealing, and (iii) prohibitions against dealings with parties in interest. Importantly, BDs and RIAs that are ERISA fiduciaries should not assume that compliance with the Exchange Act or Advisers Act, as applicable, will lead to compliance with ERISA. The courts have interpreted ERISA's prudence requirements to impose a fiduciary standard of care that is one of the highest known under the law. Furthermore, ERISA's duty of loyalty, when combined with ERISA's self-dealing prohibited transactions provisions, prohibit ERISA fiduciaries from acting on behalf of a plan when a conflict of interest exists except in very limited circumstances. For example, common transaction-based fees and performance-based compensation arrangements may not be permissible under ERISA although permitted under the Exchange Act and the Advisers Act. In addition, mere disclosure of a conflict of interest will never be sufficient under ERISA.

Notes

1. Exchange Act § 15(a)(1).

2. Exchange Act § 3(a)(4).

3. Exchange Act § 3(a)(5).

4. Advisers Act § 202(a)(11).

5. *Id.*

6. Advisers Act § 203A(a)(1) & (2); *see also Rules Implementing Amendments to the Investment Advisers Act of 1940*, Advisers Act Release No. 1633 (May 15, 1997) and *Rules Implementing Amendments to the Investment Advisers Act of 1940,* Advisers Act Release No. 3321 (June 22, 2011).

7. Advisers Act § 203A(a)(2)(A).

8. 29 C.F.R. § 2510.3-21(c).

9. Department of Labor (EBSA) Proposed Rule, Definition of Fiduciary, 75 FR 65263 (Oct. 22, 2010); *see also* Department of Labor (EBSA), Announcement, *US Labor Department's EBSA to Re-propose Rule on Definition of a Fiduciary* (Sept. 19, 2011).

10. 29 C.F.R. § 2510.3-21(d).

11. 75 FR 65264.

12. 75 FR 65267.

13. 75 FR 65266.

14. *See* Zang v. Paychex, Inc., 728 F.Supp.2d 261 (W.D.N.Y.2010).

15. Exchange Act § 10b.

16. *Id.*

17. *Order Execution Obligations*, Exchange Act Release No. 34-37619A (Sept. 6, 1996), pp.160-162.

18. *Id.*

19. *Id.*

20. S.E.C. v. Capital Gains Bureau, 375 U.S. 180 (1963).

21. *Id.* at 191.

22. *See In the Matter of Arleen W. Hughes*, Exchange Act Release No. 4048 (Feb 18, 1948).

23. *In the Matter of Kidder Peabody & Goodwin*, Advisers Act Release No. 232 (Oct. 16, 1968).

24. *See* "Regulation of Investment Advisers by the US Securities and Exchange Commission," SEC, Division of Investment Management (April 2012) at *http://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf*. (The SEC states that "the duty of an investment adviser to refrain from fraudulent conduct includes an obligation to disclose material facts whenever failure to do so would defraud or operate as a fraud or deceit upon any client.").

25. *See Suitability of Investment Advice Provided by Investment Advisers*, Advisers Act Release No. IA-1406 (March 22, 1994).

26. *Id.*

27. *In the Matter of Alfred C. Rizzo*, Advisers Act Release No. 897 (Jan. 11, 1984).

28. *In the Matter of Portfolio Advisory Services,* LLC, Advisers Act Release No. IA-2038 (June 202, 2002); *see also In the Matter of Renberg Capital Management, Inc.*, Advisers Act Release No. IA 2064 (Oct. 1, 2002), *Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1984 and Related Matters*, Exchange Act Release No. 34-23170 (April 28, 1986), and *In the Matter of Kidder Peabody & Goodwin, supra* n.23.

29. 17 C.F.R. § 275.206(3)-2.

30. 17 C.F.R. § 275.206(3)-3T.

31. 17 C.F.R. § 275.206(4)-2.

32. 17 C.F.R. § 275.206(4)-6.

33. Advisers Act § 205(a)(1).

34. 17 C.F.R. § 275.205-3.

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