

Dueling Fiduciaries

The debate over who should be considered a fiduciary

In October, the U. S. House of Representatives approved H.R. 2374, the “Retail Investor Protection Act,” which, among other things, would block the secretary of Labor from prescribing any regulation defining when an individual is considered a “fiduciary” under the Employee Retirement Income Security Act (ERISA) until at least 60 days after the Securities and Exchange Commission (SEC) issues a final rule relating to standards of conduct for broker/dealers (B/Ds) authorized under the Dodd–Frank Wall Street Reform and Consumer Protection Act. Although we do not believe that H.R. 2374 will pass the Senate, it demonstrates the significance of this issue. Here’s some background on why the House felt compelled to act.

Securities Law Fiduciaries

Investment advisers are fiduciaries who must serve in the best interest of their clients. Broker/dealer conduct, however, is generally governed by the antifraud provisions of the Securities Act of 1933, the Exchange Act of 1934 and the rules and requirements of the Financial Industry Regulatory Authority (FINRA)—the broker/dealers’ self-regulatory organization. A broker/dealer’s recommendation must be “suitable” for the investor.

Many investor advocates claim that these disparate approaches lead to investor confusion, and they argue that both advisers and broker/dealers should operate under the same standard of care when performing similar functions. As part of Dodd–Frank, Congress directed the SEC to conduct a study evaluating: 1) the effectiveness of existing legal and regulatory standards for broker/dealers and investment advisers, and 2) whether there are gaps, overlaps or shortcomings in the legal or regulatory standards governing the standards of care applicable to both when they provide personalized advice to retail customers.

Section 913 of Dodd–Frank also authorized the SEC to, following its study, commence a rulemaking to address the legal and regulatory standards of care for broker/dealers and investment advisers. In findings published in January 2011, SEC staff recommended new rulemakings, guidance and other policy changes that would impose a “uniform fiduciary standard”—no

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less stringent than the one currently applied to investment advisers. The SEC has been working on drafting new rules and regulations to implement its staff’s suggestions.

ERISA Fiduciaries

While the SEC was working on its study, the Department of Labor (DOL) had been drafting a proposal for a regulation amending its rule on the definition of a fiduciary. Since 1975, a person has been treated as a fiduciary if he satisfies a specific five-part test.

On October 22, 2010, the DOL published its proposed regulation, which would replace the test with a more encompassing fiduciary definition. In addition to broadening the types of investment advice that would subject an adviser to ERISA’s fiduciary standards, the proposal expanded the plans covered by the rule to include individual retirement accounts (IRAs). If the rule is adopted as proposed, many broker/dealers would find themselves regulated as ERISA fiduciaries.

Adding to the regulated community’s displeasure was the apparent lack of coordination between the DOL and the SEC in their respective rulemakings. Section 913 of Dodd–Frank explicitly provides that the receipt of commission-based compensation for the sale of securities should not violate a uniform fiduciary standard of conduct applied to a broker/dealer. However, under ERISA, fiduciaries may receive commission-based compensation only in certain limited circumstances.

Faced with significant opposition, in September 2011, the DOL announced that it would withdraw and re-propose. We are still waiting for that re-proposal.

As noted, H.R. 2374 appears unlikely to gain any traction in the Senate and is facing a veto threat by the White House. Recently, the Obama administration issued a policy statement that asserted that the DOL and the SEC are working closely to avoid conflicting requirements. Nevertheless, the fact that nearly 15% of the House Democratic caucus broke ranks and voted in favor of the bill underscores the Congressional scrutiny that the DOL and the SEC face with their rulemakings.

Both agencies have reassured their communities that they are coordinating with each other. They have also made clear that their intention is that financial professionals will be able to simultaneously comply with any new ERISA and securities law fiduciary rules. Only time will tell how well they will be able to harmonize their fiduciary rulemakings.