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Principal Transactions

Advisers are still fiduciaries under the 5-part test

By David Kaleda

Art by Tim Bower

One of the trickiest areas of compliance for advisers and their supervising firms is related to principal transactions. The Securities and Exchange Commission (SEC), Financial Industry Regulatory Authority (FINRA) and Department of Labor (DOL) recognize that principal transactions pose acute conflicts of interest.

Advisers should understand that their compliance obligations in connection with principal transactions will depend on whether their activities are governed by the Securities Exchange Act of 1934, Investment Advisers Act of 1940—aka the Exchange Act and the Advisers Act, respectively—the Employee Retirement Income Security Act of 1974 (ERISA) or the Internal Revenue Code of 1986 (IRC). The impact of these statutes and underlying regulations have come to the forefront as firms have begun to react to the vacatur of the DOL's fiduciary rule and related exemptions.

An adviser supervised by a broker/dealer (B/D) that recommends an investor purchase a security in a principal transaction is subject to the requirements of the Exchange Act and FINRA when making these recommendations.

Therefore, an adviser must make such recommendations in accordance with FINRA's suitability requirements in FINRA Rule 2111 and best execution requirements in Rule 5310. Further, Exchange Act 10b-10 requires that the firm disclose that it sold the security as principal, as well as certain compensation it received, while the anti-fraud provisions of Exchange Act Rule 10b-5 require the disclosure of certain conflicts. FINRA also requires substantial recordkeeping by firms of principal and of riskless principal transactions.

An adviser who acts as a fiduciary for purposes of the Advisers Act has additional responsibilities. According to the U.S. Supreme Court in SEC v. Capital Gains Bureau, Section 206 of the Advisers Act imposes fiduciary duties on advisers. These duties include the disclosure of material facts, avoidance of engaging in transactions involving a conflict of interest unless such conflicts are disclosed, determination of suitability, best execution and loyalty.

Section 206(3) of the act specifically prohibits an adviser from engaging in principal transactions with his clients unless he discloses, before completion of a transaction, that his firm is entering into it as principal and obtains consent to proceed.

These restrictions apply to principal transactions including those in which the adviser or an affiliate is an issuer or underwriter. The adviser must comply with the remaining fiduciary duty provisions of Section 206 even if the requirements in 206(3) are met.

ERISA and the IRC place further restrictions on advisers acting as fiduciaries with regard to ERISA-governed accounts. Additionally, the IRC places limits on those acting as fiduciaries for non-ERISA tax-favored accounts such as individual retirement accounts (IRAs). Both ERISA and the IRC prohibit a fiduciary from engaging in a such as individual retirement accounts (IRAs). Both ERISA and the IRC prohibit a fiduciary from engaging in a self-dealing transaction or a transaction in which the fiduciary or an affiliate receives payments from a third party.

ERISA also prohibits fiduciaries or their affiliates from acting on both sides of a transaction. Principal transactions result in such prohibited transactions.

Such issues also arise when an adviser or his affiliate is an issuer, underwriter or member of the selling group.

Under ERISA and the IRC, the adviser must comply with prohibited transaction exemptions (PTEs). With the vacating of the DOL's best interest contract (BIC) exemption and the principal transactions exemption, advisers who act as fiduciaries may have limited relief. In the interim, DOL Field Assistance Bulletin (FAB) 2018-02 states that advisers may continue to apply transition versions of the BIC exemption, which allows advice fiduciaries to engage in riskless principal transactions, or of the principal transaction exemption, which lets them engage in principal transactions with respect to certain securities.

Notably, the FAB is only temporary and provides only enforcement relief from the DOL. Thus, the FAB may be more helpful when a principal transaction involves an IRA rather than an ERISA-governed plan.

Otherwise, there is no specific prohibited transaction exemption that applies to principal transactions when the adviser is a fiduciary. DOL PTE 86-128 may be read to cover riskless principal transactions, which are more in the nature of agency transactions. However, the DOL has not confirmed this interpretation and is unlikely to interpret its own exemption this broadly.
Additionally, DOL PTE 75-1 provides limited relief when a fiduciary or its affiliate is a member of an underwriting or selling group.

Given the lack of exemptive relief, fiduciary advisers may find it challenging to comply with the prohibited transaction provisions when engaging in principal transactions.

David Kaleda *is a principal in the fiduciary responsibility practice group at Groom Law Group, Chartered, in Washington, D.C. He has an extensive background in the financial services sector. His range of experience includes handling fiduciary matters affecting investment managers, advisers, broker/dealers, insurers, banks and service providers. He served on the Department of Labor's ERISA Advisory Council from 2012 through 2014.*

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