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Defining "Fiduciary": Differences in Fiduciary Standards within the Securities Industry

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DEFINING "FIDUCIARY": DIFFERENCES IN FIDUCIARY STANDARDS WITHIN THE SECURITIES INDUSTRY

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The financial advice industry is heavily regulated. There are state regulators – both securities and insurance regulators; there are federal regulators – including the SEC, the CFTC, and the DOL; and there are self-regulatory organizations – including FINRA, the MSRB, and the NFA. The standards set by each regulator are different, leading to varying standards across the industry based on the type of advice given, the type of product being sold, where the advice is given, as well as the title of the person giving the advice. The standards range from ensuring that the advice is suitable for the recipient to adhering to fiduciary standards when giving advice.

This article will discuss the various fiduciary standards that govern brokers and investment advisers. It will examine statutory fiduciary standards that govern investment advisers, common law fiduciary standards that govern certain brokers, and the ERISA fiduciary standards that govern certain individuals who are providing advice with respect to retirement assets.

I. A Brief History of Securities Regulation

Towards the end of the nineteenth century, the sale of securities expanded. The expansion of railroads and heavy manufacturing led to greater demands for capital.[1] The industries could tap the increased wealth of the middle class. Bond issuers began offering securities in denominations of $100, making them more accessible.[2] The U.S. Government began offering Liberty Bonds during World War I, creating a broader public interest in securities.[3]

Prior to the post-war boom, individuals "had been more likely to put their funds in savings banks, mortgages, local investments, the managers of which they knew personally, or which were such a factor in their surroundings, their neighborhood, that they felt some confidence in them.[4] Following the War, an "unhealthy volume of credit was sucked into securities markets to the deprivation of agriculture, commerce, and industry," causing widespread securities inflation.[5] By 1934, it was estimated that over

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[1]*See* Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 Tex. L. Rev. 347, 353 (1991).

[2]*See id.*

[3] Sean M. O'Connor, *Be Careful What You Wish For: How Accountants and Congress Created the Problem of Auditor Independence*, 45 B.C. L. REV. 741, 796 (2004).

[4] *See* Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission, Pursuant to Section 30 of the Public Utility Holding Company Act of 1935, on Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services, H.R. Doc. No. 477, 76th Cong., 2d Sess. 1, 4 (1939) ("SEC Report on Investment Advisers").

ten million individuals owned stocks and bonds; and "that over one fifth of all the corporate stock outstanding in the country is held by individuals with net incomes of less than $5,000 a year."[6]

Financial advice was first regulated at the state level. Blue sky laws, which goverened the sale and trading of securities, first appeared in the 1910s.[7] The blue sky laws were controversial, and their constitutionality was challenged.[8] However, in 1917, the Supreme Court upheld the blue sky laws as constitutional.[9] By 1933, every state except Nevade had a blue sky law on its books.[10]

Although states had the ability to regulate conduct within their borders, states lacked any effective power to regulate the national securities market, making state-by-state regulation largely ineffective.[11] As more money was invested in securities, the value of stocks increased, creating a bubble that inevitably burst in October 1929. "The market value of all stocks listed on the New York Stock Exchange slumped from $89,000,000,000 on September 1, 1929, to $15,000,000,000 on July 1, 1932,"[12] a drop of more than eighty percent. It became clear that the securities markets were a significant part of the economy, yet there was no federal regulation of the markets. There was concern that stock exchanges, which now handled the distribution and trading of a substantial portion of the economy, could not continue to operate under the same traditions and practices as pre-war stock exchanges – which generally handled only the transactions of professional investors and speculators.[13] Congress held hearings and examined the lack of federal oversight of the securities industry. Initially, Congress enacted the Securities Act of 1933 (the "33 Act").[14] President Franklin Roosevelt encouraged Congress to pass the legislation and add to "the ancient rule of caveat emptor the further doctrine, 'Let the seller also beware.'"[15]

The 33 Act focuses primarily on the issuance of securities, and has primary goals: (1) to ensure that investors receive full disclosure in connection with securities being offered for public sale; and (2) to prohibit fraud in connection with the sale of securities.[16] The 33 Act requires an issuer to fully disclose all

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[5]S. Rep. No. 73-792, 3 (1934).

[6]H.R. Rep. No. 73-1383, 3 (1934).

[7]*See* Macey & Miller, *supra* note 1 (describing the origin of state blue sky laws).

[8]*See id.* at 386 (citing *Merrick v. Halsey & Co.*, 242 U.S. 568 (1917); *Caldwell v. Sioux Falls Stock Yards Co.*, 242 U.S. 559 (1917); *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917).).

[9]*See id.*

[10]*See* O'Connor, *supra* note 3 at 795.

[11]*See* Macey & Miller, *supra* note 1 at 388.

[12]S. Rep. No. 73-792, at 3.

[13]H.R. Rep. No. 73-1383, at 4.

[14]The Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. §§ 77a *et seq.*).

[15]H.R. Rep. No. 73-85, at 2 (1933).

[16]*The Laws That Govern the Securities Industry*, Sec. & Exch. Comm'n, http://www.sec.gov/about/laws.shtml.

material facts about the offering so that investors may make their own decisions about whether to purchase a company's securities.[17] The federal securities laws apply to securities, which Section 2(a)(1) of the 33 Act defines as including:

> any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing . . . .[18]

The 33 Act does exclude certain investment contracts from the definition of "security." In particular, Section 3(a)(8) explicitly excludes "[a]ny insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia[.]"[19]

Following enactment of the 33 Act, Congress continued to investigate the securities industry. "Speculation, manipulation, faulty credit control, investors' ignorance, and disregard of trust relationships by those whom the law should regard as fiduciaries, are all a single seamless web. No one of these evils can be isolated for cure of itself alone."[20] President Roosevelt tasked Congress with enacting legislation "providing for the regulation by the Federal Government of the operations of exchanges dealing in securities and commodities for the protection of investors, for the safeguarding of values, and . . . for the elimination of unnecessary, unwise, and destructive speculation."[21] In response, Congress adopted the Securities Exchange Act of 1934 (the "34 Act").[22]

The 34 Act was meant to deal with three principal problems: (1) "the excessive use of credit for speculation," (2) "the unfair practices employed in speculation," and (3) "the secrecy surrounding the financial condition of corporations which invite the public to purchase their securities."[23] The 34 Act also

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[17] *See id.*

[18] 15 U.S.C. § 77b(a)(1).

[19] 15 U.S.C. § 77c(a)(8).

[20] H.R. Rep. No. 73-1383, at 6.

[21] S. Rep. No. 73-792, at 2.

[22] The Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (1934) (codified at 15 U.S.C. § 78a, *et seq.*).

[23] S. Rep. No. 73-792, at 5.

created the Securities and Exchange Commission (the "SEC").[24] The SEC was created to enforce the securities laws.[25] Congress included a broad antifraud provision in the 34 Act.[26] However, it left the SEC responsible for developing rules and regulations defining the conduct that would be covered by the provision. The SEC promulgated Rule 10b-5, which broadly prohibits fraud in connection with the purchase or sale of securities.[27]

In 1938, the Maloney Act amended the 34 Act to provide for a system of self-regulation of brokerage firms.[28] The section permitted the registration of an association of brokers and dealers as a national securities association.[29] Only one such association has ever registered pursuant to this section—the National Association of Securities Dealers ("NASD"), which is today known as the Financial Industry Regulatory Authority ("FINRA").[30] Under the watch of the SEC, FINRA has the primary responsibility of regulating brokers and writing and enforcing rules for every broker in the United States.[31]

Following the enactment of the 34 Act, Congress continued to evaluate the securities markets to determine whether additional legislation was necessary. In 1939, the SEC submitted a report to Congress on Investment Trusts and Investment Companies.[32] It was recognized that although many different sources of advice existed, there was "no one to whom [an investor] could turn and retain professionally the way he would retain a lawyer on a technical problem where he was up against technical men on the

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[24]15 U.S.C. § 78d(a).

[25]*See* SEC, *What We Do*, http://www.sec.gov/about/whatwedo.shtml.

[26]*See* 15 U.S.C. § 78j.

[27]*See* 17 C.F.R. § 240.10b-5. Rule 10b-5 states the following:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
> (a) [t]o employ any device, scheme, or artifice to defraud,
> (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

[28]*See* 15 U.S.C. § 78o-3.

[29]*Id.* § 78o-3(a).

[30]In 2007, FINRA was created through the consolidation of NASD and the member regulation, enforcement, and arbitration operations of the New York Stock Exchange. FINRA Press Release, NASD and NYSE Member Regulation Combine To Form the Financial Industry Regulatory Authority—FINRA (July 30, 2007), http://www.finra.org/Newsroom/NewsReleases/2007/P036329. Today, it is the largest independent regulator for all securities firms doing business in the United States, and it oversees over 3,800 brokerage firms and over 600,000 brokers. FINRA, *About the Financial Industry Regulatory Authority*, http://www.finra.org/AboutFINRA/.

[31]FINRA, *Get To Know Us*, http://www.finra.org/web/groups/corporate/@corp/@about/documents/corporate/p118667.pdf.

[32]*See* SEC Report on Investment Advisers, *supra* note 4.

other side who knew more than he did."[33] Investment advisers (or investment counselors as they were called in the report) offered advice on investing, yet were not broadly regulated at that point. There were no uniform standards for training investment advisers.[34] As a result, "individuals without the requisite qualifications and financial responsibility who indulged in exaggerated claims constituted a menace not only to the investor but to the counselors."[35]

Investment advisers acknowledged that their function was the "furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments" and they could not do this "unless all conflicts of interest between the investment counsel and the client were removed."[36] Investment advisers were concerned that affiliations between investment advisers and brokers

> fostered undesirable and irreconcilable conflicts of interest, for 'the broker receives his income principally or entirely from the commissions received on transactions—the larger the number of transactions the larger his gross income' and 'the broker's interest in turnover might be a temptation to advise clients to trade more than might be to their advantage or than might be necessary in their interest.'[37]

Following the receipt of the SEC's report, Congress adopted the Investment Advisers Act of 1940 (the "Advisers Act").[38] "The nature of the functions of investment advisers, their increasing widespread activities, their potential influence on security markets and the dangerous potentialities of stock market tipsters imposing upon unsophisticated investors, convinces this committee that protection of investors requires the regulation of investment advisers on a national scale."[39]

Like the 34 Act, the Advisers Act prohibits fraud and deceptive practices on the part of an investment adviser.[40] Unlike the 34 Act, the Advisers Act is more explicit in the conduct it prohibits.[41] For example, the Advisers Act prohibits an adviser from acting as a principal in any trade with a client "without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction."[42]

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[33] *Id.* at 4–5.

[34] *Id.* at 16.

[35] *Id.* at 28.

[36] *Id.*

[37] *Id.* at 29.

[38] The Investment Advisers Act of 1940, Pub. L. No. 76-768, 54 Stat. 847 (1940) (codified at 15 U.S.C. § 80b-1, *et seq.*).

[39] S. Rep. No. 76-1775, at 21 (1940).

[40] *See* 15 U.S.C. § 80b-6.

[41] *See id.*

[42] *Id.*

Congress remained concerned about the standards of conduct governing those who provided investment advice. In 1974, Congress adopted the Employee Retirement Income Security Act of 1974 ("ERISA").[43] Although ERISA does not exclusively regulate the securities industry, it does regulate investment advice when rendered in connection with retirement accounts. Congress determined that it would protect participants in employee benefit plans and their beneficiaries "by establishing standards of conduct, responsibility, and obligation for fiduciaries of employee benefit plans, and by providing for appropriate remedies, sanctions, and ready access to the Federal courts."[44] ERISA also amended the Internal Revenue Code (the "Code") to create Individual Retirement Accounts (IRAs).[45]

By 1978, the Department of Labor ("DOL") was given certain responsibilities under both ERISA and the Code for employee benefit plans and IRAs, as explained by President Carter: "Labor will have statutory authority for fiduciary obligations. ERISA prohibits transactions in which self-interest or conflict of interest could occur, but allows certain exemptions from these prohibitions. Labor will be responsible for overseeing fiduciary conduct under these provisions."[46] Accordingly, the DOL was given authority to enforce ERISA as well as certain sections of the Code.

Over the decades since the securities laws were first enacted, Congress frequently amended them, creating a patchwork of legislation.[47] In the aftermath of the 2008 financial crisis, it adopted Dodd-Frank to "protect consumers from abusive financial services practices."[48] Title IX of the statute is entitled, "Investor Protections and Improvements to the Regulation of Securities. Among other things, Dodd-Frank directed the SEC to review and report on the standards of care for brokers and investment advisers giving advice to retail customers.[49] It also authorized—but did not require—the SEC to harmonize these standards of care by imposing a fiduciary duty on brokers.[50]

II. The Standards of Care

The standards of care which were set forth by the 34 Act and the Advisers Act were not clear. Although both statutes contained antifraud provisions, the courts have interpreted each provision differently. This has led to disparities in the obligations of brokers and investment advisers, even though both statutes

[43]The Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat 832 (1974) (codified at 29 U.S.C. § 1001, *et seq.*).

[44]29 U.S.C. § 1001(b).

[45]26 U.S.C. § 408.

[46]Reorganization Plan No. 4 of 1978, § 102, 43 Fed. Reg. 47,713 (1978).

[47]*See* John C. Coffee, Jr. & Hillary A. Sale, Securities Regulation 57 (11th ed. 2009) ("The 1934 Act has been frequently amended; indeed, it has become the Christmas tree on which Congress almost annually hangs a new ornament in the form of new amendments.").

[48]The Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[49]*Id.* § 913(b), 124 Stat. 1824.

[50]*See* 15 U.S.C. § 78o(k).

aimed to prevent fraudulent conduct. Over time, courts interpreted the antifraud section of the Advisers Act to establish a fiduciary duty on the part of investment advisers, but considered that the antifraud section of the 34 Act only prohibited fraud.[51] On the other hand, ERISA was much clearer in the duties it imposed.[52]

a. Investment Advisers

When determining what obligations an investment adviser had to his or her clients, the Court considered the level of scienter necessary to find a violation of the Advisers Act's antifraud provision.[53] In 1963, in *SEC v. Capital Gains Research Bureau, Inc.*, the Supreme Court considered the relationship between an investment adviser and a client, and concluded that the relationship was fiduciary in nature.[54] Justice Goldberg, writing for the majority, stated,

> And the Committee Reports indicate a desire to preserve 'the personalized character of the services of investment advisers,' and to eliminate conflicts of interest between the investment adviser and the clients as safeguards both to 'unsophisticated investors' and to 'bona fide investment counsel.' The Investment Advisers Act of 1940 thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline as investment adviser—consciously or unconsciously—to render advice which was not disinterested. It would defeat the manifest purpose of the Investment Advisers Act of 1940 for us to hold, therefore, that Congress, in empowering the courts to enjoin any practice which operates 'as a fraud or deceit,' intended to require proof of intent to injure and actual injury to clients. [55]

The SEC brought an action against an investment adviser for purchasing securities for its own account, recommending those securities in a newsletter to approximately 5,000 subscribers, and then selling the securities for a profit following the recommendation.[56] The SEC sought an injunction which would require the investment adviser to disclose any purchase of recommended securities that occurred prior to the recommendation, as well as the adviser's intent to sell the securities shortly after the recommendation.[57] In other words, the SEC was asking that the investment adviser be required to disclose a material conflict

[51]*Compare SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191 (1963) (holding that under the Advisers Act, a relationship between an investment advisor and a client is fiduciary in nature) *with Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201 (1976) (holding that scienter is a necessary element of the antifraud section of the 34 Act and therefore it does not confer a fiduciary duty on brokers).

[52]*See* 29 U.S.C. § 1104.

[53]*See Capital Gains Research Bureau*, 375 U.S. at 191–92.

[54]*Id.* at 191.

[55]*Id.* at 191–92.

[56]*Id.* at 182-183.

[57]*Id.* at 183.

of interest. The Court was not asked to consider whether this type of conflict should be eliminated because the SEC sought disclosure of the conflict; it did not seek to prohibit the conflict.[58]

The Court recognized that the investment adviser might be placing trades because he was motivated by the same potential for long term price increase that led the investment adviser to recommend the security to his customers in the first place.[59] Alternatively, the investment adviser might be motivated by the potential for short term price increase in response to the increased trading activity resulting from recommending the securities to his customers.[60] The Court determined that an investor seeking advice from this investment adviser must "be permitted to evaluate such overlapping motivations, through appropriate disclosure, to decide if the investment adviser is serving 'two masters' or only one, especially if one of the masters happens to be economic self-interest."[61]

In considering a breach of this fiduciary duty, the Court determined that the motivation of the investment adviser was not relevant.[62] "It misconceives the purpose of the statute to confine its application to 'dishonest' as opposed to 'honest' motives."[63] The court determined that disclosure is necessary in such situations to "preserve the climate of fair dealing which is so essential to maintain public confidence in the securities industry and to preserve the economic health of the country."[64]

The SEC has interpreted the Advisers Act as imposing continuing duties of loyalty and care.[65] The duty of loyalty requires investment advisers to act in their clients' best interests and disclose all conflicts of interest.[66] The duty of care requires investment advisers to provide suitable investment advice after investigating a customer's financial situation and investment objectives.[67]

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[58]*Id.* at 196.

[59]*Id.*

[60]*Id.*

[61]*Id.*

[62]*Id.* at 192.

[63]*Id.* at 201 (footnotes omitted).

[64]*Id.*

[65]*See Opinion of Director of Trading and Exchange Division, relating to section 206 of the Investment Advisers Act of 1940, section 17 (a) of the Securities Act of 1933, and sections 10 (b) and 15 (c) (1) of the Securities Exchange Act of 1934; Investment Advisers Act Release No. 40*, 11 Fed. Reg. 10,997 (Feb. 5, 1945) ("Director Opinion") ("An investment adviser is a fiduciary. As such he is required by the common law to serve the interest of his client with undivided loyalty. In my opinion a breach of this duty may constitute a fraud within the meaning of clauses (1) and (2) of section 206 of the Investment Advisers Act (as well as the anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934)."); *see also* SEC Staff, *Study on Investment Advisers and Broker-Dealers,* 22 (2011) ("Fiduciary Study"), http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

[66]*See* Fiduciary Study, *supra* note 65.

[67]*See id.* at 27–28.

While the SEC sought disclosure of the conduct at issue in *Capital Gains*, it has considered other conduct to be violative of the Advisers Act, regardless of whether it has been disclosed. For example, in a no-action letter issued in 1971, the SEC determined that the fees proposed by the investment adviser were unconscionably high, and expressed doubt that the excessive nature of the fees could be adequately disclosed:

> Based upon your representations, it is our view that the fees you propose to charge investment advisory clients are substantially in excess of the prevailing fees charged by other investment advisers offering comparable services. Apart from the fact that it is our view that it remains doubtful whether any amount of disclosure could adequately apprise potential clients of the excessive nature of the fees, especially when compared to similar and like services being rendered at substantially lower costs, such fees appear to be so unconscionably high as to violate the applicable anti-fraud provisions of the federal securities laws.[68]

In that case, the investment adviser's behavior was so egregious that he could not avoid a violation of the anti-fraud section merely by disclosing his behavior to his client.

Investment advisers charge fees in a number of different ways: a flat charge, an hourly rate, or, more commonly, as percentage of their clients' asset value.[69] Paying fees as a set percentage of assets-under-management has been praised for removing an investment adviser's incentive simply to recommend securities that will pay the adviser higher commissions.[70] Of course, the fees must be reasonable. This fee structure may also incentivize investment advisers to protect their clients' assets from market downturns because if the value of the clients' assets decline, the advisers' compensation will also decline.[71]

However, this compensation structure carries its own conflicts. To increase their clients' assets, and by extension, their own compensation, investment advisers may take inappropriate risks to maximize the

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[68]*Richard J. Laibinger, Jr.*, 1971 WL 7757, at *1 (S.E.C. No - Action Letter Sept. 11, 1971); *but see Philip R. Bulliard*, 1974 WL 10973, at *3 (S.E.C. No - Action Letter July 5, 1974) ("Furthermore, it is our view that an investment adviser who charges excessive fees may violate the antifraud provisions of Section 206 of the Act. Since our experience indicates that any fee greater than 2% of assets under management is greater than that normally charged by investment advisers, we have taken the position that any investment adviser charging such a fee would incur liability under Section 206 if he does not disclose to existing and potential clients that such fee is higher than that normally charged in the industry and that other advisers can provide the same or similar services at lower rates. Since it is possible that the fees you propose to charge based on a percentage of net worth or a percentage of annual income would under certain circumstances exceed 2% of the assets actually managed, you must disclose to your clients: that your manner of charging fees is different from that generally used in the industry; that investment advisers normally base fees on a percentage of assets under management; that any fee greater than 2% of assets under management is higher than that normally charged in the industry; that the fee you charge may under certain circumstances be greater than 2% of assets actually managed; and that, in such case, the same or similar services would be available from other advisers at lower rates.").

[69]*See* Fiduciary Study, *supra* note 65, at 7, 10–11.

[70]*See* Daisy Maxey, *How to Pay Your Financial Adviser*, Wall St. J. (Dec. 12, 2011), http://online.wsj.com/news/articles/SB10001424052970204554204577024152103830414.

[71]*Id.*

potential gains.[72] Moreover, asset-based fees may not be at all appropriate for clients who have a passive buy-and-hold strategy. The SEC has expressed concern with this practice, "reverse churning."[73] An investment adviser reverse churns an account when the investment adviser collects a fee from a client for purportedly managing an account that requires little or no management.[74] The SEC has recognized that fee-based programs may not fit every investor, and commissions may lead to lower costs for low-activity accounts.[75]

With respect to conflicts of interest related to principal transactions, the Advisers Act requires the investment adviser to disclose "in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction."[76] The SEC interprets this requirement to apply prior to every transaction: "In my opinion the requirements of written disclosure and of consent contained in this clause must be satisfied before the completion of each separate transaction. A blanket disclosure and consent in a general agreement between investment adviser and client would not suffice."[77]

Overall, although the Advisers Act imposes a broad fiduciary duty, as discussed above, the duty may be primarily met through disclosure of conflicts of interest.

b. Brokers

The Court considered the 34 Act in a similar manner to the Advisers Act when determining the contours of a broker's relationship with his or her client. With respect to section 10(b) of the 34 Act, the Court has determined that, because scienter is a necessary element to find a violation of the section, the section does not confer a fiduciary duty on brokers.[78] As explained by the Court, "Section 10(b) makes unlawful the use or employment of 'any manipulative or deceptive device or contrivance' in contravention of Commission rules. The words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest that [section] 10(b) was intended to proscribe knowing or intentional conduct."[79]

The Court also considered whether or not Rule 10b-5 may cover negligent acts, determining that it could not.[80] The Court recognized that Rule 10b-5 was enacted by the SEC pursuant to authority granted to it

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[72] *Id.*

[73] Daisy Maxey, *SEC Targets 'Reverse Churning' by Advisers*, Wall St. J. (Feb. 24, 2014), http://online.wsj.com/news/articles/SB10001424052702304610404579403251590760602.

[74] *See* Fiduciary Study, *supra* note 63, at 152.

[75] SEC Committee on Compensation Practices, *Report on Broker-Dealer Compensation* (April 10, 1995) ("SEC Report on Compensation"), https://www.sec.gov/news/studies/bkrcomp.txt; *see also* NASD Notice to Members 03-68, *Fee-Based Compensation* (Nov. 2003), http://www.finra.org/sites/default/files/NoticeDocument/p003079.pdf.

[76] 15 U.S.C.A. § 80b-6(3).

[77] Director Opinion, *supra* note 65.

[78] *See Ernst & Ernst*, 425 U.S. at 201.

[79] *Id.* at 197.

by section 10(b) of the 34 Act.[81] "Thus despite the broad view of the Rule advanced by the Commission in this case, its scope cannot exceed the power granted the Commission by Congress under [section] 10(b)."[82] Accordingly, both section 10(b), and Rule 10b-5 require a finding of scienter, foreclosing liability for negligent violation of either.

In addition to the standards set forth under section 10(b) and Rule 10b-5, a broker has additional obligations as defined by FINRA rules. When giving personalized financial advice, brokers must "observe high standards of commercial honor and just and equitable principles of trade."[83] More specifically, FINRA Rule 2111 (the "Suitability Rule") provides that:

> A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation.[84]

The Suitability Rule does not explicitly provide that a broker's recommendations must be in the customer's best interests; however, FINRA enforcement decisions and guidance have made clear that "a broker's recommendations must be consistent with his customers' best interests."[85]

Even though the law requires the brokers recommend suitable investments, brokers may be incentivized to consider their and the firms' interests over the interests of the client. The amount of commission a broker may receive can vary based on the product sold to the client. This may create a conflict, preventing the broker from providing objective advice to his clients.[86] For example, a broker may choose to

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[80]*Id.* at 201.

[81]*Id.* at 212–13.

[82]*Id.* at 214.

[83]FINRA Rule 2010, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=5504.

[84]FINRA Rule 2111(b), http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=9859&print=1. (A "member" is a broker-dealer and an "associated person" is a Broker).

[85]*See* James S. Wrona, *The Best of Both Worlds: A Fact-Based Analysis of the Legal Obligations of Investment Advisers and Broker-Dealers and A Framework for Enhanced Investor Protection*, 68 Bus. Law. 1, 19, n. 137 (2012) (collecting sources).

[86]*See* Donald C. Langevoort, *Brokers As Fiduciaries*, 71 U. Pitt. L. Rev. 439, 448 (2009) ("There is evidence that investors pay significantly more for mutual fund investments sold via the broker channel, without receiving any better fund performance. The conflicts of interest here are clear enough-brokers are tempted to push high load shares, shares of funds that pay for "shelf space" (i.e., featured presence in brokers' recommendations) or of proprietary funds sponsored by the broker's firm, which are naturally more profitable for the firm.").

recommend B share mutual funds to a client, instead of lower cost A shares because the broker is paid more when B shares are sold.[87] Brokers may also recommend transactions for the primary purpose of generating commissions for the broker.[88]

In 1995, the SEC released the Report of the Committee on Compensation Practices, which recognized that paying brokers compensation that differed based on the product sold raised questions as to whether a broker rendered "objective advice or simply maximize[ed] commission income."[89] FINRA echoed these concerns in 2013 when it released a report on conflicts of interest, praising brokerage firm efforts to mitigate the financial incentive to recommend one product over another.[90]

FINRA requires brokerage firms to closely supervise the compensation of brokers so that a broker does not recommend a transaction because of his own financial incentives.[91] FINRA requires brokerage firms to create a system of supervision "that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules."[92] In the past, the SEC has sanctioned firms for establishing a compensation structure that provided substantially higher payouts to its brokers for stocks covered by the firm's research department.[93] The production requirements and position quotas that the firm imposed on its brokers had the effect of requiring the brokers, if they were to be successful, to concentrate their selling efforts on the firm covered stocks.[94] A number of customers with conservative investment needs and objectives ended up with most or all of their assets concentrated in these firm covered stocks.[95] The SEC found that the brokers had violated their suitability obligation to these

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[87]*See*, *e.g.*, *In Re Belden*, SEC Release No. 47859, 2003 WL 21088079 (May 14, 2003)("As a result of Book's purchase of Class B shares, Belden received significantly greater commissions than he would have received had Book purchased the Class A shares. Indeed, as Belden testified, this is the precise reason that he recommended the Class B shares instead of the Class A shares. In short, Belden put his own interest before that of his customer.").

[88]*See*, *e.g.*, *In the Matter of the Application of Scott Epstein for Review of Disciplinary Action Taken by Finra*, SEC Release No. 59328, 2009 WL 223611 (Jan. 30, 2009)("The record shows that Epstein's mutual fund switch recommendations served his own interest by generating substantial production credits, but did not serve the interests of his customers. Epstein abdicated his responsibility for fair dealing when he put his own self-interest ahead of the interests of his customers.").

[89]SEC Report on Compensation, *supra* note 75.

[90]FINRA, Report on Conflicts of Interest 26–30 (Oct. 2013) ("FINRA Conflicts Report"), *http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p359971.pdf*.

[91]*See* Wrona, *supra* note 85, at 37.

[92]FINRA Rule 3110(a), http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=11345.

[93]*In the Matter of Olde Disc. Corp.*, S.E.C. Release No. 7577, 1998 WL 575171 (Sept. 10, 1998).

[94]*See id.* at *3 - *6.

[95]*See id.* at *21.

customers, and the firm had failed to establish a system of supervision which would prevent such violations.[96] In fact, the compensation structure established by the firm contributed to such violations.[97]

Following that case, FINRA examined whether differential compensation structures should be prohibited with respect to proprietary products:

> The Tully Report concluded that the payment of higher compensation to registered representatives for the sale of proprietary products can create incentives to inappropriately favor such products over nonproprietary products. Such compensation arrangements can create conflicts of interest by encouraging representatives to recommend proprietary products to maximize their commissions, rather than to best meet their customers' needs. Such arrangements may provide point-of-sale incentives that could compromise proper customer suitability determinations and may present a situation where the salesperson's interests are not, in some circumstances, fully aligned with the interests of customers. In this regard, the Tully Report cited as a "best practice" the use of identical payout ratios for representatives that offer both proprietary and non-proprietary products, noting that most firms interviewed had already adopted this practice.[98]

FINRA (NASD at the time) sought comment on whether such compensation should be prohibited specifically with respect to mutual funds. While this proposal was never adopted, FINRA had already implemented prohibitions on incentives which favor one mutual fund over another on the basis of the commission paid by the mutual fund. For example, a firm may not:

> [P]rovide to salesmen, branch managers or other sales personnel any incentive or additional compensation for the sale of shares of specific investment companies based on the amount of brokerage commissions received or expected from any source, including such investment companies or any covered account. Included in this prohibition are bonuses, preferred compensation lists, sales incentive campaign or contests, or any other method of compensation which provides an incentive to sales personnel to favor or disfavor any investment company or group of investment companies based on brokerage commissions.[99]

In addition, FINRA was focused on potential conflicts with proprietary products. FINRA examined firms and their policies and practices to manage or avoid those conflicts:

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[96]*See id.* at *21 - *22.

[97]*See id.*

[98]NASD Notice To Members 99-81, "*Salesperson Compensation Practices; NASD Regulation Requests Comment on Proposed Salesperson Compensation Rules,*" 607 (Sept.1999), http://www.finra.org/sites/default/files/NoticeDocument/p004080.pdf.

[99]FINRA Rule 2341(k)(7)(A), http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=12338.

> An effective practice is that for comparable products, firms not provide higher compensation, or provide other rewards, for the sale of proprietary products or products from providers with which the firm has entered into revenue-sharing agreements. The firms with which FINRA met each stated that their registered representatives are not compensated more highly for the sale of comparable proprietary or preferred provider products.[100]

Accordingly, firms avoid incentivizing the sale of proprietary products by not differentiating the compensation. If a firm does differentiate compensation, it risks violating the Suitability Rule.

Notably, under FINRA rules, a broker is only obligated to give suitable investment advice if the broker is making a recommendation. Unlike the standards set forth by the Advisers Act, SEC and FINRA rules do not create continuing duties on the part of brokers.

In some cases, ongoing duties may arise if a broker has discretionary control over a client's account or state common law imposes a fiduciary duty. While the law varies significantly from state to state, some states, like California, impose a fiduciary duty on brokers operating within their jurisdiction.[101] In other states, the duty a broker owes to a customer depends on the type of account the customer has. When the broker is handling a discretionary account, courts have routinely held that the broker has a fiduciary duty to the customer.

Some courts have also recognized that other circumstances create a fiduciary relationship. In *Leib v. Merrill Lynch*, the court observed that although an account may be non-discretionary, a broker may nonetheless have handled the account in a manner more closely akin to a discretionary account. "Such an account is one in which the broker has usurped actual control over a technically non-discretionary account. In such cases, the courts have held that the broker owes his customer the same fiduciary duties as he would have had the account been discretionary from the moment of its creation."[102] *Leib* then set forth several factors courts should consider in determining whether the broker has usurped control over the account:

> In determining whether a broker has assumed control of a non-discretionary account the courts weigh several factors. First, the courts examine the age, education, intelligence and investment experience of the customer. Where the customer is particularly young, old, or naive with regard to financial matters, the courts are likely to find that the broker assumed control over the account. Second, if the broker is socially or personally involved with the customer, the courts are likely to conclude that the customer relinquished

[100]FINRA Conflicts Report, *supra* note 90, at 30.

[101]*See Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690, 708 (1968); *Hobbs v. Eichler*, 164 Cal. App. 3d 174, 201 (1985) ("The relevant law is clear. 'The relationship between a broker and principal is fiduciary in nature and imposes on the broker the duty of acting in the highest good faith toward the principal.'"); *E.F. Hutton & Co. v. Weeks*, 304 S.E.2d 420, 422 (Ga. Ct. App. 1983) ("The broker's duty to account to its customer is fiduciary in nature, resulting in an obligation to exercise the utmost good faith."); *Roth v. Roth*, 571 S.W.2d 659, 668 (Mo. Ct. App. 1978).

[102]*Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 954 (E.D. Mich. 1978), aff'd, 647 F.2d 165 (6th Cir. 1981).

> control because of the relationship of trust and confidence. Conversely, where the relationship between the broker and the customer is an arms-length business relationship, the courts are inclined to find that the customer retained control over the account. Third, if many of the transactions occurred without the customer's prior approval, the courts will often interpret this as a serious usurpation of control by the broker. Fourth, if the customer and the broker speak frequently with each other regarding the status of the account or the prudence of a particular transaction, the courts will usually find that the customer, by maintaining such active interest in the account, thereby maintained control over it.[103]

In *Leib*, the court specifically set forth the duties the brokers owe customers when acting with discretion:

> Unlike the broker who handles a nondiscretionary account, the broker handling a discretionary account becomes the fiduciary of his customer in a broad sense. Such a broker, while not needing prior authorization for each transaction, must (1) manage the account in a manner directly comporting with the needs and objectives of the customer as stated in the authorization papers or as apparent from the customer's investment and trading history; (2) keep informed regarding the changes in the market which affect his customer's interest and act responsively to protect those interests; (3) keep his customer informed as to each completed transaction; and (5) [*sic*] explain forthrightly the practical impact and potential risks of the course of dealing in which the broker is engaged.[104]

As discussed above, if a fiduciary duty is present, even if the account is labeled as non-discretionary, the broker owes the same duties as if it was discretionary.[105] Notably, the duty is on-going, creating an obligation on the part of the broker to "act responsively" to protect a client's interests. Courts have found conduct such as churning (excessive trading) and recommendations of imprudent investments (unsuitability) to be violative of a broker's fiduciary duty.[106]

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[103]*Id.* (Internal citations omitted.) *See also de Kwiatkowski v. Bear, Stearns & Co., Inc.*, 306 F.3d 1293, 1308-09 (2d Cir. 2002) (setting forth 'special circumstances' which can create a fiduciary duty on the part of the broker).

[104]461 F. Supp. at 953.

[105]*See id.* at 954.

[106]*See Paine, Webber, Jackson & Curtis, Inc. v. Adams*, 718 P.2d 508, 511 (Colo. 1986)(Customer alleged that the broker and firm "breached their fiduciary duties by their conduct, including disbursing more than two million dollars out of the personal account in 1973 and 1974 without her knowledge or approval; selling large amounts of her ITW stock without her knowledge, and using the proceeds to invest in highly speculative, low-quality corporate bonds; trading in corporate bonds to a grossly excessive degree (a practice commonly known as "churning"); and managing the accounts more for the defendants' benefit and financial gain than for the benefit and gain of [the customer]."); *Gochnauer v. A.G. Edwards & Sons, Inc.*, 810 F.2d 1042, 1050 (11th Cir. 1987)(Court upheld lower courts finding that the broker "induced the [customers] from switching their sizable investment in corporate bonds, one of the safest investments available, to option trading, one of the most speculative investments available. [The broker] should have known that such a switch was not one that adequately met the [customers'] needs of security and income from their investments. The court finds defendant [broker] breached his fiduciary duty to the [customers] when he advised them and assisted them in hiring Kerr and in establishing the speculative option trading account. A more studied opinion of the risks of option trading in light of the [customers'] then-existing investment objective was owed by [the broker] to the [customers]. This he failed to do, in breach of his fiduciary duty.").

c. Retirement Advice

Investment advisers and brokers who provide advice to retirement investors are subject to further standards under ERISA. ERISA was created to protect employee benefit and pension plans by, among other things, putting forth certain general fiduciary duties that apply to the management of these plans.[107] Unlike the 34 Act and the Advisers Act, ERISA explicitly sets forth that a certain category of individuals will be considered fiduciaries. ERISA provides that a person is a fiduciary to the extent that:

(i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets;
(ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so; or
(iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.[108]

A parallel definition was adopted under the Code, as applicable to IRAs.[109] Courts have found that the term "fiduciary" should be given a liberal construction in keeping with the remedial purpose of ERISA.[110]

In 1975, shortly after the enactment of ERISA, the DOL issued a regulation which created a five part test that must have been satisfied before a person would be treated as "rendering investment advice for a fee," and establishing a fiduciary relationship under the second prong of the test.[111] The Department of Treasury issued a virtually identical regulation under the Code.[112] Under the five part test, for advice to be considered investment advice, an adviser must:

(i) render advice as to the value of securities or other property, or make recommendations as to the advisability of investing in, purchasing or selling securities or other property
(ii) on a regular basis

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[107]*See Varity Corp. v. Howe*, 516 U.S. 489, 496 (1996); *see also* 70 C.J.S. Pensions § 42.

[108]*Id.* at § 1002 (21)(A); *See also Glaziers & Glassworkers Union Local No. 252 Annuity Fund v. Newbridge Sec., Inc.*, 93 F.3d 1171, 1182 (3d Cir. 1996).

[109]*See* Tax on Prohibited Transactions, Pub. L. 93-406, 88 Stat. 829, 971 (1974) (codified at 26 U.S.C. § 4975(e)(3)).

[110]*See Reich v. Lancaster*, 55 F.3d 1034, 1046 (5th Cir. 1995); *see also Donovan v. Mercer*, 747 F.2d 304, 308 (5th Cir. 1984)("It is clear that Congress intended the definition of "fiduciary" under ERISA to be broadly construed. As was pointed out in the legislative history, "the definition includes persons who have authority and responsibility with respect to the matter in question, regardless of their formal title." House Conference Rep. No. 93–1280, 93d Congress, 1974 U.S.Code Cong. and Ad.News 4639, 5038, 5103. Thus, "fiduciary" should be defined not only by reference to particular titles, such as "trustee", but also by considering the authority which a particular person has or exercises over an employee benefit plan. *See e.g., Brink v. DaLesio,* 496 F.Supp. 1350, 1374–75 (D.Md.1980), *rev'd in part on other grounds,* 667 F.2d 420 (4th Cir.1982).").

[111]29 C.F.R. § 2510.3-21(c)(1).

[112]26 C.F.R. § 54.4975-9(c).

(iii) pursuant to a mutual agreement, arrangement or understanding, with the plan or plan fiduciary that

(iv) the advice will serve as the primary basis for investment decisions with respect to plan assets; and that

(v) the advice will be individualized based on the particular needs of the plan or IRA.[113]

In 2016, the DOL adopted amendments to these regulations that redefined who would be considered a fiduciary under ERISA (the "Fiduciary Rule").[114] The Fiduciary Rule sets forth two categories of advice, which when provided in exchange for a fee or other compensation – either directly or indirectly – will constitute investment advice:

(i) a recommendation as to the advisability of acquiring, holding, disposing of, or exchanging, securities or other investment property, or a recommendation as to how securities or other investment property should be invested after the securities or other investment property are rolled over, transferred, or distributed from the plan or IRA; or

(ii) a recommendation as to the management of securities or other investment property, including, among other things, recommendations on investment policies or strategies, portfolio composition, selection of other persons to provide investment advice or investment management services, selection of investment account arrangements (e.g., brokerage versus advisory); or recommendations with respect to rollovers, distributions, or transfers from a plan or IRA, including whether, in what amount, in what form, and to what destination such a rollover, transfer or distribution should be made.[115]

The advice must also be rendered in one of these circumstances where the person giving the advice, either directly or indirectly:

(i) represents or acknowledges that it is acting as a fiduciary within the meaning of the Act or the Code;

(ii) renders the advice pursuant to a written or verbal agreement, arrangement, or understanding that the advice is based on the particular investment needs of the advice recipient; or

(iii) directs the advice to a specific advice recipient or recipients regarding the advisability of a particular investment or management decision with respect to securities or other investment property of the plan or IRA.[116]

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[113] 29 C.F.R. § 2510.3-21(c)(1) (2016); 26 C.F.R. § 54.4975-9(c) (2016).

[114] DOL, *Definition of the Term "Fiduciary"; Conflict of Interest Rule – Ret. Inv. Advice* ("Fiduciary Rule"), 81 Fed. Reg. 20,946 (Apr. 8, 2016), https://www.federalregister.gov/documents/2016/04/08/2016-07924/definition-of-the-term-fiduciary-conflict-of-interest-rule-retirement-investment-advice.

[115] 29 C.F.R. § 2510.3-21(a)(1).

[116] 29 C.F.R. § 2510.3-21(a)(2).

The Fiduciary rule defines “recommendation” as “a communication that, based on its content, context, and presentation, would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action.”[117] The DOL defined recommendation consistent with FINRA’s interpretation of recommendation – based on the facts and circumstances.[118] A communication that triggers the suitability rule will be considered a recommendation under the Fiduciary Rule. The more individually tailored it is, the more likely it will be considered a recommendation.

The DOL explicitly set out what sort of communications would not be considered recommendations pursuant to the rule; including certain activities and communications in connection with marketing or making available a platform of investment alternatives that a plan fiduciary could choose from; the provision of information and materials that constitute investment education or retirement education; and general communications and commentaries on investment products such as financial newsletters.[119] The Fiduciary Rule also excludes certain communications which may otherwise meet the definition of “recommendation” from the Fiduciary Rule, including communications with independent fiduciaries with financial expertise; certain swap transactions; and certain communications involving plan sponsor employees.[120]

Once an individual is considered a fiduciary under ERISA, the statute sets forth the duties and responsibilities of the individual.[121] ERISA requires that a fiduciary carry out his or her duties with respect to a plan solely in the interest of the participants and beneficiaries and:

(A) for the exclusive purpose of:
  (i) providing benefits to participants and their beneficiaries; and
  (ii) defraying reasonable expenses of administering the plan;
(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and
(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter and subchapter III of this chapter.[122]

The duties and responsibilities of a fiduciary “include the proper management, administration, and investment of plan assets, the maintenance of proper records, the disclosure of specified information and

[117]29 C.F.R. § 2510.3-21(b)(1).

[118]*See* Fiduciary Rule, 68 Fed. Reg. at 20,972.

[119]*See* 29 C.F.R. § 2510.3-21(b)(2); *see also* Fiduciary Rule, 68 Fed. Reg. at 20,948.

[120]*See* 29 C.F.R. § 2510.3-21(c); *see also* Fiduciary Rule, 68 Fed. Reg. at 20,948.

[121]*See* 29 U.S.C. § 1104.

[122]29 U.S.C. § 1104(a)(1).

the avoidance of conflicts of interest."[123] For example, "a fiduciary has a legal duty to disclose to the beneficiary only those material facts, known to the fiduciary but unknown to the beneficiary, which the beneficiary must know for its own protection. The scope of that duty to disclose is governed by ERISA's Section 404(a) [29 U.S.C. § 1104], and is defined by what a reasonable fiduciary, exercising "care, skill, prudence and diligence," would believe to be in the best interest of the beneficiary to disclose."[124]

The list of fiduciary duties in ERISA is not exhaustive, and Congress intended that the statute define the general scope of fiduciaries' authority and responsibility.[125] ERISA fiduciary duties are often drawn from the common law of trusts, however the concept of fiduciary under ERISA is broader than the common-law concept of a trustee.[126] Therefore, the law of trusts frequently will inform, but will not automatically determine, the outcome of an effort to interpret ERISA's fiduciary duties.

ERISA prohibits fiduciaries from engaging in certain conduct it deems to be conflicted. For example, a fiduciary may not "receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan."[127] Practically speaking, this means that a broker or an investment adviser who is deemed an ERISA fiduciary is prohibited from receiving common forms of compensation, including brokerage or insurance commissions, 12b–1 fees and revenue sharing payments.[128] Accordingly, the DOL adopted a prohibited transaction exemption, the Best Interest Contract Exemption (the "BIC Exemption"), at the same time it adopted the Fiduciary Rule.[129] The BIC Exemption permits the receipt of these forms of compensation provided the other conditions of the exemption are met.

The exemption requires that firms:

- (i) Acknowledge fiduciary status with respect to investment advice to the Retirement Investor;
- (ii) Adhere to Impartial Conduct Standards requiring them to:
    - a. Give advice that is in the Retirement Investor's Best Interest (i.e., prudent advice that is based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor, without regard to

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[123]*Mertens v. Hewitt Associates*, 508 U.S. 248, 251-52 (2003).

[124]*Glaziers & Glassworkers Union Local No. 252 Annuity Fund*, 93 F.3d at 1182.

[125]*Id.* at 1180.

[126]*Id.* at 1184 ("There are times when "the law of trusts ... will inform, but will not necessarily determine the outcome, of an effort to interpret ERISA's fiduciary duties." *Varity Corp. v. Howe,* 516U.S. 489, ——, 116 S.Ct. 1065, 1070, 134 L.Ed.2d 130 (1996). In such a case, the common law of trusts is the "starting point, after which courts must go on to ask whether, or to what extent, the language of the statute, its structure, or its purposes require departing from common law trust requirements." *Id.*").

[127]29 U.S.C. § 1106(b).

[128]*See* DOL, *Best Interest Contract Exemption*, 81 Fed. Reg. 21,002 (PTE 2016-01) (Apr. 8, 2016), https://www.federalregister.gov/documents/2016/04/08/2016-07925/best-interest-contract-exemption.

[129]*Id.*

financial or other interests of the Adviser, Financial Institution, or their Affiliates, Related Entities or other parties);

b. Charge no more than reasonable compensation; and

c. Make no misleading statements about investment transactions, compensation, and conflicts of interest;

(iii) Implement policies and procedures reasonably and prudently designed to prevent violations of the Impartial Conduct Standards;

(iv) Refrain from giving or using incentives for Advisers to act contrary to the customer's best interest; and

(v) Fairly disclose the fees, compensation, and Material Conflicts of Interest, associated with their recommendations.[130]

The exemption requires that the firm commit to the Impartial Conduct Standards in an enforceable contract, the "Best Interest Contract."[131] Initially, firms were to adhere to the Impartial Conduct Standards and make certain disclosures by April 10, 2017, and adhere to the remaining conditions, including execution of the contract, by January 1, 2018.[132] However, on February 3, 2017, the President issued a Memo to the DOL directing it to "examine the Fiduciary Duty Rule to determine whether it may adversely affect the ability of Americans to gain access to retirement information and financial advice."[133] To allow it time to conduct the review, as of June 9, 2017, firms must adhere to the BIC exemption's Impartial Conduct Standards; firms need not comply with the other conditions of the exemption until January 1, 2018.[134]

The DOL has expressed similar concerns to the SEC and FINRA about the use of differential compensation. For example, the DOL has informed firms that they "must take special care in developing and monitoring compensation systems to ensure that they do not run counter to the fundamental obligation to provide advice that is in the customer's best interest."[135]

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[130]*Id.* at 21,007.

[131]*Id.* at 21,008.

[132]*Id.* at 21,069.

[133]White House, *Presidential Memorandum on Fiduciary Duty Rule* (Feb. 3, 2017), https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-memorandum-fiduciary-duty-rule.

[134]*See*, DOL, *Definition of the Term ''Fiduciary''; Conflict of Interest Rule—Retirement Investment Advice; Best Interest Contract Exemption (Prohibited Transaction Exemption 2016–01); Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs (Prohibited Transaction Exemption 2016–02); Prohibited Transaction Exemptions 75–1, 77–4, 80–83, 83–1, 84–24 and 86–128*, 82 Fed. Reg. 16,902, 16,905 (Apr. 7, 2017), https://www.federalregister.gov/documents/2017/04/07/2017-06914/definition-of-the-term-fiduciary-conflict-of-interest-rule-retirement-investment-advice-best.

[135]DOL, *Conflict of Interest FAQS (PART I- Exemptions)*, Q9 (Oct. 27, 2016), https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/faqs/coi-rules-and-exemptions-part-1.pdf.

Firms must also consider the services to be offered to clients, including whether the services will include the ongoing monitoring of a client's account; as ERISA does not necessarily create any ongoing duties on the part of retirement advisers. However, the DOL cautioned firms that they:

> should carefully consider whether certain investments can be prudently recommended to the individual Retirement Investor, in the first place, without a mechanism in place for the ongoing monitoring of the investment. This is particularly a concern with respect to investments that possess unusual complexity and risk, and that are likely to require further guidance to protect the investor's interests. Without an accompanying agreement to monitor certain recommended investments, or at least a recommendation that the Retirement Investor arrange for ongoing monitoring, the Adviser may be unable to satisfy the exemption's Best Interest obligation with respect to such investments. Similarly, the added cost of monitoring such investments should be considered by the Adviser and Financial Institution in determining whether the recommended investments are in the Retirement Investors' Best Interest.[136]

Accordingly, an adviser may or may not have an ongoing duty to monitor client accounts, dependent on the product sold to the client.

Conclusion

Brokers and investment advisers have varying duties to clients, depending on a number of different factors. Even when called "fiduciary," the duties owed vary depending on the origin of the duty. An investment adviser fiduciary is not necessarily the same as an ERISA fiduciary. Each statutory scheme handles conflicts between the fiduciary and his or her client differently, sometimes requiring disclosure, sometimes elimination or avoidance of the conflict. However, each fiduciary duty does require that the fiduciary act in the client's best interest.

[136] Best Interest Contract Exemption, 81 Fed. Reg. at 21,016.