Broker-Dealers and Other Non-Fiduciaries as Fiduciaries?

There's a regulatory wrestling match going on in Washington.

W. Scott Simon, 09/03/2009

I normally don't worry too much about legislative and regulatory proposals concerning the financial-services industry for two reasons. First, most such proposals eventually fall by the wayside. Second, I can't influence their outcome anyway. I thought, nonetheless, that it might be interesting this month to explore one of these proposals that is shaping up as a truly monumental wrestling match between the executive branch of the federal government and the mighty special interest groups whose members can be impacted so heavily by it.

This match has now commenced with the proposed Investor Protection Act of 2009 and the Department of Treasury white paper titled "Financial Regulatory Reform, a New Foundation: Rebuilding Financial Supervision and Regulation." Part of this proposal, in which the Obama administration is effectively pitted against the broker-dealer industry, seeks to (1) subject broker-dealers providing investment advice to their clients to a fiduciary standard and (2) "harmonize" the regulation of broker-dealers and registered investment advisors by replacing the suitability standard that now governs broker-dealers with the fiduciary standard that now governs registered investment advisors.

In a nutshell, the two-pronged goal of the administration is to turn broker-dealers into fiduciaries and then subject them to the same fiduciary standard that governs registered investment advisors. The great uncertainty of this titanic struggle, of course, will be whether broker-dealers will actually be turned into fiduciaries and, even if they are, what kind of fiduciary standard they will actually have to meet.

Note that Treasury's white paper speaks to individual investors, not participants in qualified retirement plans governed by the Employee Retirement Income Security Act of 1974. It's likely, though, that if Treasury's proposal is adopted it will govern the conduct of broker-dealers in their relations with participants (and their beneficiaries) in retirement plans such as 401(k) plans. Given that (conditional) likelihood, my discussion in this month's column is focused on retirement plans.

A Bit of History

The SEC was established by Congress in 1934 to, among other things, regulate the nation's stock market. Part of the responsibility of the SEC is to administer a number of laws that govern the securities industry, including the Securities Exchange Act of 1934, which regulates broker-dealers, and the Investment Advisers Act of 1940, which regulates registered investment advisors.

The World of (Fiduciary) Registered Investment Advisors

Section 202(a)(11) of the 1940 Act defines an "investment adviser (as it was spelled in the Act)"--i.e., an RIA as well as the investment advisor representatives of an RIA--as: "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 who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities. "

Surprisingly, the word "fiduciary" doesn't appear in the text of the 1940 Act. If there was ever any doubt, though, the U.S. Supreme Court made clear in SEC v. Capital Gains Research Bureau, Inc. (375 U.S. 180 (1963)) that the 1940 Act "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 expose, all conflicts of interest which might incline an investment adviser--consciously or unconsciously--to render advice which was not disinterested." Further, an RIA owes its clients a duty of "utmost good faith, and full and fair disclosure of all material facts" as well as an affirmative obligation "to employ reasonable care to avoid misleading clients."

Given its legal status, an RIA must follow the fiduciary standard of the 1940 Act which requires it to place the interests of its clients ahead of its own and to fulfill critical fiduciary duties such as attempting to avoid outright (and if not possible, minimize) all material conflicts of interest (and to disclose any such conflicts that cannot be avoided or minimized) which might tempt the RIA to render disinterested investment advice. Under this standard, an RIA must provide its "best advice" to clients.