The Evolving Retirement Savings Market, Fiduciary Duty, And Our Capital Markets By Norman B. Arnoff

This article addresses the Department of Labor's new Fiduciary Duty Rule published in April 2016 for ERISA Plans and IRA accounts as it will relate to the Fiduciary Duty Rule to be promulgated by the Securities and Exchange Commission in April 2017 as it will relate to a broader category of accounts serviced by investment advisers and broker-dealers.

In April 2016 in the Federal Register, Volume 81,No.68,Part V, the Department of Labor ("DOL") promulgated and explained its final Fiduciary Duty Rule for ERISA plans and IRA accounts that are the principal means for Americans to invest in the evolving and ever expanding retirement savings market. In April 2017 the SEC is supposed to promulgate its Fiduciary Duty Rule making the standards of professional competency and ethics for broker-dealers no less stringent than investment advisers in accord with Section 913 of the Dodd–Frank Wall Street Reform and Consumer Protection Act (" Dodd-Frank")

Not only should we address the DOL's Fiduciary Duty Rule because of the special significance of retirement accounts for an ever increasing senior population but whether and how the SEC's Fiduciary Duty Rule will mesh and be coordinated with the DOL Rule, when it is promulgated in April 2017. A more significant issue is whether the DOL and SEC Rules will now represent the right way to financial regulatory reform. After our first identifying the systemic capital market problems and then adopting rules and the most effective remedial measures to eliminate or mitigate the harm that has been and will be caused if nothing is done ,true reform can be achieved.. The key to financial regulatory reform is to have the market driven by professionalism rather than a sales mindset and this is why the primary task should be to develop and sustain professionalism and fiduciary responsibility in not merely the retirement account market but with respect to certain public customer-client accounts.

The defining differences between the broker-dealer and the associated registered representative and the investment advisor and the adviser representative with respect to the public customer and adviser client is the degree of discretion and control of the financial service professional and the dependency that the public customer has on the professional and his or her organization. This is the critical point for consideration.

The investment adviser is a fiduciary without qualification. Whereas the broker-dealer and its registered representative, while required to make a suitable recommendation on a solicited trade to a customer who has a non-discretionary account; is not deemed to be a fiduciary. However, the broker does become a fiduciary when the facts and circumstances change such as when the broker exercises authorized or unauthorized discretion. A customer-broker/dealer relationship preserves a higher degree of customer responsibility even with the suitability and know your customer rules. Therefore, the same unconditional fiduciary duty does not apply to broker-dealers as investment advisers. When there is control and significant dependency, the law has traditionally assigned fiduciary responsibility, whether broker or adviser representative. This policy is fair, sound, and well recognized including being acknowledged in the DOL's new Final Rule.

The New DOL Final Fiduciary Duty Rule

In summary an "investment advice fiduciary" is a person who is rendering investment advice and /or management services with respect to the funds or securities of an ERISA plan account or IRA for " compensation, direct or indirect. " The investment advice fiduciary also "{represents} or acknowledges that.....{he or she} is acting as a fiduciary" in order that there will be a clear understanding of the nature of the relationship.

The Rule breaks down further into a number of essential elements to define "fiduciary investment advice" as follows: (1)"...{a} recommendation as to the advisability of acquiring, holding, disposing of ,or exchanging securities or other investment property or ...how securities or other investment property are rolled over, transferred, or distributed... {and making a} recommendation as to the management of securities or other investment property;" (2)" the investment recommendation is made either directly or indirectly through or together with any affiliate..." ; (3) "*the advice is rendered pursuant to a written or verbal agreement or understanding that the advice is based on the particular investment needs of the advice recipient...." ; and (4) the investment advisor fiduciary " {directs} the advice to a specific recipient.....regarding the advisability of a "particular investment or management decision with respect to securities or other investments of the Plan or IRA...."*(Emphasis Added) {1}

For the purposes of defining when a communication becomes a "recommendation" to trigger the investment professional's fiduciary duty, "'recommendation' means a communication that based on its content, context, and presentation would reasonably be viewed as a suggestion that the advice recipient engages in or refrains from taking a particular course of action." The communication to the advice recipient is specific to a particular security or selective group of securities.

Providing services to an ERISA plan or IRA account does not automatically trigger fiduciary responsibility provided there is an independent fiduciary and " the plan fiduciary is independent of the person who markets or makes available...{the services}and the person discloses in writing to the plan fiduciary that the person is not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity." (Emphasis Added)2}

The independent fiduciary is assigned an oversight role in addition to being responsible to give "fiduciary investment advice" consisting of "recommendations" and managerial services for the plan or account. This is to reasonably assure that there will be at all times the exercise of fiduciary responsibility in connection with any servicing and management of retirement plans and accounts and also not have to unnecessarily make everyone who provides some form of service a fiduciary.

<u>Exclusions From Fiduciary Duty Investment Advice</u>

A broker-dealer " <u>shall not be deemed to be fiduciary regarding any assets of the plan or IRA with respect to which such broker-dealer, reporting dealer or bank does not have any discretionary authority, discretionary capital or discretionary responsibility</u>,....{and} does not render investment advice.. for a fee or other compensation, and does not have any authority or responsibility to render such investment advice" (Emphasis Added) {3}The foregoing preserves the traditional distinction between investment adviser and broker-dealer delineating those who are fiduciaries without qualification and those by virtue of specific factual circumstances who assume control of the account and its activity and therefore must assume fiduciary responsibility.

Excluded from "fiduciary investment advice" are certain types of communications and services as the providing of " investment alternatives that meet objective criteria specified by the plan fiduciary... { e.g.} stated parameters concerning expense ratios, size of fund, type of asset, or credit quality.. provided that the person identifying the investment alternatives discloses in writing whether the person has a financial interest in any of the investment alternatives..." Providing such information is not a recommendation when it is in "response to a request for a proposal...identifying a limited or sample set of investment alternatives...{and there is disclosure} whether the person... has a financial interest in any of the alternatives....{and } the information provided is based upon objective financial data and comparisons with independent benchmarks to the plan fiduciary."

Facilitating general and/or educational information by a party not economically biased is <u>not</u> a "recommendation" constituting "fiduciary investment advice."{4}

"General Communications that a reasonable person would not view as an investment recommendation including ... {a news-letter of general circulation}, public talk shows, remarks, and representations in widely attended speeches and conferences,...{and} research ...prepared for general circulation" are excluded communications ,not deemed a "recommendation." Also excluded is general education and plan information materials, general financial, investment and retirement information " that do <u>not</u> address specific investment products , specific plan or IRA investment alternatives or distributions available..." {5}

In regard to one of the core functions of a broker-dealer i.e. taking buy and sell orders and executing trades; that function is excluded from "fiduciary investment advice" <u>provided that certain conditions are satisfied</u>. The new DOL Final Rule states in pertinent part:

"...A person who is a broker or dealer registered under the Securities Exchange Act of 1934,a reporting dealer who makes primary markets in securities of the United States Government and reports daily to the Federal Reserve Bank of New York its positions with respect to such securities and borrowings thereon shall not be deemed to be a fiduciary... with respect to a plan or IRA solely because such person executes transactions for the purchase or sale of securities on behalf of such plan in the ordinary course of its business as a broker, dealer, or bank pursuant to instructions of a fiduciary with respect to such plan or IRA."

A failure to provide best execution, if the broker is <u>not</u> acting in good faith, should be considered a breach of fiduciary duty This is because after the order is placed and not yet executed, it is the broker who has complete control of the order including its timing.

Fiduciary status also is not conferred in respect to all the plan's and IRA account's assets and activity <u>merely</u> because there is general discretion and control with respect to management services or disposition of assets. The discretion has to be exercised in the <u>specific</u> context. The determination of fiduciary status is based on fact specific discretionary authority or control.

The fiduciary cannot be an affiliate of the broker, dealer, or bank and the order can only be entered after specific trade instructions (i.e. limiting discretion) to the broker with respect to (a) the security purchased or sold;(b) the price range;(c) the time in which the order can be filed which will not exceed five (5) business days; ...{and} (d)"..{the} minimum or maximum quantity of such security which may be purchased or sold.." if fiduciary status is not to be imputed.

However, the above is not a general exemption of the broker-dealer for other breaches of fiduciary duty with respect to plan assets; does not exclude the broker-dealer or bank as "a party in interest; " or as "a disqualified person with respect to any assets of the plan or IRA". It should be understood and it is well settled that there are other basis for assigning to a broker-dealer fiduciary status other than the giving of "fiduciary investment advice" e.g. custody of client funds and securities, irrespective of whether investment advice is given to the customer.

<u>**Further Summary of the Rule's Essential Elements**</u>

In summary fiduciary investment advice to an ERISA plan or IRA account triggers a fiduciary duty. However, it must be the giving of specific investment advice or rendering specific services with respect to what security or select group of securities are to be bought or sold and this is done for a fee. In respect to ERISA plan assets or the securities in the IRA account, the management services, which are covered; also have to be for a fee.

A fiduciary duty does not attach merely because there generally is discretionary authority, control, and responsibility with respect to the plan or account assets and securities and the providing of services (even specific ones) do not necessarily constitute "fiduciary investment advice" .*This is only the case if the advice or services take place in the context of an ERISA plan or IRA account that has an independent and financially knowledgeable fiduciary to evaluate and approve the transaction*. Further, the service provider also is required to disclose at the outset of the service or relationship that it does not have an intent to nor is it acting as fiduciary.

The thrust of the rule is to assign responsibility to those who in the circumstances should have it, expressly accept it, and those who will exercise an independent oversight function with respect to plan or account assets and services rendered. In the context where there is an independent plan fiduciary, the advice provided by another professional or vendor will not necessarily be deemed to be " fiduciary investment advice".

Arguably also even when the advice or service is of a fiduciary nature and there is an apparent self- interest conflict so as to render the person who purportedly is acting as a fiduciary ,disqualified from engaging in such a prohibited transaction; there are exemptions that allow the party to undertake and continue to act consistent with settled past practices and customs..

The Exemptions

To protect against self-dealing the ERISA Statute and Internal Revenue Code proscribe certain prohibited transactions that by reason of custom, practice, and practicality allow certain exemptions to permit traditional securities transactions in their ordinary course to take place. The Federal Register states in respect to the DOL Final Rule:

"The exemptions and amendments..{will} allow, subject to appropriate safeguards, certain broker-dealers, insurance agents and others that act as investment advice fiduciaries to nevertheless continue to receive a variety of forms of compensation that would otherwise violate prohibited transactions rules and trigger excise taxes....

Investment advice fiduciaries to plans and plan participants must meet ERISA's standards of prudence and loyalty to plan customers. Such fiduciaries also face excise taxes, remedies, and other sanctions for engaging in certain transactions such as self-dealing with plan assets or receiving payments from third parties in connection with plan transactions, unless the transactions are ... {exempt}.. from ERISA's and the...{Internal Revenue} Code 's prohibited transaction rules... {that} help ensure that investment advice provided to plan participants and IRA owners is **not** driven by the adviser's financial self-interest."{7} (Emphasis Added)

Two of the principal exemptions are the *Best Interest Contract Exemption and the Class Exemption For Principal Transactions In Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs*. In respect to the former it is "specifically designed to address the conflicts of interest associated with retail transactions involving plans and IRAs. " The financial service professional must explicitly and consciously commit to and act in the best interest of the customer where there is an apparent conflict. Only where the professional cannot effectively negate the conflict by formal and written informed consent, will the professional be disqualified.

The latter exemption permits investment advice fiduciaries to sell or purchase debt securities and other investments out of their own inventories in connection with transactions to or from plans and IRAs. Core to the above exemptions is the following:
"These exemptions require among other things, that advice fiduciaries adhere to certain *Impartial Conduct Standards*, which are fundamental impartial obligations of fair dealing and fiduciary conduct and include obligations to act in the customer's best interest, and avoid misleading statements and receive no more than reasonable compensation."

The standards are a mixture of a norm of aspiration and fact driven determinations . Value based compensation is an illustration that the issue of fiduciary status or determining whether there is a breach is premised upon a fact specific inquiry. As the Federal Register notes,
".........Whether a particular relationship or compensation structure would result in an adviser having an interest that may affect the exercise of its best judgment as a fiduciary when providing a recommendation in violation of the self-dealing provisions of prohibited transaction rules...depends on the surrounding facts and circumstances....{The} ongoing receipt of compensation calculated as a fixed percentage of the value of a customer's assets under management, <u>where such values are determined by readily available independent sources or independent valuations, typically would not raise prohibited transaction concerns for the adviser</u>. Under these circumstances, the amount of compensation received depends solely on the value of the investments in a client account, and ordinarily the interests of the adviser in making prudent investment recommendations, which would have an effect on compensation received, are consistent with the investor's interest in....{the adviser} giving and protecting account investments." (Emphasis Added) {8}

On the other hand a recommendation to take a full or partial distribution from a plan will generate a fee implicating the prohibited transaction rule, and this is even the case if the fee going forward is based on a fixed percentage of assets. In the latter context the Best Interest Contract Exemption would have to apply if the transaction would be deemed permissible.

Conclusions And Recommendations

Conceptually the DOL's new Fiduciary Rule is sound in seeking to combine textual clarity, fact specific status and breach determinations, and having the flexibility to have norms of aspiration (i.e. a professional without conflict or engaging in the necessary conduct but substantially avoiding and mitigating harm both in perception and reality) apply when the textually based rules, at least from our perceptions leave doubt or do not definitively resolve that the conduct in issue complies with what are and should be the appropriate standards of ethical conduct.

The Need For An Operative Ideal

Textually based rules give educative notice to those to whom the rules apply and are essential but will not provide the maximum protection to the "main street investor" unless we also keep conscious of Chief Judge Benjamin Cardozo's notion of who is a fiduciary and what type of conduct will meet the highest ethical standard. In **Meinhard v Salmon** { 9 } , Judge Cardozo wrote,

" Many forms of conduct permissible in a workday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate .Uncompromising rigidity has been the attitude of the courts when petitioned to undermine the rule of undivided loyalty by the' disintegrating ' erosion of particular exceptions .....Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court."

The standard articulated above is not so much of a standard but an operative ideal that gives a tribunal the flexibility to apply equitable principles in addition to the law to maintain high ethical standards in the interstices of the law where the text based rules are not a complete fit. The full, pragmatic, and sound development of fiduciary duty in our capital markets will not be achieved by mere rule making, no matter how expansive are the studies and rules the regulators are mandated to perform and promulgate. It will only come about by rule making informed by an arbitration and claim processes addressing actual customer-client financial service professional disputes and where reasoned awards will be a basic right of every party, whether industry or client-customer; so that there will be a principled development of the securities laws. An internal appeals process in the SRO forum needs to be considered, not merely to lighten the burden on the courts but also to maintain the sound development and application of the securities laws. The process described will better inform the SEC's and self-regulatory organizations' ("SRO") inspection and enforcement programs as well as the SEC and SRO rule making process.

Hoping to achieve conflict free professionalism by each of the respective industry professionals will not be achieved by a mechanical formulation of a one size fits all standard for all professional groups. This will not do the job. What is needed is not to think merely in terms of either holding all professional groups to uniform professional standards of competency and high ethical and fiduciary standards but to take an approach resulting in a more holistic regulatory and self-regulatory framework that will facilitate behavior of a high level of responsibility and include but not be limited to (1) separate SROs for groups such as investment advisors so that the professional conduct standards can be customized for each of the groups and best serve their client-customers;(2) required professional liability insurance not merely to mitigate loss in cases of negligent mistakes but loss prevention through the underwriting process that will serve also as an additional dimension of self-regulation;(3) pervasive and independent private sector compliance auditing to minimize ,if not eliminate regulatory and self-regulatory inspection gaps and maintain greater transparency with respect to industry and firm practices ; and (4) above all a more transparent and informative arbitration and claims process that will not only right the wrongs to individual investors but more effectively inform the SEC and SROs in respect to their rule-making and enforcement.

There is **no** source of information that is more sensitive and closer to the "main street investor" than the arbitration and claim processes. However, arbitration has and still is an untapped resource for financial regulatory reform. A review of the Federal Register in respect to the DOL's Final Fiduciary Duty Rule demonstrates a total absence of any analysis in order that we can properly utilize the arbitration and claims processes in respect to enacting and implementing the new fiduciary rules and informing the inspection, enforcement, and rule making processes of the SEC and the SRO's.

A more singular and effective focus on the "main street investor" for not just the investor's sake but the financial services industry and our capital markets, can only come about by more ground level attention. Whether option disclosure by way of example is truly informative to the public customer and whether new and complex products are being comprehended by the individual investor and serving his or her needs can only really be assessed in the context of arbitration and claims processes, which to date have not been given full attention in the efforts to achieve financial regulatory reform.

In the last analysis a viable and operative fiduciary duty standard for professionals in the capital markets in regard to retirement plans and markets will require a fair balance in the rules between textual clarity and a flexibility to allow the law to respond where and when the rules are not fully effective as well as to be a constant dynamic to improve those standards pragmatically by instilling in the highest degree best practice standards for the various professional groups serving the investor in the capital markets and rooting out systemic problems that can easily slip by when those responsible are unable to see or are not attentive. Nor should our efforts be limited to the retirement markets.

Coordination With The SEC

The conceptual framework adopted by the DOL in their fiduciary Duty Rule i.e. (1) identifying key plans or accounts requiring special attention or significance ; (2) establishing pre-requisites for the fiduciary to be able to follow settled customs and practices in respect to categories of investment products and transactions, provided that the contract and the performance execution was and is in the best interest of the client -customer; and (3) permissibly allowing some professionals or vendors of services not to be held accountable as a fiduciary, provided there was and is an *independent* fiduciary in place; is fundamentally sound.

Independence is core to the professional responsibility of auditors and there is no reason why such independence cannot be an essential element for the plan fiduciary, especially when the fiduciary is to monitor the services of other service providers.

I believe the DOL Rule will be able to be made compatible with the Fiduciary Duty Rule that the SEC will promulgate in April 2017. Certain types of accounts can be tagged as requiring fiduciary responsibility and servicing because of the significance of the type of account's basic purpose for and to the investor. Such accounts of special significance are as important to the investor as the ERISA Plan and IRA accounts and equally require the protection of fiduciary responsibility without qualification.

These accounts would include by way of example trust and estate accounts, minor guardian and education accounts, and escrow accounts. These would be ,essentially, the type of accounts where the account owner or beneficiary would predominantly not make the investment decisions nor have" the care, custody, and control" of the funds and securities in the account on a consistent or regular basis and there would be a dependency of trust the account beneficiary or owner would have in respect to the fiduciary.

To reasonably assure that "fiduciary investment advice" and the necessary management services are being provided to these accounts of special significance there should be an independent fiduciary (in addition to the firm's supervisory structure and internal controls pursuant to Section 20(a) of the Securities and Exchange of 1934) and independent private sector compliance auditing as recommended above as one of the keys to financial regulatory reform. The traditional customer-broker relationship in the ordinary and non-discretionary account context would remain governed by the traditional rules and customs with the know your customer and suitability standards still in place.

A Just And Transparent Process For The Client-Customer

In defining standards for broker-dealers and investment advisers there should be an appreciation that while textual clarity is essential; there needs to be measured flexibility to allow for the application of equitable principles that will decide individual cases with greater fairness and be more informative for future rulemaking and enforcement.
As this author has stated as an advocate for sound financial regulatory reform, the best source of information and mechanism for the reform that we seek will be a transparent and an improved arbitration and claims process. A sign, hanging on the wall of the New York Stock Exchange arbitration department,quoted Aristotle as stating:

"Equity is justice in that it goes beyond the written law, and it is equitable to prefer arbitration to the law court, for the arbitrator keeps equity in view, whereas the judge looks only on the law and the reason why arbitrators were appointed was that equity might prevail." {11}

In our efforts to more effectively establish professionalism and fiduciary responsibility in our capital markets, especially in reference to retirement accounts, the required textual clarity in rulemaking must be combined with the flexibility of Aristotle's notion of equity in the arbitration and claims processes whose basic purpose is to fairly decide customer-broker disputes.. This will only come about if we assure that the claims and arbitration processes will inform us of how the "main street investor" is being impacted as well as correct any wrongs to such individual investor quickly, effectively and fairly on a priority basis.

Key to financial regulatory reform in today's context is not merely defining terms but creating a framework where the different components better inform the system as a whole; there is more transparency; and by a better and more cooperative coordination of the various elements of the system the best interest of the investor will more likely be achieved .

Endnotes

1. Federal Register, Volume 81,No.68,Part V, pages 20947-20952,20969-20960
2.Federal Register , pages 20972,20974-20975,20979-20984
3. Federal Register , page 20987
4 Federal Register, pages 20975-20980
5.. Federal Register, pages 20975-20960
6.Federal Register, page 21001
7.Federal Register, pages 20991-20992
8.Federal Register , page 20992
9.249 NY 458,164 N.E. 545 (NY Court of Appeals,1928)
10.Franlin Ormsten , Norman B. Arnoff and Gregg Evanglist, **Securities Broker Malpractice And Its Avoidance**, 25 Seton Hall Law Review 190, (1994), page 16.