MORNINGSTAR

Fiduciary Focus:

The Great Compromise to the Fiduciary Debate

The best way to resolve the fiduciary dilemma lies in subjecting both RIAs and broker/dealers to the 'sole interest' fiduciary standard of care found in ERISA, argues W. Scott Simon of Prudent Investment Advisors.

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As most advisors must know by now, the U.S. Department of Labor (DOL) has gone back to the drawing board in an attempt to craft a fiduciary standard of care that will encompass both registered investment advisors (RIAs)--who are already covered by the "best interest" fiduciary standard of care under the Investment Advisors Act of 1940 ('40 IAA)--and registered representatives and their broker/dealers (B/D)--who are covered by the (non-fiduciary) suitability standard of care under the Securities Exchange Act of 1934.

Those who demand a "level playing field" usually want B/Ds to be governed by the best interest fiduciary standard of the '40 IAA--which, as noted, governs RIAs. On the other side are those who believe that B/Ds need not be subjected to any fiduciary duty or, if they are, be subject to one, in my view, so eviscerated by exemptions such as the seller's exemption (found in the rule proposed by the DOL and since withdrawn but sure to resurface) as to make it unrecognizable as a fiduciary standard.

We can see that the ground over which this fight has taken place includes allowing B/Ds to either be left alone, as is, with their suitability standard or be subjected to a standard characterized by some as "fiduciary lite." But no one in this fight, including even the most rabid defenders of the status quo, has demanded that RIAs be brought under the suitability tent.

The Great Compromise: The Sole Interest Fiduciary Standard
I have long believed that the best way to resolve this fight lies in subjecting both RIAs and B/Ds to the "sole interest" fiduciary standard of care found in the Employee Retirement Income Security Act of 1974 (ERISA). In one fell swoop, ERISA's fiduciary standard--"the highest known to law" (*Donovan v. Bierwirth*, 680 F.2d 263, 272 (2d Cir. 1982))--would level that proverbial playing field for all concerned.

This compromise has the merit of disturbing both sides in this fight because it would change the existing standard of care under which each operates. For RIAs, they would be lifted from the best interest fiduciary standard of the '40 IAA to the sole interest fiduciary standard of ERISA. No longer would an RIA be allowed under the ERISA standard (unlike under the '40 IAA standard) to, for example, "double dip" by (1) receiving a fee on the advice it provides to its clients and also (2) earning commissions from the RIA's brokerage firm, bank, or custodial affiliate as a result of the trades it directs them to make to implement that advice.

For B/Ds, they would be lifted from the suitability standard all the way up to ERISA's "highest known to law" standard. This proposed compromise comports with what an official from the American Society of Pension Professionals & Actuaries (ASPPA) stated last year in commenting on the DOL's proposed rule to redefine fiduciary advice: "In our members' experience, these small-business owners are surprised when they find out the 'advice' they have received for their ERISA-covered 401(k) plan is not actually ERISA-covered investment advice." Further: "We urge the DOL to remove this confusion by clarifying the definition [of a fiduciary] so all parties--particularly plan sponsors--can be sure they are receiving the full protections under ERISA."

My proposed compromise removes all such confusion. Indeed, ensuring that all those providing advice to 401(k) plans and their participants (and their beneficiaries) must adhere to ERISA's sole interest fiduciary standard of care should meet the concerns of this ASPPA official. After all, any small-business owners that he speaks of won't be surprised anymore because the "advice" they receive for their ERISA-covered 401(k) plan will, in fact, be ERISA-covered investment advice. And that official is certainly correct in saying that by clarifying the definition [of a fiduciary], all parties--particularly plan sponsors--can be sure they're receiving the full protections under ERISA.

This proposed compromise would also seem to fully satisfy the chairman of the U.S. Securities and Exchange Commission (SEC) who said in an interview just three years ago: "I think [a fiduciary standard of care for all advisors is] entirely possible. I've said for a long time that it's really a flaw in our system that investors get different standards of care and different standards of regulatory protection depending on whether they're going to an investment advisor, a registered rep., an insurance agent, or an unregulated advisor of some sort. And it's not fair for us to leave it to investors to figure out what protections they're entitled to depending on which regulatory regime just happens to capture the person they're dealing with."

Indeed, it's not fair to investors--including sponsors of qualified retirement plans as well as plan participants and their beneficiaries--to be confused about such matters. Subjecting all those who freely make the choice to compete, say, in the 401(k) plan marketplace to the sole interest fiduciary standard of ERISA would indeed correct the "flaw" in the system identified by the SEC chairman.

The Brutal Political Reality

There's no good reason, then, why any RIA, B/D, insurance agent, benefits broker, or any other entity providing investment advice to qualified retirement plans and their participants (or to individuals, for that matter) should not be charged with living up to the sole interest fiduciary standard found in ERISA.

Well, even though there's no good reason, there is a reason: money. And money translates into political power ("Money is the mother's milk of politics;" see Jesse M. Unruh AKA "Big Daddy," former Speaker of the California State Assembly). There are just too many B/Ds, insurance agents, and others that use a transaction-based, commission-generating business model buzzing about 401(k) plans (and individual investors) that have no interest in being subjected to ERISA's sole interest fiduciary standard.

Such individuals completely dominate, or comprise a significant portion of, the membership of ASPPA (the trade association lobbyist for retirement plan professionals), the Investment Company Institute (the trade association lobbyist for the mutual fund industry), the Financial Services Institute (the trade association lobbyist for financial advisors and broker-dealers), the Securities Industry and Financial Markets Association (the trade association lobbyist for securities firms, banks, and asset management companies), the National Association of Insurance and Financial Advisors (the trade association lobbyist for life insurance agents and financial advisors), as well as others. These lobbyists are just too well organized and too well funded to allow any meaningful reform of the standard to which much of their membership is subject.

The brutal political reality is that those who engage in the practices of an established (transaction-based, commission-generating) business model will likely prevail over any efforts to subject them to any credible notion of a fiduciary standard.

Does Disclosure Really Bring Transparency?

The foregoing lobbyists were successful in attacking the DOL's proposed rule to redefine fiduciary advice so the DOL withdrew it. The DOL has since pledged to propose a new rule that likely will include a series of exemptions (such as a seller's exemption) cloaked in the guise of disclosures favored by the lobbyists. One lobbyist explained how the seller's exemption would work, for example, with the advisor of record for a 401(k) plan. "If [the] advisor ... says to a [plan sponsor] client, 'you should offer these 20 mutual fund options in your plan[,]' [d]oes that constitute advice? Common sense says absolutely. But how does that work from a fiduciary standpoint?"

My answer to this question would be: subject the advisor to the sole interest fiduciary standard of ERISA. Simple, case closed. The lobbyist's answer to how this works from a fiduciary standpoint: "Disclosure is the key, through some sort of seller's exemption." Further: "If the advisor discloses to the client that they aren't acting in a fiduciary capacity, that they are being compensated by the plan provider and they are transparent about the amount of the fees they are charging--and the client is OK with that--then they have satisfied their disclosure requirements." And: "We believe very heavily in transparency, and this is an issue of transparency."

To be sure, making disclosures to, say, a plan sponsor client sure sounds like it's in line with what Louis Brandeis, former Justice of the U.S. Supreme Court, said about the benefits of openness and transparency: "Sunlight is the best disinfectant." But are disclosures in the seller's exemption (which I've referred to in another column as "the exception that swallows the rule") really an issue of transparency? Nope, for the simple reason that virtually no one to whom such disclosures must be made has any bloody idea what they mean, even if they read them, which most of them won't.

Why would anyone--especially the lobbyists who are pushing such silly ideas (from the perspective of plan fiduciaries but brilliant from the perspective of much of the lobbyists' membership)--think that busy business owners would be able to understand the myriad of ramifications that inhere in such disclosures? One has only to recall that even an RIA subject to the best interest fiduciary standard who is engaged in practices permitted under such standard as double-dipping can fairly well damage plan participants and their beneficiaries.

Disclosure and Asymmetrical Information Risk

The lobbyists in this case favor a bare-bones "disclosure" regime (e.g., I'm not acting as an ERISA fiduciary and my advice is not subject to the protections of ERISA nor may my advice be impartial). In the qualified retirement plan marketplace, this results in asymmetrical information risk where plan sponsors are at the mercy of B/Ds and others that have a near-monopoly on information.

That kind of distortion shouldn't exist between B/Ds as well as others who follow the transaction-based, commission-generating business model, and plan sponsors. But it does because it reflects this model's "morals of the marketplace" (coined by Judge Benjamin N. Cardozo--prior to his ascent as a Justice of the U.S. Supreme Court, in the 1928 New York state case of *Meinhard v. Salmon*) worldview and the commercial standards of conduct--such as the suitability standard--through which it operates.

This model presumes that both parties in a financial relationship such as a B/D and a plan sponsor are equal in knowledge. The *Braden v. Wal-Mart* case is one of the latest to show that this simply isn't true, even when the party in the relationship with inferior information has enormous resources that could significantly shrink any information deficit. The recent item in The New York Times written by an ex-Goldman Sachs employee (and especially the nature of the written response to it by the head of Goldman Sachs) also shows clearly that the morals of the marketplace predominate in this kind of relationship. While the suitability standard makes it possible for customers to be legally treated as "Muppets," the sole interest fiduciary standard does not.

Summary

There is a fundamental, underlying reason for the logical inconsistency of a broker fiduciary standard: It is not possible to serve two masters. The oldest and most central fiduciary duty is the duty of loyalty--the notion that a fiduciary must place the interests of its beneficiary (participants and their beneficiaries in the ERISA context) before its own and any third parties. Registered representatives of B/Ds and other like entities cited in the last two columns fail in this most basic of duties because they are forced to pay legal homage to their B/Ds and the products they push, a requirement that leads to advice about such products that always has the potential to be in conflict with the best (or sole) interests of their clients. Not to mention that many good advisors who truly care about their clients are hobbled by this business model.

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