

Broker-Dealer  
Investment Adviser  
Insurance  
Research

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## Pitfalls for Registered Representatives Under ERISA

Recent trends in examination, enforcement, and litigation reveal an area of significant exposure for registered representatives and broker-dealers under ERISA. Due to concerns relating to supervision, compensation, and the complexity of ERISA compliance, most broker-dealers do not allow their representatives to service plans or participants in a fiduciary capacity. The test for fiduciary status under ERISA, however, is functional, so a representative can (and often does) become an ERISA fiduciary unknowingly. Inadvertent fiduciary status can give rise to violations of ERISA's prohibited transaction rules and subject the representative to personal liability and leave the broker-dealer exposed to significant penalties, including disgorgement and excise taxes.


While many prohibited arrangements may have gone unexamined in the past, service providers are now subject to increased scrutiny on all fronts. As class action cases continue to attract more attention from the plaintiffs' bar, and the results of formal information sharing arrangements between regulatory agencies (e.g., DOL and SEC) lead to increased examination of ERISA service providers, broker-dealers are looking for ways to mitigate or eliminate fiduciary liability. Many firms are looking to "remote" third-party registered investment advisers (RIAs) that will provide fiduciary services while allowing the representative to maintain his/her role as the key resource for the plan in providing non-fiduciary services.

### *Fiduciary Status*

ERISA provides three different ways for a person to become a fiduciary, but rendering investment advice for a fee most often classifies a representative an ERISA fiduciary. Under ERISA §3(21), a representative will be deemed to be rendering "investment advice" if he/she makes individualized recommendations (to an ERISA plan and/or its participants) as to the advisability of investing in, purchasing, or selling securities (or other property) on a regular basis that serves as the primary basis for investment decisions for a plan and/or its participants. Discretion over investment decisions is not a prerequisite to fiduciary status.

Because representatives are often the only financial professionals with whom the plan (or its participants) interacts, they are commonly looked to for individualized recommendations. If the representatives respond with specific recommendations, they will be ERISA fiduciaries and must demonstrate strict compliance with procedural prudence and disclosure requirements and cannot engage in prohibited transactions.

### NOTABLE

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### COMING SOON

- [NSCP's National Meeting](#)  
Meet LIMRA's Compliance and Regulatory experts, Booth #9  
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- [LIMRA's 2009 Annual Meeting](#)  
Keynote speaker Ben Stein speaks about the economic crisis  
Hilton New York, NY, October 25-27

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### CONTACT US

For information, assistance, or proposals:

LIMRA Compliance and Regulatory Services  
300 Day Hill Road, Windsor, CT 06095  
Phone: 877-843-2641  
Email: [Compliance-RegSvs@limra.com](mailto:Compliance-RegSvs@limra.com)

[www.limra.com/compliance](http://www.limra.com/compliance)

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## Areas of Exposure

Broker-dealers that operate with the view that their representatives do not provide advice generally do not have effective risk management processes to identify and monitor inadvertent fiduciary activity. For example, the receipt of variable compensation and/or revenue sharing, which is a common practice among broker-dealers and investment advisers, often gives rise to a fiduciary breach if not properly structured. ERISA prohibits fiduciaries from using the authority that makes them a fiduciary (e.g., investment recommendations) from generating additional fees for themselves and/or their affiliates. Consequently, if a representative recommends investments that pay variable 12b-1 fees or proprietary products that pay additional compensation to the broker-dealer or an affiliate, a prohibited transaction would result.

Even where the representative's (and the affiliate's) compensation remains level, there may still be exposure, as most errors and omissions policies do not cover ERISA fiduciary services unless specifically negotiated for and acknowledged in the policy. Because most broker-dealers do not permit their representatives to act as ERISA fiduciaries, the representative and the broker-dealer are typically not covered for these types of claims.

## Leveraging "Remote" RIAs to Shift Fiduciary Risk

Utilizing a "remote" RIA to serve as an ERISA §3(21) fiduciary will protect against these claims, as the RIA will expressly assume fiduciary status for providing ongoing investment advice. In most instances, the RIA contracts directly with the plan sponsor to provide quarterly recommendations based upon the investment objectives of the plan (or its participants) and the investment alternatives available on the particular platform. While the RIA monitors the investments, the representative can continue to receive compensation for the provision of non-fiduciary support (e.g., employee enrollment, education, plan design). The specifics of such arrangements vary among advisers and providers; but, at a minimum they operate to relieve the representative of the expectation that he/she will provide investment advice. By shifting the fiduciary risk to a third party, the representative and the firm can substantially mitigate their liability for ERISA violations.

*By Jason Roberts, Esq., a speaker at LIMRA's recent Compliance Market and Conduct Exchange. For more information on "remote" fiduciary arrangements please contact Jason at [Reish & Reicher](#).*

## Adding an RIA to an Existing Broker-Dealer

There are several key factors to consider before adding a registered investment adviser (RIA or Adviser) operation to an existing broker-dealer. Not only does the addition of the RIA add a new regulatory regime, it creates a potentially higher standard of care for all activities performed by advisory personnel.

### Fiduciary Duty Standard of Care

Section 206 of the Investment Advisers Act of 1940 (Advisers Act) imposes a fiduciary duty on RIAs. This means that the RIA and its representatives must act at all times with the utmost good faith and in the best interest of its clients, especially when there are potential conflicts of interest. The Adviser must also disclose all material facts and never take advantage of a client's trust, especially when setting fees and conducting its own investment activities.

### Federal or State Registration

Adviser registration is primarily driven by its assets under management (AUM). If an Adviser has \$25 million or more AUM, conducts business in 30 or more states, or is an adviser to a registered investment company, it generally must register with the SEC. If the AUM is less, the RIA must register with the state or in the states in which it has a physical place of business.

### Regulatory Overview

If the Adviser is federally registered, the SEC will examine the Adviser on a risk-based schedule. However, new RIAs should expect to be examined by the SEC within 12 to 24 months of initial registration. SEC registered advisers also must designate a Chief Compliance Officer (CCO) who will design, implement, and be responsible for the effectiveness of the Adviser's compliance program. The CCO must prepare and document an annual compliance review. This document will be reviewed by the SEC during the firm's examinations.

If the Adviser is registered with a state, then its primary regulator will be the state securities division of the state where the main operations of the Adviser are located. Most states do not disclose their RIA examination criteria or schedules. A state-registered RIA will also register or file notice in other states where it maintains physical offices or has enough clients to trigger state filing requirements. Most states have adopted a form of the Uniform Securities Act. Each state's laws and regulations roughly follow or refer to the Advisers Act and other SEC requirements.

However, a notable exception to this is the "CCO Rule" — SEC Rule 206(4)-7 — which became effective in 2004. States have not adopted a mirror rule to this federal requirement. Instead, they rely on pre-existing state statutes and regulations for advisory firms to create compliance programs and to supervise RIA activities. So even though

states might not have formal CCO and annual compliance review requirements, during examinations state securities regulators will ascertain whether Advisers have adequate compliance programs and conduct reasonable compliance reviews and supervision.

### ***Building on Existing Compliance Infrastructure***

A common threshold question for new RIAs is whether to start the RIA as a new legal entity or to add the new RIA and its operations to the existing broker-dealer. Another issue involves the degree to which broker-dealer and RIA compliance functions should be integrated in order to leverage existing resources. Deciding these issues is highly fact-intensive. Therefore, it should be considered on a case-by-case basis.

### ***Start-Up Considerations***

Generally, adding an RIA to an existing broker-dealer is not overly complicated; however, it requires close attention to detail and nuance in order to make the registration, disclosure, and implementation of the new Adviser a success. Using a consultant that specializes in this area can add considerable value to your project by identifying potential pitfalls and providing additional subject matter expertise that might not be available within your broker-dealer.

*By Max Mahoney, Esq., a LIMRA Consultant who specializes in financial services regulatory matters*

## **The New Reality of Product Due Diligence Review**

The basic product due diligence process implemented by firms a few years ago may not be enough to protect them from future client claims and complaints about third-party products that don't perform as predicted. Compliance professionals face more challenges than ever with product complexities and the interconnectedness of firms. Add to this the inability of firms to rely exclusively on a stamp of approval from a ratings agency, and you have your work cut out for you.

Below are some questions and approaches you should consider adding to your due diligence toolbox as your firm evaluates not only what new products to offer, but also those that are still being sold by your representatives.

### ***Stress Testing***

What might a future complaint look like? Put yourself in the buyers' shoes and build a worst case scenario of what might happen to this product given a convergence of the worst possible events. Evaluate the product disclosures and risk documentation, contractual terms or guarantees, historical trends, and what you know about the underlying assets backing the investment. Figure out where your client will be in the line of creditors standing outside the issuer's door. Will they be first in line or last? And of those who may get paid ahead of your client, do they have any obligation to make your client whole or have they indemnified your firm for any losses due to their negligence?

### ***Asset Backing***

What are the underlying assets for the product? Who holds them? What is their typical duration or maturity? What market or systemic risks can affect their value? For assets with clear and known value and title, how confident are you that they are worth what the issuer claims and are they subject to independent audit or verification? How

are ownership and the distribution of revenue to investor partners structured? If the product is tied to specific assets like real estate limited partnerships or REITS then some offering firms may provide previously prepared documents prepared by third parties selected and hired by the offering firm. Selling firms should be wary of unduly "rosy" projections of condition or performance in such documents. Some selling firms insist on hiring their own third-party reviewer; however, multiple firms seeking to distribute the same offering can reduce cost by hiring the same third-party reviewer to examine the offering. Are there other parties to the product who should be reviewed as part of the due diligence (e.g., brokers or intermediaries, dealers or distributors, administrators, resellers, and reinsurers)?

### ***Who Should Buy — and Why?***

A large part of avoiding future complaints is selling to investors who understand the product and its risks. Representatives should be able to explain why their clients should buy the product. How clear are the descriptions of the standard features, riders or optional features, and charges? How do they operate, and how are they communicated in sales materials, brochures, or advertising? What is the typical holding period, maturity or benefit period or structure? In the end, you should be able to describe the suitable investor in terms of client profile data points (e.g., age, income, liquid net worth, tax status, dependent status, time horizon, risk profile, investment objective, or other specific purpose, and who it would *not* be suitable for). Know whether the product is only intended for "accredited" or "sophisticated" investors. There may be limitations as to how the product can be marketed. Make sure your head office principals or trade desk principals are aware of any special suitability criteria before actual solicitation begins.

### **Product Benefits and Risks**

How does the client benefit? What advantages does the product offer over other investment or product choices? For example, evaluate the death benefit, living benefits, tax deferral or deductibility, income, asset growth potential, wealth transfer, guaranteed rate of return or income, and what the guarantees and rate provisions are. How could the client lose? Has that risk been clearly disclosed? Be sure all securities sales materials meet your firm's standards, are fair and balanced, equally present the risks and benefits, clearly disclose fees and charges, and do not highlight or stress features and benefits over risks and charges. You may want to file with FINRA prior to first use even if this is not required. Conduct similar reviews for computer-based illustrations, seminar slides, or other materials including invitations and public advertising.

### **Charges and Fees**

Most complainants allege at some point that not all charges or fees were explained clearly or disclosed. Be sure you can identify the following, using the client-approved materials and the offering document: What are the charges? When are they charged? Are they clearly disclosed? Are there excessive profit margins or charges by anyone in the offering firm or selling chain? What are the charges and fees deducted from the deposit, premium, or purchase price? When are they deducted or charged? How are they disclosed? Is it on the confirmation, prospectus, policy or contract, or some other document? Is a client signature required on disclosures? How do the charges compare to alternative products or investments? Are charges waived for any reason or certain events such as death, disability, maturity, or ownership change? Are there any discrepancies between the offering documents and sales materials? Any discrepancies must be corrected, as these are "red flags." Other "red flags" to watch for during your review are: (1) inaccessible or missing financial data, (2) lack of recent or annual audits, (3) refusal to provide financial information, (4) conflict of interest among offering principals, (5) due diligence materials provided and paid for by the product issuer, and (6) higher distribution charges or GDC than similar offerings.

### **Ongoing Due Diligence**

Assign someone to monitor each offering firm and investment periodically. Provide selling representatives with updates on prior offerings as well as new offerings. Consider a strategy for client and representative outreach for deals that perform poorly or will no longer be offered by your firm. Have a process to re-evaluate your criteria as market conditions change. Are there public filings available on the financial condition of that company? If not, then request specific and up-to-date audited financials.

*By Larry Niland, LIMRA Senior Regulatory Advisor and former CCO of the John Hancock Financial Network*

## **Compliance 101 for Agents, IARs, and RRs**

The fundamentals of regulatory compliance need to be communicated to producers in a way that is easy to remember and apply to all aspects of their business.

**"DECK"** is a simple mnemonic which helps producers quickly digest four fundamentals of regulatory compliance: 1) Documentation; 2) Ethics; 3) Communication; and 4) Knowledge. These fundamentals provide a framework upon which an understanding of complex compliance requirements can be built.

**D**ocumentation encompasses all record keeping rules and defensive best practices. Good documentation means not only filling out forms, but keeping excellent notes and memos. Documentation is a form of career "compliance insurance" for which the premium paid is time. Ethical producers facing complaints or regulatory inquiries often find that the time invested in maintaining good records can make the difference between favorable and unfavorable resolution.

**E**thics have different technical definitions depending on the regulator. There are reasonable basis standards, fiduciary standards, and appropriateness standards. All of these standards have a few points in common: put the interests of the client first, and of course, don't lie, cheat or steal.

**C**ommunication includes all professional communications, regardless of format or venue, and is subject to regulation. Communications, both written and verbal, must meet the highest ethical standards for truth and clarity. Excellent written documentation of verbal communication, such as phone calls or face-to-face meetings, is merely "premium" paid for compliance insurance.

**K**nowledge requires producers to have a thorough understanding of their clients, products (including riders, options, and fees), markets, and competition. It is through the ethical and practical application of their knowledge that producers make compliant sales.

Compliance is one subject among many competing for the attention of today's producers. While compliance professionals cannot remove the burden of compliance, memory aids like DECK can help producers understand the requirements and hopefully integrate good compliance practices into their daily routine.

*By Stephen Selby, LIMRA's Director of Regulatory Services*