

Drinker Biddle

**The Death of the DOL
Fiduciary Rule and the Birth
of the SEC Best Interest Rule:
What Does that Mean for
Advisers?**

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The Fiduciary Rule

Timeline for fiduciary rule and exemptions:

- March 15, 2018: Decision by 5th Circuit Court of Appeals vacating the DOL fiduciary rule.
- May 9, 2018: SEC proposed best interest guidance for broker-dealers and RIAs.
- June 2019: Estimated time of issuance of SEC final rules for broker-dealers and RIAs.
- January 1, 2020: Estimated applicability date of SEC Reg BI.
- Late 2019, 2020 and 2021: Estimated dates of applicability of state fiduciary and best interest standards.

DOL, ERISA and Internal Revenue Code

- The “new” DOL fiduciary rule was vacated by the 5th Circuit.
- The “old” DOL fiduciary rule continues:
 - Standard of care and prohibited transaction rule for retirement plans.
 - Prohibited transaction rule for IRAs.
- The old definition:
 - 5-part test.
 - Discretion is fiduciary.

The 5-Part Test

Old rule definition of fiduciary:

- Recommendations provided for compensation;
- On a regular basis;
- Pursuant to a mutual understanding that;
- The advice will serve as a primary basis for investment decisions; and that
- The advice is individualized and based on the particular needs of the retirement investor.

Best Interest Standard

The ERISA Best Interest Standard for Retirement Plans:

*Investment advice is in the “Best Interest” of the Retirement Investor when the Adviser and Financial Institution providing the advice act with the **care, skill, prudence, and diligence** under the circumstances then prevailing that a prudent person 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, . . . **without regard to the financial or other interests of the Adviser, . . .***

SEC Proposed RIA Interpretation

- Interpretation Regarding Standard of Care for RIAs:
 - Proposed—or not?
 - Best interest for all advice to all clients.
 - Includes plans.
 - Includes rollovers.
 - Material conflicts and need for informed consent.
 - What is needed for “informed” consent?
 - Duties of best interest and loyalty.
 - Standard of care.

Reg BI Best Interest Obligation

*A broker, dealer, or a natural person who is an associated person of a broker or dealer, **when making a recommendation** of any securities transaction or investment strategy involving securities to a retail customer,*

*. . . shall **act in the best interest** of the retail customer at the time the recommendation is made,*

*. . . **without placing the financial or other interest of the broker, dealer, or natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer.***

Best Interest Standard in Reg BI

SEC's Proposed Reg BI Care Obligation for Broker-Dealers:

*The broker, dealer, or natural person who is an associated person of a broker or dealer, in making the recommendation exercises reasonable **diligence, care, skill, and prudence** to: . . .*

Have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks and rewards associated with the recommendation; . . .

Query re: Standard of care for RIAs.

What Does Reg BI Cover for Broker-Dealers?

- A **retail customer** is defined within the proposed rule as a person, or the legal representative of such person, who receives the broker-dealer's recommendation and uses it "primarily for personal, family or household purposes."
- Does not cover advice to plans, but does cover advice to participants.

How Do Broker-Dealers Satisfy Their “Best Interest” Obligations?

To demonstrate that a broker-dealer has acted in the customer’s best interest, Reg BI requires they satisfy **three** obligations:

- (1) Disclosure
- (2) Care
- (3) Conflict of Interest

Obligation Two: Conflicts of Interest

BDs must create and enforce **written** policies and procedures that are **reasonably designed** to:

(1)

(2) disclose and **mitigate**, if not eliminate, material conflicts of interest arising from financial incentives associated with a recommendation.

Note: Definition of “material.”

What Is A Conflict of Interest: SEC Examples

- *Proprietary products or products of affiliates.*
- *One share class versus another share class of a mutual fund.*
- *The rollover or transfer of assets from one type of account to another (such as recommendations to rollover or transfer assets in an ERISA account to an IRA, when the recommendation involves a securities transaction).*

Note: Mitigate.

What Is A Conflict of Interest: SEC Examples

- *Compensation practices . . . , including fees and other charges for the services provided and products sold.*
- *Quotas, bonuses, sales contests, special awards, differential or variable compensation, incentives tied to appraisals or performance reviews.*

Note: Mitigate.

What Is A Conflict of Interest: SEC Examples

- *Compensation practices involving third parties, including both sales compensation and compensation that does not result from sales activity, such as compensation for services provided to third-parties (e.g., sub-accounting or administrative services provided to a mutual fund).*
- *Receipt of commissions or sales charges, or other fees or financial incentives, or differential or variable compensation, . . .*

Note: Mitigate.

Conflicts of Interest for RIAs

Prohibited transactions under ERISA and the Internal Revenue Code are essentially the same as material financial conflicts of interest.

Under the SEC rules, material conflicts of interest should be disclosed on the Form ADV Part 2A (or a compliant brochure) or, if not required to be in the ADV, should be disclosed elsewhere.

FINRA on Conflict of Interest

The 2018 FINRA Examination Priorities included the following:

“ . . . FINRA will focus on the suitability of firms’ and registered representatives’ recommendations made to plan participants, including Individual Retirement Account rollover recommendations involving securities transactions. FINRA will also review the supervisory mechanisms firms establish for these recommendations.”

Note: A rollover recommendation includes two securities recommendations.

IRA Rollover Market in Billions



Source: Money in Motion — Understanding the Dynamics of Rollovers, Roll-ins, and IRA Transfers, LIMRA Secure Retirement Institute, 2017, The IRA Investor Profile: Traditional IRA Investors' Activity, 2007-2014, Investment Company Institute, and LIMRA Secure Retirement Institute analysis. Note: Rollover market size for years 2017 through 2021 are projections.

Recommendations of Rollovers

In Advisory Opinion 2005-23A, the DOL explained:

Question 2: *Does a recommendation that a participant roll over his or her account balance to an individual retirement account (IRA) to take advantage of investment options not available under the plan constitute investment advice with respect to plan assets?*

Answer: *It is the view of the Department that merely advising a plan participant to take an otherwise permissible plan distribution, even when that advice is combined with a recommendation as to how the distribution should be invested, does not constitute "investment advice" within the meaning of the regulation (29 CFR § 2510-3.21(c)).*

But: Subject to SEC Reg BI best interest standard and mitigation, as well as SEC RIA fiduciary standard.

Recommendations of Rollovers

However, the DOL went on to say:

Where, however, a plan officer or someone who is already a plan fiduciary responds to participant questions concerning the advisability of taking a distribution or the investment of amounts withdrawn from the plan, that fiduciary is exercising discretionary authority respecting management of the plan and must act prudently and solely in the interest of the participant.

Note: Fiduciary recommendations are subject both to standard of care and prohibited transaction/conflict of interest rules.

Recommendations: Best Interest Standard

- What are the “relevant factors” a prudent fiduciary would consider in making a distribution and rollover recommendation?
- What is an enterprise of a like character and with like aims?

FINRA Regulatory Notice 13-45

The IRA Rollover Decision

*A recommendation to roll over plan assets to an IRA rather than keeping assets in a previous employer's plan or rolling over to a new employer's plan should **reflect consideration of various factors, the importance of which will depend on an investor's individual needs and circumstances.** [Emphasis added.]*

FINRA Regulatory Notice 13-45

- *Investment Options.*
- *Fees and Expenses.*
- *Services.*
- *Penalty-Free Withdrawals.*
- *Protection from Creditors and Legal Judgments.*
- *Required Minimum Distributions*
- *Employer Stock*

. . . the list is not exhaustive.

BICE Level Fee Fiduciary Provision

*This **documentation must include consideration** of the Retirement Investor's alternatives to a rollover, including leaving the money in his or her current employer's Plan, if permitted, and...*

BICE Level Fee Fiduciary Provision

*. . . **must take into account** the fees and expenses associated with both the Plan and the IRA; whether the employer pays for some or all of the plan's administrative expenses; and the different levels of services and investments available under each option....*

Recommendations of Distributions and Rollovers

Q14. Can an adviser [provide] investment advice to roll over from an existing plan to an IRA if the adviser does not have reliable information about the existing plan's expenses and features?

DOL Conflict of Interest FAQs (Part I—Exemptions), October 27, 2016.

Recommendations of Distributions and Rollovers

[T]he adviser and financial institution must make diligent and prudent efforts to obtain information on the existing plan. In general, such information should be readily available as a result of DOL regulations mandating plan disclosure of salient information to the plan's participants (see 29 CFR 2550.404a-5).

Recommendations of Distributions and Rollovers

*If, despite prudent efforts, the financial institution is unable to obtain the necessary information or if the investor is unwilling to provide the information, even after fair disclosure of its significance, **the financial institution could rely on alternative data sources**, such as the most recent Form 5500 or reliable benchmarks on typical fees and expenses for the type and size of plan at issue.*

State Changes Affecting Plans

- New York best interest rule.
- Nevada fiduciary rule
- Several other states are considering (e.g., Maryland, California, Connecticut, New York).
- NAIC enhanced suitability/best interest standard.

New York Rule 187

The “prudence” part of best interest:

- Must reflect the
“care, skill, prudence, and diligence that a prudent person acting in a like capacity and familiar with such matters would use under the circumstances then prevailing”
- ERISA says fiduciaries must act 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”

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