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SEC finalizes broker-dealer conduct standards — paves way for DOL's fiduciary rule

The SEC has released guidance that represents a major shift in the responsibility of broker-dealers to make investment recommendations in the best interest of retail customers. Although the regulation does not directly impose duties on plan fiduciaries, it does affect broker-dealer conversations with participants about investments — including rollover decisions — and may obligate fiduciaries to keep a watchful eye on those interactions.

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Background

In 2016 DOL issued its "fiduciary rule," expanding the scope of the definition of fiduciary and impermissible conflicts of interest for advisors who provide services to employer-sponsored retirement plans and certain non-ERISA investment vehicles. On February 3, 2017, President Donald Trump directed DOL to re-evaluate the rule's likely impact on retirement savings (the fiduciary rule was originally scheduled to take effect on April 10, 2017). DOL extended the effective date for the written disclosures and fiduciary representations until July 1, 2019, but the rest of the regulation went into effect on June 9, 2017, along with an "enforcement lite" policy for fiduciaries working diligently and in good faith to comply. (See our November 28, 2017 *FYI*.)

The DOL proposed fiduciary rule was eventually vacated on March 15, 2018, by the 5th Circuit Court of Appeals. (See our March 19, 2018 *FYI Alert*.) This resulted in a retroactive reinstatement of the old fiduciary rule and exemptions. In Field Assistance Bulletin 2018-02, DOL issued a nonenforcement policy saying DOL would not take any action against an "investment advice fiduciary" and confirmed that IRS would follow suit and respect this policy for purposes of applying IRC 4975 (which provides for excise taxes on prohibited transactions). (See our May 9, 2018 *FYI*.)

Meanwhile, on April 18, 2018, the SEC proposed enhancements to the standard of conduct that applies when broker-dealers make recommendations to retail customers. At the time, the "suitability standard" applied to broker-dealers; it required that a broker make recommendations that are suitable based on a client's personal situation, but the standard did not require the advice to be in the client's best interest. The proposal would have established a best interest obligation that would require all

broker-dealers, when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer, to 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 associated person making the recommendation ahead of that of the retail customer.

> **Buck comment.** The existing broker-dealer rule lacked an enforcement mechanism, and the SEC explicitly disavowed creating "any new private right of action." This contrasts with DOL's approach in the fiduciary rule, which would have imposed (for most providers) a "Best Interest Contract" requirement that created privately enforceable obligations.

In addition, the SEC proposed an interpretation (Interpretation) of the standard of conduct applicable to investment advisers under the Investment Advisers Act of 1940, as amended (Advisers Act).

SEC issues broker-dealer rule …

On June 5, 2019, the SEC released Regulation Best Interest: The Broker-Dealer Standard of Conduct (Reg BI), recognizing the inherent conflicts of interest in the broker-dealer and customer relationship, including a compensation structure that may incentivize a broker-dealer to seek to increase its own compensation or other financial interests at the expense of the customer. Reg BI requires broker-dealers who provide investment recommendations to act in the best interest of their "retail customers" and is meant to go beyond the existing "suitability" standard that applies to broker-dealers.

Effective June 30, 2020, broker-dealers are subject to four "obligations" in connection with retail client account recommendations:

- **Disclosure Obligation.** They must provide, before or at the time of the recommendation, a "Client Relationship Summary" (Form CRS), disclosing all material facts of the relationship including identifying themselves as a broker-dealer and not as an investment adviser, the costs of the relationship (e.g., fees/commissions), services provided, and all conflicts of interest that may be connected to the account recommendation.
- **Care Obligation.** They must act with reasonable care and prudence in connection with account recommendations.
- **Conflict of Interest Obligation.** They are required to establish, maintain, and enforce written policies and procedures reasonably designed to identify, and disclose or eliminate, conflicts of interest associated with recommendations.
- **Compliance Obligation.** They must establish, maintain and enforce written policies and procedures reasonably designed to achieve compliance with Reg BI.

… and clarifies investment adviser standards

Recognizing that investment advisers have a different relationship with their customers, offer various fee arrangements (thus providing choices to investors), and are explicitly "fiduciaries," the SEC did not include in Reg BI any changes to the standards for investment advisers. However, the SEC did

finalize the proposed Interpretation, which does not purport to modify the existing investment adviser standard of conduct, but rather to reaffirm and clarify the SEC's view on certain aspects of the existing standard. An investment adviser's fiduciary duty under the Advisers Act comprises a duty of care and a duty of loyalty. The SEC points out that at the time an account recommendation is made, key elements of the Reg BI standard of conduct that apply to broker-dealers will be similar to key elements of the fiduciary standard for investment advisers.

> **Buck comment.** In its proposed form, investment advisers were required to both avoid and disclose conflicts of interest. In the final Interpretation, investment advisers can choose between elimination or disclosure of conflicts.

Effects of SEC rule and interpretation on retirement plans

SEC's final regulation includes protections for plan participants and possible fiduciary responsibilities for plan sponsors and administrators.

Application to plan participants

Reg BI requires that when a broker or associate makes an account recommendation to a retail customer, it must act in the "best interest of the retail customer … without placing the financial or other interest of the [broker/affiliate] ahead of the interest of the retail customer." For these purposes, "retail customer" means natural persons (and their (non-professional) legal representatives) who use the recommendation "for personal, family, or household purposes." Thus, the rule would cover participants in retirement plans (e.g., 401(k), 403(b) and 457 plans, including governmental plans) but would not cover recommendations made to plan fiduciaries acting on behalf of the plan. Additionally, Reg BI applies to recommendations on the investment of retail customer IRAs, Health Savings Accounts, Coverdell education savings accounts, Archer Medical Savings Accounts, and qualified tuition programs, as well as 529 plans.

"Recommendations" covered by the rule include recommendations to roll over assets from a retirement plan to an IRA (and vice versa) and to take a plan distribution or plan loan. Not covered by the rule are communications by brokers about required minimum distributions (unless it includes a recommendation about which securities to sell or purchase), general education about a plan's investment options, and general conversations about retirement planning.

Broker-dealer's obligations to participants

For recommendations to roll over assets into an IRA, the Care Obligation requires a broker-dealer to have a reasonable basis to believe that the IRA rollover is in the best interest of the participant at the time of the recommendation and does not place the financial or other interests of the broker-dealer ahead of the interests of the participant, considering the risks, rewards, and costs in light of the participant's investment profile and compared to the participant's existing account or other investment vehicle. In addition to fees and expenses, broker-dealers should look at the services available, available investment options (including employer stock), withdrawal limitations, and any special aspects of the existing retirement account.

Broker-dealers and their associated persons (including broker-affiliated plan call centers) should discuss the basis for any account recommendation with participants, including all potential risks, especially when the recommendation is given to a participant who is considering taking a plan distribution and/or rolling it over to an IRA. The SEC warns that broker-dealers can't assume that an IRA having more investment options than a 401(k) is warranted as "the basis for recommending a rollover" and that cost can be a "fairly significant factor" in assessing such recommendations, because IRAs are almost always more expensive than 401(k) plans.

> **Buck comment.** Although Reg BI does not specifically reference defined benefit plans, neither does it exclude them. Thus, the rule could apply to broker-dealers providing recommendations on rollovers from pension plans.

Application to plan fiduciaries

Retirement plan fiduciaries generally have a legal obligation under ERISA to monitor the conduct of plan service providers. That duty may extend to monitoring compliance with federal securities laws, including Reg BI. Since Reg BI appears to directly apply to any participant recommendations provided by broker-dealers or registered investment advisors pertaining to rollovers, investment allocations, and distributions, Reg BI is likely to have a significant effect on broker conduct. Plan sponsors will want to review with broker-affiliated service providers whether and how the new rules will affect the services they provide. Reg BI may also affect plan fiduciary responsibilities, especially to the extent of the plan fiduciary's duty to monitor compliance with the new rules. Plan fiduciaries will want to understand the extent of their duties and discuss with service providers how the conduct of broker-affiliated service providers will be monitored going forward.

> **Buck comment.** Given participants' willingness and ability under ERISA to sue plan fiduciaries for breaches of fiduciary duties, there is a risk that a failure by plan fiduciaries to monitor compliance with federal securities laws by service providers could expose them to litigation by plan participants.

In closing

Reg BI makes clear the obligations broker-dealers owe to their clients. Reg BI and Form CRS impact recommendations given to plan participants and IRA owners but will not affect advice given to plan fiduciaries.

The DOL is currently working to issue its own fiduciary regulation, expected in December, that is anticipated to parallel Reg BI and will likely impact retirement plan sponsors. However, in light of the departure of Labor Secretary Alexander Acosta, it is unclear whether DOL's new fiduciary regulation will be delayed under Acting Labor Secretary Patrick Pizzella. This month, the president announced that he will nominate Eugene Scalia as a replacement. Scalia was the lead attorney in the case that brought down the ERISA fiduciary rule promulgated by the Obama administration.

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