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Conduct Becoming: The SEC's Latest Rules Proposal

The SEC is floating potential regulations that would change conduct standards for broker-dealers and others. We take a closer look.

The SEC recently proposed (1) a "Regulation Best Interest" providing new conduct standards for broker-dealers, (2) an "Interpretation Regarding Standard of Conduct for Investment Advisers" that "reaffirms, and in some cases clarifies, certain aspects of the fiduciary duty that an investment adviser owes to its clients," and (3) a requirement that investment advisers and broker-dealers provide retail investors a "Relationship Summary"—a standardized, short-form disclosure highlighting "key differences in the principal types of services offered, the legal standards of conduct that apply to each, the fees a customer might pay, and certain conflicts of interest that may exist."

Comments on the SEC's proposals are due within 90 days.

Significance for Plan Sponsors

These proposals are of primary interest to investment professionals. However, as discussed in our last article, "Fiduciary Rule Forensics," they also indirectly affect sponsor retirement plan fiduciaries because those fiduciaries have a legal obligation under ERISA to monitor the conduct of plan service providers, including, for example, call center operators and participant advice and education providers affiliated with financial services firms. Those service providers (call center operators, etc.) are often broker-dealers, investment advisers or both.

In Field Assistance Bulletin 2007-1, the DOL described that duty to monitor (with respect to investment advisers) as including monitoring "whether the adviser continues to meet applicable federal and state securities law requirements." Connecting the dots, under the SEC proposal, the federal securities law requirements applicable to these retirement plan service providers would be changed significantly by the SEC proposal, thereby altering what plan fiduciaries must monitor as well.

In this article, we focus on the proposed broker-dealer regulation and offer some thoughts on its significance for plan sponsors.

Regulation Best Interest
The proposal is less comprehensive than the "impartial conduct" standard and the contract, disclosure and pay policy standards under the DOL's Fiduciary Rule and related Best Interest Contract Exemption (BIC). Nevertheless, its provisions in many respects address similar issues—disclosure, standard of care and elimination or mitigation of conflicts— in a way that's similar to the approach taken by the DOL in the Fiduciary Rule and (especially) the BIC. Thus, in the proposing release the SEC stated, "We believe that the principles underlying our proposed best interest obligation, and the specific Disclosure, Care, and Conflict of Interest Obligations …, generally draw from underlying principles similar to the principles underlying the DOL's best interest standard, as described by the DOL in the BIC Exemption."

The proposed Regulation Best Interest generally requires that the broker-dealer (or an individual associated with the broker-dealer) when making a recommendation to a retail customer 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 individual] … ahead of the interest of the retail customer."

For purposes of this rule, "retail customer" is limited to persons who use the recommendation "for personal, family, or household purposes." Thus, the rule would, for example, cover 401(k) plan participants but would not cover recommendations made to fiduciaries of small and medium-sized employer plans (a group that was covered by the Fiduciary Rule).

In its proposing release, the SEC elaborated on its "best interest" formulation as follows: "[T]he broker-dealer's financial interest can and will inevitably exist, but these interests cannot be the predominant motivating factor behind the recommendation. Our proposed language makes this intention clear by stating a broker-dealer and its associated persons are not to put their interests ahead of the retail customer's interests."

Best Interest Standards

To meet the regulation's best interest requirement, a broker-dealer/associated individual must do four things:

1. **Disclosure Obligation:** Disclose the key facts about the relationship, including material conflicts of interest.
2. **Care Obligation:** Exercise "reasonable diligence, care, skill, and prudence, to (i) understand the product; (ii) have a reasonable basis to believe that the product is in the retail customer's best interest; and (iii) have a reasonable basis to believe that a series of transactions is in the retail customer's best interest." (The latter requirement is, among other things, intended to address the issue of churning.)
3. **Conflict of Interest Obligation "Prong 1":** Establish, maintain and enforce written policies and procedures reasonably designed to identify, and disclose, or eliminate, all material conflicts of interest associated with covered recommendations.
4. **Conflict of Interest Obligation "Prong 2":** Establish, maintain and enforce written policies and procedures reasonably designed to identify, and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with covered recommendations.

The similarity between the language of Conflict of Interest Obligation Prongs 1 and 2 may be a little confusing. In essence, the SEC is saying in Prong 1 that with respect to non-financial material conflicts disclosure may be sufficient. In Prong 2, it is saying that, with respect to *financial incentives* that present material conflicts, disclosure is not enough; these conflicts must either be eliminated or disclosed and mitigated. In this regard, the SEC's proposing release defines "financial incentives" broadly to include (among other things) employee compensation or employment incentives (e.g., quotas, bonuses, sales contests, special awards, differential or variable compensation, and incentives tied to appraisals or performance reviews), compensation practices involving third parties and differential or variable compensation.

While some have characterized these requirements as a "safe harbor," they are in fact substantive requirements. The proposing release states, "Failure to comply with any of these requirements when making a recommendation … would violate Regulation Best Interest."

Issues Relevant to Retirement Plans

In connection with the proposed Regulation Best Interest, the SEC published a 407-page "proposing release" that includes, among other things, an extensive discussion of the proposed regulation. In the proposing release, the SEC discusses a number of issues that will be relevant to retirement plans

The proposing release clarifies that securities transactions covered by the rule "may also include recommendations to roll over or transfer assets from one type of account to another, such as recommendations to roll over or transfer assets in an ERISA account to an IRA." It further states that the broker-dealer generally should disclose "material conflicts associated with recommending 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)."

With respect to the disclosure of fees, the SEC states that it would generally expect the broker-dealer to disclose detail (including quantitative information, such as amounts, percentages or ranges) regarding the types of fees and charges described in the Relationship Summary.

In meeting the Care Obligation, the SEC believes that the cost (including fees, compensation and other financial incentives) associated with a recommendation would generally be an important factor. In that regard, the SEC discusses situations in which recommending a higher cost product may (or may not) violate the rule:

> We preliminarily believe that, in order to meet its Care Obligation, when a broker-dealer recommends a *more expensive* security or investment strategy over another reasonably available alternative offered by the broker-dealer, the broker-dealer would need to have a reasonable basis to believe that the higher cost of the security or strategy is justified (and thus nevertheless in the retail customer's best interest) based on other factors (e.g., the product's or strategy's investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility and likely performance in a variety of market and economic conditions), in light of the retail customer's investment profile. When a broker-dealer recommends a *more remunerative* security or investment strategy over another reasonably available alternative offered by the broker-dealer, the broker-dealer would need to have a reasonable basis to believe that – putting aside the broker-dealer's financial incentives – the recommendation was in the best interest of the retail customer.
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> [W]here, for example, a broker-dealer is choosing among identical securities available to the broker-dealer, it would be inconsistent with the Care Obligation to recommend the more expensive alternative for the customer.
>
> We preliminarily believe that under the Care Obligation, a broker-dealer could not have a reasonable basis to believe that a recommended security is in the best interest of a retail customer if it is more costly than a reasonably available alternative offered by the broker-dealer and the characteristics of the securities are otherwise identical, including any special or unusual features, liquidity, risks and potential benefits, volatility and likely performance.

Finally, in its recommended "list of potential practices" that should be a focus of mitigation/elimination efforts under Conflict of Interest Obligation Prong 2, the SEC identifies recommendations that "involve 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)."

Outlook

Many have criticized the SEC's proposal as confusing, and there are a number of areas where further explanation—or the articulation of a bright-line rule—might be helpful. The proposing release includes nearly 50 pages of requests for comments. Thus, we would expect significant further work on the proposal.

To repeat what we said at the outset, Regulation Best Interest is relevant to sponsor fiduciaries because it would change the compliance obligations of plan service providers (including call center operators and participant advice and education providers) that, under ERISA, sponsor fiduciaries have a duty to monitor.

As the new standards applicable to brokers take shape, sponsors will want to evaluate their relationships with relevant plan service providers with a view to adequately discharging this duty to monitor.

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