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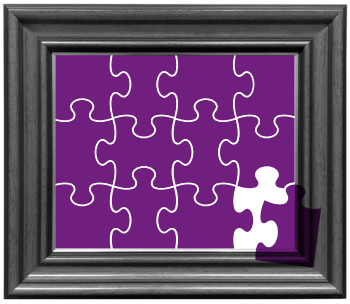

Getting the full picture

The emerging best interest and fiduciary duty patchwork

August 12, 2019

The SEC's new standard of conduct rules – application to retirement accounts

On June 5, 2019, the US Securities and Exchange Commission (SEC) adopted its Regulation Best Interest (Rule 15*l*-1 under the Securities Exchange Act of 1934), a rule that requires a broker-dealer registered with the SEC to act in the best interest of its retail customers when making a recommendation of any securities transaction or investment strategy involving securities. The SEC interprets "investment strategy involving securities" to include account recommendations. At the same time, the SEC adopted the Form CRS Relationship Summary (Form CRS) as well as related rulemakings requiring broker-dealers and investment advisers to file Form CRS relationship summaries with the SEC (through the Central Registration Depository and Investment Adviser Registration Depository systems) and deliver Form CRS relationship summaries to retail investors.

In completing its rulemaking on Regulation BI and Form CRS, the SEC addressed important questions about the applicability of those requirements to retirement accounts. Central to the resolution of these questions are the definition of "retail customer" in Regulation BI and the definition of "retail investor" in connection with the Form CRS delivery requirements:

- A retail customer, for purposes of Regulation BI, includes any natural person (or the legal representative of such person) who receives a recommendation from a broker-dealer with respect to any transaction or investment strategy involving securities and uses such recommendation primarily for personal, family or household purposes, irrespective of the person's net worth, financial literacy, sophistication or experience in investment-related matters.[1]
- In a clarification from the proposal, the definition of "legal representative" covers only "nonprofessional" legal representatives, such as nonprofessional trustees, executors, conservators and persons holding a power of attorney for a retail customer.[2]

The Form CRS is to be delivered to retail investors, a term defined as a natural person or the legal representative of a natural person who seeks to receive or receives services primarily for personal, family, or household purposes.[3]

As noted above, Regulation BI applies when a broker-dealer makes recommendations of any securities transaction or investment strategy involving securities to its retail customers.[4] Under Regulation BI, an "investment strategy involving securities" includes "account recommendations."[5] According to the adopting release, the SEC explains that it interprets account recommendations to include "recommendations by broker-dealers of securities account types generally," which includes recommendations to open an individual retirement account (IRA) or other brokerage account or recommendations to open an advisory account.[6] The SEC also interprets account recommendations to include recommendations of rollovers or transfers of

1 Exchange Act Rule 15*l*-1(b)(1).
2 *See Regulation Best Interest: The Broker-Dealer Standard of Conduct*, 84 Fed. Reg. 33318, 33343 (June 5, 2019) (Regulation BI adopting release).
3 Exchange Act Rule 17a-14(e)(2).
4 *See* Regulation BI adopting release at 33320.
5 *See* id. at 33320.
6 See id. at 33325.

assets from one type of account to another.[7] For example, Regulation BI would apply to a broker-dealer who makes a recommendation to a retail customer to transfer assets from a retirement plan to an IRA.[8] Regulation BI would also apply to certain implicit hold recommendations.[9] As a result, certain account recommendations involving retirement plan assets will trigger the obligations of Regulation BI even if the account recommendations do not involve a securities transaction.[10]

Under the SEC's companion interpretive release under the Investment Advisers Act of 1940 (the Advisers Act), an investment adviser's fiduciary duty applies to advice to existing clients about account types, including advice about whether to open or invest through a certain type of account, such as a brokerage account or an advisory account.[11] In addition, an investment adviser's fiduciary duty applies to advice to existing clients about whether to roll over assets from one account into a new or existing account that is managed by the adviser or an affiliate of the adviser.[12] An adviser's fiduciary duty requires the adviser to consider all types of accounts offered by the adviser when providing advice about account types.[13] If the account types offered by an adviser are not in a client's best interest, the adviser is expected to disclose that to the client.[14] Furthermore, while advisers do not owe a fiduciary duty to prospective clients, investment advisers are required to comply with the antifraud provisions of Section 206 of the Advisers Act when providing advice. Section 206 requires an adviser to have sufficient information about the prospective client and the client's objectives to form a reasonable basis for advice prior to providing any advice about investment strategies, engaging sub-advisers, or account types.[15]

Out of Scope

Given the retail customer and investor definitions, recommendations to the following are out of scope for both the Regulation BI and Form CRS requirements:

- Institutions, including providers of retirement plans and accounts.
- Plan sponsors or other plan fiduciaries, at least with respect to plan-level investment matters unrelated to the retirement savings of specific individuals. Accordingly, plan-level advice to a plan sponsor about investment options for a defined contribution plan or about the investment of trust assets for a defined benefit plan generally does not create a retail customer relationship that triggers Regulation BI or Form CRS. To the extent, however, there is an identity between the plan and participating individuals—for example, in the case of a micro-plan covering only a sole proprietor or a very small number of self-employed persons—the adopting release suggests that Regulation BI may apply even to plan-level recommendations.

Consistent with the Department of Labor's (DOL) longstanding position under the Employee Retirement Income Security Act (ERISA), the final rules also make it clear that "investment education"—as long as it does not become transaction-specific—is not a recommendation in the scope of Regulation BI. Investment education includes:

- general financial and investment information,
- descriptions of the provisions of an employer-sponsored retirement plan, plan participation and its benefits, and the investment options available,
- asset allocation models based on generally accepted investment theory that meet other requirements, and
- interactive investment materials that incorporate the foregoing.

Finally, these rules do not cover notifications to individual retirement investors that a required minimum distribution is due, although a recommendation about the retirement account investments that should be liquidated to fund that distribution is in scope if it implicates securities.

It should be noted, however, that the Form CRS delivery requirements key off various factors, which may go beyond making a recommendation. Accordingly, investment education coupled with one of these other factors could trigger the delivery of a Form CRS.

- Broker-dealers and their financial professionals must deliver the Form CRS to a retail investor before or at the earliest of (i) a recommendation of an account type, a securities transaction or an investment strategy involving securities; (ii) placing an order for the retail investor; or (iii) the opening of a brokerage account for the retail investor.
- Investment advisers must deliver a relationship summary to each retail investor before or at the time they enter into an investment advisory contract with the retail investor.

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7 *Id.* at 33336.
8 *Id.*
9 *Id.* at 33339.
10 *Id.*
11 *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, 84 Fed. Reg. 33669, 33674 (June 5, 2019) (Advisers Act interpretive release).
12 *Id.* at 33674.
13 *Id.*
14 *Id.*
15 *Id.* at 33674, n. 42.

In Scope

The following interactions are in scope and would require both compliance with Regulation BI and, in connection with the formation of the retail investor relationship, delivery of Form CRS:

- Recommendations to defined contribution plan participants, whether or not the plan is covered by ERISA, and to IRA owners about (i) the type or opening of investment account for their retirement savings in order to affect securities transactions and (ii) securities transactions or strategies in that account.
- Rollover advice to plan participants and IRA owners—whether to roll retirement assets out of the existing retirement arrangement and, if so, into what type of new arrangement (for example, an IRA) and if applicable, investment account under that arrangement—even if that advice is not tied to a specific securities transaction. The SEC's interpretive statement on investment advisers' standards of conduct similarly and specifically includes rollover advice as being in the scope of the investment adviser's fiduciary duty of care and loyalty. For dually registered representatives, the capacity in which the representative provides the recommendation generally will determine which rule governs, although if the recommendation is to roll funds into an IRA advisory account, the greater likelihood is that the Advisers Act standards will apply.

Eversheds Sutherland Observations

- The decoupling of covered rollover advice from a specific securities transaction is a significant change from the proposal and, at least as to broker-dealers, may be among the more aggressive legal positions taken by the SEC in this rulemaking. Although the Regulation BI release makes mention of rollovers to a new employer's retirement plan, it is not explicitly stated in the release whether such a recommendation—or a hypothetical roll-out recommendation without any roll-in advice—triggers the rule. If it does, however, this would be a circumstance—there may be others—where Regulation BI would apply prior to account opening, indeed, without any account opening, which in turn would cause firms to consider training representatives not to make recommendations until they have collected the requisite investor profile information.
- As with the proposals, the final rules do not expressly address interactions with defined benefit plan participants. Logically, however, and while there may be outliers, the only recommendation to such participants that could implicate Regulation BI and potentially Form CRS would generally seem to be rollover advice and, conceivably, lump-sum cash-out recommendations.
- Although also not directly addressed, there is an argument that an explicit or implicit "hold" recommendation to remain in an existing retirement arrangement is a form of "rollover advice" subject to these rules.
- The Regulation BI adopting release suggests a diligence process for rollover advice at least as rigorous as the process articulated in FINRA Regulatory Notice 13-45. As under that notice and the (now vacated) DOL fiduciary rule, firms will need to consider how to deal with the many circumstances in which optimal information to inform that advice—for example, specific cost information about the retirement plan in which the investor's savings is currently held—cannot be reasonably or reliably obtained. Also, consistent with that other guidance, the mere availability of additional investment options under an IRA cannot alone be used to justify a rollover recommendation.
- The Regulation BI adopting release explains that a broker-dealer's best interest obligation requires consideration of "reasonably available alternatives," which, in the case of a defined contribution plan, must necessarily be limited to the investment options available under the plan.
- In circumstances where the firm is assisting both a retirement plan sponsor and individual participants, it may be providing (i) an ERISA 408(b)(2) disclosure to the plan sponsor and (ii) Regulation BI disclosure and Form CRS to plan participants. If the firm is dually registered and acting in part in an investment adviser capacity, Form ADV disclosure will also be involved. While the purposes of these various disclosures are similar, their form and content can differ, and firms should take care to avoid any discontinuities with these other existing disclosures when preparing the Regulation BI disclosure and Form CRS for retirement investors.
- Coordination with existing retirement account procedures will also need to be considered in operationalizing the new SEC rules—for example, in the case of an IRA rollover, the timing of the delivery of Regulation BI disclosure and Form CRS with IRA account-opening documentation, including the IRS-mandated IRA disclosure statement.
- On the other hand, there may be opportunities to simplify or even discontinue existing retirement account disclosure documentation to the extent it overlaps with Regulation BI disclosure and/or Form CRS. For example, the disclosures required under ERISA PTE 77-4 and PTE 84-24, to the extent delivered to a plan participant or IRA owner, will be substantially, although perhaps not completely, replicated by the new SEC disclosures.
- Well-advised plan sponsors may incorporate securities firms' observance of these new requirements into their fiduciary selection and monitoring processes.

Contacts

For more commentary regarding the emerging landscape related to the standards of conduct for investment professionals, visit Eversheds Sutherland's www.secfiduciaryrule.com.

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