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Best Interest and Best Practices: Improving Retirement Outcomes #1

DrinkerBiddle
Article By
Fred Reish
Drinker Biddle & Reath LLP
FredReish.com

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What is the "Best Interest?"

This is the first of a new series of articles titled "The Bests." This series will focus on Best Interest and Best Practices. Those topics will give me flexibility to talk about a range of subjects that affect both service providers, including advisors, and plan sponsors, including 401(k) committees.

For this inaugural article, let's talk about the meaning of "Best Interest."

There are at least four Best Interest standards. (While "best interest" can also refer to management of conflicts of interest, this article is about the best interest standard of care.)

- ERISA's best interest standard of care for plan sponsors and fiduciary advisors for private sector retirement plans. (While ERISA doesn't literally have a best interest standard—because the Best Interest Contract Exemption was vacated by the 5th Circuit Court of Appeals, that best interest standard was a combination of ERISA's prudent man rule and duty of loyalty which, of course, are still in the law. As a result, I will use the term to refer to the combination of ERISA's prudent man rule and duty of loyalty.)
- The SEC's proposed best interest standard for broker-dealers in its Regulation Best Interest.
- The best interest standard in the SEC's proposed "Interpretation" for

investment advisers.
- The New York State Best Interest standard for recommendations of life insurance policies and annuity contracts.

Let's look at how each of those are defined.

- The ERISA Best Interest Standard for Retirement Plans (copied from the Best Interest Contract Exemption):

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, based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor, without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity, or other party.

- The SEC's Proposed Best Interest Standard for Broker-Dealers:

The best interest obligation . . . shall be satisfied if: 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; . . .

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.

- The SEC's Proposed Best Interest Standard for Investment Advisers:

The SEC proposal did not include a definition of best interest. However, the SEC proposal reaffirms that investment advisers are fiduciaries for their clients and includes the best interest standard as a part of the RIA fiduciary duty. It seems inconceivable that the best interest standard for investment advisers would be lower than that same standard for broker-dealers. And, since the SEC uses the same label —"best interest"—for both investment advisers and broker-dealers, the likelihood is that the standard is the same. (In some ways, though, those best interest rules are different, for example, the RIA best interest standard applies to a much wider range of advice and includes monitoring.)

- The New York State Best Interest Standard:

The producer, or insurer where no producer is involved, acts in the best interest of the consumer when . . .

the producer's or insurer's recommendation to the consumer reflects 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. Only the interests of the consumer shall be considered in making the recommendation. The producer's receipt of compensation or other incentives permitted by the Insurance Law and the Insurance Regulations is permitted by this requirement provided that the amount of the compensation or the receipt of an incentive does not influence the recommendation; and . . .

I have highlighted language in each of the definitions. My purpose is to emphasize how similar the standards are. All of the Best Interest standards seem to require a process. That is, how can an advisor be careful, skillful, prudent and diligent without engaging in a process? In my view, there are several steps to that process. The first is determining the needs and circumstances of the investor; the second is evaluating the investment or insurance strategies in light of those needs; and the third is a consideration of the costs and quality of the investment and insurance products that are being considered. The gathering and analysis of that relevant information must be done carefully and skillfully based on a hypothetical knowledgeable and experienced advisor. In other words, the standard is not the ability of a particular advisor, but instead the industry expectations of professional advisors. The evaluation and performance of the advisor is based on that objective standard.

In addition, each of the definitions requires that an advisor place the interests of the investor ahead of the interests of the advisor. The Best Interest standard imposes a duty of loyalty on the advisor.

"Best Interest" does not mean that an advisor must pick the best investment or insurance product. However, it does impose a higher duty than suitability in the development of recommendations, and it may prove to be more demanding than many people expect. It does mean that quality and costs are more significant considerations than they are under the suitability standard.

The views expressed in this article are the views of Fred Reish, and do not necessarily reflect the views of Drinker Biddle & Reath.

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