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Best Interest and Best Practices #10: What Does Best Interest Mean . . . In the Real World? (Part 2)

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This is the 10th of a new series of articles titled "The Bests." The series focuses on Best Interest and Best Practices. Those topics give me flexibility to discuss a range of subjects that affect both service providers, including advisors, and plan sponsors, including 401(k) and 403(b) committees.

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My last article, **Bests #9**, discussed different definitions of a "best interest" standard of care. The point of that article is that, while there may be slight differences in the wording, the rules converge to require that an advisor (and the advisor's supervisory entity) act with care, skill, diligence and prudence to make recommendations that are in the best interest of the investor. This article discusses how the standard applies to specific circumstances.

As background, there are three parts to any best interest standard. The first is that the advisor engage in a process–carefully, skillfully, diligently and prudently–to develop the recommendation. That process is measured by an objective standard . . . what are the relevant factors that a knowledgeable professional advisor would consider and how would that hypothetical advisor evaluate those factors. The second is that the advisor act with loyalty to the investor. The advisor cannot put his interests ahead of the investor's. The third is that the recommendation appropriately consider the investor's profile (*e.g.*, the needs and circumstances of the investor).

Let's focus on the first part–the process and the relevant factors.

In its proposed Regulation Best Interest (Reg BI), the SEC said that its best interest standard for broker-dealers elevates (as compared to the suitability standard) the importance of costs. That is consistent with the fiduciary standard in ERISA's prudent man rule. And, in my opinion, it is consistent with the fiduciary standard for registered investment advisers (RIAs). In other words, the new best interest "world" is placing greater emphasis on costs as a "relevant" factor for determining whether a recommendation satisfies that standard. Obviously, the requirement is that costs (and the impact of those costs on an investor's returns), among other things, must be objectively and prudently considered (and given appropriate weight).

Using mutual funds as an example, that means that advisors need to make sure that the expense ratios of recommended mutual funds are reasonable. For example, the best interest standard would generally require that an advisor recommend the lowest cost share class of a mutual fund that is available to the advisor and the investor. Depending on the circumstances, that could mean a particular share class for one investor, but a different share class of the same mutual fund for another investor (for example, if a share class requires a threshold investment amount).

Here's another example of the consideration of costs in a best interest process for different investors.

If a retail (*e.g.*, IRA) investor's time horizon is for the long term, *e.g.,* for retirement investing, and therefore it is contemplated that the mutual fund could be held for decades, it is likely to be cheaper to use A shares with a front end load (as opposed to C shares). However, if an investor's time horizon for holding a fund is short term, it will likely be less expensive to hold a C share. A "best interest" analysis requires that an advisor consider the investor's needs and circumstances in determining which recommendation would result in a lower cost to the investor based on, among other things, the holding period. This point is not limited to considerations of A shares versus C shares. The issue is bigger than that—and involves careful consideration of costs, considering the alternatives, based on an investor’s needs, circumstances, investment horizon and other relevant factors.

Similarly, where an advisor is managing an account for an investor, it may or may not be in their investor’s best interest to choose NTF (No Transaction Fee) mutual funds. In that case, if the investor’s anticipated holding period is short term, the NTF funds will likely produce a lower cost and, therefore, may be in the best interest of the investor. However, if the investor anticipates holding the mutual funds for the long term, it would ordinarily be more cost-effective to pay a transaction fee, in exchange for a lower expense ratio.

Those are examples of how a “best interest” advisor would consider the “relevant” factors in developing a recommendation.

That’s it for this article . . . but my next post will discuss other best interest considerations.

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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