

THE
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Parallels Between the SEC Regulation Best Interest and the DOL Best Interest Contract Exemption (Part 1): Interesting Angles on the DOL's Fiduciary Rule #90

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This is my 90th article about interesting observations concerning the Department of Labor's (DOL) fiduciary rule and exemptions. These articles also cover the DOL's FAQs interpreting the regulation and exemptions and related developments in the securities laws.

The SEC's proposed Regulation Best Interest ("Reg BI") is remarkable in its similarities to the DOL's vacated Best Interest Contract Exemption ("BICE"). This article describes some of those similarities. Keep in mind as you read this that Reg BI applies to securities recommendations, while BICE would have covered any investment or insurance recommendation by a fiduciary advisor.

Reg BI, if finalized, will require that broker-dealers and their representatives act in the "best interest" of "retail customers," which includes IRA owners and participants. The DOL's BICE also would have required that fiduciary advisors (including broker-dealers and their representatives) act in the "best interest" of participants and IRA owners. A major difference is that the SEC proposal covers all retail customers, while the DOL's BICE would have covered "qualified accounts"—which includes only plans, participants and IRA owners. (I should note that Reg BI says that it covers recommendations to "legal representatives" of retail customers. That reference could include the trustees and plan committees for retirement plans. However, it's not clear.)

Also, Reg BI is similar to BICE in that it covers recommendations to participants to take distributions from retirement plans and roll over to IRAs. Reg BI only applies where securities recommendations are made. But it appears to be the position of both the SEC and FINRA that a recommendation to take a distribution from a 401(k) plan implicitly includes a recommendation to liquidate the investments in the participant's account, which would be a securities transaction. (I will get into more detail about recommendations to participants to take distributions and roll over to IRAs in a future article.)

In addition, both Reg BI and BICE include a duty of loyalty for recommended securities transactions. While the wording in the two pieces of guidance is slightly different, the outcome is the same . . . broker-dealers and their representatives cannot prioritize their own interests ahead of the interests of investors.

While some people refer to the new standard of care as being "suitability plus" or "enhanced suitability," I see it differently. Based on my reading of the guidance and on comments by SEC commissioners, the suitability standard is incorporated into the new Best Interest Standard of Care, rather than the other way around. As a result, it might be better referred to as "transactional best interest."

Unfortunately, the SEC proposal does not fully define the Best Interest Standard of Care. However, it does say that broker-dealers and their representatives have to act with "diligence, care, skill, and prudence," which was also in the DOL's Best Interest Standard of Care. (As an aside, the requirement to act diligently, carefully, skillfully, and prudently suggests the need for a process—similar to ERISA's prudent man rule.) The proposed Reg BI goes on to say that its duty of care is based on the principles in the DOL's Best Interest Standard of Care. To me, that means that a starting point for understanding the Reg BI requirements is to look at the DOL's Best Interest

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Standard of Care which says that:

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.

If you read that closely, it easily divides into three categories: a prudent person rule; a know-your-customer requirement; and a duty of loyalty. The preamble to the proposed Reg BI discusses those three principles as being key elements of its standards.

However, while the proposal would require best interest for recommendations of securities transactions, it would not mandate a duty to monitor. That is significantly different from the role of an investment adviser (RIA), where best interest monitoring is generally expected.

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

Part 1- [Interesting Angles on DOL's Fiduciary Rule #1](#)

Part 2 - [Best Interest Standard of Care: Interesting Angles on the DOL's Fiduciary Rule #2](#)

Part 3 - [Hidden Preamble Observations: Interesting Angles on the DOL's Fiduciary Rule #3](#)

Part 4 - [TV Stock Tips and Fiduciary Advice: Interesting Angles on DOL's Fiduciary #4](#)

Part 5 - [Level Fee Fiduciary Exemption: Interesting Angles on DOL's Fiduciary Rule #5](#)

Part 6 - [Fiduciary Regulation And The Exemptions: Interesting Angles on the DOL's Fiduciary Rule #6](#)

Part 7 - [Fiduciary Regulations And The Exemptions : Interesting Angles on the DOL's Fiduciary Rule #7](#)

Part 8 - [Designated Investment Alternatives: Interesting Angles on the DOL's Fiduciary Rule #8](#)

Part 9 - [Best Interest Standard and the Prudent Man Rule: Interesting Angles on the DOL's Fiduciary Rule #9](#)

Part 10 - [FINRA Regulatory Notice: Interesting Angles on the DOL's Fiduciary Rule #10](#)

Part 11- [ERISA and the Internal Revenue Code: Interesting Angles on the DOL's Fiduciary Rule #11](#)

Part 12- [Potential Prohibited Transactions: Interesting Angles on the DOL's Fiduciary Rule #12](#)

Part 13- [Investment Policies: Interesting Angles on the DOL's Fiduciary Rule #13](#)

Part 14- [Investment Suggestions: Interesting Angles on the DOL's Fiduciary Rule #14](#)

Part 15- [Best Interest Contract Exemption: Interesting Angles on the DOL's Fiduciary Rule #15](#)

Part 16 - [Adviser Recommendations: Interesting Angles on DOL's Fiduciary Rule #16](#)

Part 17 - [Level Fee Fiduciary: Interesting Angles on DOL's Fiduciary Rule #17](#)

Part 18- [Best Interest Contract Exemption and IRA Advisor Compensation: Interesting Angles on the DOL's Fiduciary Rule #18](#)

Part 19- [Interesting Angles on the DOL's Fiduciary Rule #19: Advisors' Use of "Hire Me" Practices.](#)

Part 20- [Three Parts of "Best Interest Standard of Care": Interesting Angles on the DOL's Fiduciary Rule #20](#)

Part 21- [Retirement Plan Documentation and Prudent Recommendation: Interesting Angles on the DOL's Fiduciary Rule #21](#)

Part 22- [Banks and Prohibited Transactions: Interesting Angles on the DOL's Fiduciary Rule #22](#)

Part 23- [Prohibited Transactions: IRA and RIA Qualified Money: Interesting Angles on the DOL's Fiduciary Rule #23](#)

Part 24 - [Differential Compensation Based on Neutral Factors: Interesting Angles on DOL's Fiduciary Rule #24](#)

- Part 25- [Reasonable Compensation Versus Neutral Factors: Interesting Angles on the DOL's Fiduciary Rule #25](#)
- Part 26- [Interesting Angles on the DOL's Fiduciary Rule #26- Reasonable Compensation for IRAs: When and How Long?](#)
- Part 27 - [Definition of Compensation: Interesting Angles on DOL's Fiduciary Rule #27](#)
- Part 28 - [What About Rollovers that Aren't Recommended?: Interesting Angles on the DOL's Fiduciary Rule #28](#)
- Part 29- [Capturing Rollovers: What Information is Needed?: Interesting Angles on the DOL's Fiduciary Rule #29](#)
- Part 30- [Three Kinds of Level Fee Fiduciaries . . . and What's A "Level Fee?": Interesting Angles on the DOL's Fiduciary Rule #30](#)
- Part 31 - ["Un-levelizing" Level Fee Fiduciaries: Interesting Angles on the DOL's Fiduciary Rule #31](#)
- Part 32 - [What "Level Fee Fiduciary" Means for Rollover Advice: Interesting Angles on the DOL's Fiduciary Rule #32](#)
- Part 33- [Discretionary Management, Rollovers and BICE: Interesting Angles on the DOL's Fiduciary Rule #33](#)
- Part 34- [Seminar Can Be Fiduciary Act: Interesting Angles on DOL's Fiduciary Rule #34](#)
- Part 35- [Presidential Memorandum on Fiduciary Rule: Interesting Angles on the DOL's Fiduciary Rule #35](#)
- Part 36 - [Retirement Advice and the SEC: Interesting Angles on the DOL's Fiduciary Rule #36](#)
- Part 37 - [SEC Retirement-Targeted Examinations: Interesting Angles on the DOL's Fiduciary Rule #37](#)
- Part 38- [SEC Examinations of RIAs and Broker-Dealers under the ReTIRE Initiative: Interesting Angles on the DOL's Fiduciary Rule #38](#)
- Part 39- [FINRA Regulatory Notice 13-45: Guidance on Distributions and Rollovers: Interesting Angles on the DOL's Fiduciary Rule #39](#)
- Part 40 - [New Rule, Old Rule - What Should Advisers Do Now?: Interesting Angles on the DOL's Fiduciary Rule #40](#)
- Part 41 - [While We Wait: The Current Fiduciary Rule and Annuities: Interesting Angles on DOL's Fiduciary Rule #41](#)
- Part 42 - [Rollovers under DOL's Final Rule: Interesting Angles on DOL's Fiduciary Rule #42](#)
- Part 43 - [BICE Transition: More Than the Eye Can See - Interesting Angles on DOL's Fiduciary Rule #43](#)
- Part 44 - [Basic Structure of Fiduciary Package \(June 9\): Interesting Angles on DOL's Fiduciary Rule #44](#)
- Part 45 - [DOL Fiduciary "Package": Basics on the Prohibited Transaction Exemptions: Interesting Angles on the DOL's Fiduciary Rule #45](#)
- Part 46 - [How Does an Adviser Know How to Satisfy the Best Interest Standard?: Interesting Angles on the DOL's Fiduciary Rule #46](#)
- Part 47- ["Real" Requirements of Fiduciary Rule: Interesting Angles on DOL's Fiduciary Rule #47](#)
- Part 48- [The Last Word: The Fiduciary Rule Applies on June 9- Interesting Angles on the DOL's Fiduciary Rule #48](#)
- Part 49- [The Requirement to Disclose Fiduciary Status: Interesting Angles on the DOL's Fiduciary Rule #49](#)
- Part 50- [Fourth Impartial Conduct Standard: Interesting Angles on DOL's Fiduciary Rule #50](#)
- Part 51- [Recommendations to Transfer IRAs: Interesting Angles on the DOL's Fiduciary Rule #51](#)
- Part 52 - [The Fiduciary Rule and Exemptions: How Long Will Our Transition Be?: Interesting Angles on the DOL's Fiduciary Rule #52](#)
- Part 53 - [Fiduciary Rule and Discretionary Investment Management: Interesting Angles on DOL's Fiduciary Rule #53](#)
- Part 54 - [The DOL's RFI and Possible changes to BICE: Interesting Angles on the DOL's Fiduciary Rule #54](#)

- Part 55- [DOL's RFI and Recommendation of Annuities- Interesting Angles on DOL's Fiduciary Rule #55](#)
- Part 56- [Recommendations of Contributions as Fiduciary Advice: Interesting Angles on the DOL's Fiduciary Rule #56](#)
- Part 57- [Relief from 408\(b\)\(2\) Requirement on Change Notice: Interesting Angles on the DOL's Fiduciary Rule #57](#)
- Part 58- [Recommendations to Contribute to a Plan or IRA- Interesting Angles on the DOL's Fiduciary Rule #58](#)
- Part 59- [What Plans and Arrangements Are Covered by the Fiduciary Rule: Interesting Angles on the DOL's Fiduciary Rule #59](#)
- Part 60- [What the Tibble Decision Means to Advisers: Interesting Angles on the DOL's Fiduciary Rule #60](#)
- Part 61- [The Fiduciary Rule, Distributions and Rollovers: Interesting Angles on the DOL's Fiduciary Rule #61](#)
- Part 62 - [Is It Possible To Be An Advisor Without Being A Fiduciary? - Interesting Angles on the DOL's Fiduciary Rule #62](#)
- Part 63- [Policies and Procedures: The Fourth BICE Requirement - Interesting Angles on the DOL's Fiduciary Rule #63](#)
- Part 64 - [What Does the Best Interest Standard of Care Require?-Interesting Angles on the DOL's Fiduciary Rule #64](#)
- Part 65- [Unexpected Consequences of Fiduciary Rule - Interesting Angles on the DOL's Fiduciary Rule #65](#)
- Part 66- [Concerns About 408\(b\)\(2\) Disclosures: Interesting Angles on the DOL's Fiduciary Rule #66](#)
- Part 67- [From the DOL to the SEC - Interesting Angles on the DOL's Fiduciary Rule #67](#)
- Part 68- [Recommendations of Distributions - Interesting Angles on the DOL's Fiduciary Rule #68](#)
- Part 69- [Compensation Risks for Broker-Dealers and RIAs: Interesting Angles on the DOL's Fiduciary Rule #69](#)
- Part 70- [The Fiduciary Rule and Recordkeeper Services: Interesting Angles on the DOL's Fiduciary Rule #70](#)
- Part 71- [Recordkeepers and Financial Wellness Programs: Interesting Angles on the DOL's Fiduciary Rule #71](#)
- Part 72- [The "Wholesaler" Exception: Interesting Angles on the DOL's Fiduciary Rule #72](#)
- Part 73- [Recordkeeper Investment Support for Plan Sponsors: Interesting Angles on the DOL's Fiduciary Rule #73](#)
- Part 74 - [One More Fiduciary Issue for Recordkeepers: Interesting Angles on the DOL's Fiduciary Rule #74](#)
- Part 75 - [The Fiduciary Rule: Mistaken Beliefs-Interesting Angles on the DOL's Fiduciary Rule #75](#)
- Part 76 - [Discretionary Management of IRAs: Prohibited Transaction Issues for RIAs- Interesting Angles on the DOL's Fiduciary Rule #76](#)
- Part 77 - [The Fiduciary Rule: Mistaken Beliefs \(#2\): Interesting Angles on the DOL's Fiduciary Rule #77](#)
- Part 78 - [The Fiduciary Rule: Mistaken Beliefs \(#3\): Interesting Angles on the DOL's Fiduciary Rule #78](#)
- Part 79 - [The Fiduciary Rule: Mistaken Beliefs \(#4\)- Interesting Angles on the DOL's Fiduciary Rule #79](#)
- Part 80 - [Enforceable During Transition?: Interesting Angles on the DOL's Fiduciary Rule #80](#)
- Part 81 - [The Fiduciary Rule Prohibits Commissions... or Not \(Myth #6\): Interesting Angles on the DOL's Fiduciary Rule #81](#)
- Part 82 - [Undisclosed \(and Disclosed\) 12b-1 Fees: The Different Views of the SEC and DOL - Interesting Angles on the DOL's Fiduciary Rule #82](#)
- Part 83 - [Part 2 of Undisclosed \(and Disclosed\) 12b-1 Fees: Interesting Angles on the DOL's Fiduciary Rule #83](#)
- Part 84- [What Does the 5th Circuit Decision Mean for Rollover Recommendations?: Interesting Angles on the DOL's Fiduciary Rule #84](#)

Part 85 - [The Fiduciary Rule: What's Next \(Part 1\)? : Interesting Angles on the DOL's Fiduciary Rule #85](#)

Part 86- [The Fiduciary Rule: What's Next \(Part 2\)? : Interesting Angles on the DOL's Fiduciary Rule #86](#)

Part 87 - [The Fiduciary Rule: What's Next \(Part 3\)? : Interesting Angles on the DOL's Fiduciary Rule #87](#)

Part 88 - [The Fiduciary Rule: What's Next \(Part 4\)? : Interesting Angles on the DOL's Fiduciary Rule #88](#)

Part 89 - [The 5th Circuit Decision, Prohibited Transactions, and New Non-Enforcement Policies: Interesting Angles on the DOL's Fiduciary Rule #89](#)

Part 91- [Parallels Between the SEC Regulation Best Interest and the DOL Best Interest Contract Exemption \(Part 2\): Interesting Angles on the DOL's Fiduciary Rule #91](#)

Part 92 - [SEC Proposed Reg BI and Recommendations of Rollovers \(Part 1\): Interesting Angles on the DOL's Fiduciary Rule #92](#)

Part 93 - [SEC Proposed Reg BI and Recommendations of Rollovers \(Part 2\): Interesting Angles on the DOL's Fiduciary Rule #93](#)

Part 94 - [SEC Proposed Reg BI and Recommendations of Rollovers \(Part 3\) : Interesting Angles on the DOL's Fiduciary Rule #94](#)

Part 95 - [Regulation Best Interest Recommendations by Broker-Dealers: Part 1- Interesting Angles on the DOL's Fiduciary Rule #95](#)

Part 96 - [Regulation Best Interest Recommendations by Broker-Dealers: Part 2- Interesting Angles on the DOL's Fiduciary Rule #96](#)

Part 97 - [Regulation Best Interest Recommendations by Broker-Dealers: Part 3 - Interesting Angles on the DOL's Fiduciary Rule #97](#)

Part 98 - [Regulation Best Interest: Consideration of Cost and Compensation- Interesting Angles on the DOL's Fiduciary Rule #98](#)

Part 99 - [Investment Advisers and the SEC's Interpretation of Their Duties: Interesting Angles on the DOL's Fiduciary Rule #99](#)

Part 100 - [Investment Advisers and the SEC's Interpretation of Their Duties: Part II- Interesting Angles on the DOL's Fiduciary Rule #100](#)

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