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

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This is my 93rd article about interesting observations concerning the Department of Labor's (DOL) fiduciary rule and exemptions and the SEC's "best interest" proposals.

In my last post, I described the similarities between the SEC proposed Regulation Best Interest (Reg BI) and the DOL's Fiduciary Rule (and especially the Best Interest Contract Exemption [BICE]) regarding recommendations to participants to take distributions and roll over into IRAs. The similarities include a best interest standard of care and the treatment of conflicts of interest. This article discusses the requirement of the best interest standard of care in Reg BI and compares it to the standard of care in BICE (and the requirements of FINRA Regulatory Notice 13-45). My next article—Part 3—will cover the conflict of interest issues.

In its discussion of recommendations about distributions and rollovers in proposed Reg BI, the SEC says that, where the recommendation involves a securities transaction, the best interest standard of care will apply to broker-dealers. The SEC goes on to describe the best interest standard of care as requiring care, skill, prudence and diligence and making a recommendation that is in the best interest of, loyal to, the participant.

With regard to the question of whether a recommendation to take a distribution and roll over is a securities transaction, the SEC refers to FINRA Regulatory Notice 13-45. The SEC guidance and that Regulatory Notice, in combination, point out that, in the typical recommendation to a 401(k) participant, there are two securities transactions. The first transaction is the liquidation of the investments in a participant's account, since a distribution cannot ordinarily be made without first selling the investments in the account. (In other words, a recommendation to take a distribution usually inherently includes a recommendation to sell the investments in the participant's account.) The second transaction is in the rollover IRA, where a new investment recommendation will be made. As a result, distribution and rollover recommendations to 401(k) and 403(b) participants will ordinarily involve two securities transactions and both will be subject to the proposed best interest standard of care.

However, the SEC does not discuss the process and analysis required to make a best interest recommendation of a distribution. As discussed above, though, the SEC makes a number of references to Regulatory Notice 13-45. That notice goes into some detail that the information needed to evaluate whether a rollover recommendation would be suitable. It seems safe to assume that, at the least, the same information would be required for a best interest recommendation.

In its Regulatory Notice, FINRA points to a number of factors to be considered, including the investments, services, and fees and expenses in the plan. A broker-dealer will need to gather information in order to evaluate those factors . . . and then compare them to the services, expenses, and investments in the proposed rollover IRA. That analysis must be done in light of the financial needs, circumstances and preferences of the participant.

While it is easy to say that plan information is needed, it is hard to find that information.

How do I know that? It is because those are the same factors that the DOL said were primary considerations for making a best interest recommendation under BICE.

The DOL, SEC and FINRA have converged to agree on the important factors that need to be considered to make

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a rollover recommendation. However, it's proven to be difficult to gather information about plan investments, expenses and services. Fortunately, though, the DOL did offer guidance for situations where it was not possible to find the information. I assume that the SEC and FINRA will share the alternative approach provided by the DOL, which was described in a set of FAQs. Broadly stated, the DOL permits use of "alternative data" where a participant cannot find, or does not want to use, the primary plan data.

Also, I should point out that there continues to be an education alternative, which is that a broker-dealer can provide distribution and rollover education, rather than making recommendations. However, it's important that the education be unbiased and relatively complete. Otherwise, it could be viewed as a disguised recommendation.

In my next post, I will discuss the conflict of interest issues where distribution and rollover recommendations are made.

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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