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

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This is 96th article about interesting observations concerning the Department of Labor's (DOL) fiduciary rule and the SEC's "best interest" proposals.

In my last post, I compared the proposed best interest standard of care for broker-dealers—the SEC's Regulation Best Interest ("Reg BI"), and the SEC's proposed Interpretation Regarding Standard of Conduct for Investment Advisers ("RIA Interpretation"). In that article, I focused on the types of recommendations that implicated the best interest standard of care. For broker-dealers, the best interest standard only applied to recommendations of securities transactions and securities strategies. However, for RIAs the best interest standard applies to all advice and recommendations.

This article focuses on the advice recipients, that is, which investors will be protected by the best interest standard of care if the advice is given by a broker-dealer or, alternatively, if the advice is given by an RIA. Part 3 of this series gives examples of how the proposals apply to investors.

Focusing on the recipients of the advice, Reg BI's standard of care would only protect "retail customers":

*"A broker, dealer, or a natural person who is an associated person of a broker or dealer, when making recommendations 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," [Emphasis added.]*

Reg BI defines "retail customer" as:

"A person or the legal representative of such person, who . . . [u]ses the recommendation primarily for personal, family, or household purposes."

Based on my reading of the SEC proposal, and on my conversations with securities lawyers, a "retail customer" includes individual investors, family and personal trusts, IRA owners, and plan participants. However, it does not include businesses, retirement plans, and tax-exempt organizations. Unfortunately, the SEC did not explain why they excluded some of those investors, who may be relatively unsophisticated. For example, if a small business owner has a 401(k) plan, advice about the business owner's personal account would be protected by the best interest standard of care; advice about the investments in the plan would not be; advice to the owner about investing his participant account would be; and advice about investing the corporate account would not be.

It seems difficult to imagine that the small business owner—who has the same level of sophistication regardless of which account he or she is investing—would understand that the protections under the securities laws varied depending on which "hat" the business owner was wearing. This will, undoubtedly, lead to confusion.

On the other hand, in its RIA Interpretation, the SEC explains: *"An investment adviser has a fiduciary duty to all of its clients, whether or not the client is a retail investor,"* and *"This obligation to provide advice that is suitable and in the best interest applies not just to potential investments, but to all the investment advice provides to clients"*

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In other words, the best interest duties of investment advisers are much broader than the proposed rule for broker-dealers. Looking at the example above, an investment adviser has a best interest duty to the small business owner when recommending investments for the business; investments for a retirement plan; personal investments; and investments in a participant account in the retirement plan. In addition to the material differences in the range of recommendations and recipients, an investment adviser also has a duty to monitor the investment recommendations (unless there is a contractual agreement that the adviser will not). However, a broker-dealer's best interest obligation ends when a recommendation is made; that is, there isn't an obligation to monitor.

This article is not intended to favor either RIAs or broker-dealers, but instead is to explain the SEC's proposals. Each reader of this column can decide whether the benefits and burdens of the proposals favor one business model or the other. Also, I should point out that Reg BI is just a proposal. On the other hand, while the RIA Interpretation is labeled as a proposal, it is a compilation, or interpretation, of the SEC's position on the rules regulating investment advisers.

In my next post, Part 3, I will expand on the examples in this article.

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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