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Investment Advisers and the SEC's Interpretation of Their Duties: Interesting Angles on the DOL's Fiduciary Rule #99

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Investment Advisers and the SEC's Interpretation of Their Duties: Part I

This is my 99th article about interesting observations concerning the Department of Labor's (DOL) Fiduciary Rule and the SEC's "best interest" proposals.

The SEC labeled its interpretation of the standard of care for RIAs (the "RIA Interpretation") as a proposal. However, in that proposal, the SEC explained that the RIA Interpretation was based on the SEC's current understanding of the duties of investment advisers. More specifically, the SEC described the RIA Interpretation as reaffirming and clarifying the RIA fiduciary rule: *". . . we believe it would be appropriate and beneficial to address in one release and reaffirm—and in some cases clarify—certain aspects of the fiduciary duty that an investment adviser owes to its clients under section 206 of the Advisers Act."*

As a result, investment advisers should treat the RIA Interpretation as governing guidance and should make sure that they are complying with the duties explained in the RIA Interpretation.

This article discusses some of those duties and compares them to the DOL's vacated fiduciary rule and the SEC's proposed Regulation Best Interest ("Reg BI") for broker-dealers.

The RIA Interpretation says that all advice to all clients is fiduciary advice and, therefore, subject to the RIA duty of care and duty of loyalty. (There are several duties of care, but this article focuses on the best interest standard of care. There is also a duty of loyalty, which, for example, covers the disclosure requirements for RIAs.) To juxtapose the RIA duties with Reg BI, broker-dealers also have a best interest standard of care, but only for recommendations to "retail customers" about securities or strategies involving securities. Other recommendations by broker-dealers are not covered by the best interest standard.

With regard to the DOL, when the 5th Circuit Court of Appeals vacated the Fiduciary Rule, the old fiduciary regulation was revived. That regulation imposes a 5-part test for fiduciary status. (Note that the 5-part test only applies to non-discretionary investment advice. Whenever an advisor has discretion over assets in a plan, a participant's accounts or an IRA, the advisor is automatically a fiduciary under a separate part of the regulation. And the DOL's definition of discretion is very broad.) One of the 5 "parts" is that the advice must be given on a "regular basis," meaning that a one-time recommendation would not cause a person to be a fiduciary. As a practical matter, the 5-part test is usually satisfied by the services typically offered by investment advisers to plans, participants' accounts and IRAs. In addition, it is a functional test. As a result, where representatives of broker-dealers regularly make recommendations to those qualified accounts (and satisfy the other 4 parts), representatives and broker-dealers will be fiduciaries, even if they do not think they are.

To understand how those rules operate, let's look at several scenarios involving recommendations of plan distributions and rollovers.

Under the DOL's 5-part test, an advisor who recommends a distribution and rollover would not ordinarily be a fiduciary. However, there is an exception. Where the advisor is a fiduciary to a plan, and makes a

recommendation to a participant in that plan to take a distribution and roll over to an IRA with the advisor, the DOL will consider the advisor (either a broker-dealer or RIA) to be a fiduciary for that purpose. See DOL Advisory Opinion 2005-23A.

The DOL's position applies to all types of ERISA-governed plans, including 401(k)s, 403(b)s, cash balance plans, profit sharing plans and pension plans. (While most private sector plans are covered by ERISA, government plans are not. In addition, some private sector plans are not, for example, one-person plans and most church plans.)

With regard to RIAs, the SEC said, in its RIA Interpretation, that recommendations of plan distributions and rollovers would be fiduciary advice, subject to the best interest standard of care. Since the SEC RIA Interpretation applies to all recommendations to all clients, an investment adviser would be held to the best interest standard of care for distribution and rollover recommendations to all plans (even if not ERISA covered), including 401(k)s, 403(b)s, cash balance plans, pension plans and profit sharing plans.

Under the proposed Reg BI, a broker-dealer's rollover recommendation to a participant in a participant-directed plan would also be subject to the best interest standard of care. That is because the recommendation to take a distribution necessarily includes a recommendation to liquidate the investments inside the participant's account. In other words, it is a securities recommendation. However, it appears to me that a recommendation to take a distribution from a cash balance or pension plan would not involve a securities recommendation and, therefore, would not be subject to the best interest standard. Similarly, a recommendation to take a distribution from a "pooled" defined contribution plan, such as a profit sharing plan, may not involve a securities recommendation, since the participant does not have any authority to determine which investments are sold to finance the distribution.

In both cases—RIAs and broker-dealers, the recommendation about how to invest the money in the rollover IRA would be covered by the SEC's best interest standard. (However, while RIAs would have an ongoing duty to monitor the account, broker-dealers do not. The duty to monitor could be modified by the agreement. For example, RIAs can contract to not monitor, while broker-dealers can agree to monitor.)

Now that we know which rollover recommendations are subject to the best interest standard, there are two remaining questions. The first is, what is the best interest standard? The second is, what does the best interest standard require for distribution recommendations?

Those two questions will be answered in Part II of this Angles.

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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