The Investment Lawyer
Covering Legal and Regulatory Issues of Asset Management
VOL. 25, NO. 10 • OCTOBER 2018

Broker-Dealers as Fiduciaries After the DOL Rule Vacatur

By David C. Kaleda

On April 8, 2016, the Department of Labor (DOL) issued a regulation (Fiduciary Regulation) redefining the term "investment advice" for purposes of Section 3(21) of the Employee Retirement Income Act of 1974, as amended (ERISA), and Section 4975(d)(e)(3) of the Internal Revenue Code of 1986, as amended (Code). The DOL also issued the Best Interest Contract Exemption (BIC Exemption) and the Principal Trading Exemption (PrTE) and substantially changed a number of the prohibited transaction provisions on which financial institutions relied to address conflicts of interest set forth in Section 406 of ERISA and Section 4975(d) of the Code. That rulemaking is now dead due to its vacatur by the Court of Appeals for the Fifth Circuit,[1] which became effective June 21, 2018. In the meantime, the Securities and Exchange Commission (SEC) has proposed to substantially change the standards of conduct applicable to broker-dealers and their associated persons by imposing a "best interest" standard.

The purpose of this article is to explain a broker-dealer's obligations when it provides recommendations to accounts subject to ERISA and the Code post-vacatur. Additionally, we look to where broker-dealer activities may be headed in light of the SEC's proposed Regulation Best Interest[2] and compare that to what is required under ERISA and the Code. Many broker-dealers, particularly if they provide investment advice, will find complying with an SEC "best interest" standard and the fiduciary and prohibited transactions of ERISA and the Code quite challenging.

Vacatur of Fiduciary Rule

In *Chamber of Commerce of the United States v. U.S. Department of Labor*, the court concluded that the DOL overreached in its interpretation of the meaning of ". . . renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so . . .," which is found in Section 3(21)(A)(ii) of ERISA and a parallel provision in Section 4975(e)(3)(B) of the Code.[3] In particular, the court disagreed with the DOL that a broker-dealer or insurance agency that simply sold securities or insurance could be a fiduciary for purposes of ERISA and the Code as set forth in the Fiduciary Regulation based upon the common law meaning of the term "fiduciary," the nature of the financial services industry existing at the time Congress enacted ERISA, the surrounding statutory text, and the wording of the DOL's prior regulation promulgated in 1975 (1975 Regulation) in which it defined "investment advice."[4]

The court concluded that the DOL, in formulating its 2016 definition of "investment advice," ignored the long-existing requirement under common law that "a relationship of trust and confidence" exist between a person and a client in order for the person to be a fiduciary.[5] In the court's opinion, such a relationship does not exist in a typical sales relationship. Rather, pointing to the DOL's 1975 Regulation, the court states that a broker-dealer who receives commissions provides investment advice only if the broker-dealer provides "individualized advice on a regular basis pursuant to a mutual agreement with his client."[6] The court also opined that the DOL improperly imposed a fiduciary standard on fiduciaries to individual retirement accounts (IRAs).[7] The DOL does not have the authority to do this under the ERISA statute, which applies only to "benefit plans." Rather, the DOL may grant prohibited transaction exemptions only in connection with IRAs.[8] Further, the court stated the DOL abused its power to issue prohibited transaction exemptions by imposing a fiduciary standard of conduct vis-à-vis the BIC Exemption.[9] While the court's opinion primarily focused on the 2016 definition of "investment advice" and the BIC Exemption, the court vacated the Fiduciary Regulation, BIC Exemption, PrTE, and changes to other exemptions on which broker-dealers might otherwise rely, that is, the entire 2016 rulemaking package.

Effect of Vacatur

The DOL's 2016 rulemaking, in part, became effective on June 9, 2017. As a result of the vacatur, the entire 2016 rulemaking should be treated as if the rulemaking never existed. The practical effect of the vacatur is described below in more detail.

On June 9, 2017, the 2016 definition of "investment advice" became effective. Additionally, the BIC Exemption, PrTE, and changes to exemptions that already existed came into effect, in part, as follows:

- In the case of the BIC Exemption, only compliance with the Impartial Conduct Standards was required. The substantial disclosure and contract requirements, including the prohibition on language prohibiting an investor from using arbitration to resolve disputes involving whether the broker-dealer complied with the contract, never became effective. As such, the broad exemptive relief available under the BIC Exemption was available without what many viewed as the more draconian components of the exemption, particularly what came to be known as the "private right of action," becoming effective.[10]
- In the case of the PrTE, which exempted prohibited transactions that arose when a broker-dealer recommended to sell or purchase a security as principal, the only requirements that became effective were compliance with the Impartial Conduct Standards, a best execution requirement, and a prohibition on making false or misleading statements. The definition of a "security," which did not include, among other things, equity securities, also became effective. Restrictions on the broker-dealers being an issuer or underwriter of the security did not become effective.[11]
- In the case of Prohibited Transaction Exemption 77-4, which addresses prohibited transactions that arise when recommending or investing in proprietary mutual funds, Prohibited Transaction Exemption 84-24, which addresses prohibited transactions that arise when recommending proprietary mutual funds and insurance, and Prohibited Transaction Exemption 86-128, which addresses prohibited transactions that arise when broker-dealers receive commissions when it or an affiliate recommends or invests in securities, only the Impartial Conduct Standards apply. Other substantive amendments to each of these exemptions, which are commonly used by fiduciary broker-dealers, did not become effective.[12]

But for the court's vacatur, the remaining conditions of these exemptions would have gone into effect on January 1, 2018.

A key component of the Impartial Conduct Standards, applicable as of June 9, 2017, was that the broker-dealer make recommendations that were in the "Best Interest" of the investor. The "Best Interest" was defined by the DOL as acting:

> …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 would exercise based on the investment objectives, risk tolerance, financial circumstances, and the needs of the Retirement Investor without regard to the financial or other interests of the Adviser, Financial Institution or any…

affiliates or parties in which they have an interest.[13] The Impartial Conduct Standards also required that any compensation paid to the broker-dealer and its representative not be more than "reasonable compensation" and that the firm or representative not make any materially misleading statements in connection with a recommendation.[14]

As a result of the vacatur, the law that broker-dealers believed applied prior to June 9, 2017, has always applied, while the law that broker-dealers believed applied on or after June 9, 2017, to June 12, 2018, never applied.[15] This resulted in some confusion because broker-dealers that may have been providing "investment advice" during the period from June 9, 2017, to June 12, 2018, pursuant to the 1975 Regulation, would have been complying with exemptions the terms of which were never applicable. The DOL issued guidance intended to remedy this situation by stating that it would not bring enforcement actions against broker-dealers that in "good faith" complied with the exemptions as described above during the period June 9, 2017, to June 10, 2018.[16]

In that same guidance, the DOL also stated that broker-dealers that may be fiduciaries under the 1975 Regulation post-vacatur have two options to comply with ERISA's and the Code's prohibited transaction exemptions on an interim basis. First, the broker-dealer may comply with the Impartial Conduct Standards as required by the DOL under the BIC Exemption or PrTE as it did during the period from June 9, 2017, to June 10, 2018, so long as the broker-dealer makes a good faith effort to comply with such standards. This option will remain until the DOL issues "regulations or exemptions or other administrative guidance" with regard to addressing prohibited transactions when a broker-dealer acts as a fiduciary. Second, the broker-dealer may comply with ERISA and the Code, including the prohibited transaction exemptions, as effective prior to June 9, 2017, and as again effective on June 10, 2018.

The option to continue to comply with the Impartial Conduct Standards was provided as an accommodation to broker-dealers and other firms that may have adjusted their business practices in a manner that resulted in their providing investment advice for purposes of ERISA and the Code under the 1975 Regulation. Additionally, some firms may have concluded that in operation they always provided investment advice under the 1975 Regulation. If this was the case, the exemptive relief available under the BIC Exemption and PrTE is much more expansive than the relief available under the pre-DOL rulemaking prohibited transaction exemptions.

Broker-Dealers Are Subject to ERISA and the Code Post-Vacatur

Post-vacatur, the DOL continues to have jurisdiction over the activities of accounts associated with ERISA-covered plans and certain tax-preferred accounts not subject to ERISA but described in Section 4975(e)(1) of the Code, for example, IRAs, just as it did prior to the Fiduciary Regulation. As explained in the next section, the number of broker-dealers that will be considered a "fiduciary" for purposes of ERISA and the Code will be less, but a lack of fiduciary status does not mean that a broker-dealer should not be concerned with the application of ERISA's and the Code's prohibited transaction provisions.

ERISA applies to a "benefit plan" as defined in Section 3(3) of ERISA "established or maintained by any employer" so long as the plan is not otherwise excepted from coverage under ERISA.[17] Thus, most benefit plans offered by private-sector employers to their employees are covered by ERISA, while plans offered by governmental employers are not subject to ERISA because they are specifically excepted from ERISA coverage.[18] Other exceptions also exist.[19] Notably, IRAs are not specifically excluded from ERISA coverage. However, the DOL has stated that an IRA is not a benefit plan covered by ERISA so long as it is made available to employees in a way that the IRA is not "established or maintained by the employer."[20] Similarly, a health savings account (HSA) is not specifically excluded from ERISA, but the DOL issued guidance explaining in what circumstances an HSA is not subject to ERISA.[21]

The Code applies to certain tax-preferred benefit plans or other accounts by reason of the prohibited transaction provisions found in Section 4975 of the Code.[22] Specifically, these provisions apply to (1) a plan intended to be tax-qualified under Section 401(a) of the Code, (2) an IRA described in Section 408(a) of the Code, (3) an individual retirement annuity described in Section 408(b) of the Code, (4) an Archer medical savings account (MSA) described in Section 220(d) of the Code, (5) an HSA described in Section 223(d) of the Code, and (6) a Coverdell education savings account (ESA) described in Section 530 of the Code.

Post-Vacatur Broker-Dealers May Be Fiduciaries under ERISA and the Code

A broker-dealer may be a fiduciary for purposes of ERISA and the Code under the 1975 Regulation with regard to an ERISA-covered account, IRA, HSA, or another of the above-described tax-favored accounts just as they may have been prior to June 9, 2017. While the Fifth Circuit stated that the DOL overreached in redefining "investment advice" by not considering that a fiduciary relationship involves a "relationship of trust," the court did not state a broker-dealer could not be a fiduciary if such a relationship exists.

The 1975 Regulation provides that a person provides "investment advice" if he or she:

(1) renders advice to a plan as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing, or selling securities or other property;
(2) on a regular basis;
(3) pursuant to a mutual understanding;
(4) that such advice will be a primary basis for investment decisions; and that
(5) the advice will be individualized to the plan.[23]

This is commonly known as the five-part test for determining fiduciary status with respect to the provision of "investment advice."[24]

In reviewing the 1975 Regulation, the Fifth Circuit used the 1975 Regulation as a basis for supporting its opinion that the DOL improperly interpreted the meaning of "investment advice" in its 2016 regulation. The court's reference to the 1975 Regulation could be interpreted to provide that such regulation captured the nature of a fiduciary relationship under common law, that is, if all five parts apply, there exists a "relationship of trust and confidence." Alternatively, the court may have been stating that, in addition to meeting the requirements of the five-part test, the broker-dealer and client must have a "relationship of trust and confidence." In either case, broker-dealers and their representatives should be aware of the fact that a plan, IRA, or other account subject to ERISA or the Code could be a fiduciary account even if the account is established as a commission-based, brokerage account. Additionally, holding oneself out as a "trusted adviser" or similar would appear to suggest fiduciary status, particularly if all five parts of the 1975 Regulation are met.

Broker-Dealers Should Consider the Impact of Providing Rollover Recommendations Post-Vacatur

The general rule is that the vacatur results in the application of the 1975 Regulation and the prior prohibited transaction exemptions. However, some of the DOL's statements made during the 2016 rule-making process call into question how the DOL will treat broker-dealers that make recommendations to ERISA-covered plan participants to take a distribution from the plan and rollover the distribution to an IRA, that is, rollover recommendations.

In 2005, the DOL issued an advisory opinion to Deseret Mutual Fund Administrators in which the DOL concluded that an investment adviser who was not otherwise a fiduciary with regard to an ERISA-covered plan would not be deemed a fiduciary with respect to the ERISA plan solely on the basis of making a rollover recommendation to a plan participant, even if the adviser gave specific advice as to how to invest the distributed funds. In reaching this conclusion, the DOL stated that such a recommendation did not meet part one of the five-part test; that is, the recommendation is not a recommendation as to the advisability of investing in, purchasing, or selling securities. The Deseret advisory opinion stated further, however, that where a plan officer who is already a fiduciary to the plan responds to questions regarding a plan distribution or the investment of amounts withdrawn from the plan, such fiduciary would be exercising discretionary management over the plan, thus resulting in fiduciary status.[25]

However, in the Preamble to the 2016 regulation, the DOL rejected its prior position with regard to rollover recommendations not being a recommendation to sell securities.[26] The DOL explained:

> The advisory opinion failed to consider that advice to take a distribution of assets from a plan is actually advice to sell, withdraw, or transfer investment assets currently held in a plan. Thus, a distribution recommendation involves either advice to change specific investments in the plan or to change fees and services directly affecting the return on those investments.[27]

Given the general premise that the vacatur of the Fiduciary Rule means that the 1975 Regulation has always been effective, one possible outcome is that the analysis in Deseret again applies. However, the Deseret advisory opinion is not a regulation but rather an expression of the DOL's interpretation of the 1975 Regulation, which is in effect. Therefore, the DOL may take the position that a distribution recommendation is a recommendation to sell securities held in the plan account and thus conclude that a broker-dealer provides investment advice if the remaining parts of the five-part test are met.

Broker-dealers will have varying views on whether the Deseret opinion once again becoming effective or not is a positive outcome. Broker-dealers, including their affiliates, that have no relationship to the plan likely will favor this result. However, if a broker-dealer's affiliate is a fiduciary to the plan for any reason, those firms need to address the DOL's position in the advisory opinion about the broker-dealer's possibly exercising control over the plan, rather than providing advice, and thus acting as a fiduciary with regard to the distribution and rollover recommendation.

Standard of Conduct under ERISA and the Code Applicable to Broker-Dealers Post-Vacatur

ERISA imposes fiduciary duties on parties who are fiduciaries to a plan. Pursuant to ERISA's duty of prudence, a fiduciary must discharge his or her duties "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."[28] This prudence standard is commonly known as a "prudent expert" standard. Fiduciaries must also discharge their duties with respect to the plan solely in the interest of the participants and beneficiaries for the "exclusive purpose" of providing benefits to participants and their fiduciaries and defraying reasonable expenses of the plan.[29] Thus, a fiduciary owes a duty of loyalty that has also come to be known as the "exclusive purpose" requirement. The courts have interpreted this provision of ERISA in a manner that does not preclude a fiduciary from receiving a benefit in connection with a plan transaction so long as that benefit is "incidental" to the primary purpose of benefitting the plan.[30] ERISA's fiduciary duty provisions also require that plan fiduciaries follow the terms of a governing plan's documents and, depending on the fiduciary's role, diversify the plan's assets against losses, unless under the circumstances it is clearly prudent not to do so.[31]

Fiduciaries to IRAs and other tax-deferred accounts not covered by ERISA are not subject to ERISA's fiduciary duty provisions. However, fiduciaries to ERISA-covered plans and tax-deferred accounts not covered by ERISA, like IRAs, are subject to the prohibited transaction provisions of ERISA and the Code (Fiduciary Prohibited Transactions). ERISA and the Code provide that such a fiduciary may not deal with assets of the plan in the fiduciary's own interest or own account (that is, no self-dealing)[32] and that a fiduciary may not receive any consideration for the fiduciary's own personal account from any party dealing with the plan in connection with a transaction involving plan assets (that is, no receipt of kickbacks, third-party payment, etc.).[33] ERISA also provides that a fiduciary to a plan, but not an IRA or other non-ERISA account subject to Code Section 4975, may not act in any transaction involving the plan on behalf of a party whose interests are adverse to the interests of the plan or the plan's participants and beneficiaries (that is, the fiduciary or an affiliate may not be on both sides of the transaction).[34]

Additionally, ERISA Section 406(a) prohibits plan fiduciaries from engaging in the following transactions (Party in Interest Prohibited Transactions):

- A fiduciary may not engage in a transaction that constitutes a direct or indirect sale or exchange of property between the plan and a party in interest or disqualified person.
- A fiduciary may not engage in a transaction that constitutes a direct or indirect lending of money or other extension of credit between the plan and a party in interest or disqualified person.
- A fiduciary may not engage in a transaction that constitutes a direct or indirect furnishing of goods, services, or facilities between the plan and a party in interest or disqualified person.
- A fiduciary may not engage in a transaction that constitutes a direct or indirect transfer to, or for the use by or for the benefit of, a party in interest or disqualified person of plan assets. [35]

A "party in interest" is defined broadly to include, among others, another fiduciary, a plan service provider, and their affiliates.[36] The Code includes the same prohibited transactions but uses the term "disqualified person," which is defined slightly differently from the term "party in interest."[37] In both the Fiduciary Prohibited Transactions and the Party in Interest Prohibited Transactions, ERISA and the Code in effect set forth the conflicts of interest about which broker-dealers must be concerned.

In summary, a broker-dealer that is a fiduciary to an ERISA-covered plan account is subject to ERISA's fiduciary duty requirements. Additionally, a fiduciary broker-dealer should comply with the prohibited transaction provisions of ERISA and the Code when it provides fiduciary services to an ERISA account and prohibited transactions of the Code when it provides services to an IRA or other tax-preferred account described in Section 4975(e)(1). ERISA allows the DOL, fiduciaries, and other parties to bring an action in federal court against a broker-dealer acting as a fiduciary to address failures to comply with ERISA.[38] Additionally, a broker-dealer that is a "party in interest" and "disqualified person" that engages in the above-described prohibited transactions may be subject to excise taxes under Section 4975 of the Code.[39] On the other hand, if the account is not subject to ERISA, the broker-dealer is not subject to ERISA liability and thus should be concerned only about the excise tax.

Even if a broker-dealer is not a fiduciary, the firm should be concerned about the Party in Interest Prohibited Transactions. It is the "disqualified person" that bears the excise tax, not the fiduciary that causes the prohibited transaction. Thus, a broker-dealer, which in many cases will be a "disqualified person," could be subject to the tax even though it was not a fiduciary that caused the prohibited transaction.

The Internal Revenue Service has not traditionally assessed the tax in the IRA context because it does not have the capacity to investigate IRA providers on a large scale. Of course, a reduced risk of enforcement does not mean that broker-dealers should not be mindful of their compliance obligations under Section 4975.

ERISA and the Code's Exemption Requirements

If a prohibited transaction under ERISA or the Code arises, the broker-dealer should address the conflict pursuant to statutory prohibited transaction exemptions found in Section 408(b) of ERISA and Section 4975(d) of the Code (statutory exemptions) or class exemptions issued by the DOL pursuant to Section 408(a) of ERISA and Section 4975(c)(1)(2) of the Code. Alternatively, the broker-dealer can restructure its customer relationship in a manner that eliminates the conflict.

Statutory exemptions that fiduciary broker-dealers often use to address Fiduciary Prohibited Transactions and the prohibited transactions they address include, among others, (1) ERISA Section 408(b)(4) and Code Section 4975(d)(4) (investment in affiliated bank deposits), (2) ERISA Section 408(b)(6) and Code Section 4975(d)(6) (provision of ancillary services by an affiliated bank), and (3) ERISA Section 408(b)(8) and Code Section 4975(d)(8) (investment in back collective trusts and pooled insurance company separate accounts). Class exemptions that broker-dealers often use and the Fiduciary Prohibited Transactions they address include (1) Prohibited Transaction Exemption 86-128 (payment of commissions with regard to trades of certain securities),[40] (2) Prohibited Transaction Exemption 77-4 (investment in proprietary mutual funds),[41] (3) Prohibited Transaction Exemption 84-24[42] (investment in proprietary mutual funds and insurance), and (4) Part II of Prohibited Transaction Exemption 75-1 (investment in non-proprietary mutual funds).[43]

The statutory and class Prohibited Transaction Exemptions on which the broker-dealer might rely are very specific as to how to address the conflict. Each exemption has conditions that must be met. Past-vacatur, none of these exemptions include the Impartial Conduct Standards and, thus there is no requirement that the broker-dealer act in the customers' "best interest" in making a recommendation with regard to an IRA or other non-ERISA account. Of course, with regard to an ERISA-covered account, the broker-dealer must comply with the duty or prudence and loyalty.

In some cases, compliance with the exemptions do not prohibit the firm from receiving commission-based compensation or other compensation that would otherwise be prohibited under ERISA or the Code in connection with a recommendation to buy or sell securities or insurance. However, broker-dealers may find that the exemptive relief available under the statutory and class exemptions very limited in other situations. For example, there is no exemption to address the conflicts that arise when a fiduciary recommends that the customer engage in a principal transaction with the firm. Additionally, there is no exemption that addresses conflicts that arise when a fiduciary recommends that a participant take a distribution from a plan and rollover to an IRA. Another area where there is no exemptive relief involves the sale of interests in unregistered funds.

Because of the limitations on prohibited transaction relief available after the vacatur, broker-dealers that believe that they are fiduciaries under the five-part test or will be if they structure their client relationships accordingly, yet they still want to provide services through brokerage accounts and receive commissions or other compensation that raises prohibited transactions, should consider reliance on the above-discussed DOL's temporary enforcement policy as an option. As discussed below, compliance with the Impartial Conduct Standards may be more compatible with the SEC's Regulation Best Interest than other prohibited transaction exemptions. However, there are limitations to this approach. First, the relief is only temporary. To date, the DOL has not expressed an interest in providing a class exemption that would provide comparable relief, and it is not yet known when the DOL will end the temporarily enforcement relief. A broker-dealer could, however, request an individual exemption from the DOL that applies only to it as the applicant.[44] The terms of such an exemption would likely include the Impartial Conduct Standards and possibly other conditions. Second, temporary enforcement relief from the DOL does not protect firms from actions brought by private litigants.[45] The threat of litigation is higher for ERISA-covered accounts because ERISA includes a mechanism whereby such lawsuits, including class actions, may be brought.

SEC's Proposed Best Interest Regulation

The SEC's proposed Best Interest Regulation, if adopted by the Commissioners in its current or similar form, may subject broker-dealers to a standard of conduct that in many ways is similar to the DOL's Impartial Conduct Standard. We discuss below how Regulation Best Interest will interact with the requirements of ERISA, the Code, and the regulations promulgated thereunder. Broker-dealers should consider the interaction of the SEC's proposed requirements and the requirements applicable under ERISA and the Code as they comment on the SEC proposal and begin to develop their compliance strategies.

Regulation Best Interest would apply to a "broker, dealer, or a natural person who is an associated person of a broker or dealer" that makes "a recommendation of any securities transaction or investment strategy involving securities to a retail customer."[46] If such a recommendation is made by one of these parties, the broker, dealer, or associated person would have to "act in the best interest of the retail customer at the time the recommendation is made…" Further, these parties could not "plac[e] the financial or other interest of the broker, dealer, or natural person who is an associated person…ahead of the interest of the retail customer."[47] In order to demonstrate a "best interest" standard, Regulation Best Interest requires that the broker, dealer, or associated person comply with (1) a disclosure obligation, (2) a care obligation, and (3) conflict of interest obligations.[48] The applicability of Regulation Best Interest and the standard of care proposed under Regulation Best Interest raise issues regarding how compliance will be coordinated across the SEC and DOL regulatory regimes.

Application of Regulation Best Interest to ERISA Accounts and IRAs

Regulation Best Interest applies when a broker-dealer or associated person makes a "recommendation of any securities transaction or investment strategy involving securities." The SEC states that such a recommendation made under Regulation Best Interest would be the same as a recommendation made for purposes of determining whether the suitability obligation under Financial Industry Regulation Association (FINRA) Rule 2111 applies.[49] The terminology used in the regulation is similar to that found in part one of the five-part test, which provides investment advice is a "recommendation as to the advisability of investing in, purchasing, or selling securities or other property[.]"[50] However, unlike under the 1975 Regulation, which requires such recommendations on a "regular" basis, a single recommendation will trigger the requirements of Regulation Best Interest.

Additionally, under Regulation Best Interest, the recommendation must be made to a "Retail Customer." A "Retail Customer" is defined as "a person, or the legal representative of such person, who (i) receives a securities recommendation as described above from a broker-dealer or a natural person who is an associated person of the broker-dealer and (ii) [u]ses the recommendation primarily for personal, family, or household purposes."[51] This definition clearly applies to participants in ERISA-covered plans, IRA owners, and owners of other tax-preferred accounts subject to the Code but not subject to ERISA. A recommendation to each of them likely would be for "personal" purposes.

However, it is less clear whether this definition extends to recommendations to the named fiduciary of the plan or the trustee of the plan who has the authority to invest the assets of the plan. Such named fiduciaries or trustees could be viewed as the legal representatives of the participants in the plan much like the legal representatives of the trust beneficiaries referenced in the preamble to the Best Interest Regulation.[52] However, it is not clear whether the SEC intends that Regulation Best Interest will cover recommendations to employee benefit plans that will be used by the plan as a whole and whether the status of the plan as a "participant-directed" plan versus a "trustee-directed" plan will make a difference.

Requirements of Regulation Best Interest

The proposed Regulation Best Interest sets forth a number of requirements that the broker-dealer and associated person must meet when making securities recommendations. Some of those requirements are different from those found in the Impartial Conduct Standards, while others are very similar. A certain level of commonality makes sense, as the SEC noted throughout its proposal that Regulation Best Interest is consistent with the BIC Exemption and PrTE in many respects. However, firms may find that there is no such consistency between Regulation Best Interest and the permanent prohibited transaction exemptions on which fiduciary broker-dealers may rely post-vacatur.

Broker-Dealer Cannot Put Its Interests Ahead of Those of the Customer

Regulation Best Interest provides that a recommendation must be in the "best interest" of the customer "without placing the financial or other interest of the broker, dealer, or natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer." The SEC specifically rejected the language found in the DOL's Best Interest standard, which requires that a recommendation be made "without regard to the financial or other interests" of the broker-dealer or its associated person. It did so because there are certain inherent conflicts between the broker-dealer and its customer, for example, the receipt of transaction-based compensation, and it is simply impossible to make recommendations "without regard to" such firm's or associated person's interests. The SEC Staff is concerned that use of the "without regard to" language could be interpreted to require that all conflicts be eliminated.[53]

This requirement in Regulation Best Interest is not entirely inconsistent with the ERISA standard. ERISA's fiduciary duty requirements require that the fiduciary act for the exclusive purpose of the plan participant's beneficiaries. As discussed, the courts have said that a broker-dealer's receipt of an incidental benefit in connection with a transaction is not contrary to its duty of loyalty. However, to the extent that firms rely on the DOL's temporary non-enforcement relief and thus the DOL's Best Interest standard in connection with recommendations made to IRAs, the "without regard to" language still applies. This may be less of a concern because the contract requirements of the BIC Exemption and PrTE never became effective. In requesting an individual prohibited transaction exemption, the DOL may be willing to consider the removal of the "without regard to" language. The other prohibited transactions on which broker-dealers rely do not currently include the Best Interest standard.

Disclosure Obligation

Regulation Best Interest includes a disclosure obligation. The broker-dealer or associated person must "prior to or at the time of such recommendation, reasonably disclose[] to the retail customer, in writing, the material facts relating to the scope and terms of the relationship with the retail customer, including all material conflicts of interest that are associated with the recommendation."[54] This requirement is an extension of the SEC's proposed Form CRS Relationship Summary.[55] The Form CRS is intended to explain to the customer in general terms the key differences between a broker-dealer relationship and an advisory relationship. The disclosure obligation in Regulation Best Interest is intended to provide more specificity regarding the nature of the transactions that will occur in the account, the fees that the customer will pay for particular transactions, and the material conflicts of interest that arise in connection with the recommendation.[56] The SEC Staff views this disclosure as necessary to promote the purpose of the regulation, which is to encourage broker-dealers and associated persons making recommendations in the Best Interest.

Firms that have been relying on the BIC Exemption and PrTE since June 9, 2017, have not been required to meet the disclosure obligations found in those exemptions, as they never became effective. If firms rely on the DOL's temporary enforcement relief, that will continue to be the case until such relief is no longer available. Firms should expect that if they apply for an individual prohibited transaction exemption, the DOL would require some disclosure as a condition of the exemption. However, if a firm intends to use the other exemptions available under ERISA and the Code, many of those exemptions include disclosures as a condition of the exemption. Such disclosures are very specific and are different from what is proposed in Regulation Best Interest.[57]

Care Obligation

Regulation Best Interest would impose a care obligation on broker-dealers and their associated persons. They would have to "exercise reasonable diligence, care, skill and prudence" in determining whether they would have a "reasonable basis to believe" whether the recommendation was in the "best interest." In this context, "best interest" is largely stated in terms of the suitability requirements currently set forth in FINRA Rule 2111. The description of suitability in the proposal largely mirrors the reasonable basis suitability, customer-specific suitability, and quantitative suitability requirements with which firms and their associated persons currently apply. However, under the proposal, there must be a "reasonable basis" for the suitability determination based upon the exercise of reasonable diligence, care, skill, and prudence. With regard to quantitative suitability determinations, the SEC proposes to remove the current requirement under FINRA Rule 2111.05(c) that a member or associated person have "de facto control over a customer account" in order to be required to comply with quantitative suitability. As such, no discretion on the part of the firm or associated person would be required for quantitative suitability to apply, which would be a significant change.

The requirement that the firm and associated person "exercise reasonable diligence, care, skill and prudence" to make suitability determinations is not in the current FINRA rule and seems to put more emphasis on the effort required to reach the conclusion that there is a "reasonable basis" for the suitability determination. The terms "care," "skill," and "prudence" are used when describing the responsibilities of a fiduciary. In fact, broker-dealers that are fiduciaries under ERISA must make recommendations with the "care, skill, prudence, and diligence" that a "prudent" person with appropriate investment expertise would make under the same circumstances.[58] However, it is not clear that the DOL or a court would agree that making a recommendation in accordance with the standard set forth in Regulation Best Interest is the equivalent of a recommendation made in accordance with a fiduciary duty of prudence under ERISA. This would not be a concern for broker-dealers that are fiduciaries to IRAs and other non-ERISA tax-advantaged accounts because ERISA does not apply to those accounts unless the broker-dealer complies with the Impartial Conduct Standards, which include the Best Interest standard, pursuant to the DOL's temporary enforcement policy.

Conflict of Interest Obligations

Finally, Regulation Best Interest would require broker-dealers and their associated persons to comply with conflict of interest obligations. Such obligations vary by whether the conflict is a financial incentive or some other conflict. In the case of a conflict that involves a financial incentive, the broker-dealer meets the obligation if it "establishes, maintains, and enforces written policies and procedures reasonably designed to *identify and disclose and mitigate*, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations."[59] In the case of other material conflicts of interest, the firm meets its obligation if it "establishes, maintains and enforces written policies and procedures reasonably designed to identify and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with such recommendations."[60] Therefore, in the case of material conflicts associated with financial incentives, the broker-dealer also may have an obligation to disclose and *mitigate* the conflict.

The SEC's inclusion of the "mitigate" language in connection with material conflicts caused by financial incentives was purposeful. The SEC states that a reasonable person would expect that such conflicts would "incline a broker-dealer—consciously or unconsciously—to make a recommendation that is not disinterested."[61] Therefore, the broker-dealer should have policies and procedures in place designed to mitigate such conflicts, which include, but are not limited to, the following:

> Fees and other charges for the services provided and products sold; employee compensation or employment incentives (e.g., quotas, bonuses, sales contests, special awards, differential or variable compensation, incentives tied to appraisals or performance reviews); compensation practices involving third parties, including both sales compensation and compensation that does not result from sales activity, such as compensation for services provided to third-parties (e.g., sub-accounting or administrative services provided to a mutual fund); receipt of commissions or sales charges, or other fees or financial incentives, or differential or variable compensation, whether paid by the retail customer or a third-party; sales of proprietary products or services, or products of affiliates; and transactions that would be effected by the broker dealer (or an affiliate thereof) in a principal capacity.[62]

The SEC noted that the mitigation requirement does not require the elimination of all conflicts but also said elimination may be the only reasonable approach to address certain conflicts.

The SEC proposed a principles-based approach that would allow for limited differences in pricing among products based upon "neutral factors," such as the "time and expertise" involved in selling those products. Additionally, more supervision of associated persons may be needed, as associated persons meet compensation thresholds or when a rollover of assets from a plan to an IRA is necessary for the broker-dealer to get paid. The SEC also recognized that principal trades, proprietary products, and the sale of products that generate revenue paid by third parties to the firm raise conflicts that should be addressed through policies and procedures. On the other hand, certain practices should probably be completely avoided, such as "sales contests, trips, prizes and other similar bonuses based upon accumulation of assets under management."[63]

The SEC's proposed conflict of interest requirement and the SEC's commentary on how to comply should be strikingly familiar to broker-dealers because it is very similar in many respects to how the DOL stated broker-dealers and their representatives should comply with the BIC Exemption and PrTE.[64] Indeed, many firms revised or were in the process of revising their product pricing, compensation grids, bonus programs, incentive arrangements, and supervisory programs to comply with the BIC Exemption and the PrTE. Particular attention was paid to not transferring conflicts of the firm to associated persons as required by the DOL. Additionally, a great deal of time and effort was spent putting procedures in place to address conflicts arising in making distribution and rollover recommendations. Many of those revisions likely fall in line with what the SEC suggests in its proposal. Thus, a question arises regarding whether a firm should completely abandon the policies and procedures it has implemented for DOL Fiduciary Rule compliance.

Importantly, however, the BIC Exemption and PrTE no longer exist. Further, while the DOL allows for continued reliance on non-enforcement relief that requires compliance only with the Impartial Conduct Standards on an interim basis, the duration of such relief is finite. Thus, if a broker-dealer is a fiduciary for purposes of ERISA or the Code, at some point, it likely will have to rely on the statutory exemptions and class exemptions applicable post-vacatur unless the firm is willing to obtain an individual prohibited transaction exemption from the DOL. These exemptions are not "principles-based," but prescriptive as to how to avoid the non-exempt prohibited transactions or, in other words, how to mitigate the conflict. Further, prior to the BIC Exemption and PrTE, the DOL never recognized the concept that the firm and associated persons may have separate interests and thus certain conflicts of the firm need not be prohibited so long as the conflict is not shifted to the associated person. Therefore, the broker-dealer's obligations under ERISA and the Code likely will not be consistent with its obligations under the conflict of interests obligation under Regulation Best Interest.

Summary and Conclusion

The DOL's Fiduciary Rule is dead. Therefore, a broker-dealer will be a fiduciary to an ERISA-covered plan, IRA, or other non-ERISA tax-preferred account subject to Section 4975 of the Code by reason of providing "investment advice" if the firm provides "investment advice" pursuant to the 1975 Regulation's five-part test. Broker-dealers should be aware that they may be a fiduciary under the 1975 Regulation even though they take the position that they provide incidental investment advice for securities law purposes in connection with a brokerage account. However, the likelihood of being a fiduciary is less than what it would have been if the Fiduciary Rule survived. If they are fiduciaries, they will be subject to ERISA's fiduciary duty and prohibited transaction requirements in connection with recommendations to an ERISA-covered plan and the Code's prohibited transactions requirements in connection with IRAs and other tax-preferred accounts. Where the broker-dealer is subject to the prohibited transaction provisions, the firm should comply with the statutory exemptions and class exemptions that were effective prior to the Fiduciary Rule and are again effective post-vacatur unless the broker-dealer takes advantage of interim enforcement relief, which allows for compliance with the Impartial Conduct Standards, but not most of the other requirements of the BIC Exemption or PrTE. Finally, there is some lack of clarity regarding how rollover recommendations should be treated post-vacatur.

The SEC has now entered the fray by proposing its Regulation Best Interest. The requirements of Regulation Best Interest are substantially different from those found in the statutory exemptions and class exemptions under the Code and ERISA.

If the Commissioners adopt the proposal in its current or a substantially similar form, compliance with Regulation Best Interest will likely look more like compliance with the now-defunct BIC Exemption and PrTe. Firms that are not relying on the DOL's temporary enforcement relief or otherwise choose to comply with the statutory exemptions and class exemptions may find compliance with both regimes challenging. Of course, only time will tell whether Regulation Best Interest will be adopted and whether the DOL is willing to consider how its exemptions may align with the SEC's regulation. Broker-dealers may find that an individual prohibited transaction from the DOL would allow for better coordination between the two regulatory regimes.

David C. Kaleda is a Principal at Groom Law Group Chartered.

NOTES

1 *Chamber of Commerce of the U.S. v. U.S. Dept. of Labor*, No. 17-10238 (5th Cir. 2018)

2 Proposed Regulation Best Interest, 83 Fed. Reg. 21574 (May 9, 2018).

3 *Id*. at 14-15.

4 *Id*. at 15-30.

5 *Id*. at 15.

6 *Id*. at 21, *citing*, Definition of the Term "Fiduciary," 40 Fed. Reg. 50842, 50842-43 (Oct. 31, 1975) (removed internal quotations).

7 *Id*. at 34.

8 *Id*.

9 *Id*. at 35-41.

10 82 Fed. Reg. 16902, 16917 (April 7, 2017).

11 *Id*. at 16918.

12 *Id*.

13 Best Interest Contract Exemption, 81 Fed. Reg. 21022, 21077 (Apr. 8, 2016), § II(c)(1).

14 *Id*.

15 *Envtl. Def. v. Leavitt*, 329 F. Supp. 2d 55, 64 (D.C. Cir. 2004); *Prometheus Radio Project v. F.C.C.*, 652 F.3d 431, 453 n.25 (3d Cir. 2011); *Paulsen v. Daniels*, 413 F.3d 999, 1008 (9th Cir. 2005) ("The effect of invalidating an agency rule is to reinstate the rule previously in force.").

16 DOL F.A.B. No. 2018-02 (May 7, 2018).

17 ERISA §§ 4(a) & (b).

18 ERISA § 4(b)(1).

19 ERSA §§ 4(b)(2) – (5).

20 29 CFR § 2509.99-1.

21 DOL Field Assistance Bulletin No. 2004-01 (Apr. 7, 2004); DOL Field Assistance Bulletin No. 2006-02 (Oct. 27, 2006).

22 I.R.C. § 4975(c)(1).

23 29 C.F.R. §2510.3-21(j)(1)(i)(B)(2)

24 29 C.F.R. § 2510.3.21(c).

25 DOL Adv. Op. 2005-23A (Dec. 7, 2005).

26 29 C.F.R. § 2510.3-21(a)(1)(ii), as published at 81 Fed. Reg. 20946, 20997 (Apr. 8, 2016).

27 81 Fed. Reg. 20946, 20964 (Apr. 8, 2016).

28 ERISA § 404(a)(1)(B).

29 ERISA § 404(a)(1)(A).

30 *See, e.g., Donovan v. Bierwirth*, 680 F. 2d 263, 271 (2d Cir. 1982) (although an ERISA fiduciary's duty is the "highest known to the law" and requires that a fiduciary act with an "eye single to the interests of the plan's participants and beneficiaries" that duty may be satisfied if the fiduciary takes an action which, following careful and impartial investigation, is reasonably concluded to promote the interests of participants and beneficiaries even if the act incidentally benefits the fiduciary itself); *Donovan v. Walton*, 609 F. Supp. 1221, 1245 (S.D. Fla. 1985) (ERISA's exclusive benefit rule "does not prohibit a party other than the plan's participants and beneficiaries from benefitting in some measure from a prudent transaction with the plan"; "Congress did not intend [ERISA's exclusive purpose standard] . . . to make illegal the fact of life that most often a transaction benefits both parties").

31 ERISA §§ 404(a)(1)(C) & (D).

32 ERISA § 406(b)(1); I.R.C. § 4975(c)(1)(E).

33 ERISA § 406(b)(3); I.R.C. § 4975(c)(1)(F).

34 ERISA § 406(b)(2).

35 ERISA §§ 406(a)(1)(A) – (D); I.R.C. §§ 4975(1)(A) – (D).

36 ERISA § 3(14).
37 I.R.C. § 4975(e)(2).
38 ERISA § 502.
39 I.R.C. §§ 4975(a) & (b).
40 51 Fed. Reg. 41686 (Nov. 18, 1986), as amended, 67 Fed. Reg. 64137 (Oct. 17, 2002).
41 42 Fed. Reg. 18732 (Apr. 8, 1977).
42 49 Fed. Reg. 13208 (Apr. 3, 1984).
43 40 Fed. Reg. 50845 (Oct. 31, 1975), amended 71 Fed. Reg. 5883 (Feb. 3, 2006).
44 ERISA § 408(a); I.R.C. § 4975(c)(2).
45 DOL F.A.B. No. 2018-02 ("This Bulletin is an expression of the Department's temporary enforcement policy, and it does not address the rights or obligations of other parties.").
46 Proposed Regulation Best Interest, 81 Fed. Reg. at 21574, 21681, 17 C.F.R. § 240.51-1(a)(1).
47 *Id*.
48 83 Fed. Reg. at 21681-2; 17 C.F.R. § 240.51-1(a)(2)(i) – (iii).
49 83 Fed. Reg. at 21592.
50 29 C.F.R. § 2510-3.21(c)(1)(ii)(B).
51 81 Fed. Reg. at 21682, 17 C.F.R. § 240.51-1(b)(1).
52 81 Fed. Reg. at 21595-96.
53 81 Fed. Reg. at 21586.
54 81 Fed. Reg. at 21681; 17 C.F.R. § 240.51-1(a)(2)(i).
55 *See* Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles, Release No. 34–83063, IA–4888, File No. S7–08–18.
56 83 Fed. Reg. at 21600.
57 *See* PTE 84-24, §§V(b) & (c); PTE 86-128, §§ III(d) & (e); PTE 77-4, § II(d).
58 ERISA § 404(a)(1)(B).
59 83 Fed. Reg. at 21681-2; 17 C.F.R. § 240.51-1(a)(2)(iii)(B) (emphasis added).
60 Id. at 17 C.F.R. § 240.51-1(a)(2)(iii)(A).
61 83 Fed. Reg. at 21618.
62 *Id*.
63 83 Fed. Reg. at 21621-22.
64 81 Fed. Reg. at 21039-40.