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Best Interest Standard of Care for Advisors #32

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Regulation Best Interest: Best Interest and Suitability—How They Differ (Part 3)

Regulation Best Interest (Reg BI) imposes a "best interest" standard of care on broker-dealers for their recommendations of securities and investment strategies to retail customers. That raises the question, what does best interest mean and how does it differ from suitability?

(Note: While the discussion in this article is based on Reg BI's best interest requirements for broker-dealers, the SEC has also imposed a best interest standard on investment advisers. As a result, investment advisers should also be attentive to these issues.)

As I explained in Parts 1 and 2 of this article (Best Interest Standard of Care for Advisors #30 and #31), the difference between best interest and suitability is a hard question without an easy answer. However, based on the SEC's discussion in the Adopting Release, I have developed examples of where best interest appears to impose a more demanding standard than suitability. These examples focus on the Reg BI requirement that broker-dealers (and their registered representatives) consider costs in the development of recommendations. While costs are not the only factor to be considered, the SEC says that the best interest rule makes cost a more important factor than it was under the suitability standard.

The SEC's approach requires that cost be considered in the context of the retail customer's investment profile, that is, the investment profile dictates the investment needs of the retail customer and a broker-dealer must take cost into account, as well as other important factors, in recommending account types, investments and strategies. Stated slightly differently, the consideration of costs and other relevant factors should be done in a manner that is in the investor's best interest and without putting the interests of the broker-dealer (and the financial professional) ahead of the interests of the retail customer. In some cases, though, a greater emphasis on costs could be warranted. In my last two posts, I gave examples of three scenarios where costs would likely be weighed heavily in making a recommendation. This article gives additional examples.

Example 4: The best interest standard requires that a broker-dealer and its representatives consider all of the reasonably available investment alternatives offered by the broker-dealer. That applies at two levels. The first is the "account type" and the second is the investments in the recommended account type. For example, a broker-dealer, through its representative, could determine that a variable annuity is in the best interest for a retail customer (for a portion of the investor's assets) based on the retail customer's investment profile. That determination needs to be made carefully, skillfully and diligently (and with consideration of cost as one important factor). The documentation of the considerations and recommendation would support compliance with the best interest standard of care. As a result of that determination, the broker-dealer will need to recommend an account type that includes variable annuities.

The next step would be to review the variable annuities reasonably available through the broker-dealer. At first blush, the lowest cost annuity might be the safest to recommend. However, if a higher cost annuity has superior contract features relative to the needs of the investor (based on the retail customer's investment profile), a more expensive annuity contract could be justified.

Discussion: The point here is that a Reg BI recommendation is a two-step process: the account type and the service or product within that account type. Each requires a consideration of cost. For example, if a less expensive account type or investment (or investment strategy) could accomplish the investor's objective, the question arises, why was the more costly alternative recommended? That question may be asked on examination or arbitration and a broker-dealer should have a reasonable answer.

Example 5: In some cases, the application of the cost factor may be more clear-cut. For example, if a broker-dealer recommends that a participant (a "retail customer") roll over his 401(k) account to an IRA with the broker-dealer, it may be more obvious whether a rollover is or is not in the best interest of the investor. For example, very large 401(k) plans may have investments that all have expense ratios of less than 25 bps. If expenses alone are considered, it would be difficult to justify a rollover recommendation. However, if robust services are provided to the IRA owner, those services may be valuable enough to offset the higher costs of a retail IRA. However, absent a good process and relevant data, it may be hard to demonstrate that the recommendation was in the best interest of the participant.

Discussion: The SEC staff has indicated that rollover recommendations warrant special scrutiny. That is at least partially due to the higher costs typically found in IRAs and to the conflict of interest inherent in a rollover recommendation. As a result, where broker-dealers and their financial professionals will be recommending rollovers, it would support compliance to have defined practices for gathering and evaluating the relevant information. (Note that the SEC described specific considerations for rollover recommendations in the Adopting Release for Reg BI.)

The best interest duty of care examples in my three posts illustrate the importance that Reg BI (and the SEC's Interpretation for investment advisers) places on considering costs in making recommendations. Where the costs discussed in these scenarios are higher, it may be because the compensation paid to the broker-dealer and the financial professional is higher (for example, a more expensive mutual fund may pay higher 12b-1 fees or more revenue sharing). That additional compensation is separately regulated by Reg BI's duty to mitigate conflicts of interest *"that create an incentive for a natural person who is an associated person of a broker or dealer to place the interest of the broker, dealer, or such natural person ahead of the interest of the retail customer."* In plain English, that means that a broker-dealer must have and enforce policies and procedures to dampen the effect of incentives so its financial professionals aren't incented (*e.g.*, compensated) to put their interests (or those of the broker-dealer) ahead of the retail customer.

Since the compensation of broker-dealers and their financial professionals is often embedded in products (and increases the cost of the product) or related to the number of transactions, the costs and compensation attributable to recommendations to retail customers will be regulated by several parts of Reg BI. For example, the costs must be considered under the Care Obligation, disclosed under the Disclosure Obligation, and mitigated under the Conflict of Interest Obligation. Needless to say, broker-dealers need to have compliant practices that focus on cost and compensation, as well as training, written supervisory procedures and supervision related to recommendations.

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