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HOW TO NAVIGATE THE EVOLVING STANDARDS OF CARE FOR RETAIL INVESTMENT ADVICE

Retail investment advice standards are converging. Financial institutions will want to develop a holistic and flexible framework for complying with the ever-changing rules from federal and state securities, retirement, insurance, and banking regulators.

By Lindsay B. Jackson, Daniel R. Kleinman, and Natalie R. Wengroff *

The standards of care that apply to investment professionals[1] who work with retail investors have been evolving dramatically for the last 14 years.[2] During this time, we have seen various U.S. federal and state securities, retirement, and insurance regulators take steps to define, strengthen, and enforce more consumer protective standards for providing investment advice. Most recently, the Department of Labor ("DOL") finalized its fourth iteration of its "fiduciary rule" in 2024 — a rule that is already being challenged in federal court. While the regulators undoubtedly act with good intentions, they have left a patchwork of standards (with different vocabularies) that continue to evolve as they appear to be converging towards what can be construed as the lowest common denominator — an increasingly restrictive, principles-based, fiduciary standard of care backed by threats (real or perceived) of aggressive, and potentially inconsistent, enforcement, and litigation. This article is intended to aid financial institutions and their legal and compliance teams in understanding the general landscape and developing an approach to operationalizing these standards in an ever-changing regulatory environment.

A BRIEF (RECENT) HISTORY OF RETAIL INVESTMENT ADVICE CONDUCT STANDARDS

2005 – *Deseret Letter*[3] – The DOL issues an advisory opinion stating that recommendations to rollover assets

[1] Investment professionals include registered representatives of broker-dealers and investment advisers, bankers, and insurance company agents.

[2] Others may pick a different date, but we base our timeline on two significant events that happened in 2010, following the 2008 financial crisis: (1) the DOL's first proposal to redefine "investment advice" for purposes of the fiduciary duties and prohibited transaction rules that apply to employee benefit plans, IRAs, and other qualified accounts and (2) the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which, among other things, authorized the U.S. Securities and Exchange Commission ("SEC") to adopt a uniform fiduciary standard of care for investment advisers and broker-dealers and conduct the so-called 913 Study entitled "Study on Investment Advisers and Broker-Dealers."

[3] Advisory Opinion 2005-23A (Dec. 7, 2005); *available at* https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/advisory-opinions/2005-23a.

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FORTHCOMING

● ***THE USE OF AI IN THE SECURITIES INDUSTRY: REGULATORY CONSIDERATIONS FOR BROKER-DEALERS AND SEC-REGISTERED INVESTMENT ADVISERS***

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from an employer-sponsored retirement plan to an individual retirement account ("IRA") are not fiduciary investment advice. It also recognizes that advice to a plan participant regarding his or her individual plan account is subject to Employment Retirement Income Security Act's ("ERISA's") fiduciary standards, even where the plan fiduciary is not involved in the arrangement.

2010 – *DOL Fiduciary Rule 1.0*[4] – The DOL proposes a new definition of fiduciary "investment advice" to broaden the circumstances under which non-discretionary advice with respect to retirement account assets (IRA or employee benefit plan) could result in the advice provider's fiduciary status. Although the proposal includes coverage of advice provided to IRAs and their owners, it does not focus on it. Under broad pressure from the financial services industry and Congress, the proposal is withdrawn.

2013 – *FINRA Notice 13-45*[5] – "Reminds" broker-dealers of their suitability obligations when recommending a rollover from a retirement plan. It notes several non-financial/investment factors to be considered in the recommendation process.

2016 – *DOL Fiduciary Rule 2.0*[6] – The DOL finalizes a sweeping rule package that would cause nearly all investment recommendations to retirement investors (which includes IRAs) to be fiduciary investment advice, require compliance with DOL-created and coined "impartial conduct standards" (including a "best interest" standard of care), and create a private right of action through client contracts. This new standard, which would apply to non-ERISA plans, including IRAs and Keogh plans, is strictly aligned with ERISA's fiduciary standard of care under ERISA Section 404. Withdrawing the Deseret Letter, which generally concluded that rollover and distribution recommendations were not "investment advice" and therefore were not subject to fiduciary standards, the DOL now concludes that rollover recommendations are fiduciary investment advice, as well as day-to-day recommendations from financial services providers, including broker-dealers, insurance agents, and banks (as well as investment advisers and consultants). The rule package is very focused on IRAs.

2018 – *DOL Fiduciary Rule 2.0 Vacated*[7]*; SEC Reg. BI Proposed*[8] – On **March 15,** the Fifth Circuit Court of Appeals vacates the DOL rule *in toto*, concluding the DOL's fiduciary definition is overbroad, lacking the hallmarks of a relationship of trust and confidence, and that the DOL went beyond its statutory authority in creating a private right of action for IRAs and other non-ERISA covered tax-qualified retirement and savings accounts and plans. On **April 18**, the SEC proposes Regulation Best Interest ("Reg. BI") for broker-dealers and an interpretation of the fiduciary duty for investment advisers. Reg. BI and the fiduciary duty interpretation carry forward many of the key concepts the DOL included in its fiduciary rule 2.0, including the best interest standard, treating rollover and account-type recommendations as subject to the standard of care, and new, extensive conflicts and compensation disclosures for broker-dealers. One can only speculate that given the enormity of the impact of the SEC's new rulemaking, particularly on broker-dealers, and the close timing of the proposal's release to the court's decision, which may not have been expected, Reg. BI was most likely designed to co-exist with the DOL Fiduciary Rule. Thus, the similarities in approach to retail investment advice between these two regulators is apparent.

[4] *Definition of the Term "Fiduciary,"* 75 Fed. Reg. 65,263 (Oct. 22, 2010).

[5] FINRA Reminds Firms of Their Responsibilities Concerning IRA Rollovers, FINRA Reg. Notice 13-45 (Dec. 30, 2013), *available at* https://www.finra.org/rules-guidance/notices/13-45.

[6] *Definition of the Term "Fiduciary" Conflict of Interest Rule – Retirement Investment Advice*, 81 Fed. Reg. 20945, 20958-59 (Apr. 8, 2016); *Best Interest Contract Exemption*, 81 Fed. Reg. 21002, 21089 (Apr. 8, 2016).

[7] *Chamber of Commerce of the U.S.A v. U.S. Dep't of Labor*, No. 17-10238 (5th Cir. Mar. 15, 2018) (mandate issued June 21, 2018).

[8] Proposed in *Regulation Best Interest*, Release No. 34-83062 (April 18, 2018), 83 Fed. Reg. 21,574 (May 9, 2018), and finalized in *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, Exchange Act Release No. 34-86031 (June 5, 2019), 84 Fed. Reg. 33,318 (July 12, 2019).

2018-2020 – *Nevada,*[9] *Massachusetts,*[10] *New York*[11] *and New Jersey Fiduciary Rules*[12] – Various state securities and insurance regulators (most notably NV, MA, NY, and NJ) propose broad fiduciary rules that would apply to broker-dealers under state law. These rules reflect novel constructs of the standard of care that go beyond Reg. BI and, in some respects, the DOL fiduciary rule. After significant pushback, Massachusetts adopts a fiduciary standard that appears to more closely align with Reg. BI than the proposal, but significant gaps remain. (This rule was invalidated by a Massachusetts court in 2022,[13] but then reinstated by the Massachusetts high court in 2023.[14]) The polarization of these standards and the ebb and flow of moving regulation from mainly disclosure-based to consumer protection-focused is accelerating.

2020 – *DOL Fiduciary Rule 3.0*[15] *& NAIC Model Best Interest Standard*[16] – The DOL officially reinstates the more limited "five-part test" of fiduciary status, as required by the Fifth Circuit, and adopts a new prohibited transaction exemption ("PTE 2020-02"), permitting financial institutions to be compensated for fiduciary investment advice (including securities, insurance and rollover recommendations, and certain principal trades) subject to meeting the "impartial conduct standards" and other requirements. As part of this more limited rulemaking and without formally changing its regulations defining fiduciary investment advice, the DOL, in dicta in the preamble to PTE 2020-02, reinterprets the five-part test to result in fiduciary status any time a rollover recommendation is made in anticipation of an ongoing investment advice relationship. The DOL further requires, through PTE 2020-02's conditions, that rollover recommendations be supported by a cost comparison, and documentation and disclosure of the reasons the recommendation is in the retirement investor's best interest. The DOL's approach here is controversial, with many not adopting the new interpretation of its longtime regulations and other challenging portions of it in the courts. Meanwhile, the National Association of Insurance Commissioners ("NAIC") issues a model best interest rule that would require insurance producers to recommend annuities in the customer's best interest in the states that adopt the rule.

2022-2023 – *SEC Staff Bulletins on Reg. BI*[17] *& Predictive Data Analytics Proposal*[18] — SEC Staff publishes three Staff Bulletins clarifying the Staff's view that the obligations of broker-dealers and investment advisers are *generally the same* when providing investment advice to retail investors. Thus, the distinction between the "fiduciary" standard of care required by investment advisers and the "best interest" standard of care for broker-dealers becomes further blurred. These bulletins also seem to expand broker-dealer and investment adviser obligations beyond the text of Reg. BI and the Advisers Act fiduciary duty interpretation. Significantly, the Staff tries to move the needle on rollovers beyond the DOL's requirements and indicates that rollover recommendations should be based on actual information about the plan, seeming to reject the use of benchmarks and estimates. SEC also limits

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[9] NEV. REV. STAT. §§ 90.575, 628.010, and 628.020, as modified by Senate Bill No. 383 (Jan. 18, 2019), *available at* https://www.nvsos.gov/sos/home/showpublisheddocument/6156/636834071925530000.

[10] 950 CODE MASS. REGS. § 12.207.

[11] Suitability and Best Interest in Life Insurance and Annuity Transactions, 11 NY Comp Codes Rules and Regs § 224.

[12] Fiduciary Duty of Broker-Dealers and Investment Advisers (Proposal Number: PRN 2019-044); Proposed New Rule N.J.A.C. 13:47A-6.4; (Apr. 15, 2019), *available at* https://www.njconsumeraffairs.gov/Proposals/Pages/bos-04152019-proposal.aspx.

[13] *Robinhood Financial LLC v. Galvin*, No. 2184 CV 00884, 2022 Ma Super Lexis 19, 2022 WL 1720131 (Mass. Super. Ct. Mar. 30, 2022).

[14] *Robinhood Financial LLC v. Secretary of the Commonwealth,* 492 Mass. 696, 214 N.E.3d 1058 (2023).

[15] Prohibited Transaction Exemption 2020–02, *Improving Investment Advice for Workers & Retirees*, 85 Fed. Reg. 82,798 (Dec. 18, 2020).

[16] Suitability in Annuity Transactions Model Regulation #275, NAIC (Feb. 2020), *available at* https://content.naic.org/sites/default/files/inline-files/MDL-275.pdf.

[17] SEC Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors (Mar. 29, 2022), *available at* https://www.sec.gov/tm/iabd-staff-bulletin; SEC Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Conflicts of Interest (Aug. 3, 2022) https://www.sec.gov/tm/iabd-staff-bulletin-conflicts-interest; SEC Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Care Obligations (Apr. 20. 2022) *available at* https://www.sec.gov/tm/standards-conduct-broker-dealers-and-investment-advisers.

[18] Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, 88 Fed. Reg. 53,960, Exch. Act Rel. No. 97,990 (Aug. 9, 2023), *available at* https://www.federalregister.gov/documents/2023/08/09/2023-16377/conflicts-of-interest-associated-with-the-use-of-predictive-data-analytics-by-broker-dealers-and.

the ability to rely on investor preference as the basis of a best interest recommendation. The SEC's Predictive Data Analytics Proposal could be seen as further expansion of these types of principles-based consumer protectionism by again attempting to apply fiduciary-like obligations to interactions that fall short of a "recommendation," requiring firms to "neutralize" conflicts where digital tools "nudge" investors to take a particular course of action, including when the tool is used by an investment professional. The North American Securities Administrators Association reflects similar concepts in a proposed model fiduciary rule under state securities laws on September 5, 2023.[19]

2023 – *DOL Fiduciary Rule 3.0 Rollover Interpretation Struck Down*[20] — A U.S. District Court concludes that the DOL's interpretation of the five-part test is inconsistent with the statute, and that a rollover recommendation where there is no pre-existing advice relationship with the plan is not fiduciary investment advice. Under this ruling, one-time advice to a plan generally does not meet the regular basis element of the five-part test.

2024 – *DOL Fiduciary Rule 4.0*[21] – The DOL finalizes a new definition of fiduciary investment advice (and amendments to a number of existing PTEs, including PTE 2020-02 and 84-24)[22] that results in fiduciary status for individualized recommendations that are based on a review of a particular retirement investor's circumstances. This new definition closely follows Financial Industry Regulatory Authority's ("FINRA's") and the SEC's concept of equating a "recommendation" to a "call to action" that is individualized to the investor. The DOL signals further alignment with Reg. BI by eliminating certain restrictions on principal trades under PTE 2020-02. More controversial elements apply to rollover and distribution recommendations and force the non-securities world (i.e., insurance, banking, real estate, and commodities) into a Reg. BI-like compliance regime. The DOL's new approach to recommendations seems to provide that advice as to how to invest assets if rolled out of the plan, regardless of disclaimers, which are held in an ERISA-covered plan (e.g., a 401(k) plan) at the time of the recommendation *necessarily implies* a recommendation to roll (or distribute) the assets out of the plan. This interpretation could be viewed as being at odds with the general construct of relationships of trust, confidence, and fiduciary responsibility, as a person is generally only a fiduciary "to the extent" they are acting as such. The DOL's attempt to broaden the fiduciary's responsibility by overriding the element of mutual understanding with the client and bootstrapping the roll out/distribution recommendation onto any recommendation that could be implemented with assets currently held in an ERISA plan seems similar to elements of the *DOL Fiduciary Rule 2.0* rule package, including the creation of a private right of action, which was vacated by the Fifth Circuit as overly broad and beyond their authority. There are currently two lawsuits challenging DOL Fiduciary Rule 4.0 and, in July 2024, the effective date of the rule was indefinitely stayed by the courts.[23]

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[19] Proposed Revisions to NASAA's Dishonest or Unethical Business Practices of Broker-Dealers and Agents Model Rule (Sept. 5, 2023), *available at* https://www.nasaa.org/wp-content/uploads/2023/09/Request-for-Public-Comment-on-BD-Best-Interest-Model-Rule.pdf.

[20] *American Securities Association v. U.S. Department of Labor*, Case No. 8:22-cv-330 (M.D. Fla. Feb. 13, 2023).

[21] Retirement Security Rule: Definition of an Investment Advice Fiduciary, 89 Fed. Reg. 32,122 (Apr. 25, 2024), *available at* https://www.federalregister.gov/documents/2024/04/25/2024-08065/retirement-security-rule-definition-of-an-investment-advice-fiduciary; Amendment to Prohibited Transaction Exemption 2020-02, 89 Fed. Reg. 32,260 (Apr. 25, 2024), *available at* https://www.federalregister.gov/documents/2024/04/25/2024-08066/amendment-to-prohibited-transaction-exemption-2020-02; Amendment to Prohibited Transaction Exemption 84-24, 89 Fed. Reg. 32,302 (Apr. 25, 2024), *available at* https://www.federalregister.gov/documents/2024/04/25/2024-08067/amendment-to-prohibited-transaction-exemption-84-24; Amendment to Prohibited Transaction Exemptions 75-1, 77-4, 80-83, 83-1, and 86-128, 89 Fed. Reg. 32,346 (Apr. 25, 2024), *available at* https://www.federalregister.gov/documents/2024/04/25/2024-08068/amendment-to-prohibited-transaction-exemptions-75-1-77-4-80-83-83-1-and-86-128.

[22] Other Prohibited Transaction Class Exemptions (as opposed to statutory exemptions) were also amended, generally for the purpose to direct non-discretionary advice to PTEs 2020-02 (for all assets) and 84-24 (for non-securities insurance contracts).

[23] The first lawsuit challenging DOL Fiduciary Rule 4.0 was filed in the U.S. District Court in the Eastern District of Texas. *Federation of Americans for Consumer Choice v. U.S. Department of Labor*, No. 6:24-cv-00163 (E.D. Tex. May 2, 2024). On July 25, 2024, that court issued a stay on the effective date of Rule 4.0 and the DOL's amendment to PTE 84-24. *Federation of Americans for Consumer Choice v. U.S. Department of Labor*, No. 6:24-cv-163-JDK (E.D. Tex. July 25, 2024). A second lawsuit challenging Rule 4.0, *American Council of Life Insurers, et al v. U.S. Department of*

I. BASICS — FOUR PRACTICAL STEPS FOR EVALUATING COMPLIANCE APPROACHES WITH THE EVOLVING STANDARD OF CARE

As the timeline above shows, the development of fiduciary and fiduciary-like standards is complex and ever-changing, with numerous regulators promulgating new rules, while attempting to expand their standards through sub-regulatory guidance. At the same time, litigation against the regulators brings additional uncertainty as rules have, at various times, been struck down by the courts, and in some cases reinstated (e.g., Massachusetts), or reproposed in different forms (e.g., the DOL). Additionally, the regulators are beginning to meaningfully enforce these standards and expand them through sub-regulatory guidance, which will likely lead to the need to further adapt compliance approaches. This creates challenges for developing practical, scalable, compliance solutions that appropriately identify and manage the risks and implications of multiple regulations across the financial institution's business lines. Doing so requires a holistic view across the traditional regulatory silos (i.e., federal securities laws, state securities laws, state insurance laws, retirement fiduciary rules, and bank fiduciary standards). With this in mind, we have outlined a four-step process below that we have found to be a helpful approach for our clients.

A. Break Each Ruleset into its Four Component Elements

While the standards in this space may at first appear to be complicated and sometimes in conflict with each other, each standard is generally composed of the same four basic elements – the foundations of fiduciary responsibility as developed under common law of trusts and supplemented through the development of ERISA's fiduciary standards – don't be distracted by different vocabulary and nomenclature:

1. **Duty of Care** – Whether this is called "prudence" or "best interest," this standard requires a reasonable and thoughtful due diligence "process" based on the investor's individual circumstances and needs and the available investments' risks and returns. The regulators, particularly the SEC, are signaling that there should be an upfront process of formulating (and supporting) the recommendation, as opposed to the recommendation merely being tested by compliance/supervision after the fact to determine whether it was compliant with the firm's standards. Under fiduciary law, duty of care means process, not outcome. Firms with well-designed and defined processes will be in a better position to fend off claims and challenges, even where investment outcomes are less than optimal.

2. **Duty of Loyalty** – This element requires that conflicts of interest be addressed to ensure that the recommendation is in the investor's best interests. Requirements here vary, as some regulations require only disclosure and consent, while others require affirmative mitigation or elimination. The elements of mitigation and elimination here are extremely confused, as the regulators, each acknowledging in one form or another that the standard is not to be conflict-free, have not articulated practicable, operational, or scalable standards for specifically differentiating those conflicts that are permissible from those that are not. This is a particular focus for brokerage, which is premised on the transaction-based compensation model and therefore inherently conflicted. Nevertheless, all regulators have generally signaled that the brokerage model is viable without establishing safe harbors or specific rules for compliance. Thus, we expect to see continued and potentially increased regulation by enforcement in this area.

3. **Disclosure** – Disclosure requirements are similar across most regulatory regimes and are focused on ensuring that the investor has material information about services, scope of relationship, fees, compensation, and conflicts. For the securities space, these requirements are generally outlined in Reg. BI for broker-dealers and Form ADV for federally registered advisers. For the retirement world, some of the requirements, mainly sources of compensation, are covered in the ERISA 408(b)(2) regulations for ERISA plan service providers and PTE 2020-02 where relied upon. But for insurance, banking, real estate, and commodities, comprehensive relationship conflict disclosures may be new.

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Labor, Case No. 4:24-cv-00482-O (N.D. Texas May 24, 2024), was filed in the U.S. District Court in the Northern District of Texas. On July 26, 2024, that court issued a stay applying to the effective date of the entire DOL Fiduciary Rule 4.0 package (including the revised definition of fiduciary investment advice and the accompanying proposed changes to existing PTEs). *American Council of Life Insurers, et al v. U.S. Department of Labor*, Case No. 4:24-cv-00482-O (N.D. Texas July 26, 2024). Both courts indicated that the stays applied beyond the parties before the court. As a result, the status of DOL Fiduciary Rule 4.0 remains very much up in the air at the time this article was finalized.

4. **Policies and Procedures** – Firms are generally required (or advised) to implement policies and procedures to support compliance with the applicable standards. There is increased focus on the specificity of these types of policies and procedures, the periodic testing of their effectiveness, and identifying officers and individuals to be responsible for their upkeep and effectiveness.

B. Analyze the Gaps Between Each Ruleset

Given the similarities in each rule, it may be possible, and preferable, to leverage existing compliance approaches, policies, and procedures to support compliance with multiple rulesets. This is particularly true given that the rules are generally principles-based and may be viewed as setting a floor rather than a ceiling for the required standard. However, each rule will need to be reviewed carefully to determine where there may be a gap or unique approach that will need to be separately addressed.

As the duty of care and duty of loyalty create the most variation, the table in the appendix summarizes certain key elements for the five primary rulesets currently impacting the retail investment advice space. The significant differences are highlighted in *italic*.

C. Identify What Activities are Strictly Prohibited or Specifically Required

Looking beyond the principles-based standards, financial institutions will need to decide whether to implement a specific requirement or prohibition across the board, or cabin it to customers and transactions that fall under the specific standard. In considering the approach here, the firm will need to think about risks, operational issues, and business objectives, as well as how regulators and customers will react. In particular, when prohibiting an activity to satisfy one regulator, consider how another regulator would view allowing the practice under its rules. Also consider how customers will react to "Yes, we can do that in your taxable accounts but not your retirement accounts," and whether representatives can be effectively trained to maintain any differences.

Moreover, consider any impact on how the firm will approach cross-selling among regulated affiliates (i.e., cross-selling among the affiliated bank, RIA, BD, and insurance agency) and holistic customer/family relationship building. Furthermore, can you take a risk-based approach to compliance, for example, by enhancing the compliance requirements for recommendations of high cost/complex products, account type, and rollovers? As a general matter, it will be important to focus on transactions that present the most significant conflicts for the firm and its investment professionals. As discussed more fully below, our experience is that this will generally lead firms to reduce their product shelf offerings, eliminating or significantly reducing access to those products and services (including certain advisory services) that require specific types of specialized training and/or time-consuming supervision. Thus, maintaining an open architecture platform is becoming a more complicated and potentially expensive proposition under these evolving rulesets.

D. Adopt Policies and Procedures for Each Ruleset

While policies and procedures for one ruleset can increasingly be leveraged for another ruleset, it is important to play back each regulation to each regulator in their own vocabulary, relying on cross-references where possible to minimize conflicting policies and procedures but being mindful that the use of cross-references could open the door to a regulator regarding activities that were not the original focus of their inquiry.

For example, a broker-dealer will have adopted policies and procedures to meet Reg. BI's Conflicts Obligation. These can form the basis of policies and procedures for the DOL's and Massachusetts's Fiduciary Rules, but an addendum or separate policy may be the best practice to specifically reflect DOL- and Massachusetts-specific requirements and terminology. Being able to show the regulator that the firm adopted policies and procedures specific to its rule will be extremely helpful in addressing regulatory inquiries, at least in their early stages.

Firms will want to ensure that compliance processes leveraged for one ruleset will not necessarily lead to an automatic violation of another where a breakdown is identified. For example, a firm leveraging their Reg. BI processes to meet the DOL's Impartial Conduct Standards should avoid tying their policies and procedures so closely together as to lead an examination by the DOL into a finding that Reg. BI was also violated. Firms will also want to avoid having to turn over compliance materials to a regulator focused on an issue that is unrelated. For example, a bank may not want to turn over DOL-required rollover materials where the OCC does not specifically request them.

II. COMPLIANCE CHALLENGES AND BEST PRACTICES

The standards of care discussed in the appendix particularly impact common financial institution practices, as discussed below.

A. Product Availability – Fiduciary Standards Put Pressure on Open Architecture

Asset class variety (similar to share class) puts a focus on pricing (cost to investor) and compensation (to firm/professional). The duty of loyalty requires firms to identify and address conflicts of interest. Conflicts are intensified when compensation to the firm and its investment professionals for different investment products vary. While mutual fund and product support compensation continue to be scrutinized, regulators have recently increased their focus on more expensive, complex products, including private funds and variable annuities, through regulatory guidance and enforcement actions. Additionally, there is an intensifying focus on sweep programs offered and used through brokerage and advisory, including where firms offer money market funds and multi-bank FDIC-insured options.

The differences in how these types of products developed in the market and are sold, including wholesale/product-support services and payments, will continue to represent significant challenges as to how to view them in a procedural prudence/best interest analysis (i.e., standard of care).

B. Considering and Documenting Reasonably Available Alternatives

According to the SEC, Reg. BI, and the Advisers Act, fiduciary duty requires firms and investment professionals to consider "reasonably available investment alternatives" when making an investment recommendation. However, the SEC (and other regulators) has not clearly defined the scope of investment options that could be viewed as a reasonably available alternative to a particular investment product or strategy, creating some uncertainty for firms as they try to develop a scalable compliance approach. Given the uncertainty, firms may consider the following in their approach:

1. Focus first on higher-risk investments and investments and transactions that are more lucrative to the firm or investment professional (i.e., those that create the greatest conflicts), such as rollovers, account types, variable annuities, and private funds.

2. Can the firm's investment professionals identify products with similar risk and return profiles that are lower cost? If so, can investment professionals determine when it would be appropriate to recommend the higher-cost option? This generally requires the determination as to what risk, return, and market correlation the proposed investment is intended to address for the customers (and their portfolios) and whether lower-cost alternatives are available to meet the same need — there is nothing in these rulesets requiring that the lowest cost product be chosen, but procedural prudence/best interest generally require a reason why it was not.

3. Is there a system or tool that could be implemented to help investment professionals compare reasonably available alternatives? This goes to the continued automation of the industry and the use of both internal and external facing tools in aiding the delivery of investment advice. (This also implicates the SEC's PDA rule proposal's focus on such tools, as that proposal applied equally to tools aimed externally at investors and internally used by investment professionals.)

4. Is it feasible to require investment professionals to document the basis of their recommendations and evaluation of reasonably available alternatives (perhaps again focusing on higher risk/higher conflict investments and transactions)?

C. Focus on Investment Professional Compensation and Incentive Programs

The regulatory standards discussed generally include explicit requirements to mitigate or eliminate certain conflicts of interest that investment professionals have. While regulators' approaches to compensation and incentive arrangements continue to develop, certain practices have drawn regulatory scrutiny. A central theme seems to be whether the incentive involves a specific sales or asset target and an "all-or-nothing" award:

1. **Recruiting Compensation – DOL Fiduciary Rule 2.0.** A 2016 FAQ interpreting the best interest standard under DOL Fiduciary Rule v. 2.0 questioned the practice of agreeing to provide a "back-end award" in recruitment compensation packages for financial advisors. These awards generally provide for a bonus or loan forgiveness if the investment professional achieves an agreed-upon asset or revenue target over multi-year periods. The DOL raised the concern that these awards "significantly increase conflicts of interest for the

advisers [dealing with retirement investors], . . . particularly as the adviser approaches the target" because the awards "commonly result in large amounts of income to the adviser . . . on an '*all or nothing*' basis."[24] The focus here seems to be on ensuring that the firm, through its compensation structure, does not put the investment professional in too great of a personal conflict as to encourage the investment professional to breach their duty to the investor. Thus, general prospective and incremental grid sales compensation is permissible; repricing historic sales compensation when passing a specified target may not be.

2. **Sales contests, quotas, and bonuses – Reg. BI and Massachusetts Fiduciary Rule.** Reg. BI requires firms to *eliminate* sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or types of securities within a limited period of time. In a Staff Bulletin interpreting broker-dealer and investment adviser conflicts of interest obligations, the SEC staff indicated that additional conflicts may need to be eliminated where "significant benefits or penalties" are based on "success or failure in meeting certain benchmark, quota, or performance metric . . . (beyond those that are specifically prohibited under Reg. BI) . . . [T]he greater the reward . . . for meeting particular thresholds (or conversely, the more severe the consequence for failing to meet them), the greater is the concern whether the incentive program complies with Reg BI and the IA fiduciary standard."[25]

In contrast, the Massachusetts Fiduciary Rule calls into question all "sales contests," regardless of whether they are product-specific or time-limited, providing that any recommendation made in connection with a sales contest is presumed to breach the fiduciary duty of loyalty.[26] While the Massachusetts Securities Division ("MSD") has not specifically defined "sales contest," two enforcement sweeps[27] under the rule suggest a similar focus on whether an incentive arrangement involves meeting a specific threshold as they are focused on criteria, such as:

— generating income in a certain time frame could be viewed as any limited time frame, including annually;

— opening a certain number of accounts could be viewed as objective target;

— signing up new customers; or

— capturing new assets.

At the same time, the MSD has recognized that not all conflicts can be eliminated, and that conflicts associated with transaction-based brokerage compensation and compensation for the sale of proprietary products can be mitigated by ensuring that fees earned for recommendations are reasonable and complying with the remainder of the fiduciary duty.

Accordingly, the regulators seem to understand that firms in a sales-structured business environment, such as the brokerage model, need to be able to effectively identify, compensate, and reward high-performing representatives; a clear view of where those lines are is still developing.

3. **Trips and conferences – DOL Fiduciary Rule 4.0.** The DOL addressed the common practice of sending investment professionals to educational conferences, stating that firms should "avoid creating situations where training is merely incidental to the event, and an imprudent recommendation . . . is the only thing standing between an Investment Professional and a luxury getaway vacation."[28] At the same time, the DOL recognized that educational conferences can be appropriate, so long as they do not violate the care or loyalty obligations, and indicated that incentives that are "aimed at increasing the overall amount of retirement saving and investing, without promoting specific products," are permissible.[29] The DOL took a step further, stating that "it can be appropriate to tie attendance to sales thresholds in certain circumstances (for example, insurance companies could not reasonably be expected to provide training

[24] DOL Fiduciary Rule FAQs re: Best Interest Contract Exemption, FAQ 12 (Oct. 27, 2016).

[25] SEC Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Conflicts of Interest, Q.6 (Aug. 3, 2022), https://www.sec.gov/tm/iabd-staff-bulletin-conflicts-interest.

[26] 950 CODE MASS. REGS. § 12.207(2)(d).

[27] MSD Enforcement Inquiry No. 7283; MSD Enforcement Inquiry No. 2024-0088.

[28] Amendment to Prohibited Transaction Exemption 2020-02, 89 Fed. Reg. 32,260, 33,275 (Apr. 25, 2024), *available at* https://www.federalregister.gov/documents/2024/04/25/2024-08066/amendment-to-prohibited-transaction-exemption-2020-02.

[29] *Id*.

for independent agents who are not recommending their products)."[30] Here again, the regulator's focus seems to be on thresholds that put pressure on the investment professional to make a specific sale to obtain the award, rather than standard compensation practices that are designed to incentivize performance. Helpful here is that the DOL clearly provides that the focus is on whether the trip or conference (or access to additional compensation more broadly) actually affects the recommendations provided to the investor. Consistent with its prior guidance with respect to recruitment compensation, DOL's focus is on the effects of the conflict, as opposed to the potential provocativeness of the award or compensation. Query whether the other regulators will adopt a similar approach.

This guidance suggests that firms should review their compensation and incentive arrangements to determine whether any are based on attaining specific targets or benchmarks, or provide all-or-nothing awards that would not be received "but for" the investment professional's investment advice or recommendations. If the awards are based on investment advice or recommendations, the focus should be on whether the award arrangement could reasonably be viewed as causing the actual recommendations being provided to violate the applicable care obligation. If so, then consider whether the arrangement can be restructured to reduce the magnitude of the conflict on the representative.

Key areas of focus may be recruitment compensation practices, forgivable loans, annual or periodic bonuses, stock and profits interest arrangements, and trips and other non-cash compensation or prizes. As a general matter, we have not seen a particular focus on commission or production-based grids with prospective and incremental increases based on production. However, firms may want to review compensation grids to see if percentage increases are particularly steep or applied retroactively, as these structures may raise concerns similar to those discussed above.

D. Continued Debate/Scrutiny Over Rollover and Account Transfer Approaches

The decision to roll (or distribute) an individual's retirement savings out of an employer-sponsored retirement plan ("Plan") is identified by the regulators as one of the most significant financial decisions an investor will make. As a result, the SEC, FINRA, state securities regulators, and the DOL have long been focused on sales practices involving rollovers and are imposing stringent and evolving requirements on rollover (and distribution) recommendations. In fact, one of the DOL's primary goals in issuing fiduciary rule 4.0 was to ensure that recommendations to roll assets out of a Plan are treated as fiduciary investment advice under Title I of ERISA (which is subject to a private right of action) and that such recommendations are made only after a comprehensive comparison of the costs and benefits of the Plan to the costs and benefits of the IRA. Another was to address one-time advice to take a permissible ERISA plan distribution and invest it in an insurance contract.

Key to developing an approach to rollover interactions is understanding that a rollover is really composed of three independent transactions:

- the decision to roll out of the Plan,
- the decision to roll or transfer the assets into an IRA, and
- the decision as to how to invest the assets once they are in the IRA.

Guidance from the DOL, the SEC, and FINRA, in varying degrees, can be read to support the three-transaction approach. However, the DOL (in the preamble to its recent amendments to the definition of fiduciary investment advice and discussed more generally above) is attempting to collapse each decision point into a single rollover transaction: "[R]ecommendations of how securities or other investment property should be invested after the securities or other investment property are rolled over…often involve an implicit rollover recommendation. For this reason, the Department does not agree . . . that . . . a financial professional should be permitted to agree with its customer that any advice to be given will concern how to dispose of assets once removed from a Title I plan and no advice will be given regarding whether to remove the assets from the plan."[31]

The DOL's statement, applied broadly, seems inconsistent with market experience, which shows that many, if not most, potential and current investors come to financial services firms already highly motivated (if

[30] *Id*.

[31] Retirement Security Rule: Definition of an Investment Advice Fiduciary, 89 Fed. Reg. 32,122, 32, 146 (Apr. 25, 2024), *available at* https://www.federalregister.gov/documents/2024/04/25/2024-08065/retirement-security-rule-definition-of-an-investment-advice-fiduciary.

not determined) to move their retirement assets. These investors are often more concerned with the mechanics of moving their assets and where/how they are going to be invested, than the possibility of staying in the current plan. Thus, our view is that not every rollover interaction results in (or from) a "rollout" recommendation, including where a fiduciary or best interest "roll-in" recommendation is provided. This is the case particularly where the firm and investment professional have made clear that they are not providing a recommendation to roll out of the ERISA plan and the retirement investor should not have an expectation that they are doing so, even where the investment professional provides advice on how the assets could be invested should the investor decide to roll the assets over to an IRA with the firm.

The DOL's and other regulator's rules and guidance raise a number of issues for firms to address, including:

- **Will the firm take an education-only approach or allow fiduciary recommendations?** The DOL's guidance puts pressure on the education-only approach, so firms that choose this path will want to consider taking steps to substantiate that recommendations are not being provided, including through clear and direct disclosures, training, and other methods of delineating where investment professionals are and are not acting as fiduciaries. The firm should consider whether a simple direct standalone communication piece (similar in concept to SEC's Form CRS and CFPB's Trust in Lending Disclosures) delivered to the investors explaining the firm's approach to only educate (and not to provide roll-out recommendations) adequately addresses the DOL's concerns here.

- **If recommendations are provided, what information must be considered — plan specific vs. benchmarks?** Note that while the DOL has approved benchmarks and estimates of plan costs and expenses where the investment professional cannot obtain actual information, the SEC has indicated that investment professionals should consider not making a recommendation where they lack actual information about the plan. The SEC has also made clear that recommendations cannot be made entirely based on customer preferences. We understand that there are a number of potential technology solutions in this area, but have heard concerns that some may be more of investors' information/preference playback tools than actual advice providing systems.

- **Systems for documenting and disclosing the basis of recommendation.** Given that the DOL requires firms to document and disclose the basis of rollover recommendations, firms will want to consider whether to implement a customized approach or adopt one of the many third-party tools to aid investment professionals who are making rollover recommendations.

E. Pace of Rule Development (and Regulations by Enforcement and Politics) Make Compliance Difficult to Manage

Principles-based standards are flexible but frequently change based on informal guidance, enforcement outcomes, market development, and industry-adopted practices. Additionally, regulatory leadership and agency personnel changes, as well as litigation against the regulators, have been shown to have significant impacts on the rules that apply to retail investment advice. These rapid changes in the regulatory landscape have caused significant challenges for legal and compliance teams, as well as business decision-makers who seek to manage regulatory risk and business objectives and goals. As such, a measured and holistic approach to implementation can offer greater flexibility to adapt to the changing rules over time. Additionally, providing regular and regularly updated training and guidance will be key to ensuring that investment professionals continue adhering to the most up-to-date legal and regulatory requirements.

III. CONCLUSION

We hope this framework is helpful in developing and evaluating an effective compliance approach to address the evolving retail investment advice standards. As these standards continue to evolve, undoubtedly reassessment of current approaches and areas of focus will be needed. Sorry to say, but stay tuned. ■

APPENDIX

	Reg. BI	IA Interpretation	DOL Fiduciary 4.0	Massachusetts	NAIC Model Rule
Applies to ….	Securities recommendations to broker-dealer retail customers	Investment advice to advisory clients	Individualized recommendations to retirement investors	Massachusetts broker-dealer recommendations and investment advice with specific institutional carveouts	Annuity/insurance recommendations to an individual consumer
Duty of Care	Reasonable basis Best Interest recommendations based on customer investment profile and risks, rewards, and costs of investment recommendation	Reasonable basis Best Interest recommendations based on customer investment profile and risks, rewards, and costs of investment recommendation	*Prudence/Impartial Conduct* Best Interest recommendations based on investor's objectives, risk tolerance, financial circumstances, and needs, all characteristics of investment recommendation	*Prudence* Must consider risks, costs, and conflicts of interest related to customer's investment objectives, financial situation, and needs; and any other relevant information	Reasonable basis Best Interest recommendation based on the consumer profile information and risks, rewards, and costs of the annuity recommendation
Duty of Loyalty	Without putting interests ahead of 1. Disclose and mitigate RR financial incentives; 2. Disclose firm conflicts; *3. Eliminate time-sensitive product-specific sales contests*	Without putting interests ahead of … Disclose and obtain informed client consent	Without putting interests ahead of … 1. Disclose and mitigate all conflicts; *2. May not use quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation, or similar actions or incentives that are intended or are likely to result in recommendations that violate duty of care or loyalty*	Without regard to …. 1. Avoid and eliminate; 2. Disclose and mitigate conflicts that cannot be avoided or eliminated; *3. All sales contests presumed to breach duty of loyalty*	Without putting loyalty ahead of … 1. Identify and avoid; 2. Reasonably manage and disclose material conflicts related to ownership; 3. Obtain customer's informed consent