

# Morgan Lewis

## MEMORANDUM

TO: Morgan Lewis Financial Institutions Clients

FROM: Lindsay B. Jackson  
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DATE: February 18, 2021 **DRAFT**

SUBJECT: Comparison of the SEC’s Regulation Best Interest and DOL’s Final Investment Advice Class Exemption

The table below compares the requirements of the SEC’s Regulation Best Interest (“Reg. BI”) and the conditions of the DOL’s Improving Investment Advice for Workers and Retirees Final Class Exemption (the “Final Class Exemption”), along with select preliminary observations. Compliance with the final class exemption is not mandatory and other exemptions may be available for certain transactions, or an exemption may not be needed where a financial institution is not acting as a fiduciary or is not retaining variable compensation in connection with transactions for which it (or an affiliate) provided fiduciary investment advice.

Requirement	Reg. BI	Final Class Exemption	Observations
<b>Covered Customers/ Clients</b>	“Retail customer”— a natural person, or legal representative of such natural person, who receives a recommendation of any securities transaction or investment strategy involving securities from a broker-dealer (or natural person who is an associated person) and <b>uses the recommendation primarily for personal, family, or household purposes.</b>	“Retirement Investor” — a <b>participant</b> or <b>beneficiary</b> of an ERISA-covered <b>plan</b> with authority to direct the investment of assets in his or her account or to take a distribution; the <b>beneficial owner of an IRA</b> (including HSAs, Archer MSAs, and Coverdell education savings accounts); or a <b>fiduciary</b> of a Plan or an IRA.	<p>Reg. BI’s definition of retail customer includes any natural person or legal representative who will use a broker-dealer’s recommendation for personal, family or household purposes.</p> <p>Both Reg. BI and the exemption would apply to recommendations to plan participants and IRA owners, but Reg. BI generally does not apply to recommendations to plan sponsors/fiduciaries acting as such.</p> <p>Note that the DOL’s vacated Best Interest Contract Exemption (and presumably the current DOL non-enforcement relief) would not have been available with respect to advice provided to large plan fiduciaries, which was a</p>

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			problematic condition to operationalize. The exemption does not include this limitation.
<b>Covered financial institutions</b>	Registered broker-dealers	<p>Available to:</p> <ul style="list-style-type: none"> <li>• State and federally registered investment advisers,</li> <li>• State and federally supervised banks and savings associations,</li> <li>• State-qualified insurance companies, and</li> <li>• Registered broker-dealers.</li> </ul> <p>Unless the financial institution (or investment professional) is disqualified or barred from making investment recommendations by any insurance, banking, or securities law or regulatory authority (including any self-regulatory organization).</p> <p><i>Other entities may apply for individual prohibited transaction exemptions based on the same conditions as the final class exemption.</i></p>	<p>While Reg. BI applies only to broker-dealers, the exemption would also be available to investment advisers, banks and insurance companies.</p> <p>It is not available to non-regulated entities, such as IMOs (“independent marketing organizations,” a type of insurance intermediary – the DOL had proposed a class exemption for IMOs that has now been withdrawn).</p> <p>Firms may find the exemption helpful in non-discretionary advisory programs.</p>
<b>Covered transactions</b>	<p>Recommending:</p> <ul style="list-style-type: none"> <li>• Securities transactions, or</li> <li>• Investment strategies involving securities (including account-type and rollover recommendations).</li> </ul>	<p>“Fiduciary” investment advice (i.e., non-discretionary advice or recommendations with respect to securities or other property that would cause the financial institution or investment professional to be an ERISA or Code section 4975 fiduciary under the 5-part test, including with regard to rollovers) that results in:</p> <ul style="list-style-type: none"> <li>• The receipt of <i>reasonable compensation</i>, or</li> <li>• The purchase or sale of an asset in a riskless principal transaction or a Covered</li> </ul>	<p>Reg. BI applies to brokerage securities recommendations, while the exemption would be available for securities and “other property.”</p> <p>Both apply to rollover and account-type recommendations.</p> <p>A key issue to consider in assessing the exemption is the limitation on securities that can be sold to a plan in a principal transaction. Notably, the DOL declined to broaden the exemption’s definition of Covered Principal Transaction to explicitly include equity securities</p>

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		<p>Principal Transaction, and the receipt of a mark-up, mark-down, or other payment.</p> <p>For sales to plans and IRAs, the "Covered Principal Transaction" is limited to transactions involving:</p> <ul style="list-style-type: none"> <li>• U.S. corporate debt securities,</li> <li>• U.S. Treasury and other federal agency securities,</li> <li>• Debt securities of a government-sponsored enterprise,</li> <li>• Municipal securities</li> <li>• Certificates of deposit, and</li> <li>• Interest in UITs.</li> </ul> <p><i>The DOL will consider individual class exemptions for other investments subject to the same conditions as the class exemption.</i></p>	<p>(including IPOs, underwritings and syndicates) and closed-end funds. The DOL stated that an individual exemption request would provide them with the opportunity to gain additional information needed to determine whether an investment should be included in the exemption.</p> <p>The exemption does not cover extensions of credit, and so margin accounts, structured products, and certain other products and services involving lending/borrowing activities will need to be evaluated.</p>
<b>Exclusions and Ineligibility</b>	None	<p>Not available to financial institutions and investment professionals who:</p> <ul style="list-style-type: none"> <li>• Sponsor the plan involved in the transaction, or</li> <li>• Are the named fiduciary or plan administrator of the plan involved in the transaction, unless selected to provide advice by an independent plan fiduciary.</li> </ul> <p>A fiduciary is considered independent if:</p>	<p>Consider potential issues and limitations where advice is provided to participants by a financial institution that is a named fiduciary to the plan (e.g., in OCIO arrangements).</p> <p>The ineligibility provisions are different from those under the QPAM exemption—narrower in the sense that they include only crimes involving advice to retirement investors, but broader in that the DOL has fairly broad discretion to determine that a firm or investment professional is ineligible to rely on the exemption.</p>

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		<ul style="list-style-type: none"> <li>• It is not the financial institution, investment professional, or an affiliate;</li> <li>• It does not have a relationship to or an interest in the financial institution, investment professional, or any affiliate that might affect the exercise of the fiduciary's best judgment in connection with transactions covered by the exemption; and</li> <li>• It does not receive and is not projected to receive within the current federal income tax year, compensation or other consideration for his or her own account from the financial institution, investment professional, or an affiliate, in excess of 2% of the fiduciary's annual revenues based upon its prior income tax year</li> </ul> <p>The exemption is not available to pure robo-advisors (without personal interaction) and where the investment professional is acting in a fiduciary capacity other than as an investment advice fiduciary.</p> <p>Financial institutions and investment professionals may not rely on the exemption if convicted of a crime listed in ERISA section 411 as a result of their or a control group member providing investment advice to a retirement investor, or where the DOL provides notice of ineligibility for intentionally, or engaging in a "systematic pattern or practice" of, violating the exemption or providing materially misleading information to the DOL in connection with the exemption. The exemption includes procedures for hearings and a one-year wind-down period, among other procedures.</p>	<ul style="list-style-type: none"> <li>• This condition poses significant risks to firms who choose to rely on it as a DOL finding may effectively prohibit a firm from providing recommendations and advice to retirement investors, absent relying on another exemption (limited options) or restructuring the firm's and its professionals' compensation to avoid a prohibited transaction (inconsistent with brokerage model).</li> <li>• The 2% revenue test for independence is more restrictive than the 5% test under the <i>SunAmerica</i> letter, but consistent with the test under the DOL's exemption application procedures.</li> </ul>

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<b>Standard of conduct</b>	"best interest"	"best interest"/"fiduciary"	<p>The exemption defines the applicable standard as "best interest," but requires firms to affirmatively acknowledge fiduciary status under ERISA and the Code.</p> <ul style="list-style-type: none"> <li>• This contrasts with the SEC's express decision to differentiate broker-dealers and investment advisers by not calling the broker-dealer standard a "fiduciary" standard.</li> <li>• While ERISA/Code and the securities laws are under different statutory regimes, consider the potential for investor confusion here, as well as potential issues under state fiduciary laws.</li> <li>• Moreover, firms will face additional compliance and supervision challenges in trying to operationalize different standards across their retail offerings.</li> </ul>
<b>Obligation</b>	<p>The best interest standard is satisfied by meeting four obligations:</p> <ul style="list-style-type: none"> <li>• Care</li> <li>• Disclosure</li> <li>• Conflicts</li> <li>• Compliance</li> </ul>	<p>The exemption imposes the following obligations:</p> <ul style="list-style-type: none"> <li>• Impartial Conduct Standards</li> <li>• Disclosure</li> <li>• Policies and procedures</li> <li>• Retrospective review</li> </ul>	Each of the obligations is discussed below.
<b>Conflict of interest</b>	"Conflict of interest" — an interest that might incline a broker, dealer, or a natural person who is an associated person of a broker or dealer —consciously or unconsciously—to make a recommendation that is not disinterested.	"Conflict of Interest" — an interest that might incline a financial institution or investment professional — consciously or unconsciously — to make a recommendation that is not in the best interest of the retirement investor.	Both define conflict of interest similarly.
<b>Loyalty/ Conflicts</b>	Act <b><i>without placing the financial or other interest</i></b> of the broker, dealer, or	Advice <b><i>does not place the financial or other interests</i></b> of the investment professional,	Both raise questions as to the extent to which disclosure can address a conflict of interest,

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	<p>natural person who is an associated person from making the recommendation <b>ahead of</b> the interest of the retail customer.</p> <p>Must establish, maintain, and enforce written policies and procedures <b>reasonably</b> designed to:</p> <ul style="list-style-type: none"> <li>Identify and at a minimum <b>disclose, or eliminate, all conflicts of interest</b> that are associated with such recommendations;</li> <li>Identify and <b>mitigate any</b> conflicts that create an incentive for a natural person who is an associated person of a broker-dealer to place the broker-dealer's or associated person's interests ahead of the retail customer's interests;</li> <li>Identify and <b>disclose any material limitations</b> placed on recommendations of securities or investment strategies and <b>any conflicts of interest associated</b> with such limitations. <b>Prevent such limitations and associated conflicts of interest</b> from causing the broker, dealer, or natural person who is an associated person to make recommendations that places their interest ahead of the retail customer; and</li> <li>Identify and <b>eliminate</b> any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or</li> </ul>	<p>financial institution or any affiliate, related entity, or other party <b>ahead of the interest</b> of the retirement investor, or subordinate the retirement investor's interests to their own.</p> <p>Policies and procedures mitigate Conflicts of Interest to the extent that <b>a reasonable person reviewing</b> the policies and procedures and <b>incentive practices as a whole would conclude that they do not create an incentive</b> for a financial institution or investment professional to place their interests ahead of the retirement investor's interests.</p>	<p>and, if not, what additional steps to mitigate the conflict are required.</p> <p>Unlike Reg. BI, the exemption does not expressly limit the requirement to mitigate conflicts to financial incentives for investment professionals.</p> <p>The preamble to the exemption indicates the DOL's view that supervisory oversight and mitigation of financial incentives complement each other and provide flexibility to adjust the stringency of each component based on the business model—as an example, where there is significant variation in compensation, the firm could implement more stringent supervisory oversight.</p> <ul style="list-style-type: none"> <li>Page 82,835 of the preamble includes examples of mitigation identified by the DOL as potential strategies that could satisfy the exemption.</li> <li>The DOL also provides examples of business models and practices that may present conflicts of interest and how the DOL believes firms should address those conflicts through their policies and procedures.</li> <li>The DOL indicated that sales contests prohibited under Reg. BI would not be permitted under the exemption.</li> <li>Limited menus, focusing on proprietary products or products that pay third party compensation, are permissible but such limitations would need to be disclosed to the retirement investor.</li> </ul>

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	<p>specific types of securities within a limited period of time.</p>		<ul style="list-style-type: none"> <li>Firms are not required to compare proprietary products with all other investment alternatives available in the marketplace.</li> </ul>
<p><b>Care</b></p>	<p>Must act in the retail customer’s best interest and exercise reasonable diligence, care, and skill to:</p> <ul style="list-style-type: none"> <li><b>Understand</b> the potential <b>risks, rewards, and costs</b> associated with the recommendation and have a reasonable basis to believe the recommendation could be in the best interest of at least some retail customers;</li> <li>Have a <b>reasonable basis</b> to believe that the recommendation is in the <b>best interest of a particular retail customer based on</b> that retail customer’s <b>investment profile</b> and the potential <b>risks, rewards and costs</b> associated with the recommendation and does not place financial or other interests ahead of retail customer’s interests; and</li> <li>Have a <b>reasonable basis</b> to believe that a <b>series of recommended transactions</b>, even if in the retail customer’s best interest when viewed in isolation, <b>is not excessive</b> and is in the retail customer’s <b>best interest when taken together</b> in light of the retail customer’s investment profile and does not place financial or other interests ahead of the retail customer’s interests.</li> </ul>	<p>Advice must reflect the care, skill, <b>prudence</b>, and diligence under the circumstances that a prudent person acting in a like capacity and familiar with such matters would use, based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor.</p> <ul style="list-style-type: none"> <li>Financial institution must <b>document</b> “the specific reasons” that <b>any rollover recommendation</b> (plan-to-IRA, plan-to-plan, IRA-to-plan, IRA-to-IRA, or from one account type to another account type) is in the best interest of the retirement investor and provide that documentation to the Retirement Investor <b>before</b> engaging in the rollover.</li> <li>If the transaction is a sale to a plan or IRA in a principal transaction, and the recommended investment is a debt security, must have written policies and procedures that are reasonably designed to ensure that the security, at the time of the recommendation, has no greater than moderate credit risk and sufficient liquidity that it could be sold at or near carrying value within a reasonably short period of time.</li> </ul>	<p>The SEC expressly declined to use “prudence” in the Reg. BI Care Obligation.</p> <p>Nonetheless, the preamble to the exemption states that the DOL intends the best interest standard to be consistent with Reg. BI.</p> <p>In contrast to the exemption, Reg. BI does not require documentation of the basis of any recommendation, but the SEC indicated that documentation may be viewed as a <i>best practice</i> for certain types of recommendations.</p> <p>Reg. BI does not impose express limits on credit risks and liquidity.</p>

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<b>Reasonable Compensation</b>	No specific requirement; SEC noted in proposed Reg. BI that broker-dealers are already required to receive only fair and reasonable compensation.	Compensation received, directly or indirectly, does not exceed reasonable compensation within the meaning of ERISA section 408(b)(2) and Code section 4975(d)(2).	Neither expressly requires that the lowest cost option be recommended.  Under DOL guidance, as explained in the exemption's preamble, reasonable compensation within the meaning of the cited provisions is generally a facts and circumstances determination.
<b>Best Execution</b>	No specific requirement; broker-dealers are already subject to best execution obligations.	Must seek to obtain the <i>best execution</i> of the investment transaction reasonably available under the circumstances.	The DOL noted in the preamble that it intends the best execution requirement to be consistent with federal securities laws.  Consequently, SEC enforcement/settlements could more directly affect reliance on exemption and corrections thereunder.
<b>On-going/episodic</b>	Obligation applies <b><i>at the time recommendation is made.</i></b>	Obligation applies <b><i>at the time investment advice is provided.</i></b>	Obligations for both are generally limited to the time a recommendation/investment advice is provided, and do not impose ongoing obligations, including an obligation to monitor (which could implicate Advisers Act status).  <ul style="list-style-type: none"> <li>The DOL and SEC have indicated that whether or not a broker-dealer monitors investments or accounts should be disclosed (e.g., in Form CRS).</li> <li>The DOL indicated in the preamble that fiduciaries should consider whether an investment can be recommended without ongoing monitoring (including by a third-party) – creating additional pressure on distribution of complex products.</li> </ul>



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<b>Compliance</b>	Establish, maintain, and enforce written policies and procedures <b>reasonably</b> designed to achieve compliance with Reg. BI.	<p>Establish, maintain, and enforce written policies and procedures <b>prudently</b> designed to ensure compliance with the Impartial Conduct Standards in connection with covered fiduciary advice and transactions.</p> <p><i>See above under "Loyalty/Conflicts" for policies and procedures to mitigate conflicts, and under "Care" for policies and procedures requiring documentation of the reasons for a rollover recommendation.</i></p>	It is unclear whether "reasonably" versus "prudently" would suggest a meaningfully different standard in practice.
<b>Retrospective Review</b>	<p>None.</p> <p>But the DOL indicated that the exemption's retrospective review requirement is based on FINRA Rules 3110, 3120 and 3130.</p>	<p>Financial Institution must conduct a retrospective review, at least <b>annually</b>, reasonably designed to assist in detecting and preventing violations of, and achieving compliance with, the Impartial Conduct Standards and the policies and procedures governing compliance with the exemption.</p> <p>The methodology and results of the retrospective review must be reduced to a written report that is certified by a senior executive officer:</p> <ul style="list-style-type: none"> <li>• The officer has reviewed the report of the retrospective review;</li> <li>• The financial institution has in place policies and procedures prudently designed to achieve compliance with the conditions of this exemption; and</li> <li>• The financial institution has in place a <b>prudent</b> process to modify such policies and procedures as business, regulatory and legislative changes and events dictate, and</li> </ul>	The DOL stated in the preamble that the retrospective review is a protective measure and targeted opportunity for the DOL to review compliance of firms within its existing oversight and enforcement authority under ERISA.

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		<p>to test the effectiveness of such policies and procedures on a periodic basis, the timing and extent of which is reasonably designed to ensure continuing compliance with the conditions of this exemption.</p> <p>A "Senior Executive Officer" is any of the following: the chief compliance officer, the chief executive officer, president, chief financial officer, or one of the three most senior officers of the financial institution.</p> <p>The retrospective review of the report, certification, and supporting data must be kept for a period of six years, and must be made available to the DOL upon request.</p>	
<b>Recordkeeping</b>	<p>Must keep records of all information collected from and provided to the retail customer and the identity of each representative responsible for the account.</p> <p>Records must be retained for at least <b>six years</b> after the earlier of the date the account was closed or the date on which the information was collected, provided, replaced, or updated.</p> <p>Must maintain a record of the fact that oral disclosure was provided to the retail customer, if applicable.</p>	<p>Records would need to be kept for <b>six years</b> demonstrating compliance with the exemption.</p> <p>Records would need to be made available upon request to any authorized employees of the DOL or Department of the Treasury.</p>	<p>The exemption amended the recordkeeping requirements to better align with SEC recordkeeping requirements.</p> <p>Concern is to what extent this could give the DOL enforcement authority over IRAs.</p>
<b>Disclosures</b>	<p>Must disclose <b>prior to or at the time</b> of the recommendation <b>all material facts</b> relating to the scope and terms of the relationship with the retail customer, including broker-dealer capacity, material fees and costs, type and scope of services (including any material limitations) and all</p>	<p>Must disclose <b>prior to</b> engaging in the transaction:</p> <ul style="list-style-type: none"> <li>• A written <b>acknowledgment of fiduciary status</b> under ERISA and the Code, as applicable, with respect to any fiduciary</li> </ul>	<p>Exemption allows for disclosures to be satisfied through disclosures provided pursuant to other regulators' requirements, in order to minimize duplicative and voluminous disclosures.</p>

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	<p>material facts regarding conflicts of interest associated with the recommendation.</p> <p>Must provide disclosure in writing either prior to or at time of the recommendation.</p>	<p>investment advice provided,</p> <ul style="list-style-type: none"> <li>• A written description of the services to be provided,</li> <li>• A written description of all material Conflicts of Interest that is accurate and not misleading in all material respects, and</li> <li>• The specific reasons for a rollover recommendation.</li> </ul> <p>Statements to the retirement investor about the recommended transaction and other relevant matters may not be materially misleading when made.</p>	<ul style="list-style-type: none"> <li>• Page 82,827 of the preamble provides the following model fiduciary acknowledgment language that firms may use: <p style="margin-left: 40px;"><i>When we provide investment advice to you regarding your retirement plan account or individual retirement account, we are fiduciaries within the meaning of Title I of the Employee Retirement Income Security Act and/or the Internal Revenue Code, as applicable, which are laws governing retirement accounts. The way we make money creates some conflicts with your interests, so we operate under a special rule that requires us to act in your best interest and not put our interests ahead of yours.</i></p> </li> <li>• The DOL confirmed (consistent with Reg. BI) that the standard for materiality for this exemption should be consistent with the standard under the securities laws, as articulated in <i>Basic v. Levinson</i>.</li> </ul>
<b>Self-Correction</b>	None.	<p>A non-exempt prohibited transaction will not occur due to a violation of the exemption's conditions with respect to a transaction, provided:</p> <ul style="list-style-type: none"> <li>• Either the violation did not result in investment losses to the retirement investor or the financial institution made the retirement investor whole for any resulting losses;</li> <li>• The financial institution corrects the violation and notifies the DOL of the violation and the correction within 30 days of correction;</li> </ul>	<p>The exemption is unique because it provides a specific method for firms to use to self-correct prohibited transactions under the exemption (i.e., correct to the exemption).</p> <p>The notice provision to the DOL could result in the DOL becoming a more active regulator in this area, particularly given the DOL's ability to disqualify firms from being able to use the exemption. Also, may signal more enforcement activity in the IRA market.</p>

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		<ul style="list-style-type: none"> <li>• The correction occurs no later than 90 days after the financial institution learned of the violation or reasonably should have learned of the violation; <b>and</b></li> <li>• The financial institution notifies the person(s) responsible for conducting the retrospective review during the applicable review cycle and the violation and correction is specifically set forth in the written report of the retrospective review.</li> </ul>	
<b>Private Right of Action</b>	SEC indicated that it did not intend Reg. BI to create a private right of action.	DOL indicated that it did not intend the exemption to create a private right of action.	<p>The creation of a private right of action was one of the most significant legal risks created by the vacated DOL fiduciary rule, and one of the primary reasons the 5th Circuit struck it down.</p> <p>While both the SEC and the DOL do not intend their standards to create private rights of action, there are open questions as to whether plaintiffs' lawyers could successfully assert contract claims based on required disclosures (e.g., Form CRS or fiduciary acknowledgment under the exemption).</p>
<b>Effective Date</b>	June 30, 2020	February 16, 2021	<p>While the exemption is now in effect, the final exemption notice announced that the DOL non-enforcement policy for fiduciary investment advice put in place after the DOL fiduciary rule was vacated is extended to December 20, 2021, to provide a transition period for firms to come into compliance with the conditions of the exemption.</p>