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Flashpoint: Mid-Summer Update: More About Reg BI and Preventing MEP Spoilage from the One Bad Apple

By S. Derrin Watson, Of Counsel

More About Reg BI: Identifying, Disclosing, Mitigating, and Eliminating Conflicts of Interest

In our earlier Flash, "Regulation Best Interest and More," we provided an overview of the Securities and Exchange Commission's ("SEC") recently finalized Regulation Best Interest ("Reg BI"), which impacts transactions between broker-dealers and retail customers, including retirement plan participants. Reg BI has a compliance date of June 30, 2020. As we discussed, Reg BI imposes obligations related to disclosure, duty of care, conflicts of interest, compliance, and recordkeeping.

This Flash will focus on the most complex of these obligations, the duty to identify and disclose, mitigate, or eliminate conflicts of interest. This obligation is imposed on the investment firm, but focuses on the conflicts of interest that would cause individuals working for or with the firm to put their own interests, or those of the firm, ahead of the interests of customers.

Overarching obligation. Reg BI imposes "an overarching obligation to establish, maintain and enforce written policies and procedures that are reasonably designed to identify and at a minimum disclose . . ., or eliminate, all conflicts of interest associated with" a recommendation made to a retail customer. The first step in this process is to identify what conflicts exist. According to associated SEC guidance, the procedures should:

1. define such conflicts in a manner that is relevant to a broker-dealer's business, in a way that enables employees to understand and identify conflicts of interest;
2. establish a structure for identifying the types of conflicts that the broker-dealer (and persons associated with the broker-dealer) may face;
3. establish a structure to identify conflicts in the broker-dealer's business as it evolves;
4. provide for an ongoing (e.g., based on changes in the broker-dealer's business or organizational structure, changes in compensation incentive structures, and introduction of new products or services) and regular, periodic (e.g., annual) review for the identification of conflicts associated with the broker-dealer's business; and

5. establish training procedures regarding the broker-dealer's conflicts of interest, including conflicts of natural persons who are associated persons of the broker-dealer, how to identify such conflicts of interest, as well as defining employees' roles and responsibilities with respect to identifying such conflicts of interest.

There is a great deal of flexibility in this approach. Ultimately, it is up to the firm to determine what conflicts exist and decide how it will address them. This is not supposed to be a "one and done" event, but rather an ongoing process taking into account changing business environments and the firm's experience.

Reg BI does not demand that firms eliminate all conflicts. The approach to be taken depends on the conflict. In some situations, disclosure is sufficient to resolve the conflict. In other situations, a conflict is so serious that it must either be eliminated, or at least sufficiently mitigated using other means, so that disclosure is then adequate.

Within this overarching obligation, there are three specific additional rules:

Mitigate incentives. The firm must identify and mitigate conflicts that create an incentive for individuals to put their interests ahead of those of their customers. It is important to note that firm-level conflicts can be resolved through disclosure, but individual-level conflicts should be "mitigated." Individual-level conflicts that require attention include compensation from the broker-dealer or third parties, other employment incentives, and other variable compensation, whether paid by the customer, the broker, or a third party.

Mitigate recommendation limitations. Reg BI takes a two-pronged approach for "material limitations placed on the securities or investment strategies . . . that may be recommended to a retail customer" and their associated conflicts of interest. These limitations would include selling proprietary products or a limited range of products. First, firms must identify and disclose the limitation and associated conflicts. Second, firms must prevent these limitations from generating recommendations that put the interests of the firm, or its associated individuals, ahead of the interest of the retail customer.

Eliminate specified conflicts. The firm must eliminate sales contests, sales quotas, bonuses, and non-cash compensation (merchandise, prizes, trips, etc.) based on sales of specific securities or types of securities within a limited period of time. While the firm is allowed to decide whether other conflicts must be eliminated, mitigated, or simply disclosed, the SEC placed these incentives outside the discretion of the firm, saying, "We believe that these practices, particularly when coupled with a time limitation, create high-pressure situations for associated persons to engage in sales conduct contrary to the best interest of retail customers."

Conclusion. Much of the criticism of Reg BI centers on the fact that the SEC did not take a one-size-fits-all approach, either with broker-dealers as a group, or comparing broker-dealers to investment advisors. The SEC deliberately avoided taking such a stance. Firms and their compensation practices vary widely, making it impossible to lay out a detailed series of "thou shalt nots," except in limited areas. The SEC decided that a flexible approach was best, letting firms decide how they would address conflicts of interest on an ongoing basis.

However, as the critics note, this flexibility may result in insufficient controls to truly protect investors. It remains to be seen whether Reg BI will be an effective means of providing a safer investment environment for consumers.

In Other News … The Bad Apple May Not Be a Spoiler After All

The Treasury released proposed regulations that, if finalized, provide a mechanism for multiple employer plans (MEPs) to deal with uncooperative adopting employers and the disqualification failures they cause.

One of the disadvantages of MEPs is that they are subject to what is commonly called the "one bad apple" rule (named for the notion that "one bad apple spoils the whole barrel"). Under that rule, a failure of one adopting employer and its part of a MEP to comply with qualification rules causes the entire plan to be disqualified.

While many MEP documents provide a mechanism for spinning off the "bad" part of a plan, this process has not been sanctioned by the IRS as a means of avoiding the application of the one bad apple rule. The proposed regulations give MEP sponsors the needed guidance to protect the innocent part of the MEP in this situation.

If finalized, the proposed regulations would give a defined contribution MEP relief from the one bad apple rule (called the "unified plan" rule by the IRS in the regulations) if the MEP Plan Administrator (MEP PA) complies with a detailed sequence of requirements. Under these requirements, the MEP PA must send the "unresponsive participating employer" a series of three increasingly demanding 90-day notices, advising it of its noncompliance and soliciting compliance and/or needed information. The last of these notices also must be sent to participants and the DOL. At any time in that process, the nonresponsive participating employer can provide the necessary information, make required contributions, or request a spin-off to another plan. If a spin-off occurs without correction of the qualification failure, the failure follows the spun-off assets to the new plan (but leaves the MEP unaffected). Correction by the unresponsive participating employer, on the other hand, would enable the MEP PA to correct the plan's issues under EPCRS. Furthermore, the regulation provides certain relief to the MEP in regard to EPCRS timing issues related to when a plan comes "under examination" by the IRS while the 90-day notice procedures are pending.

On the other hand, if the nonresponsive participating employer does nothing, the MEP PA would spin off the assets of that part of a plan into a separate plan and promptly terminate that plan. That spin-off must be reported to the IRS, presumably using Form 5310A.

Spinning off the assets has two positive effects. First, it protects the remaining part of the MEP from disqualification as a result of the failure by the nonresponsive employer. Second, it provides the innocent participants in the spun-off/terminated plan with normal rollover options. (Of course, if an affected participant has an outstanding participant loan when the plan terminates, the loan would be taxable if it could not be repaid to the MEP prior to distribution or to an IRA before the participant's tax return due date under the new plan loan offset rollovers available under Code section 402(c)(3)(C).)

The news is not so good for those who were unresponsive to the MEP. Under the proposed regulations, the IRS has the right to "pursue appropriate remedies" against anyone responsible for the failure of that part of the plan (such as the owner of the nonresponsive employer), including refusing them the opportunity to make an eligible rollover.

These regulations are merely proposed, and the Treasury specifically provides that they cannot be relied upon until if and when they are finalized. Once that occurs, a MEP would need to be amended to enable use of the new procedure. It would be helpful to MEPs and their innocent adopting employers if the finalization of the rules is quickly forthcoming.

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