SEC Proposal to Enhance Protections and Preserve Choice for Retail Investors in Their Relationships With Investment Professionals: Regulation Best Interest and Related SEC Proposals

By

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On April 18, 2018, the Securities and Exchange Commission (SEC) voted to propose a package of rulemakings and interpretations designed, in the words of the accompanying press release, "to enhance the quality and transparency of investors' relationships with investment advisers and broker-dealers while preserving access to a variety of types of advice relationships and investment products." The proposals consist of:

- A new Regulation Best Interest (Regulation BI), requiring a broker-dealer to act in the best interest of a retail customer when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer (Release No. 34-83062);

- Interpretive guidance reaffirming and, in some cases, clarifying the SEC's views of the fiduciary duty that investment advisers owe to their clients (Release No. IA-4889); and

- A requirement to provide a new short-form relationship summary called Form CRS (for client or customer relationship summary)(Release Nos. 34-83063 and IA-4888).

The public comment period officially closed on August 7, 2018. In a speech on December 6, 2018, Chairman Jay Clayton said that in 2019 completing the SEC's rules relating to the standards of conduct for financial professionals would be a key priority for the Commission.[1]

BACKGROUND

The SEC began to look seriously at the question of fiduciary duty and potential consumer confusion about the role of brokers and investment advisers in the mid-2000s. In 2006, the SEC commissioned a study by the RAND Institute for Civil Justice on Investor and Industry Perspectives, in which RAND concluded,

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1 Jay Clayton, "SEC Rulemaking Over the Past Year, the Road Ahead and Challenges Posed by Brexit, LIBOR Transition and Cybersecurity Risks," available at www.sec.gov/news/speech/speech-clayton-120618.

after a study that included a survey of 654 households, that there was significant confusion among investors about the difference between investment advisers and brokers, caused in part by the proliferation of titles such as "financial advisor" and "financial consultant."

Section 913 of the Dodd-Frank Act (2010) required the SEC to conduct a study of the effectiveness of existing legal or regulatory standards of care for providing personalized investment advice and recommendations about securities to retail customers and whether there are legal or regulatory gaps or shortcomings relating to standards of care that should be addressed by rule or statute. The SEC issued its Study on Investment Advisers and Broker-Dealers in 2011, recommending implementation of a uniform fiduciary standard, which is different from the tailored approach used in the current proposals.

On April 8, 2016, the Department of Labor (DOL) adopted a new, expanded definition of "fiduciary" that treats persons who provide investment advice or recommendations for a fee or other compensation with respect to assets of an ERISA plan or IRA as fiduciaries in a wider array of advisory relationships than under the previous regulations and guidance (DOL Fiduciary Rule). (See Goodwin Client Alert, DOL Issues Final Fiduciary Rule.) On March 15, 2018, the DOL Fiduciary Rule was vacated by the United States Court of Appeals for the Fifth Circuit.[†] Many financial industry participants and organizations have taken the position that it would be more appropriate for the SEC to establish standards of fiduciary duty for the broker and investment adviser industry in lieu of the DOL Fiduciary Rule. (See for example, the position of SIFMA, which represents broker-dealers, banks and asset managers, and was one of the plaintiffs in the Chamber of Commerce case against the DOL.)

SEC'S TAILORED APPROACH IN THE PROPOSALS

Instead of adopting a uniform fiduciary standard, the SEC has used a tailored approach that applies separate but similar standards of care to broker-dealers and investment advisers that take into account differences in how they serve their customers or clients. Proposed Regulation BI applies to broker-dealers and their individual associated persons (collectively, "brokers"), the proposed interpretation regarding standards of conduct applies to investment advisers and Form CRS applies to both, prescribing disclosure to be provided to broker-dealer customers or investment adviser clients.

REGULATION BEST INTEREST

Under proposed Rule 15*l*-1 of Regulation BI, a broker, when making a recommendation of a securities transaction or investment strategy to a retail customer, will be required to act in the best interest of that

[†] Chamber of Commerce of the U.S.A. et al. v. U.S. Dep't of Labor, et. Al. No. 17-10238 (5th Cir., Mar. 15, 2018).

customer at the time the recommendation is made, without placing the financial or other interest of the broker ahead of the interest of the retail customer. This best interest duty is discharged if the broker complies with the following disclosure obligation, care obligation, and conflict of interest obligations:

- *Disclosure*. The broker must reasonably disclose to the retail customer the material facts relating to the scope and terms of the relationship, including material conflicts of interest associated with the recommendation;

- *Care*. The broker must exercise reasonable diligence, care, skill and prudence to (A) understand the potential risks and rewards associated with the recommendation and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers; (B) have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks and rewards associated with the recommendation; and (C) have a reasonable basis to believe that a series of recommended transactions is not excessive and is in the retail customer's best interest;

- *Conflicts of Interest*. The broker must establish, maintain, and enforce written policies and procedures reasonably designed to identify and then to (A) at a minimum disclose, or eliminate, material conflicts of interest associated with the recommendation; and (B) disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with the recommendation.

KEY ELEMENTS OF THE BEST INTEREST OBLIGATION

Definition of "Retail Customer." In FINRA Rule 2111, the Suitability Rule, and elsewhere in the FINRA rules, a retail customer is a customer that is not an "institutional account," which is defined to include, among other things, a "person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million." For purposes of proposed Rule 15*l*-1, "retail customer" would mean "a person, or the legal representative of such person, who:

(A) Receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer or a natural person who is an associated person of a broker or dealer; and

(B) Uses the recommendation primarily for personal, family, or household purposes."

There is no net worth or income test in this definition; it can apply to billionaires so long as the recommendation is used for personal, family or household purposes. The person who receives the recommendation can be an individual or an entity. For example, a family trust can be a retail customer. A bank acting as custodian or fiduciary of an individual could be a "legal representative" within the meaning of the rule. It is not clear whether an investment adviser acting on behalf of an individual is a legal representative for this purpose. This is an area in which commenters should seek clarification.

When Making a Recommendation. Regulation BI applies when the broker is "making a recommendation of any securities transaction or investment strategy involving securities to a retail customer." In the Regulation BI Release, the SEC states that the term "recommendation" should be interpreted as it is for purposes of existing broker-dealer regulation, including the FINRA Suitability Rule. Consistent with the Suitability Rule, transactions by a broker acting with discretionary authority for a retail customer would be deemed to constitute an implicit recommendation, even if not directly discussed with the customer. The SEC further states that the best interest obligation applies at the time a recommendation is made and would not, for example:

- Extend beyond a particular recommendation or generally require a broker to have a continuous duty to a retail customer or impose a duty to monitor the performance of the account;

- Require the broker to refuse to accept a customer's order that is contrary to the broker's recommendations; or

- Apply to self-directed or otherwise unsolicited transactions by a retail customer, who may also receive other recommendations from the broker-dealer.

Retail Customer Investment Profile. Proposed Rule 15*l*-1(a)(2)(ii)(B) requires a broker to "have a reasonable belief that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks and rewards associated with the recommendation." This is intentionally similar to the customer-specific suitability requirement of FINRA Rule 2111, except that it is not limited to a determination that the recommendation is *suitable* for the customer; the recommendation must be in *the best interest* of the customer. "Retail customer investment profile" is a defined term in the proposed Rule, and would include, but not be limited to: "the retail customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the retail customer may disclose to the broker… in connection with a recommendation." The SEC states that brokers would be able to weigh which elements of the retail customer investment profile are

important to determining whether the recommendation is in the best interest of the client, and to decide that it is not necessary to obtain certain information. The SEC states that, for example, a broker "may conclude that liquidity needs are irrelevant regarding all customers for whom only liquid securities will be recommended."

The SEC proposes to add a paragraph (a)(25) to Exchange Act Rule 17a-3 (Records to Be Made by Certain Exchange Members, Brokers, and Dealers) requiring brokers to make a record of all information collected from and provided to retail customers pursuant to Rule 15*l*-1, as well as information with respect to information that the broker was unable to obtain as a result of the neglect, refusal or inability of the retail customer to provide or update information for the retail customer investment profile. There would be a similar amendment to Rule 17a-4 (Records to Be Preserved by Certain Exchange Members, Brokers, and Dealers), adding paragraph (e)(5), requiring brokers to maintain records required by Rule 17a-3(a)(25) for a period of six years after the earlier of the date the account was closed or the information was obtained.

<u>Conflicts Resulting From Financial Incentives</u>. Proposed Rule 15*l*-1(a)(2)(iii)(B) would require brokers to establish, maintain and enforce written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendation. The SEC states that it believes that the limitation to financial incentives *associated with a recommendation* is appropriate because brokers "often provide a range of services as part of any relationship with a retail customer, many of which would not involve a recommendation, and such services already are subject to general antifraud liability and specific requirements to address associated conflicts of interest."

The SEC also states that Regulation BI would not *per se* prohibit a broker from transactions involving conflicts of interest, such as the following:

- Charging commissions or other transaction-based fees;
- Receiving or providing differential compensation based on the product sold;
- Receiving third-party compensation;
- Recommending proprietary products, products of affiliates or a limited range of products;
- Recommending a security underwritten by the broker or broker-dealer affiliate, including IPOs; recommending a transaction to be executed in a principal capacity;

- Recommending complex products;
- Allocating trades and research, including allocating investment opportunities, such as IPO allocation or proprietary research or advice, among different types of customers and between retail customers and the broker's own account; or
- Considering cost to the broker of effecting the transaction or strategy on behalf of the customer (for example, the effort or cost of buying or selling an illiquid security).

STANDARD OF CONDUCT FOR INVESTMENT ADVISERS

The second item is a proposed interpretation of the standard of conduct for investment advisers. The proposed interpretation addresses, reaffirms, and clarifies the fiduciary duty that an investment adviser owes to its clients under the Investment Advisers Act of 1940 (Advisers Act) and requests comments on three potential enhancements to the duty owed by investment advisers.

Investment Advisers' Fiduciary Duty

The SEC's proposed interpretation highlights the fiduciary standard that exists today for investment advisers under the Advisers Act and provides a high-level summary of past fiduciary duty guidance. The fiduciary standard is, as stated in the release, based on "equitable common law principles and is fundamental to investment advisers' relationships with their clients under the Advisers Act." The SEC generally restates the well-known concept of fiduciary duty comprising the duty of care and duty of loyalty: that an adviser steps into the shoes of its client and adopts the client's goals, objectives, or ends. A client cannot waive and an investment adviser cannot disclose or negotiate away its fiduciary duty to the client.

In addition to requests for comments on specific elements of the proposed interpretation, the SEC identified the following three discrete topics for public comment for prospective rulemaking, topics in which the existing broker-dealer regulatory framework provides certain investor protections that may not necessarily exist in the investment adviser regulatory framework:

Federal Licensing and Continuing Education. Although broker-dealers must be registered with FINRA and meet minimum qualifications such as qualifying exams and continuing education requirements, SEC-registered investment advisers have no such federal requirements. The SEC requests comment on whether a similar licensing regime and continuing education should be required for personnel of SEC-registered investment advisers. State-registered investment advisers and most investment adviser

representatives of SEC-registered advisers are currently subject to state licensing and education requirements.

Provision of Account Statements. Advisers are required under the Advisers Act to provide clients with periodic account statements in only certain circumstances. The SEC believes that many retail clients are uncertain about the fees they pay for advisory services and requests comment on whether SEC-registered investment advisers should be required to provide account statements to clients.

Financial Responsibility. Broker-dealers are required to adhere to comprehensive safeguards of client assets, such as maintaining minimum levels of net capital, segregating customer assets, extensive recordkeeping and reporting requirements, and becoming members of the Securities Investor Protection Corporation. The SEC requests comment on whether investment advisers should be subject to similar requirements that would be additional to those currently applied under the Advisers Act.

PROPOSED FORM CRS

The third item of the proposals is a new disclosure document intended to address retail client confusion on the differences between broker-dealers, investment advisers and dually registered firms, the specific scope of services, fees and costs, and which standards and duties apply to the client's relationship. The proposed client relationship summary form (Form CRS) would require investment advisers and broker-dealers to summarize:

- the relationships and services the firm offers,
- the standard of conduct and the fees and costs associated with those services,
- specified conflicts of interest, and
- whether the firm and its financial professionals currently have reportable legal or disciplinary events.

A firm would provide this summary to a client at the beginning of the client's relationship with the firm and updated information following material changes in the relationship or information previously provided.

The SEC also proposes two new rules, the first restricting broker-dealers and associated persons of broker-dealers from using the term "adviser" or "advisor" when communicating with retail investors, and the second requiring broker-dealers and investment advisers (including their associated and supervised persons) to disclose, in communications with retail clients, the firm's registration status with the SEC.