SEC Proposes Enhanced Standards for Advice to Retail Investors

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The SEC recently **proposed** rules and interpretations seeking to enhance the standard of conduct of broker-dealers and investments advisers when they interact with retail investors. This action comes more than ten years after an SEC-commissioned study by the RAND Corporation found that retail investors generally did not understand the differences between broker-dealers and investment advisers, and seven years after a Dodd-Frank Act-mandated SEC staff study evaluating the need for uniform fiduciary standards between broker-dealers and investment advisers. Although the proposals do not impose a uniform fiduciary duty, as authorized by the Dodd-Frank Act, the set of new requirements would substantially increase the obligations imposed, particularly on broker-dealers, when providing investment advice to retail investors, while attempting to allow the commission-based brokerage model to remain viable. The SEC's proposed standards would differ from the fiduciary duty standards adopted by the Department of Labor (the "**DOL Fiduciary Rule**") to apply to broker-dealers and investment advisers providing advice to certain retirement accounts.[1]

Among other things, the proposals would:

- establish a new "best interest" standard of conduct for broker-dealers when recommending a securities transaction or investment strategy to a retail customer, including that the broker-dealer act without placing its own interests ahead of the retail customer's interests, and disclose and mitigate certain conflicts of interest;
- require both broker-dealers and investment advisers to provide retail investors with a brief form ("**Form CRS**") summarizing the firm's relationship with the investor; and
- restrict broker-dealers and their associated persons from using the term "adviser" or "advisor"; and
- reaffirm and, in some cases, clarify the fiduciary duty standard of conduct for investment advisers.

The proposals contain significant ambiguities which, if adopted as proposed, would result in a number of implementation challenges.

Comments on the proposal are due 90 days after publication in the Federal Register, which has not yet occurred.

[1] In March 2018, the DOL Fiduciary Rule, including the Best Interest Contract Exemption, was vacated by the United States Court of Appeals for the Fifth Circuit. The Fifth Circuit recently denied motions by third parties to intervene and seek *en banc* review and it does not appear that the Department of Labor plans to appeal the decision to the Supreme Court. Before the Fifth Circuit decision, the Department of Labor had postponed the applicability date of the full requirements of the BIC Exemption until July 1, 2019.

Proposed Standard of Conduct for Broker-Dealers—Regulation Best Interest

The SEC's proposed Regulation Best Interest would impose a new standard of conduct for broker-dealers and associated persons when making a recommendation[2] regarding a securities transactions or investment strategies involving securities to a retail customer. Specifically, the broker-dealer or associated person would be required to act in the "best interest"—a standard for which the SEC declined to propose a definition[3]—of the "retail customer" at the time the recommendation is made, without placing the financial or other interests of the broker-dealer or associated person ahead of the interest of the retail customer. A "retail customer" would be defined as a person, or the legal representative of such person (such as a trust that represents the assets of a natural person), who receives a recommendation from a broker-dealer or associated person and uses the recommendation primarily for personal, family, or household purposes. As many legal entities ultimately act on behalf of one or more individuals, and as it may be difficult to know for what purpose particular advice is being used, determining whether a legal entity would be a "retail customer" may present challenges.[4]

To meet the best interest standard, four obligations would have to be satisfied: a "**Disclosure Obligation**," a "**Care Obligation**" and two "**Conflicts of Interest Obligations**" (collectively, the "**Best Interest Obligations**"). The Best Interest Obligations overlap with many existing requirements imposed on broker-dealers, such as suitability requirements under FINRA Rule 2111, but would also expand upon, and, in some cases, be more prescriptive than, existing requirements. In developing Regulation Best Interest, the SEC stated that it attempted to strike a balance between enhancing the applicable standard of conduct, while minimizing the risk that additional regulatory burdens on the broker-dealer commission model may cause investors to lose choice and access to products, services and payment options—a common criticism that the DOL's fiduciary rule faced.

Disclosure Obligation

To satisfy the Disclosure Obligation, the broker-dealer would be required to disclose in writing, prior to or at the time of the recommendation, the "material facts"[5] relating to the scope and terms of the relationship with the retail customer, including all "material conflicts of interest" (discussed below) that are associated with the recommendation. This Disclosure Obligation is separate from the additional Conflict of Interest Obligations and the required Form CRS disclosures, each described below.

The SEC did not propose to specify the form, manner, timing or frequency of the required disclosures, provided that they are given "prior to or at the time of" the recommendation. The SEC suggested that this approach would allow flexibility in determining the most appropriate and effective way to meet the

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[2] FINRA has historically interpreted "recommendation" for purposes of its suitability rule broadly, including where a communication reasonably could be viewed as a "call to action" or a suggestion that the customer engage in a securities transaction. In general, the more individually tailored the communication is to a specific customer or a targeted group of customers, the greater the likelihood that the communication may be viewed as a "recommendation."

[3] The SEC explained that it believes that whether a broker-dealer acted in the best interest of the retail customer when making a recommendation will turn on the facts and circumstances of the particular recommendation and the particular retail customer, along with the facts and circumstances of how the Best Interest Obligations (discussed below) are satisfied.

[4] The definition of "retail" customer differs from the definition used for purposes of proposed Form CRS, as well as the definition for FINRA's existing suitability rule, which would continue to apply. The overlapping but different definitions of retail customer, if adopted, will likely raise implementation challenges for firms, which would have to determine whether an investor is "retail" for at least three different regulatory purposes.

[5] The SEC explained that it would consider the following to be examples of material facts relating to the scope and terms of the relationship: (i) that the broker-dealer is acting in a broker-dealer capacity with respect to the recommendation; (ii) the fees and charges that apply to the retail customer's transactions, holdings and accounts; and (iii) the type and scope of services provided by the broker-dealer.

Disclosure Obligation. It also noted, however, that while some disclosures effectively may be provided in a standardized document at the beginning of a relationship, others may need to be tailored to the particular recommendation. As a result, firms may need to consider whether existing standardized disclosures made prior to making a recommendation to retail investors would be deemed sufficient under the new standard.

Care Obligation

To satisfy the Care Obligation, the broker-dealer would be required to effectively meet FINRA's obligations for "reasonable-basis," "customer-specific," and "quantitative" suitability, but at a "best interest" rather than "suitable" standard. Specifically, broker-dealers and their associated persons would be required to exercise reasonable diligence, care, skill, and prudence to:

- 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;
- 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 specific investment profile and the potential risks and rewards associated with the recommendation; and
- have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile.

In carrying out this obligation, the SEC noted that a broker-dealer would not be required to find the single "best" security or investment strategy for the retail customer, but would be required to consider reasonably available alternatives offered by the broker-dealer. A broker-dealer would be permitted to recommend the more remunerative or more expensive of two reasonably available alternatives, but would need to be able to justify that the recommended product is nonetheless in the best interest of the retail customer in light of the retail customer's investment profile, putting aside the broker-dealer's financial incentives. If the products are substantially identical, other than one being more expensive, the broker-dealer would likely not be able to justify recommending the more expensive product.

Conflict of Interest Obligations

To satisfy the Conflict of Interest Obligations, the broker-dealer would be required to establish, maintain, and enforce written policies and procedures reasonably designed to:

- identify and at a minimum disclose, or eliminate, all "material conflicts of interest"[6] that are associated with such recommendations; and
- identify and disclose ***and mitigate***, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations.

In other words, while a broker-dealer could satisfy its obligation by disclosing non-financial material conflicts of interest, disclosure alone would not suffice for material conflicts of interest that arise from financial incentives. Rather, the broker-dealer would have to adopt policies to affirmatively mitigate

[6] The SEC proposed to interpret a "material conflict of interest" for purposes of Regulation Best Interest as a conflict of interest that a reasonable person would expect might incline a broker-dealer—consciously or unconsciously—to make a recommendation that is not disinterested. The breadth of this proposed definition may pose challenges for firms.

conflicts arising from financial incentives, if not eliminate them. Conflicts arising from "financial incentives" associated with a recommendation would include:

- compensation practices established by the broker-dealer, including fees and other charges for the services provided and products sold;
- employee compensation or incentives (e.g., quotas, bonuses, sales contests, special awards, differential or variable compensation, incentives tied to appraisals or performance reviews);
- compensation practices involving third parties, including both sales compensation and compensation that does not result from sales activity, such as compensation for services provided to third parties (e.g., sub-accounting or administrative services provided to a mutual fund);
- receipt of commissions or sales charges, or other fees or financial incentives, or differential or variable compensation, whether paid by the retail customer or a third party;
- sales of proprietary products or services, or products of affiliates; and
- transactions that would be effected by the broker-dealer (or an affiliate thereof) in a principal capacity.

Although the SEC indicated that it is seeking to preserve the broker-dealer commission-based business model, that model raises inherent conflicts of interests arising from financial incentives (e.g., where firms are compensated only if transactions occur or where different recommendations would result in disparate compensation). It is not clear how firms would demonstrate that they have sufficiently mitigated these conflicts inherent in broker-dealer business models.

SEC Interpretive Guidance

In discussing the proposed Regulation Best Interest, the SEC provided a number of important interpretive clarifications, including the following points:

- Regulation Best Interest would apply only "when making" a recommendation. It would not, for example, generally require a broker-dealer to have a continuous duty to a retail customer or impose a duty to monitor the performance of the account.
- Scienter would not be required to establish a violation of Regulation Best Interest.
- Regulation Best Interest is not intended to create any new private right of action or right of rescission.
- Retail customers would not be able to waive the protections of Regulation Best Interest by contract.
- The Best Interest Obligations would not extend to recommendations of account types generally, unless the recommendation is tied to a securities transaction or investment strategy involving securities (e.g., to roll over or transfer assets such as IRA rollovers).
- When a requirement of proposed Regulation Best Interest is similar to an existing SRO standard, the SEC would expect—at least as an initial matter—to take into account the SRO's interpretation and enforcement of its standard when interpreting and enforcing Regulation Best Interest.

Relation to DOL Rule

The Regulation Best Interest proposal took into account and has similarities to the Best Interest Contract Exemption ("**BIC Exemption**") from certain prohibited transaction provisions contained in the DOL Fiduciary Rule. As described in Davis Polk's **visual memorandum** on the DOL Fiduciary Rule, the BIC Exemption would allow persons who are deemed investment advice fiduciaries under the DOL Fiduciary Rule, such as broker-dealers making recommendations in connection with certain retirement accounts, to receive various forms of compensation (e.g., brokerage commissions) that would be prohibited in the absence of an exemption. Reliance on the BIC Exemption would require, among other things, that advice be in a retirement investor's best interest, where "best interest" means that the person providing the advice acts "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use…without regard to the financial or other interests" of the person. The standard of care under the SEC's proposed Best Interest Obligations reflects an effort by the SEC to be more practical than the DOL Fiduciary Rule, as the SEC indicated that the standard under the Best Interest Obligations is not intended to prohibit broker-dealers from having conflicts when making a recommendation and the Care Obligation only requires broker-dealers to have a "reasonable basis to believe" that their recommendations are in the retail customer's best interest. In what now appears to be the unlikely event that the DOL Fiduciary Rule is upheld and ultimately goes into full effect, firms would have to comply with both regimes when providing recommendations to retail customers in connection with their retirement accounts.

Recordkeeping and Retention

In connection with Regulation Best Interest, the SEC proposed to amend Rule 17a-3 under the Securities Exchange Act of 1934 generally to require broker-dealers to create a record of all information collected from and provided to each retail customer pursuant to Regulation Best Interest, as well as the identity of each associated person, if any, responsible for the account. In addition, the SEC proposed to amend Exchange Act Rule 17a-4 to require that such information be retained for at least six years.

Proposed Form CRS

The SEC is proposing to require registered broker-dealers and registered investment advisers to deliver a relationship summary to retail investors[7] in the form of proposed Form CRS. Form CRS would be a short (limited to four pages or the electronic equivalent) written disclosure statement in a highly prescriptive format that would include the following sections:

- introduction;
- the relationships and services the firm offers to retail investors;
- the standard of conduct applicable to those services;
- the fees and costs that retail investors will pay;
- comparisons of brokerage and investment advisory services (for stand-alone broker-dealers and investment advisers);
- conflicts of interest;

[7] For this purpose, a "retail investor" would be defined as a prospective or existing client or customer who is a natural person. The definition would include a trust or other similar entity that represents natural persons. As noted above, this definition of "retail investor" would differ from the definition of "retail customer" used in Regulation Best Interest, which is limited to persons who receive investment advice primarily for personal, family or household purposes.

- where to find additional information, including whether the firm and its financial professionals currently have reportable legal or disciplinary events and who to contact about complaints; and
- key questions for retail investors to ask the firm's financial professionals.

The SEC explained that the relationship summary would be designed to facilitate comparisons across firms that offer the same or substantially similar services. To accomplish this goal, much of the content and presentation of Form CRS would be prescribed by the form's instructions and firms would be prohibited from including any information other than what the form's instructions and the applicable item require or permit. Firms would also be required to use "plain language" principles taking into consideration retail investors' level of financial sophistication. To demonstrate the SEC's expectations for Form CRS, the SEC attached to the proposal mock-ups illustrating how Form CRS might be completed for hypothetical firms.

Delivery, Updating and Filing Requirements

Firms would have to comply with a number of requirements relating to the delivery, updating and filing of Form CRS.

- Initial Delivery: For investment advisers, the Form CRS initially would be delivered before or at the time the firm enters into an investment advisory agreement with the retail investor. For broker-dealers, initial delivery would occur before or at the time the retail investor first engages the firm's services.
- Delivery to Existing Clients: A firm would be required to provide a relationship summary to an existing client or customer who is a retail investor before or at the time a new account is opened or changes are made to the retail investor's account(s) that would materially change the nature and scope of the firm's relationship with the retail investor.
- Updating Form CRS: A firm would be required to update its relationship summary within 30 days whenever the relationship summary becomes materially inaccurate, and communicate without charge the information in an amended relationship summary to retail investors who are current clients of the firm within 30 days after the updates are required to be made.
- Filing with the SEC: Firms would be required to electronically file the relationship summary with the SEC (through EDGAR, for broker-dealers, and IARD, for investment advisers), which would then be made available on the SEC's public disclosure website.
- Website Posting: Firms would also be required to post the latest version of the relationship summary on their websites. Firms that do not maintain a website would be required to include in their relationship summaries a toll-free number for investors to call to obtain documents.
- Delivery on Request: A firm would be required to deliver the relationship summary to a retail investor within 30 days upon request.

Restrictions on the Use of Certain Names and Titles and Required Disclosures

In connection with the Form CRS proposals, the SEC is also proposing to restrict broker-dealers and associated persons, when communicating with a retail investor, from using as part of a name or title the term "adviser" or "advisor," unless the broker-dealer is an investment adviser registered with the SEC or a State, or the associated person is supervised by, and provides investment advice on behalf of, such an investment adviser.

Similarly, the SEC is proposing to require broker-dealers and investment advisers (and their associated persons) to prominently disclose in print or electronic communications with retail investors whether the firm is a registered broker-dealer or registered investment adviser.

Proposed Interpretation Regarding Standard of Conduct for Investment Advisers

In light of the Regulation Best Interest and Form CRS proposals, the SEC has also proposed to reaffirm, and in some cases clarify, in a single release certain aspects of the fiduciary duty that an investment adviser owes to its clients under Section 206 of the Advisers Act (the "**IA Proposal**").

In that regard, the IA Proposal seeks to restate clearly the fundamental elements of an investment adviser's duty of loyalty and duty of care, including duties to provide advice that is in the client's best interest, to seek best execution, to act and to provide advice and monitoring over the course of the advisory relationship, and to put its clients' interests ahead of its own. While most, if not all, of the ground covered by the IA Proposal's restatement of an adviser's fiduciary duty is familiar, it is notable that the SEC has sought to compile in a single interpretation a wide body of law that has heretofore been dispersed across numerous rules, court decisions, SEC releases and other guidance.

Request for Comment

Additionally, the SEC has requested comment on (i) whether the proposed interpretation offers sufficient guidance concerning an adviser's fiduciary duty under Section 206 of the Advisers Act; (ii) whether there are any significant issues related to the fiduciary duty that are not addressed in the IA Proposal; and (iii) whether it would be beneficial for investment advisers or broker-dealers if any portion of the proposed interpretation were codified under the Advisers Act.

The IA Proposal also contains a request for comment regarding three areas of potential enhanced investment adviser regulation, noting that there are a few discrete areas of broker-dealer regulation that provide additional protections to investors that may not have counterparts in the investment adviser context, including (i) federal licensing and continuing education requirements; (ii) the provision of account statements to clients; and (iii) financial responsibility requirements. These questions will be considered along with any "future proposed rules or other proposed regulatory actions with respect to these matters."

Impact of Investment Discretion on "Solely Incidental" Exception for Broker-Dealers

Section 202(a)(11)(C) of the Advisers Act excludes from the definition of investment adviser a broker-dealer whose performance of advisory services is "solely incidental" to the conduct of the broker-dealer's business and who receives no special compensation for those services (the "**broker-dealer exclusion**"). The SEC has over the years scrutinized the scope of this exclusion and considered whether the advice inherent in a broker-dealer exercising investment discretion over a customer account can be considered solely incidental to its broker-dealer business. Although it did not propose a new formal interpretation or approach to the broker-dealer exclusion, in light of Regulation Best Interest and the other proposed rules, the SEC requested comment on whether a broker's exercise of investment discretion (whether or not limited) should render it an investment adviser subject to the Advisers Act.

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