FIDUCIARY STANDARD REFORM - THE SEC ENTERS THE RING

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U.S. ERISA Fiduciary Alert

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An investment professional who provides advice to an investor who has a 401(k), an annuity, and a brokerage account is subject to regulation by no less than five regulators: the Securities and Exchange Commission ("Commission"), Financial Industry Regulatory Authority ("FINRA"), the Department of Labor ("DOL"), state securities regulators, and state insurance regulators. [1] On April 18, one of those regulators, the Commission, prominently asserted itself into the fray surrounding fiduciary standard reform.

At the end of an open meeting that was widely viewed via live webcast, the Commission voted 4-1 to release a set of proposals for public comment. According to the Commission, the proposals seek to enhance retail investor (including retirement investor) protection and decision making, preserve retail investor access in terms of choice and cost to a variety of types of investment services and products and raise retail investor awareness of whether they are transacting with registered financial professionals. The proposals consist of three components: a best interest duty of care rule; a rule that requires certain disclosures for broker-dealers and investment advisers (each an "IA") who work with retail investors and addresses the labeling of investment professionals; and an interpretation of the standard of conduct for IAs under the Investment Advisers Act of 1940 (the "Advisers Act").

REGULATION BEST INTEREST

The Commission proposed a new rule called "Regulation Best Interest," which would impose a duty on registered broker-dealers when making recommendations to retail customers. [2] Broker-dealers would be required to act in the best interest of the retail customer at the time the recommendation is made, without putting the financial or other interest of the broker-dealer ahead of the retail customer. This best interest duty is discharged if the broker-dealer complies with a disclosure obligation, a care obligation, and two conflict of interest obligations.

Specifically, the disclosure obligation requires the broker-dealer to 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. This disclosure obligation could be satisfied by the delivery of the proposed Form CRS described below.

For the care obligation, when making a recommendation to a retail customer, broker-dealers 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 would 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 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 is not excessive and is in the retail customer's best interest.

A broker-dealer's current standard of care requires a reasonable basis to believe that a recommended transaction or investment strategy is suitable for the retail customer, based on the information obtained through reasonable diligence to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the 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 customer may disclose to the broker-dealer or its associated persons in connection with such recommendation. [3] The reasonable-basis obligation requires that the recommendation is suitable for at least some investors as well as for the specific customer. [4]

For the conflict of interest obligations, the proposed rule would require broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to identify and then to:

At a minimum disclose, or eliminate, material conflicts of interest associated with the recommendation; and

Disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with the recommendation.

The proposed rule is designed to do more than require broker-dealers to simply disclose conflicts of interest. The Commission singled out sales practices such as contests, trips, and prizes as inherently risky.

The proposed rule was criticized by several of the Commissioners, most harshly by Commissioner Kara Stein in a blistering dissent, for, among other things, failing to define the term “best interest.” It remains to be seen if or how this term will be defined after the comment period for the proposal.

FORM CRS

The Commission also proposed a new form, called Form CRS, which is short for Customer/Client Relationship Summary. Form CRS is designed to help investors understand what type of investment professional they are working with and what fees, conflicts, and other material factors might affect their relationship. The form requires IAs and broker-dealers to provide a brief relationship summary to retail investors to (1) inform them about the relationships and services their firms offer, (2) outline the standard of conduct and the fees and costs associated with those services, (3) identify specified conflicts of interest, and (4) disclose whether the firm and its financial professionals currently have any reportable legal or disciplinary events. Retail investors would receive Form CRS, which will be standardized and can be no longer than four pages, at the beginning of a relationship with an IA or broker-dealer, and would receive updated information following any material change.

To assist broker-dealers, IAs, and retail customers in visualizing what Form CRS will look like, the Commission provided mock-up forms in its proposing release. The Commission recognized that electronic and graphic presentations could be more effective for many investors, and the release specifically permits broker-dealers and IAs to use electronic communications and graphics to meet their Form CRS obligations, provided that such presentations are consistent with the content requirements and page limits of the form.

Finally, recognizing that investors may often be confused by titles used by investment professionals and the differences between them, the Commission proposed a new rule under the Exchange Act that would prohibit broker-dealers and their associated persons from using the term “adviser” or “advisor” as part of their names or titles when communicating with retail investors, unless such broker-dealers are dually registered as IAs. [5]

INTERPRETATION OF STANDARD OF CONDUCT FOR INVESTMENT ADVISERS

The Commission also proposed to issue interpretative guidance with respect to the applicable standard of conduct for IAs under the Advisers Act, which is intended to reaffirm, and in some instances clarify, the terms of the fiduciary relationship that IAs have with all investors (the “Proposed Guidance”). Additionally, the Commission voted to request feedback regarding whether the Commission should propose rules requiring IAs to meet certain investor protection requirements that are already applicable to broker-dealers, including licensing and continuing education requirements, a requirement to deliver account statements, and financial responsibility requirements (e.g., net capital and fidelity bonding).

Through the Proposed Guidance the Commission voted to reaffirm the fact that in its view IAs have a fiduciary duty to their clients enforceable under the anti-fraud provisions of the Advisers Act. The Proposed Guidance acknowledges that an IA's fiduciary duty is not specifically defined in the Advisers Act or in Commission rules, but rather reflects a Congressional recognition with the adoption of the Advisers Act “of the delicate fiduciary nature of an investment advisory relationship” as well as a Congressional intent to “eliminate, or at least to expose, all conflicts of interest which might incline an [IA] – consciously or unconsciously – to render advice which was not disinterested.” [6]

The Proposed Guidance notes that an IA's fiduciary standard of conduct is based on equitable common law principles of fiduciary duty, and imposes on IAs both a duty of care and a duty of loyalty to the client. The fiduciary duty of IAs requires the IA to act in the best interests of the client and not to subordinate the client's interests to its own. Notwithstanding these duties, the Proposed Guidance reaffirms the ability of the IA and the client to shape the relationship through the negotiation of a detailed investment advisory agreement, provided that the client receives full and fair disclosure and provides informed consent to the terms of the agreement. However, the Proposed Guidance also confirms that the IA cannot disclose or negotiate away, and the client cannot waive, the fiduciary duty.

With respect to the required duty of care, the Proposed Guidance states that, among other things, IAs have a duty to: (i) act and to provide advice that is in the best interest of the client, (ii) seek best execution of a client's transactions where the adviser has the responsibility to select broker-dealers to execute client trades, and (iii) provide advice and monitoring over the course of the relationship. With respect to the duty of loyalty, the Proposed Guidance states that IAs must not favor their own interests over those of a client, and must not unfairly favor the interests of one client over another. In meeting this duty, the Proposed Guidance states that IAs must, among other things, (i) seek to avoid conflicts of interests with its clients and (ii) make full and fair disclosure to clients of all material facts related to the advisory relationship, including with respect to any material conflict of interest that could affect the relationship. The Proposed Guidance offers the views of the Commission on how to comply with these aspects of the duty of care and the duty of loyalty.

The Commission noted that it has identified a few discrete areas where the current broker-dealer regulatory framework provides investor protections that do not have counterparts under the Advisers Act or the regulations

thereunder. As a result, the Commission is seeking comment regarding whether the Commission should adopt regulations imparting such requirements for IAs. Accordingly, the Commission has posed a number of questions related to whether it should consider:

Implementing federal licensing and continuing education requirements for investment adviser representatives;

Creating an express requirement for IAs to deliver periodic account statements, including specific fee and expense information to clients; and

Establishing a comprehensive financial responsibility program, including net capital and fidelity bonding requirements.

CONCLUSION

While IAs and broker-dealers crave certainty - “tell me what I need to do” is a common refrain - it could take some time before fiduciary reform takes hold. The Commission's proposals are subject to a comment period and, like the DOL's fiduciary rule, could encounter legal challenges. During the Commission's April 18 open meeting, the Commissioners acknowledged that there is much more work to be done on the proposals before they become final rules.

Some have speculated that the Commission's proposals could make it easier for the DOL to walk away from its own rule. In the coming days, we will see if the DOL appeals the 5th Circuit's mid-March ruling that vacated the DOL's fiduciary rule. [7] Adding to the uncertainty around fiduciary reform, several states, including Connecticut, Maryland, Nevada, New Jersey, and New York have passed or are considering their own fiduciary bills. [8] IAs, broker-dealers and investors will need to continue to go about their business in this uncertain environment for the foreseeable future.

Notes:

[1] “Overview of the Standards of Conduct for Investment Professionals Rulemaking Package”, Public Statement, Chairman Jay Clayton, April 18, 2018.

[2] “Retail Investors” are defined as prospective or existing clients or customers who are natural persons, regardless of account type or net worth. See Proposed Rule 17a-14(e)(2) under the Securities and Exchange Act of 1934 (“Exchange Act”).

[3] FINRA Rule 2111.

[4] FINRA Rule 2111.

[5] *See* Proposed Rule 15l-2 under the Exchange Act.

[6] *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963) (“SEC v. Capital Gains”).

[7] On March 15, 2018, the 5th Circuit issued an opinion that vacated the DOL's fiduciary rule and related prohibited transaction exemptions in their entirety. U.S. Chamber of Commerce v. DOL, No. 17-10238, 2018 WL 1325019 (5th Cir. Mar. 15, 2018). Vacatur will take effect when the court issues its “mandate”, which could happen as early as May 7, 2018. The DOL has until April 30, 2018, to request a rehearing.

[8] Fin. Consumer Protection Act of 2018, 2018 MD S.B. 1068 (NS); 2018 N.J. S.B. No. 735, N.J. 218th Legislature, 2018 First Annual Session, 2018 N.J. S.B. 735 (NS) (Jan. 9, 2018); Fin. Planners-Investments-Fiduciary Duties, 2017 Nevada Laws Ch. 322 (S.B. 383) (July 1, 2017); Retirement & Pensions-Administration-Adverse or Pecuniary Interest-Disclosure, 2017 Conn. Pub. Acts No. 17-142; Proposed First Amendment to Suitability in Life Insurance and Annuity Transactions, 11 NYCRR 224, available at https://www.dfs.ny.gov/insurance/r_prop/rp187a1text.pdf.

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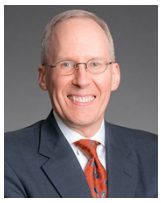

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