SEC ADOPTS BROKER-DEALER BEST INTEREST STANDARD, DISCLOSURE DUTIES FOR BROKER-DEALERS AND INVESTMENT ADVISERS, AND PUBLISHES KEY INTERPRETATIONS

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U.S. Investment Management Alert

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At an Open Meeting on June 5, 2019, and after over a year of consideration, approximately 6,000 comment letters and investor testing, the Securities and Exchange Commission ("SEC" or "Commission") formally adopted four regulatory measures intended to enhance the protection of retail investors while preserving existing investment industry business models and the ability of investors to choose among different types of providers. Specifically, the SEC adopted:

- New Regulation BI (for "Best Interest");
- New Form CRS (for "Customer Relationship Summary");
- An interpretation of an investment adviser's fiduciary duties ("IA Interpretation"); and
- An interpretation of the "solely incidental" prong of the broker-dealer exclusion from the definition of an "investment adviser" under the Investment Advisers Act of 1940 ("Advisers Act") ("Solely Incidental Interpretation" and with the IA Interpretation, the "Interpretations").

The following is a summary of the Commission's actions. We will be publishing additional client alerts with more detailed analyses of each of the above in the near future. In addition, we will host a telephone conference for clients and other industry contacts on June 11th as an open forum to discuss these rules and the interpretations. To participate in the conference, please click here.

I. THE OPEN MEETING.

SEC Chairman Clayton clarified that the Commission would not adopt a uniform standard of care for broker-dealers and investment advisers, on the grounds that doing so would increase the costs of investment and reduce investor choices. He also emphasized the preeminence of the SEC as the regulator with the most interest and expertise in the oversight of investment advisers and broker-dealers. He maintained that multiple standards among different states would raise costs for investors and make law enforcement more difficult.

The vote to adopt each of the new measures was 3–1, with a strong dissent from Commissioner Jackson, who asserted that the package's "weak mix of measures" was not likely to improve the advice that retail investors need. He encouraged industry participants and investors to "keep pushing for meaningful protections in the states who choose to give their citizens the best chance for a safe retirement."

In the past year, several state securities regulators have proposed to adopt rules to apply fiduciary-based standards to securities broker-dealers. In addition, according to its Spring 2019 Regulatory Agenda, the Department of Labor ("DOL") has not abandoned rulemaking on fiduciary duties. In the absence of the preemption of state regulation or further statements from DOL, we are likely to see further action in this space.

II. TIMING.

Broker-dealers and their natural-person "associated persons" (hereinafter "broker-dealers") must begin complying with Regulation BI, and broker-dealers and SEC-registered investment advisers will be required to prepare, deliver to retail investors, and file relationship summaries pursuant to Form CRS requirements by June 30, 2020.

The Interpretations, on the other hand, will be effective immediately upon publication in the *Federal Register*.

III. KEY POINTS.

A. Regulation Best Interest.

Regulation BI establishes a new standard of conduct that requires broker-dealers (and their associated persons) to act in the "best interests" of their "retail clients" [1] when recommending securities and investment strategies. The best interest standard is intended to enhance current duties of suitability and fair dealing that historically have applied to a broker-dealer's business. Regulation BI imposes four obligations on broker-dealers in their recommendations of securities and investment strategies to retail customers:

- *Disclosure.* A broker-dealer will be required to disclose the material facts about the relationship and recommendations, including information as to fees, conflicts, the broker-dealer's capacity in providing services, and, to the extent formally agreed upon, account monitoring.
- *Care.* A broker-dealer will be required to exercise reasonable diligence, care, and skill when making a recommendation. This will entail understanding the risks, rewards, and costs of any recommended transaction or series of transactions, considering these factors in light of the retail customer's investment profile, and having a reasonable basis to believe that the recommendation is in the best interest of the retail customer (and not excessive in the case of a series of recommended transactions), and does not place the financial or other interests of the broker-dealer ahead of the interest of the customer.
- *Conflicts.* A broker-dealer will be required to implement written policies and procedures reasonably designed to identify and, at a minimum, disclose or eliminate conflicts of interest, including specific policies and procedures to:
    - Mitigate conflicts that may motivate the broker-dealer's associated persons to place their interests, or the interests of their firm, ahead of the customer's;
    - Prevent material limits on offerings, such as a limited or proprietary-only product menu, from causing the firm or its associated persons to place their interests ahead of the customer's; and
    - Eliminate sales contests, quotas, bonuses, and non-cash compensation that are based on the sale of specific securities or specific types of securities within a limited period of time.
- *Compliance Policies and Procedures.* A broker-dealer will be required to implement written policies and procedures reasonably designed to ensure compliance with Regulation BI as a whole.

Finally, the Commission declined to issue a specific rule prohibiting broker-dealers from using the term "adviser" or "advisor" in their name or title, but indicated in the release adopting Regulation BI, that a broker-dealer's or associated person's use of those terms in a name or title would amount to a violation of Regulation BI's disclosure obligations (unless the firm was also registered as an investment adviser). This will require some firms to undergo significant branding changes as a result.

B. CUSTOMER RELATIONSHIP SUMMARY.

As was originally proposed, both investment advisers and broker-dealers will be required to provide relationship summaries on Form CRS to retail investors at the outset of their relationship. Firms will have to file the Form CRS with the SEC and will be required to periodically update the Form as information becomes outdated or otherwise inaccurate. These Forms will be in a uniform, machine-readable format in order to assist with comparisons of services from different brokerage and advisory service providers. The Form CRS will include references to investor education resources and "conversation starter" questions for investors to take up with their investment professional. The final Form CRS has been modified from the proposed version in order to permit broker-dealers and investment advisers to have more flexibility in their descriptions of services. The Form CRS will also include a section for disclosure of disciplinary histories.

C. INVESTMENT ADVISER FIDUCIARY STANDARD INTERPRETATION.

The Commission's Best Interest package of proposals included a proposed interpretation of the fiduciary standards that apply to advisers under the Advisers Act. The final version approved by the Commission is generally consistent with the proposal from April of 2018. The final version also includes provisions that summarize the Commission's views regarding an adviser's services to institutional clients. Thus, the IA Interpretation reaffirms that an investment adviser has a nonwaivable fiduciary duty to its clients, but also notes that the parties to an advisory agreement are free to negotiate individualized terms.

At the Open Meeting, SEC Chairman Clayton stated his view, and the SEC Staff confirmed, that the final IA Interpretation could not be read to weaken or reduce the fiduciary standard of care that applies to investment advisers under the Advisers Act and established case law and that any criticism to that effect was "clearly misguided."

D. SOLELY INCIDENTAL INTERPRETATION.

The Commission also approved an Interpretation of the "solely incidental" prong of Section 202(a)(11)(C) of the Advisers Act, which provides an exclusion from the definition of "investment adviser" for certain securities broker-dealers. A broker-dealer whose performance of advisory services is "solely incidental" to the conduct of business as a broker-dealer and who receives no special compensation for those services is not deemed to be an investment adviser. [2]

The newly released Interpretation is intended to confirm and clarify the Commission's prior interpretations of the term "solely incidental." In brief, it states that a broker-dealer's advice as to the value and characteristics of securities or as to the advisability of transacting in securities falls within the "solely incidental" prong of this exclusion "if the advice is provided in connection with and is reasonably related to the broker-dealer's primary business of effecting securities transactions." [3]

The Solely Incidental Interpretation discusses the circumstances where the possession of discretion over a customer account would not be deemed "solely incidental." Although unlimited discretion would not be solely incidental to brokerage, and thus trigger investment adviser status for broker-dealers, the Solely Incidental Interpretation confirms that discretion that is "limited in time, scope, or other manner and lacks [such] comprehensive and continuous character" would not. It provides examples of limited discretion that would not trigger adviser status, such as time and price discretion, discretion on an infrequent or isolated basis, or discretion to purchase any bond with a specified credit rating and maturity.

Finally, the Solely Incidental Interpretation discusses the practice of account monitoring by broker-dealers and confirms that a broker-dealer's review of accounts (whether on a periodic basis or otherwise) would not automatically fall outside the "solely incidental" prong of the exclusion. The Commission suggested that broker-dealers and investment advisers may wish to create account monitoring policies and procedures for personnel that are tailored to their proper capacities.

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Every U.S. investment adviser and broker-dealer, regardless of whether they have retail customers or not, will need to consider whether and how these measures impact their regulatory obligations. Please register for our telephone conference for clients and other industry contacts on June 11th to discuss these actions in more detail. To participate in the conference, please click here.

NOTES

[1] In brief, a "retail customer" is defined as a natural person (or their legal representative) who receives and uses a securities recommendation primarily for personal, family, or household purposes and includes natural persons having assets of at least $50 million that are defined under FINRA Rule 4512(c)(3) as an "institutional account."

[2] 15 USC § 80b-2(a)(11). The SEC only permits this exclusion for broker-dealers that are registered with the SEC.

[3] *Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser*, SEC Rel. No. IA-5249, at 12 (Jun. 5, 2019).

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