

SEC Proposes Broker-Dealer and Investment Adviser Standard of Conduct Rules and Interpretations to Enhance Retail Investor Protections and Transparency

On April 18, 2018, the SEC proposed a package of rulemakings and interpretations aimed at increasing transparency in the relationships of clients with their broker-dealers and investment adviser and address investor confusion regarding the duties and obligations across different types of investment professionals.¹ A summary of the new SEC proposals can be found below.

Exchange Act Regulation Best Interest

As proposed, Regulation Best Interest would require broker-dealers to act in the best interest of their retail customers when making recommendations as to securities transactions or an investment strategy and would prohibit broker-dealers from putting their own financial interests ahead of those of retail customers when making such recommendations.² Broker-dealers would be able to discharge this duty to retail customers in the following three ways:

1. Disclosure – Broker-dealers (or natural persons who are associated persons of broker-dealer) would be obligated to disclose in writing to retail customers the material facts relating to the broker-dealer and client relationship, including a disclosure of fees and material conflicts of interest prior to or at the time of any such recommendation.
2. Care – Broker-dealers (or natural persons who are associated persons of broker-dealer) would be obligated when making a recommendation to a retail customer to exercise reasonable diligence, care, skill and prudence to (a) understand the risks and rewards of the investment product being recommended and that the recommendation was in the best interests of at least some retail customers, (b) have a reasonable basis to believe that the product is in the best interest of a particular retail customer based upon that retail customer's investment profile, and (c) have a reasonable basis to believe that a series of transactions, even if the recommendation is in the retail customer's best interest when viewed in isolation, is not excessive and would be in the best interest of the retail customer when considering the retail customer's investment profile.
3. Conflicts of Interest – Broker-dealers (or natural persons who are associated persons of broker-dealer) would be obligated to adopt and implement policies and procedures

Related Capabilities

- Securities & Financial Services Litigation & Enforcement
- Investment Management

that would identify, disclose and mitigate, or eliminate material conflicts of interest that arise as a result of a broker-dealer's financial incentives associated with a broker-dealer's recommendation to retail customers.

The SEC believes that proposed Regulation Best Interest would improve investor protection by enhancing the professional standards of conduct that currently apply to broker-dealers when they make recommendations to retail customers. Furthermore, the SEC believes that the best interest obligation will reduce the potential harm to retail customers from recommendations provided in circumstances where conflicts of interest, including those arising from financial incentives, exist while preserving investor access to advice and choice with regard to advice relationships and compensation methods, and is workable for the transaction-based relationship offered by broker-dealers.

Proposed Regulation Best Interest would only apply to retail customers, as defined in the proposed rule. A retail customer would be a person (or their legal representative) who 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 uses the recommendation primarily for personal, family, or household purposes.

Notably, the SEC stated in the proposing release that proposed Regulation Best Interest would not create a new private right of action nor would it create a new right of rescission.

As proposed, Regulation Best Interest purportedly proposes a standard of conduct for broker-dealers however, it does not define what "best interest" means in the text of the proposed rule. Further, it remains to be seen how meaningful overlap of Regulation Best Interest with the existing FINRA requirement of fair dealing and the suitability standard currently applicable to broker-dealers and the fiduciary standard applicable to investment advisers will be addressed or resolved.

Investment Adviser Fiduciary Duty Interpretation

In light of the SEC's proposal of Regulation Best Interest, the SEC issued an interpretation to reaffirm and in some cases clarify the fiduciary duty that an investment adviser owes to its clients under the anti-fraud provisions of Section 206 of the Investment Advisers Act of 1940, as amended.³ The interpretation provides a full discussion on the implied duty of care (i.e., to provide advice that is in the client's best interest, to seek best execution and to provide advice and monitoring over the course of the relationship) and the duty of loyalty (to put client's interest first, not to favor one client over another, to make full and fair disclosure and avoid conflicts of interest). In addition, the interpretation requests comment on whether there are any significant issues the interpretation has not address and whether the fiduciary duty should be codified under Investment Advisers Act Section 206. The interpretation also includes a request for comment regarding areas of enhanced investment adviser regulation, including, federal licensing and continuing education to address minimum and ongoing competency requirements for personnel, provision of accounts statements specifying the dollar amounts of fees and expenses and financial responsibility, such as net capital and

fidelity bonding requirements.

Client Relationship Summary—New Form CRS and Form ADV Part 3

In furtherance of achieving greater transparency and informing retail investors about the relationships and services their investment professionals offer, the SEC would require that broker-dealers and investment advisers to provide a short form “client relationship summary” document to retail investors.⁴ Limited to four pages in length, the client relationship summary would provide disclosures to retail investors outlining eight separate items covering:

1. an introduction briefly explaining the types of accounts and services the firm offers generally;
2. the relationships and services the firm provides to retail investors;
3. the legal standard of conduct applicable to those to those services
4. the fees and costs payable by retail investors for such services,
5. comparisons of brokerage and investment advisory services (for standalone broker-dealers and investment advisers)
6. conflicts of interests, and
7. direction as to where to find additional information, including about the firm’s or its investment professional’s disciplinary history and who to contact about complaints (in fact, the summary must include instructions on reporting problems to the SEC via its investor assistance hotline); and
8. key questions for retail investors to ask the firm’s professionals.

Firms would be required to provide the client relationship summary to their retail investors at the beginning of their relationship with the firm and then again following a material change. For broker-dealers, the client relationship summary would be filed with the SEC on new cForm CRS via EDGAR . For investment advisers, the client relationship summary would be filed with the SEC on new Part 3 of Form ADV via IARD. The client relationship summary for both broker-dealers and investment advisers would be available on the SEC’s public disclosure website. To provide adequate transition time, the relationship summary would not be required to be filed or delivered by broker-dealers or investment advisers until the date six months after the effective date (for investment advisers, as part of the firm’s next annual updating amendment to Form ADV that is required six months after the effective date).

As a visual aid, the SEC has released three mockups of the client relationship summary to give of what the disclosure document may look like: one for investment advisers, one for broker-dealers, and one for dual-registrants.⁵

In addition, this SEC proposal would limit the ability of broker-dealers to identify themselves as “advisors” or “advisers” in communications with retail customers unless the broker-dealer was dually registered with the SEC as an investment adviser. This restriction is an attempt by the SEC to prevent investor confusion about the different roles of broker-dealers and investment advisers and the financial services that are offered by each – confusion that the SEC believes likely arises from the use of misleading titles by market professionals. Broker-dealers and investment advisers—as

well as their associated natural persons and supervised persons, respectively--would also be required to disclose in retail investor communications clearly and directly their SEC registration status and, in the case of associated natural persons and supervised persons, their relationship to the firm, to both current and prospective clients.

These proposals are an effort by the SEC to strengthen and clarify the standard of conduct that broker-dealers and investment adviser owe to their retail customers and provide customers with clear and meaningful disclosure regarding their investment professionals. The proposals include copious requests for comments—reminiscent of the Dodd-Frank rulemaking process. The SEC will be seeking public comments on these proposals over a 90 day period. For more information, please contact Dan Baich and Genna Garver.

¹ <https://www.sec.gov/news/press-release/2018-68>

² <https://www.sec.gov/rules/proposed/2018/34-83062.pdf>

³ <https://www.sec.gov/rules/proposed/2018/ia-4889.pdf>

⁴ <https://www.sec.gov/rules/proposed/2018/34-83063.pdf>

⁵ <https://www.sec.gov/news/public-statement/clayton-overview-standards-conduct-investment-professionals-rulemaking>