

# SEC ADOPTS REGULATION BEST INTEREST

*New rule includes a heightened standard for broker-dealers, among other developments*

By Eric Mikkelson and Gerry Griffith

## REGULATION BEST INTEREST

### Overview

On June 5, 2019, by a vote of 3-1, the SEC adopted [Regulation Best Interest](#) (Regulation BI), using its rule-making authority under the Securities Exchange Act of 1934. Regulation BI closely emulates the proposed rules, [published on April 18, 2018](#).

Regulation BI regulates broker-dealers and associated persons when they make recommendations regarding securities transactions and investment strategies to retail customers. While the adopted rule stops short of establishing a fiduciary duty for broker-dealers, the new standard moves in that direction. According to SEC Chairman Jay Clayton, Regulation BI requires broker-dealers to be “very candid” when advising investors.

Regulation BI heightens broker-dealers’ standard by requiring that, when advising a customer, the broker-dealer must act in the customer’s best interest by placing the customer’s financial and other relevant interests ahead of his or her own and 2 address conflicts of interest by establishing, maintaining and enforcing policies and procedures relating to the conflict. Where addressing the conflict is an insufficient remedy, the broker-dealer must eliminate the conflict. A broker-dealer cannot satisfy the standard through disclosure alone.

### Background

Currently, broker-dealers are governed by “suitability,” a lower standard than the fiduciary duty. In contrast, investment advisers must adhere to a fiduciary standard. Many consumer advocates sought a uniform standard for broker-dealers and investment advisers in order to reduce industry confusion and protect retail investors. However, the SEC opted for an enhanced form of the suitability standard for broker-dealers.

The adopted rule requires a broker-dealer to “**act in the best interest of the retail customer at the time the recommendation is made without placing the financial or other interest of the [broker-dealer] ahead of the interest of the retail customer.**” The SEC opted for a distinct broker-dealer standard due to the differences between services offered by investment advisers and broker-dealers. While a broker-dealer typically provides recommendations on a transactional basis, an investment adviser’s fiduciary duty includes monitoring the customer’s investment and providing ongoing advice. To tailor the rule to broker-dealers’ particular business model, the best interest standard applies at the time of the recommendation.

### Broker-Dealer Best Interest Standard

Regulation BI does not provide a precise definition of “best interest.” Instead, to act in the customer’s best interest, the broker-dealer must fulfill four distinct obligations: (1) the Disclosure Obligation, (2) the Care Obligation, (3) the Conflict of Interest Obligation, and (4) the Compliance Obligation. Whether a broker-

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dealer has acted in the customer's best interest will be determined based on the facts and circumstances present at the time of the recommendation.

### **The Disclosure Obligation**

Under the Disclosure Obligation, the broker-dealer must, prior to or at the time of a recommendation, reasonably disclose to the customer, in writing, all material facts relating to the scope and terms of the relationship with the customer and all material conflicts of interest associated with the recommendation. Examples of material facts include fees and costs that will accrue, the nature and scope of the services provided, and any material limitations on the broker-dealers' recommendations. In addition, the broker-dealer must disclose any conflict of interest relating to a recommendation that might affect the broker-dealer's recommendation.

### **The Care Obligation**

The Care Obligation is a substantive obligation, requiring that the broker-dealer exercise reasonable diligence, care and skill when making a recommendation. Examples of transactions within the Care Obligation include recommendations such as choosing investment account types and whether to rollover a retirement fund. The broker-dealer must consider the customer's risk appetite and investment goals and reasonably believe that, in making recommendations, he or she is not placing the broker-dealer's interests ahead of the customer's.

While cost is an important factor, the SEC will examine cost in light of the customer's investment profile. Further, simply because a broker-dealer only offers a limited number of products does not excuse the broker-dealer from acting in the best interest of the customer. Whether a broker-dealer has satisfied the care obligation is evaluated at the time of the recommendation, not in hindsight.

### **The Conflict of Interest Obligation**

To comply with the Conflict of Interest Obligation, the broker-dealer must establish, maintain and enforce reasonably designed written policies and procedures to mitigate conflicts of interest. A conflict of interest is an interest that might cause a broker-dealer or associated person to, consciously or unconsciously, make a recommendation that is not disinterested.

Conflict of interest processes must be reasonably designed to identify all conflicts and, at a minimum, disclose or eliminate them. Policies and procedures must be reasonably designed to mitigate conflicts of interest for an associated person to ensure the individual does not place his or her interests or the interests of the firm above the customer's. In addition, broker-dealers must eliminate incentives such as sales contests, sales quotas, bonuses and non-cash compensation based on the sale of specific securities or specific types of securities within a limited period of time.

### **The Compliance Obligation**

To fulfill the Compliance Obligation, a broker-dealer must establish, maintain and enforce written policies and procedures designed to achieve compliance with Regulation BI.

### **Related Issues**

The SEC is not required to show intent to establish a violation of Regulation BI.

Regulation BI does not explicitly preempt any state law relating to broker-dealer and customer interactions. Instead, the viability of state regulation will be determined in future judicial proceedings based on the specific language and effect of the state law. This deference to the courts is particularly important in light of higher, fiduciary duty rules and regulations under way in New Jersey, Nevada and other states. This could lead to a complicated patchwork of different standards across different states.

A broker-dealer cannot waive compliance with Regulation BI, and a customer cannot waive his or her protections under Regulation BI.

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Regulation BI does not create any new private right of action or rescission, and by its implementation, the SEC does not intend such a result.

The Department of Labor has indicated that it will propose rules and guidance aligning with Regulation BI in the future.

### Compliance Date

Regulation BI will be effective 60 days after the rule is published in the Federal Register, and the compliance date is June 30, 2020.

## NEW FORM: CLIENT RELATIONSHIP SUMMARY

The SEC also adopted [form amendments](#) that require broker-dealers and investment advisers to provide a brief relationship summary to retail customers. The Client Relationship Summary (CRS) must not exceed two pages for broker-dealers and investment advisers and four pages for dual-registrants. Dual-registrants are encouraged to prepare a single relationship summary discussing both brokerage and investment advisory services.

The relationship summary is intended to inform retail investors about (1) the types of client and customer relationships and services the firm offers; (2) the fees, costs, conflicts of interest, and required standard of conduct associated with those relationships and services; (3) whether the firm and its financial professionals currently have reportable legal or disciplinary history; and (4) how to obtain additional information about the firm. The relationship summary introductory paragraph must also reference and link to [investor.gov/CRS](http://investor.gov/CRS), the SEC's investor education website.

The relationship summary must be user-friendly. The final instructions of the summary must be in question-and-answer format, with standardized questions serving as headers. Firms are permitted to use their own wording in addressing the required topics. To further assist with readability, firms are encouraged to use charts, graphs, tables, and other graphic or text features to explain or compare different aspects of the firm's offerings. For electronic summaries, firms must use hyperlinks and use text features that make cross-references more prominent in relation to surrounding text. Firm should also use simple, plain English terms when necessary and utilize white space on documents. When possible, the CRS form should be visually appealing to encourage readability. Firms may not use multiple negatives, legal jargon, or highly technical business terms. The relationship summary includes prescribed wording to describe investment professionals' standard of conduct.

The proposed fees and costs sections of the summary must discuss conflicts of interest and standards of conduct. Further, the relationship summary will include a summary of fees and costs and a description of how the firm makes money. Firms must also disclose their financial professionals' compensation.

Firms must also include a separate heading indicating whether the firm or any of its professionals have reportable disciplinary history and where investors can conduct further research on these events.

Investment advisers must deliver the relationship summary to each new and prospective retail investor client before or at the time of entering into an investment advisory contract with the retail investor. Broker-dealers must deliver the relationship summary to new and prospective retail investor clients before or at the earliest of (1) recommending an account type, a securities transaction, or an investment strategy involving securities; (2) placing an order for a retail investor; or (3) opening a brokerage account for a retail investor. Updates are required when information becomes materially inaccurate.

The compliance date for firms to file their initial relationship summaries is June 30, 2020, and the rules and forms are effective 60 days after publication in the Federal Register.

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### FIDUCIARY DUTY INTERPRETATION

The SEC also [clarified investment advisers'](#) fiduciary duties under the Investment Advisers Act of 1940.

Under the Advisers Act and applicable case law, an investment adviser is bound by the fiduciary duties of care and loyalty. The duties are broad and encompass the entire adviser-client relationship. The fiduciary duties are not defined in the Advisers Act or the SEC's rules, though enforcement against breach of the duties is located within antifraud provisions in the Advisers Act.

An adviser's fiduciary duty is principles-based and applies to the entire adviser-client relationship. While an adviser cannot waive the fiduciary duty, the adviser and client may shape the relationship by agreement, provided that there is full and fair disclosure and informed consent. An adviser's fiduciary duty applies to all investment advice, such as advice about investment strategy, whether to engage a sub-adviser, and which account type to choose. The scope and nature of the fiduciary duty also depends on the type of client the adviser serves and the agreed-upon parameters of their relationship. Due to the substantial analytical and legal resources most institutional investors maintain, the investment adviser's duties are likely to be informed by a detailed contractual agreement between the institutional client and the adviser. In contrast, a retail investor is less likely to possess both knowledge of general fiduciary duties and access to professionals who can inform the investor of the advisers' duties to the investor, so the adviser's fiduciary duties to the retail client are likely to be more expansive.

The duty of care includes (1) the duty to provide advice that is in the best interest of the client, (2) the duty to seek the best execution of a client's transactions where the adviser has the responsibility to select broker-dealers to execute client trades, and (3) the duty to provide advice and monitoring over the course of the relationship.

An investment adviser must reasonably believe that the advice it provides is in the client's best interest, based on the client's objectives and investment profile. The adviser must conduct a reasonable investigation of the investment sufficient not to base its advice on materially inaccurate or incomplete information. An investment adviser must also have the goal of maximizing its clients' value when facilitating a transaction. However, maximizing value encompasses more than simply minimizing cost. The determinative factor is whether the transaction represents the best qualitative option.

The duty of loyalty requires that an adviser cannot place its interests before the client's. The adviser must make full and fair disclosure to its clients regarding all material facts relating to the adviser-client relationship. An example of a material fact is the advisory capacity—broker-dealer or investment adviser—in which the firm is acting. Further, the adviser must eliminate or expose, through full and fair disclosure, all conflicts of interest that might cause an investment adviser to act in a manner that is not disinterested. However, mere disclosure and informed consent do not themselves satisfy the adviser's duty to act in the client's best interest.

For disclosure to be full and fair, it must be sufficiently specific so the client is able to understand the material fact or conflict of interest and make an informed decision regarding whether to give consent. The informed consent requirement does not mean that advisers must affirm that the particular client understood the disclosure. Instead, disclosure must be designed to put the client in position to be able to understand and provide or deny informed consent to the conflict of interest. Further, a client's informed consent can be either explicit or implicit, depending on the facts and circumstances. Whether disclosure is full and fair depends on, among other things, the nature of the client, the scope of the services, and the material fact or conflict. Whether disclosure is full and fair also depends on the nature of the client, whether it is a retail or institutional investor.

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### Clarification of "Solely Incidental" Prong of the Broker-Dealer Exclusion from Definition of Investment Adviser

In addition, the SEC [interpreted and clarified an exclusion](#) from the definition of "investment adviser" for broker-dealers that provide investment advisory services that are "solely incidental" to the conduct of the broker-dealer's business.

### CONTACT US

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