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# SEC Proposes New Standard of Conduct for Broker-Dealers

On April 18, 2018, by a vote of 4-1, the Securities and Exchange Commission proposed a package of rulemaking and interpretations addressing investors' relationships with broker-dealers and investment advisers. Under proposed Regulation Best Interest, a broker-dealer and a natural person who is an associated person of a broker-dealer would be required, when making a recommendation regarding any securities transaction or any investment strategy involving securities, to act in the best interest of a retail customer without placing their respective financial interests ahead of the customer. The SEC also proposed a rule establishing a new short-form disclosure document that would provide retail investors with information about the nature of their relationship with their investment professionals, and issued an interpretation to reaffirm and, in some cases, clarify the SEC's views of the fiduciary duty that investment advisers owe to their clients.

## Background

The SEC has been considering issues relating to the standards applicable to investment advisers and broker-dealers for many years. Under current SEC rules, investment advisers are subject to a fiduciary duty to their clients, while broker-dealers are subject to the less stringent "suitability" standard. Because of the inherent conflict of interest in the commission-based compensation model applicable to broker-dealers, various market participants have questioned whether broker-dealers should be held to a standard higher than "suitability" when advising retail customers.

In 2011, the SEC staff issued a study mandated by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act in which it proposed to establish a uniform fiduciary standard of conduct for both investment advisers and broker-dealers. In 2016, the Department of Labor adopted a rule requiring that finance professionals adhere to a fiduciary standard when advising clients on retirement accounts. In March 2018, the Fifth Circuit Court of Appeals vacated this rule.

In June 2017, SEC Chairman Jay Clayton issued a statement containing a number of questions regarding standards of conduct for investment advisers and broker-dealers. For the most part, commenters responding to the questions indicated support for changes to the standard of conduct, and in particular the establishment of a fiduciary or best interest standard specific to broker-dealers.

Regulation Best Interest, as proposed, establishes a new, higher standard of care for broker-dealers when making recommendations to retail customers, but does not adopt the proposals of the 2011 SEC study and does not establish a uniform fiduciary standard of conduct for both investment advisers and broker-dealers.



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## Proposed Rules

### *Regulation Best Interest*

Under the proposed Regulation Best Interest, a broker-dealer would have a duty 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. A retail customer is defined as a "person, or the legal representative of such person, who: (A) [R]eceives 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 (B) [U]ses the recommendation primarily for personal, family, or household purposes."

A broker-dealer would discharge its best interest obligation in connection with any recommendation by:

- prior or at the time of such recommendation, reasonably disclosing to the retail customer, in writing, the material facts relating to the scope and terms of the relationship with the retail customer, including all material conflicts of interest that are associated with the recommendation (the "Disclosure Obligation");

- exercising reasonable diligence, care, skill, and prudence to understand the potential risks and rewards associated with the recommendation, and having a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers; having 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 having 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 (the "Care Obligation"); and

- establishing, maintaining and enforcing written policies and procedures reasonably designed (i) to identify, and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with such recommendation and (ii) to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendation (the "Conflict of Interest Obligations").

Notably, Regulation Best Interest does not define what it means to act in an investor's best interest, leading some members of the SEC to question the feasibility of the proposed standard. The SEC did, however, indicate that the best interest obligation "encompasses and goes beyond a broker-dealer's existing suitability obligations." The SEC noted that one key difference between the Care Obligation of Regulation Best Interest and the historical suitability obligation that flows from the antifraud provisions

of the federal securities laws is that the antifraud provisions require an element of fraud or deceit, which would not be required to be shown under Regulation Best Interest.

Regulation Best Interest would be triggered "when making" a recommendation, and a broker-dealer would be required to act in the best interest of a retail customer "at the time the recommendation is made." The SEC noted that the proposed rule is not intended to change the relationships that currently exist between a broker-dealer and its retail customers, ranging from one-time to episodic or more frequent advice. Accordingly, the best interest obligation would not, for example: (i) extend beyond a particular recommendation or 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; (ii) require the broker-dealer to refuse to accept a customer's order that is contrary to a broker-dealer's recommendations; or (iii) apply to self-directed or otherwise unsolicited transactions by a retail customer, who may also receive other recommendations from the broker-dealer.

The SEC noted that it may be in a retail customer's best interest to allocate investments across a variety of investment products, or to invest in riskier or more costly products. It does not intend for proposed Regulation Best Interest to limit the diversity of products available, the higher cost or risks that may be presented by certain products, or the diversity in retail customers' portfolios. Ultimately, the customer's best interest would be determined based on the facts and circumstances of a particular recommendation and of the particular retail customer, together with the facts and circumstances of how the components of the rule are satisfied.

***Disclosure Obligation.*** With respect to the Disclosure Obligation, the SEC noted the following as examples of material facts relating to the scope and terms of the relationship with the retail customer: (i) that the broker-dealer is acting in a broker-dealer capacity with respect to the recommendation; (ii) 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, including, for example, monitoring the performance of the retail customer's account. Additionally, the Disclosure Obligation would explicitly require the broker-dealer, prior to or at the time of such recommendation, to reasonably disclose in writing all material conflicts of interest associated with the recommendation.

***Care Obligation.*** The SEC noted that the Care Obligation would make the cost of the security or investment strategy, and any associated financial incentives, more important factors in understanding and analyzing whether to recommend a security or investment strategy. However, the SEC also noted that there are other factors that a broker-dealer should consider in determining whether a recommendation is in the best interest of a retail customer, including the product's or the strategy's investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility and likely performance in a variety of market and economic conditions. Accordingly, the SEC stated that it preliminarily believes that a broker-dealer would not satisfy its Care Obligation—and hence Regulation

Best Interest—by simply recommending the least expensive or least remunerative security without any further analysis of these other factors and the retail customer's investment profile.

***Conflict of Interest Obligations.*** The SEC emphasized that it was not its intent for the Conflict of Interest Obligations to cause broker-dealers to avoid offering certain products or limit recommendations to only certain low-cost and low-risk products that would appear on their face to satisfy the proposed best interest obligation. Specifically, proposed Regulation Best Interest would not *per se* prohibit a broker-dealer from transactions involving conflicts of interest, such as the following:

- charging commissions or other transaction-based fees;
- receiving or providing differential compensation based on the product sold;
- receiving third-party compensation;
- recommending proprietary products, products of affiliates or a limited range of products;
- recommending a security underwritten by the broker-dealer or a broker-dealer affiliate, including initial public offerings;
- recommending a transaction to be executed in a principal capacity;
- recommending complex products;
- allocating trades and research, including allocating investment opportunities (e.g., IPO allocations or proprietary research or advice) among different types of customers and between retail customers and the broker-dealer's own account;
- considering cost to the broker-dealer of effecting the transaction or strategy on behalf of the customer (for example, the effort or cost of buying or selling an illiquid security); or
- accepting a retail customer's order that is contrary to the broker-dealer's recommendations.

Although these practices would not be *per se* prohibited by Regulation Best Interest, the SEC made clear that these practices are not necessarily consistent with Regulation Best Interest or other obligations under the federal securities laws. Rather, these practices, which generally involve conflicts of interest between the broker-dealer and the retail customer, would be permissible under Regulation Best Interest only to the extent that the broker-dealer satisfies the specific requirements of the rule.

Notably, the SEC stated that it believes that a broker-dealer would violate proposed Regulation Best Interest's Care Obligation and Conflict of Interest Obligations if any recommendation was predominantly

motivated by the broker-dealer's self-interest (*e.g.*, self-enrichment, self-dealing or self-promotion), and not the customer's best interest—in other words, putting aside the broker-dealer's self-interest, the recommendation is not otherwise in the best interest of the retail customer based on other factors, in light of the retail customer's investment profile, and as compared to other reasonably available alternatives offered by the broker-dealer.

Regulation Best Interest and its component obligations, including the Disclosure Obligation, Care Obligation, and Conflicts of Interest Obligations, would not apply to advice provided by a dual-registered broker-dealer/investment adviser when acting in the capacity of an investment adviser, even if the person to whom the recommendation is made also has a brokerage relationship with the broker-dealer/investment adviser or even if the broker-dealer/investment adviser executes the transaction.

***Form CRS – Relationship Summary***

A concurrently issued proposed rule would require investment advisers and broker-dealers, and their respective associated persons, to provide retail investors with a relationship summary. This standardized, short-form (four-page maximum) disclosure, required to be provided at the start of a client relationship, would highlight key differences in the principal types of services offered, the legal standards of conduct that apply to each, the fees a customer might pay, and certain conflicts of interest that may exist.

Investment advisers and broker-dealers, and the financial professionals who work for them, would be required to be clear about their registration status in communications with investors and prospective investors. Certain broker-dealers, and their associated persons, would be restricted from using, as part of their name or title, the terms "adviser" and "advisor" — which, the SEC notes, are so similar to "investment adviser" that their use may mislead retail customers into believing their firm or professional "adviser" is a registered investment adviser.

***Investment Adviser Interpretation***

The concurrently issued proposed interpretation reaffirms, and in some cases clarifies, certain aspects of the fiduciary duty that an investment adviser owes to its clients. The release cites recent SEC enforcement actions that found disclosing that an investment adviser "may" have a conflict of interest is not adequate disclosure when the conflict "actually" exists. The interpretation is intended to highlight the principles relevant to an investment adviser's fiduciary duty and thereby provide investment advisers and their clients with greater clarity about investment advisers' legal obligations.

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The SEC will seek public comment on the proposed rules and interpretations for 90 days.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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