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This *Risk & Reward* is the first of our initial analyses of the SEC's new best interest standard of conduct rulemaking package. Here, we identify the core components of the releases. We'll discuss our perspective on the nuances of the rulemaking from a practical standpoint during our webcast on April 23, at 1 p.m. (EDT), and in future Fiduciary Governance Group materials, including on fiduciarygovernanceblog.com.

To register for Monday's webcast, please click here.

SEC Rulemaking Package Would Impose Best Interest Standard of Conduct

On April 18, the Securities and Exchange Commission ("SEC") released for public comment a package of rulemaking proposals on the standards of conduct and required disclosures for broker-dealers and investment advisers who provide services to retail investors. The release of the long-awaited proposals was approved by a 4 – 1 vote of the Commissioners, with Commissioner Kara Stein dissenting. However, all of the Commissioners expressed some concerns with the proposals, suggesting that the rulemaking will likely need to evolve before it can be approved.

The Dodd-Frank Act authorized the SEC to adopt rules on the standards of care for broker-dealers, investment advisers, and their associated persons,[1] and the SEC staff in 2011 issued a study recommending that the SEC engage in rulemaking to adopt and implement a uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers.[2] The SEC did not propose a uniform fiduciary standard, however, but instead proposed a best interest standard for broker-dealers that it characterized as an enhancement to existing standards but separate and distinct from the fiduciary duty applicable to investment advisers. The SEC also proposed a new requirement for both broker-dealers and investment advisers to provide a brief relationship summary to retail investors, and it published for comment a proposed interpretation of the standard of conduct for investment advisers.

Regulation Best Interest

The SEC proposed to adopt rule 15*l*-1, titled "Regulation Best Interest," which would require broker-dealers and their associated persons who are natural persons to act in the "best interest" of a retail customer[3] at the time a recommendation[4] of a securities transaction or investment strategy involving securities is made to that customer, without placing the financial or other interest of the broker-dealer or associated person ahead of the interest of the customer.[5] The proposed best interest obligation draws from principles underlying and reflects the underlying intent of many of the recommendations of the 2011 staff report and also generally draws from underlying principles similar to the principles underlying the Department of Labor's best interest standard. This "best interest" duty would be discharged if the broker-dealer or associated person complies with multiple obligations, specifically:

Disclosure Obligation

The broker-dealer or associated person must reasonably disclose to the retail customer in writing the material facts relating to the scope and terms of the relationship, including all material conflicts of interest associated with the recommendation.

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913, 124 Stat. 1376, 1824 – 30 (2010).

[2] Staff of the U.S. Securities and Exchange Commission, Study on Investment Advisers and Broker-Dealers As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Jan. 2011), https://www.sec.gov/news/studies/2011/913studyfinal.pdf.

[3] A "retail customer" is proposed to be defined under Regulation Best Interest as a person who receives a recommendation and uses it primarily for personal, family, or household purposes.

[4] "Recommendation" is not defined but is proposed to be interpreted consistent with existing FINRA rules, under which factors that have historically been considered in the context of broker-dealer suitability obligations include whether the communication "reasonably could be viewed as a 'call to action'" and "reasonably would influence an investor to trade a particular security or group of securities."

[5] Regulation Best Interest, Release No. 34-83062 (Apr. 18, 2018), https://www.sec.gov/rules/proposed/2018/34-83062.pdf.

Care Obligation

The broker-dealer or associated person must 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 could 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 when taken together in light of the retail customer's investment profile.

Conflict of Interest Obligations

The broker-dealer must 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 SEC states that Regulation Best Interest is not intended to create any new private right of action or right of rescission. It remains to be seen, however, whether it would have an effect on existing rights of action.

Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles

The SEC also proposed to require both broker-dealers and investment advisers to provide retail investors[6] with information intended to clarify the relationship via the proposed Form CRS Relationship Summary.[7] Form CRS would be limited to four pages, with a mix of tabular and narrative information, and contain sections covering:

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[6] For purposes of the Form CRS delivery requirement, a "retail investor" is proposed to be defined as a prospective or existing client or customer who is a natural person, including a trust or other similar entity that represents natural persons.

[7] Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles, Release Nos. 34-83063, IA-4888 (Apr. 18, 2018), https://www.sec.gov/rules/proposed/2018/34-83063.pdf; https://www.sec.gov/rules/proposed/2018/34-83063-appendix-a.pdf; https://www.sec.gov/rules/proposed/2018/34-83063-appendix-b.pdf; https://www.sec.gov/rules/proposed/2018/34-83063-appendix-c.pdf; https://www.sec.gov/rules/proposed/2018/34-83063-appendix-d.pdf; https://www.sec.gov/rules/proposed/2018/34-83063-appendix-e.pdf; https://www.sec.gov/rules/proposed/2018/34-83063-appendix-f.pdf.
"CRS" stands for "Customer Relationship Summary."

- the relationships and services the firm offers to retail investors;
- the standard of conduct applicable to those services;
- the fees and costs that retail investors will pay;
- comparisons of brokerage and investment advisory services (for standalone broker-dealers and standalone investment advisers);
- conflicts of interest;
- where to find additional information, including whether the firm and its financial professionals currently have reportable legal or disciplinary events and who to contact about complaints; and
- key questions for retail investors to ask the firm's financial professional.

Form CRS would be provided to investors, filed with the SEC, and available online. The form would not supersede the Form ADV Part 2 brochure, which investment advisers would continue to prepare and provide to clients. The SEC has provided mock-ups of Form CRS that would be used by standalone broker-dealers, standalone investment-advisers, and dually-registered firms.

The SEC also proposed (A) to require broker-dealers and investment-advisers to prominently disclose their registration status; and (B) to restrict standalone broker-dealers and their financial professionals from using the terms "adviser" and "advisor" as part of their name or title. These proposed changes are part of greater scrutiny by federal and state regulators over the titles financial professionals use that could confuse investors as to the nature of the relationship, which has been the focus of a number of state legislatures.

Notice of Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation

The third element of the package is a proposed interpretive release on the fiduciary duty that investment advisers owe to their clients.[8] Existing enforcement proceedings and SEC interpretations hold that the Investment Advisers Act of 1940 establishes a federal fiduciary standard for investment advisers. The proposed interpretation is intended to summarize the SEC's understanding of that fiduciary duty and put the market on notice of the SEC's views.

The release also includes a request for comments on areas where the current broker-dealer framework provides investor protections that may not have counterparts in the investment adviser context. The SEC intends to consider these comments in connection with any future proposed rules or other proposed regulatory actions with respect to these matters. Accordingly, the SEC requests comment on whether there should be federal licensing and continuing education requirements for personnel of SEC-registered investment advisers; whether registered investment advisers should be required to provide account statements, either directly or via the client's custodian; and whether registered investment advisers should be subject to financial responsibility requirements along the lines of those that apply to broker-dealers.

[8] Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, Release No. IA-4889 (Apr. 18, 2018), https://www.sec.gov/rules/proposed/2018/ia-4889.pdf.

The Path Forward

Each of the Commissioners expressed reservations, to varying degrees, with the proposals (and complained about their heft – in aggregate, they take up almost 1,000 pages) at the SEC open meeting at which their issuance was approved. It became clear during the open meeting that the Commissioners have concerns, including with the proposals' clarity, the appropriate comparison to existing broker-dealer suitability standards, and the cost-benefit analysis. Public comments will weigh heavily as the SEC considers these proposals, and for this reason interested parties may wish to submit a comment letter in response to the numerous questions the SEC posed.

Comments on the proposals will be due 90 days after their publication in the Federal Register, which will likely occur at some point in the next month. The SEC will then need time to consider what are likely to be a large number of comments. We should not expect consideration of final rules much before the end of 2018, and final action could be considerably later.

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