



Getting the full picture

The emerging best interest and fiduciary duty patchwork

June 3, 2019

Counting down to June 5th

Admittedly, it is not one of those “Do you remember where you were when it happened?” moments (for those old enough to remember, think November 16, 1981, when Luke and Laura married), but for the broker-dealer and investment adviser community, this June 5th will come pretty close. It is the day when the SEC commissioners are to vote to finalize the SEC’s financial professional standard of conduct rulemaking package.

It will be interesting to see whether this meeting will bring the same level of heated disagreement among the Commissioners that surfaced the last time they held an open meeting to discuss this rulemaking package. The divisions during that April 2018 meeting were along political party lines, and were highlighted by the scathing statements of former Commissioner Kara Stein, who objected to even releasing proposed Regulation Best Interest for comment, arguing among other things that the proposal was sorely lacking because it did not define the term “best interest.” Now that Commissioner Stein no longer sits on the Commission (her term has since expired) and her presumed successor, Allison Lee, has yet to be confirmed by the Senate, Commissioner Robert Jackson is the lone remaining Democratic voice. Jackson had his own significant disagreements with the original proposal but struck a more conciliatory tone, and did end up voting to release it for comment. It would be a bit of a surprise if he were to vote in favor of adopting Regulation Best Interest this week, but his vote probably won’t be necessary, given that there are three Republican voices currently sitting on the Commission, and common wisdom is that another party-line vote should be expected.

So, what can we expect the rulemaking package to look like? We will find out in short order, but as we count down to June 5th, there are a number of questions on our minds relating to the final versions of Regulation Best Interest, Form CRS, and the Investment Adviser Fiduciary Duty Interpretive Guidance. Any answers the SEC provides to those questions will be critical for broker-dealers and investment advisers as they work toward coming into compliance with these new obligations.

With respect to the Regulation Best Interest proposal, we are looking for clarity on the following points:

- 1. Will “best interest” be defined?** The SEC’s Regulation Best Interest proposal did not define “best interest.” The proposing release explained that best interest does not lend itself to a definition, given that it turns on particular facts and circumstances. This approach received many comments, a good number urging the SEC to provide a definition. While still a commissioner, Kara Stein questioned leaving the term undefined, stating, “If the commission does not define ‘best interest,’ will broker-dealers and their customers understand their obligation?”
- 2. What will be the new “default setting”?** Regulation Best Interest will be transformative, establishing new requirements for the handling of broker-dealer conflicts and customer disclosures. At the same time, the SEC said in the proposing release that the rule is not meant to favor or disfavor the brokerage model vis-à-vis the advisory model or less expensive products vis-à-vis more expensive products. But comment letters reflect a debate—will the rule go far enough? Or will it go too far and lead to the favoring of the advisory model or cheaper products? The final language the SEC uses to address this foundational issue will likely set the stage for retail financial services going forward.

3. **State fiduciary laws.** In recent months, certain states (such as Nevada and New Jersey) have advanced regulatory initiatives that would impose a fiduciary duty on broker-dealers. The states have argued that they are staying in their lanes in advancing these initiatives because federal preemption provisions apply only to state broker-dealer rules that touch upon “capital, custody, margin, financial responsibility, making and keeping records, bonding, or financial or operational reporting requirements.” We will see if the SEC weighs in on its view of the permissibility of Nevada’s or New Jersey’s regulations in light of the federal preemption of broker-dealer regulation.
4. **Hat switching.** Proposed Regulation Best Interest would allow for hat switching in the case of dual registrants (broker-dealers and their representatives who are dually registered as investment advisers and investment adviser representatives). The proposing release indicated that dual registrants must comply with Regulation Best Interest when they act as a broker-dealer but not when they act as an investment adviser, in which case they would be subject to the Investment Advisers Act of 1940. The release indicated that dual registrants would need to be clear as to the capacity in which they are providing services (i.e., which hat they are wearing). The states (i.e., the North American Securities Administrators Association) were very critical of this aspect of the rule, arguing in their comment letters that once a person engages in advisory activity with a client, they should remain subject to an adviser’s fiduciary duty throughout the course of the relationship with the client.
5. **Duty to monitor.** Advisers generally have an ongoing duty to monitor client accounts; broker-dealers do not have such a duty. However, some broker-dealers may voluntarily assume such a duty as a customer service. The North American Securities Administrators Association commented that “ongoing account monitoring is a sine qua non of an investment adviser’s fiduciary duty to clients.” We will see if the SEC imposes additional obligations on broker-dealers that undertake to monitor customer accounts or if it goes even further and says account monitoring constitutes advisory activity.
6. **Discretionary authority.** The Regulation Best Interest proposing release requested comment on whether broker-dealers that exercise discretionary authority over customer accounts should be subject to the Advisers Act. Look for the SEC to weigh in on this issue in the final release, perhaps combining this issue with the duty-to-monitor issue in guidance that will provide a clearer boundary between investment adviser and broker-dealer activities. Note that in the announcement for the June 5th meeting, the SEC signaled possible action on discretionary authority and account monitoring by including the following agenda item: “The Commission will consider whether to publish a Commission interpretation of the solely incidental prong of section 202(a)(11)(C) of the Investment Advisers Act of 1940.” This prong is also known as the “broker-dealer exclusion” because it appears in a clause in the statutory definition of investment adviser,” excluding broker-dealers that provide investment advice on a basis that is solely incidental to their broker-dealer activities and receive no special compensation therefor.
7. **Mitigation of conflicts.** SEC commissioners and staff point to mitigation (or elimination) of conflicts arising out of financial incentives as the centerpiece of Regulation Best Interest and the critical requirement that sets the new duty apart from the current suitability obligation. Commenters have argued that more guidance is needed on this requirement. Look for guidance on what it means to mitigate these types of conflicts and how much mitigation is required.
8. **Financial incentives.** The conflict mitigation (or elimination) requirement applies to conflicts arising from financial incentives. Expect clarity as to whether any financial incentive received by the broker-dealer or its representatives—or just those financial incentives that reach the broker-dealer’s representatives—calls for conflict mitigation or elimination.
9. **Sales contests.** The Regulation Best Interest proposing release noted that certain conflicts of interest are difficult to mitigate and that avoidance may be more appropriate. The SEC pointed to sales contests as the prime example. Will the SEC simply ban sales contests?
10. **Rule text versus release.** Some have criticized proposed Regulation Best Interest for being light in rule text but expansive in the rule’s accompanying release explaining the rule text. These commenters argue that any requirements need to be explicitly stated in the rule text and not left to the narrative discussion in the release. We will see whether the SEC responds to this criticism in any manner.

With respect to the Form CRS proposal, we are hoping the SEC can provide further guidance on the following topics:

1. **Directly held investments.** Form CRS’s required narrative disclosures address eight specific topics, including mandated disclosures regarding a broker-dealer’s or an investment adviser’s standard of conduct, services, fees and costs, and conflicts of interest. Many of the required disclosures would create inaccuracies or misrepresentations in the context of certain directly held investments, such as mutual funds, oil and gas interests, non-traded REITs or business development companies, private funds, and insurance and annuity contracts. Since these investments may be held directly with the issuer, the prescribed language in Form CRS repeatedly referring to clear distinctions between investments held in either a “brokerage account” or an “advisory account” may create investor confusion. Will the SEC clarify this narrow construction between brokerage and advisory accounts in the context of directly held investments in the final rule?

2. **Consistency with Regulation Best Interest's conflicts disclosures.** The "conflicts of interest" information required to be disclosed in Form CRS differs in several key respects from the information required to be provided in the conflicts disclosure statement under proposed Regulation Best Interest. Will the SEC align the two conflicts disclosures or will it continue to maintain separate conflicts disclosures between Form CRS and Regulation Best Interest? And if the SEC maintains separate and different conflicts disclosures, how will its final rule address potential investor confusion concerns?
3. **Role of investment advisers and broker-dealers.** Form CRS asserts that investment advisers provide investment advisory accounts. Following the Madoff Ponzi scheme, many investment advisers emphasized in their Form ADVs and marketing material that clients' assets are maintained in accounts held with independent qualified custodians and that the advisers' services are limited to providing investment advice. We will be reviewing whether the SEC clarifies in the final form that investment advisers act as agents for their clients in providing investment advice but do not "provide accounts" unless the agent is also a qualified custodian, such as a bank or broker-dealer. We also will be checking whether the SEC clarifies the role played by broker-dealers in primary offerings of securities (including mutual funds and variable annuities) by requiring disclosure that (i) the primary role of the broker-dealer is to offer and distribute securities to the market on behalf of, and as agent of, the issuer; (ii) the broker-dealer is paid for its distribution and sales efforts by the issuer to the extent it is successful in its distribution and sales efforts; and (iii) the advice provided to brokerage customers is incidental to the broker-dealer's distribution and sales efforts provided on behalf of issuers.
4. **"Retail investor" vs. "retail customer."** As proposed, Form CRS applies to retail investors, whereas Regulation Best Interest applies to retail customers. Because the two terms are defined differently (retail investors include both prospective and actual customers, while retail customers include only actual customers), the upshot is that Form CRS has potentially much broader applicability than Regulation Best Interest. We will be reviewing the SEC's final rule to see whether it standardizes these two definitions to ease compliance and administrative burdens.
5. **Flexibility of Form CRS language.** The Form CRS proposal requires broker-dealers and investment advisers to provide certain prescribed and narrative disclosures to retail investors in a summary document limited to a maximum of four pages. For certain of the required disclosures, the SEC prescribed specific language to be used by firms (e.g., summary of fees and costs), but other disclosures allowed firms flexibility in choosing the specific wording (e.g., conflicts of interest). Will the SEC's final form include more prescribed language or will it allow firms to describe certain information in their own terms?
6. **Flexibility of Form CRS delivery.** The Form CRS proposal allows broker-dealers and investment advisers certain flexibility to deliver the relationship summary to retail investors by either paper or electronic means. We will be reviewing the SEC's final rule to determine whether it requires paper delivery of the relationship summary to certain retail investors (e.g., senior investors) or continues to allow a flexible delivery approach.
7. **Will the SEC clarify recordkeeping concerns?** The Form CRS proposal also includes conforming amendments to the recordkeeping rules for broker-dealers and investment advisers. These Form CRS recordkeeping amendments require firms to retain copies of each relationship summary as well as records noting the date the relationship summary was delivered to each and every retail investor, even if the retail investor never opens an account and enters into a formal customer relationship with the firm. How will the SEC's final rule address industry concerns regarding capturing and tracking these required records?
8. **Will the titling restrictions expand?** As part of the Form CRS proposal, the SEC also proposed a new rule that would impose certain titling restrictions on the use of the terms "adviser" or "advisor" by broker-dealers and their associated persons. Notwithstanding this restriction, the SEC did not propose to restrict the use of terms that are similar to or synonymous with adviser or advisor, such as wealth manager, financial consultant, financial manager, money manager, investment manager, or investment consultant. It remains to be seen whether the SEC will focus its restrictions on the terms adviser and advisor or whether it will expand the restriction to include other terms.
9. **Investment adviser exceptions to titling restrictions.** The titling restriction does not apply to dually registered broker-dealers and investment advisers or to supervised persons of a registered investment adviser who provide investment advice on behalf of the adviser. Some pro-industry commenters felt that anyone registered with an investment adviser, regardless of whether they provide investment advice, should be excepted from the titling restrictions. Will the SEC make any changes to these exceptions based on industry comment?
10. **Will the SEC clarify titles used by banks or insurance agents?** The SEC's proposing release noted that the titling restrictions would not apply to a broker-dealer or its associated persons' use of the terms adviser or advisor when acting on behalf of a bank or insurance company. We will be reviewing the final rule to determine whether the SEC clarified that this statement includes appointed agents or brokers of an insurance company selling insurance or annuity contracts to retail investors.

And finally, with respect to the proposed Investment Adviser Fiduciary Duty Interpretive Guidance, we are hoping to receive clarity on the following issues:

- 1. When are investment advisers required to mitigate or eliminate conflicts, if at all?** In a February 2015 speech, Julie Riewe, former Co-Chief of the Asset Management Unit in the SEC’s Division of Enforcement, ignited a debate about whether an investment adviser can meet its fiduciary obligations and generally cure conflicts through full and fair disclosure and informed consent alone. Detractors may point to things such as a multitude of items in Form ADV Part 2 that require advisers to describe how they “address” various types of conflicts (see, for example, Items 5.E.1., 6, 10.C., 10.D., 11.B., 11.C., 11.D., 14.A., and 17 of Part 2A) and a number of recent enforcement actions brought against advisers. These actions, related to mutual fund share class selection issues, alleged best execution violations that, in the Division of Enforcement’s view, could not be disclosed away and thus needed to be eliminated. The SEC’s proposed Investment Adviser Fiduciary Duty Interpretive Guidance appeared to make an attempt at settling the debate, stating that there may be “cases in which full and fair disclosure and informed consent is insufficient,” thereby requiring the “adviser to eliminate or adequately mitigate the conflict so that it can be more readily disclosed.” But this statement still does not provide clarity on which conflicts in particular are so severe or complex that they need to be mitigated or eliminated.
- 2. What will become of the requests for comment on potential investment adviser regulatory proposals that would be designed to level the playing field between investment advisers and broker-dealers?** Toward the end of the proposed Investment Adviser Fiduciary Duty Interpretive Guidance, the SEC asked for comment on whether it should propose certain rulemakings to enhance investment adviser regulation. These rulemakings would potentially impose federal licensing and continuing education requirements on personnel of SEC-registered investment advisers; require investment advisers to provide account statements to their clients regardless of whether they have custody or sponsor wrap programs; and subject investment advisers to certain financial responsibility requirements such as a net capital rule, a customer protection rule, or fidelity bonding. In requesting comment on whether it should go forward with proposals on these issues, the SEC noted that the current broker-dealer framework already provides these investor protections, leading observers to conclude that one goal of any such rulemaking would be to level the compliance-related playing field for these registrants. Will the SEC say anything about whether it plans to go forward with these proposals?

We will learn a lot more in the next few days. Next stop, the DOL’s anticipated rulemaking, possibly later this year.

Contacts

For more commentary regarding the emerging landscape related to the standards of conduct for investment professionals, visit Eversheds Sutherland’s www.fiduciaryregulatory.com.

If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Eversheds Sutherland attorney with whom you regularly work.

Clifford Kirsch, Partner
T: +1 212 389 5052
cliffordkirsch@eversheds-sutherland.com

Michael Koffler, Partner
T: +1 212 389 5014
michaelkoffler@eversheds-sutherland.com

Susan Krawczyk, Partner
T: +1 202 383 0197
susankrawczyk@eversheds-sutherland.com

Issa Hanna, Counsel
T: +1 212 389 5034
issahanna@eversheds-sutherland.com

Ben Marzouk, Counsel
T: +1 202 383 0863
benmarzouk@eversheds-sutherland.com

Related people/contributors

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|-------------------|--------------------|-----------------|--------------------|
| – Eric Arnold | – Carol McClarnon | – Holly Smith | – Dimitriy Kotov |
| – Wilson Barmeyer | – S. Lawrence Polk | – W. Mark Smith | – Nicholas Rinaldi |
| – Bruce Bettigole | – Stephen Roth | – John Walsh | – Sarah Sallis |
| – Adam Cohen | – Brian Rubin | – Bria Adams | – Amber Unwala |
| – Olga Greenberg | – Cynthia Shoss | – Pooja Kohli | |

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