SEC Proposes Best Interest Standard for Broker-Dealers, Related Investment Adviser Guidance and New Customer Relationship Summary Form

Authored by K. Susan Grafton, Mark D. Perlow, Michael L. Sherman, Andrew L. Oringer, James V. Catano, Christine Ayako Schleppegrell, Nicholas DiLorenzo, Shayna Gilmore, Brian J. McGrady Jr., Jennifer O'Brien, Ashley N. Rodriguez and Yevgeniy Yalon

July 2018

Dechert LLP

SEC Proposes Best Interest Standard for Broker-Dealers, Related Investment Adviser Guidance and New Customer Relationship Summary Form

July 2018 / Authored by K. Susan Grafton, Mark D. Perlow, Michael L. Sherman, Andrew L. Oringer, James V. Catano, Christine Ayako Schleppegrell, Nicholas DiLorenzo, Shayna Gilmore, Brian J. McGrady Jr., Jennifer O'Brien, Ashley N. Rodriguez and Yevgeniy Yalon

The U.S. Securities and Exchange Commission has published a package of proposed rules and a proposed interpretation (collectively, Proposals) intended to improve the retail investor experience and to provide greater clarity regarding customers' relationships with broker-dealers and investment advisers.[1] The proposed rules and interpretation would: (i) create a principles-based standard of conduct for broker-dealers and require broker-dealers to act in the best interest of their retail customers; (ii) "clarify and reaffirm" investment advisers' fiduciary obligations to their clients under the Investment Advisers Act of 1940 (Advisers Act); and (iii) create additional disclosure obligations for broker-dealers and investment advisers that are intended to help retail investors better understand the scope and material facts surrounding their relationships with investment professionals. The SEC also proposed certain compliance obligations for investment advisers, which currently apply only to broker-dealers, as well as labeling requirements to address investor confusion about the capacity in which their financial professionals are acting.

The SEC noted in the Proposals that the proposed rules and interpretation are the culmination of years of study by its Staff with respect to previously gathered data related to the provision of investment advice to retail investors. The amended fiduciary rule of the U.S. Department of Labor, which was an impetus for SEC action and forms the basis for some aspects of the Proposals, has now been vacated in its entirety with nationwide effect by the Court of Appeals for the Fifth Circuit.[2]

At the open meeting where the SEC voted 4-1 on the Proposals, Commissioner Kara M. Stein voted against publishing the Proposals for comment, and Commissioner Robert J. Jackson Jr. stated that he would not approve the Proposals unless there were substantial changes to the final rules and interpretation. With Commissioner Michael S. Piwowar stepping down on July 7, 2018, the ability of the SEC to obtain enough votes to pass the final rules and interpretation is an open question.

Comments on the Proposals are due August 7, 2018.[3]

Regulation Best Interest

Proposed Regulation Best Interest, which would be codified as Rule 15l-1 under the Securities Exchange Act of 1934 (Exchange Act), would build upon certain existing obligations of broker-dealers, and incorporate concepts from the now-vacated Department of Labor fiduciary rulemaking, to create an express standard of conduct requiring a broker-

---

1 This *OnPoint* summarizes the Proposals and, in some instances, tracks the proposed rules and interpretation without the use of quotation marks.

2 *See* Chamber of Commerce, et al. v. Dept. of Labor, No. 17-10238 (5th Cir., Mar. 15, 2018).

3 Certain commenters have requested an extension to the comment period.

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, or a natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer."[4] A broker-dealer would meet this standard of conduct by fulfilling its "Care Obligation," "Disclosure Obligation," and "Conflict of Interest Obligations," each of which is described in greater detail below.

The SEC developed this proposal based in part on its evaluation and understanding of investor confusion regarding different regulations and duties applicable to broker-dealers and investment advisers, as well as the potential for further confusion relating to standards based on the type of account (*e.g.*, retirement or non-retirement) created by the Department of Labor's fiduciary rulemaking. In doing so, the SEC recognized the importance of "clear, understandable and consistent standards" for recommendations by broker-dealers, regardless of whether the account is for retirement or non-retirement purposes, which are more closely aligned with the standards for other advice relationships.

The SEC acknowledged that, despite the existence of certain inherent and unavoidable conflicts of interest between broker-dealers and retail customers, broker-dealers play an important role in the provision of a variety of services to these investors and that the services differ from those provided by investment advisers to their retail clients. Rather than adopt a uniform standard of conduct for broker-dealers and investment advisers, the SEC stated that proposed Regulation Best Interest is "tailored to the unique structure and characteristics of the broker-dealer relationship with retail customers and existing regulatory obligations (applicable to broker-dealers), while taking into consideration and drawing on (to the extent appropriate) the principles of the obligations that apply to investment advice in other contexts." As discussed below, however, SEC Chairman Jay Clayton, as well as the Directors of the Divisions of Trading and Markets and of Investment Management, have stated that under the Proposals, both broker-dealers and investment advisers would have the equivalent of a fiduciary duty when providing recommendations or investment advice to retail customers; the difference would largely be the scope of the duty (*i.e.*, at the point in time of a recommendation or over the course of the relationship).[5]

Background

Broker-dealers are currently subject to a duty of fair dealing, which includes suitability obligations, under the federal securities laws and the rules of the Financial Industry Regulatory Authority, Inc. (FINRA). Under FINRA Rule 2111, a broker-dealer and its associated persons are required to have a "reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the [firm] or associated person to ascertain the customer's Investment Profile."[6] Additionally, FINRA Rule 2111 sets forth a broker-dealer's three main suitability obligations: (i) reasonable basis (also known as "general suitability"); (ii) customer-specific; and (iii) quantitative suitability.

---

4 *Regulation Best Interest*, Exchange Act Release No. 83062 (Apr. 18, 2018) (Regulation Best Interest Proposing Release).

5 *See* Fireside Chat with FINRA President and CEO Robert Cook and The Honorable Jay Clayton, Chairman, U.S. Securities and Exchange Commission (May 22, 2018) (noting that under the proposal, "the core duty is the same" for broker-dealers and investment advisers); Remarks at the FINRA Annual Conference, Brett Redfearn, Director, Division of Trading and Markets (May 22, 2018), *and* Remarks at the PLI Investment Management Institute 2018, Dalia Blass, Director, Division of Investment Management (April 30, 2018).

6 A customer's Investment Profile would generally include the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs and risk tolerance.

However, this suitability obligation does not explicitly require that a broker-dealer's recommendation be in the best interest of its customer.[7]

Based on the absence of a best interest obligation for broker-dealers, the SEC stated that Regulation Best Interest "would address certain conflicted recommendations and set a clear minimum standard for broker-dealer conduct" to enhance investor protection while "generally preserving (to the extent possible) the range of choice and access – both in terms of services and products – that is available to brokerage customers today."[8] Regulation Best Interest is the culmination of a number of regulatory initiatives over the past several years that have sought to evaluate the standards of conduct applicable to investment advice provided by broker-dealers and investments advisers, including a 2011 study mandated by Section 913 (Section 913 Study) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). In its Section 913 Study,[9] the SEC Staff recommended that the Commission 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. Subsequently, the SEC issued a public request for information to help evaluate, enhance and consider possible alternatives to the standards of conduct for broker-dealers and investment advisers. [10] After receiving more than 250 comment letters, the SEC's Investment Advisory Committee, in November 2013, recommended, among other things, that the Commission adopt a uniform fiduciary standard for broker-dealers and investment advisers.[11] In 2016, the Department of Labor adopted a rule that would have expanded the definition of "fiduciary" under the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code of 1986, while including some provisions to make the resulting regime more workable. The U.S. Court of Appeals for the Fifth Circuit issued a mandate to vacate this rule on June 21, 2018.[12]

Overview

Regulation Best Interest would require a "broker, dealer, or a natural person who is an associated person of a broker or dealer, when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer ... [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, or natural person who is an associated person of a broker

---

7 As noted by the SEC in the Regulation Best Interest Proposing Release, "FINRA and a number of cases have interpreted FINRA's suitability rule as requiring a broker-dealer to make recommendations that are 'consistent with his customers' best interests" or are not "clearly contrary to the best interest of the customer[.]" In this regard, *see, e.g.,* FINRA Regulatory Notice 12-25, Additional Guidance on FINRA's New Suitability Rule (May 2012).

8 Regulation Best Interest Proposing Release.

9 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).

10 *Request for Data and Other Information: Duties of Brokers, Dealers and Investment Advisers*, Exchange Act Release No. 69013 (Mar. 1, 2013) (observing that the lines between full-service broker-dealers and investment advisers have blurred and expressing concern that the duties owed to customers depend more on the statute under which a financial intermediary is registered rather that the type of services provided).

11 *See* Recommendation of the Investor Advisory Committee, Broker-Dealer Fiduciary Duty (Nov. 2013).

12 For further information regarding the Fifth Circuit opinion, please refer to *Dechert OnPoint*, Fifth Circuit Opinion Vacates DOL Fiduciary Rule.

or dealer making the recommendation ahead of the interest of the retail customer."[13] Regulation Best Interest provides that this obligation will be satisfied if all of the following obligations are fulfilled:

(i) Disclosure Obligation. The broker, dealer, or natural person who is an associated person of a broker or dealer, prior to or at the time of such recommendation, reasonably discloses 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.

(ii) Care Obligation. The broker, dealer, or natural person who is an associated person of a broker or dealer, in making the recommendation exercises reasonable diligence, care, skill and prudence to:

(A) 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;

(B) 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 (as hereinafter defined) and the potential risks and rewards associated with the recommendation; and

(C) have 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.

(iii) Conflict of Interest Obligations. The broker or dealer establishes, maintains and enforces written policies and procedures reasonably designed to identify:

(A) and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with such recommendations; and

(B) disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations.

13 Regulation Best Interest Proposing Release. The SEC did not propose, as part of proposing Regulation Best Interest, to alter a broker-dealer's obligations under the general antifraud provisions of the federal securities laws, and the SEC stated that Regulation Best Interest should not, and is not intended to, create any new private right of action or right of rescission for any customer.

Scope and Applicability

Generally, Regulation Best Interest would apply to all recommendations made by broker-dealers, or their associated persons,[14] to retail customers. Below is an overview of the types of conduct that would be subject to Regulation Best Interest, as well as activities that specifically would be excluded from the scope of the proposed regulation.

When Making a Recommendation, At Time Recommendation is Made. Regulation Best Interest does not define the term "recommendation," as the SEC noted that this term "is not susceptible to a bright line definition."[15] Rather, the SEC stated that a recommendation should continue to be interpreted in accordance with existing regulatory provisions and guidance, including the Exchange Act and FINRA rules. According to current FINRA guidance, the facts and circumstances of a particular communication drive whether a broker-dealer has made a recommendation to a customer; these facts and circumstances include the communication's content, context and manner of presentation, as well as the extent to which a communication about a security or a strategy involving securities is tailored to a specific customer or group of customers.[16] In other words, the question is whether a communication is a "call to action" or an instruction to refrain from taking action.[17] A "recommendation" would not include any communication that provides general investor education (such as discussions of asset allocation strategies) or limited investment analysis tools (such as retirement savings calculators). The SEC also stated that it would reconsider the scope of the brokers' exclusion from the definition of "investment adviser" under the Advisers Act in connection with the provision of investment advice that is "solely incidental" to the broker-dealer's business, as this exclusion applies to discretionary authority of broker-dealers over client accounts.[18] The SEC noted that it had stated that "the quintessentially supervisory or managerial character of investment discretion warrants the protection of the Advisers Act and its attendant fiduciary duty," but that "at least some exercise of discretionary authority by broker-dealers could be considered solely incidental to their business."[19]

Duration of Best Interest Obligation and Effect of Contractual Arrangements. Regulation Best Interest would apply to each particular recommendation made by a broker-dealer or its associated persons to a retail customer and would not be waivable by contract. The SEC stated that the best interest obligation does not extend beyond a particular recommendation, or impose a continuous duty on the broker-dealer with respect to a retail customer by virtue of a recommendation (such as a duty to monitor performance of a retail customer's account), absent a contractual

---

14 The proposal would extend to "natural persons who are associated persons of a broker-dealer," but would not include associated persons whose functions are solely clerical or ministerial. The SEC proposes to define "natural person who is an associated person" consistent with the scope of natural persons included in the definition of "associated person" in Section 3(a)(18) of the Exchange Act: "any partner, officer, director or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer, except that any person associated with a broker or dealer whose functions are solely clerical or ministerial shall not be included in the meaning of such term for purposes of section 15(b) of this title (other than paragraph 6 thereof)." Regulation Best Interest Proposing Release.

15 Regulation Best Interest Proposing Release.

16 *See* FINRA Regulatory Notice 11-02 (Jan. 2011).

17 *See* NASD Notice to Members 01-23 (Apr. 2001).

18 Section 202(a)(11)(C) of the Advisers Act excludes from the definition of investment adviser "any broker or dealer whose performance of such services [(like rendering advice)] *is solely incidental* to the conduct of his business as a broker dealer and who receives no *special compensation* therefor." The SEC requested comments relating to the discretionary authority of broker-dealers over client accounts and the treatment of similar activities as "solely incidental" to the broker-dealer's business.

19 Regulation Best Interest Proposing Release.

agreement with the retail customer to provide such services.[20] To support the proposed scope of this obligation, the SEC acknowledged that there are varied relationships between broker-dealers and their customers and noted that the SEC is not intending to change the nature of these relationships.[21]

Any Securities Transaction or Investment Strategy. As proposed, Regulation Best Interest would apply to recommendations of any securities transaction or investment strategy to a retail customer.[22] The recommendation of a securities transaction is proposed to include recommendations to roll over or transfer assets from one account to another, but would not include recommendations "of account types generally, unless the recommendation is tied to a securities transaction."[23]

Retail Customer. Regulation Best Interest would apply only to recommendations to retail customers.[24] According to the proposing release, a retail customer would be defined broadly to include any person (*i.e.*, not only a natural person), or legal representative of such person,[25] who receives a recommendation about a securities transaction or investment strategy involving securities and who uses the recommendation primarily for personal, family or household use.[26] Notably, this definition excludes recommendations related to business or commercial purposes, but does not contain any exclusions based on a customer's net worth, investment experience or sophistication.[27]

---

20 By contrast, as discussed below, the proposed IA Fiduciary interpretation would impose, as part of the duty of care, a "duty to provide ongoing advice and monitoring over the course of the relationship."

21 The SEC clarified that the "rule is not intended to supersede the body of case law holding that broker-dealers that exercise discretion or control over customer assets, or have a relationship of trust and confidence with their customers, owe customers a fiduciary duty, or the scope of obligations that attach by virtue of that duty." Regulation Best Interest Proposing Release.

22 As noted in the Regulation Best Interest Proposing Release, transactions would include sales, purchases and exchanges, whereas investment strategies would include recommendations not to sell a security or that specify the manner in which a security is to be purchased or sold.

23 As noted in the Regulation Best Interest Proposing Release, "[a] recommendation concerning the type of retirement account in which a customer should hold his retirement investments typically involves a recommended securities transaction, and thus is subject to FINRA suitability obligations."

24 Addressing the scope of the definition of "retail customer", the SEC stated that although Regulation Best Interest applies only in the context of a brokerage relationship and then only to recommendations made in the broker-dealer capacity, a brokerage relationship may exist without a formal brokerage account. For example, Regulation Best Interest would apply to recommendations of mutual fund transactions in which broker-dealers assist their retail customers, who have not established formal brokerage accounts, in purchasing mutual funds directly from the funds. The broker-dealers would typically be listed as the broker-dealer of record and receive fees or commissions from the transaction.

25 Legal representatives that are treated by FINRA as institutional accounts, including investment advisers, would meet the definition of "retail customer" under Regulation Best Interest. An "institutional account" is defined in FINRA Rule 4512(c) as "(1) a bank, savings and loan association, insurance company or registered investment company; (2) an investment adviser registered either with the SEC under Section 203 of the Advisers Act or with a state securities commission (or any agency or office performing like functions); or (3) any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million."

26 The SEC stated in the Regulation Best Interest Proposing Release that, consistent with current regulations, "broker-dealers would generally be required to obtain sufficient facts concerning a retail customer to determine an account's primary purpose for purposes of Regulation Best Interest."

27 The proposed definition of "retail customer" in Regulation Best Interest differs from the proposed definition of "retail investor" in the CRS Relationship Summary Proposal, discussed later in this *OnPoint*.

Dual-Registrants. A dually-registered broker-dealer and investment adviser would not be required to comply with Regulation Best Interest if the firm makes a recommendation to a customer in its capacity as an investment adviser (or associated person of an investment adviser), even if the firm executes the recommended transaction in its capacity as a broker-dealer.[28] The SEC acknowledged that the determination of the capacity in which a recommendation is made is "not free from doubt," but requires a facts and circumstances analysis based on, among other factors, the type of account, the type of compensation and the capacity in which the customer believed the dual-registrant or associated person was acting.[29]

Other Exclusions. The SEC also discussed the application of Regulation Best Interest to certain other broker-dealer activities. For example, the SEC clarified that the best interest obligation would not require a broker-dealer to refuse to accept a customer's order that is contrary to the broker-dealer's recommendation. The best interest obligation also would not apply to self-directed or otherwise unsolicited transactions (*i.e.*, transactions unrelated to any recommendation made by a broker-dealer or associated person) by a retail customer who may also receive recommendations from the broker-dealer.

Components of Regulation Best Interest

As noted above, Regulation Best Interest would impose three obligations on broker-dealers: a Disclosure Obligation, a Care Obligation and Conflict of Interest Obligations. The failure to meet any of these obligations when making a recommendation to a retail customer would violate Regulation Best Interest.

Disclosure Obligation

According to the proposal, the Disclosure Obligation would help better inform customers of certain key information regarding the broker-dealer/customer relationship by requiring written disclosure to the retail customer of "material facts relating to the scope and terms of the relationship … and all material conflicts of interest associated with the recommendation" at or prior to the time the broker-dealer or its associated persons make a recommendation to a customer. According to the SEC, the Disclosure Obligation would build on and complement, the information contained in Form CRS, by requiring broker-dealers to provide more comprehensive information relevant to a particular recommendation to retail customers.

Although the material facts required to be disclosed by a particular broker-dealer would largely be a facts-and-circumstances determination, the proposal sets forth a non-exhaustive list of potentially disclosable material facts relating to the scope and terms of the relationship.[30] These examples include:

- the capacity of the broker-dealer with respect to the recommendation;

---

28 Similarly, Regulation Best Interest would not apply when a broker-dealer executes a transaction, in its capacity as a broker-dealer, which was based on advice provided by an investment adviser (including by a registered representative who is providing advice in his or her capacity as an advisory representative of an affiliated or third-party investment adviser).

29 The SEC noted that the Disclosure Obligation and the CRS relationship summary would help to clarify a customer's understanding of the capacity in which a dual-registrant is acting.

30 To a large extent, these examples track the disclosure requirements set forth in the Department of Labor's Best Interest Contract Exemption.

- the fees and charges that apply to the retail customer's transactions, holdings and accounts;[31] and
- the type and scope of services provided by the broker-dealer (including, for example, monitoring the performance of the retail customer's account).

The Disclosure Obligation would also require that a broker-dealer, prior to or at the time of such recommendation, disclose all material conflicts of interest associated with the recommendation, including any financial incentives. A material conflict of interest would be defined as a "conflict of interest that a reasonable person would expect might incline a broker-dealer – consciously or unconsciously – to make a recommendation that is not disinterested."[32] According to the SEC, material conflicts associated with recommendations that should be disclosed would include those pertaining to (among others): proprietary products; products of affiliates; a limited range of products; allocations of initial public offerings among retail customers; or purchasing one share class of a mutual fund over another share class of the same mutual fund.

Other than the general requirement that a broker-dealer would have to disclose material conflicts prior to, or at the time of, the recommendation, Regulation Best Interest is intended to provide flexibility for a broker-dealer to determine the most appropriate way to satisfy the Disclosure Obligation based on the broker-dealer's business practices.[33]

Care Obligation

Regulation Best Interest would require broker-dealers to exercise reasonable diligence, care, skill and prudence when making recommendations to a retail customer. The SEC stated that this Care Obligation is intended to incorporate and enhance existing suitability requirements applicable to broker-dealers under the federal securities laws. To satisfy the Care Obligation, a broker-dealer must have a reasonable basis to believe that the recommendation: (i) could be in the best interest of "at least some retail customers" (General Best Interest Obligation); (ii) is in the best interest of the specific customer to whom the broker-dealer is making the recommendation (Customer-Specific Best Interest Obligation); and (iii) is not excessive if made as part of a series of recommendations, "even if in the retail customer's best interest when viewed in isolation" (Serial Transaction Obligation). The Care Obligation, which largely tracks broker-dealers' existing suitability obligations under FINRA Rule 2111, would require a broker-dealer to consider "reasonable alternatives, if any, offered by the broker-dealer in determining whether it has a reasonable basis for making the recommendation."[34] However, the Care Obligation would not require the broker-dealer to consider all possible securities or investment alternatives to recommend the single "best" option.

---

31 In contrast, the proposed CRS relationship summary would focus on general descriptions regarding types of fees and charges, rather than offer a comprehensive or personalized schedule of fees or other information about the amounts, percentages or ranges of fees and charges.

32 Regulation Best Interest Proposing Release.

33 The proposal provides examples of flexible approaches in certain circumstances, including in the context of recommendations by telephone. The proposal does not specify the form or manner of disclosure, although the SEC indicated that all disclosure should be concise, clear and understandable.

34 The SEC did, however, clarify in the Regulation Best Interest Proposing Release that "[o]ne key difference between the Care Obligation imposed by Regulation Best Interest and the suitability obligation derived from the antifraud provisions of the federal securities laws is that the antifraud provisions require an element of fraud or deceit" whereas scienter would not be required to establish a violation of Regulation Best Interest.

In general, the SEC stated that whether a particular recommendation is in the best interest of a customer will depend on the particular facts and circumstances. The SEC also stated that Regulation Best Interest is not intended to result only in recommendations of low-risk, low-cost options, or to eliminate recommendations of actively managed mutual funds, variable annuities or proprietary products. Rather, the SEC intends that Regulation Best Interest generally, and the Care Obligation specifically, would ameliorate incentives to recommend products for reasons that put a broker-dealer's interests ahead of the interests of its retail customer.

General Best Interest Obligation. To meet the General Best Interest Obligation, broker-dealers must have a reasonable basis to believe that a recommendation would be in the best interest of at least some retail customers. The SEC stated that this obligation would relate to the particular security or strategy recommended, rather than to any particular customer, and is "intended to incorporate a broker-dealer's existing obligations under 'reasonable-basis suitability.'"[35] A broker-dealer would be able to satisfy this obligation by undertaking reasonable diligence to: (i) understand the risks and rewards associated with a certain security it recommends; and (ii) determine that a recommendation could be in the best interest of at least some retail customers. The SEC noted that a broker-dealer's "reasonable diligence" in this regard will vary depending on, among other matters, the complexity of all risks associated, and the broker-dealer's familiarity, with the recommended security or investment strategy.[36]

In addition, the SEC provided examples of factors that a broker-dealer might consider in its reasonable diligence under the General Best Interest Obligation, which include the cost, characteristics (including any special or unusual features), liquidity, risks, potential benefits, volatility, expected returns and the likely impact of market and economic conditions of a particular security or strategy, as well as the broker-dealer's (or its associated persons') financial incentives.

Customer-Specific Best Interest Obligation. To satisfy this requirement, a broker-dealer must "exercise reasonable diligence, care, skill and prudence to ... have a reasonable basis to believe that the recommendation is in the best interest of the particular retail customer."[37] The SEC noted that the Customer-Specific Best Interest Obligation would inherently require the broker-dealer to consider the retail customer's Investment Profile in determining whether a recommendation was in that customer's best interest before making the recommendation. The SEC stated that this obligation is intended to incorporate and enhance broker-dealers' existing "customer-specific" suitability obligations, by requiring a recommendation to be "in the best interest of" a customer rather than "suitable for" the customer.[38]

---

35 Regulation Best Interest Proposing Release (noting that "[t]he courts, the Commission, and FINRA have interpreted the broker-dealer's existing reasonable-basis suitability obligation to impose a broad affirmative duty to have an 'adequate reasonable basis' for any recommendation they make.").

36 Noting that "every inquiry will be specific to the broker-dealer and the investment or investment strategy," the SEC provided a non-exhaustive list of questions that broker-dealers "may wish to consider" as part of their "reasonable diligence" about the merits of a particular recommendation, including: the existence of less expensive or risky alternatives; any legal or tax issues presented by the product; and any risks of the product of particular relevance to retail customers. Regulation Best Interest Proposing Release.

37 *Id*.

38 *Id*. The SEC noted in the Regulation Best Interest Proposing Release that this enhanced standard would require a broker-dealer to "consider whether it has sufficient information regarding the customer to properly evaluate whether a recommendation is in the best interest of the retail customer without placing the financial or other interest of the broker-dealer ahead of that particular retail customer's interests."

In developing a retail customer's Investment Profile, the SEC noted that a broker-dealer should consider specific information about the customer, including, but not limited to, the customer's age, investment portfolio, tax status, risk tolerance, investment objectives and experience, along with any other relevant information provided to the broker-dealer.[39]

The SEC affirmed that, under Regulation Best Interest, broker-dealers would be permitted to recommend proprietary products or make recommendations from a "limited range of products," provided that the broker-dealer has satisfied its obligations under the Care Obligation. The SEC indicated, however, that a broker-dealer that does not recommend the least expensive alternative among *identical* investment options to a customer (*e.g.*, different share classes of the same mutual fund) would not meet the Care Obligation. When recommending a more expensive option among similar investment alternatives (particularly when recommending an alternative that would provide greater benefit to the broker-dealer), a broker-dealer can satisfy the Care Obligation if the broker-dealer forms a "reasonable basis to believe the higher cost is justified" based on other factors (*e.g.*, the security's features), in light of the customer's Investment Profile. As with the Conflict of Interest Obligations, discussed below, the SEC indicated that disclosure alone cannot fully discharge the Care Obligation when a broker-dealer recommends a more expensive investment alternative to retail customers.

Serial Transaction Obligation. The Care Obligation also requires a broker-dealer to exercise reasonable diligence, care, skill and prudence when making a series of recommendations to a retail customer. The Serial Transaction Obligation is intended to protect retail customers from (among other things) excessive trading and unnecessary transaction costs by incorporating – and even going beyond – a broker-dealer's existing obligations under FINRA's concept of quantitative suitability.[40] Under Regulation Best Interest, a broker-dealer must have a reasonable basis to believe that a series of recommendations is not excessive and is in the retail customer's best interest in light of the retail customer's Investment Profile, even if each recommendation, if viewed in isolation, is consistent with the Care Obligation. In this respect, the SEC indicated that a broker-dealer may wish to consider (among other factors): turnover rate, cost-to-equity ratio and the use of in-and-out trading.

The SEC noted that, unlike FINRA's quantitative suitability rule, the Serial Transaction Obligation would apply to broker-dealers regardless of whether the broker-dealer has control (or *de facto* control) over a customer's account.[41] Thus, a broader set of retail customers would be protected by proposed Regulation Best Interest than are currently protected by concepts of quantitative suitability.

---

39 Notably, the considerations that would comprise a customer's Investment Profile under Regulation Best Interest differ from the considerations the SEC included in its proposed interpretation of the standard of conduct for investment advisers (which provides that a client's Investment Profile consists of the "client's financial situation, level of financial sophistication, investment experience, and investment objectives").

The Customer-Specific Best Interest Obligation would also require a broker-dealer to update a customer's Investment Profile if the broker-dealer has reason to know that a customer's investment objective(s) or financial situation has changed. The SEC indicated that limiting the broker-dealer's obligation to update a customer's Investment Profile to an "as needed" basis would minimize the imposition of unnecessary costs in connection with requiring the broker-dealer to constantly update its information when it has no reason to believe such changes are necessary, and also would decrease the use of information the broker-dealer knows or should know is stale.

40 The SEC identified "churning" and "switching" as examples of excessive trading strategies that harm investors. However, the SEC clarified that what constitutes a "series" of transactions for purposes of Regulation Best Interest depends on the particular facts and circumstances.

41 *See* FINRA Rule 2111.05(c).

Conflict of Interest Obligations

Regulation Best Interest would also require broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to: (i) identify and disclose or eliminate, all material conflicts of interest that are associated with recommendations; and (ii) identify, and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations.[42] The SEC stated that the Conflict of Interest Obligations are not intended to preclude specific activities or services, but rather to eliminate certain incentives that could motivate a broker-dealer to make certain recommendations. Consistent with the SEC's Proposed IA Interpretation, discussed below, the Conflict of Interest Obligations would provide that merely disclosing a conflict would not always be sufficient.

Under the Conflict of Interest Obligations, a conflict of interest would be material if "a reasonable person would expect [that the conflict] might incline a broker-dealer – consciously or unconsciously – to make a recommendation that is not disinterested."[43] The SEC indicated that material conflicts of interest arising from financial incentives would include, among others: certain services fees and charges; employee compensation or incentive plans (*e.g.*, quotas, sales contests or differential or variable compensation); receipt of commissions or sales charges; compensation to encourage the sale of proprietary products; and compensation that does not result from sales activity, such as compensation for services provided to third-parties (*e.g.*, sub-accounting or administrative services provided to a mutual fund). Notwithstanding the SEC's proposed two categories of conflicts of interest, it appears that there are few material conflicts of interest that do not arise from financial incentives that, therefore, would have to be mitigated or eliminated as well as disclosed. Only material conflicts of interest that arise in connection with a broker-dealer's recommendations would be subject to the Conflict of Interest Obligations of Regulation Best Interest. According to the SEC, ancillary services outside the context of investment recommendations "already are subject to general antifraud liability and specific requirements to address associated conflicts of interest."[44]

Regulation Best Interest would require broker-dealers to implement procedures reasonably designed to identify material conflicts of interest that arise in connection with recommendations to retail customers and address these through disclosure, mitigation or elimination of the conflicts.[45] The Proposal provides a broker-dealer with substantial risk-based flexibility to determine how to best draft and implement such procedures in light of its own circumstances,[46] and the SEC stated that it does not expect broker-dealers to mitigate every material conflict of interest. Notwithstanding this flexibility, the SEC suggested that procedures would be considered "reasonably designed" under the Conflict of Interest Obligations if the procedures (among other items): provide an overview of how a broker-dealer identifies, manages and escalates issues related to conflicts of interest; designate persons who are responsible for supervising the implementation of the procedures; provide mechanisms to test the efficacy of the procedures; and require employees to attend training on conflicts management.

---

42 This additional requirement to mitigate or eliminate conflicts of interest represents a departure from what has previously been required of broker-dealers under the federal securities laws.

43 Regulation Best Interest Proposing Release.

44 *Id*.

45 The SEC specifically stated that Regulation Best Interest is not intended to prohibit a broker-dealer from having conflicts when making a recommendation, given that certain conflicts of interest are inherent in the structure of the broker-dealer business model.

46 *Id*. The SEC indicated that broker-dealers may use existing compliance frameworks to the extent that they comply with the obligations proposed under the Conflicts of Interest Obligations.

In the proposal, the SEC outlined various business practices that broker-dealers should consider incorporating into their procedures to encourage compliance with the Conflict of Interest Obligations; these include: minimizing sales quotas that favor a particular product; removing sales incentives that would favor a particular type of product; monitoring recommendations that are made by a person nearing an incentive threshold; and limiting to whom a particular product may be recommended. Moreover, the SEC stated that broker-dealers could implement customer-, product-, or compensation-specific mitigation techniques, provided that the mitigation technique was appropriate in light of the conflict faced by the broker-dealer. The SEC also noted that it in the event that mitigation does not sufficiently address the conflict of interest presented with a particular business practice, it might be appropriate for a broker-dealer to avoid such business practice entirely.

SEC Proposes Interpretive Guidance Regarding Standard of Conduct for Investment Advisers

The Proposals also include a proposed interpretation of the standard of conduct for investment advisers (Proposed IA Interpretation) under the Advisers Act.[47] The SEC described the standard set forth in the Proposed IA Interpretation as "similar to, but not the same as, the proposed obligations of broker-dealers" under Regulation Best Interest. Subsequently, however, SEC Chairman Jay Clayton and Trading and Markets Division Director Brett Redfearn stated that, while the obligations are equivalent, the scope of duties differs. The SEC indicated that the Proposed IA Interpretation is intended to "reaffirm" and "clarify" certain aspects of the fiduciary duty that the SEC believes apply to investment advisers (whether or not SEC-registered). In the SEC's view, the Advisers Act imposes a fiduciary duty on investment advisers, although such duty is not explicitly defined in that statute. Instead, the SEC notes that this duty is based on equitable common law principles.[48] The Proposed IA Interpretation indicates that the fiduciary duty is enforceable through the anti-fraud provisions of the Advisers Act,[49] and consists of a duty of care and a duty of loyalty. The Proposed IA Interpretation describes what the SEC believes are certain elements of each of these duties.

While the Proposed IA Interpretation focuses on retail investors, the release expressly states that the proposed fiduciary standard applies to all clients (including institutional clients) and all aspects of the advisory relationship. The SEC has asked for comment as to whether to codify this interpretation as federal fiduciary duties under Section 206 of the Advisers Act.

The SEC also requests comment as to whether investment advisers should be subject to investor protection requirements that are comparable to those applicable to broker-dealers, with respect to: (i) licensing and continuing education requirements for personnel; (ii) account statement delivery requirements for advisory accounts; and (iii) financial responsibility requirements, including net capital and fidelity bond requirements.

Duty of Care

Acknowledging that "the [f]iduciary duty to which advisers are subject is not specifically defined in the Advisers Act or [SEC] rules," the Proposed IA Interpretation proposes to assess the duty of care in accordance with Section 206 of the Advisers Act, as well as a series of cases, enforcement proceedings and prior proposing and adopting releases. Under the Proposed IA Interpretation, the duty of care includes: (1) a duty to provide advice that is in the client's best

---

47 *Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation*, 83 Fed. Reg. 21203 (May 9, 2018).

48 See *SEC v. Capital Gains Research Bureau, Inc.* 375 U.S. 180, 194 (1963) *(Capital Gains)*; Proposed IA Interpretation.

49 Advisers Act Section 206; *see also* Proposed IA Interpretation.

interest; (2) a duty to seek best execution for the client when the adviser has the responsibility to select broker-dealers; and (3) a duty to act and provide advice and ongoing monitoring over the course of the relationship.

Duty to Provide Advice that is in the Client's Best Interest

The SEC's proposal to interpret the Advisers Act to reflect a duty to provide advice in the client's best interest is based in large part on a proposed suitability rule for investment advisers that the SEC never adopted. This proposed duty of care would require the investment adviser to make a reasonable inquiry into the client's "financial situation, level of financial sophistication, investment experience and investment objectives" (Investment Profile) before providing personalized investment advice. The information necessary to create an Investment Profile would depend on "what is reasonable under the circumstances." This duty also would require investment advisers to have an understanding of the nature of the product, security or strategy being recommended, sufficient to provide a reasonable basis to conclude that the recommendation is suitable and in the best interest of the client, based on the client's Investment Profile.

Reasonable Inquiry. According to the SEC's Proposed IA Interpretation, in making a reasonable inquiry into a client's Investment Profile, factors that an adviser should consider in determining what is reasonable under the circumstances would include the agreed-upon advisory services and the nature and complexity of the anticipated investment advice. Accordingly, an adviser creating a comprehensive financial plan for a retail investor may consider information that differs from the type of information considered when advising an institutional client. In a scenario where an adviser is formulating a comprehensive financial plan for a retail client, the adviser might consider obtaining information that includes a client's "current income, investments, assets and debts, marital status, insurance policies and financial goals."[50]

Under the Proposed IA Interpretation, an adviser must update a client's Investment Profile so that the adviser can adjust the advice given to reflect changed circumstances.[51] Notably, updating a client's portfolio would not be required for a one-time financial plan or when the adviser does not provide investment advice on an ongoing basis. Several factors will determine the frequency with which an adviser updates a client's portfolio, including whether the adviser is aware of events that would render the adviser's advice inaccurate or incomplete (*e.g.*, a change in relevant tax law or knowledge that the client has retired or that the client's marital status has changed).[52]

Suitable and in Best Interest of the Client. Under the Proposed IA Interpretation, an adviser must have a reasonable belief that the personalized advice is suitable for, and in the best interest of, the client based on the client's Investment Profile. In order to arrive at a reasonable belief, an adviser could consider, by way of example, whether the adviser is recommending investments with risks that the client is able to tolerate and whether the risks are justified by the potential benefits. An adviser should consider the client's investment portfolio and Investment Profile, when determining whether advice is in the client's best interest. Additional factors to consider in making this determination would include the cost of the advice (including fees and compensation), as well as the investment

50 Proposed IA Interpretation.

51 The SEC will consider whether the investment adviser was aware that such changes could affect the accuracy of its advice to the client in determining whether the adviser had a duty to update the Investment Profile. The SEC will view the frequency with which the investment adviser must update the Investment Profile in light of the particular facts and circumstances. Proposed IA Interpretation.

52 While the Proposed IA Interpretation is not clear, advisers would be expected to consider whether Investment Profiles remain updated in light of the nature of the client relationship and agreed-upon advisory services.

objectives, characteristics, liquidity, risks, benefits, volatility and potential performance of a product or strategy in a variety of economic circumstances. While an adviser is not required to recommend the lowest-cost product,[53] the SEC stated that an adviser could not reasonably believe that a higher-cost product is in the client's best interest when an identical lower-cost product is available.[54] Further, according to the SEC, an adviser must conduct a reasonable investigation into the investment being recommended, so as not to base the advice on materially inaccurate or incomplete information.

Duty to Seek Best Execution

The investment adviser also must seek best execution of transactions for each client when the adviser is responsible for selecting broker-dealers to execute client trades.[55] An adviser achieves best execution when the transaction reflects the best qualitative execution and when "the client's total cost or proceeds in each transaction are the most favorable under the circumstances."[56] The discussion in the Proposed IA Interpretation regarding best execution is grounded primarily on prior SEC guidance on soft dollars.[57]

Duty to Act and Provide Advice and Ongoing Monitoring over the Course of the Relationship

Under the Proposed IA Interpretation, the adviser must act and provide advice and monitoring over the course of the relationship at a frequency that is in the best interests of the client.[58] According to the SEC, the duty to provide advice and monitoring is especially important for advisers with an ongoing relationship with a client. In contrast, the steps needed to satisfy this duty may be "relatively circumscribed" where an adviser and client agree to a relationship of limited duration.[59] Under the Proposed IA Interpretation, investment advisers may tailor the scope of their relationships with clients through contracts (*e.g.*, limiting the duration of services), but may not eliminate their fiduciary

53 *See* Proposed IA Interpretation.

54 Proposed IA Interpretation. The release states that an adviser may violate its fiduciary duty and Section 206 of the Advisers Act when recommending a mutual fund share class that is more expensive than other options, where the adviser is receiving compensation and where this conflict of interest is not properly disclosed. In this circumstance, the adviser must fully and fairly disclose the conflict and obtain the client's informed consent. Regulation Best Interest also includes a Disclosure Obligation for broker-dealers. *See supra* "Regulation Best Interest - Components of Regulation Best Interest - Disclosure Obligation."

55 Considerations pertaining to best execution include (among other matters): the value of any research provided; the ability of the broker to execute; and the broker's commission, financial information and responsiveness. An adviser must consider whether the transaction represents the "best qualitative execution," but the adviser is not required to choose the provider with the lowest commission. Proposed IA Interpretation.

56 Proposed IA Interpretation. An adviser that uses an affiliated broker to execute client trades must fully and fairly disclose this conflict so that clients can provide informed consent.

57 Proposed IA Interpretation. *See Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters,* SEC Rel. No. 34- 23170 (Apr. 28, 1986) (1986 Soft Dollar Release); *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934*, SEC Rel. No. 34-54165 (July 18, 2006) (2006 Soft Dollar Release).

58 This duty of care is heightened if there is an ongoing client relationship; however, the duty is not as stringent if the client relationship is limited in duration by contract. Proposed IA Interpretation.

59 An example of a limited duration relationship occurs in financial planning where an adviser receives a fixed, one-time fee that is commensurate with the nature of the advice provided. Proposed IA Interpretation.

obligations altogether through contracts or disclosure.[60] Notably, it is unclear how the Investment Profile, reasonable inquiry requirement and ongoing monitoring requirement would apply to institutional clients and specialized mandates. The Proposed IA Interpretation suggests that the adviser should consider the nature of the client (*e.g.*, retail or institutional), as well as any specific conflict, in determining whether disclosure is full, fair and understood.[61]

Duty of Loyalty

Under the Proposed IA Interpretation, an investment adviser cannot favor its own interests over those of a client or unfairly favor one client's interests over those of another client. The adviser must attempt to avoid or mitigate – or at least disclose – conflicts of interest, and must fully and fairly disclose all material facts relating to the advisory relationship. The disclosure must provide sufficient information for the client to be able to provide informed consent to the conflict of interest, although consent need not be explicit or in writing in all cases. Depending on the circumstances, implicit consent is acceptable following adequate disclosure.[62] Where it is not possible, in light of the nature of the conflict or the client, to provide full, clear and meaningful disclosure and consent would not be informed, the adviser would be required to eliminate the conflict or mitigate the conflict so that it can be sufficiently disclosed.

Enhanced Investment Adviser Regulation

The SEC requested comment regarding three areas of potential investment adviser regulation, similar to requirements in place for broker-dealers (and, in some cases, in place for state-registered advisers and adviser representatives): (i) federal licensing and continuing education; (ii) provision of account statements; and (iii) financial responsibility. As the Proposed IA Interpretation does not propose rules setting forth particular requirements, another proposal for public comment would be required prior to any final rulemaking.[63]

Federal Licensing and Continuing Education. Currently, many states require an investment adviser representative (IAR) with a place of business in that state to become registered or licensed or to meet certain qualifications. [64] The SEC requests comment as to whether to impose comparable federal requirements for advisory personnel, including those who are not IARs.[65] Advisers Act Rule 203A-3 defines "investment adviser representative" as a supervised person of an investment adviser, who has more than five clients, and more than 10 percent of whose clients are

---

60 Proposed IA Interpretation. The release is unclear as to the line between the permissible ability "to tailor the terms" of the fiduciary duty and the impermissible waiver of fiduciary duty, although the Proposed IA Interpretation stresses "the investment adviser cannot disclose or negotiate away, and the investor cannot waive, the federal fiduciary duty."

61 Proposed IA Interpretation. *See* 1986 Soft Dollar Release; 2006 Soft Dollar Release.

62 Implicit client consent would not be sufficient where the situation indicates the client did not understand the conflict or where the adviser has not fairly or fully disclosed the material facts related to the conflict. Proposed IA Interpretation.

63 The SEC stated that it "intends to consider these comments in connection with any future proposed rules or other proposed regulatory actions with respect to these matters." Proposed IA Interpretation.

64 The Section 913 Study, *supra* note 9, recommended a uniform fiduciary standard of conduct and greater harmonization of investment adviser and broker-dealer regulation, including (among other matters) licensing and continuing education requirements for persons. For example, the Proposed IA Interpretation discusses application of federal licensing and continuing education requirements both to IARs and, more broadly, "personnel of SEC-registered investment advisers."

65 Such qualifications may include obtaining certain professional designations or passing certain securities examinations. The SEC requests comment as to whether investment advisory personnel should be required to pass examinations (*e.g.*, series 65 examinations, as required by most states) or hold other designations (*e.g.,* chartered financial analyst, which some states allow as an alternative to examinations).

natural persons (who are not qualified clients).[66] In connection with this proposed enhancement, the SEC will consider: whether, and if so which, investment advisory personnel should be required to register;[67] the scope of federal registration (including disclosure, examination and continuing education requirements); how to avoid duplicating existing requirements; and what benefits, costs or effects may result from federal registration requirements.

Provision of Account Statements. The SEC is considering whether to impose additional requirements on investment advisers in order to provide retail investors with clarity regarding the fees and expenses paid for advisory services. The SEC requests comment as to whether to require investment advisers to deliver periodic account statements to clients that specify such fees and expenses, regardless of whether the clients are otherwise required to be provided with account statements (*e.g.*, under the custody rule or Rule 3a-4), as well as the content and frequency of such statements.

Financial Responsibility. The SEC requests comment as to whether to impose on investment advisers certain financial responsibility provisions currently required of broker-dealers (including net capital and fidelity bonding requirements). Unlike other financial industry participants that have access to client assets (including banks and broker-dealers), investment advisers generally do not maintain significant capital reserves.[68] The impetus for this proposed requirement is the SEC's concern that, "when we discover a serious fraud by an adviser, often the assets of the adviser are insufficient to compensate clients for their loss."

Discussion

Commenters are likely to approach the Proposed IA Interpretation from many angles, with a particular focus on: the requirement to mitigate or eliminate certain material conflicts of interest that cannot be sufficiently disclosed; the ability to set the content and scope of the duty through informed consent based on sufficient disclosure; and application of the guidance to different client types (*i.e.*, institutional vs. retail).

The suggestion in the Proposed IA Interpretation that, in certain circumstances, advisers must eliminate and mitigate conflicts (as opposed to disclosing them fully and fairly to clients) departs from the prior understanding of the investment management bar and industry as to how advisers discharge their obligations under the Advisers Act. The Proposed IA Interpretation states that "[t]he Advisers Act establishes a federal fiduciary standard" and "[a]n adviser's fiduciary duty is imposed under the Adviser's Act," but at the same time admits that "[t]he fiduciary duty to which advisers are subject is not specifically defined in the Advisers Act." To support the conclusion that the Advisers Act establishes and imposes a fiduciary duty, the Proposed IA Interpretation relies on references in Supreme Court's

---

66 Pursuant to Advisers Act Rule 205-3, a "qualified client" is: (i) a natural person or company with at least $1,000,000 under management with the adviser; (ii) a natural person or company that the adviser reasonably believes has a net worth of more than $2,000,000 or is a qualified purchaser as defined in the Investment Company Act of 1940; or (iii) a natural person who serves as an executive officer, director, general partner, or trustee of the adviser, or is an employee of the adviser who participates in investment activities of the adviser.

67 The Proposed IA Interpretation notes that FINRA excludes from registration those persons whose functions are solely clerical or ministerial. Unlike FINRA, which grandfathered in exchange-only personnel who were in the industry for a period of years (*e.g.*, 10 or 20 years) prior to becoming subject to FINRA Rules, the SEC does not contemplate grandfathering advisory personnel with substantial experience from potential investment adviser licensing or continuing education requirements.

68 Many states have imposed net capital or fidelity bonding requirements on state-registered investment advisers. Further, advisers must maintain a fidelity bond for certain account types – this may involve, for example, registered investment companies or certain ERISA accounts where the adviser has investment discretion.

opinion in *Capital Gains* to Congress' recognition that advisers are fiduciaries, as well as in dicta in other Court opinions.[69] However, to the extent that the Court refers to fiduciary duties under the Advisers Act, the holding in *Capital Gains* relates solely to full and fair disclosure in accordance with Section 206.[70] The SEC's proposed interpretation thus may not be universally recognized as grounded in the Advisers Act or *Capital Gains*. This is not a theoretical point: by reaching beyond disclosure obligations, the Proposed IA Interpretation can be read to change the application of the Advisers Act to encompass advisers' relationships with all clients, including institutional investors.

Further, commenters will likely focus on the extent to which an adviser's fiduciary duty can be circumscribed by the agreement between the adviser and the client, as well as the sophistication of the client. Advisers may seek clarity on this point in both the retail and institutional contexts. Finally, the SEC's reliance on dicta in *Capital Gains* and in other Supreme Court opinions, as well as on a proposed (but never adopted) interpretation of an adviser's suitability obligation, could expose the Proposed IA Interpretation to legal challenges.

Comparison of the Proposed IA Interpretation and Regulation Best Interest

Each of the elements of the SEC's proposed rulemaking and interpretation is aimed primarily at the same goal – protecting retail investors. Nonetheless, while Regulation Best Interest would apply only to broker-dealers when making recommendations to retail customers, the Proposed IA Interpretation would apply to all investment advisory clients, whether retail or institutional, and would apply throughout the duration of, and cover all aspects of, the advisory relationship.

Notwithstanding these differences, Regulation Best Interest and the Proposed IA Interpretation each anticipate that in certain situations, some material conflicts would be able to be adequately addressed through disclosure alone. In other cases, broker-dealers and investment advisers may be required to take affirmative steps to eliminate or mitigate material conflicts of interest in connection with recommendations or advice.

While the Proposals outline different standards for broker-dealers and investment advisers, recent statements by Directors Blass and Redfearn and Chairman Clayton suggest that the obligations are similar for broker-dealers and investment advisers.[71] These statements indicate that, while the term "fiduciary duty" is not explicitly used in Regulation Best Interest, the broker-dealer's obligations would be based on fiduciary principles. Director Redfearn indicated that the principal distinction between the standards of conduct for a broker-dealer and an investment adviser is that the broker-dealer's best interest obligation would apply only at the time a recommendation is provided, while an investment adviser's fiduciary duty is generally ongoing over the course of its relationship with its client. It

---

69 *Capital Gains, supra* note 48.

70 The Proposed IA Interpretation reaches beyond the Section 913 Study, since the former discusses the possible need to eliminate (rather than disclose) certain conflicts. Proposed IA Interpretation, 83 Fed. Reg. 21209 ("[i]n all of these cases where full and fair disclosure and informed consent is insufficient, we expect an adviser to eliminate the conflict or adequately mitigate the conflict so that it can be more readily disclosed").

71 In recent speeches, Chairman Clayton and Director Redfearn remarked that both broker-dealer and investment advisory relationships involve a fiduciary principle, with each relationship creating a duty for the investment professional to act in the best interest of the client. Director Redfearn further stated that the "Best Interest" standard under Regulation Best Interest "is similar to 'best interest' approaches under other advice standards, including the fiduciary standard applicable to investment advisers." Jay Clayton, SEC Chairman, Fireside Chat: A Conversation with SEC Chairman Jay Clayton (May 22, 2018); Brett Redfearn, SEC Director, Division of Trading and Markets, Remarks at the FINRA Annual Conference (May 22, 2018).

should be noted that the Proposed IA Interpretation acknowledges that the scope and duration of an adviser's fiduciary duty can be determined by contract.

Form CRS Relationship Summary

The Proposals also include proposed new disclosure requirements for registered broker-dealers and investment advisers under the Advisers Act and the Exchange Act (Proposed Disclosure Rules).[72] The Proposed Disclosure Rules include a new Form CRS (Customer or Client Relationship Summary) – a standardized four-page disclosure document that is designed to promote access to information that the SEC believes retail investors should consider before establishing a relationship with a financial professional. The Proposed Disclosure Rules would: (i) require registered investment advisers, broker-dealers and dual-registrants[73] (collectively, firms) to provide retail investors with a relationship summary on Form CRS covering certain topics; (ii) restrict the use of the terms "adviser" and "advisor" by broker-dealers and their associated financial professionals in certain circumstances; and (iii) require broker-dealers and investment advisers to disclose in retail investor communications the firm's registration status and require that any associated financial professionals disclose their association with the firm. The SEC did not address how a dual-hatted individual who is associated with a broker-dealer and investment adviser that are not affiliated could comply with the Proposed Disclosure Rules in a way that would not be confusing to clients or potential clients.

Overview

Disclosure Requirements

Under the Proposed Disclosure Rules, firms would be required to deliver a new type of disclosure document to retail investors, under certain conditions. [74] A relationship summary on Form CRS, which is intended to supplement rather than supersede existing disclosure requirements, would provide information related to eight categories that the SEC believes to be important for retail investors to consider when choosing a firm or financial professional. The primary purpose of Form CRS is to assist retail investors in understanding the differences between and among broker-dealers and investment advisers. Similar to existing SEC forms, Form CRS sets forth general content and presentation requirements for a relationship summary. However, unlike existing forms, Form CRS would also prescribe specific required disclosures within each of the categories of information, unless they were inaccurate as applied to the firm.

Specifically, firms would be required to provide the following information in the sequence below:

---

72 *Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles*, SEC Rel. No. IA-4888 (Apr. 18, 2018) (Form CRS Proposing Release).

73 "Dual registrant" would be defined as "a firm that is dually registered as a broker-dealer and an investment adviser and offers services to retail investors as both a broker-dealer and investment adviser." Form CRS Proposing Release.

74 "Retail investor" would be defined as "a prospective or existing client or customer who is a natural person (an individual)." Form CRS Proposing Release. All natural persons, irrespective of net worth or investment experience, would also be considered retail investors, as would trusts or other similar entities that "represent natural persons, even if another person is a trustee or managing agent of the trust." *Id*. Broker-dealers and/or investment advisers would not be required to provide Form CRS to legal representatives of retail investors, unlike proposed Regulation Best Interest, which would require broker-dealers to provide certain disclosures to legal representatives.

1. *Introduction.* A brief introduction would include biographical information, registration status and information as to the types of accounts and services offered.[75]

2. *Relationships and Services*. A description of the firm's relationship with retail investors would include information regarding: the type and structure of any fees charged; ancillary services offered; and methods of communication.

3. *Standard of Conduct.* Firms would be required to disclose the legal standard of conduct owed to retail investors (the formulation of which would be prescribed under Form CRS) and explain associated conflicts of interest.

4. *Summary of Fees and Costs.* Firms would be required to provide an overview of specified types of fees and expenses charged to retail clients/customers for either investment advisory or brokerage accounts, including whether the firm's fees may vary and are negotiable, as well as other key factors that would help a reasonable retail investor understand the fees likely to be incurred.

5. *Comparisons.* Broker-dealers and investment advisers would be required to describe how their services differ from those of a "typical" investment adviser or broker-dealer (as applicable).

6. *Conflicts of Interest.* Firms would be required to summarize the conflicts of interests related to certain financial incentives.[76]

7. *Additional Information.* Firms would be required to provide information as to where retail investors can find additional information regarding the firm's "disciplinary events, services, fees and conflicts." Investment advisers would be required to disclose legal or disciplinary events that have been reported on Form ADV and disclose how to research associated investment personnel and report potential issues to the SEC. Broker-dealers would be required to disclose legal or disciplinary events that have been reported on Form BD and/or FINRA Forms U4, U5 and U6, as well as how to research information on associated brokerage personnel and report problems to FINRA.

8. *Key Questions.* Firms would be required to include 10 prescribed questions for a retail investor to ask a financial professional. Among other topics, the questions elicit information regarding: the nature of the relationship with the retail investor; conflicts of interest; and fee structures. Firms would be permitted to modify or omit portions of the questions based on a firm's particular operations, and would be permitted to include up to four non-prescribed questions.

---

75 Under the Proposed Disclosure Rules, the Introduction would "set[ ] up a key theme of the relationship summary – helping investors to understand and make choices among account types and services." Form CRS Proposing Release.

76 Specifically, using a combination of prescribed and tailored disclosures, firms would be required to disclose conflicts relating to "(i) financial incentives to offer to, or recommend that the retail investor invest in, certain investments because (a) they are issued, sponsored or managed by the firm or its affiliates, (b) third parties compensate the firm when it recommends or sells the investments, or (c) both; (ii) financial incentives to offer to, or recommend that the retail investor invest in, certain investments because the manager or sponsor of those investments or another third party (such as an intermediary) shares revenue it earns on those products with the firm; and (iii) the firm buying investments from and selling investments to a retail investor for the firm's own account (*i.e.*, principal trading)." Form CRS Proposing Release.

Although Form CRS largely prescribes the contents of, and required disclosures for, a relationship summary, the SEC encourages firms to consider alternative presentation formats that might be more user-friendly or interactive (including alternative presentation formats and tabular information) in order to facilitate understanding by retail investors.

Delivery, Updating and Filing Requirements

The following chart briefly summarizes the delivery, filing and periodic updating requirements for the relationship summary:[77]

	Investment Advisers	Broker-Dealers	Dual Registrants
Timing of Delivery (to New Clients/Customers)	Before or at the time the firm enters into an investment advisory agreement (including oral agreements) with the retail investor	At the time the broker-dealer is first engaged by the retail investor[78]	The earlier of the delivery required by an investment adviser or broker-dealer
Timing of Delivery (to Existing Clients/Customers)[79]	Before or at the time (i) a new account is opened or (ii) changes are made to the retail investor's account(s) that would materially change the nature and scope of the firm's relationship with the retail investor[80]		
Manner of Filing	Relationship summary filed (via proposed Form ADV Part 3) with the SEC on IARD	Relationship summary filed (pursuant to proposed Rule 17a-14) with the SEC on EDGAR	Relationship summary filed on both IARD and EDGAR
Timing and Manner of Filing Material Updates	Form CRS must be updated within 30 days of the relationship summary becoming materially inaccurate Amended Form CRS (including an amended relationship summary) must be filed via IARD/EDGAR, posted on the firm's website (if applicable) and communicated (without charge) to existing customers/clients within 30 days, by amended Form CRS delivery or other communication method.		

77 If a firm does not have any retail investor clients or customers to whom it must deliver a relationship summary, the firm would not be required to prepare or file a relationship summary. Irrespective of the specific delivery requirements set forth in this chart, the SEC encourages delivery of the relationship summary "far enough in advance of a final decision to engage the firm to allow for meaningful discussion between the financial professional and retail investor." Form CRS Proposing Release.

78 This would apply to transactions executed outside of an account and to retail investors who do not enter into an account opening agreement. It would not apply to a retail investor to whom a broker-dealer makes a recommendation, if "that retail investor does not open or have an account with the broker-dealer, or that recommendation does not lead to a transaction with that broker-dealer." Form CRS Proposing Release.

79 The SEC indicated that existing clients and customers "should be reminded of the information highlighted in the relationship summary before or at the time: (i) a new account is opened that is different from the retail investor's existing account(s); or (ii) changes are made to the retail investor's existing account(s) that would materially change the nature and scope of the firm's relationship with the retail investor." Form CRS Proposing Release.

80 The SEC indicated that material changes to the nature or scope of a firm's relationship would include "a recommendation that the retail investor transfer from an investment advisory account to a brokerage account or from a brokerage account to an investment advisory account, or move assets from one type of account to another in a transaction that is not in the normal, customary, or already agreed course of dealing." Form CRS Proposing Release.

Under the Proposed Disclosure Rules, firms would be permitted to deliver a relationship summary on Form CRS via electronic or paper delivery. If a firm utilizes electronic delivery, such delivery would be required to comply with the SEC's existing guidance on electronic delivery. If a firm utilizes paper delivery, a relationship summary should be the first document delivered if multiple documents are distributed to a retail investor in a single mailing. Further, if a firm does not maintain a website on which to post a Form CRS, the firm would be required to provide a toll-free number where retail investors could request a copy.[81]

If the Proposed Disclosure Rules are adopted, Form CRS delivery and filing would be subject to the following compliance dates:

<table>
<tr><th>Type of Firm</th><th>Filing Compliance Date</th><th>Delivery Compliance Date</th></tr>
<tr><td>Newly-Registered Broker-Dealers and SEC-Registered Adviser Applicants</td><td colspan="2">Filing and delivery required six months after the effective date of the Proposed Disclosure Rules.

After this date, the firm must file Form CRS by the date on which the firm's SEC registration becomes effective.

The SEC indicated that it would not accept any initial application for registration as an investment adviser that does not include a relationship summary.</td></tr>
<tr><td>Broker-Dealers Registered as of Proposed Disclosure Rules' Effective Date</td><td>Filing required six months after effective date.</td><td rowspan="2">Initial delivery required to all existing retail investor clients within 30 days of the firm's first filing deadline (as indicated above). Delivery to new and prospective clients and customers who are retail investors is required beginning on the date the firm is first required to electronically file its relationship summary with the SEC.</td></tr>
<tr><td>Investment Advisers and Dual Registrants Registered as of Proposed Disclosure Rules' Effective Date</td><td>Filing required by the date of the firm's first Form ADV annual amendment that occurs six months following effective date.</td></tr>
</table>

Because a relationship summary is designed to supplement, rather than replace, current disclosure obligations of broker-dealers and investment advisers, delivery of a relationship summary would not necessarily relieve a firm of other disclosure obligations to current or prospective retail investors under federal or state law.[82]

Recordkeeping Amendments

The SEC proposed conforming amendments to the recordkeeping requirements of Rule 204-2 under the Advisers Act and Rules 17a-3 and 17a-4 under the Exchange Act, to require that firms: retain copies of each relationship summary and amendment thereto; and record the date(s) a relationship summary or amendment thereto is delivered to each

81 The Form CRS Proposing Release specifically addresses potential operational challenges (including those associated with client global consent to electronic delivery) posed for robo-advisers and online broker-dealers by the new requirements.

82 Specifically, the SEC indicated that the relationship summary "would not necessarily satisfy the disclosure requirements under the proposed Regulation Best Interest." Form CRS Proposing Release.

client. For investment advisers, these records would be maintained in accordance with current Advisers Act Rule 204-2(a). Broker-dealers would be required to maintain the records for at least six years. These requirements potentially represent a significant increase in applicable recordkeeping obligations, as firms would be required to track and retain records of the dates of communications with each existing and prospective retail client.

Restrictions on Use of Certain Names and Titles; Related Required Disclosures

Restrictions on Certain Uses of "Adviser" or "Advisor"

If adopted, the Proposed Disclosure Rules would prohibit any broker or dealer (or any natural person who is an associated person of such broker or dealer) from using the words "adviser" or "advisor" as part of its name or title when communicating with a retail investor, unless the broker or dealer is: (i) registered as an investment adviser under the Advisers Act or with a state; or (ii) any natural person who is an associated person of a dually-registered firm where such natural person (a) is a supervised person of an investment adviser registered under Section 203 of the Advisers Act or with a state and (b) such person provides investment advice on behalf of such investment adviser. This restriction would not apply to dually-registered firms, nor would the restriction apply to dually-hatted professionals[83] of a dually-registered firm that provides investment advice to retail investors on behalf of the investment adviser. However, financial professionals of a dually-registered firm who provide only brokerage services would be restricted from using the title "adviser" or "advisor."

Disclosures about a Firm's Regulatory Status and a Financial Professional's Association

The Proposed Disclosure Rules would require:

- SEC-registered broker-dealers and investment advisers to prominently disclose such registered status in print or electronic retail investor communications;
- Associated persons of a broker or dealer who are natural persons, to prominently disclose that status in print or electronic retail investor communications; and
- Supervised persons of a registered investment adviser to prominently disclose that status in print or electronic retail investor communications.

The SEC indicated that the foregoing disclosures are intended to assist retail investors in determining the type of firm that is most appropriate for the investor's specific investment needs.

Requests for Comment

The Form CRS Proposing Release seeks comment on a wide variety of issues related to the Proposed Disclosure Rules, including with respect to each of the eight required elements of a relationship summary on Form CRS.

Practical Considerations in connection with Implementation of the Proposed Disclosure Rules

The Proposed Disclosure Rules, if adopted, would impose a number of disclosure, filing, recordkeeping and other obligations on registered broker-dealers and investment advisers. In some cases, current systems and controls likely

---

83 Such a financial professional would be required to be both "a supervised person of an investment adviser and an associated person of a broker-dealer." Form CRS Proposing Release.

could be reconfigured to comply with the new requirements and obligations (*i.e.*, controls related to relationship summary filing, delivery and updating). In many instances, however, the Proposed Disclosure Rules would impose requirements that are either substantively different from, or would require a materially different volume of work than, existing investment adviser or broker-dealer obligations. Further, in considering comments to the Proposed Disclosure Rules, firms may also want to consider whether, among other things:

- It would be permissible or appropriate under the Proposed Disclosure Rules to prepare one or more relationship summaries, in order to avoid materially inaccurate or incomplete disclosure based on the practical reality of varying client arrangements.

- Interpretive challenges to implementing the Proposed Disclosure Rules would be presented by potential discrepancies among: defined terms as set forth in proposed Form CRS; existing requirements; and proposed Regulation Best Interest. For example, the definition of "retail investor" under the Proposed Disclosure Rules would differ from that of "retail customer" as used in Regulation Best Interest.

- The restriction prohibiting registered broker-dealers (and their associated persons) from using the terms "adviser" or "advisor" might conflict, in certain circumstances, with existing FINRA (or other regulatory bodies' respective) rules (for example, if a broker-dealer sought to describe itself as a financial adviser within the meaning of FINRA Rule 5510).

Conclusion

While the Proposals might not be adopted in their current form, it may be anticipated that the SEC will continue to focus its regulatory initiatives on retail investors. Broker-dealers and investment advisers, and their associated financial professionals, should consider compliance and operational challenges presented by the Proposals. These and other market participants may consider submitting comment letters to address the direct and indirect consequences of the Proposals.

This update was authored by:

K. Susan Grafton
Partner
Washington, D.C | New York
+1 202 261 3399
+1 212 698 3611
susan.grafton@dechert.com

Mark D. Perlow
Partner
San Francisco
+1 415 262 4530
mark.perlow@dechert.com

Michael L. Sherman
Partner
Washington, D.C.
+1 202 261 3449
michael.sherman@dechert.com

Andrew L. Oringer
Partner
New York
+1 212 698 3571
andrew.oringer@dechert.com

James V. Catano
Associate
Washington, D.C.
+1 202 261 3376
james.catano@dechert.com

Christine Ayako Schleppegrell
Associate
Washington, D.C.
+1 202 261 3357
christine.schleppegrell@dechert.com

Nicholas DiLorenzo
Associate
Boston
+1 617 728 7171
nicholas.dilorenzo@dechert.com

Shayna Gilmore
Associate
Washington, D.C.
+1 202 261 3362
shayna.gilmore@dechert.com

Brian J. McGrady Jr.
Associate
New York
+1 212 698 3589
brian.mcgrady@dechert.com

Jennifer O'Brien
Associate
Boston
+1 617 728 7133
jennifer.o'brien@dechert.com

Ashley N. Rodriguez
Associate
Washington, D.C.
+1 202 261 3446
ashley.rodriguez@dechert.com

Yevgeniy Yalon
Associate
New York
+1 212 698 3618
yevgeniy.yalon@dechert.com