Clients&FriendsMemo

Choose One: Best Interest or Full Service[1]

April 26, 2018

On April 18, the SEC approved the publication of three releases (the "**Releases**") proposing new regulatory requirements that are intended to expand and clarify the duties that broker-dealers and investment advisers owe to their clients under the Securities Exchange Act of 1934 (the "**Exchange Act**") and the Investment Advisers Act of 1940 (the "**Advisers Act**"), respectively. The Releases were adopted by a 4-1 vote (Commissioner Stein voting no), with even the Commissioners who voted to publish the Releases expressing concerns about their substance, albeit for opposing reasons.

The first section of this memorandum provides an overview of the Releases, their significance and background to their issuance. The next three sections of the memorandum describe each of the Releases in turn. The final section of this memorandum discusses the differing viewpoints of the Commissioners and the underlying policy debates informing those viewpoints.

I. Introduction

A. Overview of the Releases

- The "**Best Interest Release**"[2] would require a broker-dealer making a recommendation to a "retail investor" to act in the "best interest" of that investor. To that end, the Best Interest Release would impose a number of new obligations (collectively, the "**Best Interest Requirement**"), including (i) increased suitability obligations, (ii) disclosure obligations concerning (x) conflicts of interest that exist in the relationship between the broker-dealer and the customer and (y) any material conflict of interest associated with any recommendation made by the broker-dealer, (iii) obligations to mitigate or eliminate certain conflicts of interest, particularly material financial conflicts of interest, and (iv) obligations to institute compliance procedures for all of the foregoing. In broad strokes, the Best Interest Release treats broker-

[1] The hyperlinks in the memorandum are generally to the "Cabinet" at FindKnowDo.com and are generally password-protected. If you wish to sign up for our free daily newsletter, you may do so at the bottom of that page. Nonsubscribers interested in a demonstration or trial of the Cabinet may contact Danielle Taylor at email address danielle.taylor@findknowdo.com. See some of our awards and honors: https://www.findknowdo.com/endorsements

[2] SEC Release No. 34-83062.

dealer recommendations as investment advice and generally imposes quasi-fiduciary duties of care and loyalty on broker-dealers with regard to such recommendations. *See SEA Rule 15l-1: Regulation Best Interest (as proposed).*

- The "**Fiduciary Guidance Release**"[3] proposes to explain in more detail the "federal fiduciary" obligations to which investment advisers are subject under the Advisers Act (the "**Fiduciary Guidance**").

- The "**CRS Release**"[4] would require broker-dealers and investments advisers to provide their retail clients with a "Client Relationship Summary" that would be akin to a prospectus summary provided by a securities issuer ("**Form CRS**"). *See* FINRA Notice 11-02 (describing the various types of suitability obligations: reasonable basis, customer specific, and quantitative).

- The Releases also would impose a number of new compliance and recordkeeping requirements, certain of which broker-dealers should consider adopting now, without regard to whether the Releases go forward. In particular, broker-dealers should asses the adequacy of their compliance procedures that relate to conflict management, markups, employee compensation and training.

Although the requirements applicable to broker-dealers and investment advisers are distinct, substantive similarities and even greater philosophical similarities link the Releases. Given that many broker-dealers and investment advisers are either dual registrants or affiliated with a registrant in the other regulatory category, it is important that each type of registrant fully understand all three Releases.

B. The Vote

The SEC Commissioners voted 4-1 in favor of publishing the Releases.[5] Commissioner Kara Stein dissented and issued a public statement vigorously opposing the SEC's approach. In addition, Commissioners Michael Piwowar, Hester Peirce and Robert Jackson each indicated they likely would have voted "no," albeit for very different reasons, if the vote had been to adopt the rules set out in the Releases as proposed.

All of the Commissioners (other than Chairman Clayton) agreed that the standards imposed by the Releases were unclear in fundamental respects. However, there were significant disagreements beyond that. Commissioners Peirce and Piwowar took the view that the material difference between

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3 SEC Release No. IA-4889.

4 SEC Release No. 34-83063; SEC Release No. IA-4888.

5 *See* "Clayton Statement," "Peirce Statement," "Piwowar Statement," "Jackson Statement" and "Stein Statement."

the services provided by broker-dealers and investment advisers should be preserved, and that the imposition of a "best-interest" standard on broker-dealers is not appropriate and would limit the services available to retail investors and drive up costs for those investors. By contrast, Commissioners Stein and Jackson advocated for a more stringent rule that would impose strict "fiduciary" and "best-interest" obligations on broker-dealers making recommendations to retail investors.

C. Significance

Collectively, the adoption of the proposals in the Releases would have a significant impact on the manner in which financial services are provided to retail investors. The Best Interest Requirement would likely discourage the offering of "full-service" brokerage and encourage alternatives such as "discount" brokerage and fee-based advisory accounts.

Beyond these issues of practical concern, the Releases (and the debate over their adoption) raise very significant questions of regulatory policy and philosophy. Of these questions, which are discussed in the last section of this memorandum, the most significant is (i) whether retail investors can be protected adequately through a disclosure-based regime in which the primary obligation that financial intermediaries have is to tell the truth and investors make self-determined investment decisions; or (ii) whether that disclosure-based regime should be replaced by a system in which broker-dealers making a recommendation must also oversee their customers' financial circumstances and are discouraged, even if not expressly prohibited, from offering more complicated or risky products.[6]

D. Department of Labor Fiduciary Rule

An important driver to the background to the publication of the Releases (or the "elephant in the room," in the words of Commissioner Piwowar) is the so-called "Fiduciary Rule." In April of 2016, the DOL issued a final regulation revising the definition of the term "fiduciary" as it relates to investment advice fiduciaries (the "Fiduciary Rule").[7] The Fiduciary Rule significantly expanded the circumstances in which a person could become an investment advice fiduciary under the Employee Retirement Income Security Act of 1974 ("ERISA"). In such event, the person becomes subject to, among other things, the fiduciary responsibility provisions of ERISA and the conflict of interest prohibited transaction provisions of ERISA and Section 4975 of the Internal Revenue Code. The

[6] This debate is ongoing on multiple levels at the SEC. See, *e.g.*, Michael S. Piwowar, *Remarks at the "SEC Speaks" Conference 2017: Remembering the Forgotten Investor* (Feb. 24, 2017) (noting, among other things, that limiting certain products to "accredited investors" provides a "blanket prohibition" on higher returns to non-accredited investors).

[7] 81 Fed. Reg. 20945 (Apr. 8, 2016). The DOL Fiduciary Rule requirements generally became applicable on June 9, 2017, but the DOL postponed the application of many conditions of the two new exemptions discussed in this section until July of 2019 while it re-examines the DOL Fiduciary Rule and exemptions as directed by the President. In March of 2018, the Fifth Circuit issued a ruling vacating the DOL Fiduciary Rule. As of this date, the DOL has yet to indicate whether it is going to seek a rehearing or appeal the decision.

Fiduciary Rule has a significant impact on broker-dealers interacting with plans and individual retirement accounts, as their sales and marketing activities to such plans accounts are now more likely to result in fiduciary status under ERISA and, as a result, such broker-dealers could be precluded from receiving transaction-based compensation with respect to, or transacting on a principal basis with, such plans or accounts.

It suffices at this point to say that Fiduciary Rule was extremely controversial, attracting both significant praise and criticism. Critics of the Fiduciary Rule, including Chair Clayton of the SEC, focused on its burdens, the fact that those burdens would discourage the provision of full-service brokerage and be confusing, as broker-dealers would become subject to two sets of customer protection rules, (i) those of the SEC and FINRA and (ii) those of the DOL.

While Chair Clayton criticized the Fiduciary Rule, its concepts are to a good extent embedded in the Best Interest Release. Chair Clayton appears to be seeking a middle ground: (i) to adopt an SEC Rule that would be close enough to the Fiduciary Rule that the DOL would be willing to drop the Fiduciary Rule on the basis that the SEC's new requirements are good enough, (ii) but not so onerous as to kill the full-service brokerage model. The reaction of his fellow Commissioners to this approach is discussed in more detail in the latter sections of the memorandum.

II. REGULATION BEST INTEREST

A. Overview

As described in the Best Interest Release, a broker-dealer would be required to "act in the best interest of the retail customer at the time a recommendation is made without placing the financial or other interest of the broker-dealer or salesperson ahead of the interest of the retail customer." As the Commissioners generally agreed, these words are so open-ended that they are essentially meaningless as practical guides for behavior. However, SEA Rule 15l-1 stating that this obligation would be satisfied as follows:[8]

- the broker-dealer or salesperson, **prior to or at the time** of the **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 and all material conflicts of interest** that are associated with the recommendation; [9]

- the broker-dealer or salesperson, in making the recommendation, exercises **reasonable diligence, care, skill and prudence** to: (1) understand the potential **risks and rewards**

[8] Certain key terms are bolded and discussed below.

[9] Note that this requirement is separate from the obligation to provide a relationship summary, as would be mandated by the CRS Release.

associated with the recommendation, and has a reasonable basis to believe that the recommendation **could be in the best interest of at least some retail customers**; (2) to have a reasonable basis to believe that the recommendation is in the **best interest of a particular retail customer** based on the retail customer's investment profile and the potential risks and rewards associated with the recommendation; and (3) to 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, **are not excessive** and are in the retail customer's best interest when taken together in light of the retail customer's investment profile (the "**Care Obligation**");

- the broker-dealer establishes, maintains and enforces written policies and **procedures reasonably designed to identify and at a minimum disclose, or eliminate, all material conflicts of interest** that are associated with recommendations; and

- the broker-dealer establishes, maintains and enforces written policies and **procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives** associated with such recommendations (these last two bullets, collectively, the "**Conflict of Interest Obligations**").

B. Key Terms

Certain of the terms used above are further explained or defined in the Best Interest Release or in the proposed rule. The key terms are as follows:

- *Prior to or at the Time of the Recommendation*. The Best Interest Release makes clear that this timing requirement is to be taken literally, and cannot be satisfied by, for example, subsequent disclosure prior to settlement. Thus, it cannot be satisfied by disclosure in a confirmation.

- *Recommendation*. According to the Best Interest Release, the SEC determined that it would use the FINRA "definition" of the term recommendation, rather than creating its own separate definition of the term, so as to avoid confusion. The problem with this supposed consistency of definitions is that FINRA's definition is completely open-ended or non-existent.[10] It could be taken to capture any mention of a security in a call with a retail investor and certainly any meaningful conversation about a security or an issuer.[11] In short, there has been no attempt to define a minimum level of information provided by a broker-dealer that would not constitute a recommendation. Likewise, the regulators have made no attempt to distinguish "sales"

[10] *See, e.g.*, FINRA Notice 11-02 (the "determination of the existence of a recommendation has always been based on the facts and circumstances of the particular case) ; see also fn. 10 ("FINRA has stated that defining the term "recommendation" is unnecessary and would raise many complex issues . . .") See generally, LOFCHIE'S GUIDE TO BROKER-DEALER REGULATION, Customers Chapter, "Liability for Recommendations."

[11] *See, e.g.*, FINRA Notice 96-60. ("In particular, a transaction will be considered recommended when the member or its associated person brings a specific security to the attention of the customer through any means . . . ")

conversations from the establishment of an actual advisory relationship, or from permitting a broker-dealer salesperson to act in a "salesy" manner. Accordingly, any firm that wishes absolutely to avoid making recommendations would be required to restrict or prohibit conversations with retail investors that referenced any individual securities.

- *Retail Investor*. The term means any "person,"[12] or legal representative of such person, who will use the recommendation "primarily for personal, family or household purposes."[13] It is not clear whether a recommendation provided to an investment adviser that had a mix of business and retail investor clients would be within scope, but that possibility cannot be excluded based on the current language. This is a point that the SEC should clarify one way or the other. It is also noteworthy that there is no wealth or economic sophistication limit on the term "retail investor."[14] Further, the SEC would not permit "contracting out" or "qualifying out" of the Best Interest Requirement. If he made purchases for his personal account, Warren Buffet would be a retail investor, and thus would be within the scope of the rule and could not contract out of its application.

- *Material*. The term "material," according to the Best Interest Release, is intended to be meaningful and to provide that not all conflicts of interest would be required to be disclosed or eliminated, Only those that are potentially significant enough to effect decision-making would be so treated.

- *Diligence, Care, Skill and Prudence*. This terminology, particularly the term "prudence," is borrowed from ERISA and is commonly referred to as the "prudent expert" standard. As compared to existing broker-dealer obligations under the FINRA Suitability Rule, this standard arguably raises the bar by (i) making a broker-dealer or salesperson liable for failures of knowledge or "skill"; (ii) requiring that a broker-dealer be mindful of an investor's entire portfolio or financial circumstances; and (iii) being conservative on the downside.[15]

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[12] Note that this use of the term "person" is not restricted to a natural person, and would thus include family trusts and offices.

[13] This language is lifted from the CFTC and SEC swap guidance, which provides an exemption for consumer contracts relating to personal, family or household purposes. Similarly, SEC Regulation S-P, which sets forth privacy requirements for broker-dealers and investment advisers, defines a "consumer" as an individual who obtains a financial product or service that is to be used "primarily for personal, family, or household purposes." *See* SEC Regulation S-P Rule 248.3(g)(1).

[14] By contrast, an individual investor with at least $50 million in total assets would be considered an "institutional account" for purposes of FINRA Rule 2111 (the "**Suitability Rule**"). *See* FINRA Rule 2111(b) incorporating the definition of "institutional account" in FINRA Rule 4512(c)(3).

[15] ERISA Section 404(a)(1)(B) establishes that a fiduciary must act with care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. Lack of knowledge is not an excuse for a bad decision; a fiduciary under ERISA is judged according to the standards of others with the necessary expertise in a particular area. A

- *The Care Obligation*. The general concepts in this obligation are largely borrowed from existing FINRA requirements that call for a broker-dealer to reasonably believe that a product is suitable for at least some customers (which is sometimes referred to as the "reasonable basis" obligation; *i.e.*, the product is not a complete dud), and that the obligation to determine that the product is suitable for the particular client (so-called "customer-specific" suitability).[16] However, the Best Interest Release says that the SEC's version imposes a higher level of obligation than does the FINRA suitability requirement: for example, (i) the SEC imposition of the "prudent expert" standard discussed above and (ii) the SEC use of the term "best interest" rather than mere suitability. (Further, it is not clear that FINRA would agree that its suitability standard is intended to be lower than the SEC's new "best interest" standard. In fact, it seems likely that FINRA would change its rules to match the SEC's standard.[17] This would have substantial significance for arbitrations before FINRA.)

- *Not Excessive*. This provision is meant to get at the issue of "churning"; *i.e.*, the concept that a transaction that is acceptable in isolation or in limited quantities becomes fraudulent when effected in volumes that either raise transaction costs unduly or concentrate risk.[18]

- *Policies and Procedures*. The Best Interest Release calls for two related sets of procedures: (i) one to reasonably identify and either disclose or eliminate all **material conflicts of interest** and (ii) another to reasonably identify, disclose and **mitigate**, or eliminate all material conflicts of interest arising from **financial incentives**. Put differently, a broker-dealer must closely examine how it makes money and how it compensates its salespersons, and whether its business model or its compensation structure must be modified. These procedures would require broker-dealers to mitigate conflicts, but it is unclear how much mitigation would be enough, given that there is

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fiduciary may satisfy ERISA's prudence requirements by giving appropriate consideration to the facts and circumstances that, given the scope of the fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action, including the role it plays in the portfolio, and act accordingly. "Appropriate consideration" would include determining that the investment is reasonably designed, as part of the investor's portfolio, to further the purposes of the investor, taking into consideration risk of loss and opportunity for gain, the investor's portfolio's diversification, liquidity and projected returns. DOL Reg. § 2550.404a-1(b)(1).

[16] See FINRA Notice 11-02 (describing the various types of suitability obligations: reasonable basis, customer specific, and quantitative).

[17] Notably, immediately after the SEC issued the Best Interest Release, FINRA issued Regulatory Notice 18-13, which would make it easier to impose liability on a broker-dealer where there had been excessive trading in a customer's account. In that Notice, FINRA also stated that that if Regulation Best Interest were adopted, it would consider the impact of the Regulation on the FINRA Suitability Rule more generally, presumably meaning that it might conform Rule 2111 to Regulation Best Interest.

[18] Currently, FINRA's equivalent "quantitative suitability" requirement applies to a broker-dealer that has control over a customer's account. *See* FINRA Rule 2111.05(c). However, following the Best Interest Release, FINRA sought comment on a proposal to eliminate the control requirement. *See* FINRA Reg. Notice 18-13.

an inherent conflict of interest in a broker-dealer recommending a transaction and acting as principal in the transaction or as broker for compensation.

C. Activities Requiring Closer Examination

The Best Interest Release identifies the activities listed below as questionable. Specifically, proposed Regulation Best Interest would not *per se* prohibit "a broker-dealer from transactions involving conflicts of interest, such as the following," but neither would they be *per se* permitted.

- *Charging Commissions or Other Transaction-Based Fees*. As noted above, the Best Interest Release states that the business model of full-service brokerage is not "*per se* prohibited." Later, the Release states that this model should be preserved insofar as preservation is possible. In either case, this is not exactly a ringing endorsement of what historically has been the predominant brokerage business model. It is not clear that the regulators are fully willing to confront the consequences of doing away with the transaction-based, full-service brokerage business model, since they concede elsewhere in the Best Interest Release that (i) many customers benefit from it and (ii) broker-dealers have been charged with misconduct for switching customers to a fee-based model where the customers paid less under a full service brokerage model.[19] This falls under the heading of "darned if you do, and darned if you don't."

- *Receiving or Providing Differential Compensation Based on the Product Sold*. Presumably, firms would be required to justify the size of commissions on different products having the same absolute cost.

- *Receiving Third-party Compensation*. This seems as if it could be dealt with as a disclosure issue to the extent that the payments are material.

- *Recommending Proprietary Products, Products of Affiliates or a Limited Range of Products*. This presents a challenge to those broker-dealers who offer only a limited range of products; for example, a limited number of types of mutual funds. Beyond that, it raises questions about many types of structured products.

- *Recommending a Security Underwritten by the Broker-Dealer or a Broker-Dealer Affiliate, Including Initial Public Offerings ("IPOs")*. There is some particular irony in this item in that the SEC has been recently concerned with the inability of retail investors to obtain access to initial public offerings.[20] This will obviously constrain such access even further, as broker-dealers

[19] Best Interest Release notes at FN. 15

[20] Cabinet News: SEC Division Director Vows Support for ICOs

selling IPOs to retail investors would now have an additional legal worry that they are conflicted in selling IPO securities.

- *Recommending a Transaction to Be Executed in a Principal Capacity*. This will not be good for liquidity in the debt markets, particularly the municipal securities markets, which have a large percentage of retail market participants.

- *Recommending Complex Products*. The Best Interest Release questions the sales of "complex or structured products, variable annuities, higher yield securities, exchange traded funds, and mutual funds with loads or distribution fees."

- *Allocating Trades and Research, Including Allocating Investment Opportunities (e.g., IPO Allocations or Proprietary Research or Advice) Among Different Types of Customers and Between Retail Customers and the Broker-Dealer's Own Account*. It is not entirely clear what is intended here. Is the SEC saying that a broker-dealer could be both liable for not giving retail investors access to IPO allocations, and in violation of the Best Interest Requirement if they give retail investors access? Another example of 'darned if you do, darned if you don't.'

- *Considering the Cost to the Broker-Dealer of Effecting the Transaction or Strategy on Behalf of the Customer (for example, the Effort or Cost of Buying or Selling an Illiquid Security)*. How can a firm not consider its own costs of doing business? Wouldn't these costs have to be passed on the investor?

- *Accepting a Retail Customer's Order that is Contrary to the Broker-Dealer's Recommendations*. Are firms really to be required to take on responsibility for rejecting customers instructions? See "darned if you do, darned if you don't."

D. Required Compliance and Compensation Structure

The Best Interest Release provides that broker-dealers would be required to institute the following procedures in their Best Interest compliance programs:

i. define material conflicts in a manner that is relevant to a broker-dealer's business (*i.e.*, material conflicts of both the broker-dealer and its salespersons), and in a way that enables employees to understand and identify conflicts of interest;

ii. establish a structure for identifying the types of material conflicts that a broker-dealer and its salespersons and other employees may face, and whether such conflicts arise from financial incentives;

iii. establish a structure to identify conflicts in a broker-dealer's business as it evolves;

iv. provide for an ongoing (*e.g.*, based on changes in a broker-dealer's business or organizational structure, changes in compensation incentive structures, and introduction of new products or services) and regular, periodic (*e.g.*, annual) review for the identification of conflicts associated with a broker-dealer's business; and

v. establish training procedures regarding a broker-dealer's material conflicts of interest, including material conflicts of employees, how to identify such material conflicts of interest (and material conflicts arising from financial incentives), as well as defining employees' roles and responsibilities as to conflicts of interest.

The Best Interest Release also explains that certain procedures that broker-dealers would be required to follow with respect to their compensation arrangements should:

- not disproportionately increase compensation through incremental increases in sales;
- minimize compensation incentives for employees to favor (i) one type of product over another, (ii) proprietary or preferred provider products, or (iii) comparable products sold on a principal basis, and instead pay compensation, criteria for which should be based on neutral factors (*e.g.*, the time and complexity of the work involved);
- eliminate compensation incentives within comparable product lines (*e.g.*, do not favor one mutual fund over another comparable fund);
- implement supervisory procedures to monitor recommendations that: (i) are near compensation thresholds; (ii) are near thresholds for firm recognition; (iii) involve higher compensating products, proprietary products or transactions in a principal capacity; or (iv) involve the rollover or transfer of assets from one type of account to another (such as recommendations to roll over or transfer assets in an ERISA plan to an IRA, when the recommendation involves a securities transaction) or from one product class to another;[21]
- adjust compensation for registered representatives who fail to manage conflicts of interest adequately; and
- limit the types of retail customers to whom a product, transaction or strategy may be recommended (*e.g.*, certain products with conflicts of interest associated with complex compensation structures).

[21] In its 2017 Exam Report, FINRA observed a variety of effective practices in recommending the purchase and sale of certain products, including tailoring supervisory systems to products' features, and sources of risk to customers.

Even without waiting for further action on the Releases, firms should consider whether to adopt some of these compliance measures now, most importantly: (i) formalized procedures to identify conflicts of interest;[22] (ii) the careful calibration of compensation schedules and the elimination of any compensation methods that appear unseemly, such as sales contests;[23] and (iii) the formalized product-specific training of salespersons.

The Best Interest Release is sending a very strong message to broker-dealers that they need to look at compensation practices. To the extent that firms have any compensation practices that appear at all inappropriate, such as sales contests, consideration should be given to discontinuing them; they are a regulatory red flag.[24] Firms should review the amounts that they charge customers, and the amounts they pay salespeople, for different types of products, and for proprietary products vs. third-party products, and be able to explain why the differences exist.

E. Litigation Risk

According to the Best Interest Release, the SEC does "not believe proposed Regulation Best Interest would create any new private right of action or right of rescission, nor do we intend such a result." The SEC's assertion is predicated upon the basis that the regulation is being proposed, "in part" in reliance on authority in Section 15(l) of the Exchange Act, which does not create a private right of action.[25]

While Regulation Best Interest may be based "in part" on Section 15(l), the Regulation is also, according to the Best Interest Release, based "in part" on at least 48 other sections of the securities laws, including the main antifraud provision of the Exchange Act, Section 10(b).[26] To the extent that Regulation Best Interest is based on Section 10(b) or any other provision of the securities laws that has an explicit or implied private right of action, it seems inevitable that plaintiffs will assert—and it seems at least possible that a court may ultimately agree—that Regulation Best Interest has expanded the grounds for lawsuits in federal court by investors for violations of the securities laws.

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[22] This is a suggestion that has been made several times by the regulators, most recently in a 2013 FINRA report on conflict management (*see* Best Interest Release at p. 18), but likely has not been institutionalized at most firms because it is a difficult and amorphous concept to embody in a conflict manual and, for most firms, Dodd-Frank and other rulemakings have been entirely overwhelming.

[23] Firms should also be mindful of the extent to which third parties provide benefits to a firm that may influence recommendations and that may not be disclosed to investors.

[24] *See*, e.g., FINRA Notice 16-29.

[25] *See* footnote 88 of the Best Interest Release.

[26] *See* footnote 87 of the Best Interest Release.

Similarly, it seems quite possible that retail investors will have increased grounds to bring claims under the FINRA Suitability Rule if a broker-dealer has not complied with Regulation Best Interest. Further, as noted above, FINRA has stated that it could examine its own Suitability Rule if Regulation Best Interest is adopted, and indeed, on the heels of the Releases, has proposed amendments to its Suitability Rule that would eliminate the requirement that a broker-dealer have control over a customer account as a predicate to any finding that the broker-dealer had violated quantitative suitability obligations. In short, we certainly expect that Regulation Best Interest could generate increased litigation and arbitration claims, as plaintiffs test the effect of the requirements in courts and arbitration.

III. Fiduciary Guidance Release

The Fiduciary Guidance Release purports to reaffirm, and in some case clarify, the fiduciary duty that investment advisers owe to their clients:[27]

> An investment adviser is a fiduciary, and as such is held to the highest standard of conduct and must act in the best interest of its client. Its fiduciary obligation, which includes an affirmative duty of utmost good faith and full and fair disclosures of all materials facts, is established under federal law and is important to the Commission's investor protection efforts.[28]

In addition, the Fiduciary Guidance Release requests comments on whether certain aspects of SEC investment adviser regulation should be expanded so that they would mirror broker-dealer regulation. Note that the Fiduciary Guidance Release generally applies to an investment adviser's relationship with all categories of clients, including institutional as well as retail clients.

A. The Federal Fiduciary Duty

The Fiduciary Guidance Release states that Section 206 of the Advisers Act establishes a federal fiduciary standard for investment advisers comprising a duty of care and a duty of loyalty. The Release states that the federal fiduciary duty cannot be negotiated or disclosed away.[29] While the existence of the duty cannot be negotiated away, the scope of the relationship between an investment adviser and its client can be modified by disclosure and "informed consent."

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[27] The Fiduciary Guidance Release applies to advisory relationships with all clients, not only retail investors.

[28] Fiduciary Guidance Release, pages 3-4.

[29] Fiduciary Guidance Release, pages 7-8 & n.21.

According to the SEC, an investment adviser's fiduciary duty is "made enforceable by the antifraud provisions of the Advisers Act,"[30] which prohibits an investment adviser from engaging in conduct that operates as a "fraud or deceit upon any client."[31] Historically, such enforcement has been "regulatory," rather than by private right of action. In *Transamerica Mortgage Advisors, Inc. v. Lewis*, the Supreme Court held that there is no general private right of action under Section 206 of the Advisers Act, and instead recognized only a limited private remedy under Section 215 of the Advisers Act to void contracts made in violation of the statute.[32] Nonetheless, the Fiduciary Guidance Release raises the specter of an increase in the amount of litigation against investment advisers, as any actual or perceived enlargement of an adviser's fiduciary obligations could result in an increase in actions that proceed under state law rather than the Advisers Act.

B. Duty of Care

Investment advisers owe their clients a duty of care. The Fiduciary Guidance Release specifies that the duty of care includes, but is not limited to, (i) the duty to provide advice in the client's best interest, (ii) a duty to seek best execution, and (iii) a duty to provide advice and monitoring over the course of the relationship. These duties, as described in the proposed Fiduciary Guidance Release, are explained in greater detail below.

C. Duty to Provide Advice in the Client's Best Interest

The Fiduciary Guidance Release would require investment advisers, before providing investment advice, to make a reasonable inquiry into a client's "financial profile" (*i.e.*, a client's financial situation, level of financial sophistication, investment experience and investment objectives). The nature of this inquiry hinges on what is reasonable under the circumstances. Advisers would have an ongoing obligation to update a client's investment profile and adjust advice accordingly.

Investment advisers also would be required to have a reasonable belief that investment advice is suitable for and in the best interest of the client based on a client's investment profile. Therefore, investment advice must take into account a client's entire circumstances, beyond the particular

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[30] Fiduciary Guidance Release, pages 6-7.

[31] 15 U.S.C. § 80b-6.

[32] *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 19-26 (1979) ("when Congress declared in § 215 that certain contracts are void, it intended that the customary legal incidents of voidness would follow, including the availability of a suit for rescission or for an injunction against continued operation of the contract, and for restitution").

The Supreme Court also has strictly limited the ability of federal courts to imply private rights of action in federal statutes:

"Like substantive federal law itself, private rights of action to enforce federal law must be created by Congress. . . . Language in a regulation may invoke a private right of action that Congress through statutory text created, but it may not create a right that Congress has not . . . [I]t is most certainly incorrect to say that language in a regulation can conjure up a private cause of action that has not been authorized by Congress." *Alexander v. Sandoval*, 532 U.S. 275, 286 & 291 (2001).

investments that are recommended or purchased. The Fiduciary Guidance Release states that investment advisers are not necessarily required to recommend the lowest cost product or strategy.[33] Advisers must take into account factors such as a product's, or strategy's investment objectives, liquidity, risk, volatility and expected performance in a variety of market conditions. The Fiduciary Guidance Release also indicates that establishing a reasonable belief that investment advice is in the best interest of a client requires a reasonable investigation into an investment, and it is not sufficient to base advice on information known or suspected to be materially incomplete or inaccurate.

D. Duty to Seek Best Execution

When an adviser has the responsibility to select broker-dealers to execute client trades, an adviser has a duty to seek best execution of the client's transactions. The Fiduciary Guidance Release states that an adviser fulfills this duty by seeking to maximize value for the client under the particular circumstances occurring at the time of a transaction. The proposed guidance provides that lowest execution cost is not necessarily a determinative factor. Rather, advisers should consider "the full range and quality of a broker's services in placing brokerage including . . . the value of research provided as well as execution capability, commission rate, financial reasonability, and responsiveness."

E. Duty to Provide Advice and Monitoring

The Fiduciary Guidance Release would require investment advisers to provide advice and services "at a frequency that is both in the best interest of the client and consistent with the scope of advisory services agreed." The duty to provide advice and monitoring would be commensurate with the scope of the relationship. This duty is particularly important where an adviser has an ongoing relationship with a client. In contrast, less would be required where the relationship is one of limited duration.

F. Duty of Loyalty

The Fiduciary Guidance Release explains that an investment adviser's fiduciary duty also encompasses a duty of loyalty. As such, an adviser must not favor its own interests or unfairly favor one client over another. In addition, an adviser must make "full and fair disclosure" of all material facts relating to the advisory relationship.

According the Fiduciary Guidance Release, the duty of loyalty requires advisers to seek to avoid conflicts of interest, and, at a minimum, make full and fair disclosure of all material conflicts. Any disclosure must be clear and detailed enough for a client to provide informed consent with respect

[33] The Fiduciary Guidance Release states that an adviser could not reasonably believe that a recommended security is in the best interest of a client if it is a higher cost than an otherwise identical security.

to a conflict. Nevertheless, the proposed guidance states that disclosure of a conflict alone is not always sufficient to satisfy an adviser's duty of loyalty. The Fiduciary Guidance Release indicates that disclosure is insufficient where (i) the facts and circumstances indicate that the client did not understand the nature and import of the conflict or (ii) the material facts concerning a conflict cannot be fully or fairly disclosed. Thus, the SEC appears to be taking the position that certain conflicts are of a nature and extent such that they cannot be disclosed away. Where disclosure is insufficient, the SEC would expect advisers to eliminate or adequately mitigate the conflict so that it can be fairly disclosed.

G. Enhanced Investment Adviser Regulation

The Fiduciary Guidance Release includes a request for comments regarding three proposals for enhanced investment adviser regulation:

1. Whether there should be federal licensing and continuing education requirements for investment adviser personnel.

2. Whether investment advisers should be required to provide account statements, regardless of whether the adviser is deemed to have custody of client funds.

3. Whether investment advisers should be subject to financial responsibility requirements, such as a requirement to purchase a fidelity bond, maintain a minimum amount of capital, or obtain an annual audit of an adviser's own financials.

If adopted, these proposals would move the regulatory framework for investment advisers closer to that of broker-dealers. The costs associated with such requirements could prove to be substantial, and risk putting smaller and start-up investment advisers out of business. Small investment advisers, in particular, would likely find the financial reporting requirements to be quite expensive relative to their revenues. Further, we would point to the potential costs not only to investment advisers, but to the SEC itself, of establishing capital requirements on investment advisers.[34] Promulgating any such set of requirements, along with related financial record keeping rules, and attempting to enforce them, would be an enormous drain on the resources of the SEC, particularly as it could not rely upon FINRA to supplement the SEC's own compliance efforts. Unless the SEC is planning a very substantial expansion of its staff, we would caution the SEC against taking on a rulemaking that seems so large in expense for so many without any obvious commensurate benefit.

[34] We note that in 2014, the National Futures Association (the "**NFA**") requested comments on, and subsequently abandoned, a similar proposal to impose capital requirements on CPOs. *See* NFA NTM I-14-3 (Jan. 23, 2014).

IV. The CRS Release

The SEC proposed a rule that would require broker-dealers and investment advisers to provide retail investors with a short-form "relationship summary" referred to as Form CRS, which would be in addition to existing disclosure and reporting obligations.[35] Additionally, broker-dealers and investment advisers would be required to deliver information as to their registration status and the obligations that attend to such status.[36] The SEC stated that it is proposing Form CRS as a means to address financial illiteracy among retail investors. In particular, the proposed CRS Release cites studies showing that retail investors do not understand the differences between broker-dealers, investment advisers, and dually registered firms.

The relationship summary would be limited to four pages and would be subject to restrictions on page size, font, and margins. Form CRS would require information on the following items:

- Introduction
- Relationship and services provided
- Standard of conduct applicable to those services[37]
- Fees and costs
- Comparisons of brokerage and investment advisory services
- Conflicts of interest
- Where to find additional information
- Key questions for retail investors to ask

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[35] The CRS Release includes as appendices mock relationship summaries for an investment advisory firm, a brokerage firm, and a dual-registrant. *See*: Proposed SEA Rule 17a-14: Form CRS, for preparation, filing and delivery of Form CRS; Proposed IAA Rule 204-5: Delivery of Form CRS; Proposed SEC Rule 249.640: Form CRS, Relationship Summary for Broker-Dealers Providing Services to Retail Investors pursuant to §240.17a-14 of this chapter

[36] Proposed SEA Rule 15l-3: Disclosure of Registration Status; Proposed IAA Rule 211h-1: Disclosure of Registration Status;

[37] The regulators have long been very focused on whether investors understand the differences between dealing with an investment adviser and dealing with a broker-dealer. This concern largely dates to a 2008 RAND Study (discussed at Best Interest Release footnote 28), which found that investors generally did not understand the difference between investment advisers and broker-dealers. Interestingly, the study also found that investors were equally pleased with both types of service providers, so the confusion over types seems of less significance than the regulators often make it out to be.

The proposed rule broadly defines "retail investor" as "a prospective or existing client or customer who is a natural person (an individual)."[38] Broker-dealers and investment advisers, therefore, would be required to deliver Form CRS to all individual investors regardless of net worth or financial sophistication.

Delivery must occur, in the case of investment advisers, before or at the time an advisory agreement is entered into, or in the case of broker-dealers, before or at the time the retail investor engages the firm's services. Firms also would be required to deliver the relationship summary when a new account is opened or if changes are made to a retail investor's account that would materially change the nature and scope of the relationship. The CRS Release includes various requirements regarding the method of delivery. In addition, firms must file Form CRS with the SEC and the document would be publicly available.

The CRS Release also seeks to mitigate investor confusion by restricting broker-dealers and any natural associated persons, when communicating with retail investors, from using as part of its name or title the words "adviser" or "advisor,"[39] unless the broker-dealer is registered as an investment adviser with the SEC or any state, or the natural associated person is a supervised person of a registered investment adviser and such person provides investment advice on behalf of such investment adviser. In addition, the proposed rule would require firms to disclose their registration status as a broker-dealer or investment adviser with the SEC in retail investor communications. Natural associated persons of broker-dealers and supervised persons of investment advisers would also need to disclose their status.

V. Policy Debate and Underlying Policy Issues

A. The Commissioners' Public Statements

As stated earlier, the DOL Fiduciary Release informs the Releases. At the most general level, the DOL Fiduciary Rule raises the following policy questions: (i) in the interest of protecting retail investors, did the DOL Fiduciary Rule impose such heavy burdens on financial service providers, that broker-dealers simply stopped offering a large range of services and products to retails investors; (ii) if so, were retail investors better off or worse off; and (iii) is it good regulatory policy for the Department of Labor to issue a rule governing the customer obligations of SEC-registered broker-dealers. It is against that background that the statements of the various Commissioners must be understood.

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[38] Note that the CRS Release proposes a different definition of "retail investor" than in the Best Interest Release.

[39] SEC Commissioner Kara Stein observed that the limited scope of this ban creates a "whack-a-mole" problem, and advocated a more robust bar on broker-dealers holding themselves out as advisors.

- *Commissioner Stein* delivered an impassioned attack on proposed Regulation Best Interest, deriding it as Regulation Status Quo and arguing that it made no change to current law. She advocated that broker-dealers should simply be required to act in the "best interest" of their clients and essentially to eliminate all, or all material, conflicts of interest. Her opposition to the proposal was so marked that she seemed to say that she would vote against any final rule version as being inadequate unless it declared that any broker-dealer making a recommendation did so in a fiduciary capacity.

  Fundamentally, Commissioner Stein seems to object to the broker-dealer model in which (i) brokers are paid based on receiving commissions for transactional business and (ii) dealers make a profit by entering into transactions as counterparties to their clients. While this may seem to trivialize Commissioner Stein's position, it is, in fact, a realistic position. In short, Commissioner Stein seems essentially to advocate for investors to interact only with investment advisers that were neither broker-dealers nor affiliated with broker-dealers. Investors could then pay fees to advisers who would be required to act purely as agents in the best interest of clients. Broker-dealers would then be simply execution agents.[40]

  The problem, or the weakness, in the model that Commissioner Stein suggests is that many investors, particularly buy and hold investors, would find it not economical to pay investment advisory fees, and thus would have only the option of discount (execution-only) brokerage. But Commissioner Stein might argue that this would not be a bad result, if one believes that the services that investors otherwise receive from broker-dealers are so materially flawed as to be worth less than nothing.

  Commissioner Stein indicated that the Fiduciary Guidance Release and the CRS Release were less concerning than the Best Interest Release, but nonetheless criticized them for not proposing meaningful change. She argued that the proposed client relationship summary is inadequate to cure investor confusion, and instead advocated for disclosures that provide retail investors with an understanding of the application of a firm's obligations to the investor. She was

[40] Commissioner Stein does not expressly advocate for the position described above, but her remarks seem strongly to point in that direction. For example, one of the questions that she would pose to the public is "Should the Commission's proposal require financial professionals to provide their retail customers with unconflicted investment advice." This is a reasonable question to ask; but if the answer is yes, it follows that the financial professional cannot have any interest in the investor's execution of the transaction; *i.e.*, it cannot be a broker or a dealer. Commissioner Stein also asks "Should a broker-dealer [be required to] consider other products in the marketplace, such as those that are offered by other firms." As a practical matter, it is not the job of a broker-dealer to market the products that it does not sell. That said, Commissioner Stein is, of course, correct that investment advisers might be directed to research the market for products offered by a variety of firms.

In short, the problem with Commissioner Stein's questions is not that they lack any basis; it's that if answered "yes," they would effectively abolish the full-service brokerage model. This is an intellectually defensible position if Commissioner Stein believes, as she seems to, that the model is inherently flawed and unworkable. But then she should make the argument straight-out, and debate the consequences of the loss of that model, rather than advocating for rules that would end the model without following through to the consequences.

also skeptical that retail investors would read and take seriously the client relationship summary unless it used "visual, design-oriented techniques," such as tables, color-coding and pictograms, to get investors to pay attention.

With respect to the Fiduciary Guidance Release, Commissioner Stein questioned why the SEC "might be in the best position to issue interpretive guidance on an area that is heavily informed by decades of common law." She also expressed concern that by limiting the interpretation of fiduciary duties to those duties required by Section 206 of the Advisers Act, the SEC might be suggesting a narrowing of an investment adviser's broader fiduciary duties.

- *Commissioner Jackson*, while voting in favor of the issuance of the proposals, indicated that he essentially shared Commissioner Stein's objections, though he nevertheless supported issuing the Releases for comment. Commissioner Jackson indicated he would have preferred if the SEC would have started from the premise of answering the question posed in Section 211(g) of the Advisers Act – that is, should the standard of conduct for broker-dealers and investment advisors, when providing personalized investment advice, be the same? In addition, Commissioner Jackson made some specific criticisms of certain compensation practices, such as sales contests, which specific criticisms may suggest that Commissioner Jackson believes that the broker-dealer business model might be worth preserving, if modified. With respect to Form CRS, Commissioner Jackson questioned whether investors would understand and use the disclosures.

- *Commissioner Peirce* shared the view of Commissioner Stein that the Releases were far too ambiguous in the requirements that they imposed.[41] However, in contrast to Commissioner Stein, Commissioner Peirce stated that she believed that the requirements did provide for a material change in law, although perhaps not a change for the better. Nevertheless, Commissioner although she said that input from market participants and investors on the Releases would be useful in understanding the practical extent of the change and the likely costs.

  In contrast to Commissioner Stein, Commissioner Peirce advocates for the continuance of the broker-dealer business model, saying that it had "served many investors so well for so many decades." Indeed, she compared the broker-dealer regulatory regime favorably to the investment adviser regime "with [the adviser regime's] lack of a self-regulatory organization, its flexible standards that can be tailored through disclosure, its relative lack of rules, and its potentially lucrative asset-based fees." In this regard, she noted that firms were generally switching from

[41] Commissioner Peirce stated bluntly that the "term Best Interest sets an impossible standard." She went on to describe the term itself as being an "incantation," that is, having a meaning that no one can define.

acting as broker-dealers to acting as investment advisers, implicitly emphasizing the point that broker-dealers are actually more heavily regulated than are investment advisers.

On the Form CRS proposal, Commissioner Peirce questioned its usefulness for retail investors. Additionally, Commissioner Peirce, although broadly supportive of the SEC providing guidance with respect to investment advisers' fiduciaries duties, expressed concern that the Fiduciary Guidance Release makes new law. By way of example she cited the imposition of an informed consent requirement on the ability to shape advisory relationships. She also criticized the proposed additional regulatory obligations for investment advisers, such as licensing and net capital requirements, arguing that they represent a paradigm shift away from the current principles-based model of adviser regulation.

- *Commissioner Piwowar* likewise criticized the ambiguity of the "best interest" requirement. Perhaps the most significant of his comments focused on the costs of the rule. In particular, he asked, "Will Regulation Best Interest raise compliance costs to such a level that it comes economically disadvantageous for broker-dealers to offer retail investors transaction-based advice?"

  Similar to Commissioners Stein, Jackson and Peirce, Commissioner Piwowar questioned the usefulness of the proposed client relationship summary in its current form. He also expressed concerns as to whether the SEC has legal authority to issue the Fiduciary Guidance due to the lack of case law underpinning much of the interpretation.

- *Chairman Clayton*, not surprisingly, took the most positive view of the Releases, occupying the middle ground between the other Commissioners. While he indicated support for the continuance of the existing full-service broker-dealer model, at least to some extent, he is also very clearly trying to fend off the final imposition of the (judicially vacated) DOL Fiduciary Rule. In short, he seems to be hoping that if the SEC adopts a Best Interest Requirement that is close enough to the DOL Fiduciary Rule, the DOL will abandon the Fiduciary Rule as moot. Arguably, the problem with this approach is that if the SEC adopts a Best Interest Requirement that is materially identical to the Fiduciary Rule, it is not the Fiduciary Rule that will have been mooted, it is the model of full-service brokerage. Further, it is not clear that anything short of having the SEC adopt the DOL Fiduciary Rule as its own would satisfy Commissioners Stein and Jackson. Conversely, if Commissioners Peirce and Piwowar are genuinely committed to preserving full service brokerage as a business model available for ordinary retail investors, it would seem likely that they would prefer that a broker-dealer's obligations to its constitutes by better defined that an ambiguous "best interest" standard would allow and might, for example, be open to allow broker-dealers and investors to define their relationship by contract.

B. The Underlying Policy Questions

The Releases and the differing views expressed by the Commissioners raise a number of very fundamental policy questions that in many ways go to the heart of the way in which our markets operate and the services and products that financial intermediaries may offer. We list a few of these issues below and then somewhat focus on two of the major issues:

- (i) to what extent are retail investors capable of making independent investment decisions or assessing recommendations;
- (ii) is "disclosure" an adequate means of protecting investors;
- (iii) is the broker-dealer model where a firm makes recommendations and earns transaction compensation based on investors following those recommendations inherently flawed;
- (iv) will retail investors be forced by the expense of the best interest standard into pure discount brokerage because it is not worthwhile to provide them with full-service brokerage given the costs and regulatory risks; and
- (v) does the broker-dealer regulatory regime provide more investor protections than does the adviser regime; and is the increasing burden of that protection the reason why the number of broker-dealers decreases while the number of advisers increases.
- should individual investors, or a subclass of such investors, be permitted to contract out of the Best Interest Requirement, which might allow them to hear of a fuller range of recommendations, including recommendations potentially involving material risk or recommendations that do not take account of their existing investment portfolios;
- what services will be available for (i) retail buy and hold investors; and (ii) small retail investors (as opposed to high net worth investors);
- what products will be available for retail investors;
- is it ever appropriate for broker-dealers to act in a "salesy" manner or capacity;
- as a society, are we better off pushing investors towards "safer" investments; and
- should we be pushing investment by retail investors to management by professionals; *e.g.*, through registered investment companies?

1. How to Deal with Financial Illiteracy

To put it in the bluntest possible terms, the underlying premises of the Best Interest Release is that (i) all household investors should be treated as "financially illiterate" and structurally vulnerable (and to the extent that there are exceptions, they are too unusual to be worried about), (ii) investors' financial illiteracy and vulnerability is so great that information asymmetries cannot be cured with disclosure,[42] and (iii) the threat of litigation risk combined with the express rules against conflicts of interest should be used to push investors into conservative investments.[43]

As a starting matter, these premises, while they sound harsh, are not so unreasonable. Studies have shown that the financial literacy of many Americans is remarkably low, that many do not understand the difference between a debt security and an equity security. In effect, for purposes of making investment decisions, these investors should be treated as a protected class.

Of course, one can say that financial illiteracy is a problem that should be confronted, but that is not a problem that the SEC is charged with solving, nor is it one that can be fixed in the short term. If one accepts that the SEC must take financial illiteracy as the norm, then a question that follows is whether any exceptions from that norm should be recognized. The answer that the Releases seems to give is "no," that exceptions are too slight, too small and too fleeting to be acknowledged.

2. The Pay-as-You-Go Model

The premise of acting as a full-service broker-dealer is that there is an inherent, but acceptable, conflict between the broker-dealer and the customer in that the broker or dealer only makes money if the investor trades and pays the broker-dealer for trading.[44] Notwithstanding this conflict of interest, this model may work sufficiently well (which is to say better than alternatives) for the same reason that many commercial sales models work sufficiently well: because the broker-dealer provides enough value that customers believe it works.[45] However, the Best Interest Release says that it is the SEC goal "to enhance investor protection, while preserving, **to the extent possible**

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[42] *See* pages 10-11 of the Best Interest Release as to disclosure alone being inherently insufficient.

[43] This is not intended as a sarcastic comment on the Releases. The belief that retail investors require protection is a central theme. Further, the concern that retail investors are not capable of making investment decisions for themselves is not a trivial or unrealistic concern. Therefore, even if society acknowledges that some investors are capable, it may be prudent for society not to attempt distinctions between investors, but simply to assume their general incapacity.

[44] The Best Interest Release acknowledges this in a number of places, including at page 22 and at footnote 33.

[45] To be sure, the SEC of 2018 is not the first person to suggest that the commission-based compensation system has its flaws. *See, e.g.*, *Report of the Committee on Compensation Practices* (Apr. 10, 1995) at 3 (committee would not, if starting from scratch, design a commission-based compensation system, noting "inevitable" conflicts of interest, but concluding that it would be too "radical" to seek changes in the near term, while noting a shift toward alternative arrangements).

access and choice for investors who prefer the "pay as you go" model for advice from broker-dealers."

At the same time, determining whether the provision of advice is "solely incidental" to the conduct of a broker-dealer[46] is not easy. And as Commissioner Jackson noted, nowhere in the Releases does the SEC appear to directly answer the policy question raised by Section 211(g) of the Advisers Act of whether a broker-dealer providing personalized investment advice and an investment adviser providing personalized investment advice should be subject to the same standards for the provision of that advice. Instead, the SEC simply implies its answer to the question is "no," that provision of advice that is "incidental" to other (paid) services should be regulated differently from advice that is paid for directly. This has merit as a policy, but is heavily reliant on the view that investors – whom the SEC elsewhere requires broker-dealers to treat as though they know little about investing – will understand, via a brief disclosure document, the complicated regulatory differences that result in financial advice given by broker-dealers, investment advisers, and others (*e.g.*, financial planners) to be subject to wholly different standards.

And this comes back to one of the core questions posed by the Releases: should the full-service, advice-providing broker-dealer model be preserved or should the market be pushed to move entirely to a combination of discount (no-advice) brokerage and investment advisers without any transaction-based fees? The SEC does not take a firm stand on this question, notwithstanding four of the five Commissioners are prepared to take one (albeit opposite stands). Instead, the SEC is proposing to adopt a regulatory scheme that suggests it believes a place for a middle ground of advice-providing broker exists (i.e., by not simply adopting the Advisers Act standard for advice from a broker), but one that also imposes obligations on broker-dealers in that middle ground that are significant enough to raise the question of what exactly is different, and will the liability and compliance risk from that standard be too costly for a broker continue to provide advice without receiving "special compensation" for that advice.

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The Releases raise very significant business and compliance questions for broker-dealers and investment advisers, and will likely create material litigation risks to the extent that firms continue with their current business models. Even if the Releases do not proceed, or are significantly modified, the Releases serve as a warning to firms that they should now review a number or their existing compliance procedures and potentially to restrict their product or service offerings.

The heated debate over the substance of the Releases reflects very substantial philosophical divides as to our appropriate regulatory model. On the one hand, there is the view that investors are

[46] *See* Advisers Act § 202(a)(11).

generally not able to fend for themselves, even given disclosures, and, thus, that any recommendations provided to investors must be given in a fiduciary capacity. Coupled with the view that broker-dealers must act entirely in the best interest of their clients, this position raises questions as to whether the full-service broker-dealer model, where broker-dealers provide advice and receive transaction fees, is viable.

On the other hand, there is the view that we should accept that broker-dealers may be less than fiduciaries and that many investors will be much better served if broker-dealers are able to present them with recommendations that do not bear all of the regulatory risk and litigation risk of being deemed a fiduciary. This model has the advantage that investors will have the opportunity to obtain a wider range of products and services, and at a lower cost; but the disadvantage that their purchases may bear more risk or they may receive advice that is conflicted in one way or another.

If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

Steve Lofchie	+1 212 504 6700	steven.lofchie@cwt.com
Dorothy Mehta	+1 212 504 6846	dorothy.mehta@cwt.com
James Frazier	+1 212 504 6963	james.frazier@cwt.com
Ellen Holloman	+1 212 504 6200	ellen.holloman@cwt.com
Nihal Patel	+1 212 504 5645	nihal.patel@cwt.com
Matthew Lefkowitz	+1 212 504 6227	matthew.lefkowitz@cwt.com
Mark Highman	+1 212 504 5604	mark.highman@cwt.com
Conor Almquist (law clerk)	+1 212 504 6082	conor.almquist@cwt.com