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Broker-Dealer and Investment Adviser Standards of Conduct - SEC Adopts Rules and Interpretations

June 11, 2019

On June 5, 2019, the Securities and Exchange Commission voted to adopt a package of rulemakings and interpretations, including (i) a new rule creating a standard of conduct for broker-dealers when recommending securities to retail investors (Regulation Best Interest), (ii) new rules requiring registered investment advisers and registered broker-dealers to provide retail investors a customer relationship summary (Form CRS), and (iii) two separate interpretations under the Investment Advisers Act of 1940, including with respect to advisers' fiduciary duties to clients. Regulation Best Interest and Form CRS will become effective 60 days after they are published in the Federal Register, and will include a transition period until June 30, 2020 to give firms sufficient time to come into compliance. The interpretations under the Advisers Act will become effective upon publication in the Federal Register.

Regulation Best Interest

Broker-dealers and their registered representatives have historically been subject to a "suitability" standard when recommending securities to their customers. Under Regulation Best Interest, a broker-dealer will be required to act in the best interests of a retail customer, and may not place its own interests ahead of the interests of a retail customer, when recommending any securities transaction or investment strategy involving securities to a retail customer. Regulation Best Interest defines a retail customer as "a natural person, or the legal representative of such natural person, who (i) receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer, or a natural person who is an associated person of a broker or dealer; and (ii) uses the recommendation primarily for personal, family, or household purposes."

Regulation Best Interest includes the following components:

- Disclosure Obligation – Broker-dealers will be required to disclose material facts about the relationship and recommendations, including specific disclosures about the capacity in which the broker-dealer is acting, fees, the type and scope of services provided, conflicts, limitations on services and products, and whether the broker-dealer provides monitoring services.
- Care Obligation – A broker-dealer will be required to exercise reasonable diligence, care, and skill when recommending any securities transaction or investment strategy involving securities to a retail customer. The broker-dealer will be required to understand the potential risks, rewards, and costs associated with the recommendation. The broker-dealer will then be required to consider these factors in light of the retail customer's investment profile and make a recommendation that is in the retail customer's best interest. The final regulation, which is an enhancement of the proposal, will explicitly require the broker-dealer to consider the costs of the recommendation.
- Conflict of Interest Obligation – The broker-dealer will be required to establish, maintain, and enforce written policies and procedures reasonably designed to identify and at a minimum disclose or eliminate conflicts of interest. This obligation, which is an enhancement of the proposed regulation, will specifically require policies and procedures to:
    - mitigate conflicts that create an incentive for the firm's financial professionals to place their interests or the interests of the firm ahead of the interests of the retail customer;
    - prevent material limitations on offerings, such as a limited product menu or an offering of only proprietary products, from causing the firm or any of its financial professionals to place his or her interest or the interests of the firm ahead of the interests of the retail customer; and
    - eliminate sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sale of specific securities or specific types of securities within a limited period of time.
- Compliance Obligation – In a modification of the proposed regulation, broker-dealers must establish, maintain, and enforce policies and procedures reasonably designed to achieve compliance with Regulation Best Interest as a whole.

While Regulation Best Interest did not include preemption provisions for the growing number of state laws addressing broker-dealer standards of conduct, the release noted in a footnote that "[w]hether Regulation Best Interest would have a preemptive effect on any state law would be determined in future judicial proceedings, and would depend on the language and operation of the particular state law at issue."

Form CRS Relationship Summary

Registered investment advisers and registered broker-dealers will now be required to deliver a relationship summary to clients who are retail investors. Form CRS defines a retail investor as "a natural person, or the legal representative of such natural person, who seeks to receive or receives services primarily for personal, family or household purposes." Consistent with interpretations of other provisions of federal law, investors in private funds who are natural persons should not be subject to the Form CRS delivery requirements if such natural persons are not otherwise considered "clients" of the registered adviser to the private fund (e.g. because a private fund investor might be considered a client if the adviser also manages a separate account for such natural person).

The relationship summary will take the form of a new Part 3 to Form ADV. In a change from the proposed regulation, broker-dealers will file the relationship summary through FINRA's Web CRD system instead of the SEC's EDGAR system. The relationship summary is intended to inform retail investors about:

- the types of client and customer relationships and services the firm offers;
- the fees, costs, conflicts of interest, and required standard of conduct associated with those relationships and services;
- whether the firm and its financial professionals currently have reportable legal or disciplinary history; and
- where the retail investor can find additional information about their brokerage or investment advisory services and request a copy of the Form CRS.

The relationship summary will have a standardized question-and-answer format to promote comparison by retail investors in a way that is distinct from existing disclosures. Retail investors will receive (i) a relationship summary at the beginning of a relationship with a firm, (ii) communications of updated information following a material change to the relationship summary, and (iii) an updated relationship summary upon certain events. The relationship summary is subject to filing with the SEC and applicable recordkeeping requirements.

The general instructions to Form CRS provide that if a registrant does not have any retail investors to whom it must deliver a relationship summary, then it is not required to prepare or file a Form CRS with the SEC. The relationship summary would also not be applicable to exempt reporting advisers.

Investment Advisers Act Interpretations

The SEC also issued two interpretive releases under the Investment Advisers Act.

- Commission Interpretation Regarding Standard of Conduct for Investment Advisers

The interpretation reaffirms, and in some cases clarifies, certain aspects of the fiduciary duty that an investment adviser owes to its clients under the Advisers Act. Specifically, the interpretation addresses both an adviser's duty of loyalty and duty of care.

Under its duty of loyalty, an investment adviser must not subordinate its clients' interests to its own. An adviser must also disclose all material facts relating to the advisory relationship and eliminate, or make full and fair disclosure of, all conflicts of interest which might incline an investment adviser, consciously or unconsciously, to render advice which is not disinterested. In order for disclosure to be full and fair, it should be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision whether or not to provide consent. The interpretation noted that full and fair disclosure for an institutional client (including the specificity, level of detail, and explanation of terminology) can differ, in some cases significantly, from full and fair disclosure for a retail client on the basis that institutional clients generally have a greater capacity and more resources than retail clients to analyze and understand complex conflicts and their ramifications.

The duty of care also includes (i) a duty to provide advice that is in the best interests of the client, (ii) a duty to seek best execution for client transactions, and (iii) a duty to provide ongoing advice and account monitoring over the course of the client relationship.

- Commission Interpretation Regarding the "Solely Incidental" Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser

Section 202(a)(11)(C) of the Advisers Act excludes from the definition of "investment adviser," and thus from the application of the Advisers Act, "any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor." The interpretation states that a broker-dealer's advice as to the value and characteristics of securities or as to the advisability of transacting in securities falls within the "solely incidental" prong of this exclusion, if the advice is provided in connection with and is reasonably related to the broker-dealer's primary business of effecting securities transactions.