Proskauer

Standards of Conduct for Investment Advisers and Broker-Dealers

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I. Introduction

On April 18, 2018, the Securities and Exchange Commission ("SEC") proposed a package of rulemakings and interpretations designed "to enhance the quality and transparency of investors' relationships with investment advisers and broker-dealers."

The package consisted of:

1. Proposed interpretation of the standard of conduct for investment advisers under the Investment Advisers Act of 1940 ("Advisers Act"), *i.e.*, the fiduciary obligations advisers owe to their clients.[1]
2. Proposed Regulation Best Interest ("Regulation BI") under the Securities Exchange Act of 1934 ("Exchange Act"), which would set a standard of conduct for broker-dealers (and associated persons) when recommending securities to retail customers.[2]
3. Proposed Form CRS, a three-page standardized "relationship summary" that must be provided to retail clients of advisers and customers of broker-dealers at the beginning of the relationship. Form CRS is designed to explain to investors the nature of the relationship between the financial professional and the client.[3]

The proposed rules differ significantly the SEC staff's 2011 report to Congress, which recommended that the SEC adopt a uniform standard of care for broker-dealers and investment advisers.[4]

II. Proposed Investment Adviser Interpretation

Investment advisers have long been held to owe their clients fiduciary duties. The nature and scope of those duties have been developed over the years by case law, SEC and staff interpretations, and enforcement actions. In the proposing release, the Commission explained that it sought to "reaffirm and – and in some cases clarify – certain aspects of the fiduciary duty."

The SEC release explained that an adviser's fiduciary duty comprises a duty of care and a duty of loyalty.

1. Duty of Care

Duty to Give Advice that is Suitable. An adviser has the duty to provide advice that it reasonably believes is suitable for the client and in the client's best interest, including (in the case of personalized investment advice) a duty to make a reasonable inquiry

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[1] *Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation*, Investment Advisers Act Rel. No. 4889 (Apr. 18, 2018) (the "Proposing Release").

[2] *Regulation Best Interest,* Exchange Act Rel. No. 83062 (Apr. 18, 2018).

[3] *Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles*; Exchange Act Rel. No. 83063 (Apr. 18, 2018).

[4] *Study on Investment Advisers and Broker-Dealers* (January 2011) (required by Section 913 of the Dodd-Frank Act).

into, and periodically update, a client's investment profile. This duty includes reasonably investigating any security before recommending it to the client.

Duty of Best Execution. When given the responsibility to select broker-dealers to execute trades, the adviser has a duty to seek to obtain the best execution of client transactions.

Duty to Monitor. At least where the adviser and the client have a continuing relationship, the adviser has a responsibility to monitor the client's account during the course of the relationship.

The SEC explained that an adviser's duty of care can be shaped by provisions of the advisory contract, as long as the contract does not seek to waive the fiduciary aspect of the relationship.

2. *Duty of Loyalty*

Interests of Clients. An adviser has a duty to place its client's interest first, and not unfairly favor its own interests above the client's or of one client's interests above another's.

Full and Fair Disclosure. An adviser must make full and fair disclosure to clients of all material facts about the advisory relationship, including all material conflicts of interest that could affect the advisory relationship.

Informed Consent. Where it has a material conflict, an adviser must obtain the informed consent of the client to the conflict. For consent to be inferred from disclosure, it must be sufficiently clear and detailed for a client to make a reasonably informed decision to consent to the conflict (or practice) or reject it.

In a departure from understood law, the SEC asserted in the Proposing Release that disclosure of a conflict alone is not always sufficient to satisfy an adviser's duty of loyalty under the Advisers Act.

3. *Requests for Comment*

The SEC also requested comment on:

a. Whether an adviser representative should be subject to a federal licensing and continuing education requirement, similar to associated persons of broker-dealers;

b. Whether advisers should be required to provide account statements to retail clients identifying, among other things, the "key categories of fees and expenses they should expect to pay"; and

c. Whether investment advisers should be subject to financial responsibility requirements, such maintenance of minimum net capital or holding a fidelity bond.

As the Proposing Release notes, each of these requirements has been considered in the past. It is unclear whether the SEC has the statutory authority to itself establish a licensing regime or impose on advisers any minimum financial responsibility requirements. In the past, it has sought legislation from Congress.

III. Proposed Regulation Best Interest

The SEC proposed Rule 15*l*-1 under the Exchange Act, which would establish a "best interest" standard of conduct for broker-dealers and their associated persons when making a recommendation of any securities transaction or investment strategy to a retail customer. It is a fiduciary-like standard, elements of which were drawn from the Advisers Act and recent ERISA rulemaking, but the proposal is grounded in concepts and limitations in the Exchange Act.

1. *Best Interest Standard*

   Broker-dealers and their associated persons must act in the best interest of retail customers at the time they make a recommendation without placing the financial or other interests of the broker-dealer or associated person ahead of the interests of the retail customer.

   a. *Retail Customer*. A "retail customer" would be a person or the legal representative of such person who receives a recommendation of any securities transaction or strategy from a broker-dealer or associated person and uses the recommendation primarily for personal family or household purposes.

   b. *Securities.* The recommendation or strategies must involve "securities."

   c. *When Recommendation Made*. The obligation to act in the best interest of the client would be limited to the time the recommendation is made.

   d. *Best Interest*. The term "best interest" is not defined, a subject of some discussion among the Commissioners when the SEC considered the proposed rule. The release explains that whether a recommendation is in the best interest of a customer will turn on the facts and circumstances of the recommendation and the customer. The proposing release explains that there is not one financial product the purchase of which is in the "best interest" of a customer, although a broker-dealer should generally consider reasonably availably alternatives.

   In both of these respects, Regulation BI would be more limited than the Advisers Act fiduciary duties, which are not limited to securities or retail clients.

2. *Safe Harbor*

   The best interest obligation would be satisfied if each of the three specific obligations are met:

   a. *Disclosure Obligation*. The broker-dealer or associated person, before or at the time of the recommendation reasonably discloses to the retail customer, in

writing, the material facts about the scope and terms of the relationship, including all material conflicts associated with the recommendation.

i. *Material Conflicts*. The SEC interprets "material conflict of interest" as any "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."

ii. *Writing.* To obtain the benefit of the safe harbor under Regulation BI, the disclosures must be in writing, although the disclosure of the same conflicts of an adviser may be satisfied by oral disclosure. What would the disclosure documents look like for a large wire house?

b. *Care Obligation*. The broker-dealer or associated person exercises reasonable diligence, care, skill and prudence. The care obligation is not be satisfied by disclosure and a violation would not require fraud or deceit.
c. *Conflict of Interest Obligations*. Broker-dealers (but not associated persons) would be required to establish, maintain and enforce written policies and procedures reasonably designed to:

i. Identify and, at a minimum, disclose or eliminate all material conflicts of interest associated with the recommendation; and

ii. Identify, disclose and mitigate, or eliminate, material conflicts of interest.

Satisfaction of the proposed conflict of interest obligations, as proposed, would be similar to compliance by an adviser of its duty of loyalty, but raises difficult questions about the controls necessary for a sales-driven organization. Might compliance drive broker-dealers to sell products that are compensation-neutral, as under the ERISA fiduciary rules? Would participation in sales contests continue to be viable? What does "mitigate" mean? Would implementation of supervisory procedures currently required of broker-dealers satisfy the obligations?

3. *Dual Registrants*

If an account is both a brokerage account and an advisory account, the Advisers Act fiduciary duty will displace Regulation BI even if the broker-dealer subsequently executes the transaction.

4. Recordkeeping

Proposed amendments to Rule 17a-3 under the Exchange Act would require broker-dealers to retain information collected from customers pursuant to Regulation BI for six years.

5. *Discretionary Authority*.

The SEC requested comment on whether investment discretion should be viewed as "solely incidental" to brokerage activity and that such authority alone should not

subject a broker-dealer to the Advisers Act. A 2007 SEC Release stated that discretionary brokerage accounts is not incidental, and the SEC appears to be re-opening the issue.[5]

IV. Proposed Form CRS – Relationship Summary; Limit on the Use of Terms

1. *Relationship Summary*

The SEC proposed a new Rule 204-4 under the Advisers Act and 17a-4 under the Exchange Act that would require registered advisers and broker-dealers to provide a brief relationship summary ("Relationship Summary") to retail clients/customers at the beginning of the relationship and upon a material change.

The Relationship Summary would be in a structured format limited to four pages, containing eight sections (discussed below). The SEC provided three "mock-ups" of what a Relationship Summary would look like, for an adviser, a broker-dealer and a dually-registered broker-dealer/adviser.

a. *Delivery*. In the case of an adviser, the Relationship Summary would have to be provided to (i) each retail client before or at the time the adviser enters into an advisory contract, and (ii) each retail investor that is an existing client before or at the time a different account is opened or changes are made to an existing account that would materially change the nature and scope of the relationship. In the case of a broker-dealer, delivery would have to be provided before or at the time the retail investor first engages the broker-dealer.[6]

b. *Additive.* The Relationship Summary is additive to other required disclosure. In the case of an adviser, it must be provided in addition to the advisory brochure. In the case of a broker-dealer, it is designed to work together with written disclosure required by Regulation BI.

c. *Filing*. Advisers would file the Relationship Summary as Part III of Form ADV. Broker-dealers would file the Relationship Summary on EDGAR.

d. *Content of Relationship Summary.* Proposed Form CRS prescribes much of the language that must be used in the document and prohibits disclosure in addition to that required by each item.

   i. *Introduction*. Begins by introducing the services and accounts the firm offers to retail investors by asking "Is an [Investment Advisory][Broker-Dealer] account right for you?" It must then explain that there are different ways to obtain advisory services.

   ii. *Relationships and Services*. Describes the services (*e.g.*, discretionary and non-discretionary advisory services) provided to

[5] *Interpretive Rule Under the Advisers Act Affecting Broker-Dealers*, Advisers Act Rel. No. 2652 (Sept. 24, 2007).
[6] Dual registrants would be required to deliver the Relationship Summary at the earlier of entering into an advisory agreement or the time at which the retail investors engages the firm,

retail clients/customers, and the types of fees that they will pay.

iii. *Standard of Conduct.* Describes the standard of conduct to which the firm is held under the securities laws as to the types of accounts offered. Per the proposed Regulation BI, brokers must "act in the best interest of their clients" and advisers are subject to a "fiduciary standard" with respect to clients.

iv. *Summary of Fees and Costs.* Explains that costs and fees affect the value of the client account over time. The item urges clients to seek personalized cost information from the "financial professional," but does not require it. Instead, broker-dealers must describe commissions, mark-ups and mark-downs, and other fees (including mutual fund fees), and advisor must describe their "asset-based fees" which "do [ ] not vary based upon the type of investments we select on your behalf."

v. *Comparisons Provided by Standalone Investment Advisers and Broker-Dealers.* This section would provide a comparison of advisory and brokerage accounts, including the types of fees paid and differences in the standard of care provided.

vi. *Conflicts of Interest.* Firms must explain that they benefit from the services they provide the client/customer and identify, from a list of conflicts provided the customer, those conflicts that apply to the accounts offered.

vii. *Additional Information.* If the firm has disciplinary event reported on the IARD or BrokerCheck, it must be acknowledged and provide a link (or toll-free phone number) so that investors may obtain more information about the event. The firm must provide information about how to report a problem to the SEC. It must also provide access to Investor.gov so the website's research tools are available to investors.

viii. *Key Questions to Ask.* Using the formats and the language provided (unless inapplicable), the Relationship Summary must set forth 10 questions each prospective customer/client should consider. The questions are designed to encourage discussion about the firm's service, fees, conflicts and disciplinary events. The item may include additional questions, but no more than 14.

2. *Restrictions on the Use of Certain Names and Titles*

Proposed Rule 15*l*-2 would preclude a broker-dealer from using the terms "adviser" or "advisor" when communicating with a retail investors unless (i) the broker-dealer is a registered adviser, or (ii) the associated person is a supervised person of a registered broker-dealer.

3. *Required Disclosure by Broker-Dealers of Registration Status*

Proposed Rule 15*l*-3 would require a broker dealers and its associated persons to prominently disclose in communications to retail investors that the firm is registered as a broker-dealer.