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SEC Adopts Rules & Interpretive Guidance Designed to Enhance and Clarify the Obligations of Financial Professionals

By The Investment Management Practice

Introduction

In April 2018, our team published an Alert detailing the Securities and Exchange Commission's (the "SEC" or the "Commission") proposed three-part regulatory package designed to enhance the quality and transparency of investors' relationships with investment advisers and broker-dealers. As noted in our 2018 Alert, in Section 913 of the Dodd-Frank Act, Congress authorized the Commission to promulgate a uniform fiduciary standard of conduct for broker-dealers and investment advisers "when providing personalized investment advice about securities to retail customers."[1]

On June 5, 2019, the SEC voted 3-1 (with the fifth seat on the Commission remaining vacant) to approve a package of rulemakings and interpretations including two adopted rules (each an "Adopted Rule" and, collectively, the "Adopted Rules") and two separate interpretations under the Investment Advisers Act of 1940, as amended ("Advisers Act"). The adopted regulatory package does not adopt a uniform fiduciary standard for broker-dealers and investment advisers. Instead, the Commission acknowledged that the broker-dealer and investment adviser business models are inherently different and as a result, adopting a rule that would provide for a uniform fiduciary standard would not be in the best interest of retail customers.

This new regulatory package comes only weeks after the Department of Labor (the "DOL") pushed back the expected date for its proposed "Fiduciary Rule and Prohibited Transaction Exemption" from September 2019 to December 2019,[2] and just over one year after the U.S. Court of Appeals for the Fifth Circuit struck down the DOL's prior "Fiduciary Rule" on the grounds that the rule [was] inconsistent with the plain text of ERISA, as well as the common law meaning of "fiduciary."[3]

At the Open Meeting on Commission Actions to Enhance and Clarify the Obligations of Financial Professionals ("Open Meeting"), SEC Chairman Jay Clayton noted that the regulatory package addresses the obligations of broker-dealers and investment advisers when they provide investment advice and services to retail investors. He further noted that the regulatory package is designed to enhance the quality and transparency of the financial professional-retail investor relationship, and includes two overarching objectives: (1) to bring the required standards of conduct for financial professionals and related mandated disclosures in line with reasonable investor expectations;

and (2) to preserve retail investor access (in terms of both choice and cost) to a variety of investment services and products.[4]

The four separate but complementary releases consist of two Adopted Rules: Regulation Best Interest: The Broker-Dealer Standard of Conduct ("Regulation Best Interest"), and Form Client Relationship Summary and Amendments to Form ADV ("Form CRS"); and two separate Commission interpretations: Commission Interpretation Regarding Standard of Conduct for Investment Advisers, and Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser. Each item is further discussed below.

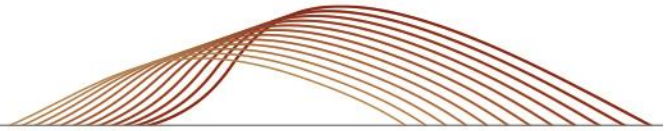
I. Regulation Best Interest

Under the SEC's Adopted Rule, a broker, dealer, or a natural person who is an associated person of a broker or dealer, when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer,[5] shall act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker, dealer, or natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer.

The SEC chose not to expressly define the term "best interest" in the rule text, but instead provided some color on what "acting in the best interest" means. The Regulation Best Interest Adopting Release (the "Adopting Release") notes that whether a broker-dealer has acted in the retail customer's best interest in compliance with Regulation Best Interest "will turn on an objective assessment of the facts and circumstances of how the specific components of Regulation Best Interest—including its Disclosure, Care, Conflict of Interest, and Compliance Obligations—are satisfied at the time that the recommendation is made (and not in hindsight)."[6]

The Adopting Release notes that while the existing fiduciary standard under the Advisers Act would not apply to broker-dealers, "key elements of the standard of conduct that applies to broker-dealers under Regulation Best Interest will be substantially similar to key elements of the standard of conduct that applies to investment advisers pursuant to their fiduciary duty under the Advisers Act."[7] The Adopting Release points out that the Adopted Rule incorporates Care and Conflict of Interest Obligations substantially similar to the fiduciary duties of care and loyalty under Section 206(1) and (2) of the Advisers Act, "even if not in the same manner as the 913 Study recommendations or identical to the duties under the Advisers Act."[8]

Notwithstanding the similarities, the Adopting Release notes that obligations of a broker-dealer under the Adopted Rule and the obligations of an investment adviser pursuant to its fiduciary duty under the Advisers Act differ in certain respects. For example, an investment adviser's duty of care encompasses the duty to provide advice and monitoring a client's account at a frequency that is in the best interest of such client. In contrast, the provision of recommendations in a broker-dealer relationship is generally transactional and episodic, and therefore the Adopted Rule requires that broker-dealers act in the best interest of their retail customers at the time a recommendation is made, and imposes no duty to monitor a customer's account following a recommendation.[9] Furthermore, the Adopting Release notes that the SEC was concerned that using the term "fiduciary" to describe a broker-dealer's obligations under Adopted Rule may create confusion by suggesting that the standards of conduct are identical in all respects. For example, the application of the adviser's fiduciary duty to the entire relationship versus Adopted Rule's recommendation-specific application, and the application of



an adviser's fiduciary duty to all clients as opposed to Regulation Best Interest's application to retail customers.

It is important to note that the Adopted Rule does not require that a broker-dealer provide conflict-free recommendations. For example, under the Adopted Rule, a broker-dealer could recommend a more expensive security if the broker-dealer has a reasonable basis to believe there are other factors about the security that make it in the best interest of the retail customer, based on that retail customer's investment profile.

According to the Adopted Rule, the "best interest" standard would be satisfied if the broker-dealer or its associated person complies with the following obligations:

Disclosure. Before or when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer, the broker-dealer must provide full and fair disclosure, in writing, of all material facts relating to the scope and terms of the relationship, and all material conflicts of interest associated with the recommendation.

Duty of Care. In making a recommendation, the broker-dealer exercises reasonable diligence, care, and skill to:

- understand the potential risks, rewards, and costs associated with the recommendation and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers;

- 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, rewards, and costs associated with the recommendation and does not place the financial or other interest of the broker-dealer ahead of the interest of the retail customer; and

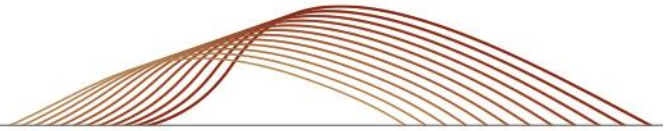
- have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile and does not place the financial or other interest of the broker-dealer ahead of the interest of the retail customer.

Conflicts of Interest. The broker-dealer establishes, maintains, and enforces written policies and procedures reasonably designed to:

- identify and, at a minimum, disclose, or eliminate, all conflicts of interest associated with such recommendations;

- identify and mitigate any conflicts of interest associated with such recommendations that create an incentive for the broker-dealer to place the interest of the broker-dealer ahead of the interest of the retail customer;

- (i) identify and disclose any material limitations placed on such recommendations and any conflicts of interest associated with such limitations, and (ii) prevent such limitations and associated conflicts of interest from causing the broker-dealer to make recommendations that place the interest of the broker-dealer ahead of the interest of the retail customer; and



- identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time.

Compliance. The broker-dealer establishes, maintains, and enforces written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.

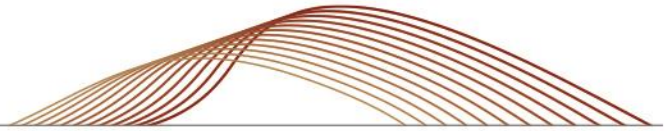
In a change from the 2018 proposal, the Adopting Release removed a provision that would have restricted broker-dealers and their associated persons, when communicating with retail investors, from using the term "adviser" or "advisor" as part of a name or title. The Commission noted that the reason it decided not to adopt a separate rule is because it "presume[s] that the use of the term 'adviser' and 'advisor' in a name or title by (1) a broker-dealer that is not also registered as an investment adviser or (2) an associated person that is not also a supervised person of an investment adviser, to be a violation of the capacity disclosure requirement under the Disclosure Obligation." According to the Commission, the capacity disclosure requirement is designed to improve awareness among retail customers of the capacity in which a broker-dealer and/or financial professional is acting when making a recommendation. The Commission further noted that it believes that "in most cases broker-dealers and their financial professionals cannot comply with the capacity disclosure requirement by disclosing that they are a broker-dealer while calling themselves an "adviser" or "advisor." Thus, according to the Commission, in most instances, the use of the titles "adviser" and "advisor" by brokers-dealers "would undermine the objectives of the capacity disclosure requirement by potentially confusing a retail customer as to type of firm and/or professional they are engaging."

II. Form CRS

The Commission also adopted a new question-and-answer, open-ended disclosure document, in order to help address investor confusion about the nature of their relationships with investment professionals: a customer or client relationship summary—Form CRS. Form CRS is intended to provide retail investors with simple, easy-to-understand information about the nature of their relationship with their investment professional and would supplement other more detailed disclosures—in no more than four pages.

Form CRS requires broker-dealers and investment advisers to deliver to retail customers a short summary, including: (1) the principal types of services offered; (2) the applicable fees the retail customer may pay;[10] (3) the legal standard of conduct applicable to the broker-dealer and the investment adviser;[11] (4) financial professional compensation and certain conflicts of interest; and (5) disciplinary history. The Adopted Rule also requires broker-dealers and investment advisers, and their associated natural persons and supervised persons, respectively, to disclose in retail investor communications the firm's registration status with the SEC and an associated person's and supervised person's relationship with the firm.

The relationship summary must be delivered to new or prospective clients or customers at the first possible opportunity, including the initial point of contact. The relationship summary is required whether or not there is a recommendation. Firms must update the relationship summary within 30 days whenever the relationship summary becomes materially inaccurate. Firms also must post the latest version on their website (if they have one), and electronically file the relationship summary with the Commission.



The biggest changes to Form CRS, from its corresponding proposal released in 2018, are to its format. Instead of prescribed text, like that of the proposed rule, the form will be in question-and-answer format. A firm can choose the questions posed to itself, and the Commission encourages the use of charts, tables, and other graphics, including hyperlinks, in its response. Firms may not omit any material facts necessary in order to make disclosures, but unlike the 2018 proposed rule, the Adopted Rule provides flexibility by taking into account the reality that not all material facts can be included within a short summary with a page limit.[12] Moreover, the relationship summary is designed to suggest follow-up questions for retail investors to ask their financial professionals. An example heading is "What investment services and advice can you provide me?" The instructions require all firms to address the following topics in the description of their services: (i) monitoring; (ii) investment authority; (iii) limited investment offerings; and (iv) account minimums and other requirements. However, the Commission still expects the form to be under four pages.

Finally, unlike the proposal made in 2018, the Adopted Rule will require Form CRS data to be filed in a structured format in order to facilitate machine readability of the information and enhance an investor's effort to compare among firms.

III. Standard of Conduct for Investment Advisers

In addition, on June 5, 2019, the Commission issued its interpretation of the fiduciary standard of conduct for investment advisers under the Advisers Act ("Final Interpretation"). While the Final Interpretation is similar in form and context to the 2018 proposal, it is worthwhile to note a few key differences.

In 2018, when discussing the duty of loyalty, the Commission noted that the duty of loyalty requires an investment adviser to put its "client's interests" first. However, the Final Interpretation notes that the duty of loyalty requires that an adviser "not subordinate its clients' interests" to its own. This revision prompted some harsh criticism from Commissioner Jackson. In his remarks he noted that "the final guidance the majority approves today removes language from last year's proposal stating that the law 'requires an investment adviser to put its client's interests first.' The guidance suggests that a careful reading of decades-old cases reveals that we were wrong last year to say that this is the law. I disagree."[13] According to the Final Interpretation, in order for an investment adviser not to subordinate its clients' interest to its own, the investment adviser must not place its own interest ahead of its client's interests.

Another change from the 2018 proposal relates to conflicts of interest. In 2018, when discussing conflicts of interest, the Commission noted that an investment adviser must "avoid conflicts of interest with its clients, and, at a minimum, make full and fair disclosure to its clients of all material conflicts of interest that could affect the advisory relationship." The Final Interpretation instead notes that "under its duty of loyalty, an investment adviser must 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 such that a client can provide informed consent to the conflict." Furthermore, the Final Interpretation notes that "[w]e disagree that this Final Interpretation includes a requirement to eliminate conflicts of interest." The Final Interpretation further notes that "…elimination of a conflict is one method of addressing that conflict; when appropriate advisers may also address the conflict by providing full and fair disclosure such that a client can provide informed consent to the conflict."[14] Similarly, this change did not go unnoticed by Commissioner Jackson. He noted in his remarks that "in addition to concluding that investment advisers need not put investor interests first, the interpretation takes a troubling turn toward a disclosure-only regime for investment advisers."[15]

The Final Interpretation also replaces the 2018 general statement about an inability to fully and fairly disclose material facts about the conflict with more specific examples of how advisers can make such full and fair disclosure. It also appears that a client's consent to conflict of interest disclosure could be either explicit or implicit. The Final Interpretation notes, "an adviser could provide a client full and fair disclosure of all material facts relating to the advisory relationship as well as full and fair disclosure of all conflicts of interest which might incline the adviser, consciously or unconsciously, to render advice that was not disinterested, through a combination of Form ADV…and the client could implicitly consent by entering into or continuing the investment advisory relationship with the adviser."[16] However, the Final Interpretation also notes that in certain instances disclosure may not be specific enough in order for a client to fully understand whether and how the conflict could affect the advice it receives. The Final Interpretation states that with respect to retail clients "it may be difficult to provide disclosure regarding complex or extensive conflicts that is sufficiently specific, but also understandable." In such instances, "the adviser should either eliminate the conflict or adequately mitigate (i.e., modify practices to reduce) the conflict such that full and fair disclosure and informed consent are possible."[17]

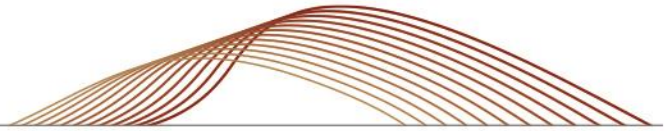
The Final Interpretation also acknowledges the ability of investment advisers and their clients to shape the scope of the advisory relationship to which the fiduciary duty applies. The Final Interpretation notes that "while advisers owe each of their clients a fiduciary duty, the specific obligations of, for example, an adviser providing comprehensive, discretionary advice in an ongoing relationship with a retail client will be significantly different from the obligations of an adviser to an institutional client, such as a registered investment company or private fund, where the contract defines the scope of the adviser's services and limitations on its authority with substantial specificity."[18]

IV. Broker-Dealer Exclusion from the Definition of Investment Adviser

The final piece of the four-part regulatory package, which was not included in the Commission's original proposals released in 2018, provides an interpretation of when a broker-dealer is outside the so-called "broker-dealer exclusion" of Section 202(a)(11)(C) of the Advisers Act and would therefore have to register as an investment adviser and meet Advisers Act fiduciary and other standards (if another exclusion or exemption is not available).

This interpretation was implemented in order to clarify the Commission's view on the exclusion of those whose performance of such advisory services is solely incidental to the conduct of his/her business as a broker or dealer and who receives no special compensation for those services (the "broker-dealer exclusion") from the definition of an "investment adviser," as defined in section 202(a)(11) of the Advisers Act. The Commission stated that advice is "consistent with the solely incidental prong if the advice is provided in connection with and is reasonably related to the broker-dealer's primary business of effecting securities transactions."[19] If, however, a broker-dealer's primary business is giving advice as to the value and characteristics of securities or the advisability of transacting in securities, or if the advisory services are not offered in connection with or are not reasonably related to the broker-dealer's business of effecting securities transactions, the broker-dealer's services would not be solely incidental to its business as a broker-dealer. The interpretation further notes that whether advisory services satisfy the solely incidental test is a facts and circumstances test based on broker-dealer specific business, services offered, and relationship between the broker-dealer and its customers.

The Commission noted that a broker-dealer that exercises unlimited discretion over a client's account generally would not be able to satisfy the solely incidental prong. Nonetheless, the Commission



acknowledged that in certain instances, a broker-dealer may exercise temporary or limited discretion in a way that is not indicative of a relationship that is primarily advisory in nature. These types of relationships would be limited in time, scope, or other manner and lack the comprehensive and continuous character of investment discretion that would suggest that the relationship is primarily advisory.

V. Looking Ahead

The Adopted Rules and interpretations are expected to have implications concerning recommendations of investments in registered investment products such as mutual funds and unit investment trusts. Specifically, the Adopted Rules may require, among other things, disclosures at various points of a client relationship regarding potential conflicts of interest in making recommendations from among a group of similar products.

Commissioner Jackson, the sole dissenter, gave unenthusiastic and cautious assessments of the Adopted Rules and interpretations. He stated that the Adopted Rules "retain a muddled standard that exposes millions of Americans to the costs of conflicted advice. Even worse, contrary to what Americans have heard for a generation, the Commission today concludes that investment advisers are not true fiduciaries."[20] He specifically noted that, with respect to broker-dealers, the Adopted Rule fails to require that investor interests come first, instead, the core standard of conduct set forth in the Adopted Rule "remains far too ambiguous about a question on which there should be no confusion. As a result, conflicts will continue to taint the advice American investors receive from brokers." Commissioner Jackson's statements are perhaps a foreshadowing of future legal challenges to overturn the Adopted Rule.[21]

It is important to also note that Regulation Best Interest does not expressly preempt state law.[22] However, the Adopting Release noted "that the preemptive effect of Regulation Best Interest on any state law governing the relationship between regulated entities and their customers would be determined in future judicial proceedings based on the specific language and effect of that state law."[23] Chairman Clayton, in his remarks, seemed to acknowledge that future discussions between the SEC, DOL, and state regulators will be necessary in order to ensure that Regulation Best Interest and future DOL/state regulations can coexist. Only time will tell how Regulation Best Interest will harmonize with other fiduciary duty initiatives.

To address at least some of the potential confusion for retail investors, according to Chairman Clayton's remarks, the Commission is undertaking significant retail investor educational efforts to help investors understand the differences between broker-dealers and investment advisers. This will include online videos explaining basic information.

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 time to come into compliance. The Commission's interpretations under the Advisers Act will become effective upon publication in the Federal Register.

The SEC's press release can be found here.

The SEC's Adopted Rules and interpretive guidance can be found at the following links: Regulation Best Interest, Form CRS, Standard of Conduct for Investment Advisers, and Broker-Dealer Exclusion.

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[1] SEC Releases Staff Study Recommending a Uniform Fiduciary Standard of Conduct for Broker-Dealers and Investment Advisers, Exchange Act Release No. 2011-20 (Jan. 20, 2011), https://www.sec.gov/news/press/2011/2011-20.htm.

[2] Recently, Preston Rutledge, head of DOL's Employee Benefits Security Administration, noted that DOL's fiduciary rulemaking will align with SEC's Regulation Best Interest. *See e.g.*, DOL's New Fiduciary Rule Will Align With SEC Reg BI: Rutledge, (June 4, 2019), available at https://www.thinkadvisor.com/2019/06/04/dols-new-fiduciary-rule-will-align-with-sec-reg-bi-rutledge/?slreturn=20190512122714.

[3] *See Chamber of Commerce of the U.S.A., et al. v. U.S. Dep't of Labor, et al.*, No. 17-10238, slip op. 46 (5th Cir. Mar. 15, 2018).

[4] Statement at the Open Meeting on Commission Actions to Enhance and Clarify the Obligations Financial Professionals Owe to our Main Street Investors (June 5, 2019), available at https://www.sec.gov/news/public-statement/statement-clayton-060519-iabd.

[5] "Retail customer" is defined as any natural person who receives a recommendation about a securities transaction or investment strategy involving securities from a broker-dealer, and who uses it primarily for personal, family, or household purposes. The Adopting Release notes that "personal, family or household purposes" would cover retirement accounts, as retirement savings is a personal, household, or family purpose. Accordingly, the definition of retail customer will include a natural person receiving recommendations for his or her own retirement account, including but not limited to IRAs and individual accounts in workplace retirement plans, such as 401(k) plans and other tax-favored retirement plans. Thus, plan participants receiving recommendations about whether to take a distribution from a 401(k) plan or other workplace retirement plan and how to invest that distribution would be covered as retail customers. Similarly, a plan participant receiving recommendations for the participant's individual account held in a 401(k) plan or other workplace retirement plan would be a retail customer for purposes of the Adopted Rule.

[6] Regulation Best Interest: The Broker-Dealer Standard of Conduct, Release No. 34-86031, (June 5, 2019), ("Regulation BI"), at pp. 35-36.

[7] *See id.* at pp. 58.

[8] *See id.* at pp. 59.

[9] It is important to note that while broker-dealers will not be required to monitor accounts, in instances where a broker-dealer agrees to provide the retail customer with specified account monitoring services, the Commission believes that such an agreement will result in buy, sell, or hold recommendations subject to the Adopted Rule, even when the recommendation to hold is implicit.

[10] This element will have a prescribed statement regarding the impact of fees and costs on investments, and a prescribed statement encouraging retail investors to understand what fees and costs they are paying. *See generally* Form CRS Relationship Summary; Amendments to Form ADV, Release No. 34-86032 ("Form CRS"), Section II(A)(1).

[11] This element will have prescribed statements. *See* Form CRS, Section II(A)(1).

[12] *See* generally Form CRS, Section II(A)(1).

[13] *See* Final Rules Governing Investment Advice (June 5, 2019), available at https://www.sec.gov/news/public-statement/statement-jackson-060519-iabd.

[14] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248, at pp. 39.

[15] See Final Rules Governing Investment Advice (June 5, 2019), available at https://www.sec.gov/news/public-statement/statement-jackson-060519-iabd.

[16] *See supra* note 13 at pp. 27 footnote 68.

[17] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248, at pp. 28.

[18] *See id.* at pp. 39-40.

[19] Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser. Release No. IA-5249 (June 5, 2019).

[20] *See* Final Rules Governing Investment Advice (June 5, 2019), available at https://www.sec.gov/news/public-statement/statement-jackson-060519-iabd.

[21] *See SEC passes Regulation Best Interest, but fiduciary rules could make a comeback*, available at https://www.financial-planning.com/news/sec-passes-regulation-best-interest-but-fiduciary-rules-could-make-a-comeback, where Barbara Roper, Director of Investor Protection, Consumer Federation of America, noted "I honestly don't expect this rule to outlast this administration. Assuming we get a rule that only gets support from the broker-dealers and is directly contradictory to Congressional intent, I would then assume that as soon as we have a modestly progressive Democrat in the White House, this issue will be reopened."

[22] There are currently fiduciary proposals in draft stages in both Nevada and New Jersey.

[23] *See* Regulation BI at pp. 43 ("we believe that Regulation Best Interest, Form CRS, and the related rules, interpretations and guidance that the Commission is concurrently issuing will serve as focal points for promoting clarity, establishing greater consistency in the level of retail customer protections provided, and easing compliance across the regulatory landscape and the spectrum of investment professionals and products.")