

Client Alert

Current Issues Relevant to Our Clients

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SIFMA Proposes “Best Interests of the Customer” Standard for Broker-Dealers

The Securities Industry and Financial Markets Association (“SIFMA”) recently proposed that the Financial Industry Regulatory Authority (“FINRA”) amend its rules to replace the current broker-dealer “suitability” standard with a new “best interests” standard along with enhanced customer disclosure about a broker-dealer’s services, conflicts of interest, fees and compensation. This “best interests” standard would generally require a broker-dealer to use the care, skill, prudence and diligence that a prudent person would exercise based on the customer’s investment profile but would allow a broker-dealer to offer only proprietary or other limited ranges of products without necessarily violating the standard and would not expressly prohibit a broker-dealer from considering its own financial or other interests in making recommendations to customers. A copy of SIFMA’s proposal is available [here](#).

Background

The SIFMA proposal is part of ongoing efforts related to a uniform standard of conduct for the provision of investment advice by broker-dealers and investment advisers. While investment advisers are generally considered to owe an obligation under the Investment Advisers Act of 1940 (the “*Advisers Act*”) to act in the best interests of their advisory clients and to provide investment advice in a client’s best interests, broker-dealers not acting in an investment adviser capacity generally have more limited obligations with respect to brokerage clients, including a duty of fair dealing, duty of best execution, suitability requirements and certain disclosure requirements. The basic FINRA suitability obligation in FINRA Rule 2111 generally requires that a broker-dealer have a reasonable basis to believe that a recommended securities transaction or investment strategy is “suitable” for the customer based on the information obtained through the reasonable diligence of the broker-dealer to ascertain the customer’s investment profile. Municipal Securities Rulemaking Board (the “*MSRB*”) Rule G-19 also imposes a similar suitability standard with respect to municipal security transactions. Accordingly, the current broker-dealer standards of conduct with respect to brokerage clients differ significantly from the fiduciary duty typically owed by investment advisers to advisory clients. For more information on the existing FINRA and MSRB suitability standards, see our *Client Alerts* available [here](#) and [here](#).

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act gave the SEC the power (but not the obligation) to adopt rules to provide that when a broker-dealer provides personalized investment advice

about securities to a retail customer, the standard of conduct with respect to the customer is the same as the standard of conduct applicable to an investment adviser under the Advisers Act. While the SEC has engaged in significant discussion of proposed rules, the SEC has not yet actually proposed such a standard. For more information on the SEC’s past actions in developing such a standard, see our *Client Alert* available [here](#).

At the same time that the SEC has been debating potential Dodd-Frank rulemaking, the Department of Labor (“*DOL*”) has separately been considering adopting changes that would change its definition of who would be a “fiduciary” under the Employee Retirement Security Income Act of 1974 (“*ERISA*”) and that would also apply fiduciary standards to individual retirement accounts (“*IRAs*”) and not just employee benefit plans. Among other things, these changes would generally make broker-dealers ERISA “fiduciaries” with respect to regular IRAs and subject broker-dealers to the ERISA prohibited transaction rules, including broad prohibitions on principal transactions with IRA customers. As part of the DOL proposal, the DOL has proposed a “best interest contract exemption” that would impose a unique “best interest” standard of care that applies only to customer retirement accounts and not to other broker-dealer customer accounts. This standard would require a broker-dealer to act with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person would exercise based on the investment objectives, risk tolerance, financial circumstances and needs of the retirement investor, without regard to the financial or other interests of the broker-dealer or any affiliate or other party.

SIFMA has consistently supported a uniform standard of conduct and has advocated for a uniform standard across

all brokerage account types to avoid different standards being applied to different brokerage accounts of the same investor serviced by the same broker-dealer. The current SIFMA proposal takes a different approach than either the SEC Dodd-Frank rulemaking or the DOL ERISA rulemaking efforts. The SIFMA proposal focuses on FINRA rules changes rather than federal agency rulemaking. In addition, the SIFMA proposal is not necessarily an all-encompassing rule proposal but is intended to focus attention on, and promote discussion about, the core elements of a proposed best interests of the customer standard for broker-dealers. SIFMA notes that its proposal does not address certain key details about how the standard would operate under various scenarios and the content, timing and manner of disclosures and consents, if any, all of which are of critical significance to SIFMA's members.

SIFMA's Proposed Best Interests Standard

The SIFMA proposal would revise the current FINRA Rule 2111 suitability standard. Under the proposed SIFMA amendments a FINRA member or an associated person would be required to have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is in the best interests of the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. The SIFMA proposal would require the following:

- **Best Interests of the Customer**—A broker-dealer would need to make recommendations that reflect the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person would exercise based on the customer's investment profile. The proposal does not change the definition of "investment profile," which would continue to include, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance and any other information the customer may disclose to a broker-dealer in connection with a recommendation. Under the best interests standard, the sale of only proprietary or other limited range of products by a firm would not be considered a violation.
- **Fee Disclosure and Management**—A broker-dealer would need to appropriately disclose and manage investment-related fees. A firm would need to ensure that investment-related fees incurred by the customer are reasonable, fair and consistent with the customer's best interests. The proposal provides that managing investment-related fees would not require recommending the least expensive alternative and should not interfere with making recommendations

from among an array of services, securities and other investment products consistent with the customer's investment profile.

- **Conflicts of Interest**—A broker-dealer would need to avoid, or otherwise appropriately manage, disclose and obtain consents to, material conflicts of interest, and otherwise ensure that a recommendation is not materially compromised by such material conflicts. A broker-dealer would need to disclose material conflicts of interest to the customer in a clear and concise manner designed to ensure that the customer understands the implications of the conflict. The customer would need to be given the choice of whether or not to waive the conflict, and must provide consent (but the consent could be provided at the time of account opening). Notwithstanding any disclosure or customer consent, a recommended transaction or investment strategy would still need to be in the best interests of the customer.

Disclosure Standards

The SIFMA proposal includes a proposed new FINRA Rule 2260 which would incorporate five new disclosure requirements.

- **Account opening disclosure**—A member would be required disclose to the customer, at or prior to the opening of the customer account, or prior to recommending a transaction or investment strategy:
 - the type of relationships available from the broker-dealer and the standard of conduct that would apply to those relationships;
 - the services that would be available as part of the relationships, and information about applicable direct and indirect investment-related fees;
 - material conflicts of interest that apply to these relationships, including material conflicts arising from compensation arrangements, proprietary products, underwritten new issues, types of principal transactions and customer consents thereto; and
 - disclosure about the background of the firm and its associated persons generally, including referring the customer to existing systems, such as FINRA's BrokerCheck database.
- **Annual disclosure**—A broker-dealer would need to provide an annual good faith summary to the customer of investment-related fees incurred by the customer from the broker-dealer with respect to all products and services provided during the prior year (or such shorter period as applicable).

- **Webpage disclosure**—A firm’s webpage would need to provide supplemental information to the customer, including access to all account opening disclosure. Paper disclosure would be provided to customers that lack effective Internet access or that otherwise so request.
- **Customer consent**—Customer consent to material conflicts of interest, such as principal transactions, or for other purposes as appropriate may be provided at account opening. Existing customers with accounts established prior to the effective date of the best interests standard would be deemed to have consented to the material conflicts of interest, if any, disclosed to the customer, upon continuing to accept or use account services.
- **Disclosure updates**—Updates to disclosures, if necessary or appropriate, would be made through an annual notification that provides a website address where specific changes to a firm’s disclosure are highlighted.

For More Information

To discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

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