Chapman and Cutler LLP

Chapman Client Alert

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Current Issues Relevant to Our Clients

SEC Proposes Regulation Best Interest to Establish New Broker-Dealer Standard of Conduct

On April 18, 2018, the Securities and Exchange Commission (the *"Commission"*) proposed new Regulation Best Interest (*"Regulation BI"*) under the Securities Exchange Act of 1934 (the *"Exchange Act"*). The proposed regulation, if adopted, would establish a federal standard of conduct for broker-dealers and natural persons who are associated persons of a broker-dealer when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer. The proposed standard of conduct is 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 associated person making the recommendation ahead of the interest of the retail customer. The full text of the Commission's release announcing proposed Regulation BI is available here.

Simultaneous with its Regulation BI proposal, the Commission also proposed the following:

1. Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles—New and amended rules and forms to (1) require registered investment advisers and registered broker-dealers to provide a brief relationship summary to retail investors, (2) prohibit the use of the words "adviser" or "advisor" in a broker-dealer's or associated person's name or title and (3) enhance registration status disclosures made to retail investors, which are described in our Client Alert available here.

2. Interpretation Regarding Standard of Conduct for Investment Advisers—An interpretation of the standard of conduct for investment advisers, which is described in our Client Alert available here.

Background

As Congress discussed what would become the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (the *"Dodd-Frank Act"*), the possibility of a uniform statutory standard of conduct for broker-dealers and investment advisers was a hotly debated topic. In the end, the House and Senate did not set a statutory duty standard, and the Dodd-Frank Act ultimately pushed the issue to the Commission by amending the Exchange Act and Investment Advisers Act of 1940 to expressly permit the Commission to adopt rules that provide a standard of conduct for broker-dealers and investment advisers when they provide personalized investment advice about securities to retail customers. The Dodd-Frank Act also required the Commission staff to conduct a study (the *"Study"*) of the legal and regulatory requirements applicable to broker-dealers, investment advisers and associated persons who provide personalized investment advice and recommendations about securities to retail customers.

The Commission initially published a request for public comment related to these issues in July 2010 in a release available here. The Commission used that information in connection with the Study, which the Commission released in January 2011 and is available here. The Commission's staff made two basic recommendations in the Study. The first was for the Commission to exercise its discretionary powers under the Dodd-Frank Act to implement a uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice to retail customers. The second recommendation was for the Commission to consider harmonizing the regulatory requirements of broker-dealers and investment advisers if the staff finds, after additional inquiry, that such harmonization would provide additional investor protection. In March 2013, the Commission sought additional public input regarding the effects of a uniform fiduciary standard in a release available here. On June 1, 2017, Chairman Jay Clayton announced that the Commission would seek further public comment from retail investors and other interested parties on the standards of

conduct applicable to broker-dealers and investment advisers. Since that time, however, the Commission has not taken any official public action towards implementation of the Study's recommendations.

In the absence of regulation by the Commission, in April 2016, the Department of Labor (the *"DOL"*) adopted its own rule to define the term "fiduciary" and address conflicts of interest in providing investment advice to retirement account investors (the *"Fiduciary Rule"*). The Fiduciary Rule generally requires those who provide retirement investment advice to employee benefit plans and individual retirement accounts to abide by a fiduciary standard. The DOL also adopted related exemptions that provided requirements that must be satisfied to prevent prohibited transactions under the Employee Retirement Income Security Act of 1974 and Internal Revenue Code. The Fiduciary Rule and exemptions were to become applicable on April 9, 2017 but the 2016 presidential election introduced uncertainty as to whether the rule would actually become applicable on that date. Shortly after taking office, President Trump directed a new review of the Fiduciary Rule with an eye towards full repeal or significant revisions. After requesting additional comment on the Fiduciary Rule and delays of the applicability date, the DOL ultimately delayed the applicability date until June 9, 2017 and delayed full compliance with certain significant parts of the exemptions multiple times until July 19, 2018. However, on March 15, 2018, in a case challenging the DOL's authority to issue the Fiduciary Rule, the U.S. Court of Appeals for the Fifth Circuit issued a ruling and judgment vacating the Fiduciary Rule in its entirety. While the period for the DOL or a potential intervenor to appeal that decision will expire after the mandate from the Fifth Circuit is issued on May 7, 2018 (absent a request for an extension of the issuance of the mandate by the DOL, or an intervenor, as it considers whether to seek appeal to the Supreme Court of the United States), the Fifth Circuit's ruling puts the fate of the Fiduciary Rule in serious jeopardy.

The Commission's new proposal represents the most important step to date to implement the recommendations of the Study as well as provide a regulatory alternative to the DOL's embattled Fiduciary Rule.

Proposal Summary

Proposed Regulation BI (which would be codified as Exchange Act Rule 15l-1), would require that all broker-dealers and natural persons who are associated persons of a broker-dealer (unless otherwise indicated, together referred to as *"broker-dealers"*), when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer, 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 making the recommendation ahead of the interest of the retail customer. The best interest obligation would be discharged if the following three obligations are satisfied:

1. *Disclosure Obligation*—The broker-dealer, prior to or at the time of such 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, including all material conflicts of interest that are associated with the recommendation.

2. *Care Obligation*—The broker-dealer, in making the recommendation exercises reasonable diligence, care, skill and prudence to:

   a. Understand the potential risks and rewards 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;

   b. Have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks and rewards associated with the recommendation; and

   c. 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.

3. *Conflict of Interest Obligation*—The broker-dealer establishes, maintains and enforces written policies and procedures reasonably designed to (a) identify and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with such recommendations, and (b) identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations.

For purposes of Regulation BI, a "retail customer" means a person, or the legal representative of such person, who (1) receives a recommendation of any securities transaction or investment strategy involving securities from a broker-dealer and (2) uses the recommendation primarily for personal, family or household purposes. A "retail customer's investment profile" includes, but is not limited to, the retail 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 retail customer may disclose to the broker, dealer, or a natural person who is an associated person of a broker or dealer in connection with a recommendation.

Analysis

Overall, Regulation BI represents some enhancements on existing broker-dealer duties and disclosure requirements while generally remaining business practice neutral, as is not the case with respect to the Fiduciary Rule. Regulation BI is notable as many of the characteristics of the "best interest" standard and disclosure requirements applicable to broker-dealers are similar to those in the 2015 Securities Industry and Financial Markets Association "best interest of the customer" proposal, which is described in our Client Alert available here. It is also notable that the standard of conduct under proposed Regulation BI is an independent standard applicable only to broker-dealers that is not specifically the same as or tied to the conduct standard applicable to registered investment advisers. This could introduce questions about the Commission's authority to adopt such a regulation pursuant to the power granted to the Commission as part of the Dodd-Frank Act, as discussed above.

Disclosure Obligation

In order to "reasonably disclose" in accordance with the disclosure obligation, a broker-dealer would need to give sufficient information to enable a retail customer to make an informed decision with regard to the recommendation. Disclosures made pursuant to the disclosure obligation must be true and may not omit any material facts necessary to make the required disclosures not misleading.

The Commission anticipates that new Form CRS, if adopted, would comprise an important part of the disclosure obligation. However, satisfactory completion and delivery of the Form CRS would not by itself satisfy the obligation. The proposal contemplates, as a general matter, that Form CRS and its related disclosure requirements would constitute the initial layers of disclosure, with other more specific and detailed layers of disclosure being provided to the retail customer at various points in the customer relationship, specifically: (1) at the beginning of a relationship (*e.g.,* in a relationship guide, such as or in addition to the Form CRS, or in written communications with the retail customer, such as the account opening agreement); (2) on a regular or periodic basis (*e.g.,* on a quarterly or annual basis, when any previously disclosed information becomes materially inaccurate, or when there is new relevant material information); (3) at other points, such as before making a particular recommendation or at the point of sale; and/or (4) at multiple points in the relationship or through a layered approach to disclosure.

Care Obligation

Generally, Regulation BI would build upon and enhance existing "suitability" requirements applicable to broker-dealers by applying, as the name implies, a "best interest of the customer" standard. The three prongs of the obligation generally impose on broker-dealers the duty to (1) conduct due diligence and understand generally the risks and rewards of the securities or investment strategies they are recommending, (2) have a reasonable basis to believe, in light of all the facts and circumstances, that the recommendation is in the best interest of a particular retail customer and (3) have a reasonable basis to believe that any series of transactions is in a particular retail customer's best interest (*i.e.,* quantitative suitability). While the care obligation is similar to the Financial Industry Regulatory Authority, Inc.'s (*"FINRA"*) suitability rule (Rule 2111), Regulation BI removes the element of control from the quantitative suitability obligation, meaning broker-dealers are still obligated act in the best interest of a retail customer even if they lack actual or de facto control over the customer account when recommending a series of transactions or a concentration in a particular investment product or type. Unsurprisingly, soon after Regulation BI was proposed, FINRA proposed its own amendment to Rule 2111 to align its quantitative suitability obligation with the standard proposed in Regulation BI. FINRA's proposal is available here.

Regulation BI's care obligation is perhaps most notable for the duties that it does not impose on broker-dealers. The care obligation does not:

- require consideration of all possible securities, all other products or all investment strategies to recommend the single "best" security or investment strategy;
- require recommendation of the least expensive or least remunerative security or investment strategy (but broker-dealers must justify a higher priced alternative or have a reasonable basis to believe a higher remunerative product is in the best interest of the customer);
- prohibit recommendations from a limited range of products;
- prohibit recommendations of proprietary products, products of affiliates or principal transactions with retail customers; or
- propose a fiduciary duty which mirrors the duties of a registered investment adviser.

Conflict of Interest Obligation

The conflict of interest obligation requires broker-dealers to adopt two categories of policies and procedures:

1. Policies and procedures reasonably designed to identify and disclose (or eliminate) all material conflicts of interest that are associated with a recommendation to a retail customer; and

2. Policies and procedures reasonably designed to identify, disclose and mitigate (or eliminate) all material conflicts of interest arising from financial incentives that are associated with a recommendation to a retail customer.

While the conflict of interest obligations would require a broker-dealer to have policies and procedures reasonably designed to at a minimum disclose or eliminate all material conflicts of interest related to the recommendation (or to disclose and mitigate or eliminate those material conflicts of interest arising from financial incentives), it does not mandate the absolute elimination of any particular conflicts, absent another requirement to do so. Under Regulation BI, broker-dealers would be permitted to exercise their judgment as to whether, for example, the conflict can be effectively disclosed, determine what conflict mitigation methods may be appropriate, and determine whether or how to eliminate a conflict, if necessary, so long as the broker-dealer's policies and procedures are reasonably designed. Whether a broker-dealer's policies and procedures are reasonably designed to meet its conflict of interest obligations will depend on the facts and circumstances of a given situation. Importantly, the proposal does not specifically identify which types of financial incentives must be mitigated, and the Commission is seeking public comment on questions related to that issue.

It is also notable that the conflict of interest obligations are limited to material conflicts of interest, and to material conflicts arising from financial incentives, that are "associated with a recommendation." The Commission believes this limitation is appropriate because broker-dealers often provide a range of services as part of any relationship with a retail customer, many of which would not involve a recommendation, and such services already are subject to general antifraud liability and specific requirements to address associated conflicts of interest.

Comment Period

Comments on proposed Regulation BI and the other Commission proposals are due by ninety days from the date of their publication in the Federal Register.

For More Information

If you would like 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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