SEC Issues Proposed Rules and Interpretive Guidance Addressing Standards of Conduct for Broker-Dealers and Investment Advisers

On April 18, 2018, following a two-hour open meeting, the U.S. Securities and Exchange Commission (the "SEC") voted 4-1 to issue the Standards of Conduct for Investment Professionals Rulemaking Package, which is roughly 1,000 pages long and comprises three releases, one of which is a proposed interpretation and two of which are proposed rules regarding the standards of conduct for investment advisers and broker-dealers (each a "Proposal" and together, the "Proposals"). In one release, the SEC proposed an interpretation of the federal fiduciary duty applicable to investment advisers and requested comment on whether registered investment advisers should be subject to three additional requirements similar to those that currently apply to broker-dealers.[1] In the second release, the SEC proposed a client relationship summary rule which would require both investment advisers and broker-dealers to provide information to retail investors prior to establishing a client relationship, and which is designed to help retail investors make a more informed choice when deciding whether to open a brokerage account or an investment advisory account.[2] In the third release, the SEC proposed Regulation Best Interest, which would establish a new standard of conduct applicable to broker-dealers when recommending securities to their retail customers.[3] In the Proposals, the SEC acknowledges that the nature of the client relationship and the models for providing advice differ between investment advisers and broker-dealers, and the Proposals do not contemplate a uniform standard of conduct or regulation applicable to investment advisers and broker-dealers, although they are designed to more closely harmonize the standards and regulations. Each Proposal is summarized below.

Proposed Interpretation of the Fiduciary Duty Standard

The SEC's stated objective in the proposed interpretation is to reaffirm, and in some cases clarify, certain aspects of the fiduciary duty that an investment adviser owes to its clients under Section 206 of the U.S.

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1 Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, Release No. IA-4889 (Apr. 18, 2018), *available at* https://www.sec.gov/rules/proposed/2018/ia-4889.pdf.

2 Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles, Release No. 34-83063; IA-4888 (Apr. 18. 2018), *available at* https://www.sec.gov/rules/proposed/2018/34-83063.pdf.

3 Regulation Best Interest, Release No. 34-83062 (Apr. 18, 2018), *available at* https://www.sec.gov/rules/proposed/2018/34-83062.pdf.

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Investment Advisers Act of 1940, as amended (the "Advisers Act"). The proposed interpretation largely reiterates existing SEC guidance and case law regarding investment advisers' fiduciary duty. An investment adviser's federal fiduciary duty consists of a duty of care and a duty of loyalty, which an investment adviser cannot disclose away and an investor cannot waive. The SEC states that an investment adviser's duty of care includes (i) a duty to provide personalized advice that is suitable for and in the best interest of the client, based on the client's investment profile; (ii) the duty to seek best execution of a client's transactions, where the adviser has the responsibility to select broker-dealers to execute client trades; and (iii) the duty to provide advice and monitoring over the course of the advisory relationship. The proposed interpretation also reiterates that an investment adviser's duty of loyalty includes (i) a duty not to favor the investment adviser's own interests over those of a client or unfairly favor one client's interests over those of another client; and (ii) a duty to avoid conflicts of interest with clients and, at a minimum, make full and fair disclosure to clients of all material conflicts of interest that could affect the advisory relationship. Furthermore, disclosure of a conflict of interest should be sufficiently specific so that a client is able to understand the conflict and the business practice that gives rise to the conflict, and it is not adequate to disclose that an investment adviser "may" have a conflict when a conflict actually exists. The SEC states that certain "complex or extensive conflicts" may be difficult to disclose with sufficient specificity. With respect to these types of conflicts, the SEC expects investment advisers to "eliminate the conflict or adequately mitigate the conflict so that it can be more readily disclosed." The SEC sought to quantify the economic impacts expected to result from this proposed interpretation, but notes that it is unable to quantify certain of the economic effects because it lacks information necessary to provide reasonable estimates. The SEC seeks public comment as to whether the proposed interpretation offers sufficient guidance with respect to the fiduciary duty standard applicable to investment advisers, whether the proposed interpretation fails to address any significant issues related to an investment adviser's fiduciary duty, and whether it would be beneficial for the SEC to codify any portion of the proposed interpretation.

In addition, the SEC seeks public comment on whether registered investment advisers should be required to meet certain enhanced standards based on existing standards applicable to broker-dealers; specifically, licensing and continuing education requirements for investment professionals, financial responsibility requirements (such as net capital requirements), and a requirement to provide account statements to retail investors on a periodic basis.

Proposed Client Relationship Summary Rule

This proposed rule would require registered investment advisers and registered broker-dealers to provide to a retail investor at the beginning of the client relationship a written disclosure statement of no more than four pages, which is designed to assist the investor in making an informed choice. The disclosure statement would include a mix of tabular and narrative information, including both prescribed text and disclosure tailored to the particular business of the investment adviser or broker-dealer, and would inform retail investors about the relationships and services offered, the standard of conduct and the fees and costs associated with those services, specified conflicts of interest, and any reportable legal or disciplinary events. The disclosure statement would also include a list of key questions for retail investors to ask their financial professionals. The SEC is seeking comment regarding the proposed content and format of the disclosure statement, including whether firms that offer a wide range of products and

services should be permitted to prepare a separate disclosure statement for each business line or type of account offered.[4]

The SEC proposes to define "retail investor" as a prospective or existing client or customer who is a natural person (an individual) or a trust for the benefit of a natural person, regardless of the individual's net worth or the nature of the trustee. However, the SEC is seeking comment as to whether the definition of "retail investor" should exclude certain categories of natural persons based on net worth or income levels, and whether the definition of "retail investor" should mirror the definition of "retail customer" proposed in Regulation Best Interest, which includes non-natural persons who use the recommendations primarily for personal, family or household reasons. The SEC is also seeking comment as to whether investment advisers and broker-dealers should be required to deliver the disclosure statement to other types of investors.

The proposed SEC rules would also restrict (i) a broker-dealer from using the term "adviser" or "advisor" unless the firm is a dual-registrant, and (ii) a natural person associated with a broker-dealer from using those terms unless he or she is a supervised person of an SEC-registered investment adviser and provides investment advice on behalf of such investment adviser.

Proposed Regulation Best Interest

Under this proposed rule, a broker-dealer, or a natural person associated with a broker-dealer, that is making a recommendation to a retail customer would have a duty to 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 the broker-dealer's associated person, ahead of the retail customer. This standard of conduct includes three specific obligations set forth below.

- Disclosure Obligation. An obligation to disclose in writing to retail customers, at or before the time of a recommendation, the material facts relating to the scope and terms of the relationship, and all material conflicts of interest associated with the recommendation.
- Obligation of Care. An obligation to exercise reasonable diligence, care, skill, and prudence, to (i) understand the product; (ii) have a reasonable basis to believe that the product is in the retail customer's best interest; and (iii) have a reasonable basis to believe that a series of transactions is in the retail customer's best interest.
- Conflict of Interest Obligation. An obligation to establish, maintain and enforce policies and procedures reasonably designed to (i) identify, and at a minimum disclose, or eliminate, all material conflicts of interest arising from a recommendation, and (ii) identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with the recommendation.

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[4] The instructions to the proposed Form CRS are available at https://www.sec.gov/rules/proposed/2018/34-83063-appendix-b.pdf. Hypothetical Relationship Summaries prepared by the SEC staff for illustrative purposes for registered investment advisers, registered broker-dealers, and dual registrants are available at the following links: https://www.sec.gov/news/statements/2018/annex-b-3-ia-registrant-mock-up.pdf (for registered investment advisers); https://www.sec.gov/news/statements/2018/annex-b-2-bd-registrant-mock-up.pdf (for registered broker-dealers) and https://www.sec.gov/news/statements/2018/annex-b-1-dual-registrant-mock-up.pdf (for dual registrants).

The SEC proposes to define "retail customer" as a person, or the legal representative of such 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.

The SEC seeks public comment on, among other things, whether the definition of "retail customer" is appropriate, whether the SEC should define the term "recommendation," and whether the proposed obligation of care enhances broker-dealers' existing suitability obligations.

Commissioner Views

Although the SEC voted 4-1 to issue the Proposals, most of the Commissioners expressed significant concerns regarding certain aspects of the Proposals. Commissioner Stein, who voted against issuing all three of the Proposals, stated that in her view the Proposals simply maintain the status quo and do not provide comprehensive reform or modernize existing rules applicable to investment advisers or broker-dealers. Commissioner Jackson, who voted "reluctantly" in favor of issuing the Proposals, cited several issues with the Proposals, including that (1) the standards set forth in proposed Regulation Best Interest are too ambiguous; (2) the Proposals do not strengthen the suitability standard already applicable to broker-dealers; and (3) the Proposals fall short of addressing the most egregious broker-dealer practices, such as sales contests and payment of bonuses based on the sale of proprietary products. Commissioner Peirce criticized the proposed "best interest" standard of conduct applicable to broker-dealers as an "impossible standard," because what is in someone's best interest is inherently a "value-laden judgment." Commissioner Piwowar voiced concerns that the Proposals lack clarity generally and fail to "clearly and adequately" explain the exact differences between the "best interest" standard and the "well-established Investment Advisers Act fiduciary standard and FINRA's suitability standard."

Observations

We expect that the Proposals will receive substantial comments that, among other things, request greater clarity regarding the interpretation of the Advisers Act fiduciary duty standard and any new or revised standard of conduct applicable to broker-dealers and investment advisers. We note that the proposed interpretation of the Advisers Act fiduciary duty standard makes several references to the duty of investment advisers to act in the "best interest" of their clients. For example, that interpretation states that an investment adviser's duty of care includes (i) a duty to provide personalized advice that is suitable for and in the best interest of the client based on the client's investment profile; and (ii) a duty to evaluate whether a client's account continues to be in the client's best interest. The SEC does not define the term "best interest" in any of the Proposals, and it is not clear what is meant by that term, or how it differs from the fiduciary standard to which investment advisers are subject under the Advisers Act. Interestingly, at the April 18, 2018 open meeting, the SEC staff indicated that they had considered defining the "best interest" standard in proposed Regulation Best Interest but ultimately determined not to do so. We also expect significant industry comment on the SEC's proposal to potentially require registered investment advisers to be subject to three standards currently applicable only to broker-dealers, including a net capital requirement. In light of the controversial nature of the Proposals and the Commissioners' comments, we would not be surprised if any final rules or interpretations are substantially different than the Proposals.

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