

July 7, 2019

SEC Adopts Regulations and Interpretations to Enhance Standards of Conduct for Broker-Dealers and Investment Advisers

On June 5, 2019, the Securities and Exchange Commission (SEC) adopted a rulemaking package. The package includes “Regulation Best Interest,” which establishes a “best interest” standard of conduct for broker-dealers when making a recommendation to a retail customer of any securities transaction. The best interest standard enhances the existing “suitability” standard applicable to broker-dealers, but does not adopt a “one size fits all” standard of conduct for broker-dealers and investment advisers. Regulation Best Interest requires broker-dealers both to act in the best interest of retail customers, without placing the financial or other interests of the broker-dealer ahead of the customer’s interest; and to address conflicts of interest by establishing, maintaining and enforcing policies designed to identify and disclose material conflicts of interest, or where disclosure is insufficient, to mitigate or eliminate the conflicts.

In addition to Regulation Best Interest, the rulemaking package includes rules and interpretations designed to enhance the quality and transparency of investors’ relationships with broker-dealers and investment advisers and align their standards of conduct with investors’ “reasonable expectations” with respect to conduct by broker-dealers and investment advisers. The rulemaking package includes:

1. Regulation Best Interest: The Broker-Dealer Standard of Conduct [available [here](#)]
2. Form CRS Relationship Summary; Amendment to Form ADV [available [here](#)]
3. Commission Interpretation Regarding Standard Conduct for Investment Advisers [available [here](#)]
4. Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser [available [here](#)]

Below is an overview of these rules and interpretations.

1. **Regulation Best Interest**

Regulation Best Interest enhances the existing standard of conduct applicable to broker-dealers specifically at the time they recommend to a retail customer any securities transaction or investment strategy involving securities. When making a recommendation, a broker-dealer must act in the retail customer's best interest and cannot place its own interests ahead of the customer's. The requirement is satisfied only if the broker-dealer complies with four specified component obligations. The obligations are: (a) providing certain prescribed disclosure before or at the time of the recommendation about both the recommendation itself and the relationship between the retail customer and the broker-dealer ("Disclosure Obligation"); (b) exercising reasonable diligence, care and skill in making the recommendation ("Care Obligation"); (c) establishing, maintaining and enforcing policies and procedures reasonably designed to address conflicts of interest ("Conflict of Interest Obligation"); and (d) establishing, maintaining and enforcing policies and procedures reasonably designed to achieve compliance with Regulation Best Interest ("Compliance Obligation").

- **Disclosure Obligation** - Before or at the time of the recommendation, a broker-dealer must disclose, in writing, all *material* facts about the scope and terms of its relationship with the customer, including the broker-dealer capacity in which it is acting, the *material* fees and costs the customer will incur, and the type and scope of the services to be provided by the broker-dealer. The broker-dealer also must disclose all *material* facts relating to conflicts of interest associated with the specific recommendation that might incline a broker-dealer to make a recommendation that is not disinterested.

- **Care Obligation** - A broker-dealer must exercise reasonable diligence, care and skill when making a recommendation to a retail customer. The broker-dealer must understand potential risks, rewards and costs associated with the recommendation, consider those risks, rewards and costs in light of the customer's investment profile, and have a reasonable basis to believe that the recommendation is in the customer's best interest. The broker-dealer must be careful not to place the broker-dealer's interests ahead of the retail customer's interest. Whether a broker-dealer has complied with the Care Obligation will be evaluated as of the time of the recommendation (not in hindsight). In other words, this obligation is not subject to ongoing monitoring, although the absence of monitoring must be disclosed to retail customers. By explicitly requiring that the broker-dealer not place its interests ahead of the retail customer's, the Care Obligation enhances the standard of conduct required of a broker-dealer beyond the "suitability" standard, which was the standard of care before adoption of Regulation Best Interest.

- **Conflict of Interest Obligation** - A broker-dealer must establish, maintain and enforce written policies and procedures that address conflicts of interest associated with its recommendations to retail customers that are reasonably designed to: (i) identify all such conflicts, and, at a minimum, disclose or eliminate them; (ii) mitigate conflicts of interests that create an incentive for associated persons of the broker-dealer to place their interests or the interests of the firm ahead of the retail customer's interest; (iii) disclose any material limitations the broker-dealer has placed on recommendations that it may have made to a specific retail customer and any associated conflicts, so as to prevent the limitations from causing the associated person or broker-dealer from placing the associated person or broker-dealer's interests ahead of that customer's interest; and (iv) identify and eliminate sales contests, sales quotas, bonuses and non-cash compensation that are based on the sale of specific securities or specific types of securities within a

limited period of time.

- **Compliance Obligation** - A broker-dealer must establish, maintain and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.

The enhancements adopted in Regulation Best Interest are designed to improve investor protection by enhancing the quality of broker-dealer recommendations to retail customers and reducing the potential harm to them that may be caused by conflicts of interest. It is important that retail customers better understand and are better able to compare the services offered by broker-dealers and investment advisers and make an informed choice of the relationship best suited to their needs. These new rules and interpretations help provide clarity with respect to standards of conduct applicable to broker-dealers and investment advisers and are intended to foster greater consistency in the level of protections provided by each regime, particularly at the time a recommendation is made.

Under Regulation Best Interest, key elements of the standard of conduct that applies to broker-dealers at the time a recommendation is made, will be “similar” to key elements of the fiduciary standard for investment advisers. Importantly, regardless of whether a retail investor chooses a broker-dealer or an investment adviser, the retail investor will be entitled to a recommendation (from a broker-dealer) or advice (from an investment adviser) that is in the best interest of the retail investor and not the financial professional.

That said, there are key differences between the standard articulated in Regulation Best Interest for broker-dealers and the fiduciary standard applicable to investment advisers. The differences reflect the distinction between the services and relationships typically offered under the two business models. For example, an investment adviser's fiduciary duty generally includes a duty to provide ongoing advice and monitoring, while Regulation Best Interest imposes no such duty on a broker-dealer, instead limiting the obligation of the broker-dealer to act in the retail customer's best interest to the time a recommendation is made.

2. Form CRS Relationship Summary

The SEC adopted new Form CRS, which requires registered investment advisers and broker-dealers to provide a relationship summary to retail investors. The relationship summary is designed to be a short and accessible disclosure that helps retain investors compare information about firms' brokerage and/or investment advisory offerings and promotes effective communication between firms and their retail investors.

Specifically, the relationship summary is intended to inform retail investors about: (i) the types of client and customer relationships and services the firm offers; (ii) the fees, costs, conflicts of interest and required standard of conduct associated with those relationships and services; (iii) whether the firm and its financial professionals currently have reportable legal or disciplinary history; and (iv) how to obtain additional information about the firm. The relationship summary includes requirements on length, formatting and content, and includes a directive not to exceed two pages (four pages for dual registrants). In addition to accessibility on each firm's website, the relationship summary also will reference [Investor.gov/CRS](https://www.investor.gov/crs), a page on the SEC's public investor education website, [Investor.gov](https://www.investor.gov), which, among other things, offers educational information to investors about investment advisers and broker-dealers.

Investment advisers will be required to deliver a relationship summary to each retail investor before or at the time the firm enters into an investment advisory contract. Broker-dealers will be required to deliver the relationship summary to each retail investor before or at the earliest of: (i) recommending an account type, a securities transaction or an investment strategy involving securities; (ii) placing an order for the retail investor; or (iii) opening a brokerage account for the retail investor.

3. Standard of Conduct for Investment Advisers

The SEC issued an interpretation of the standard of conduct for investment advisers under the Investment Advisers Act of 1940, as amended (the “Advisers Act”) that reaffirms, and in some cases clarifies, certain aspects of the fiduciary duty that an investment adviser owes to its clients under the Advisers Act. The interpretation reiterates that the investment adviser’s fiduciary duty comprises a (a) duty of care; and (b) duty of loyalty. The combination of care and loyalty requires an investment adviser to act in the best interests of its clients at all times.

- **Duty of Care**

The duty of care that an investment adviser owes its clients includes, among other things, the duty to: (i) provide advice that is in the best interest of the client; (ii) seek best execution of a client’s transactions where the adviser has the responsibility to select broker-dealers to execute client trades; and (iii) provide advice and monitoring over the course of the relationship.

The duty to provide advice that is in the best interest of the client requires the investment adviser to have a “reasonable understanding of the client’s objectives” (this would include for retail clients understanding of the investment profile; for institutional clients, an understanding of the investment mandate). In order to develop a reasonable understanding of a retail client’s objections, an adviser, at a minimum, should “make reasonable inquiry into the client’s financial situation, level of financial sophistication, investment experience and financial goals.” It would require the investment adviser to update the client’s profile and adjust the advice offered to reflect any changed circumstances. The investment adviser also must have a “reasonable belief that the advice it provides is in the best interest of the client’s objectives.” This would require an investment adviser to conduct a “reasonable investigation into the investment sufficient *not* to base its advice on materially inaccurate or incomplete information.”

The duty of care includes 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 to “provide advice and monitoring at a frequency that is in the best interests of the client.”

The duty of care also encompasses the duty to provide advice and monitoring at a frequency that is in the best interest of the client, taking into account the scope of the relationship. As a general matter, an adviser’s duty to monitor extends to all personalized advice it provides to the client, including, for example, in an ongoing relationship, an evaluation of whether a client’s account or program type continues to be in the client’s best interest.

- **Duty to Loyalty**

The duty of loyalty that an investment adviser owes its clients prohibits the adviser from “plac[ing] its own interests ahead of its client’s interests.” To meet its duty of loyalty, an adviser

must make “full and fair disclosure to its clients of all material facts relating to the advisory relationship.” An adviser must eliminate, or at least expose through full and fair disclosure, all conflicts of interest that might incline an investment adviser to render advice that is not disinterested. However, such disclosure, by itself, does not satisfy the adviser’s duty to act in the client’s best interest. For a disclosure to be full and fair, it should be sufficiently specific so that a client is able to understand the material facts or conflicts of interest and make an informed decision.

This interpretation reiterates that investment advisers and broker-dealers have different types of relationships with investors, offer different services and have different compensation models. This variety is important because it presents investors with choices regarding the types of relationships they can have, the services they can receive and how they can pay for those services.

4. SEC Interpretation Regarding the “Solely Incidental” Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser

The SEC issued an interpretation regarding what constitutes advisory services provided by a broker-dealer that are “solely incidental” to the conduct of the broker-dealer’s business. The Advisers Act regulates the activities of certain investment advisers, who are defined as persons who, “for compensation, engage in the business of advising others about securities.” The Advisers Act excludes from the definition of investment adviser - and thus from the application of the Advisers Act - a broker or dealer “whose performance of such advisory services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation” for those services (the “solely incidental prong”).

Whether advisory services provided by a broker-dealer satisfy the solely incidental prong is based on the facts and circumstances surrounding the broker-dealer’s business, the specific services offered and the relationship between the broker-dealer and the client. The interpretation clarifies that the statutory language means that a broker-dealer providing advice as to the value and characteristics of securities or as to the advisability of transacting in securities is consistent with the solely incidental prong, *only* if the advice is provided in connection with and is reasonably related to the broker-dealer’s primary business of effecting securities transactions. The interpretation states that a broker-dealer having the ongoing ability or authority to buy and sell securities on behalf of a customer without consulting the customer has “unlimited discretion” – conduct that would *not* be solely incidental to the business of a broker-dealer. A broker-dealer with unlimited discretion to effect securities transactions indicates a relationship that is primarily advisory in nature. Such a level of discretion by a broker-dealer is so comprehensive and continuous that the provision of advice in such context is *not* incidental to effecting securities transactions.

Compliance and Effective Dates

The effective date for the interpretations is the date of publication in the Federal Register. The effective date for Regulation Best Interest and Form CRS is 60 days after publication in the Federal Register, although the compliance date for Regulation Best Interest and Form CRS is June 30, 2020.

Conclusion

The “best interest” standard of conduct for broker-dealers when making recommendations to a retail customer as articulated in Regulation Best Interest marks a significant enhancement of the lesser “suitability” standard that had been in effect prior to issuance of Regulation Best Interest. While not adopting a one size fits all standard, which would mean raising the standard of conduct a broker-dealer owes to its retail customers to the fiduciary level that an investment adviser owes to its advisory clients, the new best interest standard does require enhanced obligations of a broker-dealer to its clients. The extent of the enhancements will be clarified by future SEC guidance and enforcement initiatives.

It is unlikely that there will be any material change in the conduct required of investment advisers. The current rulemaking package serves to reaffirm, and in some cases clarify, the standard of conduct applicable to investment advisers.

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If you need assistance implementing the new rules and interpretations, or making changes in your operations, including modifying mandatory disclosures, marketing material or internal compliance systems in order to be in compliance with these new rules and interpretations, please contact Meryl Wiener, any of the undersigned or your regular Warshaw Burstein attorney.

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