



May 2, 2018

SEC Proposes “Best Interest” Standard of Conduct for Broker Dealers, Interpretation of Investment Adviser Standard of Conduct and New Client Relationship Summary Disclosure Document to Protect Retail Customers

On April 18, 2018, the Securities and Exchange Commission (“SEC” or “Commission”) proposed rules and interpretative guidance on standards of conduct and required disclosures designed to enhance the quality and transparency of investors’ relationships with investment advisers and broker-dealers. The three proposals are:

- Proposed Best Interest Rule would establish a standard of conduct for broker-dealers that would require broker-dealers to act in the best interest of retail customers when making a recommendation involving securities to a retail customer.
- Proposed Interpretation Regarding Standard of Conduct for Investment Advisers would reaffirm and clarify that investment advisers owe a fiduciary duty to their clients.
- Proposed Form CRS would provide investors with a short-form disclosure document that would explain the nature of their relationship with investment professionals.

Background

The Dodd-Frank Wall Street Reform and Consumer Protection Act enacted in 2010 (“Dodd-Frank”) authorized the SEC 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, and required the SEC to study the effectiveness of existing legal or regulatory standards of care for broker-dealers and investment advisers who provide personalized investment advice and recommendations about securities to retail customers. Pursuant to Dodd Frank, in 2011, the SEC staff conducted a study and made two recommendations: first, that the Commission implement a uniform fiduciary standard of

conduct for broker-dealers and investment advisers when providing personalized investment advice to retail customers; and second, that the Commission consider harmonizing the regulatory requirements of broker-dealers and investment advisers. Despite this study, the SEC initiated no rulemaking.

Perhaps to fill the vacuum left by the SEC, or perhaps to impose stricter regulations on investment professionals providing investment advice to retirement account investors, in April 2016, the Department of Labor (“DOL”) adopted a rule defining the term “fiduciary” and addressing conflicts of interest when providing investment advice to retired account investors. Among other things, the DOL rule required those who provide investment advice to employee benefit plans and individual retirement accounts to abide by a fiduciary standard. The DOL delayed applicability of its rule until June 9, 2017 and delayed full compliance until July 19, 2018. See our Client Alert, available [here](#). On March 15, 2018 the U.S. Court of Appeals for the Fifth Circuit vacated the DOL fiduciary rule, and as of this writing, it is unknown whether the DOL will appeal that ruling.

Meanwhile, pursuant to a June 2017 direction of SEC Chairman, Jay Clayton, the SEC sought additional public comment on the standards of conduct applicable to investment professionals. The proposed rules are the outcome of the SEC’s internal consideration and its consideration of public comments, and propose a standard of conduct for broker-dealers when they make recommendations for securities transactions or investment strategy for retail investors and an interpretation of the standard of conduct for investment advisers.

Proposed Best Interest Rule

The Proposed Best Interest Rule¹ would require that a broker-dealer and natural person associated with a broker-dealer making a recommendation of any securities transaction or investment strategy to a retail customer act in the “best interest”² of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker-dealer ahead of the interest of the retail customer (“Regulation Best Interest”). The broker-dealer would discharge its duty to act in the best interest of its clients by complying with the following specific obligations:

- Disclosure obligation: disclose to the retail customer, in writing, the key facts about the relationship, including material conflicts of interest.
- Care obligation: 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: establish, maintain and enforce policies and procedures reasonably designed to identify and then at a minimum to disclose and mitigate, or

¹ The proposed Best Interest Rule is available [here](#).

² The term “best interest” is not defined in the Proposed Rule. It is anticipated that during the 90-day comment period there will be significant public comment addressing this omission.

eliminate, material conflicts of interest arising from such recommendations and financial incentives associated with such recommendations.

The SEC stated that Regulation Best Interest would not create any new private right of action or right of rescission and that scienter would not be required to establish a violation of Regulation Best Interest. The SEC also stated that compliance with Regulation Best Interest would not alter a broker-dealer's existing obligations under the federal securities laws.

Proposed Interpretation Regarding Standard of Conduct for Investment Advisers

The SEC's Proposed Interpretation of the Standard of Conduct for Investment Advisers³ under the Investment Advisers Act of 1940 reaffirms that an investment adviser is a fiduciary, and as such, is held to the highest standard of conduct and must act in the best interest of its clients. An investment adviser's fiduciary obligation includes the affirmative duty to act in the utmost good faith and provide full and fair disclosure of all material facts.

As fiduciaries, investment advisers owe their clients a duty of care and a duty of loyalty. The duty of care includes the duty to (i) act and 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 of loyalty requires an investment adviser to put its clients' interests first. An investment adviser must not favor its own interests over those of a client or unfairly favor one client over another. In seeking 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. In addition, an investment adviser must seek to avoid conflicts of interest with its clients, and, at a minimum, make full and fair disclosure of all material conflicts of interest that could affect the advisory relationship. The disclosure should be sufficiently specific so that a client is able to decide whether to provide informed consent to the conflict of interest.

In addition, the SEC also is seeking comment on three potential enhancements to investment advisers' legal obligations—obligations currently within the broker-dealer framework but which have no counterpart in the investment adviser context—specifically: (i) federal licensing and continuing education requirements; (ii) requirements for delivery of account statements to clients with investment advisory accounts; and (iii) financial responsibility requirements for registered investment advisers.

Proposed Form CRS

The SEC is proposing new rules to require broker-dealers and investment advisers to deliver to retail investors a customer or client relationship summary (Form CRS)⁴. Form CRS would be limited to four pages and would explain general information to address investor confusion between broker-dealers and investment advisers. It would help investors understand

³ The Proposed Interpretation Regarding Standard of Conduct for Investment Advisers is available [here](#).

⁴ Proposed Form CRS Relationship Summary is available [here](#).

the relationship and services a firm offers, the standard of conduct and the fees and costs associated with those services, specified conflicts of interest, and the disciplinary history of firms and financial professionals they are considering. In this context, the proposed rule would restrict broker-dealers from using as part of their name or title the terms “adviser” and “advisor.” Retail investors would receive a relationship summary at the beginning of a relationship with a firm and would receive updated information following a material change.

Public Comment

The SEC is requesting public comment on these proposed rules and interpretations. The comment period extends until 90 days after the proposed rules and interpretations are published in the Federal Register.

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Please contact Meryl Wiener or any of the undersigned if you have any questions or if you would like to submit a comment to the SEC with respect to the proposed rules and interpretations. We will keep you advised of developments.

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