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SEC Proposes Regulations to Reform Retail Investment Standards

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On April 18, 2018, the Securities and Exchange Commission (SEC) moved back to the forefront of the fiduciary regulation fray by unveiling a three-part regulatory package, totaling almost 1,000 pages, aimed at reforming the way that investment professionals service retail investors.[1] SEC Chairman Jay Clayton lauded the proposals as appropriate steps toward clarifying and enhancing current regulations, citing concerns with, among other things, the "fiduciary rule" implemented by the Department of Labor (DOL)[2], which is potentially vacated.[3]Striking a different tenor, Commissioner Kara Stein described the proposals as "essentially maintain[ing] the status quo."[4] Following their statements, the SEC Commissioners voted 4–1 to propose for public comment: 1) Regulation Best Interest; 2) interpretive guidance on the fiduciary duty applicable to investment advisers; and 3) Form CRS, requiring certain disclosures by broker-dealers (BDs) and investment advisers (RIAs) to retail investors. We analyze each of these proposals below.

Regulation Best Interest

If enacted as proposed, Regulation Best Interest (Reg BI) would impose upon BDs an obligation to act in a retail customer's "best interest" when recommending securities transactions and/or strategies. Although the language of the draft proposed rule does not define the term "best interest" explicitly, Reg BI is relatively straightforward and looks familiar. In lieu of imposing a fiduciary standard on BDs akin to the DOL rule, Reg BI lays out three specific requirements that BDs must satisfy to comply with their "best interest" obligation. If all three regulatory requirements are complied with, then Reg BI, as written, appears to provide a "safe harbor" for BDs. As discussed below, the core subsections of Reg BI require a suitability standard, certain disclosures, and written policies and procedures. Specifically, Reg BI requires:

1. **Disclosure Obligation.** BDs must communicate certain facts about the terms and the scope of their services to customers at the onset of a professional relationship. BDs must also disclose certain conflicts of interest relating to their recommendations.
2. **Care Obligation.** BDs must also exercise reasonable care, diligence, skill and prudence when making recommendations to retail customers. Specifically, they must: (i) understand the potential risks and rewards associated with a recommendation and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers; (ii) have a reasonable basis to believe that a recommendation is in the best interest of a particular retail customer based on that customer's investment profile and the potential risks and rewards associated with the recommendation; and (iii) have a reasonable basis to believe that a series of recommended transactions is not excessive and is in a retail customer's best interest.
3. **Conflict of Interest Obligations.** The final component of Reg BI requires BDs to establish, maintain and enforce written policies and procedures that are reasonably designed to identify and disclose or eliminate material conflicts of interest stemming from a recommendation, and disclose and mitigate, if not eliminate, material conflicts of interest arising from financial incentives associated with a recommendation.

A closer look at the requirements for complying with the "Care Obligation" subsection of Reg BI reveals that this language tracks the three aspects of FINRA's suitability rule, specifically: reasonable basis suitability, customer specific suitability and quantitative suitability. With this similarity in mind, BDs may want to consider the

requirements of Reg BI as a version of FINRA's suitability rule, with the added disclosure and written policies and procedures requirement discussed above. That all said, there are two specific things that Reg BI does not attempt to do: impose a fiduciary standard on BDs or seek a uniform standard for both BDs and RIAs.

Interpretive Guidance on the Fiduciary Standard Applicable to Investment Advisers

The second of the SEC's three proposals recommends interpretive guidance aimed at enhancing the SEC's fiduciary standard for RIAs (the "IA Standard"). The IA Standard is largely a codification and clarification of the existing fiduciary duties that RIAs owe to clients as derived from common law. In essence, with the proposed IA Standard, the SEC is attempting to incorporate these long-recognized, court-established fiduciary duties into the Investment Advisers Act of 1940.

The IA Standard describes both an RIA's duty of loyalty and duty of care to its clients. Specifically, the IA Standard defines an RIA's duty of care as its: (i) duty to provide advice that is in the client's best interest; (ii) duty to seek best execution for the client; and (iii) duty to act and to provide advice and monitoring over the course of its relationship with the client.

Within the IA Standard materials, the SEC also posed for public comment three general questions relating to the activities of RIAs. The first of these questions is whether there should be a federal licensing and continuing education requirement for RIA personnel. The second is whether RIAs should be required to deliver periodic account statements to customers that disclose personalized fees and expenses. The final question is whether RIAs should be subject to financial responsibility requirements (i.e., minimum levels of net capital) similar to those applicable to BDs. Posing these queries for public comment suggests that the SEC is also interested in imposing certain traditional BD requirements onto RIAs.

Form CRS and New Naming Requirements

The final components of the SEC's proposal are aimed at reducing retail investors' confusion about the differences between BDs, RIAs and the services that these entities provide. As proposed, Form CRS would require BDs and RIAs to provide retail investors with a standardized four-page disclosure document at the beginning of a customer relationship. This document would contain information about the services the BD and/or RIA offers, the standard of conduct owed to the client, the fees, and certain material conflicts of interest. Further, the form would also allow for certain answers to be provided for anticipated standard questions that clients might ask their investment professional. Also, it would contain information about whether the firm and its financial professionals have reportable legal or disciplinary events.

Along with the Form CRS proposal, the SEC included three templates of what this disclosure document might look like. The SEC's goal is to provide investors with a succinct and manageable disclosure document in plain language. However, based on the dense content and legalese used in these template forms, the SEC has a lot of work to do in order to accomplish this goal. In his remarks on the proposal, SEC Commissioner Michael Piwowar noted that the examples read as though they were drafted by securities lawyers and economists—he made it clear that he did not mean this as a compliment.[5] Accordingly, it seems likely that Form CRS and the accompanying examples will undergo significant revisions before any finalization.

In addition to Form CRS, this proposal also includes a requirement that would restrict the ability of BDs that are not RIAs from using the word "adviser" or "advisor" as part of their names or titles. Whether this naming limitation will be expanded remains to be seen, but many view it as a step in the right direction toward attempting to reduce retail clients' confusion.

Conclusion

The SEC's release of these proposed rules and guidance is only the beginning of what will likely be an active 90-day comment period. As experts comb through these dense proposals, the SEC appears prepared to accept any criticism and applause it receives for its efforts. In fact, all of the Commissioners repeatedly encouraged comment letters by all interested parties. As we conclude, one area in particular to pay close attention to is the lack of a definition for the term "best interest" in Reg BI and whether that will ultimately be addressed in any final rule. Commissioners Stein and Peirce—who did not agree on much at the open meeting—both identified this as a major deficiency with Reg BI. Whether and how the SEC addresses this controversial issue (and the many other complex regulatory issues in these proposed regulations) will ultimately reveal whether the convergence toward a more consistent standard for BDs and RIAs will continue.

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[1] *See* Jay Clayton, "Overview of the Standards of Conduct for Investment Professionals Rulemaking Package" (Apr. 18, 2018),https://www.sec.gov/news/public-statement/clayton-overview-standards-conduct-investment-

professionals-rulemaking.

[2] *Id.* For more background on the SEC's past actions with respect to fiduciary rulemaking, read our blog post "The SEC's Back In the Fiduciary Regulation 'Game.'"

[3] On March 15, 2018, a three-judge panel of the United States Court of Appeals for the Fifth Circuit issued a 2–1 decision vacating the DOL fiduciary rule. Finding that the DOL lacked statutory authority to regulate fiduciary investment advice, the court invalidated the Fiduciary Rule entirely. Although the DOL may still appeal this ruling to an en banc panel of the Fifth Circuit or the United States Supreme Court, the holding could suspend the DOL's fiduciary rule permanently.

[4] *See* Kara M. Stein, "Statement on Proposals Relating to Regulation Best Interest, Form CRS, Restrictions on the Use of Certain Names or Titles, and Commission Interpretation Regarding the Standard of Conduct for Investment Advisers (Proposed Rule)" (Apr. 18, 2018), https://www.sec.gov/news/public-statement/stein-statement-open-meeting-041818.

[5] *See* Michael S. Piwowar, "Statement at Open Meeting on Form CRS, Proposed Regulation Best Interest and Notice of Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers (Proposed Rule)" (Apr. 18, 2018),https://www.sec.gov/news/public-statement/statement-piwowar-041818.