
June 25, 2019

SEC Adopts New Standard of Conduct for Broker-Dealers

On June 5, 2019, by a vote of 3-1, the Securities and Exchange Commission adopted a package of rulemakings and interpretations addressing investors' relationships with broker-dealers and investment advisers. Under [Regulation Best Interest \(new Exchange Act Rule 15l-1\)](#), a broker-dealer and a natural person who is an associated person of a broker-dealer will be required, when making a recommendation regarding any securities transaction or any investment strategy involving securities, to act in the best interest of a retail customer without placing their respective financial interests ahead of the customer. The SEC also approved a [rule](#) establishing a new short-form disclosure document (Form CRS) that will provide retail investors with information about the nature of their relationship with their investment professionals. Lastly, the SEC issued interpretations (i) to [reaffirm](#) and, in some cases, clarify the SEC's views on the fiduciary duty that investment advisers owe to their clients and (ii) to [reaffirm](#) and, in some cases, clarify the SEC's views on the broker-dealer exclusion under the Investment Advisers Act of 1940 (the "IAA"). The new requirements come into effect June 30, 2020.

Background

The SEC has been considering issues relating to the standards applicable to investment advisers and broker-dealers for many years. Under current SEC rules, investment advisers are subject to a fiduciary duty to their clients, while broker-dealers are subject to the less stringent "suitability" standard. Because of the inherent conflict of interest in the commission-based compensation model applicable to broker-dealers, various market participants have questioned whether broker-dealers should be held to a standard higher than "suitability" when advising retail customers.

In 2011, the SEC staff issued a study mandated by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act in which it proposed to establish a uniform fiduciary standard of conduct for both investment advisers and broker-dealers. In 2016, the Department of Labor adopted a rule requiring that finance professionals adhere to a fiduciary standard when advising clients on retirement accounts. In March 2018, the Fifth Circuit Court of Appeals vacated this rule.

In June 2017, SEC Chairman Jay Clayton issued a statement setting forth a number of questions regarding standards of conduct for investment advisers and broker-dealers. For the most part, commenters indicated support for changes to the standard of conduct, and in particular the establishment of a fiduciary or best interest standard specific to broker-dealers.

In April 2018, the SEC released proposed Regulation Best Interest. The proposal created a higher standard of care for broker-dealers when making recommendations to retail customers than the current suitability

standard. The proposal declined, however, to apply the fiduciary standard for investment advisers to broker-dealers or to create a new uniform fiduciary standard for both broker-dealers and investment advisers. Following a public comment period, on June 5, 2019, the SEC adopted Regulation Best Interest, with certain modifications.

Final Rules

I. Regulation Best Interest

Under Regulation Best Interest, a broker-dealer will have a duty to act in the “best interest” of a retail customer at the time a recommendation is made, without putting the financial or other interests of the broker-dealer ahead of the retail customer’s interests (the “**General Obligation**”). A retail customer is defined as a “natural person, or the legal representative of such natural person, who: (A) 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 (B) Uses the recommendation primarily for personal, family, or household purposes.”

A broker-dealer will satisfy its General Obligation in connection with a recommendation by complying with four component obligations: the Disclosure, Care, Conflict of Interest and Compliance Obligations.

1. Disclosure Obligation

Prior to or at the time of any recommendation, a broker-dealer must provide a retail customer, in writing, full and fair disclosure of (a) all material facts relating to the scope and terms of the relationship with the retail customer, including: (i) that the broker-dealer is acting as a broker-dealer with respect to the recommendation, (ii) the material fees and costs that apply to the retail customer’s transactions, holdings, and accounts, and (iii) the type and scope of services provided to the retail customer, including any material limitations on the securities or investment strategies that may be recommended to the retail customer; and (b) all material facts relating to conflicts of interest that are associated with the recommendation (see below for definition of “conflict of interest”). The disclosure must be made before or at the time a recommendation is made.

2. Care Obligation

A broker-dealer must exercise reasonable diligence, care and skill when making a recommendation to a customer. It must (i) understand the potential risks, rewards and costs associated with a recommendation, and have a reasonable basis to believe that a 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, rewards, and costs associated with the recommendation; and (iii) 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 customer's best interest when taken together in light of the customer's investment profile. In addition, the Care Obligation requires that a broker-dealer have a reasonable basis to believe that a recommendation does not place the financial or other interest of the broker-dealer ahead of the retail customer's interest.

The SEC clarified the Care Obligation by identifying important factors for broker-dealers to consider when making a recommendation, including a security or investment strategy's investment objectives, characteristics (including special or unusual features), liquidity, volatility and likely performance in a variety of market and economic conditions, the expected return and any financial incentives to recommend such security or investment strategy. The SEC noted that a broker-dealer would not satisfy its Care Obligation by simply recommending the least expensive or least remunerative security without any further analysis of these other factors and the retail customer's investment profile.

3. Conflict of Interest Obligation

A broker-dealer must establish, maintain and enforce written policies and procedures reasonably designed to (i) identify and at a minimum disclose or eliminate, all conflicts of interest associated with its recommendations; (ii) identify and mitigate any conflicts of interest associated with its recommendations that create an incentive for the broker-dealer to place its interest ahead of the retail customer's interest; (iii) (a) identify and disclose any material limitations placed on the securities or investment strategies that may be recommended to retail customers and any conflicts of interest associated with such limitations and (b) prevent such limitations and associated conflicts of interest from causing the broker-dealer to make recommendations that place its interest ahead of the customer's interest; and (iv) identify and eliminate any sales contests, sales quotas, bonuses and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time.

The final rule defines a conflict of interest as "an interest that might incline a broker, dealer, or a natural person who is an associated person of a broker or dealer—consciously or unconsciously—to make a recommendation that is not disinterested."

The SEC notes that Regulation Best Interest will not *per se* prohibit a broker-dealer from engaging in transactions involving conflicts of interest, such as

- charging commissions or other transaction-based fees;
- receiving differential compensation based on the product;
- receiving third-party compensation;

-
- recommending proprietary or affiliate products;
 - recommending a security underwritten by the broker-dealer or its affiliate;
 - recommending a transaction to be executed in a principal capacity;
 - allocating trades and research among different types of customers and between retail customers and the broker-dealer's own account;
 - considering cost to the broker-dealer of effecting a transaction or strategy on behalf of the customer; or
 - accepting a retail customer's order that is contrary to the broker-dealer's recommendations.

Although not *per se* prohibited by Regulation Best Interest, these practices will only be permissible to the extent that the broker-dealer satisfies the Conflict of Interest Obligation.

4. Compliance Obligation

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

Regulation Best Interest does not define what it means "to act in the best interest" of an investor under the General Obligation. However, a broker-dealer satisfies the General Obligation by complying with the component obligations (*i.e.*, the Disclosure, Care, Conflict of Interest and Compliance Obligations). In response to public comments for further clarity, the SEC included more explicit requirements in the Disclosure and Conflict of Interest Obligations in the final rule. The SEC opted against a bright line definition of best interest, by noting that the best interest analysis should focus on the facts and circumstances of a particular recommendation and investor.

Regulation Best Interest enhances the broker-dealer standard of conduct beyond the existing suitability obligations by introducing an explicit Care Obligation as well as Disclosure, Conflict of Interest and Compliance Obligations. The Care and Conflict of Interest Obligations are substantially similar to the fiduciary duties of care and loyalty applicable to investment advisers. However, the SEC opted against extending the fiduciary standard for investment advisers to broker-dealers due in-part to the different nature of their client relationships (ongoing advice, in the case of investment advisers, versus transaction advice at the time a recommendation is made, in the case of broker-dealers).

Regulation Best Interest will require a broker-dealer to act in the best interest of a retail customer at the time a recommendation is made. The SEC noted that the rule is not intended to change the relationships that currently exist between a broker-dealer and its retail customers, ranging from one-time to episodic or more frequent advice. Accordingly, the best interest obligation will not, for example: (i) extend beyond a

particular recommendation or generally require a broker-dealer to have a continuous duty to a retail customer or impose a duty to monitor the performance of the account; (ii) require the broker-dealer to refuse to accept a customer's order that is contrary to a broker-dealer's recommendations; or (iii) apply to self-directed or otherwise unsolicited transactions by a retail customer, who may also receive other recommendations from the broker-dealer.

The SEC clarified that Regulation Best Interest is not intended to limit or eliminate recommendations for riskier products. Products that may pose higher risks to a retail customer may be in the best interest of certain customers in certain circumstances. In addition, Regulation Best Interest will not necessarily obligate a broker-dealer to recommend the "least expensive" security or investment strategy. A broker-dealer may recommend products that are more expensive than other products, provided the broker-dealer (i) reasonably believes that such recommendation is in a retail customer's best interest and (ii) does not place the broker-dealer's interest ahead of the customer's interest. Ultimately, whether a broker-dealer acted in a retail customer's best interest under the General Obligation will turn on an objective assessment of the facts and circumstances of how the component obligations were satisfied at the time of the recommendation (and not in hindsight).

Regulation Best Interest, including the Disclosure, Care, Conflict of Interest and Compliance Obligations, will not apply to advice provided by a dual-registered broker-dealer/investment adviser when acting in the capacity of an investment adviser, even if the retail customer has a brokerage relationship with the broker-dealer/investment adviser or the broker-dealer/investment adviser executes the transaction in its brokerage capacity.

All broker-dealers must comply with the new rule beginning June 30, 2020.

The SEC noted a few key modifications from the proposed rule, including

- *Retail Customer Definition:* The SEC modified the definition of "retail customer" to include *any natural person* who receives a recommendation from the broker-dealer for the natural person's own account (but not an account for a business that he or she works for), including individual plan participants. The SEC interprets "legal representative of such natural person" to include the nonprofessional legal representatives of such a natural person (*e.g.*, a nonprofessional trustee who represents the assets of a natural person).
- *Implicit Hold Recommendations:* The SEC noted that, while broker-dealers will not be required to monitor accounts, in instances where a broker-dealer agrees to provide the retail customer with specified account monitoring services, such an agreement will result in buy, sell or hold recommendations subject to Regulation Best Interest, even when the recommendation to hold is implicit.

- *Recommendations of account types, including recommendations to roll over or transfer assets from one type of account to another:* The SEC modified Regulation Best Interest to expressly apply to account recommendations, including (i) recommendations to roll over or transfer assets from a workplace retirement plan account into an IRA, (ii) recommendations to open a particular securities account (brokerage or advisory), and (iii) recommendations to take a plan distribution for the purpose of opening a securities account.
- *General Compliance Obligation:* The SEC established a new Compliance Obligation (as discussed above) that requires broker-dealers to establish policies and procedures to achieve compliance with Regulation Best Interest in its entirety.

II. Form CRS – Relationship Summary

A concurrently issued rule will require investment advisers and broker-dealers to provide on Form CRS a brief relationship summary to retail investors. The relationship summary must 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. This standardized, short-form disclosure cannot exceed two pages for investment advisers and broker-dealers or four pages for dual registrants.

Investment advisers and broker-dealers must file their initial relationship summaries on Form CRS with the SEC by June 30, 2020 (the “**Compliance Date**”). Investment advisers and broker-dealers must provide the relationship summary to (i) new retail investors at the start of the client relationship beginning on the Compliance Date and (ii) existing retail investors within 30 days after the Compliance Date. Investment advisers and broker-dealers must file an amended relationship summary within 30 days of any information becoming materially inaccurate.

III. Investment Adviser Interpretations

Standard of Conduct for Investment Advisers

The concurrently issued interpretation reaffirms, and in some cases clarifies, certain aspects of the fiduciary duty that an investment adviser owes to its clients. The interpretation summarizes how the SEC has applied and enforced the law in this area during past decades. The interpretation is intended to highlight the principles relevant to an investment adviser’s fiduciary duty and thereby provide investment advisers and their clients with greater clarity about investment advisers’ legal obligations. The release cites, for example, recent SEC enforcement actions that found disclosing that an investment adviser “may” have a conflict of interest is not adequate disclosure when the conflict “actually” exists. For further discussion, see [SEC Releases Interpretation of Advisers Act Fiduciary Duties](#).

The Broker-Dealer Exclusion under the IAA

The concurrently issued interpretation reaffirms, and in some cases clarifies, the SEC interpretation of section 202(a)(11)(C) of the IAA, which excludes from the definition of “investment adviser” any broker-dealer that provides advisory services when such services are “solely incidental” to its business and provided for no special compensation. The SEC held that a broker-dealer’s advisory services are “solely incidental” if provided in connection with and reasonably related to its primary business of effecting securities transactions. Advisory services are not “solely incidental” where a broker-dealer’s primary business is giving advice as to the value of securities or the advisability of transacting in securities. A broker-dealer’s exercise of unlimited discretion over customer accounts is not solely incidental to a primary business of effecting securities transactions.

* * *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Mark S. Bergman
+44-20-7367-1601
mbergman@paulweiss.com

Christopher J. Cummings
+1-416-504-0522
ccummings@paulweiss.com

Gregory A. Ezring
+1-212-373-3458
gezring@paulweiss.com

Andrew J. Foley
+1-212-373-3078
afoley@paulweiss.com

Catherine L. Goodall
+1-212-373-3919
cgoodall@paulweiss.com

David S. Huntington
+1-212-373-3124
dhuntington@paulweiss.com

Brian M. Janson
+1-212-373-3588
bjanson@paulweiss.com

John C. Kennedy
+1-212-373-3025
jkennedy@paulweiss.com

Raphael M. Russo
+1-212-373-3309
rrusso@paulweiss.com

Monica K. Thurmond
+1-212-373-3055
mthurmond@paulweiss.com

Lawrence G. Wee
+1-212-373-3052
lwee@paulweiss.com

Tracey A. Zaccone
+1-212-373-3085
tzaccone@paulweiss.com

Hank Michael
+1-212-373-3892
hmichael@paulweiss.com

Associate Michael N. Bendetson contributed to this client alert.