May 10, 2018

SEC Proposes Fiduciary Rule for Broker-Dealers

On April 18, concurrently with its publication for comment of a proposed set of enhanced investment adviser regulations,[1] the Securities and Exchange Commission (SEC) published a separate proposal related to the conduct standards broker-dealers must comply with when engaging retail customers.

The new Rule 151-1 under the Securities Exchange Act of 1934, as amended (Exchange Act), also known as "Regulation Best Interest," would require broker-dealers, and natural persons who are associated persons of broker-dealers, to adhere to a "best interest" standard when making certain recommendations to retail customers (Proposal). Compliance with this standard would require broker-dealers to comply with obligations that go beyond current suitability standards. If adopted, the Proposal would result in some of the most sweeping and comprehensive changes to the standard of care requirements for broker-dealers in decades.

This advisory provides both the context behind the Proposal as well as a general overview of its requirements. In addition, this advisory briefly discusses the implications associated with its implementation.

Background

For more than a decade, the SEC has explored how broker-dealers and investment advisers engage retail customers. Prior to the financial crisis, the SEC commissioned the Rand Corporation[2] to study the differences between and among broker-dealers and investment advisers (Rand Study). The Rand Study focused on two questions: (1) what business practices are being employed by broker-dealers and investment advisers; and (2) do retail customers understand the distinctions between these two categories. Perhaps unsurprisingly, the Rand Study concluded that retail customers typically failed to identify the important differences between broker-dealers and investment advisers.

Pursuant to authority granted by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the SEC continued to review the effectiveness of federal regulation of broker-dealers and investment advisers (Dodd-Frank Study). The January 2013 results of the Dodd-Frank Study included several recommendations for improving investor protections. For example, the Dodd-Frank Study recommended that the SEC adopt and implement a uniform fiduciary standard of conduct for broker-dealers and investment advisers. This standard would have applied when personalized investment advice about

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[1] For additional information, please refer to the May 4, 2018 Financial Services Advisory available here (IA Advisory).

[2] Available here.

securities was provided to retail customers. The SEC supplemented such studies via additional analyses of alternative conduct standards that may apply in connection with personalized investment advice provided to retail customers.[3]

The SEC's interest in these suitability standards has continued post-financial crisis. On June 1, 2017, shortly after becoming SEC Chairman, Chairman Jay Clayton requested comment on the conduct standards that should apply to broker-dealers and investment advisers.[4]

Regulation Best Interest

The Proposal contains a short and seemingly simple requirement—a broker-dealer, and natural persons who are associated persons of a broker-dealer, must "act in the best interest of the retail customer without placing the financial or other interest of the broker-dealer ahead of the retail customer's interest."[5] This sweeping and open-ended requirement is obviously subject to numerous interpretive questions, most notably what it means to "act in the best interest" of a retail customer.

The Proposal does not explicitly define "best interest." Instead, the Proposal frames "best interest" around specific disclosure, care and conflicts of interest obligations. A summary of each of such obligation is provided below.

Disclosure Obligation

The Disclosure Obligation would require a broker-dealer to provide retail customers with certain disclosures "prior to or at the time" a recommendation is made.[6] Such disclosures would need to (1) be in writing; (2) be reasonably brief; and (3) be written in plain English.[7] Oral disclosures would not be sufficient to comply with this obligation.[8]

Disclosures provided at the onset of the broker-dealer/retail customer relationship must inform the retail customer of all "material facts relating to the scope and terms of the relationship."[9] The types of "material facts" which should be disclosed include the following:

- a reference to the broker-dealer acting in a "broker-dealer" capacity with respect to the recommendation;
- the fees and charges that apply to the retail customer's transactions, holdings, and accounts; and
- the type and scope of services provided by the broker-dealer.[10]

In addition, broker-dealers also would need to disclose all "material" conflicts associated with the recommendation. Recommendation types generally deemed to be material include, but are not limited to, the following:

- proprietary products, the products of affiliates, or a limited range of products;
- securities underwritten by a broker-dealer or its affiliates; and
- the rollover or transfer of assets from one type of account to another.[11]

When evaluating compliance with these requirements, a negligence, rather than strict liability, standard has been proposed.[12] Even if a broker-dealer has seemingly complied with these obligations, disclosure alone would not be sufficient to cure every conflict.

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3 Advisers Act Rel. 3558 (May 1, 2013), available here.

4 Available here.

5 Proposal at p. 96.

6 Proposal at p. 97.

7 Proposal at p. 117.

8 Id.

9 Proposal at p. 261.

10 Id.

11 Proposal at p. 267.

12 Proposal at pp. 160-161.

Therefore, a broker-dealer would need to be mindful of both the disclosures related to certain conflicts and how those conflicts are addressed in practice.[13]

Care Obligation

The Care Obligation would require a broker-dealer to consider alternative products when making a recommendation to a retail customer, but would not require recommending only the lowest cost product available.[14] This obligation involves three elements, each of which are summarized below.[15]

First, a broker-dealer would be required to have a "reasonable basis to believe" a recommendation is in the best interests of some retail customers.[16] Broker-dealers would be required to (1) undertake reasonable diligence (i.e., reasonable investigation and inquiry) to understand the risks and rewards of the recommended security or strategy; and (2) have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers.[17]

Second, the covered recommendation would have to be in the "best interest" of a particular retail customer based on (1) an evaluation of such customer's investment profile; and (2) the risks/rewards associated with such recommendation.[18] Broker-dealers would be required to consider a variety of factors contained in an investor profile including, but not limited to, an investor's age, tax status, investment experience and risk tolerance.[19]

Finally, a broker-dealer would be required to consider not only the suitability of specific recommendations, but also the suitability of a series of recommended transactions.[20] Even if individual transactions would be in the "best interest" of a retail customer when viewed in isolation, a broker-dealer would be required to determine that the combination of those investments is not "excessive" when evaluated against the retail customer's investment profile.[21]

Conflict of Interest Obligations

The Conflict of Interest Obligations would require broker-dealers to establish and enforce policies and procedures designed to identify, disclose, mitigate, or eliminate material conflicts of interest.[22] A "material" conflict of interest is a conflict arising from "financial incentives" associated with a recommendation.[23] Such conflicts would include, but are not limited to, the following:

- compensation practices established by the broker-dealer (including fees and other charges for the services provided and products sold);
- receipt of commissions or sales charges, or other fees or financial incentives, or differential or variable compensation, whether paid by the retail customer or a third party; and
- sales of proprietary products or services, or products of affiliates.[24]

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[13] Proposal at p. 115.

[14] Proposal at p. 10.

[15] The Proposal explains that the Care Obligations combined with existing broker-dealer customer suitability requirements would create obligations that are generally consistent with the "underlying principles" of the duty of care enforced under the Investment Advisers Act of 1940, as amended. Proposal at 161.

[16] Proposal at p. 137.

[17] Id.

[18] Proposal at p. 141.

[19] Proposal at p. 144.

[20] Proposal at p. 247.

[21] Proposal at p. 258.

[22] Proposal at pp. 170-171.

[23] Proposal at p. 169.

[24] Proposal at pp. 173-174.

A broker-dealer's policies and procedures would need to (1) define material conflicts in a way that allows employees to identify such conflicts; (2) establish a structure for identifying conflicts (including conflicts that may arise as a broker-dealer business evolves); (3) provide for ongoing and regular reviews related to conflict identification; and (4) establish related employee training procedures.[25]

Such policies and procedures would need to both outline methods for identifying conflicts and include methodologies for mitigating such conflicts. Proposed areas of conflict mitigation include, but are not limited to, the following:

- avoiding compensation thresholds that disproportionately increase compensation through incremental sales increases;
- minimizing compensation incentives which could result in employees favoring specific products; and
- limiting the types of retail customers to whom a product, transaction or strategy may be recommended (e.g., certain products with complex compensation structures).[26]

A broker-dealer would not be required to eliminate all material conflicts, but would need to identify when the safeguards described above are inadequate to mitigate the risks associated with a conflict. For example, the Proposal recommends that broker-dealers avoid certain financial incentives (e.g., sales contests, trips, prizes, etc.) in their entirety for retail customers (or certain categories of retail customers) due to related conflicts being difficult to mitigate.[27]

Other Related Proposals

In addition to outlining the obligations described above, the Proposal also describes several other important broker-dealer initiatives.

Reconsideration of the "Broker-Dealer" Exception to the "Investment Adviser" Definition

The SEC is seeking comment on whether it should reinterpret the broker-dealer exception from the definition of an investment adviser.[28] The SEC notes that this topic has been the subject of prior rule-making, which was invalidated by the US Court of Appeals for the District of Columbia Circuit in 2007.[29] Nonetheless, the SEC believes that in light of the Proposal and related releases it may be appropriate to reconsider the scope of this exclusion.[30]

Amendments to Exchange Act Rules 17a-3 and 17a-4

Exchange Act Rules 17a-3 and 17a-4, respectively, specify certain record keeping requirements for broker-dealers. The Proposal would amend Rule17a-3 such that for each retail customer to whom a recommendation regarding a securities transaction or investment strategy involving securities is or will be made, a record would need to kept of (1) all information collected from, and provided to, such retail customer; and (2) the identity of each natural person who is an associated person of a broker or a dealer.[31] In keeping with these changes to Rule 17a-3, the Proposal would also amend Rule 17a-4 to require broker-dealers to retain all such information for six years.[32]

Form CRS Proposal

It is worth noting that in addition to the Proposal, the SEC also published on April 18, a separate proposal related to the new Form CRS, which would be a client relationship summary disclosure document (Form CRS Proposal).[33] Form CRS would require broker-dealers and dually registered broker-dealers and investment advisers to provide their customers with a brief summary of material

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[25] Proposal at pp. 173-174.

[26] Proposal at pp. 181-182.

[27] Proposal at p. 183.

[28] Proposal at pp. 199-200.

[29] Proposal at p. 201-202.

[30] Proposal at p. 205.

[31] Id.

[32] Proposal at p. 198.

[33] For a more complete discussion of the Form CRS Proposal, please refer to the IA Advisory, available here.

terms of the retail customer/broker-dealer relationship (not to exceed four pages) as well as a series of questions that retail customers should ask in connection with that relationship.

How the Proposal Would Change Existing Law

In some respects, the Proposal, if adopted, would not radically change existing law. When brokers make recommendations, rules of the Financial Industry Regulatory Authority (FINRA) already impose a suitability obligation,[34] albeit with a carve out for an "institutional account," which includes wealthy individuals. In all other respects, the Care Obligation closely tracks the FINRA Rule.

With respect to conflicts of interest, the Proposal would require greater disclosure than exists today. However, it is noteworthy that there is no absolute prohibition on any conflict of interest, merely a requirement to disclose and mitigate the conflict. This approach should provide flexibility to permit many current practices to continue, subject to appropriate disclosure.

Comment Period

The SEC is broadly soliciting comments about various aspects of the Proposal, including, but not limited to, the obligations described above. Comments on the Proposal must be received by the SEC no later than 90 days after the Proposal is published in the *Federal Register*.[35]

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[34] FINRA Rule 2111.

[35] Note, the Proposal was published in the *Federal Register*, available here, on May 9.