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## *SEC Proposes Rules Designed to Enhance Standards of Conduct for Broker-Dealers and Investment Advisers*

By [The Investment Management Practice](#)

### **Introduction**

Nearly eight years after the Dodd-Frank Act authorized the Securities and Exchange Commission (the "SEC" or the "Commission") to issue new rules to address the standards of conduct for broker-dealers and investment advisers, on April 18, 2018, the SEC voted 4-1 to propose a three-part regulatory package (collectively, the "Proposals") designed to enhance the quality and transparency of investors' relationships with investment advisers and broker-dealers. In addition, the Proposals arrive only one month after the U.S. Court of Appeals for the Fifth Circuit struck down the DOL's "Fiduciary Rule" on the grounds that the Rule is inconsistent with the plain text of ERISA, as well as the common law meaning of "fiduciary."<sup>1</sup>

In his opening remarks, SEC Chairman Jay Clayton noted that the objectives behind the Proposals are threefold: (1) enhance retail protection and decision making by raising the standard of conduct for broker-dealers when they provide recommendations to retail investors, and reaffirming and clarifying retail investor relationships with their investment professionals; (2) preserve retail investor access to various types of investment services and investment products; and (3) enhance retail investor awareness of whether they are transacting with registered financial professionals.<sup>2</sup>

In addition, Chairman Clayton noted that the drive behind the Proposals is the apparent investor confusion regarding the differences between broker-dealers and investment advisers, the need for standards of conduct that meet reasonable investor expectations and adequately address conflicts of interest, and the regulatory complexity in addition to the reduction of investment product offerings that resulted post DOL's Fiduciary Rule.

The three Proposals are: (1) "Regulation Best Interest" under the Securities Exchange Act of 1934 for broker-dealers ("Regulation Best Interest"), (2) proposed Form Client Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles ("Form CRS and Title Reform Proposal"), and (3) proposed SEC Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation ("Adviser Conduct Proposal"). Each Proposal is further discussed below.



## I. Proposed Regulation Best Interest

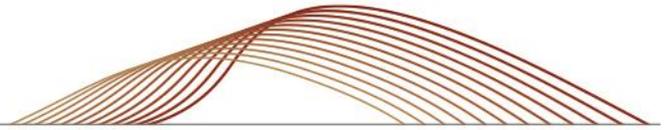
How did we get here?

In Section 913 of the Dodd-Frank Act, Congress authorized the SEC to promulgate a uniform fiduciary standard of conduct for broker-dealers and registered investment advisers “when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide).”<sup>3</sup> Subsequently, in 2011, the SEC released the Staff Study Recommending a Uniform Fiduciary Standard of Conduct for Broker-Dealers and Investment Advisers (“Staff Study”).<sup>4</sup> The Staff Study recommended that the Commission “adopt and implement, with appropriate guidance, the uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers” and that the standard should be “no less stringent than currently applied to investment advisers under the Advisers Act.”<sup>5</sup> In 2013, the Commission issued a request for information seeking additional information from the public to assist the Commission in evaluating whether and how to address certain standards of conduct for, and regulatory obligations of, broker-dealers and investment advisers.<sup>6</sup> On April 8, 2016, DOL adopted the “Fiduciary Rule” that would treat persons who provide investment advice or recommendations for a fee or other compensation with respect to ERISA plan assets or an IRA as fiduciaries in a wider array of advice relationships than under the previous regulation.<sup>7</sup> Finally, as previously noted, on March 15, 2018, the DOL Fiduciary Rule was vacated by the United States Court of Appeals for the Fifth Circuit.

In proposing Regulation Best Interest, the SEC did not propose a uniform fiduciary standard but instead opted for a “best interest” standard which it described as “enhancements” to the current broker-dealer regulatory landscape: “We wish to underscore that proposed Regulation Best Interest focuses on specific enhancements to the broker-dealer regulatory regime, in light of the unique characteristics of the brokerage advice relationship and associated services that may be provided, and therefore *would be separate and distinct from the fiduciary duty that has developed under the Advisers Act.*”<sup>8</sup> In a separate publication we will discuss what the “best interest” standard may mean, but clearly the Commission seems to intentionally draw a distinction between the “best interest” standard and the fiduciary standard of conduct applicable to investment advisers. If the Commission intended the two standards to be synonymous, then it could have said so in the Proposal and would not have needed a different term to describe the broker-dealer standard of care. In addition, the Commission noted that it does not intend for Regulation Best Interest and associated obligations to have “any impact on the Commission’s or its staff’s interpretations of the scope or nature of an investment adviser’s fiduciary obligations.”<sup>9</sup>

Under the proposed Regulation Best Interest, a broker-dealer and its associated persons who are natural persons would be required to act in the best interest of a retail customer when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer. “Retail customer” is proposed to be defined as any person who receives a recommendation about a securities transaction or investment strategy involving securities from a broker-dealer, and who uses it primarily for personal, family, or household purposes.<sup>10</sup>

It is important to also note that the Proposal does not define what it means to act in the retail customer’s “best interest.” Instead, the determination of whether a broker-dealer or its associated person acted in the best interest of the retail customer when recommending a securities transaction or an investment strategy “will turn on facts and circumstances of the particular recommendation and



particular retail customer, and whether the broker-dealer has complied with the disclosure obligation and care obligation.”<sup>11</sup>

The Proposal makes clear that a broker-dealer may not put its financial interests ahead of the interests of a retail customer in making recommendations. And, according to the Proposal, the “best interest” duty would be satisfied if the broker-dealer or its associated person complies with the following obligations:

1. **Disclosure.** Before or when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer, the broker-dealer must reasonably disclose, in writing, the material facts relating to the scope and terms of the relationship, and all material conflicts of interest associated with the recommendation.
2. **Duty of Care.** In making a recommendation, the broker-dealer exercises reasonable diligence, care, skill, and prudence to:
  - a. understand the potential risks and rewards associated with the recommendation and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers;
  - b. have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on the retail customer’s investment profile and the potential risks and rewards associated with the recommendation; and
  - c. 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 retail customer’s best interest when taken together in light of the retail customer’s investment profile.
3. **Conflicts of Interest.** The broker-dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and then to at (i) at a minimum, disclose, or eliminate, material conflicts of interest associated with the recommendation, and (ii) disclose, and mitigate or eliminate material conflicts of interest arising from financial incentives associated with such recommendations.

It is worthwhile to note that Commissioner Stein was a vehement critic of this Proposal and the sole dissenter of the regulatory package. She noted that “[d]espite repeated requests to define what best interest means in the rule text, it was decided that there was no need to define it.”<sup>12</sup> She further noted that this lack of a clear standard “could cause retail investors to reasonably believe that broker-dealers are required to act in their clients’ best interests...[c]alling it Regulation Best Interest is not just confusing, it is in effect a form of mislabeling, which may be misleading and which could have deleterious consequences.”<sup>13</sup>

## II. Proposed Form CRS

The Commission also proposed a new short-form disclosure document (four pages or equivalent limit if in electronic format), in order to help address investor confusion about the nature of their relationships with investment professionals: a customer or client relationship summary (“Form CRS”). Form CRS is intended to provide retail investors with simple, easy-to-understand information about



the nature of their relationship with their investment professional, and would supplement other more detailed disclosures.

Form CRS would require broker-dealers and investment advisers to deliver to retail customers a short summary, including: (1) the principal types of services offered; (2) the applicable fees the retail customer may pay; (3) the legal standard of conduct applicable to the broker-dealer and the investment adviser; and (4) certain conflicts of interest.

This Proposal would also restrict broker-dealers and associated persons from using as part of a name or title “adviser” or “advisor” unless they are also registered as an investment adviser with the SEC pursuant to the Advisers Act requirements. Investment advisers and broker-dealers would also need to disclose their registration status with the Commission in certain retail investor communications.

Finally, this Proposal would also require broker-dealers and investment advisers, and their associated natural persons and supervised persons, respectively, to disclose in retail investor communications the firm’s registration status with the SEC and an associated person’s and supervised person’s relationship with the firm.

While Commissioner Stein was less critical of this Proposal, she mentioned that she was fearful that these requirements would not be very helpful. She stated that it may only serve to provide customers with more pages of unread boilerplate language. Commissioner Pierce went on to criticize the Form’s standards and its attempt to differentiate broker-dealers from investment advisers. Specifically, she pointed to the relationship summary using ongoing monitoring as the “main line of demarcation” between advisers and broker-dealers. “The implication that advisers monitor continuously, while broker-dealers, if they monitor at all, do so only periodically, may not reflect the reality for either advisers or brokers.”<sup>14</sup>

### **III. Standard of Conduct for Investment Advisers**

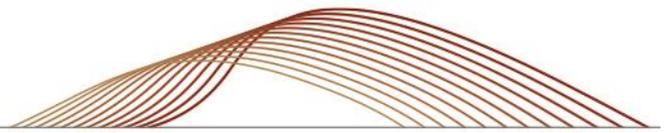
The Commission proposed an interpretation to reaffirm and, in some cases, clarify the Commission’s views of the fiduciary duty that investment advisers owe to their clients under the Advisers Act. Thus, it appears that the Adviser Conduct Proposal was not intended to create new or different obligations or requirements, but rather is an attempt to gather in one place existing components of the Advisers Act fiduciary duty and put industry participants on notice regarding such existing components.

In addition, the Advisers Conduct Proposal also includes a request for comment on three areas that are derived from regulations currently applicable to broker-dealers but not investment advisers. First is federal licensing and continuing education. Second is provision of account statements. And third are financial responsibility requirements (including net capital and fidelity bond requirements).

### **IV. Looking Ahead**

The Proposals appear to be a high priority for the Commission. While certain Commissioners, namely Piwowar, Jackson, and Pierce, gave unenthusiastic and cautious assessments of the Proposals, they nevertheless agreed with Chairman Clayton that these Proposals—in their current form—are a positive first-step forward. The Commissioners noted that there is a lot more work to be done while anticipating and encouraging robust public comment.

On April 24, 2018, the Commission issued a public statement from Chairman Clayton in which the Chairman noted that in connection with the Proposals, he has asked the SEC staff to put together a



series of roundtables to be held in different cities around the country—including Atlanta, Denver, Houston, and Miami. The roundtables are intended to gather information from retail investors directly.

The public comment period will remain open for 90 days following publication of the documents in the Federal Register.

The SEC's press release can be found [here](#).

The SEC's Proposals can be found at the following links: [Regulation Best Interest](#), [Adviser Conduct Proposal](#), and [Form CRS and Title Reform Proposal](#).



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<sup>1</sup> See *Chamber of Commerce of the U.S.A., et al. v. U.S. Dep't of Labor, et al.*, No. 17-10238, slip op. 46 (5th Cir. Mar. 15, 2018).

<sup>2</sup> Overview of the Standards of Conduct for Investment Professionals Rulemaking Package, Exchange Act Release No. 2018-68 (Apr. 18, 2018), <https://www.sec.gov/news/public-statement/clayton-overview-standards-conduct-investment-professionals-rulemaking>.

<sup>3</sup> See generally Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913 (2010).

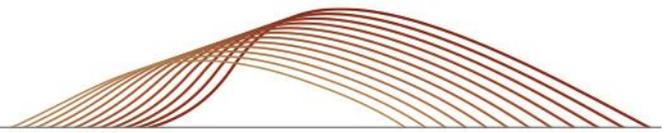
<sup>4</sup> SEC Releases Staff Study Recommending a Uniform Fiduciary Standard of Conduct for Broker-Dealers and Investment Advisers, Exchange Act Release No. 2011-20 (Jan. 20, 2011), <https://www.sec.gov/news/press/2011/2011-20.htm>.

<sup>5</sup> *Id.*

<sup>6</sup> SEC Seeks Information to Assess Standards of Conduct and Other Obligations of Broker-Dealers and Investment Advisers, Exchange Act Release 2013-32 (Mar. 1, 2013), <https://www.sec.gov/news/press-release/2013-2013-32.htm>.

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<sup>7</sup> See Regulation Best Interest, Exchange Act Release No. 34-83062, 27 (Apr. 18, 2018).

<sup>8</sup> See *supra* note 7, at 43.

<sup>9</sup> *Id.*

<sup>10</sup> See *supra* note 7, at 83-84.

<sup>11</sup> See *supra* note 7, Footnote 317.

<sup>12</sup> 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, (Apr. 18, 2018) available at <https://www.sec.gov/news/public-statement/stein-statement-open-meeting-041818>.

<sup>13</sup> *Id.*

<sup>14</sup> Statement at the Open Meeting on Standards of Conduct for Investment Professionals, (Apr. 18, 2018) available at <https://www.sec.gov/news/public-statement/statement-peirce-041818>.