

SEC's Proposed Regulation Best Interest and Structured Investments

April 30, 2018

Overview

- On April 18, 2018, the Securities and Exchange Commission (SEC) voted 4-1 to propose for public comment the following proposals relating to the standards of conduct for broker-dealers (BDs) and investment advisers (RIAs):
 - Instead of proposing a fiduciary standard for BDs, the SEC proposed a best interest standard
 - The SEC also proposed a new requirement for BDs and RIAs to provide retail investors with a relationship summary
 - Finally, the SEC published for comment an interpretation of the current standard of conduct for RIAs
- Comments are due 90 days from publication in the Federal Register (approximately mid-July)

Regulation Best Interest

- Regulation Best Interest would require that BDs and their associated persons who are natural persons act in the best interest of a **retail customer** at the time a **recommendation** of a securities or investment strategy involving securities is made, without placing the financial or other interest of the BD or associated person ahead of the interest of the customer
 - A **retail customer** is defined as a person who receives a recommendation and uses it primarily for personal, family or household purposes
 - A **recommendation** is not defined but is understood to be interpreted in a manner consistent with the FINRA definition

Discharging the Best Interest Obligation

- The BD or associated person would be deemed to have discharged the best interest obligation by complying with:
 - A disclosure obligation
 - A care obligation
 - A conflict of interest obligation

Disclosure Obligation

- The BD or associated person must **reasonably disclose** in writing the **material facts** relating to the scope and terms of the relationship, including all **material conflicts of interest** associated with the recommendation
- **Material facts** would include the BD's role (acting as a broker-dealer, not an adviser), the fees and charges applicable to the retail customer's transactions, and the type or scope of services provided by the BD
- A **material conflict of interest** is defined as “a conflict of interest that a reasonable person would expect might incline a broker or dealer—consciously or unconsciously—to make a recommendation that is not disinterested.”

Disclosure Obligation, cont'd.

- A **conflict** may arise from financial incentives or from recommending proprietary products, products of affiliates, a limited range of products, securities underwritten by the firm or securities underwritten by an affiliate
- Disclosures may be standardized in part, but must be specific enough to apply to the particular recommendation and must be in writing

Care Obligation

- The BD or associated person must exercise reasonable diligence, care, skill and prudence to:
 - Understand the potential risks and rewards associated with the recommendation, and have a reasonable basis to believe the recommendation could be in the best interest of at least some retail customers [*FINRA reasonable basis suitability*];
 - Have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks and rewards associated with the recommendation [*FINRA customer specific suitability*]; and
 - Have a reasonable basis to believe that a series of recommended transactions is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile [*FINRA quantitative suitability*].

Conflict of Interest Obligations

- The BD must establish, maintain and enforce written policies and procedures reasonably designed to identify and then to:
 - At a minimum disclose or eliminate material conflicts of interest arising from financial incentives associated with the recommendation; and
 - Disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with the recommendation

Form CRS Summary

- The SEC also proposed to require both BDs and RIAs to provide retail investors (defined differently) with information intended to clarify the relationship through a proposed Form CRS Relationship Summary
- The Form CRS is limited to four pages, with tabular and narrative information, including:
 - The relationships and services the firm offers to retail investors
 - The standard of conduct applicable to those services
 - The fees and costs that retail investors will pay
 - Comparisons of brokerage and investment advisory services
 - Conflicts of interest
 - Where to find additional information, including disciplinary information
 - Key questions a retail investor should ask the firm’s professionals

Form CRS Summary, cont'd.

- The Form CRS would be provided to investors, filed with the SEC and available online
- For these purposes, “retail investor” is defined as “a customer or prospective customer who is a natural person (an individual). This term includes a trust or other similar entity that represents natural persons, even if another person is a trustee or managing agent of the trust.”

Other Restrictions

- BDs and RIAs would be required to prominently disclose their registration
- The SEC would restrict standalone BDs and their professional from using the term “advisor” or “adviser” in their title
- The objective is to avoid investor confusion

Proposed Interpretive Release on RIA Fiduciary Duty

- The interpretation summarizes the SEC's interpretation of the fiduciary duty of investment advisers set forth in Section 206 under the Investment Advisers Act
- Advisers have a two-pronged fiduciary duty, including a duty of care and a duty of loyalty
- The duty of care for advisers consists of:
 - Acting and providing advice that is in the best interest of the client;
 - Seeking best execution of a client's transaction;
 - Providing advice and monitoring; and
 - Exercising the duty of care requires the adviser to undertake a reasonable inquiry into the client's financial situation, investment experience and investment objectives.

Proposed Interpretive Release on RIA Fiduciary Duty, cont'd.

- The advice must be personalized based on that client's profile, as updated from time to time
- The costs or fees are an important factor in determining whether a particular security or strategy is in the client's best interest

Adviser's Duty of Loyalty

- An adviser's duty of loyalty:
 - Requires that an adviser put its client's interests ahead of its own, not unfairly favor one client over another, and make full and fair disclosure of all material facts relating to the advisory relationship;
 - Requires that an adviser seek to avoid conflicts and, at a minimum, make full and fair disclosure of all material conflicts of interest that could affect the relationship;
 - Prohibits an adviser from favoring proprietary accounts over client accounts; and
 - Requires that disclosures be clear, specific enough to be understood, and detailed so that a client can give its informed consent.

Other Requests for Comment

- The SEC requests comment regarding three proposals:
 - Federal licensing, qualification and continuing education requirements for investment adviser representatives.
 - Account statements: should advisers be required to provide account statements setting forth the fees and expenses charged for advisory services?
 - Financial responsibility: whether investment advisers should be subject to financial responsibility similar to those that apply to BDs.