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Washington Pulse

June 2019

SEC Approves Regulation Best Interest Guidance

On June 5, 2019, the Securities and Exchange Commission (SEC) released a guidance package for broker-dealers and investment advisers who provide investment recommendations and investment advisory services to clients. By releasing this guidance package, the SEC is enhancing the broker-dealer standard to meet retail customers' expectations, and also confirming and clarifying the standard of conduct for investment advisers.

The SEC first proposed this guidance in April 2018, almost nine years after a provision in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 required the SEC to do so. The SEC's rulemaking and interpretation guidance package contains the following items.

- The Regulation Best Interest (Reg. BI), which establishes a new standard of conduct under the Securities and Exchange Act of 1934 for broker-dealers when making recommendations to retail customers.
- A final rule requiring investment advisers *and* broker-dealers to provide a client relationship summary (known as Form CRS) to retail investors.
- An interpretation of the standard of conduct for investment advisers.
- An interpretation of the "solely incidental" prong—under the Investment Advisers Act of 1940—which excludes certain broker-dealers from the definition of "investment adviser."

How Did Reg. BI Change From the Proposed Guidance?

Before releasing the final guidance package, the SEC modified some of the proposed Reg. BI provisions.

- Reg. BI now defines "account recommendations" to include recommendations to move assets between different types of accounts or to roll over an employer plan distribution to an IRA.
- Broker-dealers must disclose whether they will provide account-monitoring services—and the scope of those services. Hold recommendations, whether explicit or implicit, are subject to Reg. BI. For example, an implicit hold recommendation occurs when a broker-dealer reviews a customer's account under an account monitoring agreement and does not communicate any recommendations.
- Broker-dealers must adopt policies and procedures designed to "eliminate sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sale of specific securities or specific types of securities within a limited period of time."
- Investment cost considerations are now explicitly required both in a broker-dealer's Care Obligation and in the Disclosure Obligation.
- Broker-dealers must create and enforce policies and procedures that are designed to achieve compliance with all of Reg. BI.

What Is the Standard of Conduct for Broker-Dealers?

Reg. BI establishes a standard of conduct for broker-dealers when they make a recommendation to a retail customer regarding any securities transaction or any investment strategy involving securities.

Specifically, Reg. BI requires broker-dealer action.

- Broker-dealers must act in the retail customer's best interest at the time the recommendation is made, without placing the broker-dealer's financial or other interest *ahead* of the retail customer's interests. (This "General Obligation" requirement is discussed in more detail below.).
- Broker-dealers must address conflicts of interest by establishing and enforcing policies that are designed to identify and fully disclose facts about conflicts of interest. In instances where the SEC has determined that the disclosure is insufficient to reasonably address the conflict, broker dealers must mitigate or eliminate the conflict.

The SEC rule does not expressly define "best interest," nor does it establish a "safe harbor" for complying with the best interest standard. Rather, the specific obligations under Reg. BI are mandatory, and compliance with the letter and spirit of these obligations will be determined by considering all of the facts and circumstances.

The SEC's Reg. BI is *not* the same as the Department of Labor's (DOL's) Best Interest Contract, which was part of the now vacated fiduciary investment advice final rule. Unlike the DOL's guidance, the SEC's guidance applies only to securities transactions; it does not apply to traditional bank and credit union products (e.g., certificates of deposit).

Compared with the DOL's fiduciary investment advice regulations, the SEC's final investor protection rules cover a larger pool of investors. Reg. BI is not specific to retirement savers, but instead covers general retail investors. In this final version of Reg. BI, the SEC modifies the definition of a "retail investor" to include any natural person—including an individual retirement plan participant—who receives a recommendation from the broker-dealer. This would apply to any recommendations for the natural person's own account—but not for an account of a business that she works for (for example, where an individual is seeking investment services for a small business).

Reg. BI also narrows the pool of investment-recommendation providers covered by the guidance, as the SEC final rules apply only to broker-dealers and "associated persons" of a broker-dealer. The guidance does not typically apply to personnel of banking or insurance organizations.

General Obligation

The General Obligation requires that broker-dealers act in the retail customer's best interest—without placing their own interests ahead of the customer's interests. The General Obligation is satisfied only if the broker-dealer complies with four specific component obligations.

Disclosure Obligation

The Disclosure Obligation requires broker-dealers to disclose, in writing, all material facts about their relationship with a customer. The broker-dealer must disclose any conflicts of interest associated with the recommendation (e.g., conflicts associated with proprietary products or payments from third parties).

Care Obligation
The Care Obligation requires a broker-dealer to exercise reasonable diligence, care, and skill when making a securities-related recommendation. The broker-dealer must also understand the recommendation's potential risks, rewards, and costs and consider those factors in light of the customer's investment profile. The broker-dealer must reasonably believe that the recommendation is in the customer's best interest.

Conflict of Interest Obligation
Under the Conflict of Interest Obligation, broker-dealers must create and enforce written policies and procedures addressing conflicts of interest associated with their securities-related recommendations to retail customers. When broker-dealers place limitations on recommendations that they make to retail customers (e.g., offering only proprietary funds or another narrow range of products), the policies and procedures must be designed to disclose any limitations and associated conflicts and to prevent the broker-dealer from placing his interests ahead of the customer's interests.

The broker-dealer's policies and procedures "must be reasonably designed to identify and eliminate sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sale of specific securities or specific types of securities" within a limited time period.

Compliance Obligation
The Compliance Obligation requires a broker-dealer to create and enforce written policies and procedures designed to achieve compliance with all of Reg. BI. At the time a recommendation is made, key elements of Reg. BI will be similar to key elements of the fiduciary standard for investment advisers.

Which Activities Fall Under the SEC Reg. BI guidance?

The SEC guidance package addresses activities with respect to securities investments—such as stocks, bonds, and mutual funds—for retail clients. This includes the purchase, sale, exchange, or holding of such investments. A recommendation that triggers application of Reg. BI is based upon the facts and circumstances of the particular situation. Factors include whether the communication "reasonably could be viewed as a 'call to action'" and "reasonably would influence an investor to trade a particular security or group of securities." The more individually tailored the communication to a specific customer or a targeted group of customers, the greater likelihood it would be viewed as a "recommendation."

Account recommendations generally include recommendations involving securities, recommendations to roll over or transfer assets from one type of account to another (e.g., employer plan to IRA), and recommendations involving employer plan loans.

The following broker-dealer communications are *not* considered "recommendations."

- General financial and investment information
- Descriptive information about an employer-sponsored retirement or benefit plan, participation in the plan, the benefits of plan participation, and the investment options available under the plan
- Asset allocation models and related interactive investment materials
- Requirement to take an RMD, as long as there is no discussion of which assets to liquidate

- Communications on making or increasing retirement plan contributions, as long as there is no discussion of how the assets should be invested or allocated

The SEC guidance covers retirement plan participants receiving direct investment recommendations for their own account, but excludes employer plans as a business-purpose exception. The guidance also covers investors in individual tax-advantaged accounts such as IRAs, health savings accounts, Archer medical savings accounts, 529 plans, and Coverdell education savings accounts.

How does Form CRS Affect Broker-Dealers and Investment Advisors?

While the SEC guidance is primarily directed to broker-dealers and the securities recommendations they make, the client relationship summary (known as Form CRS) disclosure requirement applies both to broker-dealers and to investment advisers. Broker-dealers and investment advisers must provide Form CRS, in a standardized Q & A format, to retail clients at the beginning of their relationship. (For existing clients or customers, certain disclosures still have to occur when recommendations are made.)

Some of the information Form CRS should contain includes

- information about services, fees, and costs; conflicts of interest; standards of conduct; and whether there has been any disciplinary history with the financial professional or firm;
- a link or information on how to access the SEC's investor.gov website; and
- key questions a retail investor may want to ask (for example, Form CRS should provide greater detail about services provided or specific fees).

The SEC's intent of multiple disclosures (including Form CRS and Disclosure Obligation communications) is to layer disclosures to customers so that they have appropriate information either before or at the time a recommendation is made. In general, the SEC advises representatives to be direct and clear about their status as a broker-dealer or investment adviser—or dual status—and to refrain from using language or terms formally or informally that may mislead a customer. Form CRS is subject to SEC filing and recordkeeping requirements.

What is the Standard of Conduct for Investment Advisers?

While the fiduciary standard is not new for investment advisers, the SEC has never before adopted a formal interpretation of its fiduciary obligations. The SEC has now defined the fiduciary standards of conduct for investment advisers, which include the following duties.

Duty of Care

- Duty to provide advice that is in the customer's best interest
- Duty to seek best execution
- Duty to provide advice and monitoring over the course of the relationship

Duty of Loyalty

- Duty not to subordinate the clients' interests to their own
- Duty to make full and fair disclosure of all material facts relating to the investment adviser's relationship with the client
- Duty to eliminate (or at least expose, through full and fair disclosure) all conflicts of interest

What is the SEC's New Interpretation of "Solely Incidental"?

Broker-dealer advisory services are excluded from the scope of the Investment Advisers Act of 1940 and the definition of "Investment Adviser" (the "broker-dealer exclusion") *only* if the following requirements are met.

- The services must be solely incidental to the broker-dealer's regular business as a broker-dealer (the "solely incidental" prong).
- The broker-dealer cannot receive special compensation for those advisory services.

In response to comments, as part of its final guidance package, the SEC has published an interpretation to confirm and clarify its position with respect to the solely incidental prong of the broker-dealer exclusion.

Specifically, the SEC interprets the language to mean that a broker-dealer who provides advice is acting "consistent with the solely incidental prong if the advice is provided in connection with and is reasonably related to the broker-dealer's primary business of effecting securities transactions."

Whether the solely incidental prong is satisfied is based on the facts and circumstances of the broker-dealer's business, the services offered by the broker-dealer, and the broker-dealer's relationship with the customer.

Other Items of Interest

- Broker-dealers must maintain a record of all information pertinent to, and provided by, a customer that shows compliance with Reg. BI for six years. The records must also include the identity of all individuals associated with the broker-dealer who are responsible for the account. Broker-dealers must retain originals of all communications received from a customer and copies of all communications sent to the customer for three years; these communications must be retained "in an easily accessible place" for two years.
- Some states have adopted their own rules governing the relationship between regulated entities and their customers. Whether Reg. BI preempts such state laws would be determined in future judicial proceedings, based on the specific language and effect of that state law.
- The SEC does not believe Reg. BI creates any new private right of action or right of rescission, nor does the SEC intend such a result.

Effective Dates

Reg. BI and the Form CRS requirements will become effective 60 days after they are published in the Federal Register, and include a transition period until June 30, 2020, in order to give firms sufficient time to come into compliance. The "standard of conduct" interpretation and the "solely incidental" interpretation become effective upon publication in the Federal Register. More guidance is expected—the DOL has indicated its intent to release a new proposed fiduciary rule by the end of this year. Stay tuned to ascensus.com for the latest developments.