ALERT MEMORANDUM

SEC Proposes New Best Interest Standard for Broker-Dealers and "Clarification" of Existing Fiduciary Standard for Investment Advisers

New Standards Seek to Maintain Flexibility But Leave Open Questions About Scope and Enforcement

May 2, 2018

On April 18, 2018, the Securities and Exchange Commission ("**SEC**" or "**Commission**") proposed Regulation Best Interest under the Securities Exchange Act of 1934 ("**Exchange Act**") to establish a new "best interest" standard of conduct for broker-dealers when making a recommendation of any transaction or investment strategy involving securities to a retail customer. The SEC also proposed an interpretation to reiterate and clarify the fiduciary duty applicable to investment advisers ("**Guidance**") under the Investment Advisers Act of 1940 ("**Advisers Act**"). Finally, the SEC proposed a new disclosure form for investment advisers and broker-dealers to provide to retail investors ("**Form CRS**").

In proposing the new Regulation Best Interest and the Guidance, the SEC has attempted to align the standards of conduct applicable to broker-dealers and investment advisers more closely with each other while recognizing the fundamental differences between the services each provide and maintaining investor choice.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors.

WASHINGTON

Robin M. Bergen
+1 202 974 1514
rbergen@cgsh.com

Carl F. Emigholz
+1 202 974 1876
cemigholz@cgsh.com

NEW YORK

Arthur H. Kohn
+1 212 225 2920
akohn@cgsh.com

Colin D. Lloyd
+1 212 225 2809
clloyd@cgsh.com

Alexander Janghorbani
+1 212 225 2149
ajanghorbani@cgsh.com

- Regulation Best Interest: Regulation Best Interest would impose new disclosure, care and conflict of interest obligations on broker-dealers when providing recommendations to retail customers:
    - Consistent with the SEC's aim to maintain investor choice between business models for investment professionals, the proposal would not fully harmonize these new requirements with the fiduciary duty applicable to investment advisers.
    - The proposal instead builds on existing Financial Industry Regulatory Authority ("**FINRA**") suitability rules and related guidance. It then adds new requirements for broker-dealers to (1) make conflicts disclosures beyond what is required under general antifraud principles and (2) employ conflict mitigation measures that go beyond disclosure. Also, unlike FINRA suitability rules, the proposal would require customer-specific suitability analysis for certain institutional accounts.
    - If adopted, the proposal would give the SEC, in addition to FINRA, a non-scienter basis to pursue sales practice claims. The SEC believes, however, that the proposed requirements would not give rise to a private right of action.
- Guidance: With certain exceptions noted below, the Guidance generally reiterates the current state of the law on investment advisers' duties to clients and prospective clients by summarizing various interpretations of the fiduciary obligations of investment advisers, as interpreted by courts, the Commission and commentators over time.
    - In at least one important respect, however, the Guidance may elucidate new obligations that cannot be waived by disclosure: the Guidance states that certain conflicts may simply be too complex to be disclosed in a manner sufficiently understandable to clients. The Guidance leaves open the question of whether the level of complexity is assessed in light of an investor's sophistication, while suggesting that in fact it is. As such, if adopted as proposed, some complex conflicts may be off-limits, in the Commission's view, and actionable under the antifraud provisions, even in the absence of efforts to deceive.
    - The Guidance also requests comment on possible imposition of additional substantive requirements for investment advisers that would mirror existing requirements for broker-dealers, specifically: (1) federal licensing and continuing education, (2) provision of account statements to clients and (3) financial responsibility.

This Memorandum provides an overview of Regulation Best Interest and the Guidance, summarizes the key issues that they raise and then discusses implications for enforcement. Comments on the proposals are due 90 days after publication in the Federal Register.

PROPOSED REGULATION BEST INTEREST

The proposed Regulation Best Interest does not seek complete harmonization of the standards applicable to broker-dealers and investment advisers.[1] Rather, Regulation Best Interest is intended to (1) supplement and enhance the requirements currently applicable to broker-dealers under FINRA suitability rules and the antifraud provisions of the Exchange Act and (2) establish an explicit standard enforceable by the Commission. In this way, it preserves the ability of investors to choose the type of financial professional most appropriate to their investment objectives.

Summary

Regulation Best Interest would require a broker-dealer to act in the "best interest" of its retail customer at the time it makes a recommendation ("**conduct standard**") through compliance with specific obligations concerning disclosure, care and conflicts of interest.[2] These obligations would apply only when making a recommendation; there would be no ongoing monitoring obligation.

- *Disclosure Obligation*. The proposal would require a broker-dealer, prior to or at the time of a recommendation to a retail customer, to disclose material facts related to its relationship with the customer and all material conflicts of interest. The proposal does not otherwise prescribe the form, manner, timing and frequency of such disclosures. Importantly, disclosure could be provided at the inception of a relationship and updated periodically, not necessarily on a recommendation-by-recommendation basis (although more specific disclosure might be warranted in some cases). While the adequacy of such disclosure would depend on the facts and circumstances of a particular recommendation, some of the examples of material facts noted by the SEC include that the broker-dealer is acting in a broker-dealer (as opposed to advisory) capacity with respect to the recommendation, the broker-dealer's fees and charges and the type and scope of services provided by the broker-dealer.[3] The SEC would measure compliance with the Disclosure Obligation against a negligence standard.[4]
- *Care Obligation*. To fulfill the Care Obligation, a broker-dealer would need to understand the potential risks and rewards of the recommendation and have a reasonable basis to conclude that (1) the recommendation could be in the best interest of at least some retail customers, (2) the recommendation was in the best interests of the particular retail customer and (3) a series of recommendations was not excessive.[5] The Care Obligation would apply "regardless of whether the broker-dealer has actual or *de facto* control over a retail customer account"[6] and would generally require the broker-dealer to consider reasonable alternatives and undertake reasonable diligence.[7] Additionally, Regulation Best

[1] See Staff of the SEC, *Study on Investment Advisers and Broker-Dealers As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Jan. 2011).
[2] Proposed Rule: Regulation Best Interest, at 404 (Apr. 18, 2018) ("**NPR**").
[3] See id. at 97-98.
[4] Id. at 115.
[5] The proposal notes that "a broker-dealer could not have a reasonable basis to believe that the recommendation is in the 'best interest' of the retail customer, if the broker-dealer put its interest ahead of the retail customer's interest." Id. at 141.
[6] Id. at 154.
[7] See, e.g., id. at 56 ("When a broker-dealer recommends a *more remunerative* security or investment strategy over another reasonably available alternative offered by the broker-dealer, the broker-dealer would need to have a reasonable basis to believe that—putting aside the broker-dealer's financial incentives—the recommendation was in the best interest of the retail customer based on factors [including, the product's or strategy's investment objectives, characteristics, liquidity, risks, potential benefits, and volatility] in light of the retail customer's investment profile.") (emphasis in original).

Interest would not have an effect on a broker-dealer's best execution obligations.

- *Conflict of Interest Obligations*. Broker-dealers would generally be required to establish procedures reasonably designed to identify and disclose or eliminate all material conflicts of interest associated with recommendations.[8] For a material conflict arising from financial incentives associated with recommendations, a broker-dealer would be required to disclose *and mitigate*, or eliminate, the conflict. Thus, while disclosure alone would satisfy the general conflicts obligation, a broker-dealer would affirmatively be required to mitigate conflicts arising from financial incentives such as fees, charges, commissions and compensation. Although providing for some flexibility, the proposal suggests that certain conflicts ought to be eliminated, including sales contests, trips, prizes and similar bonuses based on sales of certain securities or assets under management.[9] Under the proposal, broker-dealers would be permitted to "use a risk-based compliance and supervisory system… rather than conducting a detailed review of each recommendation" in order to satisfy these obligations.[10]

Observations

As discussed below, Regulation Best Interest raises several interpretive questions and issues, which we expect to be more fully discussed through the comment process.

— **Definition of Recommendation**

Regulation Best Interest does not define the term "recommendation," which would continue to be interpreted in a manner consistent with existing SEC precedent and guidance.[11] Under this guidance, facts giving rise to a "recommendation" 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.'"[12] Recommendations can also be implicit in a broker-dealer's actions.[13] The SEC acknowledged comments that a broader range of communications may be covered by the concept of "fiduciary investment advice" in the 2015 Department of Labor ("**DOL**") rule applicable to fiduciaries to an employee benefit plan or individual retirement account ("**DOL Fiduciary Rule**"),[14] and helpfully clarified that existing guidance under the federal securities laws and self-regulatory organization rules would continue to apply.[15]

— **Definition of Retail Customer**

Regulation Best Interest defines a "retail customer" as a person that receives a recommendation of any securities transaction or investment strategy involving securities and uses the recommendation "primarily for personal, family, or household" purposes.[16] The SEC anticipates that broker-dealers would generally be able to ascertain the purpose of a customer's account through existing FINRA know-your-customer rules. However, the SEC did not further define or clarify what constitutes a "personal, family, or household" purpose. Moreover, retail customers could include

[8] See id. at 404-405.
[9] See id. at 183.
[10] Id. at 171. Specifically, the proposal notes that "these practices, if incorporated into written policies and procedures, may reasonably mitigate conflicts of interest arising from financial incentives." Id. at 181. The proposal also provides helpful guidance for examples of risk mitigation practices, including potentially problematic compensation incentives and appropriate supervisory procedures, that broker-dealers could incorporate into their policies and procedures to comply with the rule. Id. at 182-183.
[11] See id. at 74-75.
[12] Id. at 75.
[13] Id. at 77.
[14] The DOL Fiduciary Rule was vacated by the United States Court of Appeals for the Fifth Circuit. See Chamber of Commerce of the U.S.A., v. U.S. Dep't of Labor, No. 17-10238 (5th Cir.) (Mar. 15, 2018) ("**Chamber of Commerce**").
[15] See, e.g., Letter from Lisa Bleier, Managing Director & Associate General Counsel, SIFMA in response to DOL's Request for Information Regarding the Fiduciary Rule and Prohibited Transaction Exemptions (Aug. 9, 2017).
[16] NPR, at 406.

sophisticated and wealthy individuals as well as entities such as trusts. Conversely, the standard would appear not to apply to customers investing for business purposes, even if the customer is an individual or small business with little investment sophistication.

The purpose-based test is also inconsistent with other SEC and FINRA standards that look to customer characteristics such as net worth, regulatory status or similar standards as a proxy for sophistication rather than looking to the motivation for particular transactions. As a result, the definition of "institutional accounts" in FINRA's suitability rule includes certain high net worth individuals—meaning they are carved out of the requirements applicable to non-institutional accounts—who would be covered by Regulation Best Interest.

Comparison with Current FINRA Rules, SEC Rules and the DOL Fiduciary Rule

Regulation Best Interest would enhance currently applicable suitability requirements in the context of retail recommendations, but generally would not go as far as imposing a full fiduciary standard.

- *Suitability*. Though, as noted above, the Care Obligation would only apply when making a recommendation, it would "go beyond FINRA's concept of 'quantitative suitability'" to apply to a series of recommendations even when the broker-dealer does not control the customer's account. The presence of "control" is currently a prerequisite for FINRA's quantitative suitability requirements to apply.[17]

  In addition, the Care Obligation requires a recommendation to be in the best interest of the customer, not just suitable for the customer.[18] Although on its face this aspect of the proposal would seem to heighten a broker-dealer's obligation to the customer, case law and FINRA's guidance regarding suitability requirements currently state that "a broker's recommendations must be consistent with his customers' best interests."[19] How the Care Obligation differs in practice from this current standard is an important point for comment and clarification.

- *Disclosure*. The Disclosure Obligation would impose additional requirements on broker-dealers. Currently, broker-dealers are required to make specific disclosures—including whether they are acting as agent or principal, their compensation and any third-party remuneration—when they effect certain types of customer transactions,[20] and are subject to general disclosure obligations under the antifraud provisions of the securities laws.[21] However, there is no general requirement that broker-dealers disclose material conflicts of interest. Regulation Best Interest would impose an "explicit and broad disclosure requirement" to promote recommendations in the best interest of retail customers.[22] This requirement would be consistent with disclosures required of broker-dealers found to be acting in a fiduciary capacity.[23]

- *DOL Fiduciary Rule*. The proposal states that Regulation Best Interest "generally reflects similar underlying principles" as would be in the DOL Fiduciary Rule and cannot be satisfied merely by full disclosure.[24] However, there is

[17] Id. at 150.
[18] Id. at 142. Additionally, "a broker-dealer's duty to exercise reasonable diligence, care, skill and prudence is designed to be similar to the standard of conduct that has been imposed on broker-dealers found to be acting in a fiduciary capacity." Id. at 134. Courts have previously found that brokers had established a fiduciary relationship with customers under common law principals when, among other circumstances, such customers placed trust and confidence in the broker.
[19] *FINRA Rule 2111 (Suitability) FAQ*, at A7.1 (citing Raghavan Sathianathan, Exchange Act Rel. No. 54722, 2006 SEC LEXIS 2572, at *21 (Nov. 8, 2006) (aff'd, 304 F. App'x 883 (D.C. Cir. 2008)).
[20] Id. at 99.
[21] See, e.g., Exchange Act Rule 10b-10; Exchange Act § 10(b); Exchange Act Rule 10b-5.
[22] NPR, at 99-100.
[23] Id. at 98.
[24] Id. at 156-157.

tension between (1) the SEC highlighting that Regulation Best Interest is intended to be "consistent" with both the DOL Fiduciary Rule[25] and the investment adviser fiduciary standard and (2) expressly adopting a slightly different standard from those regimes.

Certainly, as the SEC notes, the Conflict of Interest Obligations "address the same concerns that the DOL sought to address . . . in a less prescriptive manner."[26] In light of the decision in *Chamber of Commerce*, the foregoing issues may be academic. However, considerable uncertainty remains as to the standard that will apply for determining fiduciary status under DOL rules in the future, and the implications of potentially different standards under DOL and SEC rules. We note that different standards have been applicable under the different regulatory schemes for many years, without giving rise to substantial difficulty.

— **"Solely Incidental" Exception**

The SEC noted that a broker-dealer is excluded from the definition of investment adviser if its provision of advisory services to a client is solely incidental to the conduct of the broker-dealer's business and the broker-dealer receives no special compensation for those services.[27] Because of uncertainty in application of this exception, the Commission adopted a rule in 2005 that "would have required broker-dealers to be considered to be investment advisers under the Advisers Act with respect to discretionary accounts, except that broker-dealers would have been permitted to exercise investment discretion on a temporary or limited basis," as that would have been considered solely incidental to the broker-dealer's business.[28] That 2005 rule was struck down in 2007, re-proposed later in 2007, but never adopted. The SEC has reopened this topic by requesting comment on this "solely incidental" exception, especially in the context of discretionary accounts.

— **Marketing Restrictions**

The SEC also proposed a new marketing rule that would prohibit broker-dealers and certain associated persons from holding themselves out as a "financial adviser" or "financial advisor." This aspect of the proposal is intended to reduce sources of confusion in the eyes of retail investors about the differences between broker-dealers and investment advisers, the obligations they owe and how they are compensated.

— **Obligations Under Form CRS**

The SEC proposed Form CRS, which would require both investment advisers and broker-dealers to disclose to retail investors their standards of care, fees and conflicts of interest. Filing Form CRS would not fulfill the Disclosure Obligation, which requires far more extensive disclosures. The purpose of Form CRS, rather, is to enable clients to compare basic information and to use it as a roadmap to seek additional information. Relative to existing disclosure obligations, we expect broker-dealers to bear a greater burden than investment advisers, which already disclose substantial information about conflicts of interest and potential conflicts of interest on Form ADV.

PROPOSED INTERPRETATION REGARDING INVESTMENT ADVISERS' FIDUCIARY STANDARD

The Guidance purports to "reaffirm—and in some cases clarify—certain aspects of the fiduciary duty that a registered investment adviser owes to its clients" under the Advisers Act.[29] The Commission suggests that the Guidance merely serves as a summary of already-existing obligations arising under the general duties of care and loyalty, including specific duties to disclose conflicts of interest, provide advice in a client's best interest and seek best execution. If adopted, however, some of the "clarifications" may well reflect a higher standard of conduct than is currently required under federal law.

[25] See, e.g., id. at 75 ("The DOL Fiduciary Rule follows a consistent approach in defining a "recommendation" . . .).
[26] Id. at 184.
[27] See id. at 199-200.
[28] See id. at 203-204.
[29] Guidance, at 5.

— **Potential Expansion of the "Federal Fiduciary Standard"**

As the SEC notes in the Guidance, it is well-settled that the source of an investment adviser's fiduciary duty to its clients is the general antifraud provisions of the Advisers Act.[30] However, the particular conduct required to satisfy that duty "is not specifically defined in the Advisers Act or in Commission rules."[31] Rather, the parameters of investment advisers' fiduciary duties have been established through the development of federal case law, most importantly *Capital Gains*, and with reference to industry practice and state law. Indeed, the Commission has acknowledged that the precise parameters of a fiduciary duty can be defined within the advisory contract between an adviser and its clients.

Thus, the general framework of the Advisers Act—particularly with respect to conflicts of interest—is to establish a set of principles, rather than prescribe particular conduct that advisers must follow. The Commission has historically enforced these provisions after evaluating facts and circumstances surrounding disclosure, while in fewer cases explicitly prohibiting certain conduct. For example, the Advisers Act generally prohibits investment contracts requiring advisory clients to waive certain rights under the federal securities laws, including fiduciary duties.[32] The SEC does permit, however, under limited circumstances, hedge clauses, pursuant to which a client indemnifies an investment adviser for liability arising from the adviser's misconduct. Whether a "hedge clause" is invalidated as misleading (because it could present a misimpression of waiving fiduciary duties) is a facts-and-circumstances inquiry.[33]

The Guidance may represent a limited departure from this historical, disclosure-based principle, particularly with respect to conflicts of interest. It is well settled that investment advisers are obliged to disclose both actual and potential conflicts of interest.[34] However, the Guidance suggests that, in the Commission's current view, some conflicts may be so complex that they cannot be adequately disclosed and must simply be avoided.[35] If such were the case, investment advisers would be faced with a number of potential issues, chief among them whether they can be liable for violations of the antifraud provisions for the existence of conflicts even if the adviser has provided robust conflict disclosures. Traditionally, the answer has been no; appropriate disclosure itself is curative.

In addition, the Guidance would apparently require investment advisers to undertake this determination on a client-by-client basis. In announcing this view, the Commission also stated that clients must be able to provide informed consent to a conflict.[36] This interpretation, if followed by the Commission and the courts, would move the federal fiduciary standard further away from one of disclosure. Indeed, under the Commission's proposed test, investment advisers could not "infer or accept client consent . . . where either . . . the facts and circumstance indicate that the client did not understand the nature and import of the conflict . . . ."[37] In other words, it may no longer be sufficient for an adviser to ensure that disclosure was robust, but it would be charged with making a determination as to whether clients understood that disclosure.

Such a rule would seem to be focused more on retail investors, as opposed to institutional or other sophisticated investors who are better situated to understand complex advisory structures and client relationships. However, despite at least implicitly acknowledging that the precise means of carrying out

[30] 15 U.S.C. § 80b-6; SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963) ("**Capital Gains**").
[31] Guidance, at 6.
[32] See 15 U.S.C. § 80b-15.
[33] See Heitman Capital Management, LLC (pub. avail. Feb. 12, 2007).
[34] Capital Gains, 375 U.S. at 200.
[35] Id. at 18 ("[I]n some cases, conflicts may be of a nature and extent that it would be difficult to provide disclosure that adequately conveys the material facts or the nature, magnitude and potential effect of the conflicts necessary to obtain informed consent and satisfy an adviser's fiduciary duty.").
[36] Id. at 18.
[37] Id.

an adviser's duties may depend on the sophistication of a particular client,[38] the current proposal does not offer additional guidance on how, or whether, an adviser's fiduciary obligations with respect to conflicts may differ depending on the nature of its clients, or on what types of conflicts are too complex to disclose away.

It is also unclear what the Commission's authority is to announce fiduciary obligations that go beyond current law. As noted above, the parameters of investment advisers' fiduciary obligations are a creation of federal court precedents, often grounded in state law and industry practice. Thus, should the Guidance go beyond current law—for example, with respect to forbidding certain conflicts outright—it is unclear what, if any, deference a court would pay to it.

In addition, to the extent that the SEC is incorporating state law into a federal fiduciary standard, questions will arise in enforcement if SEC and state common law interpretive questions diverge in the future, as the Commission acknowledges they do in certain unspecified contexts.[39] We would, thus, expect to see commentators on the Guidance focusing on both tensions between pre-existing state law and the Guidance, and, to the extent the Guidance expands fiduciary duties, the costs and specific burdens associated with conforming to the Guidance. For example, investment advisers may need to put in place new systems to ensure that they can confirm whether prospective clients are capable of giving sufficiently informed consent to obviate conflicts.[40]

— **Suitability Standard**

Part of an investment adviser's duty to clients is to provide advice that is suitable for a client. The Commission has imposed this obligation through no-action relief and enforcement actions; the SEC generally measures suitability against what is reasonable given the nature, extent and complexity of an individual client's investment profile and goals.[41] The suitability obligation includes the obligation to choose investments suitable for a client given a broad set of criteria. The Guidance, however, appears to add a suitability standard as a separate, standalone requirement as part of the adviser's fiduciary duty by stating that the duty of care includes "a duty to provide personalized advice that is suitable for and in the best interest of the client" (emphasis added).[42] The cited authority for this change is a proposed rule from 1994 that was never adopted to "make express the fiduciary obligation . . . to make only suitable recommendations."[43]

It is not clear from the Guidance what the contours of this standard would be and whether the intent and effect would be to impose a standard that mirrors the FINRA suitability rules or the conduct standard that would arise under Regulation Best Interest.

— **Request for Comment Regarding Additional Substantive Requirements for Investment Advisers**

The SEC has also requested comment on whether to impose additional substantive standards for investment advisers regarding: (1) federal licensing and continuing education, (2) the provision of account statements to clients and (3) financial responsibility.

These three requirements are analogous to existing standards applicable to broker-dealers. Though previously these have not been viewed as necessary, the SEC is requesting comment on these "discrete" areas where the regulatory requirements for broker-dealers provide investor protections that clients of investment advisers currently lack and that, impliedly, they ought to receive.[44] However, as a result of past

[38] Id. at 11 n.48 ("Many complex products . . . are appropriate only for sophisticated and experienced investors.")
[39] Id. at 8.
[40] Guidance, at 8. The authority the SEC cites to support this proposition are comment letters in response to Chairman Clayton's request for public input, rather than legal precedent such as court opinions or prior interpretations, whether formal or informal, from the Commission or even from Staff.
[41] See Id. at 10; Investment Advisers Act Release No. 1406 (Mar. 16, 1994).
[42] Id. at 10.
[43] Id.
[44] Guidance, at 27.

regulations as well as industry practice, investment advisers are likely already complying, at least in the main, with certain of these proposals.

Since the last time the Commission considered these substantive requirements, it adopted an investment adviser custody rule that many understood to reflect, in part, a judgment by the Commission that its requirements would achieve many of the same underlying goals and principles.[45] For example, this custody rule requires an investment adviser to have a reasonable belief that a qualified custodian (whether a third party or related party to the adviser) provides quarterly account statements to advisory clients, which includes disclosures of deductions to accounts to pay advisory fees.[46] In addition, the custody rule addresses the issue of financial responsibility in a different way, by limiting institutions permitted to serve as qualified custodians to those that are already subject to some degree of capital requirements designed to safeguard client assets, even if the custodian is a related party to the adviser.[47] We note that in 2014, the National Futures Association similarly considered imposing financial responsibility requirements on commodity pool operators and commodity trading advisors, but instead decided to require these registrants to report certain financial information to help calibrate supervision and oversight in the event of financial difficulty.[48]

ENFORCEMENT IMPLICATIONS

If adopted as proposed, the enforcement impact of Regulation Best Interest and the Guidance will only become apparent over time as the precise boundaries of the modified regulatory landscape are fully explored and the SEC and courts are given an opportunity to define the precise demarcations of the duties owed by broker-dealers and investment advisers. However, there are a few takeaways that can already be identified

The proposed rules continue the Commission's recent and marked focus on protecting retail customers. For example, Regulation Best Interest's expansion of the definition of "retail customer" as well as the Guidance's notion that certain conflicts are, due to their complexity, un-waivable even through disclosure. This is consistent with the SEC's recent enforcement priorities, which have seen both increased pronouncements by senior officers of the need to protect retail investors as well as numerous enforcement action focused on such protection.[49] Indeed, the proposal of new rules that, if adopted, would remain binding beyond the current Commission may signal an effort to maintain a retail focus that extends beyond the current enforcement trends.

The new proposals may also lead to increased enforcement actions. On the broker-dealer side, while the level of care required under the modified standard may be somewhat opaque, adopting a non-scienter standard of conduct will expand the Staff's ability to reach broker-dealers that it believes have injured retail investors. Given the absence of any definition for "best interest" or enumerated list of prohibited conduct, it may be in a broker's own best interest to exercise an abundance of "diligence, care, skill, and prudence" to ensure it falls on the right side of what the Staff views as "reasonable" until further rules, guidance and enforcement actions provide additional clarity. Although the SEC embraces a risk-based approach to conflicts mitigation, there is significant potential for the SEC to second-guess a broker-dealer's evaluation of which conflicts are so complex or otherwise difficult to understand that they cannot be

[45] See Custody of Funds or Securities of Clients by Investment Advisers, 75 Fed. Reg. 1455, 1457 (Jan. 11, 2010) (to be codified at 17 C.F.R. pts. 275 and 279).
[46] 75 Fed. Reg. 1457 ("The requirement is designed so that advisory clients will receive a statement from the qualified custodian . . . to determine whether . . . deductions to pay advisory fees are proper.").
[47] 75 Fed. Reg. 1475 (noting that the custody rule "may prevent client assets from being lost, misused, misappropriated, or subject to advisers' financial reserves.").
[48] *NFA Compliance Rule 2-46*.
[49] See, e.g., U.S. Securities and Exchange Commission Division of Enforcement, "Annual Report: A Look Back at Fiscal Year 2017," at 1, 5, 12-13; OCIE National Exam Program Examination Priorities (Feb. 7, 2018), at 4-5.

addressed through disclosure alone. It is unclear whether the "policies and procedures" formulation of the rule is sufficient to mitigate this risk.

For investment advisers, the Guidance may expand the universe of conflicts that cannot be remedied by disclosure to include those deemed "too complicated" for an investor to reasonably understand. While such circumstances currently only permit enforcement action where the related disclosure was absent or inadequate, the Guidance would seem to create the possibility of liability solely from the existence of such conflicts, irrespective of any disclosure. Should the Guidance's interpretation of an investment adviser's fiduciary duties under federal law be adopted by the courts—and this hardly seems a foregone conclusion—the SEC's Division of Enforcement may well have a powerful new tool in cases against investment advisers, allowing it to charge their substantive, underlying conduct as a violation of the fraud statutes. However, given the lack of specificity concerning "these cases where full and fair disclosure and informed consent is insufficient" and that deception is traditionally considered a necessary elements of fraud charges[50]—aggressive enforcement in this area could lead to accusations of "rulemaking by enforcement," and face skepticism in the courts.

Implementing Business and Compliance Changes

Whether these adjustments require entirely new systems or whether the changes are sufficiently incremental that firms can build on existing systems is of major significance, given the substantial cost of developing new systems. On this point, the proposed rules appear to contemplate changes to existing systems rather than the development of entirely new ones.[51]

- *Broker-Dealers.* With respect to the policies and procedures requirement of Regulation Best Interest, "a broker-dealer could comply with the . . . requirement . . . by adjusting its current systems of supervision and compliance, as opposed to creating new systems."[52] Whether a firm creates new systems or builds on existing ones, however, the key will be ensuring that updated policies and procedures are enforced.[53]
- *Investment Advisers*. The Commission acknowledges that advisers may incur "additional compliance costs to meet their fiduciary obligation,"[54] which may result from changes in business practices, particularly related to potentially refraining from (rather than simply disclosing) activities that give rise to conflicts of interest.[55]

…

CLEARY GOTTLIEB

[50] Guidance, at 19.
[51] See, e.g., Guidance, at 25 (noting "increase in [investment advisors'] compliance costs as they *change* their systems, processes and behavior, and train their supervised persons….") (emphasis added).
[52] NPR, at 168.
[53] See id. (noting that broker-dealers are subject to liability for failure to supervise under Section 15(b)(4)(e) of the Exchange Act, as well as SRO rules, and explaining a broker-dealer is not in compliance with Regulation Best Interest if it creates policies and procedures but does not maintain and enforce them).
[54] Guidance, at 26.
[55] This Alert Memorandum was prepared with the assistance of Robert A. McNamee, Robert A. Lawner, Josh Nimmo and Zachary Baum.