ALERT MEMORANDUM

SEC Adopts Best Interest Standard for Broker-Dealers and Fiduciary Duty Guidance for Investment Advisers

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

June 20, 2019

On June 5, 2019, the Securities and Exchange Commission ("**SEC**") finalized Regulation Best Interest ("**Reg BI**" or the "**Final Rule**") 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 finalized its interpretation of the fiduciary duty applicable to investment advisers (the "**Guidance**") under the Investment Advisers Act of 1940 ("**Advisers Act**") and a disclosure form for investment advisers and broker-dealers to provide to retail investors ("**Form CRS**"). Finally, the SEC issued an interpretation on the scope of the "solely incidental" prong of the broker-dealer exclusion from the Advisers Act.

In finalizing Reg BI and the Guidance, the SEC has more closely aligned the standards of conduct applicable to broker-dealers and investment advisers while noting that it recognizes the fundamental differences between the services each provide. It also stressed a goal of maintain investors' ability to choose between the two.

Reg BI and Form CRS have a June 30, 2020 compliance date; the interpretations are effective upon publication in the Federal Register.

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- Regulation Best Interest: The Final Rule largely maintained the obligations initially proposed, establishing a new standard of conduct for broker-dealers when recommending any securities transaction or investment strategy to a retail customer that requires a broker-dealer and its associated persons to (1) act in the retail customer's best interest and (2) not place their own interests ahead of the customer's interests ("**General Obligation**").
    - While the Final Rule significantly overlaps with existing Financial Industry Regulatory Authority ("**FINRA**") suitability rules and related guidance, it includes specific disclosures and only requires mitigation or elimination of certain conflicts of interest.
    - The Final Rule did not fully harmonize the standard of conduct applicable to broker-dealers and investment advisers, reflecting the SEC's goal of preserving retail investor access to different types of investor services and products and its acknowledgment of the differences between the two business models.
    - Under the Final Rule, disclosure of firm-level conflicts, rather than mitigation as was proposed, is permitted, but mitigation continues to be required for conflicts of interest of a broker-dealer's associated persons.
    - The SEC now has an independent basis to examine and enforce sales practice violations outside of the fraud context or referral to FINRA.
- Guidance: The Guidance summarizes the Commission's view on the current state of the law on investment advisers' duties to clients and prospective clients, with a few notable changes to the April 2018 proposal (the "**Proposed Guidance**").
    - The Guidance distinguishes between institutional and retail clients in permitting advisers and clients to define the scope of the fiduciary relationship; however, the SEC did not provide additional guidance on how to make that distinction.
    - The Guidance, in contrast to the proposal, retains the traditional facts-and-circumstances analysis for determining whether conflicts of interest can be cured through disclosure to institutional clients. However, disclosure may not be sufficient for retail clients in the case of very complex conflicts, in which case the Guidance would require mitigation or elimination.
    - The Guidance does not impose 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. The SEC is still evaluating the comments received on these proposed requirements, and said it may adopt one or more of these requirements in the future.

This Memorandum provides an overview of Reg BI and the Guidance, discusses our key takeaways, reflects on changes from the Reg BI proposal (the "**Proposed Rule**") and Proposed Guidance discussed in our prior Alert Memorandum, and describes implications for enforcement.

REGULATION BEST INTEREST

Similar to the Proposed Rule, the Final Rule is not intended to completely harmonize the standards of conduct applicable to broker-dealers and investment advisers. Instead, the new rule will supplement and enhance the standards of conduct to which broker-dealers are already subject under FINRA's suitability rules and the antifraud provisions of the Exchange Act when making securities recommendations to retail customers. The Final Rule draws on many of the same principles as those governing an investment adviser's fiduciary duty in placing a retail customer's interests ahead of the broker-dealer's and identifying and curing conflicts of interest through disclosure. Included as Appendix A to this Memorandum is a comparison showing changes between the text of the Proposed Rule and the text of the Final Rule as adopted.

Summary

The Final Rule will impose a General Obligation on broker-dealers and their associated persons[1] to act in the "best interest" of a retail customer whenever making a recommendation of a security or investment strategy involving securities. The rule expressly applies to securities account recommendations, bringing such recommendations fully within the scope of Reg BI.[2] As with the Proposed Rule, these obligations will only apply at the time a recommendation is made, and will not be subject to an ongoing monitoring obligation.[3] Satisfaction of the General Obligation is predicated upon satisfaction of four underlying component obligations: disclosure, care, conflict of interest, and compliance.

Disclosure Obligation. When making a recommendation to a retail customer, broker-dealers will need to provide, in writing, prior to or at the time of a recommendation, a "full and fair disclosure" of (1) all material facts relating to the scope and terms of its relationship with the retail customer, and (2) all material facts relating to conflicts of interest associated with the recommendation.[4] The primary change from the Proposed Rule was to elevate what had been guidance about certain facts that should be included in any disclosure into the rule text, with the Final Rule requiring disclosure of (a) the fact the broker-dealer is acting in such a capacity when making the recommendation, (b) material fees and costs, and (c) the type and scope of the services to be provided. In addition, the Final Rule requires "full and fair" disclosure rather than the Proposed Rule's obligation to "reasonably disclose," a change intended to align the disclosure standard for broker-dealers with that for investment advisers.

Care Obligation. The Care Obligation was left substantially unchanged from the Proposed Rule and will require that broker-dealers and their associated persons use "reasonable diligence, care, and skill" when making a recommendation to ensure that they 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 is in the best interest of the particular retail customer, and (3) a series of recommendations were not excessive and were in the retail customer's best interest when evaluated together in consideration of that customer's investment profile. Broker-dealers will be obligated to have a reasonable basis to believe that the

[1] For the purposes of the discussion of Reg BI, references to "associated persons" means "natural persons who are associated persons."

[2] SEC Release No. 34-86031, at 34 (June 5, 2019) (to be codified at 17 C.F.R. pt. 240). The SEC also highlighted recommendations to roll over or transfer assets in a workplace retirement plan to an IRA, to open a particular type of securities account (brokerage or advisory), or to take a plan distribution for the purpose of opening a securities account.

[3] *Id.* at 77 n.155. Note, however, that the SEC indicated that whether or not the broker-dealer will provide account monitoring services for a retail customer—and if so, the scope and frequency of the monitoring—are material facts that must be disclosed to satisfy this prong of the Disclosure Obligation, as an agreement to provide such services would constitute an implicit recommendation to hold the particular securities.

[4] The Proposed Rule required disclosure of material conflicts of interest instead of material facts relating to conflicts of interest.

recommendation will not place the broker-dealer's "financial or other interest" ahead of the retail customer's interest. In a change from the Proposed Rule, the Care Obligation will expressly require consideration of cost when making a recommendation.

Conflict of Interest Obligation. The Conflict of Interest Obligation was the most comprehensively revised portion of Reg BI. The Final Rule requires broker-dealers to establish, maintain, and enforce[5] written policies and procedures reasonably designed to (1) identify and disclose, or eliminate, all conflicts of interest, (2) identify and mitigate conflicts associated with the recommendation that would incentivize an associated person of the broker-dealer to place its own interests ahead of those of the retail customer, (3) identify and disclose material limitations placed on those securities or strategies and prevent conflicts of interest associated with such limitations from causing the broker-dealer to recommend a security or investment strategy that places its own interest ahead of that of the retail customer, and (4) completely eliminate certain sales contests and quotas and incentive compensation. Thus, while disclosure alone will satisfy some portions of the Conflict of Interest Obligation, particularly at the firm level, written policies and procedures will also need to focus on the mitigation, prevention, and outright elimination of those conflicts that would incentivize a broker-dealer—and particularly an associated person of such broker-dealer—to place its own interests ahead of the retail customer.

To add clarity, the SEC also formally defined "conflict of interest" in Reg BI to mean "an interest that might incline a broker, dealer, or a natural person who is an associated person of a broker or dealer—consciously or unconsciously—to make a recommendation that is not disinterested." This definition has been adopted to be consistent with the scope and meaning of the phrase as applied to investment advisers under *S.E.C. v. Capital Gains Research Bureau, Inc.* ("***Capital Gains***").[6]

This definition does not, however, provide a bright-line rule for broker-dealers to follow. Thus, where firms are already obligated to make conflict of interest determinations under other federal and state laws, such ambiguity in Reg BI may require broker-dealers to make yet another judgment as to how to comply with potentially differing conflict standards.

Compliance Obligation. In a change from the Proposed Rule, broker-dealers must also adopt comprehensive written policies and procedures reasonably designed to achieve compliance with all of Reg BI, rather than limiting such procedures to the Conflict of Interest Obligation.[7] Depending upon the facts and circumstances, the SEC indicated that satisfactory compliance programs would also include "controls, remediation of non-compliance training, and periodic review and testing."[8]

Observations

As discussed below, the Final Rule leaves open certain interpretive and compliance issues.

— **Definition of Recommendation**

The SEC affirmed its approach from the Proposed Rule in declining to define the term "recommendation." Factors to be evaluated in determining whether a recommendation has been made include "whether the communication 'reasonably could be viewed as a 'call to action' and 'reasonably

[5] We note that in a different context, the SEC recently warned broker-dealers and investment advisers to be mindful of their obligations to implement and enforce already adopted, required written policies and procedures, after identifying numerous firms that had failed to do so during the course of the SEC's inspections for compliance. *See* SEC Office of Compliance Inspections & Examinations, Risk Alert: Investment Adviser and Broker-Dealer Compliance Issues Related to Regulation S-P – Privacy Notices and Safeguard Policies (Apr. 16, 2019), https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Regulation%20S-P.pdf.

[6] 375 U.S. 180 (1963).

[7] The SEC has not mandated any specific requirements for the Compliance Obligation, instead advising that such policies and procedures should be "reasonably designed to address and be proportionate to the scope, size, and risks associated with the operations of the firm and the types of business in which the firm engages." Final Rule, at 360.

[8] *Id.*

would influence an investor to trade in a particular security or group of securities.'"[9] The more that a particular communication appears to be "individually tailored," the more likely that the communication will be viewed as a recommendation.[10] Recommendations may also be implicit, including in circumstances where the broker-dealer has agreed to perform monitoring services for its customer, broadening the scope of what constitutes an implicit recommendation.[11]

— **Definition of Retail Customer**

Reg BI as adopted defines a "retail customer" as a natural person who receives the recommendation and uses the recommendation "primarily for personal, family, or household" purposes.[12] The Final Rule helpfully makes clear that the definition is focused on natural persons, although it will continue to cover certain non-professional legal entities under the "retail customer" definition (e.g., trusts that represent the assets of a natural person). The SEC acknowledged that its purpose-based test will remain inconsistent with other SEC and FINRA standards for investor sophistication that look to objective customer characteristics such as net worth, regulatory status, or similar standards as a barometer for financial sophistication.

The SEC has also clarified that the definition of "retail customer" will include a natural person receiving recommendations for their own retirement accounts, including IRAs and 401(k) plans.[13] Where such recommendations are made, broker-dealers should also consider similar, but not perfectly overlapping conflict of interest obligations potentially applicable under other regulatory regimes, such as the Employee Retirement Income Security Act ("**ERISA**") and the federal tax code. To the extent that these standards differ, broker-dealers will need to account for these differences as applied to different types of account recommendations—for example, where a client has both an individual and an IRA account with a broker-dealer.

— **Flexibility of Disclosure Obligations**

The final version of Reg BI permits some flexibility in meeting its disclosure-related obligations:

- Form CRS and Existing Disclosure Obligations. The SEC indicated that it views the Disclosure Obligation as supplementary to the initial disclosures required by Form CRS or otherwise commonly provided to retail customers. In certain instances, such other disclosures may meet individual portions of the Disclosure Obligation entirely, particularly for standalone broker-dealers.[14] Importantly, Form CRS and other standard disclosures that broker-dealers provide to customers seem likely to provide much of the foundational disclosures necessary under the Final Rule.
- Linkage between the Disclosure Obligation and the Conflict of Interest Obligation. Under the Disclosure Obligation, Reg BI will require disclosure of all "material facts" relating to conflicts of interest associated with a broker-dealer's recommendation. Meanwhile, the Conflict of Interest Obligation will require written policies and procedures that, at a minimum, require firms to disclose all conflicts of interest associated with such a recommendation. The SEC acknowledged that mitigation or elimination of conflicts at the firm level could be more challenging, and has simplified firms' burdens by enabling satisfaction of the Disclosure Obligation to be closely linked to satisfying portions of the Conflict of Interest Obligation for the broker-dealer itself.
- Oral Disclosures and Disclosures After a Recommendation. Despite the Disclosure

[9] *Id.* at 79-80.
[10] *Id.* at 80.
[11] *Id.* at 82-83.
[12] *Id.* at 769.
[13] *Id.* at 116-17.

[14] For example, the SEC has indicated that the Form CRS disclosures will generally be sufficient for standalone broker-dealers to satisfy the capacity disclosure requirement, whereas it will be insufficient for dual-registrants.

Obligation's requirement of written disclosures at or before the time of a recommendation to a retail customer, the SEC stated that there may be instances where material facts become known after initial written disclosures, but before the recommendation is made. In these instances, oral supplementary disclosure made before or at the time of the recommendation would be sufficient to satisfy the Disclosure Obligation, so long as a record of this oral disclosure was made by the broker-dealer. Likewise, where existing regulations permit or require disclosure after a broker-dealer would have made a recommendation, such as through trade confirmations or prospectus delivery, such disclosures would comply with the Disclosure Obligation. In each case, the broker-dealer must include in an initial written disclosure notice that such disclosure may be amended and the manner of any such amendment.[15]

— **Heightened Focus on Costs**

The Care Obligation has been expanded in the Final Rule to require an express consideration of cost.[16] Broker-dealers were cautioned, however, that the "least cost" and "least remunerative" options may not always be in the retail customer's best interest and the SEC indicated evaluations of cost "would be more analogous to a broker-dealer's best execution analysis."[17]

— **Marketing Restrictions**

The SEC will no longer prohibit use of the terms "financial adviser" or "financial advisor," and instead will treat the use of these terms by a broker-dealer that is not an investment adviser as a presumed violation of the capacity disclosure requirement under the Disclosure Obligation. The SEC recognized that some broker-dealers use these terms to accurately reflect their business in providing advice that is not investment advice aimed at retail customers, but instead in roles defined by federal statute (e.g., a commodity trading adviser) that do not entail providing investment advisory services[18] or in other capacities outside of the context of investment advice to retail customers.

— **Suitability Requirements**

The SEC stated that Reg BI would supplement and enhance FINRA's suitability requirements through the Care Obligation in the following ways:

1. By explicitly requiring that recommendations be "*in*" the customer's best interest instead of being "*consistent with*" the customer's best interest, as required under FINRA's rules;

2. Through the explicit requirement to consider costs when making recommendations;

3. By applying obligations relating to a series of recommended transactions (currently referred to as "quantitative suitability") irrespective of whether a broker-dealer exercises actual or *de facto* control over a customer's account; and

4. By requiring a broker-dealer to consider "reasonably available alternatives" as part of having a "reasonable basis to believe" that the recommendation is in the best interest of the retail customer.[19]

Notwithstanding the SEC's assertion that these requirements go beyond the obligations imposed by FINRA's suitability rule, how those differences are applied in practice and interpreted by the SEC, including in the examination and enforcement context, remains to be clarified. Moreover, it will be important to pay close attention to how FINRA responds to the adoption of Reg BI to either take a new approach or

[15] *Id.* at 138.
[16] *Id.* at 260.
[17] *Id.* at 250. As the SEC detailed, the best execution analysis similarly, "does not require the lowest possible cost, but rather looks at whether the transaction represents the best qualitative execution for the customer using cost as a factor."
[18] *Id.* at 158.
[19] *Id.* at 254.

work to conform with the SEC's newly established best interest standard.

"SOLELY INCIDENTAL" PRONG OF THE BROKER-DEALER EXCLUSION

The SEC issued an interpretation on the "solely incidental" prong of the broker-dealer exclusion in the Advisers Act.[20] Section 202(a)(11)(c) of the Advisers Act excludes from the definition of "investment adviser" —and thus from the substantive obligations of the Advisers Act—a broker-dealer "whose performance of . . . advisory services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation" for those services.[21] The SEC's interpretation clarifies that a broker-dealer can satisfy the "solely incidental" prong even if it provides some investment advice to customers so long as that advice is "provided in connection with and is reasonably related to the broker-dealer's primary business of effecting securities transactions."[22] The "solely incidental" prong is not satisfied where the broker-dealer's primary business is the furnishing of investment advice or where the investment advice provided is not offered in connection with or is not reasonably related to the broker-dealer's primary services. The SEC stressed that the "quantum or importance" of the advice provided by a broker-dealer is not determinative of whether the "solely incidental" prong is satisfied.[23] In other words, advice provided by a broker-dealer can be of significant importance and nevertheless remain "solely incidental" to the broker-dealer's primary business. Although the "quantum or importance" clarification is helpful, the interpretative rule as a whole does little to advance the current understanding of the "solely incidental" prong. The SEC declined to provide further guidance on the "special compensation" prong of the broker-dealer exclusion, stating that its published views do not require clarification.[24]

FORM CRS

The SEC finalized Form CRS, a new disclosure obligation for investment advisers and broker-dealers aimed at reducing retail customer confusion and helping retail customers decide whether to engage with a particular investment adviser or broker-dealer.[25] The final form, which is consistent with the form as proposed, specifies when an investment adviser or broker-dealer must deliver its Form CRS to new and existing retail customers. A firm's Form CRS must provide, among other things, information about the relationships and services the firm offers to retail customers, the fees and costs it charges, its conflicts of interest and standards of conduct, and its reportable disciplinary history. A registered investment adviser will be required to submit its Form CRS as part of its Form ADV.

[20] A 2005 SEC rule included language that "would have required broker-dealers to be considered to be investment advisors 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." That rule was vacated by the D.C. Circuit in 2007. Although the SEC proposed a rule in 2007 that would have reinstated this interpretative language, the proposed rule was never finalized.

[21] 15 U.S.C. § 80b-2(a)(11) (2019).
[22] SEC Release IA-5249, at 12 (June 5, 2019 (to be codified at 17 C.F.R. pt. 276).
[23] *Id.* at 13.
[24] *Id.* at 6 n.17.
[25] SEC Release No. 34-86032 (June 5, 2019) (to be codified at 17 C.F.R. pts. 200, 240, 249, 275, and 279).

FINAL INTERPRETATION REGARDING INVESTMENT ADVISERS' FIDUCIARY DUTY

The Guidance purports to "reaffirm—and in some cases clarify—certain aspects" of a registered investment adviser's fiduciary duty under the Advisers Act, and it adopted the Proposed Guidance to a significant degree.[26] However, we believe that in certain key areas the Guidance expands the standard of conduct for advisers beyond what many in the industry have traditionally understood it to be.

In particular, the Guidance draws a firmer distinction between retail and institutional clients (outlined further below) and suggests that in some areas, such as complex conflicts of interest and contractual waivers of fiduciary duties, certain practices may be inconsistent with an adviser's fiduciary obligations to retail investors regardless of the particular facts and circumstances.

The Guidance also shifts the description of an adviser's fiduciary duty from an obligation to "put its clients' interests first" to an obligation to "not subordinate its clients' interests to its own." Notably, however, the SEC stated that this was not intended as a substantive change, with the former characterized as a "plain English formulation" of the latter that may be used by an adviser in disclosure to retail clients.[27] While this change was highlighted in some press commentary as a material reduction in clients' protection, in our view it is likely to be a distinction without a difference, and it is unclear how this restatement would meaningfully change the SEC's enforcement and examination priorities.[28]

Finally, the SEC also describes a set of expectations with respect to prospective clients that were not in the Proposed Guidance.[29] Specifically, and similar to Reg BI, advising a prospective client regarding whether to open an account, what type of account to open, and whether to roll over assets from one account into another may subject an adviser to antifraud liability (even in the absence of a fiduciary duty). However, we note that the application of antifraud liability under the Advisers Act to certain interactions with prospective clients is not a new concept; therefore, the question going forward (as discussed further below under Enforcement Implications) is whether this clarification will result in advisers being held to a meaningfully different standard by the SEC in their dealings with prospective clients.

— **Differentiation between Institutional and Retail Clients**

The Guidance expressly permits advisers and clients to define (and narrow) the scope of the adviser's fiduciary duty in the advisory contract, and sets forth related clarifications regarding how an adviser may tailor the services they offer to particular clients. In doing so, the Guidance draws significant distinctions between retail and institutional clients in ways that the SEC has not traditionally done under the Advisers Act. These distinctions include the following:

- Understanding Client Objectives. The SEC stated that an adviser should have a "reasonable understanding of a client's objectives" in all cases, but laid out a different basis for forming this understanding for retail clients (where the adviser should conduct a reasonable inquiry to understand the client's investment *profile*, and should actively update such understanding) versus institutional clients (where the scope of the adviser's inquiry into the client's objectives should be tailored by the client's investment *mandate* and need not necessarily be updated over the course of the client relationship if sufficiently established in the advisory contract).[30] The Proposed Guidance did not draw such a distinction as the basis for understanding client objectives, although it

[26] SEC Release IA-5248, at 3 (June 5, 2019) (to be codified at 17 C.F.R. pt. 276).
[27] E.g., Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 83 Fed. Reg. 21203, 21208 (proposed Apr. 18, 2018); *Id.* at 21 n.54.
[28] *See* Comm'r Robert J. Jackson Jr., Statement on Final Rules Governing Investment Advice (June 5, 2019).
[29] E.g., Guidance, at 18.
[30] *Id.* at 13.

seems likely that this distinction recognizes that retail customers typically have a more comprehensive relationship with an investment adviser, whereas institutional clients may tailor the scope of the adviser's responsibilities in accordance with its own objectives.

- Hedge Clauses. The SEC clarified that investment advisers may not include in their advisory contracts waivers of certain fundamental obligations; prohibited waivers include (1) a statement that the adviser will not act as a fiduciary, (2) a blanket waiver of all conflicts of interest, or (3) a waiver of any specific obligations under the Advisers Act.[31] Whether a "hedge clause" is invalidated as misleading (because it could present a misimpression of waiving fiduciary duties) is a facts-and-circumstances inquiry, including consideration of the client's sophistication. The Guidance, unlike the Proposed Guidance, states that there are "few (if any)" circumstances where a hedge clause with a retail investor would be consistent with the antifraud provisions, whereas for an institutional client it will depend on the facts and circumstances.[32] The SEC also noted in the Guidance that there are certain instances where the standards investment advisers are subject to under ERISA and state laws may differ relative to those standards that may be enforced by the SEC.[33] Although the Guidance would seem to indicate that the SEC expects to focus solely on issues presented under U.S. securities laws in evaluating compliance, it will be worth watching how these overlapping regimes influence the SEC going forward.

— **Duty to Monitor**

The Guidance makes clear that the duty of care imposes a specific duty to monitor investments over the course of an advisory relationship, which was not included in the Proposed Guidance. The Guidance further specifies that advisers should consider whether written policies and procedures relating to monitoring would be required under the Compliance Rule.[34] As with other issues where the SEC has "encouraged" advisers to address them in their compliance program, we expect industry best practices will evolve to include investment monitoring policies and procedures in compliance manuals, particularly for advisers with retail clients.

— **Higher-Cost Investments or Strategies**

The Guidance removes a statement in the Proposed Guidance that it would not be in a client's best interest to recommend a higher cost security instead of one that is "otherwise identical." Consistent with the approach to considerations of costs in Reg BI, the Guidance provides that an adviser may recommend a higher-cost investment if the adviser reasonably concludes that there are other factors that "outweigh cost and make the investment or strategy in the best interests" of the client.[35]

— **Disclosure**

The Guidance clarifies the role of full and fair disclosure in addressing conflicts of interest for retail and institutional investors, while also, in our view, introducing new standards.

- Complex and Extensive Conflicts. The Proposed Guidance indicated that, in the SEC's view, some conflicts may be so complex that they cannot be adequately disclosed and must simply be avoided. The Guidance removes this language in favor of a bifurcated approach to institutional and retail clients. With respect to institutional clients, the SEC reiterated the traditional disclosure-based approach. For retail investors, however, it "may be difficult" to provide disclosure sufficient to obtain informed consent for "complex or extensive conflicts."[36]

[31] *Id.* at 10.
[32] *Id.* at 11 n.31.
[33] *Id.* at 2 n.3.
[34] *Id.* at 21 n.52.
[35] *Id.* at 17.
[36] *Id.* at 28.

- Speculative Language. The Guidance notes that use of speculative language such as "may" to describe a conflict is inappropriate "when the conflict actually exists" because such disclosure would not be sufficiently specific to enable the client to make an informed decision. The Guidance states that speculative language would be appropriate for a conflict that does not currently exist, but may exist in the future or for a conflict that exists for some but not all clients, advice, or transactions. Using "may" would also be inappropriate if it precedes a list of all possible potential conflicts regardless of likelihood. We expect these examples to be helpful to advisers in updating their brochures, drafting private placement memoranda and seeking consent when required by advisory contracts or limited partnership agreements.[37]
- Implied Consent. The Advisers Act does not specify whether consent must be affirmative or if negative consent may be sufficient. The Guidance makes clear that consent need not be obtained in writing and may be implied through a combination of disclosure and entering into or continuing the advisory relationship.[38] This language, which was not in the Proposed Guidance, confirms the reasonableness of this established market practice.
- Allocation. The Guidance removes a phrase in the Proposed Guidance that "an adviser must treat all clients fairly" in allocating opportunities among eligible clients in response to industry comments that this sentence implied that it would be impermissible for an adviser to allocate an investment to one eligible client instead of another, even with consent.[39]

ENFORCEMENT IMPLICATIONS

The enforcement impact of the adopted modifications to the regulatory landscape created by Reg BI and the Guidance will only become apparent over time. Further, as applied to broker-dealers, the enforcement impact may be somewhat determined by how FINRA addresses the overlap and discrepancies between its own suitability rule and Reg BI. However, there are a few takeaways that can already be identified.

The proposed rules continue the SEC's recent and strong focus under Chairman Clayton on protecting retail customers. Reg BI's refining of the definition of "retail customer" now to focus on natural persons, as well as the Guidance's notion that certain conflicts are, due to their complexity, unwaivable even through disclosure, provide ample examples of this. 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 customer protection-focused enforcement actions.[40] Further—given the practical permanence of formally adopted rules and interpretations—the SEC may be signaling an effort to maintain a retail focus that extends beyond the current enforcement trends.

Adoption of Reg BI appears to involve a conscious effort on the SEC's part, through the adoption of affirmative obligations, to move the standard of conduct for broker-dealers—and consequently the orientation of enforcement—in the same direction as has long been the case for investment advisers. In particular, the SEC has explicitly read the scope, meaning, and obligations of the term "conflict of interest," as applied to investment advisers through *Capital Gains*, into the broker-dealer regulatory framework. This may signal an effort by the agency to make it easier to bring enforcement actions against broker-dealers for such violations. While the level of

[37] *Id.* at 24-25 and 25 n.60.
[38] *Id.* at 27 n.68.
[39] *Id.* at 27 n.66.
[40] SEC Division of Enforcement, "Division of Enforcement 2018 Annual Report," at 2, 6-7, 15, https://www.sec.gov/files/enforcement-annual-report-2018.pdf; SEC Office of Compliance Inspections and Examinations, "2019 Examination Priorities," at 6-8, https://www.sec.gov/files/OCIE%202019%20Priorities.pdf.

care required under the modified standard remains somewhat unclear, the formal adoption of a non-scienter standard of conduct will also expand the Staff's ability to reach broker-dealers that it believes have injured retail customers. We note, however, that the SEC Staff has indicated within the Final Rule that they "do not believe Regulation Best Interest creates any new private right of action or right of rescission, nor do we intend such a result."[41]

For investment advisers, the Guidance walks back the proposed expansion of the universe of conflicts that cannot be remedied by disclosure to comprise those deemed "too complicated" for an investor to reasonably understand. Instead, the Guidance notes that retail investors are more likely than institutional investors to lack the sophistication required to provide informed consent for such conflicts. Rather than creating the possibility of liability solely from the existence of such conflicts irrespective of any disclosure, the Guidance maintains the current approach of permitting enforcement action where the related disclosure was absent or inadequate. The distinction drawn between retail and institutional investors, however, does appear to raise the bar regarding the adequacy of consent for retail investors given their lower level of sophistication. In addition, the Guidance notes that advisers have antifraud liability under the Advisers Act to prospective clients, even before a fiduciary duty attaches to the relationship. This gap raises a question of how the SEC will evaluate potential enforcement actions for misrepresentations to prospective clients even in the absence of a fiduciary duty (or if this will in practice be a distinction without a difference). It also remains to be seen how the distinctions drawn between retail and institutional investors will ultimately be reflected in the SEC's examination and enforcement posture. Given the emphasis throughout the Guidance on different standards of disclosure and obligations owed to different types of clients, advisers with a primarily retail client base may face a greater degree of scrutiny.

Finally, we note that the SEC's actions in adopting Reg BI and promulgating the Guidance may have been partially motivated by the unsuccessful effort by the U.S. Department of Labor to implement a fiduciary standard as to the provision of investment recommendations involving retail retirement accounts by broker-dealers and investment advisers. The Department of Labor has indicated that it continues to consider the parallel conflict of interest rules under ERISA and the federal tax code. It remains to be seen how the fiduciary standards under the different regimes, such as ERISA or state law, will fit together with the securities law framework, and what compliance challenges broker-dealers may face by reason of being subject to multiple standards.[42]

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[41] *See* Final Rule at 44.

[42] This Alert Memorandum was prepared with the assistance of Arthur H. Kohn, Alexander Janghorbani, Sarah Stanton, and Amber V. Phillips.

Appendix A

§ 240.15*l*-1 Regulation Best Interest.

(a) Best Interest Obligation.

(1) A broker, dealer, or a natural person who is an associated person of a broker or dealer, when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer, shall act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker, dealer, or natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer.

(2) The best interest obligation in paragraph (a)(1) shall be satisfied if:

(i) Disclosure Obligation. The broker, dealer, or natural person who is an associated person of a broker or dealer, prior to or at the time of ~~such~~the recommendation, ~~reasonably discloses to~~provides the retail customer, in writing, ~~the~~full and fair disclosure of:

(A) All material facts relating to the scope and terms of the relationship with the retail customer, including ~~all material conflicts of interest that are associated with the recommendation.~~:

(i) that the broker, dealer, or such natural person is acting as a broker, dealer, or an associated person of a broker or dealer with respect to the recommendation;

(ii) The material fees and costs that apply to the retail customer's transactions, holdings, and accounts; and

(iii) The type and scope of services provided to the retail customer, including any material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer; and

(B) All material facts relating to conflicts of interest that areassociated with the recommendation.

(ii) Care Obligation. The broker, dealer, or natural person who is an associated person of a broker or dealer, in making the recommendation, exercises reasonable diligence, care, and skill~~, and prudence~~ to:

(A) Understand the potential risks ~~and~~, rewards, and costs 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 that retail customer's investment profile and the potential risks ~~and~~, rewards, and costs associated with the recommendation; and does not place the financial or other interest of the broker, dealer, or such natural person ahead of the interest of the retail customer;

(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 and does not place the financial or other interest of the broker, dealer, or such natural person making the series of recommendations ahead of the interest of the retail customer.

(iii) Conflict of Interest Obligation. The broker or dealer establishes,

(A) ~~The broker or dealer establishes,~~ maintains, and enforces written policies and procedures reasonably designed to ~~identify and at a minimum disclose,~~ :

(A) Identify and at a minimum disclose, in accordance with subparagraph (a)(2)(i), or eliminate, all ~~material~~ conflicts of interest ~~that are~~ associated with such recommendations.;

(B) Identify and mitigate any conflicts of interest associated withsuch recommendations that create an incentive for a natural person who is an associated person of a broker or dealer to place the interest of the broker, dealer, or such natural person ahead of the interest of the retail customer;

(C) (i) Identify and disclose any material limitations placed on the securities or investment strategies involving securities that may be recommended to a retail customer and any conflicts of interest associated with such limitations, in accordance with subparagraph (a)(2)(i), and

(ii) Prevent such limitations and associated conflicts of interest from causing the broker, dealer, or a natural person who is an associated person of the broker or dealer to make recommendations that place the interest of the broker, dealer, or such natural person ahead of the interest of the retail customer; and

(D) Identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time.

(iv) Compliance Obligation. In addition to the policies and procedures

~~(B) The~~required by paragraph (iii), the broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to ~~identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations~~achieve compliance with Regulation Best Interest.

(b) *Definitions*. Unless otherwise provided, all terms used in this rule shall have the same meaning as in the [Securities Exchange Act of 1934]. In addition, the following definitions shall apply for purposes of this section:

(1) *Retail* Customer means a natural person, or the legal representative of such natural person, who:

(A) Receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer, or a natural person who is an associated person of a broker or dealer; and

(B) Uses the recommendation primarily for personal, family, or household purposes.

(2) *Retail Customer Investment Profile* includes, but is not limited to, the retail customer's age, other *investments*, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the retail customer

may disclose to the broker, dealer, or a natural person who is an associated person of a broker or dealer in connection with a recommendation.

(3) *Conflict of Interest* means an interest that might incline a broker, dealer, or a natural person who is an associated person of a broker or dealer —consciously or unconsciously—to make a recommendation that is not disinterested.