Connecting the dots
Webcast: The SEC’s proposed fiduciary duty and standards of conduct for broker-dealers and investment advisers

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What Just Happened?

On April 18, in a 4-1 vote, the United States Securities and Exchange Commission (the SEC) proposed a comprehensive set of reforms governing the fiduciary duty and standard of conduct applicable to broker-dealers and investment advisers that provide retail investment advice. The proposed rules would:

- Require broker-dealers and investment advisers to summarize their relationship to retail investors;
- Establish a broker-dealer best interest standard of conduct;
- Restrict the use of the term “adviser” or “advisor” by broker-dealers; and
- Require investment advisers to adhere to certain conduct as fiduciaries.

The reform package comprises three parts:

- A Broker-Dealer Standard of Conduct (Regulation Best Interest);
- New Disclosures and Titling Requirements for Broker-Dealers, Advisers and Dual-Registrants (the Form CRS Relationship Disclosure); and
- Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers and a Request for Comment on Enhancing Investment Adviser Regulation.
If Adopted, What Will These New Reforms Mean?

— Broker- Dealers
  • A New Standard of Conduct
  • New Disclosures
  • Titling

— Advisers
  • New Fiduciary Interpretation
  • New Disclosures
  • Possible New Regulations

— Special Considerations for Dual-Registrants
What Led Up to the Proposal?

- **1990s**
  - Report of the Committee on Compensation Practices (the Tully Report)
  - SEC no-action letters permitting representatives to use certain designation while within limits of BD exclusion to the Advisers Act

- **2005**
  - SEC adopts a rule allowing broker-dealers to receive fee-based compensation

- **2007**
  - US Court of Appeals vacates the new SEC rule

- **2010**
  - President Obama signs the Dodd-Frank Act

- **2011**
  - DOL proposes fiduciary rule for retirement accounts
  - Pursuant to Dodd-Frank Act, SEC releases study on standards of conduct for broker-dealers and investment advisers

- **2016**
  - DOL adopts final fiduciary rule

- **2017**
  - President Trump issues a memo to the DOL requesting further review of fiduciary rule
  - DOL delays the effective date for its fiduciary rule
  - SEC Chairman Jay Clayton solicits public comments for standards of conduct for broker-dealers and investment advisers

- **2018**
  - Fifth Circuit vacates DOL fiduciary rule in its entirety
  - SEC proposes Standard of Conduct Rule Package
Current Regulatory Landscape

- Broker-Dealers
  - Act as principal or agent for issuer in distributing and selling securities to the public
  - Transaction-based compensation received from issuer for success in selling securities
  - To avoid adviser registration, advice must be incidental and no special compensation
  - Suitability requirement under FINRA rules

- Investment Advisers
  - Act as agent for client in providing advice to client
  - Fee-based compensation received from client
  - Fiduciary to clients under the Advisers Act as determined by Supreme Court

- Major Issues
  - Role of conflict disclosure
  - Reasonable compensation
  - Duties owed to customers and clients
  - “Best interest” standard
  - Enforceability of standard of conduct
Options for SEC in Approaching Reform

- Do Nothing

- Redraw the Boundaries for the BD Exclusion under the Advisers Act

- Uniform Duty for Advisers and BDs

- Tailored Duty for BDs
The Proposed Broker-Dealer Best Interest Standard

- Proposed Regulation Best Interest (Regulation BI) would require broker-dealers, as well as any persons associated with the broker-dealer, when making recommendations of any securities transaction or investment strategies to retail customers, to act in the best interest of the retail customer at the time the recommendation is made. In addition, the recommendation must not place the interests of the broker-dealer ahead of the retail customer’s interests.

- The “best interest” standard is not specifically defined in the proposal.

- “Best interest” is satisfied if the following is met:
  - Disclosure – At the time the recommendation is made, the broker-dealer must reasonably disclose to the retail customer, in writing, the material facts relating to the scope of the brokerage relationship, including all material conflicts of interest that are associated with the securities recommendation.
  - Care – In making the recommendation, the broker-dealer must exercise reasonable care. The SEC clarified that reasonable care must be taken to ensure that the recommendation could be in the best interest of at least some retail customers, is in the best interest of a particular retail customer based on that customer’s investment profile, and is not excessive and is in the retail customer’s best interest when taken together as a series of recommended transactions.
  - Conflict of Interest – Broker-dealers must establish and maintain written policies and procedures to identify and disclose, or eliminate, material conflicts of interest associated with a recommendation. More specifically, firms are required to establish procedures to identify, disclose and mitigate (or eliminate) material conflicts of interest arising from financial incentives associated with the recommendation.
How Must Broker-Dealers Address Conflicts That Create Financial Incentives?

– General Conflicts
– Conflicts Arising From Financial Incentives
– What Actions Must Be Taken?
  • Elimination of Conflicts
  • Mitigation of Conflicts
Disclosure – Form CRS – Relationship Summary

What Information Will Broker-Dealers and Investment Advisers Have to Disclose to Customers/Clients?

- Introduction
- Relationships and Services
- Standard of Conduct
- Summary of Fees and Costs
- Comparisons
- Conflicts of Interest
- Additional Information
- Key Questions
What is Entailed With Respect to the SEC’s Proposed Restrictions on the Use of the Terms “Adviser” or “Advisor”?  

- **Firms Solely Registered as Broker-Dealers and Associated Natural Persons** – Proposed Rule 15l-2 would restrict firms solely registered as broker-dealers or their associated natural persons from using the term “adviser” or “advisor” as part of a name or title when communicating with a retail investor.

- **Dually Registered Firms** – Proposed Rule 15l-2 would permit firms that are registered both as investment advisers (including state-registered investment advisers) and broker-dealers to use the term “adviser” or “advisor” in their name or title.

  - **Dual Hatted Financial Professionals** – Proposed Rule 15l-2 would permit an associated person of a dually registered firm to use these terms only where such person is a supervised person of a registered investment adviser and such person provides investment advice on behalf of such investment adviser. This would limit the ability of natural persons associated with a broker-dealer who do not provide investment advice as an investment adviser from continuing to use the term “adviser” or “advisor” simply by virtue of the fact that they are associated with a dually registered firm.
How Is the Proposed Interpretation for Advisers Different From the Fiduciary Standard That Exists Today?

— “Reaffirm(s)—and in some cases clarifies—certain aspects of the fiduciary duty that an investment adviser owes to its clients under section 206 of the Advisers Act.”

— The interpretation notes that SEC-registered investment advisers are subject to a duty of care and a duty of loyalty and that the fiduciary duty requires each adviser, at all times, to serve the best interest of its clients and not subordinate its clients’ interest to its own.
What Other New Obligation Is the SEC Considering for Investment Advisers?

– Federal Licensing and Continuing Education
– Account Statements
– Financial Responsibility Requirements
Considerations in the Retirement Space

– What is the governing ERISA/IRC law?
– How does the SEC proposal operate in the retirement space?
– Is the SEC proposal cumulative with ERISA/IRC requirements, or are there conflicts?
1975 5-Part Fiduciary Definition

For a direct or indirect fee, a person:

1. Renders advice as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing or selling securities or other property

2. On a regular basis

3. Pursuant to a mutual agreement, arrangement or understanding, written or otherwise, with the plan or a plan fiduciary, that

4. The advice will serve as a primary basis for investment decisions with respect to plan assets, and that

5. The advice will be individualized based on the particular needs of the plan.
Latest DOL Enforcement Policy

For the period from June 9, 2017, until after regulations or exemptions or other administrative guidance has been issued, the Department will not pursue prohibited transactions claims against investment advice fiduciaries who are working diligently and in good faith to comply with the impartial conduct standards for transactions that would have been exempted in the BIC Exemption and Principal Transactions Exemption.

This does not apply to private litigation.

Additional “appropriate guidance,” including possible retroactive exemptions, is expected.
What’s Next

– 90-Day Comment Period on SEC Rulemaking
– DOL: Fifth Circuit Petition for Cert. (unlikely) / New Guidance and Exemptions
– State Securities and Insurance Developments
Questions?