**COMPLIANCE CONSULT** Published in PLANADVISER May/June 2018

# A New Best Interest Model

## The SEC steps up to the plate

*By David Kaleda*

The Securities and Exchange Commission (SEC), on April 18, proposed to expand the standard of conduct applicable to broker/dealers (B/Ds) and natural persons associated with them. The SEC's action follows the demise of the Department of Labor (DOL)'s definition of "investment advice" brought on by the 5th Circuit Court of Appeals in Chamber of Commerce of the United States v. United States Department of Labor.

Remarkably, the SEC intends that the proposed standard be consistent with the best interest standard established in the defunct DOL advice rule and best interest contract exemption (BICE). And, ironically, if the proposal were to be adopted as currently drafted, broker/dealers could find themselves complying with a best interest standard and addressing conflicts of interest in a manner consistent with what they intended to use to comply with the DOL's rulemaking.

The proposed "regulation best interest" is intended to "enhance" investor protection while "to the extent possible" preserving the traditional B/D model of providing services, including the provision of incidental advice and receiving transaction-based compensation.

According to the proposal, firms and their representatives must "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 … making the recommendation ahead of the interest of the retail customer." Therefore, the proposal contains best interest language reminiscent of the DOL's best interest contract exemption.

However, unlike the DOL's definition of investment advice and its exemptions, the SEC states that it does not intend to change the law applicable for determining when a person is making a recommendation or the enforcement mechanism that applies once a violation of the Securities Exchange Act of 1934 and its underlying regulations occurs. Rather, the focus of the proposal is on a firm's, and its representative's, standard of conduct.

The SEC further proposes that, in order to meet the aforementioned best interest standard: 1) The firm and representative meet a "disclosure obligation"; 2) The firm and representative meet a "care obligation"; and 3) The firm establish policies and procedures designed to meet "conflict of interest obligations." Of particular note is the care obligation, which requires the firm and its representatives to exercise "reasonable diligence, care, skill and prudence" in forming a "reasonable basis to believe" that recommendations meet reasonable basis suitability, customer-specific suitability and quantitative suitability requirements like those under current law. The language in the care obligation looks a lot like the DOL's best interest standard.

Note, however, that the SEC specifically chose not to add language that the firm or representative must act "without regard to" its own interests, which many firms believed was an impossible standard.

Additionally, the conflict of interest obligations describe what measures a firm would have to take to resolve conflicts of interest. The SEC would require that material conflicts involving financial incentives be treated differently from other material conflicts of interest with respect to mitigation. In some cases, mere disclosure of a material conflict of interest may be sufficient to address the conflict. However, in other cases, particularly where the conflict involves a financial incentive, disclosure likely would not be enough.

For example, the SEC points to variations in pricing between securities and products. On one hand, the agency believes differential pricing may be justified based on neutral factors—e.g., the time and effort involved in advising the client on a security or product. On the other hand, such a differential may not be justifiable for two securities or products that are otherwise the same. The SEC also pointed to bonus, award and compensation program incentives that may encourage sales not otherwise in the interest of investors and suggested that elimination of such incentives or at least enhanced supervision may be needed. Again, the language in the SEC's proposal is strikingly similar to that in the DOL's explanation of how to comply with the requirements of its best interest contract exemption.

The promulgation of a final regulation best interest is far from certain. Advisers should expect substantial changes, in the event a final regulation is issued. However, firms that have made or were in the process of making such changes to their compensation practices, product and service offerings, and policies and procedures in order to comply with the DOL's rulemaking may be deciding how to unwind these changes in light of the failure of the rulemaking. They should keep in mind that the SEC may be heading in a very similar direction with regard to the standard of conduct applicable to firms and their representatives and what actions should be taken to address conflicts of interest.

***David Kaleda*** *is a principal in the fiduciary responsibility practice group at Groom Law Group, Chartered, in Washington, D.C. He has an extensive background in the financial services sector. His range of experience includes handling fiduciary matters affecting investment managers, advisers, broker/dealers, insurers, banks and service providers. He served on the Department of Labor's ERISA Advisory Council from 2012 through 2014.*

Tagged: best interest contract exemption, DoL, fiduciary rule, SEC