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## Fiduciary Proposal: Episode III - Revenge of the SEC

After the Fifth Circuit's March 15, 2018 decision striking down the Department of Labor's (the "DOL") Fiduciary Rule, many in the retirement space expected to finally be able to take a well-deserved break from years of regulatory drama and related compliance anxieties. Instead, barely a month later, on April 18, 2018, the Securities and Exchange Commission (the "SEC") signaled the opening of a new round in the effort to regulate the delivery of advice by voting to release a package of three rules, namely: (i) "Regulation Best Interest" ("Regulation Best Interest"); (ii) "Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation" ("Investment Adviser Standard"), and (iii) "Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles" ("Form CRS") (collectively, the "Best Interest Package"). SEC Chairman Jay Clayton described the goal of the Best Interest Package as being to "fill any gap between reasonable investor expectations and legal standards." Public Statement: *Overview of the Standards of Conduct for Investment Professionals Rulemaking Package* (April 18, 2018).

The Best Interest Package proposes a mix of heightened standards of care on the part of registered broker-dealers and investment advisers and new sets of disclosure obligations for both. Those who have followed the DOL's recent efforts to regulate the delivery of investment advice will recognize many of the principles contained within the Best Interest Package, since they reflect to a large extent those of the DOL Fiduciary Rule. Having said that, the SEC's effort to protect retail investors and retirement savers has been carefully recalibrated in an effort to arrive at more workable standard of care and with less extensive disclosure obligations. Whether the regulated community will embrace the Best Interest Package as an appropriate compromise remains to be seen.

Below, we provide an overview of the core provisions of the Best Interest Package, as well as high-level observations on how it tracks or departs from the DOL's Fiduciary Rule. Once the Best Interest Package is published in the Federal Register, the public will have 90 days to submit comments to the SEC.

While it would be easy to view the Best Interest Package as simply an extension of the DOL's previous efforts, the proposal is highly significant for the retirement industry and merits close attention. If the SEC effort gains traction, it could form the basis for future DOL efforts to regulate the delivery of investment advice under the Employee Retirement and Security Act of 1974 ("ERISA") and the Internal Revenue Code (the "Code"). In the near-term, retirement service providers will need to carefully consider whether compliance with the Best Interest Package when recommending securities to IRA clients will trigger obligations under ERISA and the Code. For example, when a broker-dealer meets its obligations under the Best Interest Package when recommending securities to an IRA client, it might also meet the DOL's "five part test" for determining when a securities recommendation is fiduciary investment advice for purposes of ERISA and the Code. If that is the case, those broker-dealer entities and their registered representatives will need an exemptive relief strategy to

avoid giving rise to prohibited transactions under the Code.

### **Regulation Best Interest**

Regulation Best Interest is intended to subject broker-dealers to a “best interest” standard of care, albeit one that differs in some important ways from the DOL’s standard. The SEC indicated that its intention is to align standards applicable to broker-dealers regulated under the Securities Exchange Act of 1934 (“Exchange Act”) with other advisory relationships and regulatory regimes, including the DOL’s Fiduciary Rule and Best Interest Contract Exemption (“BIC Exemption”), while preserving investor access to products, services, and payment options. Throughout its regulatory package, the SEC emphasizes that its “best interest” standard goes beyond suitability and cannot be satisfied through disclosure alone. The SEC also acknowledges that Regulation Best Interest, in combination with existing broker-dealer obligations, is generally more prescriptive than the standard of care required for advisers under the Investment Advisers Act of 1940 (“Advisers Act”).

Regulation Best Interest would require that broker-dealers and their associated persons “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 making the recommendation ahead of the interest of the retail customer.”

Unlike the DOL’s Fiduciary Rule and BIC Exemption—both of which have been vacated by the Fifth Circuit—the SEC’s best interest standard of care does not require that the recommendation be made “without regard to the financial or other interests” of the broker-dealer. The omission of this language, which was also included in section 913(g) of the Dodd–Frank Wall Street Reform and Consumer Protection Act (“Dodd–Frank Act”) is significant, and reflects the SEC’s concerns that this language “could be inappropriately construed to require a broker-dealer to eliminate all of its conflicts.” In this regard, the SEC notes that conflicts of interest are “inherent in any principal-agent relationship,” and that it does “not intend for our standard to prohibit a broker-dealer from having conflicts when making a recommendation.”

A broker-dealer is deemed to comply with Regulation Best Interest if it satisfies the regulation’s three core obligations: (i) the Care Obligation, (ii) the Conflict of Interest Obligation, and (iii) the Disclosure Obligation,

#### *Care Obligation*

The Care Obligation requires that broker-dealers exercise reasonable diligence, care, skill and prudence to:

- Understand the potential risks and rewards associated with a recommendation and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers;
- Have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on the retail customer’s investment profile and the potential risk and rewards associated with the recommendation; and
- 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.

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Notably, the SEC advises that its Care Obligation incorporates the underlying policy objectives of the BIC Exemption's Impartial Conduct Standards. The Care Obligation includes a process element for broker-dealer recommendations that resembles the "prudent process" requirement for fiduciaries rooted in ERISA Section 404 and incorporated by the BIC Exemption's Impartial Conduct Standards.

However, the SEC's standard also appears to be more forgiving to some extent as Regulation Best Interest requires only that the broker-dealer have a *reasonable basis to believe* that the broker-dealer and their associated persons' recommendations satisfy the three prongs of the Care Obligation.

The SEC emphasizes that Regulation Best Interest is not intended to limit access to particular products and services or to affect the availability of transaction-based accounts. Moreover, the SEC notes that while cost is an important factor with any recommendation, it is not a determinative factor. Instead, the SEC contemplates that a broker-dealer may have a reasonable basis to conclude that a higher cost security or strategy is more appropriate for an investor based on other characteristics and in light of the retail customer's investment profile. At the same time a broker-dealer would be unable to satisfy the Care Obligation, *even with proper disclosure*, if it recommends a costlier alternative to the retail investor where the securities were otherwise identical.

The SEC expressed the view that Regulation Best Interest would result in efficiencies for broker-dealers who have already constructed policies and procedures to comply with the DOL's Impartial Conduct Standards. The SEC also indicated it is of the view that the other requirements of the Impartial Conduct Standards were not needed to be included Regulation Best Interest (e.g., restrictions on misleading statements and receiving more than reasonable compensation), as these obligations are already covered by existing securities laws and FINRA rules.

Importantly, the SEC did not change the definition of a "recommendation" for purposes of Regulation Best Interest, and instead preserved the meaning that has been interpreted under "existing broker-dealer regulation under the federal securities laws and [self-regulatory organization] rules" in order to provide "clarity to broker-dealers and maintain efficiencies for broker-dealers with established infrastructures that already rely on this term." The SEC also notes that "[i]n determining whether a broker-dealer has made a recommendation, factors that have historically been considered in the context of broker-dealer suitability obligations" should be considered, namely whether the communication could reasonably be viewed as a call to action or "reasonably would influence an investor to trade a particular security or group of securities."

Consistent with existing SEC authority, one-time recommendations are included as recommendations under Regulation Best Interest. The SEC also specifically notes that rollover recommendations from a plan to an IRA would be covered by Regulation Best Interest. On the other hand, and in a substantial deviation from the DOL's interpretation of a "recommendation" under the Fiduciary Rule, Regulation Best Interest does not cover a broker-dealer's recommendation of a brokerage account versus an advisory account.

#### *Conflict of Interest Obligation*

The second prong of Regulation Best Interest is the Conflict of Interest Obligation. This prong requires that broker-dealers (1) establish, maintain, and enforce written policies and procedures reasonably designed to identify, and *at a minimum disclose, or eliminate, all material conflicts of interest* that are associated with recommendations covered by Regulation Best Interest, and (2) establish, maintain, and enforce 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*.

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The SEC construed the term “financial incentive” broadly and in line with how the DOL has historically interpreted the definition of compensation for purposes of defining when a person is providing investment advice for a fee or other compensation under ERISA section 3(21)(A)(ii). The SEC describes “material conflicts of interest that arise from financial incentives” to include:

1. Compensation practices established by the broker-dealer including fees and charges for products sold, employee compensation or employment incentives (quotas, bonuses, sales contests, special awards);
2. Differential or variable compensation, and incentives tied to appraisals or performance reviews;
3. Compensation practices involving third parties, including compensation for sub-accounting or administrative services to a mutual fund, receipt of commissions or sales charges, or other differential or variable compensation, whether paid by the retail customer or a third party; and
4. Sales of propriety products or services or products of affiliates and principal transactions.

In the case of material conflicts of interests associated with financial incentives, the proposal would require broker-dealers to either eliminate the conflict entirely, or mitigate the conflict in addition to providing disclosure. The SEC described that material conflicts of interests could be mitigated through various means which could include the creation of policies developed with an aim to:

- Avoid compensation thresholds that disproportionately increase compensation through incremental increases in sales;
- Eliminate compensation incentives between product lines by capping or crediting compensation that a registered representative could receive;
- Provide enhanced supervision near thresholds for compensation, thresholds for firm recognition, for sales of proprietary products and rollovers rollover recommendations from a ERISA governed plan to an IRA; or
- Institute claw-backs if registered representatives fail to manage conflicts.

Notwithstanding the foregoing, the SEC did describe that certain material conflicts of interest arising from financial incentives may be difficult to mitigate and may be more appropriately avoided in their entirety. Those practices include the payment or receipt of certain non-cash compensation taking the form of “sales contests, trips, prizes and other similar bonuses based on sales of certain securities or accumulation of assets under management.” This appears to be consistent with the DOL’s prohibition against the use of quotas, appraisals, bonuses, and sales contests within the warranty sections of the BIC Exemption.

Under the Regulation Best Interest, broker-dealers would be permitted to exercise their judgment to determine whether a conflict can be effectively disclosed or require some other conflict mitigation strategy. Importantly, the SEC stated that it would be reasonable for a broker-dealer to use a risk-based compliance and supervisory system that would allow the broker-dealer to focus on specific areas of their business that pose the greatest risk of non-compliance. Thus, unlike the BIC Exemption’s warranty requirements, which strictly prohibited certain conflicts of interest, the SEC rules require only that the broker-dealer enforce written policies and procedures to mitigate or eliminate such conflicts.

### *Disclosure Obligation*

Regulation Best Interest also requires that broker-dealers satisfy the Disclosure Obligation. Importantly, a broker-dealer's Disclosure Obligation is in addition to and distinct from the Form CRS obligation (discussed below) which must be satisfied by both broker-dealers and registered investment advisers.

The Disclosure Obligation requires that, "prior to or at the time of" a recommendation, the broker-dealer—or a or natural person who is an associated person of a broker or dealer—"reasonably disclose to the retail customer, in writing, the material facts relating to the scope and terms of the relationship with the retail customer and all material conflicts of interest associated with the recommendation."

At the outset, the SEC notes that broker-dealers "should have the flexibility to make disclosures by various means." The SEC advises that disclosures that are required to be made prior to the time a recommendation could be made, including:

- At the beginning of a relationship (e.g., in the account opening agreement);
- On a regular or periodic basis when previously disclosed information becomes materially inaccurate or when there is new relevant material information;
- At other points, such as the point of sale; or
- Through multiple points in a relationship.

The "material facts" relating to the scope of the relationship and which must be disclosed would include:

- That the broker-dealer is acting in a broker-dealer capacity with respect to the recommendation;
- The fees and charges that apply to the retail customer's transactions, holdings, and accounts; and
- The type and scope of services provided by the broker-dealer, including the monitoring the performance of the retail customer's account.

Additionally, the Disclosure Obligation requires that the broker-dealer explicitly disclose all material conflicts of interest associated with the recommendation. The SEC defined a "material conflict of interest" as a "conflict of interest that a reasonable person would expect might incline a broker-dealer – consciously or unconsciously – to make a recommendation that is not disinterested." It is unclear whether this is a higher or lower standard than the BIC Exemption's definition, which provided that a material conflict of interest is a "financial incentive that a reasonable person would conclude could affect the exercise of its best judgment as a fiduciary in rendering adviser to a Retirement Investor."

Regulation Best Interest's disclosure requirements follow the same "layered" format as the BIC Exemption. The SEC appears to share the DOL's view that a layered approach to disclosure is most appropriate. In this regard, the Form CRS disclosures would constitute the thrust of the initial layer of disclosure, while the Disclosure Obligation would require additional, more specific and detailed levels of disclosure.

Interestingly, the SEC highlighted that firms are only required to "reasonably disclose" material conflicts of interest. In the SEC's view, this means that compliance with the Disclosure Obligation will be measured against a negligence standard as opposed to the strict liability standard generally associated with the BIC Exemption.

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## Investment Adviser Standard

In addition to the specific standard of care for broker-dealers described above, the Best Interest Package contains a proposed SEC interpretation of the common law fiduciary standard owed by investment advisers under the Advisers Act. It does this by describing the component parts of the common law fiduciary duties of care and loyalty, which it interprets as requiring that an investment adviser “at all times, serve the best interest of its clients and not subordinate its clients’ interest to its own.”

Significantly, the SEC provides a mechanical description of what is required by the existing duties under the Advisers Act. First, the SEC describes the duty of care as being comprised of three prongs, namely the duties to (1) act and provide advice in the best interest of a client, (2) seek best execution, and (3) provide advice and monitoring.

The duty to provide advice in the best interest of a client itself has two parts. Specifically, it requires an investment adviser to (a) make a “reasonable inquiry into a client’s financial situation, level of financial sophistication, investment experience, and investment objectives” and (b) “provide personalized advice that is suitable for and in the best interest of the client based on the client’s investment profile.” In determining that advice is in the best interest of an investor, the SEC notes that cost is just one of many factors an investment adviser should consider. Other factors include investment objectives, characteristics, liquidity, risks and potential benefits, volatility and likely performance in a variety of market and economic conditions. The SEC cautions, however, that “an adviser could not reasonably believe that a recommended security is in the best interest of a client if it is higher cost than a security that is otherwise identical, including any special or unusual features, liquidity, risks and potential benefits, volatility and likely performance.”

The duty to seek best execution requires an adviser to seek to obtain the execution of transactions for each of its clients such that the client’s total cost or proceeds in each transaction are the most favorable under the circumstances. Again, the SEC notes that an adviser can consider factors such as “the value of research, execution capability, commission rate, financial responsibility, and responsiveness,” in addition to total commission.

Notably, the SEC suggests that an adviser can *limit* but not completely eliminate the duty to provide advice and monitoring by contract. Further, the SEC describes that this duty “extends to all personalized advice it provides the client, including an evaluation of whether the client’s account or program type continues to be in the client’s best interest.”

The SEC also describes the duty of loyalty as requiring that an investment adviser “not favor its own interest over those of a client or unfairly favor one client over another.” To satisfy this duty, an investment adviser must make a full disclosure of all material facts relating to the advisory relationship. Significantly, the SEC notes that a conflict of interest may be cured by informed client consent after a full and fair disclosure. That said, with respect to disclosing conflicts, the SEC cautions that merely stating that a conflict “may” exist is insufficient if a conflict does in fact exist, and that if a conflict is too complex to adequately explain, an investment adviser is expected to “eliminate the conflict or adequately mitigate the conflict so that it can be more readily disclosed.”

In addition to providing color on these existing duties, the SEC requests comments on additional requirements for advisers. Specifically, the SEC seeks input on several questions, including whether (1) there should be federal licensing and continuing education requirements for investment adviser representatives, (2) investment advisers that do not have custody should be required to provide periodic account statements that disclose fees, and (3) investment advisers should be required to meet minimum capital requirements, and (4) advisers should be required to obtain fidelity bonds to limit certain risks of loss for clients.

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Notably, while the fiduciary duty owed by investment advisers is described in the release as “the highest standard of conduct”, the standard departs from the wording used to describe fiduciary status under ERISA Section 404(a) in a handful of significant ways.

Under ERISA, the standards of care are described as the standards of “prudence” and “loyalty”. The prudence standard is analogous to the duty of care requirement in the Commission’s interpretation of the Advisers Act. Under ERISA, the standard requires a fiduciary to act, “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.” Essentially, it imposes a broad requirement to act like a thoughtful expert would in pursuing the aims of the client. What is surprising here is that while the SEC’s “Regulation Best Interest” reads like a less prescriptive “Best Interest Contract Exemption,” the SEC’s commentary on the standard of care owed by investment advisers is more detailed than ERISA’s description of the standard of care owed by a fiduciary found in ERISA Section 404. As investment advisers to IRAs or retirement plans would likely be considered “fiduciaries” for purposes of ERISA under the 1975 “Five Part Test”, it will be important to harmonize the SEC and DOL care standards.

### **Form CRS**

The final piece in the SEC’s package is a proposed requirement that broker-dealers and investment advisers provide a customer or client relationship summary to be known as Form CRS, prior to providing client services. At the SEC’s April 18, 2018 meeting, Chairman Clayton explained that the goal of Form CRS is to provide clear rules for how registered investment advisers present themselves to their clients, thus making it easier for “Mr. and Mrs. 401(k)” to understand the services and standard of care they are being offered.

Form CRS attempts to meet this goal in two primary ways. First, it creates a new “customer relationship summary” form that both broker-dealers and registered investment advisers would be required to provide prior to providing services and would be designed to present a short and easily understood overview of key information. Second, it would impose new labeling rules on registered investment advisers and broker-dealers. Most significantly, it would prohibit broker-dealer firms and affiliated persons from using the words “adviser” or “advisor” in their names or titles.

The “customer relationship summary” appears to have been based somewhat on the BIC Exemption’s disclosure requirements. In this regard, like the BIC Exemption’s requirement, the customer relationship summary would need to be provided to all natural persons (regardless of net worth), as well as trusts or similar entities that represent natural persons.

Because the Form CRS is only one piece of the SEC’s contemplated “layered” disclosure structure, it requires significantly less length and detail than the disclosures required by the BIC Exemption. In this regard, Form CRS must describe summary information in no more than four pages in size 11 font and standard margins. It requires eight sections with the following headings: Introduction, Types of Relationships and Services, Our Obligations to You, Fees and Costs, Compare with Typical Brokerage/Advisory Accounts, Conflicts of Interest, Additional Information, and Key Questions to Ask. For each of these sections, the SEC provides either exact language to use or explains that the information provided should be high level information. For example, Form CRS identifies three categories of conflicts that would need to be disclosed, provides directions on the sentence or two to use to describe each category of conflict, and then requires an example rather than an exhaustive list of each type of conflict.

Much like the BIC Exemption’s requirement to make additional information available on request, Form CRS would include website links for additional information. The form also would include suggested questions to ask a potential broker-dealer or registered investment adviser. The SEC indicates that the “customer relationship summary” is designed to “facilitate a layered approach to disclosure” to provide an easy to understand overview to all investors and allow “interested investors [to] find additional information.”

Significantly, Form CRS’s broad prohibition on broker-dealers (who are not dual registrants) and affiliated persons – except for certain banks or individuals working on behalf of a bank, insurance company, municipal advisor, or commodity trading advisor – from using the words “adviser” or “advisor” when communicating with retail investors is a completely novel initiative and is unlike anything proposed by the DOL. Further, Form CRS also requires individuals to prominently disclose their legal status as an associated person of a broker-dealer or registered investment adviser in print and electronic retail investor communications. These disclosures could be made on the front of an associated person’s business card or in that person’s signature block.

### **Take Away**

The Best Interest Package presents similar challenges for the financial services industry to those that were present in DOL’s Fiduciary Rule. We will continue to monitor and provide updates on the SEC’s progress and what the package means. In addition, we look forward to providing comments to the SEC to help shape this new regulatory effort and its impact in the retirement space. If you have any questions, please reach out to your regular Groom attorney or any of the attorneys listed on this alert.