Steptoe

SEC Proposes Best Interest Standard for Retail Accounts and Related Disclosure Requirements

April 26, 2018

On April 18, the Securities and Exchange Commission (SEC or Commission) voted 4-to-1 to propose a set of new rules intended to: (1) create a "best interest" standard of conduct for broker-dealers and natural persons who are associated persons of a broker-dealer (collectively, broker-dealers or brokers, unless noted otherwise herein);[1] (2) improve disclosure through summary forms and clarify relationships among broker-dealers, advisers, and their retail investor customers;[2] and (3) clarify the fiduciary standards for advisers under the Investment Advisers Act of 1940 (Advisers Act).[3]

The SEC's proposed best interest standard appears to be directed at the same goal as the "impartial conduct standards" included in the Department of Labor's (DOL) Best Interest Contract (BIC) Exemption,[4] Principal Transactions Exemption,[5] and amendments to previously granted exemptions[6] in connection with the adoption of the DOL Fiduciary Rule.[7] It would require broker-dealers, when recommending any securities transaction or investment strategy involving securities to a retail customer, to act in the best interest of the retail customer at the time of the recommendation without placing the financial or other interest of the broker-dealer ahead of the retail customer's interest. Unlike the DOL's impartial conduct standards, the SEC's proposed best interest

---

[1] *See* Regulation Best Interest, Release No. 34-83062 (Apr. 18, 2018). The proposed rule package has not yet been published in the Federal Register but is available on the SEC's website. All references in this advisory are to the rule package as published on the SEC's website.

[2] Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles, Release No. 34-83063 (Apr. 18, 2018) (Form CRS Relationship Summary).

[3] Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, Release No. IA-4889 (Apr. 18, 2018).

[4] Best Interest Contract Exemption, 81 Fed. Reg. 21002-01 (April 8, 2016).

[5] Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs, 81 Fed. Reg. 21089 (April 8, 2016).

[6] 81 Fed. Reg. 21208 (April 8, 2016); 81 Fed. Reg. 21181 (April 8, 2016); 81 Fed. Reg. 21139 (April 8, 2016); 81 Fed. Reg. 21147 (April 8, 2016).

[7] Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice, 81 Fed. Reg. 20945 (Apr. 8, 2016).

standard would apply to broker-dealers when making recommendations to all retail customers, not just retirement investors, and would be enforced by the SEC.

As part of the proposed rule package, the SEC published for comment a short-form customer or client relationship summary (Form CRS or CRS) brokers would be required to use in setting out the material facts of the relationship with their clients. Proposed Form CRS also contains a set of questions for customers to ask their brokers before agreeing to a recommendation.[8] In addition, the proposed rule would prohibit a broker-dealer from using as part of a name or title the term "adviser" or "advisor" unless the broker-dealer is registered as an investment adviser and is providing investment advice under the Advisers Act.[9] They may not, for example, use the restricted words if they only offer brokerage services to retail investors or if they are merely associated with a dually registered firm and do not provide investment adviser-supervised investment advice.

Comments on the proposed rule package must be submitted within 90-days after publication in the Federal Register. The SEC's proposed best interest standard, Form CRS requirements, and titling restrictions are discussed in greater detail below.

Part I – The Best Interest Standard for Brokers

Overview of the Best Interest Obligation

As stated previously, the SEC's proposed best interest obligation would require broker-dealers, when recommending any securities transaction or investment strategy involving securities to a retail customer, to act in the retail customer's best interest at the time the recommendation is made, without placing the financial or other interest of the broker-dealer ahead of the retail customer's interest. "Retail customer" is defined to mean "a person, or the legal representative of such person" who (1) receives a recommendation of a securities transaction or investment strategy involving securities from a broker-dealer, and (2) uses that recommendation "primarily for personal, family, or household purposes." The preamble states that this definition covers non-natural persons "such as trusts that represent the assets of a natural person," provided that the recommendation is primarily for "personal, family or household purposes."[10] The preamble makes clear that the definition of retail customer would cover "participants in ERISA-covered plans and IRAs."[11] It further states that the reference to personal, family, or household purposes is broad enough to capture

[8] Form CRS Relationship Summary, Appendix D ("Is a Brokerage Account Right for You?").

[9] This proposed rule has the potential of requiring a financial professional to refer to herself by one title when speaking with certain customers and another title when speaking to others.

[10] *See* Regulation Best Interest at 85. In contrast, the relationship summary proposal uses the term "retail investor," which is defined as an existing *or prospective* customer who is a *natural* person (an individual). *See id.* at 88-89. The preamble explains that the relationship summary proposal is "intended for a broader range of investors, before or at the time they first engage the services of a broker-dealer, to provide important information for them to consider when choosing a firm and a financial professional." *Id.* at 89.

[11] *Id.* at 95.

retirement, education, and other savings purposes, while excluding recommendations related to business or commercial purposes.[12]

The proposed rule does not define the term "recommendation." The preamble states that the term "should be interpreted consistent with existing broker-dealer regulation under the federal securities laws and SRO rules."[13] The preamble cites factors that have historically been considered in determining whether a recommendation has been made by a broker-dealer, such as 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.[14] As the DOL did in its Fiduciary Rule, the SEC rule notes that the more individually tailored the communication is to a specific customer or a targeted group of customers, the more likely it would be viewed as a recommendation.[15]

The proposed rule does not specifically define what "best interest" means. Instead, it sets forth three specific obligations that must be satisfied in order to meet the requirements of the general best interest obligation.[16] In particular, the proposed rule states that the best interest obligation will be satisfied if the following obligations are met:

- **The "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 the recommendation, reasonably discloses 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 that are associated with the recommendation.
- **The "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, skill, and prudence to: (1) understand the potential risks and rewards 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; (2) 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 associated with the recommendation; and (3) 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.
- **The "Conflict of Interest Obligations"** – The broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to: (1) identify and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with such recommendations; and (2) identify and disclose

[12] *Id.* at 84.

[13] *Id.* at 73-74.

[14] *Id.* at 75.

[15] *Id.* at 75-76.

[16] FINRA and a number of cases have interpreted FINRA's suitability rule as requiring a broker-dealer to make recommendations that are "consistent with his customers' best interests" or are not "clearly contrary to the best interest of the customer," but this is not an explicit requirement of FINRA's suitability rule.

and mitigate, or eliminate, material conflicts of interest arising from financial incentives[17] associated with such recommendations.

The best interest standard only applies when a broker-dealer is making a recommendation to a retail customer about a securities transaction or an investment strategy involving securities. Thus, while it is clear that the standard does not apply when the broker executes an unsolicited order, it also may not apply when the broker recommends managers, additional contributions, or distributions, although the preamble to the proposed rule is clear that it is intended to apply to rollover recommendations.[18]

The SEC noted that the best interest standard is designed to make it clear that a broker-dealer may not put his or his firm's financial interests ahead of the interests of his retail customer in making investment recommendations. The Commission's stated goal in designing the rule is to enhance investor protection while preserving, to the extent possible, access and choice for investors who prefer the "pay as you go" model for advice from broker-dealers, as well as retail customer choice over the level and types of advice provided and the products available.[19] The proposed rule does not create any new private right of action or right of rescission.

The preamble notes that the proposed rule intentionally departs from the "without regard to the financial or other interests of" formulation of the DOL's impartial conduct standards.[20] The SEC's reason for this departure is its "concern[] that inclusion of the 'without regard to' language could be inappropriately construed to require a broker-dealer to eliminate all of its conflicts (*i.e.,* require recommendations that are conflict free)."[21] In contrast, the preamble describes the proposed rule as recognizing that "the broker-dealer's financial interest can and will inevitably exist," but that it cannot be the "predominant motivating factor" behind the recommendation.[22]

---

[17] The SEC lists three main areas of conflicts: broker-dealer compensation incentives, sale of proprietary products, and effecting transactions on a principal basis.

[18] *See* Regulation Best Interest at 83 ("We are not proposing at this time that the duty extend to recommendations of account types generally, unless the recommendation is tied to a securities transaction (*e.g.,* to roll over or transfer assets such as IRA rollovers).").

[19] *Id.* at 9.

[20] *Id.* at 48. The Commission also notes that it has not included two components of the DOL's impartial conduct standards (barring misleading statements and unreasonable compensation) because they are already part of the securities laws. *Id.* at 61.

[21] *Id.* at 48.

[22] *Id.* at 49.

The SEC believes that its proposed formulation "appropriately reflects . . . the underlying intent of the 'without regard to . . .' formulation."[23] Pointing to Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, as well as the provisions of the Advisers Act that permit principal transactions, the Commission believes that "the overall intent of Section 913 was that a 'without regard to' standard did not prohibit, mandate or promote particular types of products or business models, and preserved investor choice among such services and products and how to pay for these services and products (*e.g.,* by preserving commission-based accounts, episodic advice, principal trading and the ability to offer only proprietary products to customers)."[24]

Although "best interest" is not defined, the term appears again in each subpart of the care obligation (discussed in greater detail below).[25] The preamble indicates that the care obligation would "make the cost of the security or strategy, and any associated financial incentives, more important factors (of the many factors that should be considered) in understanding and analyzing whether to recommend a security or an investment strategy."[26] It also states that the proposed best interest standard would not *per se* prohibit a broker-dealer from engaging in transactions involving conflicts of interest, such as:

- Charging commissions or other transaction-based fees
- Receiving or providing differential compensation based on the product sold
- Receiving third-party compensation
- Recommending proprietary products, products of affiliates, or a limited range of products
- Recommending a security underwritten by the broker-dealer or a broker-dealer affiliate, including initial public offerings (IPOs)
- Recommending a transaction to be executed in a principal capacity
- Recommending complex products
- Allocating trades and research, including allocating investment opportunities (e.g., IPO allocations or proprietary research or advice) among different types of customers and between retail customers and the broker-dealer's own account
- Considering cost to the broker-dealer of effecting the transaction on behalf of the customer (for example, the effort or cost of buying or selling an illiquid security)
- Accepting a retail customer's order that is contrary to the broker-dealer's recommendations

---

[23] *Id.* The SEC's formulation calls for a recommendation to be 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."

[24] *Id.* at 49.

[25] The Commission specifically requests comment on whether the term "best interest" should be interpreted differently for purposes of the care obligation or whether it should instead codify existing suitability obligations and impose additional obligations such as not placing the financial or other interest of the broker-dealer ahead of the retail customer. *Id.* at 163-64.

[26] *Id.* at 51.

However, the Commission caveats that it is not saying that these practices are *per se* consistent with the proposed rule.[27] It is a little worrisome that the proposed rule casts doubt on all of the above transactions, since the DOL Fiduciary Rule's creation of that very doubt may have been one of the reasons why firms limited their offerings to retirement plans.[28] As an example, the list includes recommending a transaction to be executed in a principal capacity. All bonds are traded on a principal basis; a retail account may either purchase a bond from its own broker on a principal basis or from a third-party dealer, paying its broker a commission. Requiring a customer to pay this "double fee" (the markup plus the commission), just to be free from doubt that the transaction is in the retail customer's best interest, does not seem consistent with the Commission's stated goals. In this and other parts of the preamble, the SEC repeatedly says that is not the intended result[29] – it does not want to limit retail consumers' choice or access, but the presentation is nonetheless troubling.

The preamble does make clear that there is not one "best" recommendation that would satisfy the standard:

> While to satisfy proposed Regulation Best Interest, a broker-dealer would not be required to analyze all possible securities, other products or investment strategies to find the single "best" security or investment strategy for the retail customer, broker-dealers generally should consider reasonably available alternatives offered by the broker-dealer as part of having a reasonable basis for making the recommendation, as required under the Care Obligation. Proposed Regulation Best Interest also would not necessarily obligate a broker-dealer to recommend the "least expensive" or the "least remunerative" security or investment strategy, provided the broker-dealer complies with the Disclosure, Care, and the Conflict of Interest Obligations set forth in the relevant sections below.[30]

While cost is important, the SEC notes that cost may be outweighed by other factors, including the product's or strategy's investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility, and likely performance in a variety of market and economic conditions. But it cautions:

> We preliminarily believe that under the Care Obligation, a broker-dealer could not have a reasonable basis to believe that a recommended security is in the best interest of a retail customer if it is more costly than a reasonably available alternative offered by the broker-dealer and the characteristics of the securities are otherwise identical, including any special or unusual features, liquidity, risks and potential benefits, volatility and likely performance.[31] Further, it would be

---

[27] *Id.* at 54.

[28] *See id.* at 53-54. Where ERISA-covered entities or IRAs are involved, some of these transactions may be covered by prohibited transaction exemptions but depending on the conditions contained in those exemptions, they may or may not be helpful.

[29] *See, e.g.*, *id.* at 52-53.

[30] *Id.* at 54.

[31] It seems odd that the SEC would judge whether a transaction was in the best interest of a retail customer by reference to a factor as speculative as "likely performance."

> inconsistent with the Care Obligation for the broker-dealer to recommend the more expensive alternative for the customer, even if the broker-dealer had disclosed that the product was higher cost and had policies and procedures in place that were reasonably designed to mitigate the conflict under the Conflict of Interest Obligations, as the broker-dealer would not have complied with its Care Obligation, as the higher cost of the security of would not be justified by the security's other characteristics in comparison to reasonably available alternatives (in contrast to the examples discussed below).[32]

The best interest test is applied when the recommendation is made and the Commission goes to great lengths to make clear that the standard does not require monitoring the investment once made or create a continuous duty to a retail customer or require a broker-dealer to reject an order that does not follow the broker's recommendation.[33] The preamble notes that this approach is consistent with the DOL Fiduciary Rule and the BIC Exemption.[34]

The Disclosure Obligation

The proposed rule imposes a duty on the broker-dealer to reasonably disclose to the retail customer in writing, prior to or at the time of the recommendation, "the material facts relating to the scope and terms of the relationship with the retail customer, including all material conflicts that are associated with the recommendation."[35] The preamble provides the following examples of material facts relating to the scope and terms of the relationship with the retail customer: (1) the broker-dealer is acting in a broker-dealer capacity with respect to the recommendation; (2) the fees and charges that apply to the retail customer's transactions, holdings, and accounts; and (3) the type and scope of services provided by the broker-dealer, including, for example, monitoring the performance of the retail customer's account.[36]

The SEC states in the preamble that it proposes to interpret "material conflict of interest" to mean "a conflict of interest that a reasonable person would expect might incline a broker-dealer – consciously or unconsciously –

---

[32] *Id.* at 56-57.

[33] *Id.* at 79.

[34] *Id.* at 81-82. For further background regarding the Fiduciary Rule and BIC Exemption, see Steptoe's April 13, 2016 advisory. *The Department of Labor's Final Rule Redefining Fiduciary*, STEPTOE (Apr. 13, 2016).

[35] The disclosure and care obligations of the proposed rule would impose duties not only on the broker-dealer, but also on a "natural person who is an associated person of a broker or dealer." The Commission intends this language to require "*individuals* that are associated persons of a broker-dealer (*e.g.*, registered representatives) to comply with specified components of Regulation Best Interest when making recommendations," while excluding "affiliated *entities* of the broker-dealer . . . that are not themselves broker-dealers, which are not [the Commission's] intended focus." Regulation Best Interest at 71-72 (emphasis added).

[36] *Id.* at 98.

to make a recommendation that is not disinterested."[37] This interpretation departs from the DOL definition: In the BIC Exemption, a material conflict of interest exists when an adviser or financial institution has a "financial interest that a reasonable person would conclude could affect the exercise of its best judgment as a fiduciary in rendering advice to a Retirement Investor."[38] The preamble indicates that the SEC based its interpretation on "well-established precedent regarding identification of conflicts of interest for which advisers may face liability under the Advisers Act in the absence of full disclosure."[39] Examples of conflicts that must be disclosed under the proposed rule would include "material conflicts of interest associated with recommending: proprietary products, products of affiliates, or limited range of products; one share class versus another share class of a mutual fund; securities underwritten by the firm or a broker-dealer affiliate; the rollover or transfer of assets from one type of account to another (such as recommendations to rollover or transfer assets in an ERISA account to an IRA, when the recommendation involves a securities transaction); and allocation of investment opportunities among retail customers (*e.g.,* IPO allocation)."[40]

The preamble states that the proposed disclosure obligation is part of a broader effort to address retail investor confusion about differences among financial service providers, such as broker-dealers, investment advisers, and dual registrants.[41] In the concurrent rulemaking discussed in Part II below, the SEC proposes to require broker-dealers and investment advisers to provide retail investors a short (*i.e.*, four-page or equivalent limit if in electronic format) customer relationship summary that includes general information about the services, fees, conflicts and disciplinary history of the firms they are considering, along with references to where more detailed information can be obtained.[42]

According to the preamble, Regulation Best Interest's disclosure obligation is designed to complement the CRS by providing "more specific and additional, detailed layers of disclosure."[43] For example, the Regulation Best Interest disclosure obligation would require broker-dealers to provide "more specific fee disclosures relevant to the recommendation to the retail customer." Although the proposed rule does not mandate the specific form, content or method of such disclosure, the SEC states that it "would generally expect broker-dealers to build upon the Relationship Summary, by disclosing additional detail (including quantitative information, such as amounts, percentages or ranges) regarding the types of fees and charges described in the Relationship

---

[37] *Id.* at 110. Interestingly, this test asks whether a conflict may lead to a recommendation that is not "disinterested," despite the fact that, as noted above, the Commission decided against a "without regard to the financial or other interests of" standard to gauge primary conduct.

[38] *Id.*; *see also* Best Interest Contract Exemption, 81 Fed. Reg. 21002, 21033 (Apr. 8, 2016).

[39] Regulation Best Interest at 111 (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-92 (1963)).

[40] *Id.* at 112-13.

[41] *Id.* at 100.

[42] *Id.* at 101-02.

[43] *Id.* at 103.

Summary."[44] Regulation Best Interest's disclosure obligation also would require "more comprehensive disclosure of all material conflicts of interest related to the recommendation to the retail customer."[45] The SEC believes that together the CRS and the disclosure obligation under Regulation Best Interest require broker-dealers to provide "much of the same information" as the disclosures required in the BIC Exemption "but in a less prescriptive manner that is designed to provide firms flexibility in how to satisfy the obligation."[46]

With that goal in mind, the proposed rule leaves it up to the broker-dealer to determine how best to "reasonably" disclose material facts (including material conflicts) in terms of the specific form, timing, and method of delivery, so long as the disclosure is made in writing "prior to or at the time of" the recommendation. The preamble states that "[i]nvestors should receive information early enough in the process to give them adequate time to consider the information and promote the investor's understanding in order to make informed investment decisions, but not so early that the disclosure fails to provide meaningful information."[47] The broker-dealer would need to give "sufficient information to enable a retail customer to make an informed decision with regard to the recommendation."[48] Whether the disclosures are adequate will depend on the facts and circumstances, but under applicable federal securities laws and related rules and regulations, the disclosures "must be true and may not omit any material facts necessary to make the required disclosures not misleading."[49]

The Care Obligation

The care obligation requires the broker-dealer to exercise "reasonable diligence, care, skill, and prudence"[50] in (1) understanding the securities transaction or investment strategy he is recommending and its suitability for retail investors generally; (2) having a reasonable basis for believing the transaction or strategy is in a

---

[44] *Id.* at 108-09.

[45] *Id.* at 103.

[46] *Id.* at 123.

[47] *Id.* at 119. The preamble suggests a number of different approaches for the timing of disclosures: "(1) at the beginning of a relationship (*e.g.,* in a relationship guide, such as or in addition to the Relationship Summary, or in written communications with the retail customer, such as the account opening agreement); (2) on a regular or periodic basis (*e.g.,* on a quarterly or annual basis, when any previously disclosed information becomes materially inaccurate, or when there is new relevant material information); (3) at other points, such as before making a particular recommendation or at the point of sale; and/or (4) at multiple points in the relationship or through a layered approach to disclosure." *Id.*

[48] *Id.* at 115.

[49] *Id.* at 114-15.

[50] The Commission leaves "prudence" undefined, but believes that it "conveys the fundamental importance of conducting a proper evaluation of any securities recommendation in accordance with an objective standard of care." *Id.* at 134-35. The Commission seeks comment as to whether this term is sufficiently clear.

particular investor's best interest; and (3) having a reasonable basis for believing a series of recommended transactions is not excessive and is in the customer's best interest when taken together.

The care obligation's first prong, which is taken from FINRA rules and interpretations, requires a broker-dealer to: (1) undertake reasonable diligence (*i.e.,* reasonable investigation and inquiry) to understand the potential risks and rewards of the recommended security or strategy (*i.e.,* to understand the security or strategy); and (2) have a reasonable basis to believe that the recommendation could be in the best interest of *at least some retail customers* based on that understanding. A broker-dealer must adhere to both components to meet its care obligation under the proposed rule. The preamble suggests that the broker-dealer consider cost as well as the investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility, and likely performance of market and economic conditions,[51] the expected return of the security or investment strategy, as well as any financial incentives to recommend the security or investment strategy.[52] The broker-dealer also should consider reasonable alternatives, if any, it offers in determining whether it has a reasonable basis for making the recommendation.

The second prong requires that the broker-dealer have a reasonable basis to believe a specific recommendation is in the best interest of the particular retail customer to whom it is made, in light of his investment strategy, investment objectives, financial situation, and needs. Reading this in conjunction with the Commission's discussion of "best interest," this prong builds on FINRA's existing "suitability" standard by requiring a broker-dealer to have a reasonable basis to believe its recommendation is in the "best interest" of (rather than "suitable for") the retail customer.[53] For example, the best interest requirement would require the broker-dealer to pick the less costly option when choosing among identical investments or investment strategies for a retail customer. And when choosing among differently-priced investments or strategies, the

---

[51] We assume that a broker-dealer is not supposed to predict the market or the economy but rather, to assess how the investment might fare in different markets.

[52] *Id.* at 139-40. The preamble suggests the following questions as part of the diligence exercise:

- Can less costly, complex, or risky products available at the broker-dealer achieve the objectives of the product?
- What assumptions underlie the product, and how sound are they? What market or performance factors determine the investor's return?
- What are the risks specific to retail customers? If the product was designed mainly to generate yield, does the yield justify the risk to principal?
- What costs and fees for the retail customer are associated with this product? Why are they appropriate? Are all of the costs and fees transparent? How do they compare with comparable products offered by the firm?
- What financial incentives are associated with the product, and how will costs, fees, and compensation relating to the product impact an investor's return?
- Does the product present any novel legal, tax, market, investment, or credit risks?
- How liquid is the product? Is there a secondary market for the product?

[53] *Id.* at 142.

broker-dealer must have a "reasonable basis to believe" that qualitative aspects (*e.g.,* volatility, liquidity, likely performance) justify the added cost of the pricier option.[54]

However, the proposed rule does not require the broker-dealer to scour through all options in the universe of potential recommendations to identify the literal "best" option for a particular retail customer. It does require consideration of "reasonably available alternatives" offered by the broker-dealer.[55] For many broker-dealers, however, the range of options offered is vast, and scouring through all of them to identify "reasonably available alternatives" (the exact meaning of which is unclear) is confusing. And although the Commission believes the best interest standard cannot be satisfied "if any recommendation was predominantly motivated by the broker-dealer's self-interest . . . and not the customer's best interest,"[56] as noted above, the preamble makes clear that a broker-dealer may be able to recommend a more expensive or more remunerative security or investment strategy depending on the circumstances:

> We preliminarily believe that, under this prong of the Care Obligation, when a broker-dealer recommends a more expensive 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 the higher cost is justified (and thus nevertheless is in the retail customer's best interest) based on other factors (e.g., the product's or strategy's investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility and likely performance in a variety of market and economic conditions), in light of the retail customer's investment profile. 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 the factors noted above, in light of the retail customer's investment profile. Nevertheless, this does not mean that a broker-dealer could not recommend the more remunerative of two reasonably available alternatives, if the broker-dealer determines the products are otherwise both in the best interest of—and there is no material difference between them from the perspective of—retail customer, in light of the retail customer's investment profile.[57]

The Commission notes that recommending a more expensive or more remunerative investment "in order to" maximize the broker-dealer's compensation ("*e.g.,* commissions or other fees; further the broker-dealer's business relationships; satisfy firm sales quotas or other targets; or win a firm sponsored sale contest") would not be permissible.[58] Of course, this formulation begs the question how a broker-dealer would disprove any of

---

[54] *Id.* at 148.

[55] The preamble notes that the broker-dealer need only choose among the options "offered by the broker-dealer." *Id.* at 54. Comment is sought as to whether the broker should also have to look elsewhere.

[56] *Id.* at 57.

[57] *Id.* at 148.

[58] *Id.*

these factors, which is reminiscent of the confusion surrounding the DOL rule and the difficulty firms had in determining how to adjust to the requirements.

This second prong assumes the broker-dealer has sufficient information regarding the customer to make a proper evaluation, and imposes a duty to ascertain such information and keep it current. The required information is captured by the term "retail customer investment profile," which 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 in connection with a recommendation.[59] A broker-dealer must keep records of all such information collected from a customer, except in cases of the customer's neglect, refusal, or inability to provide or update it. The broker-dealer need not document its efforts to collect such information, though the Commission seeks comment on whether documentation should be required.

As with other aspects of the proposed rule, the investment profile concept is modeled on FINRA's suitability rule. The Commission likewise believes it is consistent with DOL's BIC Exemption.[60] Correspondingly, a broker-dealer must act with reasonable diligence to determine the customer's investment profile, and must seek to update the profile of an existing customer if it has reason to believe the customer's profile has changed. The reasonableness of the broker-dealer's diligence depends on the facts and circumstances, and the importance of each factor in the profile may vary accordingly. When the broker-dealer cannot obtain some relevant information despite its diligence, it must ascertain whether it has enough information to make a recommendation that is in the customer's best interest. If it does not, it must not make a recommendation.

The care obligation's third prong requires the broker-dealer to have a reasonable basis to believe that its recommendation of a series of transactions will be in the customer's best interest and also will not be excessive – that is, will not amount to churning, which may increase the broker-dealer's overall fees. The preamble does not seek to redefine "churning," instead citing established case law and the relevant definitional factors developed thereunder.[61]

As with the FINRA "quantitative suitability" rule on which it is modeled, this prong departs from the SEC's anti-churning rule by endorsing liability in the absence of scienter.[62] However, the proposed rule's "reasonable basis" element may pose difficulties for the SEC in pleading and proving a churning violation. Further, whereas the FINRA and the SEC rules impose liability only when the broker-dealer exercises "control" or "*de facto* control" over the customer's account, the proposed rule disposes of this element and instead requires only that

---

[59] *Id.* at 144.

[60] *Id.* at 146.

[61] *See generally id.* at 150-51.

[62] *Cf.* Exchange Act 15(c)(1) and Rules 15c1-2 and 15c1-7 thereunder.

the broker-dealer recommend the transactions. The Commission seeks comment, however, as to whether a control element should be included.[63]

The preamble states that the content of the care obligation is equivalent to the "objective standards of care" of the best interest component of DOL's impartial conduct standard, as set forth in the BIC Exemption. The Commission believes that "the incorporation and enhancement of existing broker-dealer suitability obligations as part of the proposed care obligation would address many of the concerns that were raised by the DOL as a rationale for not referring to the existing FINRA suitability standard as the basis for the best interest obligation under the Impartial Conduct Standards."[64] The proposed rule, like the DOL rule, also would not be satisfied by disclosure alone.[65] The Commission further notes that it is not proposing best execution and fair pricing and compensation requirements, as suggested in the Section 913 study.[66]

The Conflict of Interest Obligations – General

SEC Chair Jay Clayton highlighted the conflict of interest obligations as "perhaps the most critical enhancement over existing standards" in the proposed rule.[67] These conflict of interest obligations require broker-dealers[68] to (1) establish, maintain, and enforce written policies and procedures reasonably designed to identify, and 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.

The conflicts based on financial incentives include:

- Compensation practices established by the broker-dealer, including fees and other charges for the services provided and products sold

---

[63] Regulation Best Interest at 166. Meanwhile, FINRA is considering whether to drop the "control" requirement from its quantitative suitability rule. FINRA Regulatory Notice 18-13 (Apr. 20, 2018).

[64] Regulation Best Interest at 157.

[65] *Id.* at 51.

[66] *Id.* at 158.

[67] Jay Clayton, *Overview of the Standards of Conduct for Investment Professionals Rulemaking Package* (Apr. 18, 2018). Indeed, this part of the proposed rule is the key expansion from the existing framework for regulating broker-dealers, going beyond existing disclosure duties and requiring broker-dealers to mitigate certain conflicts.

[68] And it is only the broker-dealers. In contrast to the disclosure and care obligations, the conflict of interest obligations apply *only* to brokers or dealers – *i.e.,* requiring them to implement, maintain, and enforce policies – and *not* to natural persons associated with a broker or dealer. The Commission has sought comment on whether to impose obligations directly on associated natural persons.

- Employee compensation or employment incentives (e.g., quotas, bonuses, sales contests, special awards, differential or variable compensation, incentives tied to appraisals or performance reviews)
- Compensation practices involving third-parties, including both sales compensation and compensation that does not result from sales activity, such as compensation for services provided to third-parties (e.g., sub-accounting or administrative services provided to a mutual fund)
- Receipt of commissions or sales charges, or other fees or financial incentives, or differential or variable compensation, whether paid by the retail customer or a third-party
- Sales of proprietary products or services, or products of affiliates
- Transactions that would be effected by the broker-dealer (or an affiliate thereof) in a principal capacity[69]

The list is quite similar to the analogous presentation in the BIC Exemption as issued by DOL but unlike BIC, there is no contract requirement or warranty requirement, and the overarching threat of excise taxes and transaction reversal are not present.[70] Those factors were a significant part of the reasons that firms changed their business models.[71]

---

[69] *Id.* at 169.

[70] Under the BIC Exemption, a financial institution must contractually warrant that: "The Financial Institution's policies and procedures require that neither the Financial Institution nor (to the best of its knowledge) any Affiliate or Related Entity use or rely upon quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation or other actions or incentives that are intended or would reasonably be expected to cause Advisers to make recommendations that are not in the Best Interest of the Retirement Investor." 81 Fed. Reg. at 21077.

The BIC Exemption also provides, however, that:

> Notwithstanding the foregoing, [the exemption] does not prevent the Financial Institution, its Affiliates or Related Entities from providing Advisers with differential compensation (whether in type or amount, and including, but not limited to, commissions) based on investment decisions by Plans, participant or beneficiary accounts, or IRAs, to the extent that the Financial Institution's policies and procedures and incentive practices, when viewed as a whole, are reasonably and prudently designed to avoid a misalignment of the interests of Advisers with the interests of the Retirement Investors they serve as fiduciaries (such compensation practices can include differential compensation based on neutral factors tied to the differences in the services delivered to the Retirement Investor with respect to the different types of investments, as opposed to the differences in the amounts of Third Party Payments the Financial Institution receives in connection with particular investment recommendations).

Id. at 21033.

[71] The SEC points to these existing changes to justify its choice of an approach paralleling the DOL's. As the preamble says, "[b]y choosing language that draws on similar principles to the principles underlying the DOL's 'best interest' Impartial Conduct Standard, which would currently apply to broker-dealers relying on the BIC Exemption and or any of the related PTEs, we believe our proposed best interest standard would result in

The Commission notes at several points that the conflict of interest obligations embrace flexibility – firms are to use their judgment to determine whether disclosure is sufficient or whether elimination is required, and firms are all but encouraged to use a risk-based compliance and supervisory system in the interest of flexibility. That said, the preamble strongly suggests that certain sales practices, such as contests, trips, or prizes cannot be mitigated,[72] and at other points lists best practices firms should adopt.

In determining whether broker-dealers have established the proper policies and procedures and are enforcing them appropriately, the Commission will look at whether a broker-dealer has adequate compliance and supervisory policies and procedures in place (as well as a system for applying such procedures) to identify and, at a minimum, disclose (and mitigate, in the case of financial incentives) or eliminate material conflicts of interest.[73] In the Commission's view, it would be reasonable for broker-dealers to use a risk-based compliance and supervisory system to promote compliance with Regulation Best Interest, rather than conducting a detailed review of each recommendation of a securities transaction or security-related investment strategy to a retail customer. That formulation is helpful, in that a review of every transaction is simply not feasible. This is another area in which the SEC rule is superior to the DOL's nuclear penalty of excise taxes, transaction reversal, and private litigation.

The preamble also contains a helpful list of components of a supervisory procedure. The SEC's substantial practical experience in this area makes these ideas all the more useful. The components include:

- Policies and procedures outlining how the firm identifies its material conflicts (and material conflicts arising from financial incentives)
- Clearly identifying all such material conflicts of interest and specifying how the broker-dealer intends to address each conflict
- Robust compliance review and monitoring systems
- Processes to escalate identified instances of noncompliance to appropriate personnel for remediation
- Procedures that clearly designate responsibility to business lines personnel for supervision of functions and persons, including determination of compensation
- Processes for escalating conflicts of interest
- Processes for a periodic review and testing of the adequacy and effectiveness of policies and procedures

---

efficiencies for broker-dealers that have already established infrastructure to comply with the DOL best interest Impartial Conduct Standard." Regulation Best Interest at 9.

[72] The preamble notes: "[W]e believe certain material conflicts of interest arising from financial incentives may be more difficult to mitigate, and may be more appropriately avoided in their entirety . . . includ[ing] the payment or receipt of certain non-cash compensation that presents conflicts of interest for broker-dealers, for example, sales contests, trips, prizes, and other similar bonuses that are based on sales of certain securities or accumulation of assets under management." *Id.* at 183. The Commission requests comment on whether there are certain practices or product classes that it should outright prohibit.

[73] *Id.* at 170.

- Training on the policies and procedures[74]

It remains to be seen how readily a financial institution could eliminate conflicts rather than simply disclose them (or disclose and mitigate them in the case of material conflicts arising from financial incentives, as discussed below). Some of the preamble's suggestions might well result in the kind of changes in product offerings that have been criticized as a consequence of the DOL rule. Thus, the preamble notes:

> A broker-dealer seeking to address its Conflict of Interest Obligations through elimination of a material conflict of interest could choose to eliminate the conflict of interest entirely, for example, by removing incentives associated with a particular product or practice or not offering products with special incentives. Alternatively, a broker-dealer could satisfy this obligation by negating the effect of the conflict by, for example, in the case of conflicts related to affiliated mutual funds, crediting fund advisory fees against other broker-dealer charges – thus effectively eliminating the material conflict of interest.[75]

None of these suggestions seem very practical.

The Conflict of Interest Obligations – Conflicts Arising from Financial Incentives

Under the proposed rule, conflicts arising from financial incentives cannot merely be disclosed but must be both disclosed *and* mitigated, or eliminated. The preamble lists the usual financial incentives but also mentions, in the case of mutual funds, compensation for account servicing, sub-transfer agency, sub-accounting, recordkeeping, or other administrative services.[76]

The preamble notes that the rules relating to these policies and procedures are intentionally non-prescriptive but suggests that certain kinds of practices should be dealt with:

- Avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales[77]
- Minimizing compensation incentives for employees to favor one type of product over another, proprietary or preferred provider products, or comparable products sold on a principal basis – for example, establishing differential compensation criteria based on neutral factors (e.g., the time and complexity of the work involved)

---

[74] *Id.* at 172.

[75] *Id.* at 175.

[76] A footnote in the preamble says that such compensation provides an incentive for a firm to offer the mutual funds from or for which the firm receives such compensation and not to offer funds or products lacking such compensation. *Id.* at 177 n.303. The comment apparently refers to those firms that eliminated index mutual funds that pay no 12b-1 or service fees.

[77] This issue proved very hard to deal with as firms attempted to comply with the BIC Exemption or assessed whether they could do so, in that it requires a wholesale revision of most firms' compensation grids.

- Eliminating compensation incentives within comparable product lines (e.g., one mutual fund over a comparable fund) by, for example, capping the credit that a registered representative may receive across comparable mutual funds or other comparable products across providers
- Implementing supervisory procedures to monitor recommendations that are: near compensation thresholds; near thresholds for firm recognition; involve higher compensating products, proprietary products or transactions in a principal capacity; or, involve the rollover or transfer of assets from one type of account to another (such as recommendations to rollover or transfer assets in an ERISA account to an IRA, when the recommendation involves a securities transaction) or from one product class to another
- Adjusting compensation for registered representatives who fail to adequately manage conflicts of interest
- Limiting the types of retail customers to whom a product, transaction or strategy may be recommended (e.g., certain products with conflicts of interest associated with complex compensation structures)

As noted above, the preamble emphasizes in this context that certain practices likely should be eliminated in their entirety: sales contests, trips, prizes, and other similar bonuses that are based on sales of certain securities or accumulation of assets under management. In so doing, the Commission notes its consistency with the approach taken by the DOL in the BIC Exemption and the recommendations of the Section 913 study relating to the duty of loyalty.

Part II – Form CRS Requirements

A centerpiece of the Commission's "layered approach" to disclosure in the proposed regulatory package is the CRS. Under the Commission's proposal, registered broker-dealers and registered investment advisers (RIAs) are required to deliver the CRS to retail investors at the beginning of the relationship and, thereafter, upon a material change in relationship. The CRS is a short document. Under the proposed rule, the CRS may not be longer than four pages, in a specified format, under specified headings, with minimum margins and font. The CRS requires a general description of the firm's relationship with the investors, its services, the applicable standard(s) of conduct, fees and expenses, conflicts of interest, and relevant disciplinary history. The CRS ends with a list of "key questions" for the investor to ask the firm. As noted in Part I, the CRS supplements the disclosure required under Regulation Best Interest, which addresses in greater detail the scope and terms of the relationship and material conflicts of interest associated with its recommendations. The prominent role of the CRS in the proposal reflects the Commission's belief that a simplified introductory disclosure will help alleviate investor confusion regarding brokerage and advisory services and advice given in connection therewith.

Coverage of Form CRS

Broker-dealers and RIAs are required to provide a CRS to "retail investors." A "retail investor" is defined as "a customer or prospective customer who is a natural person (an individual)."[78] The definition includes all natural persons, regardless of their net worth or sophistication. The definition also includes "a trust or other similar entity that represents natural persons, even if another person is a trustee or managing agent of the trust."[79] Unlike the term "retail customer" used in Regulation Best Interest, *see supra* at 2 & n.10, the term "retail

---

[78] Form CRS Relationship Summary at 463.

[79] *Id.*

investor" is not restricted to those who use investment recommendations primarily for personal, family, or household purposes.[80] The SEC specifically calls out this difference and asks for comment on whether it is appropriate. Its rationale is that if the CRS accomplishes the SEC's goals, it should be distributed as widely as possible to as many retail customers as possible.

Firms must deliver a CRS to all retail investors, regardless of their investment purpose. Additionally, the definition of "retail investor" provides no exception for otherwise in-scope individuals, trusts, or other entities represented by discretionary asset managers or other licensed financial professionals. The preamble confirms that the term "retail investor" includes IRAs, but not participants in individual retirement account plans.[81] The Commission seeks comment on the exclusion of those participants.[82] This exclusion contrasts with the definition of a "retail customer" under the Regulation Best Interest, which includes those participants, as well as IRAs.[83]

Content of CRS

The CRS must cover the following items:

- Introduction
- Relationships and services the firm provides to retail investors (e.g., brokerage, advisory, or discretionary)
- Applicable standard of conduct
- Summary of fees and costs that retail investor will pay in connection with their account
- Comparison of brokerage and investment advisory services (not applicable for dual-registrants)
- Summary of conflicts of interest
- Location of additional information, including whether the firm and its financial professionals currently have reportable legal or disciplinary events, and persons to contact about complaints

---

[80] *Id.* at 15, n. 29 ("We believe it is beneficial to require firms to provide a relationship summary to all natural persons to facilitate their understanding of account choices, regardless of whether they will receive investment advice primarily for personal, family, or household purposes. The relationship summary is intended for an earlier stage in the relationship between an investor and a financial professional, potentially before discussing the investment purposes of the investor. In contrast, Regulation Best Interest focuses on recommendations to 'retail customers' who have chosen to engage the services of a broker-dealer after receiving the relationship summary.").

[81] *See* 26 U.S.C. § 408(a) (defining an IRA as a "*trust* created or organized in the United States for the exclusive benefit of an individual or his beneficiaries," provided the trust document meets certain conditions) (emphasis added); *see also* Form CRS Relationship Summary at 140 (citing "asset transfer due to an IRA rollover" as an example of an account change requiring delivery of a CRS); *cf*. *id.* at 27 (requesting comment on whether the definition of a retail investor should be expanded "to cover plan participants in workplace retirement plans who receive services from a broker-dealer or investment adviser for their individual accounts within a plan").

[82] Form CRS Relationship Summary at 27.

[83] Regulation Best Interest at 95 ("As proposed, the definition of 'retail customer,' including the limitation, would cover, for example, participants in ERISA-covered plans and IRAs.").

- Key questions for retail investors to ask the firm[84]

This list is exclusive. As explained in the preamble:

> Firms also would be prohibited from including any information other than what the Instructions and the applicable item require or permit. We believe that allowing only the required and specified permitted information would promote consistency of information presented to investors, allow retail investors to focus on information that we believe would be particularly helpful in deciding among firms, and help retail investors to decide what further information is needed.[85]

Consistent with its summary nature, the CRS is to contain only general information about fees and costs. The preamble explains that such information shall not include: (1) personalized or comprehensive fee disclosure; (2) examples of how fees could affect a retail investor's investment returns; or (3) range of fees.[86] Firms must indicate in the CRS whether their fees vary and are negotiable and disclose the existence of certain indirect fees (*e.g.,* mutual fund loads).[87] Firms are required to list all applicable non-transaction based fees retail investors will pay (*e.g.,* account maintenance fees, account inactivity fees, and custodian fees).[88] The proposal also prescribes several general fee-related statements, including statements regarding mark-ups and mark-downs, wrap fee programs, and fee-based conflicts. The general level of these disclosures may have been intended to protect confidential business information, given that a firm's CRS would be publicly available. For more detailed disclosure, investors would look to the requirements of Regulation Best Interest. The Commission seeks comment on whether additional detail should be required.[89]

The proposal does not require disclosure in the CRS of all conflicts that could be present in that relationship. For example, the preamble specifically states that the rule does not require disclosure on the firm's use of affiliated service providers, receipt of soft dollars, or charging of performance fees to some accounts, but not

---

[84] Form CRS Relationship Summary at 23, 287.

[85] *Id.* at 23.

[86] *Id.* at 60-65.

[87] *Id.* at 67.

[88] *Id.* at 67, 73.

[89] *Id.* at 78.

others.[90] Disclosure is required, however, on the existence of certain key conflicts, including those arising from proprietary products, third-party payments (such as revenue sharing), and principal trading.[91]

The proposal includes "mock-ups" or model CRS forms for broker-dealers, RIAs, and dual-registrants. The mock-ups illustrate the generality and extent of the required or permitted information, which is particularly helpful, given that information not specifically required or permitted in the CRS is prohibited.[92]

Presentation and Form of CRS

As noted above, the proposal contains detailed requirements on the presentation and form of the CRS to ensure that it remains a summary document that is helpful to retail investors. Firms are required to present disclosures "under prescribed headings in the same order."[93] The CRS "should be no more than four 8 ½ x 11 inch pages if converted to Portable Document Format (PDF), using at least an 11 point font size, and margins of at least 0.75 inches on all sides."[94] The proposal allows for some flexibility in presentation (*e.g.,* the use of charts, graphs, tables, or other graphics in some cases), but, aside from side-by-side comparisons in the mock-ups, gives no specific examples or illustrations.

Delivery and Filing of CRS

The proposed rule requires initial delivery of the CRS before or at the time the retail investor (1) first engages the broker-dealer's services, or (2) in the case of an RIA, enters into an investment advisory agreement. Dual-registrants must provide the CRS at the earlier of the retail investor engaging the firm's services or entering into an investment advisory agreement.[95]

Subsequently, the proposed rule requires firms to deliver the CRS before or at the time the retail investor opens a new account that is different from the existing account or makes changes to the existing account that materially alters the nature and scope of the relationship with the firm (e.g., transfers money from a brokerage to an advisory account).[96] Whether any change triggers an obligation to deliver the CRS anew depends on the

---

[90] *Id.* at 101-02 ("We are not proposing to require or permit the relationship summary disclosure to include specific information about all of the conflicts of interests that are or could be present in a firm's relationship with retail investors. For example, conflicts that can be applicable to investment advisers include using certain affiliated service providers, charging performance-based fees to some accounts but not others, personal trading by an adviser's personnel, receipt of soft dollar products and services provided by brokers in connection with client transactions, and voting client securities.").

[91] *Id.* at 98-99.

[92] *Id.* at 23.

[93] *Id.* at 23, 285.

[94] *Id.* at 19.

[95] *Id.* at 13-14.

[96] *Id.* at 140.

"specific facts and circumstances."[97] The proposal also requires that a CRS be delivered to a retail investor within 30 days of his request regardless of whether he previously received one.[98]

Firms are required to post their current CRS on their website, if they have one, in a location and format that is easily accessible to retail investors.[99] Any changes to the CRS must be separately reported to existing retail customers within 30 days after the amendments are required to be made.[100]

Broker-dealers are required to file their initial CRS with the SEC within six months of the effective date of the final rule.[101] RIAs and dual-registrants must amend their Form ADV by filing Form CRS as part of the next annual updating amendment after six months of the effective date of the final rule. Firms must deliver their CRS to existing retail clients within 30 days following this six-month transition period and must begin to deliver their CRS to new and prospective clients after the end of the period.[102]

Firms must maintain the CRS and all updates as part of their books and records and make them available to the SEC upon request.[103]

Part III – Restrictions on the Use of Certain Names and Titles and Required Disclosures

Titling Restrictions – Use of "Adviser" and "Advisor" by Broker-Dealers and Associated Persons

Given the traditional differences in business models, services offered, compensation structures, and legal obligations between broker-dealers and investment advisers, the SEC contends it is vital that investors better understand whether a firm is an investment adviser, broker-dealer, or both (or whether a financial professional is an associated/supervised person of a particular type of firm). To remedy potential consumer confusion about who they are hiring, for what services, and under what legal standard of conduct – a problem the regulators believe is prevalent – the SEC proposes, in conjunction with Form CRS, to restrict the use of certain names and titles by broker-dealers and their associated natural persons.

Specifically, the SEC proposes to restrict:

- Any broker-dealer and any natural person who is an associated person of such broker-dealer,
- when communicating with any retail investor,
- from using as part of its name or title

---

[97] *Id.* at 143.

[98] Form CRS Relationship Summary, Appendix B ("Instructions to Form CRS") at iv.

[99] Form CRS Relationship Summary at 146.

[100] *Id*. at 462.

[101] *Id*. at 463.

[102] *Id*.; Instructions to Form CRS at iii-iv.

[103] Form CRS Relationship Summary at 148.

- the words "adviser" or "advisor" (including in phrases like financial adviser, wealth adviser, trusted adviser, or advisory),

Unless:

- The broker-dealer is also an investment-adviser registered under the Advisers Act or with a state (i.e., is a dually registered firm), or
- The natural person associated with the broker-dealer is also a supervised person of an investment adviser registered under the Advisers Act or with a state and such person provides investment advice on behalf of the investment adviser.[104]

The proposal allows dually registered firms to use "advisor" or "adviser" in their titles, regardless of how the firm is acting/its capacity in any particular circumstances. For "dual-hatted" natural person financial professionals (*i.e.,* broker-dealer associated persons also supervised by an investment adviser), they are permitted to use "adviser" or "advisor" in their title only if they provide investment advice on behalf of the investment adviser. They may not, for example, use the restricted words if they only offer brokerage services to retail investors or if they are merely associated with a dually registered firm and do not provide investment adviser-supervised investment advice. As with dual-hatted firms, these professionals may use an advisor/adviser title, regardless of how they are acting in a particular circumstance (*e.g.,* only offering brokerage services to a particular client).[105]

Notably, the preamble to the proposal clarifies that the titling restriction would not apply to a broker-dealer's associated person when such person is acting on behalf of a bank, insurance company, municipal advisor, or a commodity trading advisor. This seems to lend itself to more consumer confusion, not less, because some financial professionals who are not investment advisers (or supervised persons thereof) may still use the restricted terms. It also creates a potential competitive disadvantage for some financial professionals, depending on their entity affiliation – even though, functionally and from the consumers' perspective, all of them are offering similar advisory services. Finally, it may be difficult for many financial professionals who interact with customers in multiple capacities in any given conversation (*e.g.,* offering insurance products as an insurance agent *and* offering brokerage services as a broker-dealer associated person) to delineate when they are "acting on behalf of" one supervising entity or another.

We perceive several other problems with the breadth of the proposed titling restrictions because the restricted words are so generic and pervasive in the financial services space, and *many* non-investment advisers/non-investment advisor-supervised persons are authorized to – and do in fact – provide financial advice to consumers. For instance, advising clients is a key triggering element of states' licensure requirement for insurance producers (who may or may not always be acting on behalf of an insurance company). Also, the Advisers Act permits people other than investment advisers, including broker-dealers, to give advice under certain circumstances. Thus, it is hard to reconcile (1) the ability to legally give advice incidental to a

---

[104] *Id.* at 176-77.

[105] *Id.* at 178.

transaction without being required to register, with (2) a restriction crafted such that you can only use the term "adviser" if you are registered.

Additionally, this element of the SEC's proposal seems at odds with the proposed Regulation Best Interest, which is fundamentally designed to ensure that broker-dealers and their associated persons provide *advice* in their clients' best interest. That proposal, along with Form CRS – which aim to minimize consumer confusion, clarify relationships, services, and distinctions between business models, among other things – may render this titling restriction confusing and difficult to implement.

Finally, the proposed titling restrictions would cause *more* investor confusion, as acknowledged by the SEC – and significant costs for impacted businesses. As noted above, it also may create inequities among classes of investment professionals, if insurance brokers, pension consultants, commodity advisors, and others can continue to call themselves investment advisers or financial advisers.

The proposal states that approximately 103 non-dually registered broker-dealers currently use "adviser," "advisor," or "advisory" as part of their company name.[106] Of those 103 firms, 16 reported having at least one type of non-securities business (*e.g.,* insurance business). About 31% of financial professionals providing brokerage services, the SEC reports, use "adviser" or "advisor" in their title. Ultimately, therefore, a new titling restriction like the one proposed would require *numerous* firms and professionals – many likely with long histories in the marketplace and long-standing client relationships – to change not only their name, but also their sales and marketing materials, legally required disclosure materials, signage, etc. Of course, this does not account for loss of brand value and recognition built up by these businesses.

Required Disclosures of Regulatory Status by Investment Advisers, Broker-Dealers, and Financial Professionals

Also under this part of the SEC's proposed package, broker-dealers, investment advisers, and dually registered firms would be required to prominently disclose their regulatory status with the SEC (*i.e.,* in what capacity/capacities they are registered) in print or electronic retail investor communications.[107] Similarly, natural persons associated with broker-dealers would have to prominently disclose their status and the status of the firm with which they are affiliated on such investor communications, as would RIA-supervised persons. Examples of appropriate language/disclosures include:

For a dually registered firm:

> "[Firm name], an SEC-registered broker-dealer and SEC-registered investment adviser, ..."

For a financial professional supervised by an investment adviser:

---

[106] *Id.* at 226.

[107] *Id.* at 193.

> "[Name of professional], a [title] of [Name of firm], a supervised person of an SEC-registered investment adviser."[108]

The scope of "print or electronic retail investor communications" is somewhat unclear under the proposal, but it appears that the SEC would interpret it broadly. For instance, for both broker-dealer associated persons and RIA-supervised persons, the proposal refers to including such disclosures in signature blocks or on business cards (which apparently constitute print communications). The proposal also references "publication by radio or television."[109]

To ensure prominence of these disclosures in print communications, the proposal would require them to be at least as large as, but in a font different from, the font used in the "majority" of the communication. For business cards, the proposal suggests, a prominent disclosure would have to be on the front of the card "in a manner clearly intended to draw attention to it." And for radio and television disclosures to be considered prominent, they would have to be "presented in a manner reasonably calculated to draw retail investors' attention to it."

These formatting and delivery requirements, which are perhaps some of the most prescriptive in the SEC's principles-based proposal, leave several additional issues open to interpretation. For example: What would draw a customer's attention and what would not? Does a financial professional have to send a disclosure on every email ever sent to a client, even after a years-long relationship? How about every invoice sent to a client, and would such invoice disclosures have to be tailored to the types of services offered to that particular client during the invoice period (*e.g.,* if in the second quarter, this client received only brokerage services, would the disclosure change for a dually registered firm)?

The SEC suggests using a staged compliance date (not specified in the rule) for this portion of its package to allow for development and circulation of new materials. Moreover, the preamble clarifies that the proposed rule would not require new communications to replace all older print communications.

The Road Ahead

If the commissioners' comments at the hearing last week provide any indication, it seems likely that the final rules ultimately agreed upon by a majority of the commissioners will contain some significant differences from these proposals. Most of the commissioners seemed to agree, for instance, that the proposed rule was confusing in key areas – including what "best interest" means. Interested parties will have 90 days to comment on the proposed rules once they are published in the Federal Register, which will take this proposal process until at least late-July. The SEC will then have to digest and evaluate the comments it receives, and it is possible that the Commission will then put out another proposal for additional comment. Any final rules eventually adopted are not likely to be released, therefore, until 2019 at the earliest.

***

If you have any questions about this alert, please contact Melanie Nussdorf at +1 202 429 3009; Eric Serron at +1 202 429 6470; Patrick Menasco at +1 202 429 6215; Joni Andrioff at +1 312 577 1304; Scott Sinder at +1

---

[108] *Id.* at 194.

[109] *Id.* at 196.

202 429 6289; Micah Green at +1 202 429 6290; Carolyn Walsh at +1 202 429 6251; Chris Conte at +1 202 429 6425; Kate Jensen at +1 202 429 6259; Josh Oppenheimer at +1 202 429 6423; Bibek Pandey at +1 202 429 6417; Oz Vazquez at +1 202 429 3914; or Tim Work at +1 202 429 8073.