SEC Finalizes Best Interest Standard For Brokers, Related Disclosure Requirements, And Issues Interpretations Under The Advisers Act

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Overview

On June 5, 2019, the Securities and Exchange Commission (SEC or Commission) voted 3-to-1 (Commissioner Robert J. Jackson Jr. dissenting) to finalize a new set of rules for broker-dealers serving retail customers. Specifically, the rules (1) create a “best interest” standard of conduct for broker-dealers and natural persons who are associated persons of a broker-dealer (collectively and for brevity, brokers, unless noted otherwise herein); (2) improve disclosure through summary forms and clarify relationships among brokers, advisers, and their retail customers; (3) clarify the fiduciary standards for advisers under the Investment Advisers Act of 1940 (Advisers Act); and (4) clarify the term “solely incidental,” which forms the basis of an exclusion from the requirements of the Advisers Act for brokers providing advice to brokerage clients. The rules are largely similar to the rules proposed by the Commission on April 18, 2018, with some notable exceptions.

This is the second time in the last three years that brokers have been faced with the obligation to make significant changes in their compliance structure. In the interim period between the proposed and final SEC rules, the Fifth Circuit vacated in toto the Department of Labor’s (DOL) fiduciary regulation (DOL Fiduciary Rule) and its Best Interest Contract (BIC) Exemption, and amendments to previously granted exemptions in connection with the adoption of the DOL Fiduciary Rule. Those rules effectively limited the transaction-based fee model, sharply limited the securities that a dealer could trade as principal, and because of their excise tax penalty and private right of litigation, encouraged brokers to flee to an advisory fee model. Brokers spent millions of dollars attempting to comply with the rules before they were overturned by the Fifth Circuit. Unlike the DOL’s impartial conduct standards, the SEC’s final rules apply to brokers when making recommendations to all retail customers (not just retirement investors), and will be enforced by the SEC (not by private right of action). The final release emphasizes the Commission’s intent to avoid the market effects of the DOL rules, which, in the Commission’s view, limited investor choice and pushed accounts to fee-based structures.
The rule package includes the following components:

- **Regulation Best Interest (Regulation BI)** – a "best interest" standard of conduct for brokers with specific disclosure, care, conflict of interest, and compliance obligations; and which effectively incorporates the proposed rule's "adviser/advisor" titling restrictions for non-dual licensed associated persons (with some positive modifications);

- **Form CRS Relationship Summary (Form CRS)** – a high-level, two- or four-page disclosure document for brokers and investment advisers describing services offered, compensation arrangements, conflicts of interest, and standards of conduct owed to clients, designed to allow investors to compare the options for financial firms and professionals available to them;

- **Interpretation of an Investment Adviser's Federal Fiduciary Duty** – a consolidated interpretation of investment advisers' federal fiduciary standard, including its underlying duties of care and loyalty, which seeks to reaffirm and clarify previous guidance under the Advisers Act and court decisions; and

- **Interpretation of the "Solely Incidental" Exclusion for Brokers under the Advisers Act** – affirms and clarifies prior guidance regarding brokers' permissible "advice" activities that will not bring them within the investment adviser definition or the investment adviser regulatory structure, and provides examples of the interpretation as applied to situations in which brokers exercise some discretionary authority over accounts and engage in account monitoring.

This memorandum describes each of these components in detail. Regulation BI and Form CRS are effective 60 days after publication in the Federal Register and have a compliance date of June 30, 2020. The two interpretations are effective immediately upon publication in the Federal Register.

Click here to download the full report (PDF).

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[1] Regulation Best Interest: The Broker-Dealer Standard of Conduct, Release No. 34-86031 (June 5, 2019) [hereinafter "Regulation Best Interest"]. The final 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, Release No. 34-86032 (June 5, 2019) [hereinafter "Form CRS"].


[5] Regulation Best Interest [Proposed], 83 Fed. Reg. 21574 (May 9, 2018); Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles, Investment Advisers Act [Proposed], 83 Fed. Reg. 21416 (May 9, 2018); Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, 83 Fed. Reg. 21203 (May 9, 2018). The Commission did not propose an interpretation of the phrase "solely incidental" as part of its proposed rule package. Read Steptoe's release on the proposed rule package here.


[10] Chamber of Commerce v. U.S. Dept of Labor, 885 F.3d 360 (5th Cir. 2018). The DOL neither sought rehearing en banc nor certiorari to the Supreme Court. It also has yet to change its website or publish a notice in the Federal Register withdrawing the rule from the Code of Federal Regulations and making clear that current law revives the rules and the accompanying exemptions as they existed prior to April 2016. The DOL Fiduciary Rule would have required brokers, 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 regard to their own financial or other interests. The applicable exemptions contained a contractual commitment and a private right of action, even though, at least for individual retirement accounts (IRAs), the law did not provide for private litigation.
