

SEC Adopts New Broker-Dealer Rule, Also Affecting Investment Advisers

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Practice Area: Securities Law

On June 5, 2019, the Securities and Exchange Commission ("SEC") adopted Regulation Best Interest, the final rule governing broker-dealer conduct and their obligations to retail customers, under authority from Section 913 of the Dodd-Frank Act. The new rule will go into effect on June 30, 2020 and will increase broker-dealers' standard of conduct from existing suitability standards. The SEC considered increasing such standards to the level of a fiduciary, as was the case pursuant to the now-vacated Fiduciary Rule, but ultimately settled on intermediate standards consistent with broker-dealers' role in the investment services sector. These new standards have two tiers of obligations: General and Specific Component Obligations.

Scope and General Obligation

Regulation Best Interest, except as mentioned below, only applies to broker-dealers, not registered investment advisors. It requires brokers, dealers, and natural persons associated with brokers or dealers (collectively, "broker-dealers") to act in the best interest of the retail customer when making a recommendation of any securities transactions or investment strategies. Broker-dealers must also place the retail customer's interests ahead of their own. The General Obligation applies to each recommendation and generally does not create a continuous obligation. "Best interest" is deliberately undefined and depends on the facts and circumstances of the specific recommendation and the specific retail customer, as determined at the time of the recommendation. Recommendations are not limited to recommendations to buy, sell, or hold a particular security or an investment strategy. Rather, "recommendations" are defined broadly and include such recommendations as account type (e.g., 401(k) versus traditional IRA) or implicit hold recommendations. An implicit hold is only considered a recommendation if the broker-dealer has agreed to provide account monitoring services for the retail customer. If the broker-dealer who is monitoring the retail customer's account does not recommend any action with respect to a security, then he or she has, in effect, recommended that the retail customer hold the security.

Specific Component Obligations

In addition to satisfying the General Obligation, broker-dealers must also satisfy four Specific Component Obligations: (1) the Disclosure Obligation; (2) the Care Obligation; (3) the Conflict of Interest Obligation; and (4) the Compliance Obligation. While structurally these Specific Component Obligations appear to be a safe harbor, the SEC explicitly stated that the Specific Component Obligations are mandatory obligations and not a safe harbor. Failing to comply with any Specific Component Obligation would also violate the General Obligation.

Disclosure Obligation

At or prior to the time of a recommendation, the broker-dealer must make full and fair disclosure of all material facts related to the broker-dealer-customer relationship, including, without limitation, material fees and costs, the type and scope of services provided, along with any material limitation on the securities or investment strategies that may be recommended, and all material facts related to conflicts of interest that are associated with the recommendation.

The broker-dealer must make the disclosures by using Form CRS, which provides certain specific items and certain mandatory language. Form CRS must be filed with the SEC and delivered to retail customers. Such delivery must occur before or at the same time that the broker-dealer makes any recommendation, regardless of whether the retail customer is an existing customer or new customer. Additionally, Form CRS must be easily publicly accessible on the broker-dealer's website. If the broker-dealer updates its Form CRS, then the broker-dealer must deliver such updated Form CRS to each existing retail customer within 60 days after the update, at no cost to the customer. The Form CRS must also be delivered within 30 days upon request by a retail customer.

Care Obligation

The Care Obligation comprises of three components: (1) general best interest; (2) specific best interest; and (3) serial best interest.

General Best Interest

Broker-dealers must exercise reasonable diligence, care, and skill to understand the risks, rewards, and costs with each recommendation, and have a reasonable basis to believe that such recommendation could be in the best interest of at least some customers. This obligation serves as a minimum level of care and competence such that the broker-dealer exercises sufficient care to serve at least some customers.

Specific Best Interest

While the general best interest requirement is a baseline level of care and competence, the specific best interest requires care and competence when tailoring advice to the specific customer. Broker-dealers must have a reasonable basis to believe that the recommendation is in the best interest of the customer given his or her investment profile and the risks, rewards, and costs associated with the recommendation.

"Investment profile" includes, without limitation, characteristics such as: age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, and risk tolerance. Investment profile also includes any other information that the customer discloses to the broker-dealer.

Serial Best Interest

The Care Obligation must be satisfied among a series of transactions, which cannot be excessive, when viewed in their entirety and even if the isolated transactions satisfy the Care Obligation. Again, the broker-dealer must consider the retail customer's investment profile in making recommendations and have a reasonable basis to believe the recommendation is in the best interest of the customer. The purpose of this requirement is to prevent churning practices, which may, in isolation, be in the best interest of the customer, but viewed in totality may be inconsistent with the customer's investment profile.

Conflict of Interest Obligation

The Conflict of Interest Obligation requires that broker-dealers identify, and either disclose or eliminate, all conflicts of interest and material limitations associated with the broker-dealer's recommendations. Broker-dealers must identify and mitigate any conflicts of interest with any recommendation that creates financial incentives that place the broker-dealers' interests ahead of the best interest of the customer. For material limitations, the broker-dealer must prevent such limitations from placing their interests ahead of the customer. Certain pay structures for broker-dealers explicitly violate the Conflict of Interest Obligation, such as: sales contests, sales quotas, and bonuses and non-cash compensation, each based on the sale of specific securities or specific types of securities. These practices must be identified and eliminated to comply with the Conflict of Interest Obligation.

Broker-dealers must establish, maintain, and enforce written policies and procedures reasonably designed to comply with the Conflict of Interest Obligation.

Compliance Obligation

In addition to the other requirements, broker-dealers must also establish, maintain, and enforce written policies and procedures reasonably designed to be compliant with the overall Regulation Best Interest.

Remedies

The SEC did not include a private cause of action for violations of Regulation Best Interest. Indeed, it stated in adopting the final rule that no such private cause of action was created or intended.

Registered Investment Advisors Reporting Requirement

Regulation Best Interest applies only to broker-dealers. Provided that registered investment advisors do not also provide broker-dealer services, Regulation Best Interest does not apply. Nonetheless, registered investment advisors who are registered with the SEC or are exempt reporting advisors will be required to prepare and file the new Form ADV, Part 3, which incorporates Form CRS, beginning on June 30, 2020.

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