Chapman and Cutler LLP

Chapman Client Alert

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Current Issues Relevant to Our Clients

SEC Adopts Broker-Dealer "Best Interest" Standard, Disclosure Form and Investment Advisers Act Interpretations

Today, the Securities and Exchange Commission (the *"SEC"*) voted 3 to 1 to adopt highly anticipated new and amended rules, forms and guidance relating to registered investment advisers' and broker-dealers' conduct and interactions with retail customers. Specifically, the SEC has adopted the following:

1. Regulation Best Interest—A new rule to establish a "best interest" standard for broker-dealers and their associated persons when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer. The related SEC release is available here.

2. Form CRS—New and amended rules and forms to require registered investment advisers and registered broker-dealers to provide a brief relationship summary to retail investors and file the form with the SEC. The related SEC release is available here.

3. Standard of Conduct for Investment Advisers—A new interpretation of the standard of conduct for investment advisers. The related SEC release is available here.

4. Guidance on the Meaning of "Solely Incidental" Investment Advice—A new interpretation of the "solely incidental" prong of the broker-dealer exclusion from the definition of investment adviser under the Investment Advisers Act of 1940 (the *"Advisers Act"*). This is intended to delineate more clearly when a broker-dealer's performance of advisory activities causes it to become an investment adviser within the meaning of the Advisers Act. The related SEC release is available here.

The initial compliance dates for Regulation Best Interest and Form CRS are June 30, 2020. The effective date for the two interpretive releases will be the date of publication in the Federal Register.

While the final rulemaking package was similar to the original proposal, there are several noteworthy differences, including:

- Expansion of the scope of the best interest obligation to apply to recommendations of account types (such as brokerage or advisory), roll overs or transfers of assets in a workplace retirement plan account to an IRA, and recommendations to take a plan distribution;

- The addition of a fourth "compliance" prong of the best interest obligation that will require broker-dealers to adopt policies and procedures reasonably designed to achieve compliance with Regulation Best Interest as a whole;

- An explicit requirement that broker-dealers understand and consider the potential costs associated with a recommendation along with the potential risks and rewards;

- The requirement that broker-dealers adopt policies and procedures to eliminate sales contests, sales quotas bonuses, and non-cash compensation that are based on the sale of specific securities or specific types of securities within a limited period of time;

- Adoption of the guidance regarding the "solely incidental" prong of the broker-dealer exclusion noted above; and

- Elimination of broker-dealer title restrictions as a standalone rule while at the same time providing guidance that use of the terms "advisor" or "adviser" by (1) a broker-dealer that is not also registered as an investment adviser or (2) a financial professional that is not also a supervised person of an investment adviser would be presumptive violations of the disclosure obligation of the best interest obligation.

All but Commissioner Jackson voted in favor of the new rules and interpretations. The following is a brief analysis of the new rules and interpretations and background information. We will provide more detailed analysis and reactions in an additional Client Alert in the coming days.

Rulemaking Highlights

Regulation Best Interest

The SEC has adopted new Regulation Best Interest under the Securities Exchange Act of 1934 that would establish a standard of conduct for broker-dealers and natural persons who are associated persons of a broker-dealer when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer. In general, Regulation Best Interest would impose on broker-dealers, when making such recommendations, a duty to 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 ahead of the interest of the retail customer. A broker-dealer would satisfy this duty by complying with four specific obligations:

1. Disclosure Obligation—Prior to or at the time of the recommendation, a broker-dealer must provide to the retail customer, in writing, full and fair disclosure of all material facts related to the scope and terms of the relationship with the retail customer and all material facts relating to conflicts of interest that are associated with the recommendation. This includes a disclosure that the firm or representative is acting in a broker-dealer capacity, the material fees and costs the customer will incur, and the type and scope of the services to be provided, including any material limitations on the recommendations that could be made to the retail customer. Moreover, the broker-dealer must disclose all material facts relating to conflicts of interest associated with the recommendation that might incline a broker-dealer to make a recommendation that is not disinterested.

2. Care Obligation—A broker-dealer must exercise reasonable diligence, care, and skill when making a recommendation to a retail customer. The broker-dealer must understand potential risks, rewards, and costs associated with the recommendation. The broker-dealer must then consider those risks, rewards, and costs in light of the customer's investment profile and have a reasonable basis to believe that the recommendation is in the customer's best interest and does not place the broker-dealer's interest ahead of the retail customer's interest. A broker-dealer should consider reasonable alternatives, if any, offered by the broker-dealer in determining whether it has a reasonable basis for making the recommendation. When recommending a series of transactions, the broker-dealer must have a reasonable basis to believe that the transactions taken together are not excessive, even if each is in the customer's best interest when viewed in isolation.

3. Conflict of Interest Obligation—A broker-dealer must establish, maintain, and enforce reasonably designed written policies and procedures addressing conflicts of interest associated with its recommendations to retail customers. These policies and procedures must be reasonably designed to identify all such conflicts and at a minimum disclose or eliminate them. Importantly, the policies and procedures must be reasonably designed to mitigate conflicts of interests that create an incentive for an associated person of the broker-dealer to place its interests or the interest of the firm ahead of the retail customer's interest. Moreover, when a broker-dealer places material limitations on recommendations that may be made to a retail customer (*e.g.,* offering only proprietary or other limited range of products), the policies and procedures must be reasonably designed to disclose the limitations and associated conflicts and to prevent the limitations from causing the associated person or broker-dealer from placing the associated person's or broker-dealer's interests ahead of the customer's interest. Finally, the policies and procedures must be reasonably designed to identify and eliminate sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sale of specific securities or specific types of securities within a limited period of time.

4. Compliance Obligation—A broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest as a whole.

Importantly, this "best interest" standard would apply not just when making a recommendation related to securities or an investment strategy involving securities, but also to recommendations regarding account types, roll overs or transfers of assets in a workplace retirement plan account to an IRA, and recommendations to take a plan distribution.

It is also notable that the standard of conduct under Regulation Best Interest is an independent standard applicable only to broker-dealers that is not specifically the same as or tied to the conduct standard applicable to registered investment advisers.

Form CRS

The SEC has adopted new and amended rules and forms to require registered broker-dealers and registered investment advisers to provide a brief relationship summary to retail investors on new Form CRS as well as certain disclosures in communications to retail investors. Form CRS will be limited in length to two pages for standalone broker-dealers and registered investment advisers and four pages for dual registrants. Form CRS will require disclosure and explanation of (1) the types of client and customer relationships and

services the firm offers; (2) the fees, costs, conflicts of interest, and required standard of conduct associated with those relationships and services; (3) whether the firm and its financial professionals currently have reportable legal or disciplinary history; and (4) how to obtain additional information about the firm. The relationship summary is subject to SEC filing and recordkeeping requirements.

Title Restrictions

The SEC has declined to adopt its proposed rule that would have restricted broker-dealers and their associated persons from using the term "adviser" or "advisors" as part of their name or title when communicating with a retail investor. Instead, the SEC has stated its presumption that the use of the terms "adviser" and "advisor" in a name or title by (1) a broker-dealer that is not also registered as an investment adviser or (2) an associated person that is not also a supervised person of an investment adviser to be a violation of the capacity disclosure requirement under Regulation Best Interest. Although using such names or titles creates a presumption of a violation of the disclosure obligation in Regulation Best Interest, the SEC is not expressly prohibiting the use of such names and titles by broker-dealers as it recognizes that some broker-dealers use them to reflect a business of providing advice other than investment advice to retail clients. For example, a broker-dealer (or associated person) that acts on behalf of a municipal advisor or commodity trading adviser, or as an advisor to a special entity, is acting in a distinct advisory role specifically defined by federal statute that does not entail providing investment advisory services. In these and other circumstances, firms and their financial professionals may in their discretion use the terms "adviser" or "advisor." In most instances, however, when a broker-dealer uses these terms in its name or title in the context of providing investment advice to a retail customer, the SEC stated its view that such broker-dealer will generally violate the capacity disclosure requirement under Regulation Best Interest.

Standard of Conduct for Investment Advisers

The SEC has adopted a new interpretation of the standard of conduct for investment advisers. Generally, the staff intends this interpretation to reaffirm, and in some cases clarify, certain aspects of the fiduciary duty that an investment adviser owes to its clients.

Interpretation of "Solely Incidental"

The SEC has adopted a new interpretation of the "solely incidental" prong of the broker-dealer exclusion under the Advisers Act, which excludes from the definition of investment adviser—and thus from the application of the Advisers Act—a broker or dealer whose performance of advisory services is solely incidental to the conduct of his or her business as a broker or dealer and who receives no special compensation for those services. Significantly, this interpretation was not included in the rulemaking package as originally proposed. Even if a broker-dealer's services are consistent with this "solely incidental" interpretation, the broker-dealer must also receive no special compensation for the activity to be eligible for the broker-dealer exclusion. Broker-dealers receive special compensation where there is a clearly definable charge for investment advice.

For More Information

If you would like to discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

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