

# Chapman Client Alert

April 18, 2018

Current Issues Relevant to Our Clients

## SEC Proposes Broker-Dealer “Best Interest” Standard, Disclosure Form, Title Restrictions and Investment Adviser Conduct Guidance

Today, the Securities and Exchange Commission (the “*Commission*”) voted 4 to 1 to propose highly anticipated new and amended rules and guidance relating to registered investment advisers’ and broker-dealers’ conduct and interactions with retail customers. Specifically, the Commission is proposing the following:

1. **Regulation Best Interest**—A new rule to establish a “best interest” standard 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 to a retail customer. The text of proposed Rule 15l-1 under the Securities Exchange Act of 1934 is available [here](#).
2. **Form CRS and Title Restrictions**—New and amended rules and forms to require registered investment advisers and registered broker-dealers to provide a brief relationship summary to retail investors. Examples of new Form CRS are available [here](#) (dual registrant), [here](#) (standalone broker-dealer) and [here](#) (standalone investment adviser).
3. **Standard of Conduct for Investment Advisers**—A new interpretation of the standard of conduct for investment advisers.

Notably, many of the characteristics of the “best interest” standard and disclosure requirements applicable to broker-dealers are similar to those in the 2015 Securities Industry and Financial Markets Association (“*SIFMA*”) “best interest of the customer” proposal, which is described in our Client Alert available [here](#). Although several commissioners expressed serious concerns about various aspects of the proposals, all but Commissioner Stein voted in favor of releasing the proposals for public comment. It remains unclear how the Commissioners would vote on any final rules or guidance.

The following is a brief analysis of the proposals and background information. We will provide more detailed analysis and reactions in an additional Client Alert in the coming days.

### Proposal Highlights

#### Regulation Best Interest

The Commission has proposed 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 a retail customer. In general, Regulation Best Interest would impose on broker-dealers, when interacting with retail customers, 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 discharge this duty by complying with three specific obligations:

1. **Disclosure Obligation**—Disclose to the retail customer the key facts about the relationship, including material conflicts of interest.
2. **Care Obligation**—Exercise reasonable diligence, care and prudence to (i) understand the product, (ii) have a reasonable basis to believe that the product is in the retail customer’s best interest and (iii) have a reasonable basis to believe that a series of transactions is in the retail customer’s best interest.

3. Conflict of Interest Obligation—Establish, maintain and enforce policies and procedures reasonably designed to identify and then at a minimum to disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives. Other material conflicts of interest must be at least disclosed.

Importantly, this “best interest” standard would apply not just when making a recommendation related to securities, but also for any type of financial advice, including recommendations regarding rollovers.

It is also notable that the standard of conduct under proposed 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. This could introduce questions about the Commission’s authority to adopt such a regulation pursuant to the power granted to the Commission as part of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (the “*Dodd-Frank Act*”), as discussed below.

#### Form CRS and Title Restrictions

The Commission has proposed new and amended rules 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. Proposed Form CRS would be limited in length to four pages and would require disclosure and explanation of (i) the principal types of services offered, (ii) the legal standard of conduct applicable to the broker-dealer or investment adviser, (iii) the applicable fees the retail customer may pay and (iv) certain conflicts of interest. In addition, the Commission has proposed to restrict the use of the term “adviser” or “advisor” as part of a broker-dealer’s name or title under the rationale that such terms would mislead investors into believing that a broker-dealer is a registered investment adviser.

#### Standard of Conduct for Investment Advisers

The Commission has proposed a new interpretation of the standard of conduct for investment advisers. Generally, the staff expects this interpretation to reaffirm, and in some cases clarify, certain aspects of the fiduciary duty that an investment adviser owes to its clients. The Commission also sought comment on proposals to modernize and enhance the rules regarding registered investment advisers’ standard of conduct.

## Background

As Congress discussed what would become the Dodd-Frank Act, the possibility of a uniform statutory standard of conduct for broker-dealers and investment advisers was a hotly debated topic. In the end, the House and Senate did not agree on setting a statutory duty standard and the Dodd-Frank Act ultimately pushed the issue to the Commission. The Dodd-Frank Act did this by amending the Securities Exchange Act of 1934 and Investment Advisers Act of 1940 to expressly permit the Commission to adopt rules that provide a standard of conduct for broker-dealers and investment advisers when they provide personalized investment advice about securities to retail customers. The Dodd-Frank Act also required the Commission staff to conduct a study (the “*Study*”) of the legal and regulatory requirements applicable to broker-dealers, investment advisers and associated persons who provide personalized investment advice and recommendations about securities to retail customers.

The Commission initially published a request for public comment related to these issues in July 2010 in a release available [here](#). The SEC used that information in connection with the Study, which the Commission released in January 2011 and is available [here](#). The Commission’s staff made two basic recommendations in the Study. The first was for the Commission to exercise its discretionary powers under the Dodd-Frank Act to implement a uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice to retail customers. The second recommendation was for the Commission to consider harmonizing the regulatory requirements of broker-dealers and investment advisers if the staff finds, after additional inquiry, that such harmonization would provide additional investor protection. In March 2013, the Commission sought additional public input regarding the effects of a uniform fiduciary standard in a release available [here](#). On June 1, 2017, Chairman Jay Clayton announced that the Commission would seek further public comment from retail investors and other interested parties on the standards of conduct applicable to broker-dealers and investment advisers. Since that time, however, the Commission has not taken any official public action towards implementation of the Study’s recommendations.

In the absence of regulation by the Commission, in April 2016 the Department of Labor (the “*DOL*”) adopted its own rule to define the term “fiduciary” and address conflicts of interest in providing investment advice to retirement account investors. The final rule generally requires those who provide retirement investment advice to employee benefit plans and individual retirement accounts to abide by a fiduciary standard. The DOL

also adopted related exemptions that provided requirements that must be satisfied to prevent prohibited transactions under the Employee Retirement Income Security Act of 1974 and Internal Revenue Code. The rule and exemptions were to become applicable on April 9, 2017 but the 2016 presidential election introduced uncertainty to whether the rule would actually become applicable on that date. Shortly after taking office, President Trump directed a new review of the DOL's fiduciary rule with an eye towards full repeal or significant revisions. After requesting additional comment on the rule and delays of the applicability date, the DOL ultimately delayed the applicability date until June 9, 2017 and delayed full compliance with certain significant parts of the exemptions multiple times until July 19, 2018. However, on March 15, 2018, in a case challenging the DOL's authority to issue the rule, the U.S. Court of Appeals for the Fifth Circuit issued a ruling and judgment vacating the DOL's fiduciary rule in its entirety. While the period for the DOL to appeal that decision will expire after the mandate from the Fifth Circuit is issued on May 7, 2018 (absent a request for an extension of the issuance of the mandate by the DOL as it considers whether to seek appeal to the Supreme Court of the United States), the Fifth Circuit's ruling puts the fate of the DOL's fiduciary rule in serious jeopardy.

The Commission's new proposal represents the most important step to date to implement the recommendations of the Study as well as provide a regulatory alternative to the DOL's embattled fiduciary rule.

### What's Next?

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Comments will be accepted on each of the proposals for the 90-day period after the proposals' publication in the Federal Register. The full text of the proposals, including instructions on how to submit comments, are available [here](#) (the Regulation Best Interest proposal), [here](#) (the Form CRS and title restrictions proposal) and [here](#) (the standard of conduct for registered investment advisers proposal).

### For More Information

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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](http://chapman.com).

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