Blogs
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The SEC’s Fiduciary Rule Proposal — Implications for Investment Advisers (Part 4)

Welcome back for Part 4, the final installment in our discussion of the SEC's April 18, 2018 fiduciary rulemaking proposal (the "Proposal"). We will summarize the SEC's proposed Regulation Best Interest ("Regulation BI"), which seeks to create a "best interest" fiduciary duty standard for broker?dealer relationships with retail customers. We will then delve into some of the specific requirements and open questions surrounding the regulation.

Regulation Best Interest

Background. Regulation BI would add Rule 15*l*-1 under the Securities Exchange Act of 1934 (the "Exchange Act") to establish a standard of conduct for broker?dealers when making securities recommendations or investment strategy recommendations to retail customers. The SEC's Proposal notes that while a number of cases have interpreted the "suitability" requirements and other rules of the Financial Industry Regulatory Authority ("FINRA") as requiring broker?dealers to only make recommendations "consistent with [the] customers' best interests," this requirement is not explicit in FINRA's rules. The uncertainty has left retail investors without the protection of any form of a broker?dealer fiduciary rule. ***General Requirements.*** Under Regulation BI, broker-dealers making a recommendation would specifically be required "to act in the best interest of the retail consumer" at the time a recommendation is made, "without placing the financial or other interest [of the broker?dealer] ahead of the interest of the retail customer." Unlike the language of Section 913 of the Dodd?Frank Act, which permits the SEC to promulgate rules enforcing a best interest standard of conduct for broker?dealers and investment advisers that is determined "without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice," Regulation BI allows a broker?dealer to consider its own interests, but requires that they be subordinated to those of the customer. ***Standards.*** Under Regulation BI, the best interest obligation is satisfied if three obligations are met:

- Disclosure Obligation - Reasonably disclosing to the customer in writing the material facts about the scope and terms of the relationship, including all related material conflicts of interest;
- Care Obligation- Exercising "reasonable diligence, care, skill, and prudence" (i) to understand the product being recommended, and (ii) form a reasonable basis to believe the recommended product is in the customer's "best interest" when considering the retail customer's investment profile; and
- Conflict of Interest Obligation - Establishing, maintaining and enforcing written policies and procedures reasonably designed to identify, disclose, mitigate, or eliminate material conflicts of interest arising from financial incentives.

Recordkeeping. Regulation BI would amend current recordkeeping rules to require broker-dealers to retain all information collected from or provided to a retail customer pursuant to Regulation BI for a minimum of six years. ***Limitation of Liability.*** Under Section 29(a) of the Exchange Act, a broker?dealer cannot waive the best interest obligation and, per Regulation BI, a retail customer cannot agree to waive protection under the regulation. Therefore, although the scope of the specific *engagement* can be provided for by contract, the scope of Regulation BI itself cannot be reduced by contract. The SEC further notes that no private right of action is intended to be created under Regulation BI, pointing to its Regulation BI authority pursuant to Section 913 of Dodd-Frank and Section 15(l) of the Exchange Act, which do not create private rights of action or rescission.

Open Questions

The SEC expressed concern at the open meeting, and requested further comments to the Proposal, to seek guidance as to whether Regulation BI and its three?part "safe harbor" (i) provide sufficient guardrails for broker?

dealers to monitor their compliance with the rule, (ii) are not overly duplicative of existing FINRA rules governing broker?dealer conduct, and (iii) establish strong enough of a fiduciary duty for broker?dealers to adequately protect retail investors. The SEC also asks whether commenters agree with the SEC's interpretation that Regulation BI would not create a private right of action.

Future Posts

While this is the final installment for now regarding the Proposal, stay tuned for updates. Comments to the proposal continue coming in, and industry groups are likely digesting the Proposal and formulating their own stances to relay to the Commission. The SEC has also stated that it will provide updated information to the Proposal's comment file as it becomes available. Please continue to follow our blog to stay up-to-date on these and other future developments regarding the Proposal. Until next time…

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