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IN FOCUS

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The SEC's Best Interest Proposal for Advice Given by Broker-Dealers

Introduction

In April 2018, the Securities and Exchange Commission (SEC) proposed a change to the standard of care imposed on broker-dealers giving investment advice to retail investors. As described further below, *broker-dealers* are generally required to provide investment advice that is suitable for their clients with respect to factors like a client's financial goals and needs. In contrast, *investment advisors* are held to a higher, fiduciary standard, which requires they serve the best interests of their clients and subordinate their own interests to that of their clients. The SEC's new "best interest" proposal would require a broker-dealer "to act in the best interest of a retail customer when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer." The proposed rule has been controversial, with Members of Congress, industry advisors, and consumer protection groups all expressing views. This In Focus provides background on the proposed rule and describes the policy debate surrounding the rule. SEC Chairman Jay Clayton has announced that completing the rule will be a key priority for the SEC during 2019.

Background

Broker-dealer firms or their affiliated persons act as brokers when they execute securities trades for their clients and as dealers when they trade their own securities for their own benefit. Broker-dealers are largely regulated by the Securities Exchange Act of 1934 (Exchange Act; P.L. 73-291) and principally overseen by the Financial Industry Regulatory Authority (FINRA, an SEC-regulated entity).

Investment advisers are firms or persons who provide investment advice directly to their clients, including individuals and institutional investors such as mutual funds and hedge funds. In general, advisers with over $110 million in assets under management must register with the SEC under the Investment Advisers Act of 1940 (IAA, which regulates key aspects of investment advisers, 54 Stat. 847). States generally register investment adviser firms with lesser amounts under management.

Historically, brokers largely acted as securities trade facilitators compensated through transaction-based commissions. Advisers were largely responsible for providing investment advice and were typically remunerated through annual management fees, asset-based fees, or a percentage of assets managed.

Although not expressly written in the IAA, court rulings and decisions from SEC enforcement cases have led to an established investment adviser standard of retail client care, known as the fiduciary standard. Under the fiduciary standard, advisers are generally expected to serve the best interests of their clients and are required to subordinate their own interests to that of their clients. Additional expectations include the notion that a financial adviser shall either eliminate material conflicts of interest or will be fully transparent to the client about the existence of such conflicts.

By contrast, broker-dealers are generally subject to a less demanding standard of client care found in FINRA rules, the suitability standard. The suitability standard requires broker-dealers to reasonably believe that their investment advice is suitable for their clients with respect to factors such as a client's financial goals and needs. (Broker-dealers, however, are subject to a fiduciary standard in either of two circumstances: (1) when they have control of a client's discretionary account, meaning that they have a client's authority to buy and sell securities on the client's behalf; or (2) in a few states such as California, Missouri, South Dakota, and South Carolina where state courts have "imposed an unambiguous fiduciary standard" on them.)

Over time, the roles of various broker-dealers and investment advisers have converged. While differences remain, many broker-dealers today offer advisory services, such as investment planning and retirement planning similar to services offered by investment advisers. Potentially compounding this confusion is the fact that many financial firms are so-called dual-registered firms. Overseen by FINRA, they are registered as both broker-dealers and investment advisers. As a consequence, various surveys report that retail customers suffer from significant confusion regarding the distinctions between broker-dealers and advisers as well as the legal import of those differences.

In 2017, according to FINRA, approximately 30,000 firms were registered solely as investment advisers; 3,100 firms were registered solely as broker-dealers; and 600 firms were dual registered.

The Best Interest Proposal

Propelled in part by concerns over investor confusion between investment advisors and broker-dealers, Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act; P.L. 111-203) did a number of things, including granting the SEC the authority to impose fiduciary rules on broker-dealers subject to certain conditions and requiring the SEC to conduct a study on various aspects of retail investor standards of client care. Released in 2011, the required SEC study recommended a uniform fiduciary standard for retail advice given by all types of financial professionals, including broker-dealers, under the SEC's regulatory ambit.

On April 18, 2018, SEC staff issued a package of three proposals involving the duty of care financial professionals owe to retail investors, which were adopted by the agency's commissioners with one dissenting vote. The three proposals are (1) the Investment Adviser Interpretation, which would reaffirm and clarify various obligations that investment advisers owe their customers; (2) the Form CRS Relationship Summary, a standardized, short-form disclosure that would disclose key distinctions in the types of services offered by broker-dealers and investment advisers, applicable legal standards, and potential conflicts of interest; and (3) Regulation Best Interest (Reg BI).

Arguably the most contentious of the three proposals, Reg BI, would require a broker-dealer "to act in the best interest of a retail customer when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer."

The 2016 DOL Fiduciary Rules

The SEC proposals followed on the heels of the Department of Labor's (DOL's) 2016 adoption during the Obama Administration of related rules that amended the Employee Retirement Income Security Act of 1974 (ERISA; P.L. 93-406, the major law governing private sector retirement plans). Previously, under ERISA, securities brokers and dealers who provided services to retirement plans and who were not fiduciaries were subject to a suitability standard. Under the 2016 rules, brokers and dealers were generally deemed to be fiduciaries while providing recommendations to retirement plan participants. The rules provided that implementation of major parts of the rules would not take place until 2019.

Supporters of DOL's fiduciary rules, including investor advocates, argued that financial advisers such as broker-dealers would no longer be able to direct clients to products that awarded them larger commissions at the client's expense. Detractors, including broker-dealers and financial planners, stressed that the rules would result in increases in the costs of retirement accounts and would curtail various investors' access to both investment advice and the number of available products.

In early 2017, President Trump ordered DOL to conduct a new analysis of the rules with the prospect of possible revision or repeal. On March 15, 2018, in response to a lawsuit brought by business groups opposed to the rules, the Fifth Circuit Court of Appeals vacated the rules, holding, among other things, that DOL exceeded its statutory authority under ERISA in writing the rules. During the Trump Administration, DOL has not challenged the Fifth Circuit's decision; however, in October 2018, DOL announced that it would introduce a revised final ERISA fiduciary rule in September 2019.

Debate over the Best Interest Proposal

Like DOL's fiduciary rules, Reg BI would also generally apply to investment advice given by broker-dealers to holders of ERISA-based retirement accounts. Also like DOL's fiduciary rules, Reg BI has been subject to substantial debate.

Opponents of Reg BI, including investor and consumer advocates such as the Consumer Federation of America, have expressed concerns that Reg BI does not contain the word *fiduciary*; that it is not analogous to such a standard; and that it leaves "best interest" undefined, thus raising compliance concerns. Referring to the package of proposals, particularly Reg BI, Kara Stein, the dissenting SEC commissioner, argued that the "proposals fail to provide comprehensive reform or adequately enhance existing rules."

Supporters of Reg BI, including the Securities Industry and Financial Markets Association (SIFMA), assert that Reg BI's principles-based and non-definitional approach will provide for greater regulatory flexibility when it comes to gauging a broker-dealer client's best interests at any point in time. Supporters also argue, in response to criticism that the proposal does not provide a "fiduciary" standard, that the word fiduciary is not defined in the IAA and that various practitioners such as attorneys and financial professionals lack a common conception of what the term fiduciary means.

The SEC and others, including law firms with large securities practices, have argued that, although the SEC's proposed rule would not impose a uniform fiduciary broker obligation as authorized by Section 913 of the Dodd-Frank Act, the rule would significantly expand broker-dealer obligations when they give advice to retail investors. The SEC has explained that Reg BI is designed so as not to undermine the financial viability of the commission-based broker-dealer business model. The SEC argues that Reg BI would provide particular advantages to investors who most benefit from having a more transactional and episodic business relationship with their financial intermediary as opposed to an ongoing relationship as is more often found with investment advisers.

Congressional Concerns

On September 12, 2018, 35 House and Senate Democrats, including Representative Maxine Waters, who is now chairwoman of the House Financial Services Committee, and Senator Sherrod Brown, ranking member of the Senate Committee on Banking, Housing, and Urban, sent a letter to SEC Chairman Clayton. The correspondence argued for a major revision of proposed Reg BI to ensure that broker-dealers comply with the "same high standard" of retail customer care currently applicable to investment advisers.

This view contrasts with remarks made by Republican SEC Commissioner Hester Peirce during a July 2018 speech. Among other things, she argued that in certain critical ways, Reg BI would subject broker-dealers to a more exacting standard than does the fiduciary standard as described in the staff report that accompanied REG BI: She noted that broker-dealers would be required to "either mitigate or eliminate any material financial conflict of interest it may have with its client." By contrast, she observed that an adviser subject to the fiduciary standard is merely "required to disclose such a conflict."

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