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Goodbye, DOL Fiduciary Rule, and Hello, SEC Standards of Conduct?

The Securities and Exchange Commission (SEC) recently voted to propose standards of conduct for broker-dealers and investment advisers. The SEC's proposed rulemaking package (Standards of Conduct) consists of the following: (1) "Regulation Best Interest," which would raise the standards of conduct applicable to broker-dealers; (2) "Form Customer/Client Relationship Summary," a disclosure document that would be provided to retail investors by their investment professionals; and (3) a proposed interpretation of the standard of conduct for investment advisers with respect to both nonretirement and retirement accounts, such as IRAs. The proposal comes only a month after the Department of Labor's fiduciary rule (DOL Fiduciary Rule) was overturned by the U.S. Court of Appeals for the Fifth Circuit.

The Department of Labor has not sought rehearing on the DOL Fiduciary Rule. Although the administration has until June 13 to petition for writ of certiorari to the U.S. Supreme Court, this appears unlikely. However, the fate of the DOL Fiduciary Rule remains in limbo, as the states of New York, California and Oregon, along with the AARP, filed a motion late last week seeking leave to intervene in the lawsuit. If granted, the intervenors would take over as the defendant in the lawsuit and seek rehearing by the entire Fifth Circuit. If the motion to intervene is denied, the entire DOL Fiduciary Rule, including the expansive definition of "investment advice," the best interest contract exemption and the amendments to the Prohibited Transaction Exemptions, will be nullified, and the prior test for determining who is a fiduciary under ERISA will be reinstated. Although the DOL has stated it will not enforce its rule, private litigants may bring claims until the Fifth Circuit's order is final.

While it's still premature to bid farewell to the DOL Fiduciary Rule, the SEC has grabbed the spotlight with the Standards of Conduct, and these proposals, which are subject to a comment period ending 90 days after the proposals are published in the *Federal Register*, will likely generate vigorous discussion among both industry professionals and the investing public.

Regulation Best Interest

Proposed Regulation Best Interest would require a broker-dealer to act in the "best interest" of a retail customer when making a recommendation, without placing the financial or other interest of the broker-dealer or its associated persons ahead of the interest of the retail customer. Any individual who is investing primarily for personal, family or household purposes is considered a "retail customer," regardless of net worth or sophistication. While the term "best interest" is not defined in the proposed rule, it clearly does not rise to a fiduciary standard, as the proposed rule contemplates that broker-dealers would continue to receive commissions and other types of compensation that are inherently conflicted.

This enhanced duty to act in a retail customer's best interest would be satisfied by compliance with three obligations:

- Disclosure Obligation: Disclose to retail customers, in writing, the key facts about the scope and terms of the relationship between the retail customer and the broker-dealer, including material conflicts of interest (such as recommendations of proprietary products, one share class versus another and IRA rollovers).

- Care Obligation: Exercise reasonable diligence, care, skill and prudence in making the recommendation. This obligation appears to require a process that mirrors the "suitability" analysis currently required by FINRA rules, but using an enhanced standard.
- Conflict of Interest Obligation: Establish, maintain and enforce written policies and procedures designed to identify, and disclose or eliminate, material conflicts of interest that are (i) associated with recommendations and (ii) arise from financial incentives associated with such recommendations. With respect to conflicts arising from financial incentives, the broker-dealer is required to establish policies and procedures aimed at mitigating conflicts, thereby providing protection to retail customers not provided by disclosure alone.

Form Customer/Client Relationship Summary

The SEC's second proposed rule, Form CRS Relationship Summary, would require both broker-dealers and investment advisers to provide retail investors with a new disclosure document that would be a "relationship summary." A "retail investor" would be defined as a prospective or existing client or customer who is a natural person (an individual), including a trust or similar entity that represents natural persons. This disclosure, referred to as "Form CRS," would be limited to four pages; would state whether the firm is a broker-dealer or an investment adviser or is "dual-hatted"; and would highlight key differences between broker-dealers and investment advisers, including standards of conduct, fees and conflicts of interest. In addition, the proposed Form CRS would alert retail investors about where to find information about their investment professionals, whom to contact about complaints and the types of questions to ask their investment professionals. Form CRS would be required to be provided to each retail investor at the inception of the customer's relationship with an investment professional and would be updated upon a material change. To alleviate investor confusion about the distinctions between different firms and investment professionals, and to reduce the risk that a retail investor would believe that a broker-dealer with whom the investor is considering engaging or has engaged is an investment adviser that owes a fiduciary duty, the SEC proposes to restrict broker-dealers from using the term "adviser" or "advisor" in their titles/names.

Proposed Interpretation of the Investment Adviser Standard of Conduct

Rather than issuing a proposed rule regarding the standard of conduct for investment advisers, the SEC published a "proposed interpretation" that according to the SEC reaffirms and, in some cases, clarifies certain aspects of the fiduciary duty an investment adviser owes to its clients. Although the proposed interpretation does not appear to change the relationship between an investment adviser and its clients or impose any additional duties, we recommend investment advisers review this guidance to ensure that their understanding of their duties is consistent with the SEC's view.

The proposal describes the "duty of care" as including, among other things, (i) the duty to act and provide advice that is in the best interest of the client; (ii) the duty to seek best execution of a client's transactions where the adviser has the responsibility to select broker-dealers to execute client trades; and (iii) the duty to provide advice and monitoring over the course of the relationship. The "duty of loyalty" is described as requiring an investment adviser to put its client's interests first. Notably, the proposed interpretation states disclosure is not always sufficient to satisfy the adviser's duty of loyalty, for example, where a conflict is not fully and fairly disclosed to the client. The proposal emphasizes that conflict disclosures are required to be sufficiently clear and specific to enable the client to understand the nature of material conflicts of interest that could affect the advisory relationship, and to make a reasonably informed decision about whether to consent to the conflict.

Of greater concern to investment advisers will be the SEC's request for comments on areas of "enhanced" regulation that would conform the principles-based investment adviser regulatory scheme more closely to rules-based broker-dealer regulation. Among other things, the SEC asked:

- Would it be beneficial to investors or the industry for the SEC to codify its interpretation of fiduciary duty under the Advisers Act?
- Should the SEC require federal licensing and continuing education for investment adviser representatives?
- Should investment advisers be subject to financial responsibility requirements such as maintaining reserve capital or purchasing insurance protection through a fidelity bond?

The Standards of Conduct have already been criticized by two SEC commissioners for not going far enough to protect retail investors and will undoubtedly be critiqued by both industry groups and investor advocates in a flood of comments. In his statement introducing the Standards of Conduct, Chairman Jay Clayton lamented the inconsistencies in the standards of investment professional conduct resulting from the alphabet soup of financial regulators with overlapping jurisdiction. While finding a reasonable and workable standard of conduct will be an arduous process, if the Standards of Conduct ultimately reduce regulatory complexity, both the industry and investors will benefit.

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