

# Fiduciary Duties and New Best Interest Standard: The SEC Weighs In

May 14, 2018

The U.S. Securities and Exchange Commission (the “SEC”) recently proposed two rules designed to enhance the quality and transparency of the duties owed by investment advisers and broker-dealers to retail investors. The SEC also issued proposed interpretative guidance concerning the standard of conduct applicable to investment advisers under the Investment Advisers Act of 1940 (the “Advisers Act”).<sup>1</sup> The package of proposals is the SEC’s response to the concern, addressed by the controversial “best interest” rule promulgated by the Department of Labor (the “DOL Fiduciary Rule”), that many investors do not clearly understand the differences between the standards of conduct required of broker-dealers and investment advisers.

**Debevoise  
& Plimpton**

While the proposals are focused on retail broker clients, they also have implications for registered investment advisers (including those that limit their client base to institutional and high-net-worth clients). This Client Update focuses primarily on those aspects of the proposals most relevant to investment advisers.

The three releases are lengthy (approximately 1,000 pages) and are likely to be controversial. They include the following proposals:

- Regulation Best Interest 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 Investment Adviser Interpretation is intended to reaffirm and, in some cases, clarify the SEC’s views of the fiduciary duty that investment advisers owe to their clients.

---

<sup>1</sup> *Regulation Best Interest*, Securities Exchange Act Release No. 83062, available at <https://www.sec.gov/rules/proposed/2018/34-83062.pdf> (“Regulation Best Interest”); *Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation*, Investment Advisers Act Rel. No. 4889, available at <https://www.sec.gov/rules/proposed/2018/ia-4889.pdf> (“Investment Adviser Interpretation”); *Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles*, Securities Exchange Act Release No. 83063, available at <https://www.sec.gov/rules/proposed/2018/34-83063.pdf> (“Disclosure Proposal”).

- 
- The Disclosure Proposal would require broker-dealers and investment advisers to provide investors a new Form CRS—a short disclosure document designed to clarify fees, conflicts and other material matters.

**Response to DOL Fiduciary Rule.** The rulemaking package addresses many of the issues presented in the DOL Fiduciary Rule, the status of which is currently in doubt, and would preserve retail investor access to a variety of investment services and products that, as a practical matter, the DOL Fiduciary Rule would likely have curtailed. The primary difference between the SEC’s proposals and the DOL Fiduciary Rule is that, due to the different legal regimes, the SEC’s proposals address these issues primarily through additional disclosure requirements rather than forcing compliance with the proscriptive regime of the Employee Retirement Income Security Act of 1974’s prohibited transaction provisions.

**What is retail?** Both of the proposed rules focus on retail investors; however, the proposed definitions of “retail customer” and “retail investor” differ in certain respects. Regulation Best Interest would define “retail customer” as a person who “(1) receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer or a natural person who is an associated person of a broker or dealer and (2) uses the recommendation primarily for personal, family, or household purposes.” For purposes of Form CRS, a “retail investor” would be “a prospective or existing client or customer who is a natural person (an individual).” All natural persons would be included, regardless of the individual’s net worth (thus including, e.g., accredited investors, qualified clients or qualified purchasers).

The SEC explains that Form CRS is intended for a broader range of investors when they are choosing a firm, and, therefore, firms would be required to provide Form CRS to all natural persons, regardless of whether the retail customers will receive recommendations primarily for personal, family or household purposes.

**Regulation Best Interest.** Under Regulation Best Interest, a broker-dealer would have a duty to act in the best interest of the retail customer at the time the recommendation is made without putting the financial or other interest of the broker-dealer ahead of the retail customer. The proposed rule does not actually define the term “best interest”—a fact noted by most of the SEC Commissioners during the course of the meeting at which the proposal was approved.

The proposed rule would provide that a broker-dealer would satisfy this duty by:

- disclosing to the retail customer the key facts about the relationship, including material conflicts of interest;

- 
- exercising reasonable care 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; and
  - establishing and maintaining policies and procedures reasonably designed to identify and to disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives as well as to, at a minimum, disclose other material conflicts of interest.

The SEC believes that the proposed Regulation Best Interest will provide a higher standard of conduct beyond that required under existing suitability standards for broker-dealers in Financial Industry Regulatory Authority rules.

**Investment adviser interpretation.** The SEC explains that the Advisers Act establishes a "federal fiduciary standard" for investment advisers, which consists of a duty of care and a duty of loyalty and means that the adviser must at all times act in the best interest of its clients. The SEC indicates that although the terms of an adviser's fiduciary duty can be tailored to the terms of the client relationship, the adviser "cannot disclose or negotiate away, and the investor cannot waive, the federal fiduciary duty."

The SEC states that the duty of care includes the obligations (a) to act and provide advice that is in the best interest of the client, (b) to seek best execution of a client's transactions where the adviser has the responsibility to select broker-dealers to execute client trades and (c) to provide advice and monitoring over the course of the relationship. The duty of loyalty requires an adviser to put its client's interests first and not favor its own interests over those of a client or unfairly favor one client over another. As part of this duty, the adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship, which is "sufficiently specific so that a client is able to decide whether to provide informed consent to the conflict of interest."

Notably, the SEC asks for comment on three potential "enhancements" to the Advisers Act regulatory framework:

- licensing and continuing education requirements for personnel of SEC-registered investment advisers;
- delivery of account statements to clients with investment advisory accounts; and
- financial responsibility requirements for SEC-registered investment advisers, including fidelity bonds.

---

While the SEC explains that it does not intend to create a uniform standard of conduct for broker-dealers and investment advisers (as the SEC was authorized to do under the Dodd-Frank Act), these are areas in which the broker-dealer regulatory framework provides additional protections that the investment adviser framework does not. The SEC indicates that it would only consider these ideas further in connection with future proposed rules or regulatory actions.

**Form CRS—relationship summary.** The SEC proposes to require investment advisers and broker-dealers to provide retail investors with a short-form, standardized Form CRS that would highlight key differences in the principal types of services offered, the legal standards of conduct that apply to each, the fees a customer might pay and certain conflicts of interest that may exist. For investment advisers, Form CRS would be required by Form ADV.<sup>2</sup>

A second element of this proposed rule is focused on helping investors understand whether their existing or prospective investment professionals are investment advisers or broker-dealers. The proposed rule would restrict the use of the terms “adviser” and “advisor” by a broker-dealer when communicating with retail investors, unless such broker-dealer is also registered as an investment adviser.

An investment adviser would be required to deliver Form CRS to a retail investor, including high-net-worth clients and qualified purchasers, before or at the time the firm enters into an investment advisory agreement with the retail investor, which generally tracks the timing for delivery of the Form ADV Part 2 brochure. A broker-dealer would be required to deliver Form CRS before or at the time the retail investor first engages the firm’s services.

\* \* \*

Comments on the proposals are due on August 7, 2018. We will keep you apprised of further developments.

Please do not hesitate to contact us with any questions.

---

<sup>2</sup> A mock-up of a hypothetical disclosure to be provided by an investment adviser is *available at* <https://www.sec.gov/news/statements/2018/annex-b-3-ia-registrant-mock-up.pdf>.

**NEW YORK**

Jonathan Adler  
jadler@debevoise.com

Andrew M. Ahern  
amahern@debevoise.com

Lawrence K. Cagney  
lkcagney@debevoise.com

David J. Schwartz  
djschwartz@debevoise.com

Rebecca F. Silberstein  
rfsilberstein@debevoise.com

Julie Baine Stem  
jbstem@debevoise.com

**WASHINGTON D.C.**

Kenneth J. Berman  
kjberman@debevoise.com

Gregory T. Larkin  
gtlarkin@debevoise.com