



Investment Management Update

June 2019

SEC Adopts Regulation Best Interest and Other Measures for Broker-Dealers and Investment Advisers

Key Notes:

- The SEC's new Regulation Best Interest requires broker-dealers to recommend investments and take actions that are in their clients' best interests, not just actions that are merely suitable for their clients.
- Investment advisers and broker-dealers must make certain disclosures to the SEC on the new Form CRS Relationship Summary, designed to help investors compare their services.
- The SEC reaffirmed an investment adviser's fiduciary duties under the Investment Advisers Act of 1940 and issued a new interpretation distinguishing a broker-dealer from an investment adviser under the Act.
- These measures are intended to help retail investors better understand the services offered by broker-dealers and investment advisers and make more informed choices about the financial services and professionals best suited for their needs.

The Securities and Exchange Commission (SEC) recently adopted Regulation Best Interest, which requires broker-dealers to put their retail customers' best interests ahead of their own financial interests when making investment recommendations. The SEC also took action requiring broker-dealers and investment advisers to provide simple, plain-English disclosures about the nature of their customer relationships. It further clarified investment advisers' fiduciary duties and the definition of broker-dealers under the Investment Advisers Act of 1940 (Act). Collectively, these measures are intended to enhance the standard of conduct that financial professionals owe their customers.

Broker-dealers must comply with Regulation Best Interest by June 30, 2020.

Enhanced Obligations

The SEC intends Regulation Best Interest to be an improvement on the current "suitability standard" that only holds broker-dealers accountable for selling investments they believe are suitable for their clients, regardless of whether the investments are actually in their clients' best interests. Regulation Best Interest requires a broker-dealer to comply with four specific obligations:

- The **disclosure** obligation requires a broker-dealer to provide clients, in writing and before offering the client any advice, the material facts describing the scope of the client relationship and any material conflicts of interest.
- The **care** obligation compels broker-dealers to exercise reasonable diligence and skill to understand the potential risks and rewards associated with their financial advice. Broker-dealers must have a reasonable basis to believe their recommendations are in their customers' best interests. Regulation Best Interest bans sales contests and requires brokers-dealers to consider the cost of an investment before making a recommendation.
- The **conflict of interest** obligation mandates that a broker-dealer establish and enforce written procedures designed to identify, disclose and eliminate all material conflicts of interest related to any recommendations or the financial incentives associated with those recommendations.

- Finally, the **compliance** obligation calls for broker-dealers to develop and enforce written procedures for ensuring compliance with Regulation Best Interest.

Other SEC Measures

The SEC also adopted the new Form CRS Relationship Summary to provide retail investors with short and accessible disclosures that will allow them to compare investment advisers and broker-dealers. Form CRS requires a firm to disclose and explain the types of clients it services, the costs and conflicts of interest associated with those relationships, the firm's legal or disciplinary history, and how to obtain additional information about the firm. These disclosures must be presented in plain English.

In addition, the SEC affirmed and clarified the fiduciary duties investment advisers owe clients under the Act and issued a new interpretation delineating where a broker-dealer's performance of advisory activities causes it to become an investment adviser. The new interpretation defines when a broker-dealer is exempt from registering as an investment adviser because the advisory services provided are "solely incidental" to its business as a broker-dealer and such incidental advisory services are provided for no special compensation. The guidance illustrates the exception in the context of exercising investment discretion over customer accounts and account monitoring.¹

The guidance states that "a broker-dealer's provision of advice as to the value and characteristics of securities or as to the advisability of transacting in securities is consistent with the solely incidental prong if the advice is provided in connection with and is reasonably related to the broker-dealer's primary business of effecting securities transactions." Therefore, if a broker-dealer's primary business is giving advice, or if the advisory services are not offered in connection with or are not reasonably related to the broker-dealer's business of effecting securities transactions, the broker-dealer's advisory services are not solely incidental to its business as a broker-dealer. In determining whether the exception applies, broker-dealers must consider all "facts and circumstances surrounding the broker-dealer's business, the specific services offered, and the relationship between the broker-dealer and the

customer." The SEC further highlighted the fact that "[a]dvice need not be trivial, inconsequential, or infrequent to be consistent with the solely incidental prong."

Outlook

While supporters of Regulation Best Interest and these measures believe they are an improvement over the current standard for broker-dealers, critics contend they do not go far enough to protect customers. They note the potential for confusion because Regulation Best Interest does not define "best interest." While state regulators could implement stricter standards, the SEC chairman warned against creating a regulatory patchwork that would make enforcement of these measures more difficult and expensive.

FOR MORE INFORMATION

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¹ <https://www.sec.gov/rules/interp/2019/ia-5249.pdf>.