

SEC Approves Regulation Best Interest, Heightening Broker-Dealer Standards

I. Overview

On June 5, 2019, the Securities and Exchange Commission (the “Commission”) voted 3-1, with Commissioner Robert L. Jackson Jr. dissenting, to approve Regulation Best Interest (“Reg. BI”). Reg. BI will require broker-dealers, when making a recommendation, “to act in the best interest of the retail customer at the time the recommendation is made without placing the financial or other interest of the broker, dealer, or a natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer.”¹

II. Regulation Best Interest

In April 2018, the Commission voted 4-1 to move forward with releasing the proposed Reg. BI for public comment. Since then, several commentators have complained that the proposed regulations lacked sufficient detail on the standard for brokers or how to handle conflicts of interest and disclosure forms.² On the other hand, certain commentators, such as the National Federation of Independent Business, believed that the compliance costs related to the proposed Reg. BI would be too high.³ Indeed, the SEC’s Chief Economist, S.P. Kothari, recognized that Reg. BI will impose new compliance costs—some of which will be passed onto retail customers—and it may change how broker-dealers are compensated for their services.⁴

Despite the possibility of increased compliance costs, the Commission on June 5, 2019, voted 3-1 in favor of passing Reg. BI. According to Chairman Jay Clayton, Reg. BI will retain “the overall structure and scope of the proposed rule, with certain enhancements and modifications” that incorporate the feedback from commentators.⁵

Reg. BI will impose stricter requirements and disclosures for broker-dealer interactions with and recommendations to retail investors. The current FINRA regulations only require that broker-dealers have a reasonable basis for believing that a recommendation is suitable to a retail client.⁶ Reg. BI’s standard of acting in

¹ Proposed Rule: Regulation Best Interest, 83 Fed. Reg. 21574 (proposed May 9, 2018) (to be codified at 17 C.F.R. pt. 240).

² Rachel Graf, *SEC Told Proposed Broker Standards Fall Short*, Law360 (Aug. 8, 2018), <https://www.law360.com/articles/1071232>.

³ *Id.*

⁴ Remarks of S.P. Kothari, Securities and Exchange Commission Open Meeting (June 5, 2019), https://www.sec.gov/video/webcast-archive-player.shtml?document_id=060519openmeeting.

⁵ Chairman Jay Clayton, Statement at the Open Meeting on Commission Actions to Enhance and Clarify the Obligations Financial Professionals Owe to our Main Street Investors (June 5, 2019), <https://www.sec.gov/news/public-statement/statement-clayton-060519-iabd>.

⁶ FINRA Rule 2111 (“A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer’s investment profile.”).

the “best interest” of retail investors is a higher one; but, it still falls short of requiring an explicit fiduciary duty. Notably, Reg. BI does not itself define the term “best interest.”⁷ In his dissenting remarks, Commissioner Jackson criticized the regulation for being “far too ambiguous,” and pointing out that the rule does not define the term “best interest.”⁸

According to the SEC, Reg. BI is designed to make clear that a “broker-dealer may not put its financial interests ahead of the interests of a retail customer when making recommendations.”⁹ To complete this objective, Reg. BI covers four areas designed to enhance investor protection: disclosure, conflict of interest, care, and compliance.¹⁰

- 1. Disclosure Obligations.** Broker-dealers will be obligated to disclose in writing to retail investors all material facts related to the broker-dealer’s scope and terms of relationship with the customer and all material conflicts of interest related to the broker-dealer’s recommendations.¹¹ These disclosures include information about the fees, the type and scope of services provided, whether monitoring services are provided, and relevant limits on services and products.¹²
- 2. Care Obligations.** Under the regulations, when a broker-dealer is making a recommendation it must “exercise reasonable diligence, care, skill, and prudence.” Reg. BI will require broker-dealers to understand the potential risks and rewards associated with the particular recommendation and have a reasonable basis to believe that this recommendation would be in the best interest of the customer, given the customer’s investment profile.¹³ The final rule release goes further than the original proposed Reg. BI to “explicitly require[] the broker-dealer to consider the costs of the recommendation.”¹⁴ This means that while costs always must be considered, there is no *per se* obligation under Reg. BI to recommend the lowest cost option to customers.
- 3. Conflict of Interest Obligations.** Broker-dealers will have to implement and enforce written policies and procedures designed to eliminate, mitigate, or disclose certain conflicts of interest. This will include a requirement to implement policies related to mitigating the risk that professionals place the firm’s interest above the clients and eliminating sales contests or quotas.¹⁵

⁷ Proposed Rule, *supra* note 1, at 21587.

⁸ Commissioner Robert L. Jackson Jr., Statement on Final Rules Governing Investment Advice (June 5, 2019), <https://www.sec.gov/news/public-statement/statement-jackson-060519-iabd>.

⁹ Press Release, Securities and Exchange Commission, SEC Adopts Rules and Interpretations to Enhance Protections and Preserve Choice for Retail Investors in Their Relationships With Financial Professionals (June 5, 2019), <https://www.sec.gov/news/press-release/2019-89>.

¹⁰ *Id.*

¹¹ Proposed Rule, *supra* note 1, at 21599.

¹² SEC Press Release, *supra* note 9.

¹³ Proposed Rule, *supra* note 1, at 21608.

¹⁴ SEC Press Release, *supra* note 9.

¹⁵ SEC Press Release, *supra* note 9.

4. Compliance Obligations. Lastly, broker-dealers will be required to implement policies and procedures designed to achieve compliance with Reg. BI as a whole.¹⁶

These best interest obligations will apply when a broker-dealer is making a recommendation of a securities transaction or investment strategy.¹⁷ The final rule release goes even further than the proposed Reg. BI to require a best interest standard even when a broker-dealer is making an account recommendation—such as rolling over a retirement plan account to an IRA.¹⁸ Reg. BI also will not change the industry’s transaction-based compensation arrangement, although these arrangements may have to be disclosed to customers.¹⁹

At the hearing approving the final rule, Chairman Clayton praised the passing of Reg. BI and called it “long overdue.”²⁰ Chairman Clayton believed that Reg. BI would “substantially enhance the broker-dealer standard of conduct beyond existing suitability obligations.”²¹ And, the Chairman was quick to caution that compliance with Reg. BI could not be satisfied through disclosure alone.²² Commissioners Hester M. Peirce and Elad L. Roisman joined Chairman Clayton in supporting Reg. BI. Commissioner Roisman commented that Reg. BI will help preserve investor access to financial services and advice while requiring broker-dealers to have a better understanding of the accounts and products they offer.²³

Commissioner Jackson, who voted against the regulation, stated his belief that Reg. BI imposed a “muddled standard” and it would not put retail investors interests first.²⁴ Commissioner Jackson also raised concerns over the possible preemption of state broker-dealer regulations.²⁵ Commissioner Jackson believes that Reg. BI fails to make clear if and how it will preempt state regulations, which may invite “extensive and expensive litigation over the scope of the rule.”²⁶

III. Next Steps

The final Reg. BI rules will be published on the Federal Register and will become effective 60 days from publication. Broker-dealers have until June 30, 2020 to become compliant with Reg. BI. The Commissioners

¹⁶ *Id.*

¹⁷ Proposed Rule, *supra* note 1, at 21592.

¹⁸ SEC Press Release, *supra* note 9.

¹⁹ Proposed Rule, *supra* note 1, at 21576.

²⁰ Statement of Chairman Clayton, *supra* note 5.

²¹ *Id.*

²² *Id.*

²³ Commissioner Elad L. Roisman, Statement at the Open Meeting on Regulation Best Interest, the Interpretation of the Standard of Conduct for Investment Advisers, the Form CRS Relationship Summary, and the Interpretation of “Solely Incidental” (June 5, 2019), <https://www.sec.gov/news/public-statement/statement-roisman-060519>.

²⁴ Statement of Commissioner Jackson, *supra* note 8.

²⁵ *Id.*

²⁶ *Id.*

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encouraged broker-dealers to contact the SEC with questions or to obtain assistance in planning for compliance with the regulations. Relatedly, Chairman Clayton announced a “Main Street investor education campaign” to help retail investors understand the differences between broker-dealers and investment advisers, and to help them choose which one is right for them.²⁷

Some members of Congress have taken action to block the formal implementation of Reg. BI. On June 24, 2019, House Financial Services Committee Chairwoman Maxine Waters introduced an amendment to the Financial Services and General Government Appropriations Act of 2020.²⁸ The amendment would prohibit the SEC from using funds to enforce Reg. BI—effectively ending the regulation.²⁹ The appropriations bill, including Chairwoman Waters’ amendment to it, has been reported out of committee and is up for consideration on the floor of the House sometime this week.³⁰ It remains to be seen whether the amendment, or the bill itself, will survive a vote in the House or Senate.

IV. Conclusion

Reg. BI is a partial victory for financial firms and broker-dealers because it will not impose a fiduciary duty and will allow for a more flexible facts and circumstance analysis. On the other hand, consumer groups may be disappointed with Reg. BI. Some states have already implemented standards that are more stringent for broker-dealers. Reg. BI may lead to consumer groups to push for even more states to pass broker-dealer regulations that go beyond Reg. BI. Firms could be left to deal with a patchwork of federal and state regulations. And, as Commissioner Jackson discussed, litigation may arise over the scope and limits of Reg. BI and its effect on these state regulations.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Helene R. Banks at 212.701.3439 or hbanks@cahill.com; Bradley J. Bondi at 202.862.8910 or bbondi@cahill.com; Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Elai Katz at 212.701.3039 or ekatz@cahill.com; Geoffrey E. Liebmann at 212.701.3313 or gliebmann@cahill.com; Ross Sturman at 212.701.3831 or rsturman@cahill.com; or William McCaughey at 202.862.8946 or wmccaughey@cahill.com.

²⁷ Statement of Chairman Clayton, *supra* note 5.

²⁸ H.R. 3351, 116th Cong. (2019).

²⁹ Melanie Waddell, *Rep. Waters Seeks to Block SEC Regulation Best Interest*, ThinkAdvisor (June 24, 2019), <https://www.thinkadvisor.com/2019/06/24/rep-waters-seeks-to-block-sec-regulation-best-interest/>.

³⁰ *Id.*