SEC BEST INTEREST REGULATION

I. INTRODUCTION

The Securities and Exchange Commission (SEC) has finalized a rule implementing a “best interest” standard of conduct for broker-dealers when making recommendations on securities transactions or investment strategies to retail customers.

Under the final rule, a broker-dealer making a recommendation to a retail investor must act in the best interest of that customer at the time the recommendation is made. The final rule will enhance the broker-dealer standard of conduct beyond existing suitability obligations and make it clear that a broker-dealer may not put its financial interests ahead of the interests of a retail customer when making recommendations. Broker-dealers must demonstrate their compliance with this duty through three specific obligations; an obligation to disclose key facts about the relationship, including material conflicts of interest; a care obligation that requires broker-dealers to exercise reasonable diligence, care, skill and prudence in understanding products and the customer’s best interest; and a conflict-of-interest obligation that requires policies to identify, disclose, and mitigate or eliminate conflicts.

In addition, broker-dealers and registered investment advisors will be required to provide certain standardized information to retail investors through Form CRS, which has been finalized by the SEC. The Form CRS Relationship Summary will require registered investment advisors’ broker-dealers to provide retail investors with simple, easy-to-understand information about the nature of their relationship with their financial professional.

Importantly, the final rule excludes fiduciary accounts of a bank or trust company from the definition of “retail investor” or “retail customer” and does not limit bank employees also working for broker-dealers from having the term “adviser” in their titles.

The best interest regulation and Form CRS will become effective 60 days after the publication in the Federal Register, and will include a transition period until June 30, 2020, to give from sufficient time to come into compliance.

II. BEST INTEREST REGULATION

The best interest regulation imposes a new standard of conduct specifically for broker-dealers that substantially enhances the broker-dealer standard of conduct beyond existing suitability obligations. The standard of conduct draws from key fiduciary principles and cannot be satisfied through disclosure alone. It provides specific requirements to address certain aspects of the
relationships between broker–dealers and their retail customers, including certain conflicts related to compensation.

When making a recommendation of a securities transaction or an investment strategy involving securities, a broker–dealer must act in the retail customer’s best interest and cannot place its own interests ahead of the customer’s interests. The best interest regulation applies to account recommendations, including recommendations to roll over or transfer assets in a workplace retirement plan account to an IRA, and recommendations to take a plan distribution. It also applies to implicit “recommendations to hold” the result from agreed–upon account monitoring.

A broker–dealer is not able to waive compliance, nor can a retail customer agree to waive protection under the final rule. The final rule modified the definition of “retail customer” to apply to any natural person, including high net worth individuals, who receive a recommendation for the natural person’s own account, including the account of an individual plan participant. However, the definition is not extended to cover retirement plans and the fiduciaries of such plans.

The required standard of conduct (to act in the best interest of the retail customer at the time a recommendation is made without placing the financial interest or other interest of the broker–dealer ahead of the interest of the retail customer) is satisfied if:

A. Disclosure Obligation

Before or at the time of the recommendation, the broker–dealer discloses in writing to the retail customer the material facts relating to the scope in terms of the relationship, and all material conflicts of interest associated with the recommendation.

The final rule requires “full and fair” disclosure of material facts. At a minimum, a “full and fair” disclosure must indicate whether account monitoring services will be provided, account minimums, and any material limitations on securities or investment strategies that may be recommended to the retail customer.

B. Care Obligation

The broker–dealer in making the recommendation, exercises reasonable diligence, care, skill and prudence to: (i) understand the potential risks and rewards associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customer; (ii) have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on the retail customer’s investment profile and the potential risks and rewards associated with the recommendation; (iii) have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer’s best interest when viewed in isolation, is not excessive and is in the retail customer’s best interest when taken together in light of the retail customer's investment profile.
C. Conflict of Interest Obligation

The broker–dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and, at a minimum, disclose, or eliminate, all material conflicts of interest that are associated with such recommendation.

The conflict of interest obligation specifically requires policies and procedures to:
• mitigate conflicts that create an incentive for the firm’s financial professionals to place their interest or the interests of the firm ahead of the retail customer’s interest;
• prevent material limitations on offerings, such as a limited product menu or offering only proprietary products, from causing the firm or its financial professional to place his or her interest or the interests of the firm ahead of the retail customer’s interest; and
• eliminate sales contests, sales quotas, bonuses, and non–cash compensation that are based on the sale of specific securities for specific types of securities within a limited period of time.

D. Compliance Obligation

A general compliance obligation to require broker–dealers to establish policies and procedures to achieve compliance with regulation best interest.

III. FORM CRS RELATIONSHIP SUMMARY

Investment advisers and broker–dealers will be required to deliver a relationship summary to retail investors at the beginning of their relationship. The relationship summary is intended to inform retail investors about (i) the types of client and customer relationships and services that the firm offers; (ii) the fees, cost, conflicts of interest and required standards of conduct associated with these relationships and services; (iii) whether the firm and its financial professionals currently have reportable legal or disciplinary history; and (iv) how to obtain additional information about the firm.