



The SEC's New Best Interest Rule Raises More Questions Than It Answers

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On June 5, 2019, the U.S. Securities & Exchange Commission voted (3-1) to adopt a new set of conflict-of-interest rules and interpretations designed to require brokers to act in the “best interest” of clients by supposedly making more transparent retail investors’ relationships with investment advisers and broker-dealers.¹ These new rules and interpretations, according to the SEC, will align the interests of reasonable investors with the behavior of investment advisers and broker-dealers.

As a general matter, an investor or customer may have different types of relationships with broker-dealers² and investment advisers.³ Broker-dealers and investment advisers offer different services, and have different compensation models when providing investment recommendations or investment advisory services to customers. Like many principal-agent relationships—including the investment adviser-client relationship—the relationship between a broker-dealer and a customer has inherent conflicts of interest, including those resulting from a transaction-based (e.g., commission) compensation structure and other broker-dealer compensation. These and other conflicts of interest may incentivize a broker-dealer to prioritize its own interests, namely its own compensation or other financial interests, at the expense of the customer to whom it is making investment recommendations.

For decades, concerns have existed regarding the potential and actual harm resulting from retail customers acting on broker-dealer’s conflicted recommendations. Moreover, the insufficiency of existing broker-dealer regulatory requirements to address these conflicts when broker-dealers make conflicted recommendations only exacerbates investors’ and retail customers’ concerns.

On April 18, 2018, the SEC proposed Regulation Best Interest to enhance the standard of conduct that applies when broker-dealers make recommendations to retail customers.⁴ On June 5, 2019, the SEC adopted Regulation Best Interest and provided interpretations and guidance to address points raised during the comment process.

The new rule defines a new “Best Interest Obligation” as follows:

A broker, dealer, or a natural person who is an associated person of a broker or dealer, when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer, shall 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 natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer.

1 SECURITIES AND EXCHANGE COMMISSION, Regulation Best Interest: The Broker-Dealer Standard of Conduct, Rel. No. 34-86031 (June 5, 2019) (to be codified at 17 CFR §§ 240.15l-1, 240.17a-3, and 240.17a-4), <https://www.sec.gov/rules/final/2019/34-86031.pdf> (“Final Rule”).

2 Broker-dealers typically provide transaction-specific recommendations and receive compensation on a transaction-by-transaction basis (such as commissions) (“transaction-based” compensation or model). A broker-dealer’s recommendations may include recommending transactions where the broker-dealer is buying securities from or selling securities to retail customers on a principal basis or recommending proprietary products.

3 Investment advisers, on the other hand, typically provide ongoing, regular advice and services in the context of broad investment portfolio management, and are compensated based on the value of assets under management (“AUM”), a fixed fee or other arrangement (“fee-based” compensation or model).

4 SECURITIES AND EXCHANGE COMMISSION, Regulation Best Interest, Rel. No. 34-83062 (proposed Apr. 18, 2018), <https://www.sec.gov/rules/proposed/2018/34-83062.pdf>.

17 CFR § 240.15l-1(a). According to the SEC, Regulation Best Interest draws on core principles underlying fiduciary obligations, including those that apply to investment advisers under the Investment Advisers Act of 1940, while providing specific requirements to address certain aspects of the relationships between broker-dealers and their retail customers.

The SEC listed several policy objectives for Regulation Best Interest and its supporting interpretations, including:

1. clarifying the standards of conduct applicable to broker-dealers and investment advisers;
2. assisting retail investors' comprehension of and ability to compare the services offered by broker-dealers and investment advisers;
3. enabling retail investors' ability to determine what relationship best actualizes their expectations;
4. addressing conflicts of interest by establishing, maintaining, and enforcing policies and procedures reasonably designed to identify and fully and fairly disclose material facts about conflicts of interest, and in instances where the SEC determined that disclosure is insufficient to reasonably address the conflict, to mitigate or, in certain instances, eliminate the conflict; and
5. harmonizing the level of protections provided by the various regulators.⁵

The SEC hoped to achieve these policy objectives through adoption of mandated disclosures, interpretations under the Investment Advisers Act of 1940 (the "Advisers Act"), and new Regulation Best Interest. The centerpiece of the set of conflict of interest rules is Regulation Best Interest.⁶ The new rule requires compliance with the following four elements: (1) providing certain prescribed disclosures before or at the time of the recommendation about the recommendation and the relationship between the retail customer and the broker-dealer ("Disclosure Obligation"); (2) exercising reasonable diligence, care, and skill in making the recommendation ("Care Obligation"); (3) establishing, maintaining, and enforcing policies and procedures reasonably designed to address conflicts of interest ("Conflict of Interest Obligation"), and (4) establishing, maintaining, and enforcing policies and procedures reasonably designed to achieve compliance with Regulation Best Interest ("Compliance Obligation").⁷ The SEC's final rule release noted that the standard of conduct established by Regulation Best Interest cannot be satisfied through disclosure alone.

Lingering Questions

The potential impact of the SEC's adoption of Regulation Best Interest and its supporting interpretations remains to be seen. Despite SEC Chairman Jay Clayton's assurances in his statement announcing the new rule that the rule will enhance the services financial firms provide to their clients,⁸ there are several anticipated issues that the SEC must address, and that a retail customer or investor must consider.

First, the precise derivation, meaning, and application of the term "best interest" of the client (or the "financial or other interest of the broker") remains unclear. This lack of clarity is likely to continue, rather than abate, the debate over disclosing conflicts of interest. According to the SEC, the standard of conduct draws from key principles underlying fiduciary obligations, including those that apply to investment advisers under the Advisers Act. The question arises how one should interpret Regulation Best Interest when the actions of a broker, dealer, or associate person appear not to align with fiduciary principles. Future SEC staff members and Commissioners may add interpretive gloss through application of the rule in the context of inspections, examinations, and enforcement actions. Ultimately, the courts will most likely weigh in as well.

⁵ Final Rule, supra n.1, at 5. The rule also prohibits brokers from exclusively selling their employers' products. The regulator clarified that brokers have to comply with the rule when they transfer customers to an Individual Retirement Account from another retirement account.

⁶ Note, however, that the SEC's interpretive release attempting to summarize and distill the fiduciary duty requirements applicable to investment advisers from the existing statutes, case law, and prior interpretations is sure to come in for extensive comment and criticism as doing either too little (*i.e.*, weakening existing standards) or too much (*i.e.*, imposing rigidity and permanence to an appropriately fluid and common-law based requirement). See Securities and Exchange Commission, Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Rel. No. IA-5248 (June 5, 2019) (to be codified at 17 C.F.R. Part 276, Interpretive Releases), <https://www.sec.gov/rules/interp/2019/ia-5248.pdf>.

⁷ Final Rule, at 13-14.

⁸ SEC 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>.

Second, while mandating conflict of interest disclosures does present the theoretical opportunity for retail customers to be better informed decision makers, this opportunity relies upon the sophistication of the retail customer and the clarity of the disclosure. In other words, information asymmetries will still exist. Moreover, the flawed disclosure of possible conflicts of interest may create an erroneous belief that the interests of the retail customer and broker-dealer are aligned, creating further confusion. The disclosure requirements raise the specter of enforcement actions based on inadequate disclosures and, potentially, litigation in which the courts provide their own gloss on what is required.

Third, there may be legitimate difficulty and reasonable differences of opinion as to whether an investment recommendation is in the “best interest” of the customer or investor, especially where several strategies may appear viable at the time the recommendation is given. Again, this raises the specter of potential enforcement investigations and litigation to clarify the rule.

Fourth, the similarities between the Financial Industry Regulatory Authority’s (FINRA) suitability rule and the SEC’s new Regulation Best Interest raise questions.⁹ How is the SEC’s new rule different from FINRA’s suitability rule (or is it different)? The suitability rule “implicitly” requires a broker-dealer’s recommendations to a customer to be consistent with the customer’s best interest. FINRA Regulatory Notice 12-25, addressing suitability, asserted that “[t]he suitability requirement that a broker make only those recommendations that are consistent with the customer’s best interests prohibits a broker from placing his or her interests ahead of the customer’s interests.”¹⁰ Does Regulation Best Interest require any modification at all to FINRA’s suitability rule? If not, how important could the SEC’s new rule be? Is the SEC only adding some disclosure and documentation requirements around the existing FINRA standard (in which case, why did it take so long to enact this and why doesn’t the SEC just say so)?

Conclusion

At the end of the day, the SEC’s Best Interest Rule raises more questions than it answers. While appearing to provide a bright-line “fiduciary-like” requirement, the new rule is likely to engender confusion and potential additional liability for regulated entities and individual brokers. At the same time, it may give retail investors a false sense of security that their broker will, in fact, act as their fiduciary when making investment recommendations. Chairman Clayton and his fellow Commissioners who voted in favor of this rule undoubtedly intended to lay to rest a historically fraught area with a rule intended to be industry-friendly and to avoid imposing a strict fiduciary standard on brokers. Unfortunately, we can foresee a significant risk of future litigation to resolve the questions outlined above. Moreover, future Commissioners and SEC Staff members may well employ this rule in the context of enforcement actions in ways the current Commission does not fully appreciate.

⁹ See FINRA Rule 2111.

¹⁰ FINANCIAL INDUSTRY REGULATORY AUTHORITY, Regulatory Notice 12-25 (May 2012), at 3, <https://www.finra.org/sites/default/files/NoticeDocument/p126431.pdf>.

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