

# SEC Proposal Dives Into Long-Standing Debate About the Duties of Investment Professionals

April 24, 2018

Securities Litigation and Enforcement

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On Wednesday, April 18th, the SEC introduced a much-anticipated package of proposed rules and formal guidance concerning the standards of conduct for financial professionals. The more than 1,000-page proposal, which emerged eight years after Congress required the agency to conduct a study on the topic, addresses whether investment advisers and broker-dealers should have identical or different standards of conduct vis-à-vis their retail customers. While investment advisers owe their clients a fiduciary duty, broker-dealers are currently bound by a lesser standard of care centering on the concept of “suitability.” Under the SEC’s proposal, the standard of care for broker-dealers when providing services to retail customers would become higher than it is today, but still not as stringent as the standard for investment advisers. The SEC also proposed rules intended to clarify the existing fiduciary duty standard for investment advisers and to require additional disclosure to retail customers of both broker-dealers and investment advisers. In addition, the proposal would prohibit broker-dealers from using certain terminology, such as financial advisor, when describing themselves and their services.

The package proposed by the SEC has four key parts:

First, the SEC proposed a rule, which it called Regulation Best Interest, that would heighten the standard registered broker-dealers need to meet when recommending investments to their retail customers. Under this rule, all broker-dealers and associated persons of broker-dealers would be obligated to act in the “best interest” of their retail customers when offering investment advice.<sup>1</sup> As the SEC described the rule, it would mandate that broker-dealers do not prioritize their financial interests before or over those of their retail customers. According to the proposed rule, broker-dealers and associated persons would satisfy this “best interest” standard:

- through reasonable written disclosures to their retail customers about material facts regarding the scope and terms of their relationship and any material conflicts of interest pertinent to a given investment recommendation;
- through the exercise of “reasonable diligence, care, skill, and prudence” by having a reasonable basis for making investment recommendations that account for potential

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<sup>1</sup> Proposed Rule, “Regulation Best Interest,” SEC Release No. 34-83062 (Apr. 18, 2018), at 8, available at <https://www.sec.gov/rules/proposed/2018/34-83062.pdf>.

risks and rewards in the context of the overall investment profile of the retail customer in question; and

- through the implementation and enforcement of written policies and procedures that can identify and -- at a minimum -- disclose or eliminate (a) material conflicts of interest associated with investment recommendations and (b) material conflicts of interest that arise from financial incentives associated with investment recommendations.<sup>2</sup>

At the same time, the SEC stated that the “best interest” duty would not rise to the level of fiduciary duty, and that it is not proposing a uniform standard for broker-dealers and investment advisers in light of their differing relationship types and models for recommending investments.<sup>3</sup>

Second, the SEC proposed an interpretation designed to “reaffirm -- and in some cases clarify -- certain aspects of the fiduciary duty that an investment adviser owes to its clients” under Section 206 of the Investment Advisers Act of 1940.<sup>4</sup> The proposed interpretation notes that investment advisers have “an affirmative duty of utmost good faith and full and fair disclosure of all material facts” to their investors.<sup>5</sup> The SEC describes the investment adviser’s fiduciary duty as both a duty of care -- which encompasses a duty to provide advice in the customer’s best interest, a duty to seek best execution, and a duty to act and provide advice and monitoring over the course of the relationship -- and a duty of loyalty.

Third, the SEC proposed a new rule that would require investment advisers and broker-dealers to provide their retail customers with a relationship summary through completion of a short-form document called Form CRS. The form would include information regarding the “relationships and services the firm offers, the standard of conduct and the fees and costs associated with those services, specified conflicts of interest, and whether the firm and its financial professionals currently have reportable legal or disciplinary events.”<sup>6</sup> Retail investors would be provided Form CRS at the beginning of a relationship with an investment adviser or broker-dealer and would

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<sup>2</sup> Proposed Rule, “Regulation Best Interest,” SEC Release No. 34-83062 (Apr. 18, 2018), at 8-9, available at <https://www.sec.gov/rules/proposed/2018/34-83062.pdf>.

<sup>3</sup> See Proposed Interpretation, “Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers,” SEC Release No. IA-4889 (Apr. 18, 2018), at 5, available at <https://www.sec.gov/rules/proposed/2018/ia-4889.pdf>.

<sup>4</sup> Proposed Interpretation, “Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers,” SEC Release No. IA-4889 (Apr. 18, 2018), at 5, available at <https://www.sec.gov/rules/proposed/2018/ia-4889.pdf>

<sup>5</sup> Proposed Interpretation, “Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers,” SEC Release No. IA-4889 (Apr. 18, 2018), at 3-4, available at <https://www.sec.gov/rules/proposed/2018/ia-4889.pdf>.

<sup>6</sup> Proposed Rule, “Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles,” SEC Release No. 34-83063 (Apr. 18, 2018), at 1 and 14, available at <https://www.sec.gov/rules/proposed/2018/34-83063.pdf>.

receive updated information in light of any material changes.<sup>7</sup> The SEC has also made available proposed sample relationship summaries for investment advisers, broker-dealers, and dual registrants to be used for illustrative purposes.<sup>8</sup>

Fourth, as part of the package, the SEC has also proposed a new rule that would restrict broker-dealers and their employees from using the terms “adviser” or “advisor” as part of their name or title in communications with investors unless they are registered as investment advisers.<sup>9</sup> The SEC has also proposed new rules that would require broker-dealers, investment advisers, and any associated persons to disclose in communications with retail customers the firm’s registration status with the SEC and an associated person’s relationship with the firm.<sup>10</sup>

The proposed package, which applies only to retail, not institutional, customers, has already spurred concern and criticism. During the Commission meeting at which the proposed rules were introduced, SEC Commissioner Kara Stein voted against the proposal and argued that it fails to provide enough clarity as to what falls under the so-called “best interest” test. She also criticized the proposed disclosure requirements as creating further confusion for retail investors.<sup>11</sup> And while the remaining Commissioners approved putting the proposed package out for comment, several of them expressed concerns as to the broad scope of the proposal and called for greater clarity of the new standards of conduct for investment professionals.<sup>12</sup>

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<sup>7</sup> Proposed Rule, “Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles,” SEC Release No. 34-83063 (Apr. 18, 2018), at 1, available at <https://www.sec.gov/rules/proposed/2018/34-83063.pdf>.

<sup>8</sup> See “Annex B: Form CRS Mock-up - Dual Registrant,” available at <https://www.sec.gov/news/statements/2018/annex-b-1-dual-registrant-mock-up.pdf>; “Annex B: Form CRS Mock-up - Standalone Broker-Dealer,” available at <https://www.sec.gov/news/statements/2018/annex-b-2-bd-registrant-mock-up.pdf>; “Annex B: Form CRS Mock-up - Standalone Investment Adviser,” available at <https://www.sec.gov/news/statements/2018/annex-b-3-ia-registrant-mock-up.pdf>.

<sup>9</sup> Proposed Rule, “Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles,” SEC Release No. 34-83063 (Apr. 18, 2018), at 1-2, available at <https://www.sec.gov/rules/proposed/2018/34-83063.pdf>.

<sup>10</sup> Proposed Rule, “Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles,” SEC Release No. 34-83063 (Apr. 18, 2018), at 1-2, available at <https://www.sec.gov/rules/proposed/2018/34-83063.pdf>.

<sup>11</sup> SEC Commissioner Kara M. Stein, Public Statement, “Statement on Proposals Relating to Regulation Best Interest, Form CRS, Restrictions on the Use of Certain Names or Titles, and Commission Interpretation Regarding the Standard of Conduct for Investment Advisers” (Apr. 18, 2018), available at <https://www.sec.gov/news/public-statement/stein-statement-open-meeting-041818>.

<sup>12</sup> See, e.g., SEC Commissioner Michael S. Piowar, Public Statement, “Statement at Open Meeting on Form CRS, Proposed Regulation Best Interest and Notice of Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers (Proposed Rule)” (Apr. 18, 2018), available at <https://www.sec.gov/news/public-statement/statement-piowar-041818>.

Of course, the proposed package should be considered in the context of the DOL fiduciary rule, portions of which remain in effect, despite a recent Fifth Circuit decision vacating it.<sup>13</sup> Throughout Regulation Best Interest, the SEC emphasized areas of shared jurisdiction between its proposed best interest standard and the obligations imposed under the DOL fiduciary rule and its accompanying Best Interest Contract Exemption (including areas where satisfying DOL fiduciary rule requirements may result in SEC best interest obligations being met).<sup>14</sup> Nevertheless, there remain important distinctions between Regulation Best Interest and the DOL rule. For example, one-time recommendations to roll over retirement assets from an employer-sponsored retirement plan into an Individual Retirement Account are covered by the DOL rule but not the proposed package unless the recommendation was made by an investment adviser or a broker-dealer. Moreover, the proposed SEC package does not supersede the DOL rule, and investment advisers and broker-dealers are, and will continue to be, subject to separate enforcement regimes imposed by the DOL fiduciary rule (where currently applicable) and SEC regulation. Accordingly, as long as, and where, the DOL fiduciary rule remains applicable, regulated parties will need to ensure compliance with the DOL fiduciary rule — regardless of developments with respect to the proposed package.

The public comment period for the proposed package will remain open for 90 days following publication in the Federal Register. If this proposal ever emerges from the comment process as a final proposal, we anticipate that a vote by the Commission is many months, if not years, away.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Securities Litigation and Enforcement practice:

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To the extent that clients have questions about the DOL fiduciary rule, please contact [Mike Francese](#) and [Jason Levy](#), members of our Employee Benefits practice.

This information is not intended as legal advice. Readers should seek specific legal advice before acting with regard to the subjects mentioned herein.

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<sup>13</sup> *Chamber of Commerce of the U.S.A., et al. v. U.S. Dep't of Labor, et al.*, No. 17-10238 (5th Cir.) (Mar. 15, 2018).

<sup>14</sup> *E.g.*, Proposed Rule, "Regulation Best Interest," SEC Release No. 34-83062 (Apr. 18, 2018), at 58-62, available at <https://www.sec.gov/rules/proposed/2018/34-83062.pdf>.