June 21, 2019

SEC Adopts Regulation Best Interest and Issues Interpretive Release on the "Solely Incidental" Exclusion

On June 5, 2019, the SEC adopted two rules and published two interpretations "designed to enhance the quality and transparency of retail investors' relationships with investment advisers and broker-dealers." This Alert discusses the Regulation Best Interest adopting release and the SEC interpretive release regarding the "solely incidental" prong of the broker-dealer exclusion from the Advisers Act. Separate Ropes & Gray Alerts discuss the SEC release on the standard of conduct for investment advisers (available here) and the SEC adoption of Form CRS (available here).

REGULATION BEST INTEREST

Introduction. Regulation Best Interest (the "Regulation"), new Rule 15*l*-1 under the Exchange Act, imposes an overarching standard of conduct that requires broker-dealers and natural persons who are associated persons of a broker-dealer (unless otherwise indicated, each a "broker-dealer"), when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer,[1] 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 making the recommendation ahead of the interest of the retail customer (the "General Obligation").

The term "best interest" is not defined in the Regulation. Instead, whether a broker-dealer acted in the best interest of its customer is determined by an objective consideration of the facts and circumstances of how the specific components of the Regulation were satisfied when the recommendation was made. A broker-dealer's obligations cannot be modified or disclaimed by the broker-dealer, or otherwise waived by a retail customer.

Notably, the Regulation does not:

- extend beyond the time a particular recommendation is made or impose a duty on a broker-dealer to monitor a customer's account.
- require a broker-dealer to conduct an evaluation of every possible alternative in order to recommend the single best of all possible alternatives that exist, but, instead, requires the broker-dealer to consider reasonably available alternatives offered by the broker-dealer.
- require a broker-dealer to refuse to accept an order from a retail customer that is contrary to the broker-dealer's recommendation, nor does it apply to investor-directed or unsolicited transactions by a retail customer.
- create any new private right of action or right of rescission.

In determining what standard of conduct should apply to broker-dealers, the SEC opted not to apply the Advisers Act fiduciary standard to broker-dealers or to adopt a new uniform fiduciary standard that would apply to both broker-dealers and investment advisers. While the new standard of conduct under the Regulation includes several elements that are

[1] "Retail customer" is defined as "a natural person, or the legal representative of such natural person, who (i) receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer, or a natural person who is an associated person of a broker or dealer; and (ii) uses the recommendation primarily for personal, family, or household purposes." Rule 15*l*-1(b)(1). The final rules narrowed the proposed definition by limiting "retail customers" to *natural* persons (and their legal representatives).

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similar to key elements of the fiduciary standard applicable to investment advisers, the adopting release stresses that the Regulation's standard is not a fiduciary standard.

The compliance date for the Regulation is **June 30, 2020**.

Compliance with Regulation Best Interest

The General Obligation is triggered at the time a recommendation (including an implicit hold recommendation resulting from agreed-upon account monitoring services) is made to a retail customer,[2] and is satisfied by a broker-dealer complying with the four specific obligations – ***Disclosure, Care, Conflict of Interest, and Compliance*** – described below.

The Disclosure Obligation. The Disclosure Obligation requires broker-dealers to provide the retail customer, prior to or at the time of the recommendation, in writing, full and fair disclosure of:

A. all material facts relating to the scope and terms of the relationship with the retail customer, including:

    1. that the broker, dealer, or such natural person is acting as a broker, dealer, or an associated person of a broker or dealer with respect to the recommendation;

    2. the material fees and costs that apply to the retail customer's transactions, holdings and accounts;

    3. the type and scope of services provided to the retail customer, including any material limitations[3] on the recommendation to the retail customer. In this regard, the broker-dealer must disclose the general basis for the recommendation and a discussion of the risks associated with the recommendation; and

B. all material facts relating to conflicts of interest[4] that are associated with the recommendation, such as those related to compensation arrangements and recommendations of proprietary products.

Supplemental Disclosure. The SEC recognized the importance of providing broker-dealers with flexibility regarding the time and manner in which disclosure of a particular material fact is made. Therefore, the SEC clarified in the adopting release that, in certain limited circumstances, the Disclosure Obligation may be satisfied by oral disclosure or disclosure

[2] The Regulation applies broadly to recommendations of securities transactions and investment strategies involving securities. The adopting release points to existing FINRA guidance for determinations of whether a recommendation has been made, such as whether the communication "reasonably could be viewed as a 'call to action'" or "reasonably would influence an investor to trade a particular security or group of securities." Furthermore, the final rules expanded the proposed text to explicitly state that the Regulation covers recommendations of securities account types and recommendations to roll over or transfer assets from one type of account to another. As a result, account recommendations will be subject to the Regulation regardless of whether those recommendations are tied to particular securities transactions.

[3] Material limitations include, for example, (i) recommending only proprietary products, a specific asset class, or products with third-party arrangements; (ii) recommending only products from a select group of issuers; and (iii) if a firm is dually registered as both a broker-dealer and an investment adviser, but an associated person of the firm is only permitted to provide brokerage services, the fact that the associated person's services are materially narrower than the services offered by other associated persons of the firm who are permitted to provide brokerage and advisory services.

[4] The final Regulation adopts a definition of "conflict of interest" and provides that only the "material facts" of such conflicts must be disclosed. The Regulation defines "conflict of interest" as "an interest that might incline a broker, dealer, or a natural person who is an associated person of a broker or dealer—consciously or unconsciously—to make a recommendation that is not disinterested."

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after a recommendation is made if a broker-dealer provides initial, written disclosure that states what the material facts are and describes how the material facts will be supplemented, clarified or updated.[5]

Duty to Update. A broker-dealer must update when information provided becomes materially inaccurate or when there is new material information. In the adopting release, the SEC noted that the duty to update is based on facts and circumstances and, while it declined to provide a specific timeframe for when updates would be required, noted that broker-dealers generally should update disclosure documents as soon as possible and, in any event, no later than 30 days after a material change.

Use of Terms "Adviser" or "Advisor". Use of the words "adviser" or "advisor" in a name or title by (i) a broker-dealer that is not also registered as an investment adviser or (ii) an associated person who is not also a supervised person of an investment adviser will be presumed to violate the Regulation. The use of either of these words would directly conflict with the disclosure that the broker, dealer, or associated person is acting as a broker, dealer, or associated person of a broker or dealer.

The Care Obligation. The Care Obligation requires broker-dealers, in making recommendations to retail customers, to exercise reasonable diligence, care, and skill to:

1. understand the potential risks, rewards, and costs 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 customers;

2. have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on the customer's investment profile and the potential risks, rewards, and costs associated with the recommendation and does not place the financial or other interest of the broker-dealer ahead of the interest of the retail customer; and

3. 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 customer's best interest when taken together in light of the customer's investment profile and does not place the financial or other interest of the broker-dealer making the series of recommendations ahead of the interest of the customer.

While it may not be clear exactly what "best interest" means, the adopting release does state that the Care Obligation "significantly enhances the investor protection provided as compared to current [FINRA] suitability obligations."

The Conflict of Interest Obligation. The Conflict of Interest Obligation requires broker-dealers to establish, maintain, and enforce written policies and procedures designed to:

1. identify and at a minimum disclose, in accordance with the Disclosure Obligation, or eliminate, all conflicts of interest associated with recommendations to retail customers;

[5] For example, with regard to product-level fees, a broker-dealer could provide an initial standardized disclosure of product-level fees generally (e.g., reasonable dollar or percentage ranges), noting that further specifics for particular products appear in the product prospectus, which will be delivered after a transaction in accordance with the delivery method the retail customer has selected, such as by mail or electronically. Similarly, with regard to the disclosure of a broker-dealer's capacity, a dually registered broker-dealer and investment adviser could disclose that recommendations will be made in the broker-dealer capacity unless otherwise expressly stated at the time of the recommendation, and that any such statement will be made orally.

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2. identify and mitigate any conflicts of interest associated with recommendations that create an incentive for an associated person to place the interest of the broker, dealer, or associated person ahead of the interest of the retail customer;

3. identify and disclose any material limitations on recommendations to a retail customer and any conflicts of interest associated with such limitations, in accordance with the Disclosure Obligation, and prevent such limitations and associated conflicts of interest from causing the broker-dealer to make recommendations that place the interest of the broker-dealer ahead of the interest of the retail customer; and

4. identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time.[6]

Where a conflict of interest creates too strong an incentive for a broker-dealer to make a recommendation that places the broker-dealer's interest ahead of the retail customer's interest, the Conflicts of Interest Obligation requires policies and procedures designed to eliminate the conflict or to both disclose and mitigate the conflict.

The Compliance Obligation. The Compliance Obligation, which is a new requirement that did not appear in the proposing release, requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with the Regulation.

The SEC stated that a "reasonably designed compliance program" generally would include: controls, remediation of non-compliance, training, and periodic review and testing.

Recordkeeping. In connection with the Regulation, the SEC adopted new recordkeeping provisions under the Exchange Act. Specifically, Rule 17a-3(35) requires broker-dealers to retain a record of all information collected from and provided to a retail customer pursuant to the Regulation, as well as the identity of each associated person, if any, responsible for the account. With respect to information provided orally, the adopting release clarifies that broker-dealers must retain a record of the fact that oral disclosure was provided to the customer. The Regulation does not explicitly require broker-dealers to maintain a record of the substance of the disclosure.

INTERPRETATION OF "SOLELY INCIDENTAL" IN ADVISERS ACT § 202(A)(11)(C)

The Advisers Act regulates the activity of "investment advisers" as defined in the Act. Section 202(A)(11)(C) excludes from the definition of "investment adviser" brokers or dealers "whose performance of such advisory services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor" (the "exclusion"). On June 5, 2019, the SEC published an interpretive release to clarify its position with respect to the exclusion.

According to the SEC, a broker-dealer is within the exclusion if "the advice is provided in connection with and is reasonably related to the broker-dealer's primary business of effecting securities transactions." This determination will be made based on the facts and circumstances related to the broker-dealer's business, services offered and relationship with its customer. Notably, the analysis does not rely on the amount of advice or the importance of the advice.[7] As discussed below, the interpretation provides additional guidance on how the exclusion applies (i) when broker-dealers exercise investment discretion over customer accounts and (ii) when broker-dealers engage in account monitoring.

[6] The SEC believes that these incentives create the most problematic conflicts and cannot be reasonably mitigated.
[7] According to the interpretation, "[a]dvice need not be trivial, inconsequential, or infrequent to be consistent with the solely incidental prong."

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Investment Discretion

When a broker-dealer is given unlimited discretion over a customer account, the broker-dealer is not within the scope of the exclusion. When the broker-dealer is granted discretion on a temporary or limited basis, whether the broker-dealer is within the scope of the exclusion depends on the facts and circumstances.

The SEC included the following as examples of temporary or limited discretion that are typically within the scope of the exclusion: (i) discretion as to the price at which or the time to execute an order given by a customer for the purchase or sale of a definite amount or quantity of a specified security; (ii) discretion on an isolated or infrequent basis, to purchase or sell a security or type of security when a customer is unavailable for a limited period of time; (iii) discretion as to cash management, such as to exchange a position in a money market fund for another money market fund or cash equivalent; (iv) discretion to purchase or sell securities to satisfy margin requirements, or other customer obligations that the customer has specified; (v) discretion to sell specific securities and purchase similar securities in order to permit a customer to realize a tax loss on the original position; (vi) discretion to purchase a bond with a specified credit rating and maturity; and (vii) discretion to purchase or sell a security or type of security limited by specific parameters established by the customer.

Account Monitoring

Broker-dealers that *agree* to periodically monitor a customer's account for purposes of providing buy, sell or hold recommendations may be deemed to be providing advice in connection with effecting securities transactions and, therefore, may be ineligible for the exclusion.

The SEC differentiated this fact pattern from a broker-dealer that *voluntarily, without any agreement* with the customer, reviews the customer's account holdings for purposes of determining whether to provide a recommendation to the customer and, if the recommendation is determined to be appropriate, contacts the customer to make the recommendation. A broker-dealer whose actions are within this fact pattern is taking actions that are reasonably related to its primary business of effecting securities transactions.

The SEC recommended that broker-dealers consider adopting policies and procedures to govern when account monitoring is within the scope of the exclusion, stating that broker-dealers may include in their policies and procedures that:

> a registered representative may agree to monitor a customer's account at specific time frames (*e.g.*, quarterly) for the purpose of determining whether to provide a buy, sell, or hold recommendation to the customer. However, such policies and procedures should not permit a broker-dealer to agree to monitor a customer account in a manner that in effect results in the provision of advisory services . . . such as providing continuous monitoring.

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Please contact your regular Ropes & Gray attorney with any questions about Regulation Best Interest and the "solely incidental" interpretive release.

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