# Regulation Best Interest: First Analysis

**A Lexis Practice Advisor® Practice Note by Jay Baris and Russell Sacks, Shearman & Sterling LLP**

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## Introduction

This article discusses the Regulation Best Interest (Regulation BI) adopted by the U.S. Securities and Exchange Commission (the Commission or SEC) on June 5, 2019, culminating a multi-year consideration of commentary, reports, rulemaking, interpretations, and guidance and changing the landscape for how retail investors will interact with their broker dealer financial services providers. It also adopted new guidance that aims to clarify the applicable standards of care of investment advisers. The new rules standardize and implement additional disclosure obligations required of broker-dealers when dealing with retail customers. Simultaneously, the new guidance provides a description of investment advisers' fiduciary duties that effectively seeks to harmonize that existing standard with the new standards for broker-dealers set forth in Regulation BI.

### Rule Overview

Regulation BI is designed to improve investor protection by: (1) enhancing the obligations that apply when a broker-dealer makes a recommendation to a retail customer and (2) reducing the potential harm to retail customers from conflicts of interest that may affect such recommendations.

Regulation BI modifies the broker-dealer standard of care by:

- Creating a general obligation for brokers-dealers to act to in the best interest of their retail customer at the time the recommendation is made, without placing the financial or other interest of the broker-dealer ahead of the interests of the retail customer-and-
- Requiring broker-dealers to address 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 has determined that disclosure is insufficient to reasonably address the conflict, to mitigate or, in certain instances, eliminate the conflict

In so doing, the Commission declined to subject broker-dealers to a fiduciary duty (like investment advisers), or to create a uniform standard for broker-dealers and investment advisers alike or subject broker-dealers to the same standards as found under the Investment Advisers Act of 1940 (Advisers Act) for investment advisers. Rather, the Commission, chose to adopt a standard of conduct specifically for broker-dealers, relying upon and adopting key principles underlying fiduciary obligations, including obligations of care and disclosure of conflicts of interest. As a practical matter, Regulation BI moves the standard of care for broker-dealers away from the historically preeminent suitability standard, and closer to a fiduciary standard.

# Background

On April 18, 2018, the SEC published a package of proposed rules, interpretations and guidance (the Proposed Rules). In a statement the same day, SEC Chairman Jay Clayton highlighted the key issues that, in his view, informed Commission action: (1) the potential harm from misalignment between reasonable investor expectations and actual legal standards that apply to financial professionals; (2) investor confusion regarding the differences between broker-dealers and investment advisers; and (3) increasing regulatory complexity and the potential to increase confusion and reduce service offerings and investor choice. For further details, see Jay Clayton's statements at the Open Meeting on Commission Actions to Enhance and Clarify the Obligations Financial Professionals Owe to our Main Street Investors (June 5, 2019) and Open Meeting on Standards of Conduct for Investment Professionals (Apr. 18, 2018). The 2018 Proposed Rules followed years of study and recommendation relating to broker-dealer and investment adviser retail standard of conduct, including Congressional legislation requiring SEC action as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (111 P.L. 203) (Dodd-Frank Act).

### Overview of the 2018 Proposed Best Interest Standard

The Proposed Rule, issued under the Securities Exchange Act of 1934, as amended (the Exchange Act), sought to establish a best interest standard of conduct applicable to broker-dealers when making a recommendation of a securities transaction to a retail customer, which is defined as a person, or the legal representative of such person, who:

- 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-
- Uses the recommendation primarily for personal, family, or household purposes

See Regulation Best Interest, Exchange Act Release No. 34-83062 (Apr. 18, 2018) (the Regulation Best Interest Release).

The Proposed Rule followed the aftermath of the Fiduciary Rule, issued by the U.S. Department of Labor (the DOL), which expanded the applicability of fiduciary status (and corresponding duties) to various financial service providers under the Employee Retirement Income Security Act of 1974, as amended (ERISA). The Fiduciary Rule effectively imposed similar fiduciary status to comparable financial service providers to retail customers, including with respect to Individual Retirement Accounts (IRAs). The United States Court of Appeals for the Fifth Circuit subsequently vacated the rule *in toto*, returning the definition of fiduciary for purposes of ERISA and Section 4975 of the Code to its prior status, which generally did not subject broker-dealers to fiduciary status or a heightened standard of care. See Chamber of Commerce v. U.S. Dep't of Labor, 885 F.3d 360 (5th Cir. 2018).

# Next Steps

The immediate impact and reception of the rule is unclear. The Commission noted, in the adoption release, the tension between commenters to the Proposed Rule who favored a more prescriptive rule and those who favored a more principles-based rule. Accordingly, some may view the resulting final rule to be a definitive strengthening of the standards in place for broker-dealers, while other may believe it did not go far enough.

In the immediate term, however, broker-dealers must begin the process of implementing the rule's disclosure and compliance obligations by adapting systems, adopting written policies, and reviewing operational procedures. If previous experience with respect to the 2010-2011 amendments to FINRA's suitability rules acts as a guide, broker-dealers will require significant and time-consuming amendment to systems, policies, and procedures. By the same token, certain of the interpretive guidance relating to regulatory standards for investment advisers, and especially guidance relating to the role of the investor profile, may create costly and time-consuming requirements for investment advisers that do not currently meet the standards set out in the new guidance.

# Looking Ahead

The rule is effective 60 days after its publication in the Federal Register. However, there is a transition period, giving firms until June 30, 2020 to come into compliance with Regulation BI. The SEC has established an inter-Divisional Standards of Conduct Implementation Committee through which firms may engage in planning compliance.

The new package of rules and interpretive guidance represents the most significant rulemaking for the retail financial services industry in many years. These changes undoubtedly will require the investment of significant time and resources to make necessary operational and other changes, including to mandatory disclosures, marketing materials and compliance systems.

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Jay G. Baris is a partner in the Investment Funds practice and has practiced in the asset management area for more than 35 years.

Jay is widely recognized for his breadth of experience representing registered funds, investment advisers, financial institutions, broker-dealers and independent directors on the full spectrum of financial services regulation, transactions and governance matters. Jay's work with registered funds spans mutual funds, closed-end funds, exchange-traded funds (ETFs) and business development companies (BDCs). He has extensive experience advising on the regulatory aspects of fund and investment advisory operations, and has represented numerous clients on mergers and acquisitions, reorganizations, compliance, exemptive applications and compliance issues. He also advises operating companies on "status" issues that arise under the Investment Company Act of 1940. More recently, he has been advising FinTech clients on cryptocurrency issues.

An active speaker and writer on issues concerning investment management and the regulation of financial institutions, Jay has been published in a variety of trade and general interest publications, Insights: The Corporate & Securities Law Advisor, The New York Times, The Wall Street Journal, The Review of Securities & Commodities Regulation, Fund Action, The Review of Banking & Financial Services, Fund Directions and Fund Board Views.

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Russell Sacks is a partner in the Financial Institutions Advisory & Financial Regulatory practice.

He provides advice to market participants on a worldwide basis with respect to regulatory, transactional, trading and markets issues, with particular emphasis on U.S. regulation of securities broker-dealers, alternative trading systems, clearing agencies and exchanges.

Russell represents U.S. banks and broker-dealers, including Bank of America Merrill Lynch, Citi Private Bank and Citigroup Global Markets and Morgan Stanley, on a range of trading and markets issues, with particular emphasis on broker-dealer regulation and regulation of private banks and wealth management organizations; global banks and broker-dealers, including Credit Suisse, Banco Itaú, National Bank of Canada Financial and China Construction Bank International, with particular emphasis on research, trading, and capital markets issues; and investment banking boutiques, such as Qatalyst Partners and Evercore ISI, in respect of investment banking regulation and compliance. Russell also regularly represents SIFMA with respect to various issues in SEC and FINRA regulation.

Prior to joining Shearman & Sterling, he served as law clerk to The Honourable Justice Allen M. Linden of the Federal Court of Appeal in Ottawa, Canada.