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The SEC’s Best Interest Standard

How We Got Here? And Where We’re Going?

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Current Landscape

- **Broker-Dealers**
  - Act as principal or agent for issuer in distributing and selling securities to the public
  - Transaction-based compensation received from issuer for success in selling securities
  - Advice must be incidental to brokerage sales function
  - Suitability requirement under FINRA rules
  - Federal and State registration and regulation

- **Investment Advisers**
  - Act as agent for client in providing advice to client
  - Fee-based compensation received from client
  - Fiduciary to clients under the Advisers Act as determined by Supreme Court
  - Federal or State registration and regulation
Background

1995
- Report of the Committee on Compensation Practices (the Tully Report)

2005
- SEC adopts a rule allowing broker-dealers to receive fee-based compensation
- US Court of Appeals vacates the new SEC rule

2007
- SEC proposes a new interpretive rule, reinstating portions of the vacated rule

2010
- President Obama signs the Dodd-Frank Act
- DOL proposes fiduciary rule for retirement accounts

2011
- Pursuant to Dodd-Frank Act, SEC releases study on standards of conduct for broker-dealers and investment advisers
- DOL adopts final fiduciary rule

2016
- President Trump issues a memo to the DOL requesting further review of fiduciary rule
- DOL delays the effective date for its fiduciary rule
- SEC Chairman Jay Clayton solicits public comments for standards of conduct for broker-dealers and investment advisers

2017
- Fifth Circuit vacates DOL fiduciary rule in its entirety
On April 18, in a 4-1 vote, the United States Securities and Exchange Commission (the “SEC”) proposed a comprehensive rule set governing the fiduciary duty and standard of conduct applicable to broker-dealers and investment advisers that provide retail investment advice. The proposed rules would:

- Establish a broker-dealer best interest standard of conduct when recommending securities transactions to retail customers (the “Regulation Best Interest”);
- Require broker-dealers and investment advisers to summarize their relationship to retail investors in a document not to exceed 4 pages;
- Restrict the use of the term “adviser” or “advisor” by broker-dealers in specified circumstances; and
- Require investment advisers to adhere to a new SEC standard of conduct interpretation.
SEC’s Proposed Best Interest Standard

- Regulation Best Interest (or “Reg BI”) would:
  - Require broker-dealers, as well as any persons associated with the broker-dealer, when making recommendations of any securities transaction or investment strategies to retail customers, to act in the best interest of the retail customer at the time the recommendation is made.
    - Not an ongoing duty.
    - Applies to investment strategies.
    - Retail “customers” (not “investors”).
What does “Best Interest” Mean?

- The recommendation must not place the interests of the broker-dealer ahead of the retail customer’s interests.

- “Best interest” satisfied if the following three conditions met:
  
  - **Disclosure** – At the time the recommendation is made, the broker-dealer must reasonably disclose to the retail customer, in writing, the material facts relating to the scope of the brokerage relationship, including all material conflicts of interest that are associated with the securities recommendation.

  - **Care** – In making the recommendation, the broker-dealer must exercise reasonable care. The SEC clarified that reasonable care must be taken to ensure that the recommendation could be in the best interest of at least some retail customers, is in the best interest of a particular retail customer based on that customer's investment profile, and is not excessive and is in the retail customer’s best interest when taken together as a series of recommended transactions.

  - **Conflict of Interest** – Broker-dealers must establish and maintain written policies and procedures to identify and disclose, or eliminate, material conflicts of interest associated with a recommendation. More specifically, firms are required to establish procedures to identify, disclose, and mitigate (or eliminate) material conflicts of interest arising from financial incentives associated with the recommendation.
Issues?

- Conflict disclosure
  - Disclose/Mitigate vs. Eliminate
- Reasonable compensation
- Duties owed to customers and clients
- “Best interest” standard
- Enforceability of standard of conduct
- State laws
State Fiduciary Laws

- Nevada
  - Effective July 1, 2017, Nevada law amended to impose fiduciary duty on broker-dealers and investment advisers.
  - Implementing regulations issued January 18, 2019

- Other states
  - Connecticut
  - Maryland
  - New Jersey
  - New York

- NSMIA Preemption
Road Ahead

- U.S. House Financial Services Committee hearing on March 14, 2019 to discuss Regulation BI with SEC Chairman Jay Clayton
- U.S. Senator Sherrod Brown (D – Ohio) calls for U.S. Senate Banking Committee to hold hearings on Regulation Best Interest
- Final Rule:
  - Comment period expired August 7, 2018
  - Final rule expected by September 2019
- Legal challenges?
Questions?

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