Regulation Best Interest — What is it and what happens next?

By Evan Rosser

The Securities and Exchange Commission (SEC) has been authorized to craft a fiduciary rule since the Dodd-Frank Act passed in 2010. In light of this mandate and the uncertainty created by the Department of Labor's Fiduciary Rule, many expected an SEC rule proposal that would create a consistent fiduciary standard applicable to broker dealers, investment advisers, insurance agents, financial planners, and other financial professionals. In April, the SEC presented its long awaited rule proposal as a three-part regulatory package aimed at reforming the way that investment professionals serve retail investors. SEC Chairman Jay Clayton called the proposals appropriate steps toward clarifying and enhancing current regulations, citing concerns with, among other things, the apparently moribund "fiduciary rule" implemented by the DOL.

But it doesn't appear that's what the proposals do. The proposals do not bring about a consistent standard that reconciles the differences in the standards under ERISA or the DOL Fiduciary Rule, the Investment Advisers Act, state rules and regulations (including insurance regulations), or the standards imposed by quasi-governmental or private actors like FINRA and the Certified Financial Planning Board. So what do the proposals do?

If enacted as proposed, the proposals, collectively called Regulation Best Interest (Reg BI), would impose upon BDs an obligation to act in a retail customer's "best interest" when recommending securities transactions or strategies. Importantly, Reg BI does not define the term "best interest." Instead of imposing a fiduciary standard like the DOL's Fiduciary Rule for retirement accounts or the investment adviser fiduciary standard under which RIAs operate, Reg BI lays out three requirements that BDs must satisfy to comply with their "best interest" obligation. Reg BI appears to provide a "safe harbor" for BDs who comply with the three requirements: disclosure; care; and conflict of interest.

The disclosure obligation states that BDs must communicate certain facts about the terms and the scope of their services to customers at the beginning of a professional relationship and disclose certain conflicts of interest relating to their recommendations.

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Under the care obligation, BDs must also exercise reasonable care, diligence, skill and prudence when making recommendations to retail customers. That reasonable care looks similar to the current suitability determinations required by FINRA's Suitability Rule, Rule 2111, specifically: reasonable basis suitability, customer specific suitability and quantitative suitability. In fact, without Reg BI, FINRA has already noted that a recommendation must be consistent with the customer's best interest and FINRA guidance and cases note that BDs must not put their interests ahead of their customers'. There is no existing requirement, however, that BDs ignore their own interest in a transaction and it isn't clear whether that requirement exists in Reg BI.

The conflict of interest obligation requires BDs to establish, maintain, and enforce written policies and procedures that are reasonably designed to identify and then disclose or eliminate material conflicts of interest stemming from a recommendation, and disclose and mitigate, if not eliminate, material conflicts of interest arising from financial incentives from a recommendation. This conflict requirement is probably the most material change to current broker-dealer requirements.

However, there are two specific things that Reg BI does not attempt to do: impose a fiduciary standard on BDs or seek a uniform standard for both BDs and RIAs. Instead, these proposals allow a broker-dealer to meet its "best interest" obligation by fulfilling what are essentially the existing standards for broker-dealer conduct and having reasonably designed policies and procedures to eliminate, or mitigate and disclose the broker-dealer's competing interests. The "safe harbor" created by complying with the three requirements protects the broker-dealer, not the customer.

To paraphrase Commissioner Kara Stein, a critic of the proposal, Reg BI does not require financial professionals to put their customers' interests first nor does it require full and fair disclosure of any conflicting interests. Reg BI does not require all financial professionals who make investment recommendations related to retail customers to do so as fiduciaries. And Reg BI does not require financial professionals to provide retail customers with the best available options.

The SEC also posed for public comment several general questions suggesting that the SEC is also interested in imposing certain traditional BD requirements onto RIAs: should there be a federal licensing and continuing education requirement for RIA personnel?; should RIAs be required to deliver periodic account statements to customers that disclose personalized fees and expenses?; and should RIAs be subject to financial responsibility requirements (i.e., minimum net capital requirements)?

The final components of the SEC's proposal are aimed at reducing retail investors' confusion about the differences between BDs, RIAs and the services that these entities provide. Form CRS (Client Relationship Summary) would require BDs and RIAs to provide retail investors with a standardized disclosure document at the beginning of a customer relationship that contains information about the services the BD and/or RIA offers, the standard of conduct owed to the client, the fees, and certain material conflicts of interest. The SEC included three templates of what this disclosure document might look like.

In addition to Form CRS, this proposal also includes a requirement that would restrict the ability of BDs that are not RIAs from using the word "adviser" or "advisor" as part of their names or titles. Whether this naming limitation will be expanded remains to be seen, but it is a good step in reducing retail clients' confusion.

The 90-day comment period ended on August 7 and, as expected, the number of comments was well into the thousands. To their credit, all of the Commissioners repeatedly encouraged comment letters by all interested parties. It appears that the Commission knows there is much work to do on Reg BI. One significant deficiency is the absence of a "best interest" definition. The proposal studiously avoided the word "fiduciary." When asked why at the recent FINRA Annual Conference, Chairman Clayton said, "I thought calling them both fiduciary [adviser and broker standards] and then defining them would not make it clear that the relationship models were different... It's important for an investor to understand that the relationship model of the broker-dealer is different than the relationship model of the investment adviser." And therein lies the problem in establishing a consistent fiduciary standard.

Nevertheless, if the Commission wants to steer clear of that term, it should provide a definition of the term with which to replace it.

We agree with commentators who note that under proposed Reg BI, a registered rep of a broker dealer would be able to hold himself out as operating in the client's best interest, without being held to a fiduciary standard of care. That type of wordsmithing does not add to client understanding or protection.

We believe also the Form CRS needs revision. We agree in principle with providing retail investors with simple, easy-to-understand information about the nature of their relationship with their investment professional. However, the initial standardized disclosure CRS Forms provided with Reg BI do not meet the clear and concise standard. They will need work.

The SEC developed Reg BI with the goal of improving the quality of advice given by broker-dealers to clients while also preserving the 'pay as you go' model as an option for investors. Nevertheless, the current version of the proposed Reg BI, while sensitive to preserving the current broker-dealer model for those customers for whom it works best, is likely to be viewed as weak and falling short of the consistent fiduciary standard and customer protection for which many hoped.

Many industry participants and regulators are concerned about investors leaving the ERISA fiduciary protections and institutional pricing of their current 401(k) retirement plans and moving to products offered by broker-dealers and investment advisers without those protections and with retail pricing.

Recently, the Fifth Circuit Court of Appeals issued a 2-1 decision vacating the DOL Fiduciary Rule, possibly driving the final stake into the Rule's heart. The decision rejects the regulation re-defining fiduciary investment advice, as well as the new prohibited transaction exemptions and modifications to old exemptions adopted along with the regulation. The effect of the decision, if it becomes final, will be to revert to the regulatory definition of fiduciary advice adopted in 1975 and to the pre-2016 prohibited transaction exemptions.

Without the DOL Fiduciary Rule, the pressure will grow on Reg BI. If Reg Bi is viewed by state regulators and other authorities as a watered-down version of a strong, consistent fiduciary standard for all investors, it will not stem the growing effort of many states to impose their own fiduciary standards to protect investors. Nevada lawmakers approved a law last July that extends an existing fiduciary law to include financial planners, stockbrokers, and other commission-based investment representatives. '40 Act Advisers also must disclose profits or commissions they earn on client investments.

Legislation also has been adopted in Connecticut that requires a financial planner to disclose to a consumer, upon request, whether or not the planner has a fiduciary duty to the consumer for each recommendation. New York has proposed new consumer protections in life insurance sales that would adopt a "best interest" standard for sellers of life insurance and annuity products. New Jersey and Maryland are also considering legislation.

We will wait to see if the unintended result of the SEC's Reg BI could be, rather than a consistent standard, a growing patchwork of fiduciary standards and regulations around the country.

ENDNOTE

* As an Oyster consultant, Evan Rosser has served as CCO for both investment advisers and broker-dealers, as well as providing compliance support to numerous broker-dealers and registered investment advisers. Evan has also served as an independent consultant in both SEC and FINRA enforcement actions involving Rule 15c3-5 and Market Access, AML, market manipulation and low-prices securities trading. Evan has served as an expert witness in FINRA enforcement actions and arbitrations. Prior to consulting, Evan supervised FINRA Enforcement's investigative staff of more than 40 supervisors and examiners, and successfully completed hundreds of investigations alleging numerous FINRA and SEC rule violations including NASDAQ and OTCBB trading violations, excessive equity markups, and NASD/FINRA sales practice, corporate financing and advertising rule violations.