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For more information,
contact:

Patricia Jo
+1 212 556 2376
pjo@kslaw.com

Richard Margolies
+1 212 827 4080
rmargolies@kslaw.com

Russ Ryan
+ 1 202 626 5457
rryan@kslaw.com

Mirella de Rose
+1 212 827 4083
mderose@kslaw.com

Russell Johnston
+1 212 827 4081
rjohnston@kslaw.com

Michael Watling
+1 212 827 4082
mwatling@kslaw.com

Alec Koch
+1 202 626 8982
akoch@kslaw.com

King & Spalding

New York
1185 Avenue of the Americas
New York, New York 10036-4003
Tel: +1 212 556 2100

Washington, D.C.
1700 Pennsylvania Avenue, NW
Washington, D.C. 20006-4707
Tel: +1 202 737 0500

The SEC Approves Regulation Best Interest: The Broker-Dealer Standard of Conduct

INTRODUCTION

On June 5, 2019, the Securities and Exchange Commission (“SEC”) voted to adopt Regulation Best Interest: The Broker-Dealer Standard of Conduct (hereinafter, “Regulation BI”), requiring broker-dealers and their associated persons to “act in the best interest” of retail customers when recommending securities transactions or strategies to retail customers.¹ The SEC approved the rule by a 3-1 vote, with Commissioner Robert Jackson dissenting.

Regulation BI makes it clear that a broker-dealer may not put its financial interests ahead of the interests of a retail customer when making recommendations, and sets forth new disclosure, care, conflict of interest, and compliance obligations for industry members.² While some market participants hailed Regulation BI as an enhancement and improvement to existing standards of conduct set by FINRA – which currently require that investment recommendations be “suitable” for clients – critics argue that the new regulation does not go far enough to protect retail investors and falls short of the fiduciary standard that investment advisers owe their clients under the Investment Advisers Act of 1940. Notably, Regulation BI does not define “best interest.” The adoption of Regulation BI also leaves existing suitability standards up in the air pending further determination by FINRA. This alert summarizes Regulation BI and its likely impact on broker-dealer firms, associated persons, and FINRA’s longstanding suitability rules.

FROM “SUITABILITY” TO “BEST INTEREST”

Currently, broker-dealers are held to a “suitability” standard pursuant to FINRA Rule 2111 (“Rule 2111”). The suitability standard is rooted in fair dealing, and requires that broker-dealers and associated persons have a reasonable basis to believe a recommended transaction or investment strategy involving securities is suitable for a customer, based on information obtained through reasonable diligence to ascertain the



customer's investment profile.³ A customer's investment profile can include age, investments, financial situation, tax status, objectives, investing experience, investment time horizon, liquidity needs, and risk tolerance. Suitability also requires that brokers have a firm understanding of both the recommended product and the customer's investment profile.

Regulation BI alters the existing suitability standard and framework by imposing new obligations on broker-dealers, including:

- **Disclosure Obligation:** A requirement that broker-dealers disclose material facts about the scope and terms of their relationship with the customer, including disclosures that the firm or representative is acting in a broker-dealer capacity, the fees and charges the customer will incur, and the type and scope of services to be provided by the broker-dealer.⁴ In addition, broker-dealers must disclose all material facts about their recommendations to the customer, including conflicts of interest associated with the recommendation, such as conflicts associated with proprietary products, payments from third parties, and compensation arrangements;⁵
- **Care Obligation:** A requirement to exercise reasonable diligence, care, and skill when making a recommendation to a retail customer. The broker-dealer must understand potential risks and rewards, and must consider the costs associated with the recommendation;
- **Conflict of Interest Obligation:** A requirement to establish, maintain, and enforce written policies and procedures reasonably designed to identify and either disclose or eliminate conflicts of interest. The policies and procedures must (1) mitigate conflicts that create an incentive for the firm's financial professionals to place their interests above the retail customer's interest; (2) prevent material limitations on offerings, such as a limited product menu or the offering of only proprietary products, from causing the firm or its financial professionals to place their interests ahead of the retail customer's interest; and (3) eliminate sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sale of specific securities or types of securities within a limited period of time;
- **Compliance Obligation:** A requirement for broker-dealers to establish, maintain, and enforce policies and procedures reasonably designed to achieve compliance with Regulation BI as a whole.⁶

Along with Regulation BI, the SEC approved a new Form CRS Relationship Summary, which requires both investment-advisers and broker-dealers to deliver relationship summaries to retail investors at the beginning of their relationship. This summary, provided in a standardized question and answer format for easy comparison, must include information about the firm's services, fees and costs, conflicts of interest, legal standard of conduct, and existing disciplinary history.⁷ The SEC also issued an interpretation to reaffirm and clarify its views of the fiduciary duty that investment advisers owe to their clients under the Investment Advisers Act of 1940, and an interpretation of the "solely incidental" prong of the broker-dealer exclusion under the same Act, intended to more clearly delineate when a broker-dealer's performance of advisory activities causes it to become an investment adviser within the Act.⁸

IMPLEMENTING REGULATION BI

What do these obligations mean for broker-dealers? In his dissent, Commissioner Jackson warned that the rule "fails to require that investor interests come first" and that it does not define the term "Best Interest," rendering Regulation BI "far too ambiguous about a question on which there should be no confusion."⁹ Other critics have argued that Regulation BI merely codifies the status quo, or even weakens existing standards if brokers rely on merely disclosing conflicts of interest, instead of mitigating or eliminating them.¹⁰

The SEC has given the industry slightly more than a year – until June 30, 2020 – to become compliant with Regulation BI. In the interim, FINRA will likely need to decide how Regulation BI impacts its own suitability rule. While it is too early to predict the fate of FINRA Rule 2111, early commentary from FINRA suggests that the suitability standard may become moot with Regulation BI in place. Prior to the adoption of Regulation BI, FINRA's CEO said that if the regulation "covered



100% of our suitability rule . . . then we might look at whether we need our suitability rule or do we need it in all circumstances.”¹¹ Similarly, at FINRA’s annual conference in Washington, D.C., another FINRA official commented that the existing suitability rule would likely be mooted by Regulation BI, as it would “raise the bar set by FINRA’s suitability rule,” and “if there is overlap — and certainly from the proposal, it appears that there’s a lot — there would be no need for suitability.”¹²

STATE FINANCIAL REGULATORS

One issue left unaddressed by the SEC is whether state fiduciary rules would be preempted by the federally promulgated Regulation BI. Instead, the SEC deferred that issue to the judicial branch, stating that “the preemptive effect of Regulation Best Interest on any state law governing the relationship between regulated entities and their customers [will] be determined in future judicial proceedings based on the specific language and effect of that state law.”¹³ Adding to the confusion is that several state financial regulators look to be passing stronger investor protection rules at the state level; for example, regulators in Nevada, Maryland, New Jersey, and Massachusetts are already considering more restrictive proposals for uniform fiduciary standards applicable to both broker-dealers and investment advisors.¹⁴ New York is also considering a bill that would require non-fiduciaries to make conflict of interest disclosures.¹⁵

CONCLUSION

Federal approval of Regulation BI has been a long time coming, but much remains unknown for its long-term impact on broker-dealers and associated persons. All eyes will be on the SEC for clarity on how Regulation BI will be implemented and enforced and how states and self-regulatory organizations like FINRA will react with their own rulemaking. Until then, it’s safe to assume that the tide will continue to move toward stricter regulatory scrutiny for brokers’ investment recommendations to retail investors.

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¹ SEC Press Release 2019-89, *SEC Adopts Rules and Interpretations to Enhance Protections and Preserve Choice for Retail Investors in Their Relationships With Financial Professionals* (June 5, 2019), <https://www.sec.gov/news/press-release/2019-89>.

² *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, Exchange Act Release No. 34-86031, 2019 WL 2420297 (June 5, 2019), available at <https://www.sec.gov/rules/final/2019/34-86031.pdf>.

³ FINRA, "Suitability" <https://www.finra.org/industry/suitability>

⁴ *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, *supra* note 2, at *12.

⁵ *Id.* at *6.

⁶ SEC Press Release 2019-89.

⁷ *Id.*

⁸ *Id.*

⁹ SEC Statement on Final Rules Governing Investment Advice, Commissioner Robert J. Jackson Jr., June 5, 2019, <https://www.sec.gov/news/public-statement/statement-jackson-060519-iabd>; see also Rachel Graf, *SEC Approves Broker Standards Despite Objections*, Law360 (June 5, 2019, 6:54 p.m. EDT), <https://www.law360.com/articles/1166166/sec-approves-new-broker-standards-despite-objections>.

¹⁰ Tara Siegel Bernard, *S.E.C. Adopts New Broker Rules That Consumer Advocates Say Are Toothless*, N.Y. Times (June 5, 2019), <https://www.nytimes.com/2019/06/05/your-money/sec-investment-brokers-fiduciary-duty.html> ("Advocates worry that the changes don't define what it means for a broker to act in a customer's best interest, and allows brokers to rely on disclosing conflicts of interest instead of trying to mitigate or eliminate them. They also fear the changes will create confusion about investment advisers' fiduciary duty, in part because the language says they, too, can lean more on merely disclosing conflicts.").

¹¹ Melanie Waddell, *FINRA's Cook: SEC Reg BI Compliance to Be a Heavy Lift*, ThinkAdvisor (May 8, 2019, 3:11 p.m.),

<https://www.thinkadvisor.com/2019/05/08/finras-cook-two-issues-top-of-mind-regarding-sec-reg-bi-compliance/?sreturn=20190506102554>.

¹² Alison Noon, *Best Interest Standard Likely End of FINRA Suitability Rule*, Law360 (May 16, 2019, 9:45 p.m. EDT),

<https://www.law360.com/articles/1160646/best-interest-standard-likely-end-of-finra-suitability-rule>.

¹³ *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, *supra* note 2, at *15.

¹⁴ Kenneth Corbin, *As States Clash With Feds Over Fiduciary, Regulation Jitters Rise*, FinancialPlanning.com (March 1, 2019, 6:19 a.m. EST),

<https://www.financial-planning.com/news/nevada-maryland-new-jersey-push-fiduciary-proposal-as-iaa-seeks-to-shield-advisors-from-new-regulation>;

see also Melanie Waddell, *Galvin Proposes Fiduciary Rule in Massachusetts*, ThinkAdvisor (June 14, 2019, 4:06 PM),

<https://www.thinkadvisor.com/2019/06/14/galvin-proposes-fiduciary-rule-in-massachusetts/>.

¹⁵ Kenneth Corbin, *As SEC's Reg BI Looms, States Chart Their Own Fiduciary Path*, FinancialPlanning.com (Feb. 4, 2019, 4:25 p.m. EST),

<https://www.financial-planning.com/news/as-secs-regulation-best-interest-looms-states-chart-their-own-fiduciary-path>.