

## **CCS Summary**

### *SEC's Proposed Regulation Best Interest for Broker-Dealers*

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As part of its efforts to enhance investor protection by applying consistent principles to investment advisers and broker-dealers, on April 18, 2018 the U.S. Securities and Exchange Commission (the "Commission") released its proposed Regulation Best Interest to clarify that a broker-dealer may not put his or her firm's financial interests ahead of the interests of the retail customer when making investment recommendations. Regulation Best Interest is one component of a three-part package of proposed regulations and interpretive guidance released by the Commission seeking to harmonize protections offered to retail investors by the financial services industry participants.

The proposed rule represents a seismic shift in the Commission's view, whereby broker-dealers who provide investment recommendations to retail customers would now be held to fiduciary-like principles that have historically been applied only to registered investment advisers. The fiduciary-like principles proposed in Regulation Best Interest would be an additive requirement, and not a requirement designed to alter a broker-dealer's current obligations under the Exchange Act nor its obligations under the general anti-fraud provisions of federal securities laws.

Through the proposed regulation, the Commission has outlined its expected goals and benefits that would be realized with the eventual passage of the rule, including (i) an enhancement to the overall quality of investment recommendations being provided to retail customers, (ii) enhancements to disclosures to retail customers, allowing them to better opportunity to evaluate the recommendations received from broker-dealers; (iii) the facilitation of more consistent regulation of similar activities, applying key principles regarding fiduciary obligations applied to investment recommendations in other contexts; and (iv) a better alignment between a broker-dealers' legal obligations and retail customers' expectations.

Under the proposed regulation, broker-dealers, when making an investment recommendation, will be required "to act in the best interest of the retail customer at the time the recommendation is made without placing the financial or other interests of the broker, dealer, or a natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer." While notably not providing a definition of "best interest" in the proposed regulation, the Commission asserts its belief that determining whether a broker-dealer acted in the best interest of a retail customer when making a recommendation will be based on particular circumstances of each recommendation and retail customer, coupled with the broker-dealer's satisfaction of the four particular obligations of Regulation Best Interest, detailed below, are satisfied.

**Disclosure Obligation:** The broker-dealer, prior to or at the time of the recommendation, provides reasonable written disclosure to the retail customer the material facts relating to the scope and terms of the relationship with the retail customer and all material conflicts of interest associated with the recommendation.

**Care Obligation:** In making the recommendation, the broker-dealer exercises reasonable diligence, care, skill and prudence to:

1. Understand the potential risks and rewards 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 retail customer's investment profile and the potential risks and rewards associated with the recommendation; 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 retail customer's best interest when taken together in light of the retail customer's investment profile.

**Conflict of Interest Obligations:** The broker-dealer establishes, maintains and enforces written policies and procedures reasonably designed to: a) identify and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with recommendations, and b) identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations.

The Commission indicates in the proposal that Regulation Best Interest is not intended to apply a blanket prohibition on investment recommendations and transactions involving conflicts of interest (i.e. – commission charges, recommending proprietary products, etc.), but rather a broker-dealer may continue to effect such transactions for a retail customer so long as the above-referenced obligations of the Best Interest Regulation are met by the broker-dealer along with the recommendation being made in compliance with antifraud provisions of the Exchange Act and other federal securities laws.

The Commission's proposed Regulation Best Interest is now open for a 90-day public comment period, to which we anticipate much debate and comment from the financial services industry, most notably of which could be the plea for the Commission's definition of "best interest". As with any proposed rulemaking or regulations, the ultimate look and feel of Regulation Best Interest will be in flux, and the resulting impact to broker-dealers and their retail customers remains uncertain at this time. It also remains to be seen how Regulation Best Interest may impact other pending regulation set out to protect retail and retirement investors, most notably the DOL Fiduciary Rule. However, through the Commission's vote to propose this new regulation, the notice is clear that the Commission is taking the next steps in carrying out its mission to protect the investments and savings of retail investors through the adoption of harmonized obligations required of those in the business of provided investment recommendations or advise to retail customers.