

Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter Archive Message #695

Date: 11-Jun-18

Subject: Mary E. Vandenack and the SEC's Proposed Rule "Regulation Best Interest"

"The SEC has proposed a package of rules to enhance the protection of retail customers. One of the proposed rules is Regulation Best Interest. Regulation Best Interest imposes certain obligations on broker-dealers to act in the best interest of a retail customer. This commentary covers the proposed Best Interest Rule. A previous commentary covered one of the SEC's companion documents, a proposed interpretation clarifying and affirming the fiduciary duty of investment advisers. A follow up commentary will cover an additional proposed SEC rule that would require both broker-dealers and associated persons and investment advisers to provide a Customer Relationship Summary that would disclose the nature of the type of advisor and relationship as well as fees and conflicts of interest. The proposed rule requiring the Customer Relationship Summary will be covered in a follow-up commentary. Of interest in the proposed rules is the requirement that broker-dealers could not use the terms 'adviser' or 'advisor' when representing their roles to retail customers.

In [Employee Benefit & Compensation Planning Newsletter #694](#), **Mary Vandenack** provided members with her analysis of a proposed SEC interpretation clarifying and affirming the fiduciary duty of investment advisers. Now, Mary returns and shares her analysis of the SEC's proposed rule "Regulation Best Interest."

Mary E. Vandenack is founding and managing member of **Vandenack Weaver LLC** in Omaha, Nebraska. Mary is a highly regarded practitioner in the areas of tax, benefits, private wealth planning, asset protection planning, executive compensation, equity fund development, business and business succession planning, tax dispute resolution, international tax, state and local tax, and tax-exempt entities. Mary's practice serves businesses and business owners, executives, real estate developers and investors, health care providers, companies in the financial industry, and tax exempt organizations. Mary is a member of the American Bar

Association Real Property Trust and Estate Section where she serves as Co-Chair of the Futures Task Force, Co-Chair of the Technology and Economics of Law Practice Committee and Vice Chair of the Asset Protection Planning Committee. Mary is a member of the American Bar Association Techshow Board and incoming Editor-in-Chief of Law Practice Magazine. Mary was named to ABA LTRC 2018 Distinguished Women of Legal Tech. Mary is a frequent writer and speaker on tax, benefits, asset protection planning, and estate planning topics as well as on practice management topics including improving the delivery of legal services, technology in the practice of law, building sustainable law firms, and alternative fees for process-oriented law firms.

Here is her commentary:

EXECUTIVE SUMMARY:

The SEC has proposed a package of rules to enhance the protection of retail customers. One of the proposed rules is Regulation Best Interest. Regulation Best Interest imposes certain obligations on broker-dealers to act in the best interest of a retail customer. This commentary covers the proposed Best Interest Rule. A previous commentary covered one of the SEC's companion documents, a proposed interpretation clarifying and affirming the fiduciary duty of investment advisers. A follow up commentary will cover an additional proposed SEC rule that would require both broker-dealers and associated persons and investment advisers to provide a Customer Relationship Summary that would disclose the nature of the type of advisor and relationship as well as fees and conflicts of interest. The proposed rule requiring the Customer Relationship Summary will be covered in a follow-up commentary. Of interest in the proposed rules is the requirement that broker-dealers could not use the terms "adviser" or "advisor" when representing their roles to retail customers.

FACTS:

Regulation Best Interest¹ has been proposed by the SEC to establish a standard of conduct for broker-dealers, and those persons associated with broker dealers when making recommendations regarding a security transaction or investment strategy to a retail customer. Generally, the Rule requires a broker-dealer to act in the best interest of a retail customer when

a recommendation is made. The broker-dealer must place the interest of the retail customer ahead of the interest of the broker-dealer.

The SEC noted that many retail customers do not understand the regulatory differences between broker-dealers and investment advisers. With Regulation Best Interest, the SEC seeks to retain the beneficial characteristics of the differences between broker-dealers and investment advisers, while at the same time protecting retail customers by regulating broker-dealers and requiring various information be provided to retail customers.

In developing the Proposed Rule, the SEC drew from principles that apply to investment advice under other regulatory regimes, state common law, the Advisors Actⁱⁱ and the DOL Fiduciary Rule.ⁱⁱⁱ One of the goals was to establish greater consistency with respect to the protections provided to recipients of investment advice. In the Rule, the SEC notes reliance on the best interest standards of Section 913(g) of the Dodd-Frank Act, stating that the underlying intent of such section is that a broker-dealer should not put its interests ahead of the retail customer's interests when making a recommendation.

The SEC is accepting comments on the proposed rule through August 7, 2018.

COMMENT:

Regulation Best Interest would apply to broker-dealers and any natural person who is an associated person. For the definition, the SEC proposes using the definition under Section 3(a)(18) of the Exchange Act, which is "any partner, officer, director or branch manager of such broker or dealer (or any person occupying a similar status or performing a similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer, except that any person associated with a broker or dealer whose functions are solely clerical or ministerial shall not be included in the meaning of such term for purposes of section 15(b) of this title (other than paragraph 6 thereof)." The SEC's intention in using this definition is that the rule will apply to the broker-dealer entity and any individual who is associated with the broker-dealer.

The proposed rule will apply to a broker-dealer, or associated person, “when a recommendation is being made.” In the proposed rule, it is noted that the concept of making a recommendation is well understood. The factors that have historically been considered include whether the communication can reasonably be considered a call to action and whether the communication would influence an investor to trade a particular security. The more that a communication is specifically tailored to a certain customer or group of customers, the more likely the communication is a recommendation. Providing general investment information or limited investment analysis would be excluded. The rule would apply to implicit recommendations.

Regulation Best Interest would be triggered any time a broker dealer makes a recommendation. The rule does not require a broker-dealer to reject a customer’s direction that the broker-dealer disagrees with. The rule does not apply to self-directed or unsolicited transaction of a retail customer.

The proposed rule is intended to be consistent with the BIC Exemption under the DOL Fiduciary Rule in that the broker-dealer is to disclose whether the broker-dealer will monitor the retail customer’s investments and if so, the frequency of such monitoring.

A broker-dealer would not be able to include a provision in an agreement whereby a retail customer could waive the broker-dealer’s best interest obligation. The retail customer would not be able agree to waive the customer’s protection under Regulation Best Interest.

Regulation Best Interest would apply to “any securities transaction or investment strategy”. A securities transaction would include a recommendation to roll over or transfer assets from one type of account to another (but not to establishing a particular type of account that is not tied to a transaction). An investment strategy would include explicit recommendations to hold a security or the manner in which a security is purchased or sold.

A “retail customer” would be defined as “a person, or the legal representative of such person, who (1) 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 (2) uses the recommendation primarily for personal, family, or household purposes.” The rule notes that the definition tracks that of Section 913(a) of the Dodd-Frank Act.

Regulation Best Interest includes three primary components. If such components are satisfied, then a broker-dealer will have satisfied its obligation to act in the best interest of a retail customer.

Disclosure Obligation

The Disclosure Obligation would require a broker-dealer, or associated person “to, prior, or at the time of the recommendation, reasonably disclose to the retail customer, in writing, the material facts relating to the scope and terms of the relationship with the retail customer, and all the material conflicts of interest associated with the recommendation.”

Generally, the following should be disclosed:

- The fact that the broker-dealer is acting in a broker-dealer capacity.
- Details of the fees and charges that apply to the customer’s holdings and transactions.
- Type and scope of services provided by the broker-dealer.
- All material conflicts of interest associated with any recommendation.

The SEC is proposing an additional rule that will (1) require broker-dealers and investment advisers to provide a “Customer Relationship Summary” to retail customers that explains the nature of the broker-dealer or investment adviser; (2) restrict broker-dealers and associated persons from using the term “adviser” or “advisor”; and (3) require broker-dealers and investment advisers to disclose their registration status with the SEC. In the Best Interest Rule, the SEC notes that the proposed required Customer Relationship Summary will require general disclosures about the nature of the broker-dealer relationship, fees, and conflicts of interest, but that the disclosure obligation under the Best Interest Rule will typically require more detailed disclosures with reference to specific proposed transactions.

Care Obligation

The Care Obligation of the proposed rule would require that a broker-dealer, when making a recommendation “exercise reasonable diligence, care, skill, 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 that retail customer’s investments 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 profile.”

The Care Obligation would require a broker-dealer to consider reasonable alternatives. While proprietary products and products of affiliates are not prohibited, the broker-dealer would need to establish a reasonable basis for the recommendation.

Conflict of Interest Obligation

The Conflict of Interest Obligation would require a broker-dealer to “(1) establish, maintain, and enforce written policies and procedures reasonably designed to identify, and disclose, or eliminate, all material conflicts of interest that are associated with recommendations covered by Regulation Best Interest; and (2) establish, maintain, and enforce written policies and procedures reasonably designed to identify, and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations.”

A “material conflict of interest” is a “conflict of interest that a reasonable person would expect might incline a broker-dealer – consciously or unconsciously – to make recommendation that is not disinterested.” A common conflict of interest would involve financial incentives related to the broker-dealer’s compensation from a transaction.

Under the rule, broker-dealers would be required to have, and enforce written policies and procedures that help identify material conflicts of training. Broker-dealers would also be required to have training procedures for associated persons on how to identify conflicts of interest.

The rule requires broker-dealers to mitigate the conflicts of interest that arise from financial incentives. Some possible ways to mitigate include avoiding compensation that increases disproportionately with increased sales, minimizing incentives that favor one type of product, eliminating incentives within comparable product lines, and adjusting compensation for registered representatives who fail to adequately manage conflicts of interest.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Mary Vandenack

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CITATIONS:

ⁱ 17 CFR Part 240, Release No. 34-83062; File No. S7-07-18.

ⁱⁱ 17 CFR Part 275.

ⁱⁱⁱ 82 FR 16902.