Summary of the rule package

On April 18, 2018, the Securities and Exchange Commission (SEC) proposed a package of three rulemakings and interpretations (the rule package) which were designed to enhance the transparency along with quality of investors’ relationships with broker-dealers, as well as investment advisers, without compromising on the access to a variety of investment products and different types of advice relationships available to these investors.

These three proposals are:

**Proposed regulation best interest**

If adopted as proposed, this would be a new rule under the Securities Exchange Act of 1934 (Exchange Act) establishing a standard of conduct for broker-dealers and natural persons who are associated persons of a broker-dealer (natural persons), when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer. The proposed standard of conduct is to act in the best interest of the retail customer at the time a recommendation is made without placing the financial or other interest of the broker-dealers or natural persons ahead of the interest of the retail customers (regulation best interest, Reg BI).

The rule requires the broker-dealers to adhere to three primary obligations: disclosure, care, and conflict of interest:

- **The disclosure obligation** aims to facilitate the customer’s awareness of key information regarding their relationship with the broker-dealer. It would require the broker-dealer to reasonably disclose, in writing, all material facts relating to the scope and terms of the relationship and all material conflicts of interest to the customer.

- **The care obligation** requires a broker-dealer, when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer, to exercise reasonable diligence, care, skill, and prudence to: (1) understand the potential risks and rewards associated with the recommendation, (2) have a reasonable basis to believe that the recommendation is in the best interest of that customer’s investment profile, and (3) have a reasonable basis to believe that a series of recommended transactions is not excessive.
• The **conflict of interest obligation** aims to identify and address conflicts of interest, whether through elimination or, at a minimum, disclosure. The obligation requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to identify, and disclose, or eliminate, all: (1) material conflicts of interest and (2) financial incentives associated with such recommendations.

**Proposed form CRS relationship summary, amendments to form ADV, required disclosures in retail communications, and restrictions on the use of certain names or titles**

SEC is proposing a rule to reduce investors’ confusion related to their relationship with investment professionals, which requires registered investment advisers and registered broker-dealers to provide a summary to retail investors about the relationships and services the firm offers, the standards of conduct and the fees and costs associated with the services, specified conflicts of interests, and whether the firm and its financial professionals currently have reportable legal or disciplinary events. The rule also proposes to restrict broker-dealers and associated natural persons, when communicating with a retail investor, from using the term “adviser” or “advisor” in their name or title unless such broker-dealer is registered as an investment adviser under the Investment Advisers Act of 1940 (Advisers Act) or with a state. The proposed rule also requires broker-dealers and investment advisers to disclose, in retail investor communications, the firm’s registration status with the SEC, and an associated natural person’s and/or supervised person’s relationship with the firm.

**Proposed commission interpretation regarding standard of conduct for investment advisers:**

Considering the comprehensive nature of the proposed set of rulemakings, the SEC has also clarified certain aspects of the fiduciary duty that an investment adviser owes to its clients under section 206 of the Advisers Act.

The proposal addresses two primary fiduciary duties as:

- **Duty to care:** This includes duty to provide advice that is in the client’s best interest; duty to seek best execution; and duty to act and to provide advice and monitoring over the course of the relationship; and
- **Duty to loyalty:** This includes duty to put client’s interest first and duty to make full and fair disclosure to its clients of all material facts relating to the advisory relationship

Apart from above clarifications, the SEC has also proposed certain potential enhancements to registered investment advisers’ legal obligations related to: (1) federal continuing education and licensing requirements, (2) provision of account statements, and (3) financial responsibility program.

**How to prepare**

The proposed Rule Package has already garnered more than 6,000 comments during the comment period by various industry bodies, firms, individual advisors, and other regulators; and the SEC is aiming to release the final version of the rules by September 2019.

To be ready for the final rules, below are some key actions for firms to consider undertaking:

- **Assess current state:** Firms should review the requirements of the rule proposals and interpretive release in detail; and assess their current state across people, process, and technology to identify the gaps and potential enhancements needed to be compliant with new requirements. These gaps should then be used to inform an enhanced operating model that incorporates compliance.
• **Design conflicts related controls, policies, and procedures:** Firms should define what a material conflict is, with respect to their businesses; build a robust governance mechanism over the designation process to ensure it is in line with industry and regulators’ expectations, and refresh their policies and procedures accordingly. Firms may need to review the existing standard of conduct and relationship summary documents and make necessary updates. Firms should also design/update controls aimed at meeting the regulatory obligations, and later enforcing them. This will further require updating current supervision and compliance systems or implementing new systems to manage the conflicts related controls.

• **Catalog material conflicts of interest:** After defining the categories of potential material conflicts, firms should review each of their businesses to identify the existing material conflicts of interest. Once cataloged, firms should address these conflicts by mapping policies and procedures to the respective material conflict of interests that will address how these conflicts are either eliminated or mitigating, including disclosure considerations. This analysis should be undertaken at both the line of business (LOB) level and across LOBs at the enterprise level.

• **Prepare reasonable disclosures:** Under the proposed Reg BI rule, firms would be required to reasonably disclose the capacity in which they are making recommendations, their relationship summary, usage of titles, fees and charges, types and scope of services, and their material conflicts of interest in a clear and crisp manner prior to or at the time of recommendation. Firms should update their disclosures compliant with the new requirements to the extent they already exist. Tools and processes, in areas such as recordkeeping and reporting, may require updates to accommodate new and updated disclosures.

• **Assess sales practices:** Ethical sales practices and fair conduct are fundamental to compliance with these three proposals. In recent years, the product landscape, and the fees and incentives associated with those products have increased in complexity to promote sales or capture market share. Firms should revisit, and redesign if necessary, their sales practices to increase transparency of fees and incentives to investors, incentivize appropriate sales practice conduct consistent with the Rule Package, and mitigate any material conflict of interests.

• **Prepare for workforce readiness:** Compliance with regulatory obligations is highly contingent on how well a firm’s employees and advisors have embraced the change. It is extremely important for firms to educate their advisors about the new fiduciary operating model including obligations, policies, procedures, processes, and controls. Firms should monitor the adoption of the enhanced operating model after the advisor training and provide support throughout the journey.

**Conclusion**

Firms have a tremendous amount of work ahead of them to prepare for the proposed rules. While some requirements may have been assessed, and potentially implemented for retirement accounts during the Department of Labor Fiduciary Rule era, broker-dealers and investment advisers should assess how those requirements impact their retail businesses. Deloitte brings a multi-disciplinary team of consultants, attorneys, ex-regulators, and technology architects who work together to help clients prepare for these upcoming changes. The Deloitte team can assist firms in their adoption of the Rule Package by designing operating models that can balance the obligation to meet the requirements with existing business strategy objectives. Once the operating model is designed, our business, technology, and data specialists can further assist, from building systems to transforming the workforce. During this uncertainty and movement toward the fiduciary and/or best interest world, Deloitte is with you through every step.
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Endnotes

5 For purposes of Regulation Best Interest, SEC proposes to interpret a “material conflict of interest” as a conflict of interest that a reasonable person would expect might incline a broker-dealer—consciously or unconsciously—to make a recommendation that is not disinterested.