Speech

Regulation Best Interest and the Investment Adviser Fiduciary Duty: Two Strong Standards that Protect and Provide Choice for Main Street Investors

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Boston, Massachusetts

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Good evening and thank you for being here.[1]

As many of you know, in June, the Securities and Exchange Commission adopted a package of rules and interpretations that will enhance the quality and transparency of retail investors' relationships with broker-dealers and investment advisers. Importantly, they bring the legal requirements and mandated disclosures for broker-dealers and investment advisers in line with reasonable investor expectations. These actions do not attempt to favor one type of service or relationship. Rather, they are designed to increase investor protection while preserving access for Main Street investors—both in terms of choice and cost—to a variety of investment services and products.

Our rules and interpretations benefit from and build upon the Commission's extended history of broker-dealer and investment adviser regulation, the substantial experience and expertise of our staff, our analysis over many years of prior efforts to modernize and improve regulation in this area, and the many thoughtful comments and other feedback we received on our proposals.[2] Without question, these actions, individually and collectively, will significantly benefit Main Street investors.

Since we adopted our rulemaking package, there has been no shortage of views expressed, both from those in support of our efforts and from those who would have preferred a different approach. Some of this commentary has, in my view, shown a lack of understanding of the law and legal obligations of financial professionals, both before and after adoption of our rulemaking package. This has only further solidified my view that our actions were timely and appropriate, and will ultimately benefit retail investors and our markets.

Today, I will begin with a brief overview of our rulemaking package. I will then respond to some of the commentary you may have heard. Finally, building on our investor roundtable earlier this afternoon, I will provide a few words of advice to retail investors who are considering whether to work with a financial professional.

1. Summary Overview of Rules and Interpretations

Broadly speaking, our rules and interpretations address the obligations of broker-dealers and investment advisers when they provide recommendations and investment advice to Main Street investors. The rules and interpretations address an area of law and practice that has become more important and more complex.

a. Regulation Best Interest – Enhancing the Standards of Conduct for Broker-Dealers

Regulation Best Interest—or "Reg. BI"—imposes a new standard of conduct specifically for broker-dealers that substantially enhances their obligations beyond the current "suitability" requirements. The standard can be viewed as having two components. First, it establishes a general obligation that draws from key fiduciary principles, requiring broker-dealers to act in the best interest of their retail customers and not place their own interest ahead of the retail customer's interest. Second, it includes specific requirements to address aspects of the broker-dealer relationship where our experience indicated that focused attention was appropriate. More specifically, Reg. BI is satisfied only if the broker-dealer complies with four specified component obligations: Disclosure, Care, Conflict of Interest, and Compliance. Each of these obligations includes a number of prescriptive requirements, all of which must be satisfied to comply with the rule.

b. Fiduciary Interpretation – Affirming and Clarifying the Investment Adviser Fiduciary Duty

Our Fiduciary Interpretation reaffirms, and in some cases clarifies, certain aspects of the federal fiduciary duty that an investment adviser owes to its clients. This duty—comprised of both a duty of care and a duty of loyalty—is principles-based and applies to the entire relationship between the investment adviser and the client.

The Fiduciary Interpretation confirms the Commission's longstanding view that an investment adviser must, at all times, serve the best interest of its client and not subordinate its client's interest to its own.

c. Form CRS Relationship Summary – Enhancing Transparency and Comparability

Investment advisers and broker-dealers will be required to deliver a short, plain language relationship summary to retail investors at the beginning of their relationship. The relationship summary is designed to help retail investors select or determine whether to remain with a firm or financial professional by providing better transparency and summarizing in one place—on two pages—specific information about the broker or adviser.

Firms will be required to provide information about their relationship and services, fees and costs, conflicts of interest, standard of conduct, and whether or not the firm and its financial professionals have legal or disciplinary history. This disclosure will have a standardized question-and-answer format to promote comparability across firms.

d. Solely Incidental Interpretation – Clarifying Broker-Dealer and Investment Adviser Activities

Finally, the rulemaking package includes an interpretation of the solely incidental prong of the broker-dealer exclusion under the Investment Advisers Act of 1940 ("Advisers Act"). This interpretation confirms and clarifies the Commission's position, and illustrates the application in practice in connection with exercising investment discretion over customer accounts and account monitoring.

2. Commentary on Reg. BI, the Fiduciary Interpretation and other Commission Actions

Let me now address some of the commentary, or, more specifically, the criticism and misinformation, I alluded to at the outset. I believe that much of this criticism—which is focused broadly on the extent of the investor protections under Reg. BI and our Fiduciary Interpretation—is false, misleading, misguided, and unfortunately, in some cases, is simply policy preferences disguised as legal critiques.

Before discussing specific points, I want to address a general issue—whether it is appropriate to maintain a regulatory distinction between broker-dealers and investment advisers. A number of commenters expressly or impliedly advocated for regulation that would collapse the distinction, with a substantial majority of those commentators favoring the generally applicable investment adviser model where clients pay an asset-based fee or a flat fee for generally broad-based financial advice from a fiduciary. To be clear, I believe this is a good model, and for many investors, this type of investment adviser relationship may better match their needs than the typical broker-dealer relationship. However, for many other investors, the broker-dealer model, particularly after the implementation of Reg. BI—either alone or in combination with an investment adviser relationship—provides the better match. For example, a retail customer that intends to buy and hold a long-term investment may find that paying a one-time commission to a broker-dealer is more cost effective than paying an ongoing advisory fee to an investment adviser to hold the same investment. That same investor might want to use a brokerage account to hold those long-term investments, and an advisory account for other investments.

This is a key reason why one of our goals in this rulemaking was to preserve access and choice for Main Street investors. I firmly believe that as a result retail investors will be better off—choice and competition will ultimately inure to the benefit of retail investors in terms of lower fees, better services and transparency, and more offerings.

Under our approach, Main Street investors will be able to choose the type and level of services they want—from occasional recommendations about particular investments to comprehensive account management—and how they want to pay for those services. I do not believe that a "one size fits all" approach would best serve the diverse interests of our Main Street investors. Further, I believe in this area, a one-size fits all approach could reduce the availability and increase the cost of advice and services, particularly for those with relatively smaller accounts.

Claim #1: The Regulation Best Interest standard of conduct will not do enough to protect retail investors

Let me be clear: Reg. BI substantially enhances the standard of conduct for broker-dealers. Importantly, it does so in a manner that (1) establishes a standard of care for transaction-based advice that draws upon principles underlying the investment adviser fiduciary duty, and (2) is workable for broker-dealers.[3] As a result, (1) whether a retail investor chooses a broker-dealer or an investment adviser (or both), the recommendation or advice is required to be in the best interest of the retail investor and cannot place the interests of the firm or the financial professional ahead of the interests of the retail investor, and (2) the ability to choose between a broker-dealer transaction-based model and an investment adviser portfolio-based model—and choose among the various iterations and combinations of each—will be preserved.

But let me be more specific, and highlight just a few (of the many) key features of Reg. BI that enhance the standard of conduct:

1. Reg. BI applies to account recommendations, including recommendations to roll over or transfer assets in a workplace retirement plan account to an IRA, as well as recommendations to take a plan distribution. These recommendations are often provided at critical moments (such as at retirement), may be irrevocable (or very costly to reverse), can involve a substantial

portion of a retail investor's net worth, and can have significant long-term impacts on the retail investor. Accordingly, this is a critical enhancement over both existing broker-dealer obligations and our proposal.

2. Reg. BI affirmatively requires broker-dealers to act in the best interest of their retail customers and not place their own interests ahead of the customer's interests. The broker-dealer must comply with the four component obligations I mentioned:
   - The Disclosure Obligation, which requires full and fair disclosure of all material facts about the scope and terms of its relationship with the customer, including material facts relating to conflicts of interest associated with its recommendations.
   - The Care Obligation, which requires brokers to exercise reasonable diligence, care, and skill, to understand the potential risks, rewards, and costs associated with the recommendation, and to consider those risks, rewards, and costs in light of the customer's investment profile in order to make a recommendation that is in the best interest of the retail customer and does not place the broker-dealer's interests ahead of the retail customer's interest.
   - The Conflict of Interest Obligation, which requires firms to implement policies and procedures to mitigate (and in some cases, eliminate) certain identified conflicts of interest that create incentives to make recommendations that are not in the retail customer's best interest.
   - The Compliance Obligation, which requires firms to implement policies and procedures reasonably designed to achieve compliance with Reg. BI as a whole.
3. The Care Obligation will apply to a series of recommended transactions (currently referred to as "quantitative suitability") *irrespective* of whether a broker-dealer exercises actual or de facto control over a customer's account. This enhancement will allow us to bring enforcement actions against broker-dealers engaging in misconduct over the course of a relationship more efficiently and thereby return money to harmed retail investors more quickly.

Some critics have gone so far as to fault Reg. BI for failing to require elimination of all conflicts of interest. This criticism is misguided—there are conflicts of interest inherent in all principal-agent relationships, and the broker-customer relationship and the investment adviser-client relationship are no exception. Reg. BI recognizes that these conflicts exist, and requires that firms address those conflicts and provide recommendations that are in the best interest of their retail customers.

Claim #2: Regulation Best Interest is deficient because it does not define "best interest" and does not require a broker to recommend the "best" security

I disagree with this criticism.

In the comment letters and in meetings with various parties, differing views were expressed regarding whether the standard should be more principles-based or more prescriptive—and in particular, whether to provide a detailed, specific, situation-by-situation definition of "best interest" in the rule text.

We considered this issue very carefully. Our view was that the best approach would be to apply the specific component obligations of Reg. BI, including the "best interest" requirement in the Care Obligation, in a principles-based manner. Under Reg. BI, whether a broker-dealer has acted in the retail customer's best interest will turn on an objective assessment of the facts and circumstances of how the specific components of the rule are satisfied.

This principles-based approach is a common and effective approach to addressing issues of duty under law, particularly where the facts and circumstances of individual relationships can vary widely and change over time, including as a result of innovation. This approach to determining what is in the "best interest" of a retail customer is similar to an investment adviser's fiduciary duty, which has

worked well for advisers' retail clients and our markets. Indeed, there is no definition of "best interest" under the Advisers Act.

Neither investment advisers nor broker-dealers are required to recommend the single "best" product. Many different options may in fact be in the retail investor's best interest, and what is the "best" product is likely only to be known in hindsight. In short, it is appropriate and symmetrical for both standards to use a principles-based approach to determining "best interest."

Claim #3: The Fiduciary Interpretation weakens the existing fiduciary duty that applies to investment advisers by not requiring advisers to "put clients first"

This claim is flatly wrong. Our Fiduciary Interpretation in no way weakens the existing fiduciary duty; rather, it reflects how the Commission and its staff have inspected for compliance, applied and enforced the law in this area for decades. The interpretation reaffirms the important protections that the fiduciary duty under the Advisers Act has long provided and will continue to provide.

The Fiduciary Interpretation makes clear that an investment adviser's fiduciary duty is the duty that was articulated by the Supreme Court in *SEC v. Capital Gains*[4] and further explained by courts and the Commission over the years since the decision was issued.
Although courts and the Commission have used a variety of formulations to describe an adviser's fiduciary duty, the core principle has always been that the adviser must at all times serve the best interest of its client and not subordinate its client's interest to its own. This is the standard reaffirmed in the Fiduciary Interpretation.

Some have taken issue with the words we used in describing the investment adviser's fiduciary duty, that an adviser "not subordinate its clients' interests to its own" or "not place its own interest ahead of its client's interests." They would prefer the formulation that an adviser must "put its client's interest first." I have no qualms with an adviser saying that they "put their client's interest first"—as our Fiduciary Interpretation recognizes, that is a plain English formulation of the legal standard that may be more understandable to retail clients.

But in setting forth the Commission's interpretation of an investment adviser's fiduciary duty, we have stated what the law requires. In our decades of administering this standard consistent with the *Capital Gains* decision, we have never heard that the fiduciary standard is a weak legal standard, and our interpretation is firmly grounded in longstanding law in this area. Given this, it is not surprising that critics have been unable to cite to existing case law that supports the view that the "client first" formulation would provide greater legal protections to investors, nor have they been able to articulate how their preferred formulation would lead to a different result in practical application to the firms we regulate under the Advisers Act. Nothing in the law has changed, but for reasons that I cannot grasp, a few critics want to say it has.

Claim #4: The Fiduciary Interpretation weakens the existing fiduciary duty that applies to investment advisers by not requiring advisers to avoid all conflicts

There is no legal or regulatory basis for this claim.

A few commentators have erroneously pointed to an instruction in SEC Form ADV for support for this claim. The cited instruction was added without comment or commentary by the Commission in 2010. Yet a few have cited this instruction as evidence of a significant, newfound, independent legal requirement for an adviser to *seek to avoid* all conflicts, which would reflect a fundamental change in the fiduciary duty articulated in *SEC v. Capital Gains*.[5]

These critics are simply wrong. Worse, the unfounded grounds on which they place their arguments include the implication that a prior Commission effected such a significant change in regulation without public notice or comment. I am confident that the 2010 Commission did not act that way.

Let's look at the facts. First, it would be strange regulatory policy to re-interpret a foundational legal standard for the investment adviser industry through an instruction to a disclosure form; much less to do so without any indication that the standard had changed. Second, for anyone who looks carefully at the development of this instruction, it is obvious that it did not change the longstanding fiduciary duty.[6]

It is implausible that the Commission would have taken such an important action by: (1) not proposing the new language in the 2008 proposing release; (2) not requesting comment on or otherwise discussing the modification; (3) not identifying any change in law at the time of adoption; (4) creating a new "avoidance" obligation in a Form ADV instruction about disclosure obligations; and (5) not taking any post-adoption regulatory action premised on this alleged "new" standard. It is, in a word, nonsense.

Claim #5: The standards of conduct under Regulation Best Interest and our Fiduciary Interpretation can be satisfied by disclosure alone

This claim reflects a fundamental misunderstanding of how the independent component obligations of Reg. BI operate and a misconception of the investment adviser's fiduciary duty.

When making a recommendation, a broker-dealer has a general obligation to act in the retail customer's best interest and cannot place its own interests ahead of the customer's interests. The general obligation is satisfied only if the broker-dealer complies with the four specified component obligations that I discussed—again, the Disclosure, Care, Conflict of Interest and Compliance Obligations.

Let me focus on the Conflict of Interest Obligation first. In many cases, conflicts of interests will effectively have to be mitigated by broker-dealers, such as conflicts that apply at the representative level. In other cases, conflicts will effectively have to be eliminated.

However, *irrespective* of whether a conflict can be addressed through disclosure or has to be mitigated or eliminated, compliance with Reg. BI does not end with broker-dealers addressing conflicts of interest. The Conflict of Interest Obligation is just one of four specific components of the rule. In all cases, the broker-dealer will *also* need to comply with each of the other component obligations, including, in particular, the Care Obligation.[7] The Care Obligation applies to every single recommendation, regardless of whether a broker-dealer has disclosed, mitigated, or eliminated its conflicts of interest.
In sum, Reg. BI cannot be satisfied by disclosure alone.

Similarly, an investment adviser has an obligation to act in the best interest of its client—which is an overarching principle that encompasses both the adviser's duty of care and duty of loyalty. While an adviser may be able to satisfy the duty of loyalty by providing full and fair disclosure *and*obtaining informed consent, the adviser could not satisfy its duty of care solely through disclosure. Thus, the fiduciary duty cannot be satisfied by disclosure alone.

Claim #6: Regulation Best Interest is a weak standard because it does not require broker-dealers to monitor a customer's account or impose an ongoing duty

This argument is fundamentally flawed. Not only does it reflect a misunderstanding of how federal law applies, it disregards a fundamental goal of our rulemaking which I've discussed—to preserve access to different types and levels of services and related cost structures. I believe investors should be able to choose whether they want ongoing monitoring services and whether to incur the cost of those services.

In addition to preserving access and choice for retail customers, there is a legal reason for not imposing an ongoing monitoring requirement on broker-dealers. As we discussed in our Solely Incidental Interpretation, we do not believe that it would be consistent with the solely incidental prong

of the broker-dealer exclusion under the Advisers Act for a broker-dealer to agree to provide continuous monitoring of a customer account. That activity would subject the broker-dealer to regulation as an investment adviser. Therefore, and let me be clear about what such a requirement would mean: imposing an ongoing monitoring obligation would effectively prohibit brokers from providing retail customers with advice without registering as investment advisers. Again, that would mean less access and choice, and higher costs, for retail customers.

While Reg. BI would apply to any periodic monitoring a broker agrees to provide with respect to a customer account, it does not require a broker to provide such service. Why? Because—while key elements of Reg. BI and the investment adviser fiduciary duty are substantially similar—Reg. BI adopts a specific and tailored approach that recognizes that it would be inappropriate to apply certain generally applicable obligations of investment advisers (e.g., duty to monitor) in the context of a transaction-based relationship.

Claim #7: The relationship summary will not accomplish its original goals of addressing investor confusion regarding the differences between brokers and advisers

We have engaged in extensive and rigorous investor testing relating to the issues addressed by the relationship summary, not just for purposes of this rulemaking, but in connection with our long history in this space.[8] The amount of feedback, investor testing and other information our staff considered in developing the final requirements for the relationship summary, leveraging their considerable experience and expertise with investor disclosures, was extensive—perhaps even unprecedented.[9]

It is clear that retail investors are confused about the differences between brokers and investment advisers. The new Form CRS relationship summary is a substantial improvement over existing retail disclosures, which are often lengthy, framed in legal terminology and dispersed among many documents. No existing retail disclosure provides this level of transparency and comparability across SEC-registered investment advisers, broker-dealers, and dual registrants.

Our final relationship summary, which benefited from investor testing and commentary,[10] is consistent with the original goals of the proposal—it will highlight key information in one place for retail investors. This will help them select or decide whether to continue to use a particular firm or financial professional. It will encourage them—and empower them—to have meaningful and individualized conversations with their financial professionals. It will also help them to easily find additional information because of the layered disclosure approach we adopted.

Let me be clear about two enhancements to Form CRS from our proposal. First, while the final form permits more flexibility in language to enable firms to describe their services more accurately, each firm is required to provide disclosure on the same topics, in the same order and with mandated headings and specific disclosure requirements—on two pages (or four pages for dual registrants). Second, I believe that the design of the final form will result in more meaningful comparisons among firms that will be more relevant to retail investors—because they will be considering the *actual* services, fees and conflicts of firms in a format that allows comparability between and among firms.

To address general investor education, we added a requirement in the very first item of the relationship summary for firms to link to a dedicated, retail investor-oriented landing page on the SEC website Investor.gov. We are committed to undertaking a comprehensive investor education campaign in this space, and to making significant updates to Investor.gov to provide additional plain language content relating to this topic.

I believe the combination of the relationship summary with the educational resources on Investor.gov will be more helpful to retail investors than the proposed prescribed comparisons that may not accurately reflect the services, fees and conflicts of the particular firm or its financial professionals.

3. Conclusion: Some Tips for Retail Investors

Let me wrap up with a few thoughts for retail investors—and let me address my comments directly to the retail investors who have joined us here tonight.

I have covered a lot of ground here, on some very complex rules and interpretations, which are the culmination of decades of debate over what should be done to better protect your interests while preserving access to investment services and products. Interested parties on all sides of the debate have developed strident and divergent views on these issues. For me, it has always been about doing what is best for you.

I recognize that some interest groups would have preferred a different approach. But, after careful consideration, our approach addresses multiple, interrelated issues in a way that best achieves our goals of enhancing investor protection and decision making, while—again—preserving your access and choice.

Today's events are one part of an ongoing SEC investor outreach and education campaign designed to help you understand key differences between brokers and advisers, and to help you decide whether working with one of these types of financial professionals is right for you.

This is an important decision, and I urge you to do your homework and consider it carefully. For example: What types of services do you want? Do you want someone managing your account on an ongoing basis or do you want recommendations on a few stocks, bonds, mutual funds and ETFs? How do you want to pay for those services? Is the financial professional registered and do they have any prior disciplinary history? How is the financial professional compensated and what conflicts of interest do they have?

These are important questions to consider and ask. Our website Investor.gov has more information to help you no matter your level of financial sophistication, including a free and simple search tool that allows you to research financial professionals. It also has examples of questions that can get you started in a conversation with the broker or adviser you are considering—and as I mentioned we're in the process of adding additional specific content, including a series of short educational videos with my tips for Main Street investors.[11]
And if you're not sure what to ask, try my favorite question: how much of my money is going to fees and costs, and how much is going to work for me?

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[1] My words are my own and do not necessarily reflect the views of my fellow Commissioners or the SEC staff.
[2] *See* Chairman Jay Clayton, Statement at the Open Meeting on Commission Actions to Enhance and Clarify the Obligations Financial Professionals Owe to our Main Street Investors (June 5, 2019), available at: https://www.sec.gov/news/public-statement/statement-clayton-060519-iabd.
[3] I believe a standard that is not properly calibrated will result in broker-dealers exiting the market, resulting in less choice and higher costs for retail investors. *See* Regulation Best Interest, Exchange Act Release No. 86031 (June 5, 2019) (discussing ramifications for investor access, choice, and cost in connection with adoption of the Department of Labor's now vacated fiduciary rule and related prohibited transaction exemptions), available at: https://www.sec.gov/rules/final/2019/34-86031.pdf.
[4] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963) ("*SEC v. Capital Gains*").
[5] *SEC v. Capital Gains* states that advisers are required "to eliminate, or at least to expose, all conflicts of interest."
[6] The relevant language in the instruction to Form ADV was not proposed or discussed in the 2008 proposing release, and the 2010 adopting release in which that language appeared did not describe it

as changing an adviser's fiduciary duty. To the contrary, the relevant portion of the adopting release cites to the same precedents cited in our interpretation, demonstrating that the explanation in the instruction of an adviser's duty was *consistent* with settled precedent, not a change in interpretation. Critics have not identified any enforcement action, rule, guidance, or other statement by the Commission since the 2010 amendment that expressly or impliedly embraced this supposed enhancement; and we are not aware of any.

[7] As outlined above, the Care Obligation requires broker-dealers to exercise reasonable diligence, care, and skill when making a recommendation to a retail customer, taking into account the potential risks, rewards, and costs associated with the recommendation, and the customer's investment profile in order to make a recommendation that is in the best interest of the retail customer and does not place the broker-dealer's interests ahead of the retail customer's interest.

[8] *See e.g.*, Angela A. Hung, *et al.*, RAND Corporation, *Investor Testing of Form CRS Relationship Summary* (2018), *available at* https://www.sec.gov/about/offices/investorad/investor-testing-form-crs-relationship-summary.pdf; Brian Scholl, *et al.*, SEC Office of the Investor Advocate and RAND Corporation, *The Retail Market for Investment Advice* (2018), *available at*https://www.sec.gov/comments/s7-07-18/s70718-4513005-176009.pdf; Angela A. Hung, et al., *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers*, RAND Institute for Civil Justice Technical Report (2008), *available at*https://www.rand.org/content/dam/rand/pubs/technical_reports/2008/RAND_TR556.pdf ("2008 RAND Study").

[9] *See supra* note 2 (providing overview of information and feedback our staff considered in developing the final requirements for the relationship summary).

[10] We know, based on extensive testing that we conducted and that other parties submitted, investors found the prescribed wording in our proposed relationship summary to be confusing in many instances. Firms also noted that in many cases that the proposed prescribed wording did not accurately reflect their services. *See* Form CRS Relationship Summary; Amendments to Form ADV Exchange Act Release No. 86032, Advisers Act Release No. 5247 (June 5, 2019).

[11] Tips for Main Street Investors from Chairman Jay Clayton, available at: https://www.sec.gov/page/investment-tips-chairman-jay-clayton