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Regulation Best Interest and Other New SEC Standards of Conduct: Impact on Broker-Dealers, Investment Advisers and Investment Companies

WEDNESDAY, JULY 31, 2019

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Outline

- Regulation Best Interest (BI)
- Form CRS
- SEC Interpretive Release on Investment Adviser Standard of Conduct

Regulation Best Interest (BI)

Overview

- Policy Objectives
- General Conduct Obligation
- Definitional Provisions and Concepts
- Component Obligations
- Possible Next Steps

Policy Objectives

- The enhancements contained in Regulation BI "are designed to improve investor protection by enhancing the quality of broker-dealer recommendations to retail customers and reducing the potential harm to retail customers that may be caused by conflicts of interest."
- Together with the other elements of the rulemaking and interpretive package, Regulation BI also was designed to help retail customers better understand and compare the services offered by broker-dealers and investment advisers and make an informed choice of the relationship best suited to their needs and circumstances, provide clarity with respect to the standards of conduct applicable to investment advisers and broker-dealers, and foster greater consistency in the level of protections provided by each regime, particularly at the point in time that a recommendation is made.

Policy Objectives

- Regulation best interest does not subject broker-dealers to a wholesale and complete application of the existing fiduciary standard under the Investment Advisers Act of 1940 because, in the SEC's view, it:
  - is not appropriately tailored to the structure and characteristics of the broker-dealer business model;
  - would not properly take into account, and build upon, existing obligations that apply to broker-dealers; and
  - would significantly reduce retail investor access to differing types of investment services and products.

Policy Objectives

- In adopting Regulation BI, the SEC also declined to craft a new uniform standard that would apply equally and without differentiation to both broker-dealers and investment advisers.
- The SEC concluded that adopting a "one size fits all" approach would:
  - risk reducing investor choice and access to existing products, services, service providers, and payment options;
  - increase costs for firms and for retail investors in both broker-dealer and investment adviser relationships; and
  - to some extent jettison the existing fiduciary standard applicable to investment advisers.

General Conduct Obligation

- Regulation BI requires that a broker-dealer and its associated persons, when making a recommendation, to act in the retail customer's best interest and not place its own interests ahead of the customer's interests.

General Conduct Obligation

- To satisfy this General Conduct Obligation, a broker-dealer must satisfy ***each and every*** one of the following four core component obligations:
  - provide certain prescribed material disclosures before or at the time of the recommendation about the recommendation and the relationship between the retail customer and the broker-dealer ("Disclosure Obligation");
  - exercise reasonable diligence, care, and skill in making the recommendation ("Care Obligation");
  - establish, maintain, and enforce policies and procedures reasonably designed to address conflicts of interest ("Conflict of Interest Obligation"); and
  - establish, maintain, and enforce policies and procedures reasonably designed to achieve compliance with Regulation Best Interest ("Compliance Obligation") (collectively, "Component Obligations").

Definitional Provisions and Concepts

- "Recommendation"
  - Not formally defined in Regulation BI.
  - The SEC will interpret the term consistent with FINRA Rule 2111, the FINRA suitability rule currently applicable to member broker-dealers.
  - Turns on whether a communication:
    - reasonably could be viewed as a "call to action"; and
    - reasonably would influence a retail investor to trade a particular security or group of securities.

Definitional Provisions and Concepts

- Unlike under existing FINRA guidance, the term "recommendation" also includes implicit hold recommendations that are the result of an explicit agreement to monitor a customer's account.
- The term does not include the following:
  - general financial and investment information;
  - general descriptive information relating to an employer-sponsored retirement or benefit plan;
  - asset allocation models permissible under FINRA Rules;
  - certain interactive investment tools consistent with the above.

Definitional Provisions and Concepts

- "Securities Transaction or Investment Strategy Involving Securities"
  - Also not formally defined in Regulation BI.
  - The SEC interprets this phrase to include account recommendations, which encompass both:
    - recommendations of securities account types, generally (*e.g.,* to open an IRA or margin account); and
    - recommendations to roll over or transfer assets from one account type to another (*e.g.*, a 401(k) plan account to an IRA).

Definitional Provisions and Concepts

- "Retail Customer" is defined as a natural person or the legal representative of such natural person, who both:
  - receives a recommendation of any securities transaction or related investment strategy from a broker-dealer or its associated persons; and
  - uses the recommendation primarily for personal, family, or household purposes.

Definitional Provisions and Concepts

- For purposes of the "Retail Customer" definition, "legal representative" means a natural person's non-professional legal representative. Thus, it does not include a natural person's professional representatives, such as registered investment advisers, corporate fiduciaries, and insurance companies.
- The definition encompasses recommendations made directly to a natural person relating to a self-directed retirement account (e.g., an IRA or participant-directed defined contribution plan for corporate employees).

Definitional Provisions and Concepts

- "Best Interest" also is not formally defined in Regulation BI. The SEC noted the following about this term, however, in the Adopting Release:
  - it will be applied at the time a recommendation is made in a principles-based manner "similar to an investment adviser's fiduciary duty;
  - it will turn on an objective assessment of the surrounding facts and circumstances;
  - it is not susceptible to a bright line test;
  - it will not per se prohibit conflicts of interest; and
  - while a broker-dealer will inevitably have some financial interest in a recommendation – the nature and magnitude of which will vary – the broker-dealer's interests cannot be placed ahead of the retail customer's interest.

Definitional Provisions and Concepts

- "Conflict of Interest" is broadly defined in Regulation BI as any "interest that might incline a broker, dealer, or a natural person who is an associated person of a broker or dealer – consciously or unconsciously – to make a recommendation that is not disinterested.

Definitional Provisions and Concepts

- Finally, Regulation BI applies to a dual registrant and its associated persons only when making recommendations in a broker-dealer capacity.
- Thus, for example, where an investment adviser representative of a dual registrant provides investment advice to a client in his or her advisory capacity.
- Determining the capacity in which a person is acting will turn on the surrounding facts and circumstances, including, among other things, the type of account, how the account is described, the type of compensation received, and the clarity with which capacity is disclosed.

Component Obligations – Disclosure Obligation

- A broker-dealer and its associated persons, prior to or at the time of the recommendation, must provide the retail customer, in writing, with full and fair disclosure of all material facts relating to the scope and terms of the relationship with the retail customer, including:
  - that the broker-dealer or associated person is acting as a broker-dealer or associated person with respect to the recommendation ("Capacity Disclosure Requirement");
  - the material fees and costs applicable to the retail customer's transactions, holdings, and accounts ("Fee Disclosures Requirement");
  - the type and scope of services provided to the retail customer, including any material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer; ("Services Disclosure Requirement"); and
  - all material facts relating to conflicts of interest that are associated with the recommendation ("Conflicts Disclosures").

Component Obligations – Disclosure Obligation

- The materiality standard for purposes of the Disclosure Obligation is consistent with the one the Supreme Court articulated in *Basic v. Levinson* (*e.g.,* a fact is material if there is a substantial likelihood that a retail investor would consider it important).
- Broker-dealers and their associated persons are afforded considerable flexibility in satisfying this Obligation (*e.g.,* disclosures can be made in different documents and formats.
- An associated person, generally, may rely on his or her firm's disclosures, absent knowledge that they are deficient.

Component Obligations – Disclosure Obligation

- Use of the terms “adviser” or “advisor” by a broker-dealer or associated person not also registered as an investment adviser or investment adviser representative will be deemed a violation the Capacity Disclosure Requirement and, thus, the Disclosure Obligation.
- The Fee Disclosures Requirement does not mandate individualized fee disclosure specific to each retail customer. Fees may be disclosed in more standardized terms.
- For purposes of the Services Disclosure Requirement, material limitations placed on a retail customer could include, for example, recommending only proprietary products or only recommending products from a select group of issuers.
- Oral disclosures, generally, are not sufficient to satisfy the Disclosure Obligation, except in certain limited circumstances outlined in the Adopting Release where prior written disclosure is not practical.

Component Obligations – Care Obligation

- In making a recommendation, a broker-dealer or its associated persons must exercise reasonable diligence, care, and skill to:
  - understand the potential risks, rewards, and costs 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 ("Reasonable-Basis Suitability Requirement");
  - 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 investment profile and the potential risks, rewards, and costs associated with the recommendation and does not place the financial or other interest of the broker, dealer, or such natural person ahead of the interest of the retail customer ("Customer-Specific Suitability Requirement"); and

Component Obligations – Care Obligation

- 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 and does not place the financial or other interest of the broker, dealer, or such natural person making the series of recommendations ahead of the interest of the retail customer ("Quantitative Suitability Requirement").

Component Obligations – Care Obligation

- For purposes of the Care Obligation, a "Retail Customer Investment Profile" includes, but is not limited to, the following information about the Retail Customer:
  - age;
  - other investments;
  - financial situation and needs;
  - tax status;
  - investment objectives;
  - investment experience;
  - investment time horizon;
  - liquidity needs;
  - risk tolerance; and
  - any other information that the retail customer discloses.

Component Obligations – Care Obligation

- The Care Obligation, essentially, incorporates and then builds upon FINRA's existing Suitability Rule (Rule 2111) and related guidance.
- Quantitative Suitability Requirement – Unlike under Rule 2111, the Quantitative Suitability Requirement will apply irrespective of whether a broker-dealer exercises actual or *de facto* control over a customer's account.
- Cost – Also, under the Care Obligation, more generally, a broker-dealer must exercise reasonable diligence, care, and skill to understand potential costs associated with the recommendation. This does not necessarily obligate the broker-dealer to recommend the lowest cost option. Cost is one important factor that must be taken into consideration in making a recommendation. However, it is not the only one.

Component Obligations – Care Obligation

- Retail Customer's Best Interest – Finally, and, perhaps, most important, a broker-dealer and its associated persons must determine that a recommendation is in the Retail Customer's best interest and may not place the financial or other interest of the broker-dealer and its associated persons ahead of the Retail Customer's interest.
- Reasonably Available Alternatives – In meeting the Care Obligation, a broker-dealer and its associated persons, generally, must consider reasonably available alternatives offered by the broker-dealer. In terms of conducting such an evaluation, a broker-dealer does not have to conduct an evaluation of every possible alternative, either offered outside of the firm (such as where the firm offers only proprietary or other limited range of products) or available on the firm's platform.

Component Obligations – Conflict of Interest Obligation

- The broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to:
  - identify and disclose all conflicts of interest associated with a recommendation ("General Firm Conflicts Requirement");
  - identify and mitigate any conflicts of interest related to recommendations that create an incentive for a broker-dealer's associated persons to place their own interest or the interest of the broker-dealer ahead of the Retail Customer's interest ("Associated Persons Conflicts Requirement");
  - identify and disclose any material limitations placed on recommended securities or related investment strategies, as well as any related conflicts of interest in accordance with the Disclosure Obligation ***and*** prevent such limitations and associated conflicts from causing the broker-dealer and its associated persons from placing their own interests ahead of the Retail Customer's interest ("Material Limitations Conflicts Requirement"); and
  - identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited time period ("Sales Contest Elimination Requirement').

Component Obligations – Conflict of Interest Obligation

- No Materiality Requirement – The Conflict of Interest Obligation applies to any "Conflict of Interest" as defined in Regulation BI, regardless of materiality.
- Limited to Recommendations – The Disclosure Obligation is limited to those conflicts of interest associated with a Recommendation.
- Conflict Identification – A broker-dealer is required to establish, maintain, and enforce written conflict identification policies and procedures under each separate prong of the Disclosure Obligation.

Component Obligations – Conflict of Interest Obligation

- A reasonably designed conflicts identification policy and procedure, generally, should:
  - define such conflicts of interest in a manner that is relevant and appropriate to the broker-dealer's business, and in a way that is comprehensible to employees;
  - establish a structure for identifying the types of conflicts that the broker-dealer and its associated persons may actually confront;
  - create a mechanism to identify conflicts as the broker-dealer's business evolves;
  - provide for an ongoing, regular, and periodic conflicts identification review; and
  - establish training procedures regarding the broker-dealer's conflicts of interest, including conflicts of associated persons, how to identify such conflicts of interest, as well as defining employees' roles and responsibilities with respect to identifying such conflicts of interest.

Component Obligations – Conflict of Interest Obligation

- The Associated Person Conflicts Requirement applies only in connection with incentives that a broker-dealer or control affiliate provides to associated persons. These incentives, may include for example, the following:
  - compensation from the broker-dealer or from third parties, including fees and other charges for the services provided and products sold;
  - employee compensation or employment incentives (*e.g.*, incentives tied to asset accumulation); and
  - commissions or sales charges, or other fees or financial incentives, or differential or variable compensation, whether paid by the Retail Customer, the broker-dealer or a third party.

Component Obligations – Conflict of Interest Obligation

- The SEC stated in the Adopting Release that the following non-exhaustive list of practices could be used as potential mitigation methods for demonstrating compliance with the Associated Person Conflicts Condition:
  - avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales;
  - minimizing compensation incentives for employees to favor one type of account over another, or to favor one type of product over another, proprietary or preferred provider products, for example, by establishing differential compensation based on neutral factors;
  - eliminating compensation incentives within comparable product lines by, for example, capping the credit that an associated person may receive across mutual funds or other comparable products across providers;
  - implementing supervisory procedures to monitor recommendations that are near compensation thresholds, near thresholds for firm recognition, involve higher compensating or proprietary products, or involve the rollover or transfer of assets from one type of account to another or from one product class to another;
  - adjusting compensation for representatives who fail to adequately manage conflicts of interest; and
  - limiting the types of retail customers to whom a product, transaction, or strategy may be recommended.

Component Obligations – Conflict of Interest Obligation

- For purposes of the Material Limitations Conflicts Requirement, a "material limitation" would include recommending only proprietary products, a specific asset class, or products with third-party arrangements (*e.g.*, revenue sharing). In addition, the fact that the broker-dealer recommends only products from a select group of issuers could also be a material limitation.

Component Obligations – Conflict of Interest Obligation

- The Sales Contest Elimination Requirement does not apply to the following:
  - compensation practices based on total products sold, asset growth or accumulation, or customer satisfaction;
  - the receipt of certain employee benefits by statutory employees; and
  - training or education meetings, including attendance at company-sponsored meetings such as annual conferences, provided such meetings are not based on the sale of specific securities or types of securities within a limited time period.

Component Obligations – Compliance Obligation

- Finally, in addition to the foregoing Component Obligations, a broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation BI.
- The Compliance Obligation does not enumerate specific requirements that broker-dealers must include in their policies and procedures. The manner in which broker-dealers operate their businesses are too varied to impose a single set of universally applicable required elements.

Other Takeaways

- The SEC will not have to show scienter (bad intent) to establish a violation of Regulation BI.
- A broker-dealer will not be able to waive compliance with Regulation BI, nor can a retail customer agree to waive his or her protections under Regulation BI.
- The SEC does not believe Regulation BI creates any new private right of action or right of rescission, nor does it intend such a result.
- Compliance with Regulation BI will not alter a broker-dealer's obligations under the general antifraud provisions of the federal securities laws. Regulation BI applies in addition to any applicable securities laws and regulations.

Possible Next Steps

- Compliance Date is June 30, 2020.
- Deadline is fast approaching and, likely, will entail a considerable amount of work, particularly for larger firms that make securities recommendations to retail customers.
- Begin the process of gearing up for compliance with Regulation BI sooner, rather than later. Now is not too early.
- Consider forming an integrated committee with representatives from across your firm to oversee this initiative.

Form CRS

Form CRS

- Registered investment advisers and broker-dealers are required to provide a brief relationship summary to retail investors and to file it on Form CRS.
  - 1934 Act Rule 17a-14; Advisers Act Rule 204-5
- Designed to summarize in one place selected information about a particular broker-dealer or investment adviser.
- Format intended to allow for comparability among broker-dealers and investment advisers in a way that is distinct from other required disclosures.

Form CRS: Pathway to Adoption

- The SEC engaged the RAND Corporation to conduct investor testing of Form CRS following its proposal in April 2018. The testing included surveys and qualitative interviews of individual participants.
- Many industry personnel expressed dissatisfaction with the scope, design, and outcome of the study and urged the SEC to delay its finalization of the proposed form until it could be determined that the disclosure in Form CRS and its utility to dispel investor confusion work as intended.
- Despite these concerns, the SEC adopted the final rule without delay for further testing, noting that the "feedback we have received . . . Demonstrate[s] that the proposed relationship summary would be useful for retail investors and provide information, *e.g.*, about services, fees and costs, and standard of care, that would help investors to make more informed choices when deciding among firms and account options."
- The SEC did amend its proposed Form CRS in order to improve its presentation, drafting, and filing requirements as a result of commenter suggestions on the proposal.

Form CRS: Plan for Review

- In the adopting release, the SEC provides for a review of the effectiveness of Form CRS to help ensure that it "fulfills its intended purpose."
  - In particular, the SEC directs the staff to review a sample of relationship summaries and provide the SEC with results of this review.
- However, there are no further details regarding the scope or timing of the review, or what the SEC will do with the staff's report once it is provided.

Form CRS: Presentation and Format I

- **Presentation**
  - Instead of the four-page relationship summary that was proposed, the summary will now be limited to two pages (or four pages for dual registrants).
  - The final instructions do not prescribe paper size, font size, and margin width, but say only that they must be "reasonable."
    - Definitely reasonable: 8½ x 11 paper, 11 point font, 0.75" margins
- **Format**
  - The instructions to Form CRS permit (and in some instances require) "layered" disclosure, whereby additional information can be found through cross-references, embedded URLs, and QR codes. The SEC also encourages the use of charts, graphs, tables, and other graphics to help retail investors easily digest the information.

Form CRS: Presentation and Format II

- While firms will be required to respond to a list of required topics in a prescribed order, firms will now have the flexibility to generally use their own wording to respond to the items on Form CRS.
- However, firms are not permitted to use legal jargon – such as "asset-based fee" and "load" – unless firms clearly explain them in plain English, *even if the firm believes a reasonable retail investor would understand those terms*.
- In addition, firms are obligated to provide accurate information and may not omit any material facts necessary to make the required disclosures, *in light of the circumstances under which they were made*, not misleading.
  - This language is intended to clarify that the disclosure is intended to be a summary, and firms must still adhere to the page limit.

Contents of the Relationship Summary I

- The final instructions require a question-and-answer format, with standardized questions serving as the headings in a prescribed order. Firms will generally use their own wording to address the required topics, although some specific disclosures are prescribed.
- Firms will be required to link to additional information, which for investment advisers will be to their Form ADV Part 2A brochures or equivalent information and for broker-dealers will be to their Regulation Best Interest disclosures.
- Firms must also include prescribed "conversation starters" to encourage further dialogue (*e.g.*, "How might your conflicts of interest affect me, and how will you address them?").
  - Conversation starters must be more noticeable and prominent
- Required disclosures and conversation starters are set, but can be omitted if inapplicable or modified if inaccurate

Contents of the Relationship Summary II

- The required headings address:
  - identifying information about the firm and a link to the SEC's website;
  - the types of client and customer relationships and services each firm offers;
  - the fees, costs, conflicts of interest and required standard of conduct associated with those relationships and services;
  - whether the firm and its financial professionals currently have reportable legal or disciplinary history; and
  - how to obtain additional information about the firm.

Contents of the Relationship Summary III

- Description of Services
  - Monitoring
  - Investment Authority
  - Limited Investment Offerings
  - Account Minimums and Other Requirements
- Description of Principal Fees and Costs

Contents of the Relationship Summary IV: Standards of Conduct Disclosure

- The standard of conduct disclosure (which was modified in the adopting release) now eliminates legal jargon, such as "fiduciary," and instead uses the term "best interest" across the board, to describe how broker-dealers, investment advisers, and dual registrants must act when providing recommendations as a broker-dealer or when acting as an investment adviser.
- Considering that the final form of Regulation BI still does not place a "fiduciary standard" on broker-dealers, the harmonizing of the standard of care under Form CRS appears to imply that the broker-dealer standard is as high as a fiduciary standard, even though it is not defined as such.
- In this regard, the SEC noted that, "we believe that requiring firms – whether broker-dealers, investment advisers, or dual registrants – to use the term 'best interest' to describe their applicable standard of conduct will clarify for retail investors their firm's legal obligation in this respect, regardless of whether that obligation arises from Regulation BI or an investment adviser's fiduciary duty under the Investment Advisers Act."

Contents of the Relationship Summary V

- Conflicts of Interest
  - Proprietary Products
  - Third-Party Payments
  - Revenue Sharing
  - Principal Trading
- None of these apply? Come up with one anyway!
- Disciplinary History
  - Yes/No
  - Will be yes if: Form ADV Part 1A or 2A; Form BD; Form U4, U5, or U6

Form CRS: Applicability

- The relationship summary requirement applies to investment advisers and broker-dealers with **retail investors**.
- Investment advisers to institutional separate accounts, private funds, and registered funds will not be required to deliver relationship summaries.
- In addition, the adopting release states that the SEC would not consider a broker-dealer that is serving solely as a principal underwriter to a mutual fund or variable annuity or variable life insurance contract issuer to be offering services to a retail investor for this purpose, when acting in such capacity.

Form CRS: Delivery to "Retail Investors"

- The SEC's final rule defines a retail investor as a natural person, or the legal representative of a natural person, who seeks to receive or receives services primarily for personal, family, or household purposes.
- The SEC interprets a "legal representative" of a natural person to cover only non-professional legal representatives (*e.g.*, a non-professional trustee that represents the assets of a natural person and similar representatives such as executors, conservators, and persons holding a power of attorney for a natural person).
- The definition includes a natural person seeking to select and retain a firm to provide brokerage or advisory services for his or her own retirement account, including but not limited to IRAs and individual accounts in workplace retirement plans, such as 401(k) plans and other tax-favored retirement plans.
- The definition excludes natural persons seeking services for commercial or business purposes (though a relationship summary is required to be delivered to those persons who might be seeking services for a mix of personal and commercial or other non-personal purposes).
- The definition does not distinguish based on a net worth or other asset threshold.

Form CRS: Delivery Requirements I

- **Investment Advisers**
  - The SEC requires delivery of a relationship summary before or at the time the firm enters into an investment advisory contract and is intended to generally track the initial delivery requirement for Form ADV Part 2A.
- **Broker-Dealers**
  - In a change from the proposal, broker-dealers must deliver the relationship summary to each new or prospective customer who is a retail investor before or at the earliest of one of three triggers:
    - a recommendation of an account type, a securities transaction, or an investment strategy involving securities;
    - placing an order for the retail investor; or
    - the opening of a brokerage account for the retail investor.
- **Dual Registrants**
  - Dual registrants, and affiliated broker-dealers and investment advisers that jointly offer their services, must deliver at the earlier of the initial delivery triggers for an investment adviser or a broker-dealer.

Form CRS: Delivery Requirements II

- To facilitate retail investors receiving the relationship summary as early as possible, a firm may deliver the initial relationship summary to a new or prospective client or customer in a manner that is consistent with how the retail investor requested information about the firm or financial professional (*e.g.*, by email if information requested by email).
- With respect to existing clients or customers, firms must comply with the SEC's electronic delivery guidance, which provides that a person who has a right to receive a document under the federal securities laws and chooses to receive it electronically, should be provided with the information in paper form whenever specifically requesting paper.

Form CRS: Filing and Updating

- Relationship summaries will be filed with the SEC and accessible via Investor.gov, in addition to each firm's website.
- Broker-dealers and investment advisers must update the relationship summary and file it within **30 days** whenever any information in it becomes materially inaccurate, and any changes must be communicated to existing clients or customers within **60 days** (instead of 30 days as proposed).
- The SEC also added a requirement that firms delivering updated relationship summaries to existing clients or customers must highlight the most recent changes by, for example, marking the revised text or including a summary of material changes.
  - This additional disclosure must be filed as an exhibit to the unmarked amended relationship summary (but would not be counted toward the two-page or four-page limit, as applicable).

Form CRS: Recordkeeping

- The SEC is adopting amendments to the recordkeeping and record retention requirements under Advisers Act rule 204-2 and Exchange Act rules 17a-3 and 17a-4. The amended rules also set forth the manner in which and the period of time for which these records must be retained.
- **Investment Advisers**
  - Pursuant to paragraph (a)(14)(i) Advisers Act rule 204-2 as amended, investment advisers will be required to make and preserve a record of the dates that each relationship summary was given to any client or prospective client who subsequently becomes a client.
  - In addition, paragraph (a)(14)(i) of Advisers Act rule 204-2, as amended, will require investment advisers to retain copies of each relationship summary and each amendment or revision thereto.
- **Broker-Dealers**
  - New paragraph (a)(24) of Exchange Act rule 17a-3, as adopted, will require broker-dealers to create a record of the date on which each relationship summary was provided to each retail investor, including any relationship summary provided before such retail investor opens an account.
  - Paragraph (e)(10) of Exchange Act rule 17a-4, as amended, will require broker-dealers to maintain and preserve a copy of each version of the relationship summary as well as the records required to be made pursuant to new paragraph (a)(24) of Exchange Act rule 17a-3.

Form CRS: Compliance Date

- In the final rule, the SEC extended the time to comply with the relationship summary requirements:
  - For firms that are **registered**, or investment advisers who **have an application for registration pending**, with the Commission prior to June 30, 2020, will have a period of time beginning on May 1, 2020 until June 30, 2020 to file their initial relationship summaries with the SEC.
  - On and after June 30, 2020, newly registered broker-dealers will be required to file their relationship summary with the SEC by the date on which their registration with the SEC becomes effective, and the SEC will not accept any initial application for registration as an investment adviser that does not include a relationship summary that satisfies the requirements of Form ADV, Part 3: Form CRS.
- Firms will be required to deliver their relationship summary to new and prospective clients and customers who are retail investors as of the date by which they are first required to electronically file their relationship summary with the SEC.
- In addition, firms will be required, as part of the transition, to deliver their relationship summaries to all existing clients and customers who are retail investors on an initial one-time basis within 30 days after the date the firm is first required to file its relationship summary with the SEC.

SEC Interpretive Release on Investment Adviser Standard of Conduct

Overview of SEC Interpretive Release on Investment Adviser Standard of Conduct

- The Securities and Exchange Commission (SEC) released an Interpretive Release, effective immediately, in conjunction with Regulation BI and the adoption of Form CRS on June 5, 2019.
- SEC reaffirmed and clarified certain aspects of the fiduciary duty than an investment adviser owes to its clients. Including that the fiduciary duty:
  - is broad;
  - applies to the entire adviser-client relationship; and
  - is made enforceable by the anti-fraud provisions of the Advisers Act.
- SEC warned the industry that an adviser may not waive its fiduciary duty, regardless of how sophisticated the client is.
  - Additionally, SEC withdrew the Heitman Capital Management LLC SEC Staff No-Action Letter (Feb. 12, 2007) with regard to an adviser's ability to use a "hedge clause" within an advisory contract.

Overview of SEC Interpretive Release on Investment Adviser Standard of Conduct (cont.)

- The fiduciary duty under the Advisers Act is comprised of both the **duty of loyalty** and the **duty of care**, and when read in conjunction with Regulation BI, can be characterized as requiring an investment adviser "**to act in the best interests of its clients at all times**."
- An adviser's fiduciary duty follows the contours of the relationship between the adviser and the client, who may shape their relationship by agreement, provided that there is full and fair disclosure.

What is the Duty of Care?

- In general, the duty of care requires an adviser to provide investment advice in the best interests of its client based on clients' objectives. Specific guidance from the SEC includes:
  1. ***An Adviser Must Provide Advice That Is in the Best Interests of the Client:***
     - An adviser needs to provide advice that is suitable for each client. To do so, an adviser must have a reasonable understanding of each client's objectives.
       - *Retail Clients* – The adviser should:
         - at a minimum, make a reasonable inquiry into the client's financial situation, level of sophistication, investment experience, and financial goals; and
         - update the client's investment profile in order to maintain a reasonable understanding of the client's objectives and adjust the advice to reflect any changed circumstances.
       - *Institutional Clients* – the nature and extent of the reasonable inquiry into clients' objectives generally is shaped by the specific investment mandates from those clients.
       - *Pooled Vehicles* – the adviser will need to have a reasonable understanding of the fund's investment guidelines and objectives.

What is the Duty of Care? (cont.)

2. *An Adviser Must Have a Reasonable Belief That Advice Is in the Best Interests of the Client:*

- SEC confirmed that the duty of care includes the requirement that the adviser have a reasonable belief that the advice is in the best interests of the clients. SEC provided the following guidance:
  - adviser should evaluate its advice in the context of the portfolio of the client, the client's objectives and the nature of the client (*i.e.* retail v. institutional);
  - high-risk products require heightened scrutiny;
  - adviser should conduct a reasonable investigation into the investment; and
  - adviser should examine the costs associated with the investment advice, and the investment objectives, liquidity, characteristics, risks, volatility, likely performance, time horizon, and cost of exit of the product.
- The duty of care applies to all investment advice provided to clients, including advice about investment strategy, engaging a subadviser, and account type.

What is the Duty of Care? (cont.)

3. *Duty to Seek Best Execution:*

- SEC stated that an investment adviser's duty of care also includes a duty to seek best execution of a client's transactions where the adviser has the responsibility to select broker-dealers to execute client trades.
- To meet this obligation, an adviser must seek to obtain the execution of transactions for each of its clients "such that the client's total cost or proceeds in each transaction are the most favorable under the circumstances."

4. *Duty to Provide Advice and Monitoring Over the Course of the Relationship:*

- SEC stated for the first time that an investment adviser's duty of care encompasses the duty to provide advice and monitoring at a frequency that is in the best interests of the client.
  - takes into account the scope of the agreed relationship; and
  - adviser's duty to monitor extends to all personalized advice it provides to the client.

What is the Duty of Loyalty?

- SEC has interpreted the duty of loyalty such that an adviser may not subordinate its clients' interests to its own. To meet this standard the adviser must:

  A. make full and fair disclosure* to its clients of all material facts relating to the advisory relationship, including the capacity in which the firm is acting with respect to the advice provided; and

     - *Full and fair disclosure will depend on, among other things, the nature of the client, the scope of services rendered, and the material fact or conflict.

       – SEC clarified that this disclosure just requires that the client was put in a position to understand the disclosure and provide informed consent.

  B. eliminate, or at least expose through full and fair disclosure, all conflicts of interest "which might include an investment adviser-consciously or unconsciously-to render advice which was not disinterested."

What is the Duty of Loyalty? (cont.)

- SEC provided additional guidance on what is required by the Duty of Loyalty:
  1. Specificity of Disclosure
     - For disclosure to be full and fair, it should be sufficiently specific so that a client is able to understand the material fact or conflict and make an informed decision; and
     - A disclosure that an adviser "may" have a particular conflict, without additional details, is insufficient.
  2. Trade Allocation
     - SEC reaffirmed its prior position as to how an adviser can meet its duty of loyalty with regard to trade allocations;
       - The adviser must eliminate or at least expose through full and fair disclosure the conflicts associated with its allocation policies such that a client can provide informed consent.
     - When allocating investment opportunities, an adviser is permitted to consider the nature and objectives of the client and the scope of the relationship and need not have any particular method of allocation.

Consequences of the Adoption of the Interpretive Release

- As the Interpretive Release is effective immediately, registered investment advisers should promptly consider examining their businesses for compliance with the Interpretive Guidance, including but not limited to, asking the below questions:
  - Do my advisory contracts clearly describe the contours of the client relationship, and does that contract provide for full and fair disclosure and informed consent?
  - Do my advisory contracts have "hedge clauses?"
  - Do I have sufficient processes to understand each client's investment profile? And do I update that profile to reflect changed circumstances?
  - Does my firm have policies and procedures designed to provide me with a reasonable belief that the advice I provide is in my clients' best interests?
  - Do I use the word "may" or similar words appropriately within my disclosure documents?
  - Do my trade allocation procedures consider the nature and objectives of each client and the scope of each relationship?

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