2019 SECURITIES LAW DEVELOPMENTS CONFERENCE
December 3, 2019

Standards of Conduct: A Fund Perspective on Implementation

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Overview of SEC Retail Advice Requirements: including Reg. BI, Advisers Act Interpretation & Form CRS[1]

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I. Regulation Best Interest

The SEC's Regulation Best Interest requires that recommendations be in the retail customer's best interest, creates a more explicit and broader disclosure obligation for broker-dealers, and requires broker-dealers to mitigate certain conflicts of interest.

After nearly nine years of debate, on June 5, the US Securities and Exchange Commission (SEC) adopted its long-awaited rule governing the standard of conduct for broker-dealers when recommending securities to retail customers. At only four pages long, Regulation Best Interest (Reg. BI) itself does not initially seem daunting, but once one digs into the nearly 800 pages of guidance on how the SEC interprets Reg. BI, the layers of complexity become apparent, and certain key themes develop.[2]

- The SEC sought to raise the standard of conduct for broker-dealers while maintaining investor choice and access to services.
- The SEC did not pursue an approach of deeming broker-dealers to be fiduciaries, but "crafted Regulation Best Interest to draw on key principles underlying fiduciary obligations." The SEC declined to adopt uniform standards for broker-dealers and investment advisers, but made efforts to reconcile and in many ways align the two approaches. As a result, both broker-dealers and investment advisers are required to act in the client's best interest.
- Disclosure alone does not satisfy Reg. BI (a point the SEC made 18 times).

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[2] Regulation Best Interest, Securities Exchange Act Release No. 86031 (June 5, 2019), 84 Fed. Reg. 33318, 33345 (July 12, 2019).

- The SEC did not resolve state preemption issues, instead stating preemption "would be determined in future judicial proceedings based on the specific language and effect of that state law."

- While the SEC does "not believe Regulation Best Interest creates any new private right of action or right of rescission, [or] intend such a result," whether plaintiffs' attorneys seek creative ways to exploit Reg. BI in pursuing class action or other claims remains to be seen.

Reg. BI includes a best interest obligation that is satisfied by meeting four component obligations: (1) disclosure obligation, (2) care obligation, (3) conflict of interest obligation, and (4) compliance obligation.

> **Best Interest Obligation:** "A broker, dealer, or a natural person who is an associated person of a broker or dealer, when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer, shall act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker, dealer, or natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer."[3]

Below we discuss when Reg. BI applies and the four component obligations, and provide some initial observations on interpretive and operational challenges.

A. WHEN DOES REG. BI APPLY?

Reg. BI applies when a broker-dealer or a natural person who is an associated person of a broker or dealer (1) makes a recommendation (2) of any securities transaction or investment strategy involving securities (including account recommendations) (3) to a retail customer.

1. WHAT DOES THE SEC MEAN BY A "RECOMMENDATION"?

The SEC declined to define "recommendation" for purposes of Reg. BI and instead pointed to existing interpretations under the antifraud provisions of the federal securities laws and FINRA Rule 2111.[4] These interpretations generally look to whether a communication "reasonably could be viewed as a 'call to action'" and "reasonably would influence an investor to trade a particular security or group of securities." Under these interpretations, the more individually tailored a communication is toward a particular customer or targeted group of customers, the greater the likelihood that it might be viewed as a recommendation.[5]

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[3] Rule 15l-1(a)(1).

[4] *See* FINRA Regulatory Notice 12-25 at 4-5 (May 2012) (discussing guiding principles as to what constitutes a recommendation).

[5] *See* NASD Notice to Members 01-23, Online Suitability – Suitability Rules and Online Communications (Apr. 2001).

The SEC stated that general investment education is not, however, subject to Reg. BI as long as it does "not include, standing alone or in combination with other communications, a recommendation of a particular security or securities or particular investment strategy involving securities." The types of general education the SEC identified are (1) general financial and investment information, (2) plan information, (3) certain asset allocation models, and (4) interactive investment materials.

2. WHO IS A "RETAIL CUSTOMER"?

Reg. BI defines a retail customer as "a natural person, or the legal representative of such natural person, who: (A) 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 (B) Uses the recommendation primarily for personal, family, or household purposes."[6]

Legal Representative of a Natural Person. As adopted, a retail customer includes only a natural person or a legal representative of one. The SEC stated that it "view[s] a 'legal representative' of a natural person to only cover 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 SEC's illustrations of professional legal representatives cover various types of regulated entities, including "registered investment advisers and broker-dealers, corporate fiduciaries (e.g., banks, trust companies and similar financial institutions) and insurance companies."

> **Observations:** The SEC did not specifically address whether recommendations to family offices, private family trust companies, and other vehicles used to invest family assets would be subject to Reg. BI. These entities may be managed by financial professionals that exercise their own independent professional judgment and do not rely directly on a broker-dealer's recommendation, but that may not be regulated entities. For example, single family offices might not be registered as investment advisers as they are excluded from the definition of investment adviser by Section 202(a)(11)(G) of the Investment Advisers Act and Rule 202(a)(11)(G)-1 thereunder.

No High-Net-Worth Exception. The SEC declined to adopt a high-net-worth test similar to the institutional suitability exception in FINRA Rule 2111(b). As a result, Reg. BI extends to dealings with any natural person who uses a recommendation for personal, family, or household purposes no matter their net worth.

Uses the Recommendation for Personal, Family, or Household Purposes. Reg. BI only applies where a natural person or legal representative of a natural person uses a recommendation for personal, family, or household purposes. The SEC stated it would view a retail customer as having used a recommendation if "(1) the retail customer opens a brokerage account with the broker-dealer, regardless of whether the broker-dealer receives compensation, (2) the retail customer has an existing account with the broker-dealer and receives a recommendation from

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[6] Rule 15l-1(b)(1).

the broker-dealer, regardless of whether the broker-dealer receives or will receive compensation, directly or indirectly, as a result of that recommendation, or (3) the broker-dealer receives or will receive compensation, directly or indirectly as a result of that recommendation, even if that retail customer does not have an account at the firm." The SEC also sought to clarify what it means for a recommendation to be used for personal, family, or household purposes, stating that it would include "any recommendation to a natural person for his or her account . . . other than recommendations to natural persons seeking these services for commercial or business purposes." So framed, whether a natural person or legal representative uses a recommendation for personal, family, or household purposes is determined not by the character of the recommendation, but potentially on a look-back or hindsight basis. The SEC also clarified that personal, family, or household purposes would include retirement accounts, "including but not limited to IRAs and individual accounts in workplace retirement plans, such as 401(k) plans and other tax-favored retirement plans," but generally would not include workplace retirement plans.

3. What is an Investment Strategy Involving Securities?

The SEC stated that Reg. BI applies to any recommendation of a securities transaction, including the purchase, sale, or exchange of a security, and to any investment strategy involving securities, including an explicit recommendation to hold a security. The SEC also stated that investment strategy would involve certain account monitoring and account recommendations.

Account Monitoring and Implicit Hold Recommendations. The SEC extended Reg. BI to "any recommendations that result from the account monitoring services that a broker-dealer agrees to provide." This decision introduces the concept of implicit hold recommendations where a broker-dealer agrees—in writing or orally—to provide ongoing account monitoring. According to the SEC, "by agreeing to perform account monitoring services, the broker-dealer is taking on an obligation to review and make recommendations with respect to that account (e.g., to buy, sell or hold) on that specified, periodic basis," and "the quarterly review and each resulting recommendation to purchase, sell, or hold, will be a recommendation subject to Regulation Best Interest . . . even in instances where the broker-dealer does not communicate any recommendation to the retail customer." The SEC stated that where there is such an agreement, "silence is tantamount to an explicit recommendation to hold, and should be viewed as a recommendation to hold the securities for purposes of Regulation Best Interest." In comparison, silence as to a retail customer's account holdings would not appear to be subject to Reg. BI, including where a broker-dealer voluntarily reviews the account, provided that there is no agreement to provide ongoing monitoring.

> **Observations:** While many broker-dealers currently do not formally agree to provide account monitoring, the concept of implicit hold recommendations introduces new considerations for brokerage agreements and policies and procedures. A broker-dealer that does not formally provide account monitoring services should consider adding explicit provisions to its brokerage agreements whereby a retail customer agrees that the broker-dealer has no obligation to monitor the account and has no obligation to revisit past recommendations or otherwise provide recommendations about the retail customer's account. In addition, broker-dealers that market their services as encompassing holistic or relationship-based advice might evaluate whether such marketing might be construed as an agreement to monitor customer accounts and

tweak such marketing accordingly. The broker-dealer might also consider adopting policies and procedures restricting representatives from agreeing—either in writing or orally—to provide ongoing account monitoring.

Account Recommendations. The SEC also extended Reg. BI to "account recommendations," including "recommendations of securities account types generally (e.g., to open an IRA or other brokerage account), as well as recommendations to roll over or transfer assets from one type of account to another (e.g., a workplace retirement plan account to an IRA)." The SEC provided examples of different brokerage accounts, such as "education accounts (e.g., 529 Plans and tax-free Coverdell accounts); retirement accounts (e.g., IRA, Roth IRA, or SEP-IRA accounts); and specialty accounts (e.g., cash or margin accounts, and accounts with access to Forex or options trading)." The SEC also identified factors that broker-dealers should generally consider in recommending an account type, including "(1) the services and products provided in the account (ancillary services provided in conjunction with an account type, account monitoring services, etc.); (2) the projected cost to the retail customer of the account; (3) alternative account types available; (4) the services requested by the retail customer; and (5) the retail customer's investment profile." With rollover recommendations, the SEC identified the following factors to consider: "fees and expenses; level of service available; available investment options; ability to take penalty-free withdrawals; application of required minimum distributions; protection from creditors and legal judgments; holdings of employer stock; and any special features of the existing account."

Observations: Firms will want to analyze what types of communications would go beyond solicitation or marketing of services and be viewed as a recommendation, and how to apply the best interest obligation in this context, taking into account the factors identified by the SEC. Those firms that developed tools in response to the since-vacated Department of Labor (DOL) fiduciary rule might be able to modify those tools to address Reg. BI. Developing policies and procedures, and related controls, around this new concept of identifying an account type that is in a retail customer's best interest may prove especially challenging for firms with a large number of offerings, and particularly those that are dually registered. For dual registrants, the selected approaches to addressing account recommendations will need to also consider whether a brokerage or advisory account would be in the retail customer's best interest, including what factors distinguish the accounts (e.g., transaction-based charges vs. ongoing fees, one-time or episodic recommendations vs. ongoing advice) and customer preference as to the type of relationship desired.

B. WHAT DOES THE DISCLOSURE OBLIGATION REQUIRE?

Under Reg. BI, prior to or at the time of a recommendation, a broker-dealer must provide full and fair disclosure, in writing, of all material facts relating to the scope and terms of the relationship with the retail customer, including capacity as a broker-dealer, material fees and costs, and type and scope of services, as well as "any material limitations on the securities or investment strategies involving securities that may be recommended." The SEC described the disclosure obligation as "a more explicit and broader disclosure obligation" than currently exists and as being designed to "promote broker-dealer recommendations that are in the best interest of retail customers."

1. WHAT DOES THE SEC MEAN BY "FULL AND FAIR DISCLOSURE"?

The SEC stated that full and fair disclosure requires that a broker-dealer "give sufficient information to enable a retail investor to make an informed decision with regard to the recommendation." The requirement to make full and fair disclosure is a change from the proposed rule's requirement that a broker-dealer "reasonably disclose" material facts that the SEC stated "will more closely align the Disclosure Obligation with existing requirements for investment advisers and is consistent with disclosure standards in other contexts under the federal securities laws."

> **Observations:** Firms might consider undertaking a holistic review of existing disclosures to determine how they fit together, and whether any enhancements are needed, to satisfy the disclosure obligation.

2. WHAT DOES THE SEC MEAN BY "MATERIAL FACTS"?

The disclosure obligation is limited to "material" facts. The SEC looked to the materiality standard in *Basic v. Levinson*, 485 U.S. 224 (1988), in stating that for purposes of Reg. BI, a fact is material if there is a substantial likelihood that a reasonable retail customer would consider it important. In addition, the SEC defined "conflict of interest" as "an 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." The SEC stated this is intended to reflect the description of conflicts in *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

> **Observations:** Firms might consider analyzing the impact of the requirement to disclose all material facts about all conflicts. Under longstanding SEC and staff statements, as well as the text of Form ADV, investment advisers have been explicitly required to make full disclosure of *material* conflicts. While the SEC stated in Reg. BI that "it would be difficult to envision a 'material fact' that must be disclosed pursuant to the Disclosure Obligation that is not related to a conflict of interest that is also material," it is unclear how this plays out in practice, including whether the SEC ultimately takes the position that the existence of a conflict is a material fact that must be disclosed without regard to the materiality of the conflict, and how this impacts conflicts that advisers have deemed immaterial and excluded from disclosures.

3. WHAT MATERIAL FACTS DID THE SEC IDENTIFY AS REQUIRING DISCLOSURE?

In many instances, the disclosure obligation builds on disclosures required by Form CRS, as shown in the table below.

	Form CRS	Reg. BI
Capacity	• Broker-dealer • Investment adviser	• Satisfied by Form CRS for broker-dealers that are not dual registrants

	Form CRS	Reg. BI
	• Dual registrant	• Disclose capacity of representatives that are also associated persons of an investment adviser
Material Fees and Costs	• Principal fees and costs (transaction-based fees), frequency, and conflicts • Other fees and costs (e.g., custodian fees, account maintenance fees, fees related to mutual funds and variable annuities, and other transactional fees and product-level fees) • Reference to additional information	• Build upon fees and costs in Form CRS • Disclose other categories of fees not required by Form CRS • Explain how and when the fees are charged • Use narrative or numerical disclosure (e.g., standardized or hypothetical amounts, dollar or percentage ranges) that "reasonably reflect[s] the actual fees to be charged" • May rely on mandated disclosure document (e.g., prospectus, offering document, 10b-10 confirmation) for specifics of product-level fees
Type and Scope of Services	• Summarize the principal services, accounts, or investments • Monitoring services • Limited investment offerings • Account minimums • Reference to additional information	• Material limitations on securities and investment strategies ▪ Proprietary products ▪ Limited range of products/select group of issuers ▪ Specific asset class ▪ Products with third-party arrangements (e.g., revenue sharing, mutual fund service fees) ▪ Making IPOs available only to certain clients • Whether broker-dealer will monitor account and scope and frequency of monitoring • Requirements to open or maintain an account or establish a relationship

	Form CRS	Reg. BI
		• General basis for a recommendation (e.g., firm's investment approach, philosophy, or strategy) and any deviations therefrom • Risks associated with a recommendation
Conflicts of Interest	• Proprietary products • Third-party payments • Revenue sharing • Principal trading • Reference to additional information	• Build on conflicts in Form CRS • Summarize how broker-dealer and financial professionals are compensated, sources and types of compensation received, and conflicts the compensation creates • Receipt of differential compensation • Other examples of conflicts identified: ▪ Charging commissions or transaction-based fees ▪ Recommending a security underwritten by the broker-dealer or an affiliate ▪ Recommending a transaction to be executed as principal ▪ Allocating trades and research, including investment opportunities ▪ Cost to the broker-dealer to effect the transaction ▪ Accepting an order contrary to the broker-dealer's recommendations

4. WHEN MUST DISCLOSURE BE PROVIDED?

The SEC did not specifically mandate the timing of disclosure in relation to a particular recommendation, but did state its belief that disclosure should be provided "early enough" to give retail customers "adequate time to consider the information and promote the investor's understanding in order to make informed investment decisions," but not "so early that the disclosure fails to provide meaningful information (e.g., does not sufficiently identify material conflicts presented by a particular recommendation, or overwhelms the retail customer with

disclosures related to a number of potential options that the retail customer may not be qualified to pursue." The SEC also "encourage[d] broker-dealers to consider whether it would be helpful to repeat or highlight disclosures already made pursuant to the Disclosure Obligation at the time of the recommendation." The SEC's principles for timing of disclosures depart from the largely transaction-based timing of broker-dealer disclosures and the prospective disclosure approach for advisers (i.e., on Form ADV, Part 2).

> **Observations:** The SEC's statements raise questions about whether the SEC might second guess whether a retail customer received appropriate disclosures and provided informed consent when the retail customer is not reminded of a relevant disclosure at the time of a recommendation.

5. WHEN MUST DISCLOSURE BE UPDATED?

The SEC stated that disclosures should be updated when they "contain materially outdated, incomplete, or inaccurate information," and that updates should be made "as soon as practicable," but "no later than 30 days after the material change." Until the time written disclosures are updated, the SEC stated that "broker-dealers are encouraged to provide, supplement, or correct written disclosure with oral disclosure as necessary prior to or at the time of the recommendation." The SEC noted that oral disclosure may be necessary in these circumstances, and that broker-dealers "must" maintain a record of oral disclosures (e.g., recording of telephone conversations, contemporaneous written notations); the SEC did not mandate that broker-dealers memorialize the substance of the oral disclosures but encouraged doing so as a best practice.

> **Observations:** Firms should consider developing a process to evaluate and review disclosures on an ongoing basis, as well as processes for providing updated disclosures at the time of the recommendation, whether with supplemental materials or oral disclosures.

6. CAN BROKER-DEALERS USE LAYERED DISCLOSURES?

Yes. The SEC did not prescribe the method of satisfying the disclosure obligation (e.g., by mandating a document similar to an investment adviser's Form ADV, Part 2A), and instead is allowing broker-dealers to determine how to provide full and fair disclosure, including through layered disclosures. The SEC stated that electronic delivery is permitted consistent with existing SEC guidance on the use of electronic media (albeit with no acknowledgement of the E-Sign Act).

> **Observations:** The SEC views Form CRS as the first layer in a "layered disclosure" regime that should cross-reference additional disclosures for more detailed information. Firms should consider their approaches to the SEC's "layered disclosure" regime, including its pros and cons. In developing a layered disclosure approach, firms might consider cataloguing and leveraging existing customer disclosures (e.g., account agreements, advisory brochures, guides to services, fee schedules, 408(b)(2) disclosures, prospectuses and other offering documents) and disclosures developed for other purposes (e.g., for the since-vacated DOL Best Interest Contract Exemption). Firms might also keep in mind the challenges in mapping and maintaining consistency

among disclosures where changes and updates are made, and consider establishing "golden source" disclosures and using technology to make and implement changes.

7. WHAT DISCLOSURES ARE REGISTERED REPRESENTATIVES REQUIRED TO MAKE?

The disclosure obligation also applies to a broker-dealer's registered representatives. The SEC stated that a representative may be able to rely on a broker-dealer's disclosure unless the representative "knows or should have known that the broker-dealer's disclosure is insufficient to describe 'all material facts.'"

> **Observations:** Firms should consider developing processes to facilitate representative disclosure, including to address situations where a representative is not a supervised person of an investment adviser, or is not acting as one; a representative does not offer advisory services or can only sell certain products; a representative's conflicts of interest are not disclosed by the firm; or a representative has a distinct investment approach.

C. WHAT DOES THE CARE OBLIGATION REQUIRE?

The care obligation requires a broker-dealer to "exercise[] reasonable diligence, care, and skill" in satisfying three obligations when recommending a security or investment strategy involving securities: a reasonable-basis obligation, a customer-specific obligation, and a quantitative obligation. While the SEC did not include the prudence element from the proposed rule, the SEC stated that "requiring broker-dealers 'to exercise reasonable diligence, care, and skill' conveys 'the fundamental importance of conducting a proper evaluation of any securities recommendation in accordance with an objective standard of care' that was intended by the inclusion of 'prudence.'" The SEC stated that compliance with the care obligation "will be evaluated as of the time of the recommendation (and not in hindsight)."

1. WHAT IS THE REASONABLE-BASIS OBLIGATION?

The reasonable-basis obligation requires that a broker-dealer and its registered representatives "[u]nderstand 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."[7] The SEC stated that what will constitute reasonable diligence "will vary depending on, among other things, the complexity of and risks associated with the recommended security or investment strategy and the broker-dealer's familiarity with the recommended security or investment strategy." The SEC also identified the following factors that "broker-dealers generally should consider": "the security's or investment strategy's investment objectives, characteristics (including any special or unusual features), liquidity, volatility, and likely performance in a variety of market and economic conditions; the expected return of the security or investment strategy; as well as any financial incentives to recommend the security or investment strategy."

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[7] Rule 15l-1(a)(2)(ii)(A).

2. WHAT IS THE CUSTOMER-SPECIFIC OBLIGATION?

The customer-specific obligation requires that a broker-dealer and its registered representatives "[h]ave 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."[8] The SEC stated that "what is in the 'best interest' of a retail customer depends on the facts and circumstances of a recommendation at the time it is made, including matching the recommended security or investment strategy to the retail customer's investment profile at the time of the recommendation, and the process for coming to that conclusion."

> **Observations:** As a general matter, firms will want to review the SEC's guidance on the care obligation in light of existing FINRA interpretations of FINRA Rule 2111—which can be expected to change—to identify any differences and evaluate the impact on existing policies and procedures.

Reasonably Available Alternatives. As part of the process in meeting the customer-specific obligation, the SEC believes "a broker-dealer generally should consider reasonably available alternatives offered by the broker-dealer." According to the SEC, this does not require a broker-dealer to evaluate every possible alternative, whether offered by the firm or available outside the firm. The SEC recognized that the scope of reasonably available alternatives will depend on the retail customer's investment profile as well as other factors, such as a registered representative's customer base; the investments and services available to recommend; and "other factors such as specific limitations on the available investments and services with respect to certain retail customers (e.g., product or service income thresholds; product geographic limitations; or product limitations based on account type, such as those only eligible for IRA accounts)."

> **Observations:** The customer-specific obligation requires that a recommendation be in the "best interest" of the retail customer—not just suitable—in light of the retail customer's investment profile and the potential risks, rewards, and costs (an additional consideration in the final rule), and that the broker-dealer and its financial professionals not place their financial or other interests ahead of the retail customer's interests. It is unclear, however, what "best interest" means in this context and whether it requires something beyond not placing the broker-dealer's interest ahead of the retail customer's interest. Developing a process or criteria to identify the "reasonably available alternatives" to be considered in making a recommendation might be an important component of putting registered representatives in a position to satisfy the customer-specific obligation. We will watch how the obligation to consider reasonably available alternatives ultimately impacts choice and product offerings, including whether it results in firms trimming their product offerings as a way to reduce the array of reasonably available alternatives.

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[8] Rule 15*l*-1(a)(2)(ii)(B).

Cost. The SEC elevated consideration of costs to the rule text, meaning that cost, along with potential risks and rewards, must always be considered when making a recommendation. Cost, however, is not the only factor, and "the standard does not necessarily require the lowest cost option." In fact, the SEC stated that recommending the lowest cost option might even violate the customer-specific obligation, and that "a broker-dealer would not satisfy the Care Obligation by simply recommending the least expensive or least remunerative security without any further analysis of these other factors and the retail customer's investment profile." Broker-dealers can recommend a more expensive or more remunerative security where "there are other factors about the product that reasonably allow the broker-dealer to believe it is in the best interest of the retail customer, based on that retail customer's investment profile."

> **Observations:** Similar to our discussion of reasonably available alternatives, we will watch the impact on product offerings of elevating cost as a key consideration in making a recommendation. While various statements by the SEC suggest cost is but one factor in making a recommendation, it remains unclear how the SEC will examine a broker-dealer's consideration of cost in connection with the requirement that a broker-dealer not put its interests ahead of the retail customer's interests where cost corresponds to broker-dealer revenues.

Documenting Recommendations. The SEC has not required that broker-dealers or registered representatives document the basis for their recommendations, and instead stated that "broker-dealers may choose to take a risk based approach when deciding whether or not to document certain recommendations," such as for complex products or "where a recommendation may seem inconsistent with a retail customer's investment objectives on its face." The SEC noted that firms might rely on exception reports or other measures in satisfying the care obligation.

3. WHAT IS THE QUANTITATIVE OBLIGATION?

The quantitative obligation requires that a broker-dealer and its registered representatives "[h]ave 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."[9]

> **Observations:** Reg. BI expands the quantitative obligation to all retail customer relationships, not only to situations where a broker-dealer exercises actual or de facto control over an account, which is the focus on quantitative suitability under current law. Although the core obligation generally is evaluated at the time of the recommendation, the quantitative obligation involves a look back. To the extent they have not already done so, firms will need to expand their controls to review trading across all retail customer accounts.

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[9] Rule 15l-1(a)(2)(ii)(C).

D. WHAT DOES THE CONFLICT OF INTEREST OBLIGATION REQUIRE?

The conflict of interest obligation requires that a broker-dealer "establishes, maintains, and enforces written policies and procedures reasonably designed to . . . [i]dentify and at a minimum disclose, in accordance with [the disclosure obligation], or eliminate, all conflicts of interest associated with such recommendations" and to mitigate certain identified conflicts (if those conflicts were not otherwise eliminated).[10] According to the SEC, broker-dealers "have flexibility to reasonably design their policies and procedures to tailor them to account for their business model, given the structure and characteristics of their relationships with retail customers, including the varying levels and frequency of recommendations provided and the types of conflicts that may be presented." The SEC identified certain components of policies and procedures that it views as effective, including "policies and procedures outlining how the firm identifies conflicts, identifying such conflicts and specifying how the broker-dealer intends to address each conflict; robust compliance and monitoring systems; processes to escalate identified instances of noncompliance for remediation; procedures that designate responsibility to business line personnel for supervision of functions and persons, including determination of compensation; processes for escalating conflicts of interest; processes for periodic review and testing of the adequacy and effectiveness of policies and procedures; and training on policies and procedures."

1. HOW MIGHT BROKER-DEALERS GO ABOUT IDENTIFYING CONFLICTS OF INTEREST?

The SEC identified conflicts of interest as falling into three categories: (1) conflicts between the broker-dealer and the retail customer; (2) conflicts between a registered representative and the retail customer; and (3) conflicts between the broker-dealer and its registered representatives. While not included in the SEC's list, another category of conflicts that broker-dealers should consider identifying are conflicts of interest between retail customers, a point reflected in the SEC's examples of conflicts, which included "allocating investment opportunities . . . among different types of customers." The SEC stated that reasonably designed policies and procedures to identify conflicts of interest generally should

- "define such conflicts in a manner that is relevant to a broker-dealer's business (i.e., conflicts of both the broker-dealer entity and the associated persons of the broker-dealer), and in a way that enables employees to understand and identify conflicts of interest";
- "establish a structure for identifying the types of conflicts that the broker-dealer (and associated persons of the broker-dealer) may face";
- "establish a structure to identify conflicts in the broker-dealer's business as it evolves";
- "provide for an ongoing (e.g., based on changes in the broker-dealer's business or organizational structure, changes in compensation incentive structures, and introduction of new products or services) and regular, periodic (e.g., annual) review for the identification of conflicts associated with the broker-dealer's business"; and
- "establish training procedures regarding the broker-dealer's conflicts of interest, including conflicts of natural persons who are associated persons of the broker-dealer,

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[10] Rule 15l-1(a)(2)(iii).

how to identify such conflicts of interest, as well as defining employees' roles and responsibilities with respect to identifying such conflicts of interest."

2. Do conflicts need to be eliminated?

With the exception of sales contests, which as discussed below must be eliminated, the SEC has not required that a broker-dealer eliminate any particular conflicts of interest. The SEC did, however, caution that "where a broker-dealer cannot fully and fairly disclose a conflict of interest . . . , the broker-dealer should eliminate the conflict or adequately mitigate (i.e., reduce) the conflict such that full and fair disclosure . . . is possible." In this regard, the SEC stated that "conflicts of interest may be of a nature and extent that it would be difficult to provide disclosure that adequately conveys to a retail customer the material facts or the nature, magnitude and potential effect of the conflict for informed decision-making or where disclosure may not be sufficiently specific or comprehensible for the retail customer to understand whether and how the conflict will affect the recommendations he or she receives."

3. What about sales contests?

The conflict of interest obligation requires that broker-dealers "[i]dentify 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 period of time."[11] The SEC stated that it interprets non-cash compensation to mean "any form of compensation received in connection with the sale and distribution of specific securities or specific types of securities that is not cash compensation, including but not limited to merchandise, gifts and prizes, travel expenses, meals and lodging except we do not intend it to cover certain employee benefits, including healthcare and retirement benefits." The SEC recognized that certain production requirements may exist for other reasons, and that the prohibition "does not apply to compensation practices based on, for example, total products sold, or asset growth or accumulation, and customer satisfaction." The SEC declined to define what would constitute a "limited period of time," apparently out of concerns that broker-dealers might game that timeframe by using slightly longer periods. The SEC's focus appears to be on "time limitations that create high-pressure situations for associated persons to increase the sales of specific securities or specific types of securities which compromise the best interests of their customers." In this regard, the SEC stated its agreement with commenters "that broker-dealers cannot reasonably be expected to make recommendations in a particular retail customer's best interest consistent with the requirements of the Care Obligation, if they are motivated to 'push' certain securities or types of securities in order to win a contest or reach a target in order to receive a bonus or other non-cash compensation."

4. What conflicts must be mitigated?

Broker-dealers are required to "[i]dentify and mitigate any conflicts of interest associated with such recommendations that create an incentive for a natural person who is an associated person of a broker or dealer to place the interest of the broker, dealer, or such natural person

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[11] Rule 15l-1(a)(2)(iii)(D).

ahead of the interest of the retail customer."[12] The SEC stated that it interprets this requirement "to only apply to incentives *provided to* the associated person, whether by the firm or third-parties that are within the control of or associated with the broker-dealer's business" (emphasis added). The SEC provided examples of incentives that would need to be mitigated, including

- "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 not prohibited under [the prohibition on sales contests], special awards, differential or variable compensation, incentives tied to appraisals or performance reviews)"; 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."

5. HOW DOES THE SEC EXPECT BROKER-DEALERS TO MITIGATE THESE CONFLICTS?

The SEC has not mandated specific mitigation measures or established a one-size-fits-all approach, and instead is allowing broker-dealers to develop reasonably designed policies and procedures based on each firm's circumstances. The SEC stated it would look to whether policies and procedures are "reasonably designed to reduce the incentive for the associated person to make a recommendation that places the associated person's or firm's interests ahead of the retail customer's interest." According to the SEC, mitigation measures should reflect "the nature and significance of the incentives provided to the associated person and a variety of factors related to a broker-dealer's business model (such as the size of the broker-dealer, retail customer base (e.g., diversity of investment experience and financial needs), and the complexity of the security or investment strategy involving securities that is being recommended), some of which may be weighed more heavily than others." The SEC identified the following examples of mitigation measures that broker-dealers might consider:

- "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, or comparable products sold on a principal basis, 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 products, proprietary products or transactions in a principal capacity; or, involve the roll over or transfer of assets from one type of account to another (such as

[12] Rule 15*l*-1(a)(2)(iii)(B).

recommendations to roll over or transfer assets in an ERISA account to an IRA) or from one product class to another";
- "adjusting compensation for associated persons who fail to adequately manage conflicts of interest"; and
- "limiting the types of retail customer to whom a product, transaction or strategy may be recommended."[13]

6. WHAT FIRM-LEVEL CONFLICTS MUST BE MITIGATED?

The SEC has not required that broker-dealers mitigate all firm-level financial incentives, and has instead decided to allow "firm-level conflicts to be generally addressed through disclosure." However, in the rule text the SEC is explicitly requiring that broker-dealers mitigate material limitations on the available product offerings. The conflict of interest obligation requires that broker-dealers "(i) [i]dentify and disclose any material limitations placed on the securities or investment strategies involving securities that may be recommended to a retail customer and any conflicts of interest associated with such limitations, in accordance with [the disclosure obligation], and (ii) [p]revent such limitations and associated conflicts of interest from causing the broker, dealer, or a natural person who is an associated person of the broker or dealer to make recommendations that place the interest of the broker, dealer, or such natural person ahead of the interest of the retail customer."[14] The SEC stated it would view a material limitation to include "recommending only proprietary products (i.e., any product that is managed, issued, or sponsored by the financial institution or any of its affiliates), a specific asset class, or products with third-party arrangements (i.e., revenue sharing)," and recommending "only products from a select group of issuers." The SEC is providing firms with flexibility in meeting this obligation. The SEC stated its belief that "firms should, for example, consider establishing product review processes for products that may be recommended, including establishing procedures for identifying and mitigating the conflicts of interests associated with the product, or declining to recommend a product where the firm cannot effectively mitigate the conflict, and identifying which retail customers would qualify for recommendations from this product menu." The SEC went on to identify additional considerations, including:

- "evaluating the use of 'preferred lists'";
- "restricting the retail customers to whom a product may be sold";
- "prescribing minimum knowledge requirements for associated persons who may recommend certain products"; and

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[13] We submitted a comment letter to the SEC on this issue urging the SEC to "recognize that firms may appropriately employ only some—or various combinations—of these approaches depending on their businesses and business models, compensation structures, and related conflicts of interest, and should not prescribe a one-size-fits-all approach to mitigating compensation-related conflicts." *See* Letter from Steven W. Stone & Brian J. Baltz, Morgan, Lewis & Bockius LLP (May 3, 2019).

[14] Rule 15*l*-1(a)(2)(iii)(C).

- "conducting periodic product reviews to identify potential conflicts of interest, whether the measures addressing conflicts are working as intended, and to modify the mitigation measures or product selection accordingly."

The SEC then identified certain practices that FINRA identified in its 2013 *Report on Conflicts of Interest* as effective in identifying and managing conflicts of interest, including:

- "a product review process to identify and mitigate conflicts of interest that may be associated with a product";
- "evaluation of whether to decline to offer products to customers when the conflicts associated are too significant to be mitigated effectively";
- "differentiation of product eligibility between institutional and retail clients";
- "post-launch reviews of products to identify potential problems";
- "evaluation of registered representatives' ability to understand a product, provide training where necessary, and limit access to products for which they cannot demonstrate sufficient understanding to perform a suitability analysis and effectively explain a product and its risks to customers"; and
- "disclosure of product conflicts and risks."[15]

Observations: Arguably, disclosure that a broker-dealer only provides proprietary products or a limited range of products should suffice to address conflicts of interest, especially given related Advisers Act precedent. It is not immediately clear if the chosen test for limited or proprietary products is based on duty of loyalty concepts (i.e., placing the broker-dealer or its financial professional's interests ahead of the retail customer's interests) versus duty of care concepts, or a combination of the two.

E. WHAT DOES THE COMPLIANCE OBLIGATION REQUIRE?

The compliance obligation requires a broker-dealer to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Reg. BI.[16] According to the SEC, a broker-dealer "should consider the nature of that firm's operations and how to design such policies and procedures to prevent violations from occurring, detect violations that have occurred, and to correct promptly any violations that have occurred." In this regard, the SEC stated its view that "policies and procedures should be reasonably designed to address and be proportionate to the scope, size, and risks associated with the operations of the firm and the types of business in which the firm engages." The SEC also stated that, "[i]n addition to the required policies and procedures, depending on the size and complexity of the firm, we believe a reasonably designed compliance program generally would also include: controls; remediation of noncompliance; training; and periodic review and testing."

Observations: As a separate obligation under Reg. BI, it appears the SEC could allege that a broker-dealer violated Reg. BI based solely on having inadequate policies and procedures, as has been the case with policies and procedures on the handling of

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[15] *See* FINRA, Report on Conflicts of Interest (Oct. 2013).

[16] Rule 15*l*-1(a)(2)(iv).

material nonpublic information required by Exchange Act Section 15(g) and Advisers Act Section 204A, as well as the Advisers Act rule on policies and procedures, Rule 206(4)-7.

F. FINAL THOUGHTS

While only a rule, Reg. BI effectively creates a principles-based regime for the provision of recommendations to retail customers that includes a care obligation and obligation not only to disclose conflicts of interest, but also to mitigate certain conflicts. While the SEC's guidance on Reg. BI is extensive, significant questions nonetheless remain in addition to those identified in this article. Broker-dealers will want to evaluate whether any of these questions are ones for which additional guidance would be helpful. The SEC and its staff have indicated that they want to hear from broker-dealers about issues in implementing Reg. BI. However, decisions to approach the SEC or its staff should be balanced against the prospect that the industry might not like or agree with additional guidance provided, as well as whether broker-dealers can take reasonable approaches based on guidance in the adopting release and longstanding interpretations of broker-dealer obligations under the federal securities laws and FINRA rules. With Reg. BI taking effect June 30, 2020, the next year will be a challenging time for all broker-dealers providing recommendations to retail customers.

II. SEC's Standard of Conduct for Investment Advisers

The SEC's interpretation of the investment adviser standard of conduct appears to refine the contours of the fiduciary duty that investment advisers owe their clients under the Advisers Act, enhance disclosure obligations and expand initial and ongoing suitability considerations. In a companion interpretation, the SEC also clarified when investment advice by broker-dealers is "solely incidental" to brokerage for purposes of the exclusion from SEC investment adviser registration.

A. INVESTMENT ADVISER STANDARD OF CONDUCT

1. Is there a new standard of conduct for investment advisers?

Under the Interpretation,[17] an investment adviser has an obligation to act in the best interest of its clients, which the SEC characterizes as a broad and overarching principle that encompasses both the duty of care and the duty of loyalty.

The Interpretation affirms the SEC's longstanding position that Sections 206(1) and (2) of the Advisers Act establish a federal fiduciary standard governing the conduct of investment advisers. In contrast to Reg. BI, the fiduciary standard for investment advisers, as clarified in the Interpretation, is a flexible principles-based standard based on the scope and nature of the advisory relationship.

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[17] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. 5248 (June 5, 2019), 84 Fed. Reg. 33669 (July 12, 2019) (Interpretation); Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, Investment Advisers Act Rel. No. 4889 (Proposed Interpretation).

Observations: While the principles-based approach is helpful to investment advisers in creating the flexibility to conduct business and build appropriate controls based on the nature of the advisory services they provide, the Interpretation also gives the SEC examination and enforcement staff a significant amount of flexibility to interpret and enforce this best interest obligation in any particular situation.

2. IS THE INTERPRETATION LIMITED TO ADVICE PROVIDED TO RETAIL CLIENTS?

No. Unlike Reg. BI, which focuses exclusively on advice provided to retail customers, the Interpretation applies to investment advice provided to *all* clients – both retail and institutional. The Interpretation acknowledges that investment advisers provide advice to a range of clients from retail investors in digital advisory services to institutional investors such as pooled investment vehicles, endowments and foundations. In response to a number of comments, the SEC made an effort to differentiate the impact of the Interpretation on retail and institutional clients in certain circumstances.

3. DOES THE FIDUCIARY DUTY VARY BASED ON THE TYPE OF ADVICE PROVIDED TO A CLIENT?

No, the components of the fiduciary duty – duty of loyalty and duty of care – do not vary based on the type of advice provided. Further, the Interpretation states that the fiduciary duty applies to the "entire relationship" between an adviser and its client. However, the SEC acknowledged that an adviser and its client are free to define the scope of the advisory relationship by contract – and, in particular, the specific functions and responsibilities that the adviser "as agent, has agreed to assume for the client, its principal."

Observations: Many advisory agreements are drafted with a broad grant of discretion to give advisers maximum flexibility. Going forward, advisers may wish to consider defining the scope of their services in a narrower manner and to focus on describing the limitations of their authority and responsibility to more clearly delineate the scope of the fiduciary duty that attaches to those services. This is particularly true in the case of multi-adviser relationships (e.g., advisory/sub-advisory agreements, co-advisory relationships, advisory services distributed through investment adviser intermediaries, and wrap programs that rely on sponsors, portfolio managers, and overlay managers) where advisory responsibilities are allocated among a number of different advisers that each play distinct roles.

4. CAN AN INVESTMENT ADVISER DISCLAIM ITS FIDUCIARY DUTY?

No. The SEC recognizes in the Interpretation that the scope and extent of an investment adviser's services and responsibilities can be shaped by agreement, but states that advisers cannot disclaim their fiduciary duty. According to the SEC, contract provisions that broadly disclaim an adviser's fiduciary responsibility, act as a blanket waiver of conflicts of interest, or waive specific obligations under the Advisers Act are inconsistent with an adviser's fiduciary duty for retail *and institutional* clients alike. The SEC withdrew the SEC staff's 2007 *Heitman* no-action letter, in part because the SEC was concerned that the letter was being misinterpreted as defining the scope of an adviser's fiduciary duty, rather than identifying circumstances where a hedge clause (a clause in an advisory agreement that attempts to limit an adviser's liability)

would be misleading such that it would violate Section 206 of the Advisers Act. The SEC reaffirmed the concept that whether a hedge clause violates the antifraud provisions of the Advisers Act depends on the facts and circumstances, including the sophistication of the client. Although the SEC withdrew *Heitman*, it left in place the 1974 *Auchincloss* SEC staff no-action letter allowing the use of savings clauses to clarify that certain exculpatory provisions are not intended to "constitute a waiver or limitation of any rights which the [client] may have under any federal securities laws."[18] However, the SEC stated its view that there are "few (if any) circumstances in which a hedge clause in an agreement with a retail client would be consistent" with the antifraud provisions of the Advisers Act, "even where the agreement otherwise specifies that the client may continue to retain its non-waivable rights"—in effect making the point that a savings clause will not save an otherwise impermissible hedge clause.

> **Observations:** From a practical perspective, advisers should review their advisory agreements to assess whether there are any contractual provisions that could be viewed as waiving a client's nonwaivable rights, notwithstanding the presence of a general savings clause that clients retain all rights that they would otherwise have from an Advisers Act or fiduciary perspective. The Interpretation does not change the advisability of using a savings clause indicating that clients will not be deemed to have waived any of their nonwaivable rights. However, including the savings clause language in a contract will not protect a hedge clause that otherwise purports to waive an adviser's fiduciary duty.

5. WHEN DO INVESTMENT ADVISERS HAVE TO COMPLY WITH THE INTERPRETATION?

The Interpretation took effect on July 12, 2019, upon publication in the *Federal Register*. There is no implementation period as in the case of Reg. BI and Form CRS, which have a compliance date of June 30, 2020.

> **Observations:** The immediate effectiveness of the Interpretation reflects the SEC's stated conclusion that the Interpretation was not intended to create new legal obligations for investment advisers. In the SEC's view, the Interpretation is intended to "reaffirm—and in some cases clarify—certain aspects of the fiduciary duty that an investment adviser owes to its clients under section 206 of the Advisers Act." Reasonable minds may differ, however, about whether the Interpretation is simply a restatement of an investment adviser's fiduciary duty or whether it expands the fiduciary duty in significant ways (e.g., by creating an overarching best interest obligation, applying the fiduciary duty to advice about account types). Firms might consider revisiting and, in some cases, enhancing existing practices and disclosures to conform to the Interpretation, as discussed below.

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[18] *Auchincloss & Lawrence Inc.,* SEC Staff No-Action Letter (Feb. 8, 1974).

6. HOW WILL THE SEC ENFORCE COMPLIANCE WITH THIS INTERPRETATION?

The SEC did not adopt a rule codifying the standard of conduct for investment advisers, even though the SEC has authority in Section 206(4) to define by rule "any act, practice, or course of business which is fraudulent, deceptive, or manipulative" and in Section 211(g) to adopt a "best interest" standard—authority that was granted by Congress just nine years ago in Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Rather, the SEC decided to issue an interpretation of an investment adviser's fiduciary duty. This means that the SEC's authority to bring actions to enforce compliance with the Interpretation is limited to Advisers Act Sections 206(1) and (2), which have been construed by the federal courts as limited to common law principles.

> **Observations:** The Interpretation is designed to consolidate SEC guidance on the federal fiduciary duty in one place, although the Interpretation seemingly stakes out new ground in some key respects. As a result, the Interpretation will effectively become the standard the SEC examination and enforcement staff will look to in evaluating whether an investment adviser breached its fiduciary duty under Section 206(1) and (2). Whether the positions articulated in the Interpretation go beyond the common law principles underpinning Sections 206(1) and (2) may well be an issue for debate in SEC examinations and enforcement actions. Regardless of how that debate plays out, advisers should read the Interpretation from the perspective of how they can document – through policies, procedures, disclosure, supervision and surveillance – that they are addressing the various fiduciary obligations described in the Interpretation when providing advice.

B. INTERPRETATION OF THE DUTY OF CARE

1. WHAT IS THE DUTY OF CARE THAT INVESTMENT ADVISERS OWE TO THEIR CLIENTS?

The Interpretation states that investment advisers owe their clients a duty of care, which includes (among others) the duty to:

- provide advice that is in the best interest of, and is suitable for, the client;
- seek best execution of client transactions where an adviser has the responsibility to select executing broker-dealers; and
- provide advice and monitoring over the course of the relationship.

2. DOES THE BEST INTEREST STANDARD ONLY APPLY ONLY IN THE CASE OF A RECOMMENDATION?

Not according to the SEC. Unlike Reg. BI, which is triggered by a recommendation, the duty to provide advice that is in the client's best interest applies to "all investment advice" that an adviser provides. This includes advice about investment strategies, engagement of a sub-adviser, and significantly, account type, which the SEC characterizes (but does not define) as including the type of accounts that a client may open (e.g., fee-based advisory or commission-based brokerage). It also applies to advice about retirement plan account (such as 401(k) plans

and IRAs) roll-overs. The SEC considers roll-over advice to incorporate advice around account type. Applied by the SEC to this context, the best interest component of the duty of care requires advisers to "consider all types of accounts offered by the adviser and acknowledge to a client when the account types the adviser offers are not in the client's best interest."

> **Observations:** Under longstanding SEC guidance, "[t]he relationship of a broker or dealer to his brokerage customers does not become an investment advisory relationship merely because the broker or dealer is a registered investment adviser,"[19] and the Advisers Act applies only to those accounts to which the broker-dealer provides investment advice that is not solely incidental to brokerage services or for which the firm receives special compensation. The SEC's articulated obligation to consider all types of accounts offered by the adviser will be challenging for dual registrants and advisers that have supervised persons that are also registered representatives of a broker-dealer. In order to manage these obligations, advisers might consider how to define their relationships with clients and the universe of available account types. Advisers might also consider ways to aid representatives in documenting account choice, perhaps even revisiting tools, approaches, and training modules developed in regard to implementing the now-vacated Department of Labor (DOL) Fiduciary Rule (e.g., onboarding tools and pull-downs, client-facing educational brochures, and decision trees).

3. WHAT FIDUCIARY OBLIGATIONS ARE OWED TO PROSPECTIVE CLIENTS?

Under the Interpretation, an investment adviser has an obligation to confirm that advice regarding account type that it provides to *prospective* clients continues to be appropriate at the inception of the fiduciary relationship. The SEC acknowledges that an adviser is not acting in a fiduciary capacity prior to the inception of the advisory relationship, and states that the relationship with a prospective client is governed by the general antifraud provisions of Section 206. The SEC asserts that once an advisory relationship is established, the adviser "must satisfy its fiduciary duty" with respect to account type and other advice that predates the inception of the advisory relationship.

> **Observations:** Although the Interpretation does not appear to go so far as to make an investment adviser's fiduciary duty retroactive to advice that predates the inception of the advisory relationship, it does highlight the importance of having appropriate controls around the advice provided to prospective clients, including with investment proposals and account type selection. Additionally, advisers should consider the need to revisit any advice provided to prospective clients to determine whether there are additional factors that might change or better inform that advice if and when a prospect becomes a client. Moreover, firms should consider revising disclosures on materials provided to prospective clients (including investment proposals) to indicate that the information provided is based on the initial discussion and information collected as part of the proposal process, reflects the adviser's perspective at that particular point in time, and will not be updated prior to the inception of the advisory relationship.

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[19] Advisers Act Release No. 626 (Apr. 27, 1978); *see, e.g.,* Goldman, Sachs & Co., SEC No-Action Letter (Feb. 22, 1999) (pertaining to the applicability of Advisers Act restrictions on principal trades to transactions effected for clients of the broker-dealer's prime brokerage services).

4. HOW CAN AN INVESTMENT ADVISER SATISFY ITS OBLIGATION TO PROVIDE ADVICE IN THE BEST INTEREST OF THE CLIENT?

According to the SEC, an investment adviser is required to have a "reasonable understanding" of the client's objectives in order to render advice that is suitable for and in the best interest of the client. In order to form such a "reasonable understanding," an adviser must make a "reasonable inquiry" into the client's objectives.

5. WHAT IS A "REASONABLE INQUIRY" FOR RETAIL CLIENTS?

According to the SEC, an adviser would, at a minimum, have to inquire into a retail client's "investment profile," which includes financial situation, level of financial sophistication, investment experience, and financial goals. In addition, the SEC states that an adviser is required to update the client's investment profile "to maintain a reasonable understanding of the client's objectives and adjust its advice to reflect any changed circumstances," and that the frequency of updates would turn on a number of factors, including the extent to which the adviser is aware of events that could render the client's investment profile inaccurate or incomplete.

> **Observations:** Advisers will want to consider how the concept of an "investment profile" applies to their business and whether they have or retain information that sufficiently constitutes an investment profile for their clients. The Interpretation leaves unanswered how frequently an investment adviser is required to update a client's investment profile and under what situations an investment adviser would be deemed to be "aware of" new information that could cause the investment profile to become inaccurate or incomplete. This is particularly the case where advisory clients have additional financial relationships with their adviser or its affiliates (e.g., banking, brokerage, insurance) and the affiliate receives information about the client that may affect the investment profile.

6. WHAT IS A REASONABLE INQUIRY FOR INSTITUTIONAL CLIENTS?

The SEC stated that, when advising institutional clients, the nature and extent of an adviser's "reasonable inquiry" into the client's objectives depends on the specific investment mandate, guidelines and objectives. In contrast to retail investors, advisers acting on specific investment mandates for institutional clients – "particularly funds" – would not have an obligation to "update a client's objectives" unless required under the terms of the advisory agreement.

7. HOW CAN AN ADVISER SATISFY THE OBLIGATION TO HAVE A "REASONABLE BELIEF" THAT ADVICE IS IN THE BEST INTEREST OF A CLIENT?

The Interpretation states that an investment adviser is required to "have a reasonable belief that the advice it provides is in the best interest of the client based on the client's objectives." The concept of a reasonable belief will depend on the particular facts and circumstances of the advisory relationship, including the overall portfolio that the adviser manages for the client, as well as its objectives. According to the SEC, the adviser must also consider the risks of the

investment strategies and securities it recommends,[20] and conduct a reasonable investigation into the investment that is "sufficient not to base its advice on materially inaccurate or incomplete information."

8. How do fees and expenses impact the best interest obligation?

The SEC asserts that the fees and compensation associated with an investment are not solely determinative of whether that investment is in the best interest of a client. Rather, fees and compensation are "one of many important factors" that must be considered—along with investment objectives, characteristics, liquidity, risks and potential benefits, volatility, likely performance in different market and economic conditions, time horizon, and cost of exit. According to the SEC, "when considering similar investment products or strategies, the fiduciary duty does not necessarily require an adviser to recommend the lowest cost investment product or strategy." The SEC stated that an adviser would not satisfy its fiduciary duty to provide advice that is in a client's best interest by "simply advising its client to invest in the lowest cost (to the client) or least remunerative (to the investment adviser) investment product or strategy" without considering other factors.

> **Observations:** While the Interpretation makes clear that an adviser could recommend a higher-cost investment or strategy if the adviser reasonably believes that there are other factors that outweigh cost, as a practical matter it may be difficult to satisfy the standard in the case of identical investments—such as mutual fund share classes—where the only differences are the fees and expenses paid by the client and the remuneration to the adviser or its affiliates. As many firms experienced in attempting to implement processes for the DOL Fiduciary Rule, applying a fiduciary standard to an open-architecture platform may prove challenging. This is also a consideration for firms that offer a range of different advisory products that may have similar features and investment characteristics at different price points.

9. Does the Interpretation affect an investment adviser's duty to seek best execution?

No, the Interpretation appears to reconfirm existing SEC guidance that an investment adviser has the duty to seek best execution of client transactions where the adviser has the responsibility to select executing broker-dealers for the transactions. The Interpretation cites to prior guidance for the proposition that "the 'determinative factor' is not the lowest possible commission cost, 'but whether the transaction represents the best qualitative execution,'" and that advisers should periodically and systematically evaluate execution quality.

> **Observations:** In the Interpretation, the SEC again declined to provide affirmative guidance on the application of best execution to mutual fund share class selection. Despite having brought charges against investment advisers for failure to obtain best execution in the context of mutual fund share class selection in a number of settled enforcement actions, the SEC did not lay the foundation for this theory of best execution.

10. WHAT IS THE DUTY TO PROVIDE ONGOING ADVICE AND MONITORING?

In what may be the most significant change from SEC guidance, the SEC stated that the duty of care also requires advisers to provide advice and monitoring at a frequency that is in the best interest of the client. Previously, advisers were (and remain) required to disclose in Form ADV Part 2A limited information on account reviews, including if they periodically review client accounts. Under the Interpretation, the scope of the duty takes into account the nature of the relationship with the client, and consequently, ongoing advisory relationships where advisers receive asset-based fees will have more extensive duties than in more limited advisory relationships. The SEC stated that advisers and clients may define the scope and frequency of monitoring obligations provided there is full and fair disclosure and informed consent. According to the SEC, the duty would extend to all personalized advice, including, in an ongoing relationship, "an evaluation of whether a client's account or program type (for example, a wrap fee program account) continues to be in the client's best interest."

The SEC also stated that monitoring frequency is a material point of disclosure for clients, and suggested that advisers should consider adopting written policies and procedures governing monitoring for purposes of meeting their compliance obligations under Rule 206(4)-7.

C. INTERPRETATION OF THE DUTY OF LOYALTY

1. DID THE SEC CHANGE THE FORMULATION OF THE DUTY OF LOYALTY?

Yes. The Proposed Interpretation stated that "the duty of loyalty requires an investment adviser to put its client's interests first." The SEC refined this standard in the Interpretation to say that an investment adviser may not place its own interest ahead of its client's interest. The SEC reformulated the standard in response to comments it received, which argued that there is a material difference between putting client interests first and the requirement not to subordinate or subrogate client interests. The SEC noted that the refined standard is more consistent with how it has previously described the duty of loyalty.

2. HOW DOES THE SEC DEFINE A CONFLICT OF INTEREST?

The SEC's statements around conflicts of interest reflect a shift from the standard articulated in the Proposed Interpretation, which is that an adviser "must seek to avoid conflicts of interest with its clients" and at a minimum, make "full and fair disclosure of all *material* conflicts of interest that could affect the advisory relationship." (Emphasis added.) Under the Interpretation, advisers must "eliminate or at least expose through full and fair disclosure *all* conflicts of interest which *might* incline an investment adviser – consciously or unconsciously – to render advice which was not disinterested."

The critical difference is that the standard for disclosure in the Interpretation does not have a materiality component. Rather, the limiting factor is whether the conflict might cause an investment adviser to provide advice that is not disinterested. This construction appears to be a departure from the instructions to Instruction 3 of Form ADV, Part 2A, which states:

> Under federal and state law, you are a fiduciary and must make full disclosure to your clients of all material facts relating to the advisory relationship. As a fiduciary, you also must seek to avoid conflicts of interest with your clients and, at a minimum, make full disclosure of all *material* conflicts of interest between you and your clients that could affect the advisory relationship.

(Emphasis added.) In the Interpretation, the SEC effectively reads out the "material conflict" concept in the second sentence above and emphasizes the first part of the instruction for the premise that in order to satisfy the duty of loyalty, an adviser must disclose "all material facts relating to the advisory relationship."

The Interpretation states that the duty to disclose material facts relating to the advisory relationship includes disclosure about the capacity in which the firm is acting, including, in the case of dual registrants or individuals that are dually licensed, the circumstances where the adviser would be acting in its capacity as a broker-dealer. Disclosure about capacity (and any changes thereto) can be accomplished through a variety of means, including written disclosure at the beginning of the advisory relationship that clearly lays out when the adviser would be acting in a brokerage capacity. The Interpretation also states that, when providing investment advisory services to clients, dual registrants should disclose any circumstances under which their investment offerings will be limited to a menu of products offered through their affiliated broker-dealers or advisory channels.

> **Observation:** Under longstanding SEC and staff statements, as well as the text of Form ADV, investment advisers have only been required to make full disclosure of material conflicts. While the SEC stated in Regulation Best Interest that "it would be difficult to envision a 'material fact' that must be disclosed pursuant to the Disclosure Obligation that is not related to a conflict of interest that is also material," it is unclear how this plays out in practice, including whether the SEC ultimately takes the position that the existence of a conflict is a material fact that must be disclosed without regard to the materiality of the conflict and how this impacts conflicts that advisers have deemed immaterial and excluded from disclosures.

3. DOES THE SEC VIEW DISCLOSURE AS SUFFICIENT TO SATISFY THE DUTY OF LOYALTY, OR DO ADVISERS HAVE TO MITIGATE OR ELIMINATE CERTAIN CONFLICTS OF INTEREST?

Although there is no affirmative obligation to eliminate or mitigate conflicts *per se* under the Interpretation, elimination or mitigation may be required if an adviser cannot provide sufficiently specific disclosure to obtain informed consent.[21]

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[21] *See* Interpretation at text accompanying FN 92 ("We disagree that this Final Interpretation includes a requirement to eliminate conflicts of interest. As discussed in more detail above, elimination of a conflict is one method of addressing that conflict; when appropriate advisers may also address the conflict by providing full and fair disclosure such that a client can provide informed consent to the conflict.")

The SEC's position is that disclosure of conflicts is sufficient to satisfy the duty of loyalty, but that disclosure incorporates an informed consent element that requires disclosure to clients around conflicts of interest be sufficiently specific such that clients can understand the conflict of interest and make "an informed decision" about whether to consent. The Proposed Interpretation stated that "[d]isclosure of a conflict alone is not always sufficient to satisfy the adviser's duty of loyalty and section 206 of the Advisers Act." This statement called into question whether the SEC was backing away from the fundamental common law foundation of the fiduciary duty of loyalty, as well as SEC precedent, both of which do not prohibit an investment adviser from benefitting from a transaction with a client if the investment adviser provides appropriate disclosure of the conflicts of interest related to the transaction and the client consents.[22] A client may generally consent to a conflict of interest that would otherwise constitute a breach of the duty of loyalty where the adviser has provided appropriate disclosure of the conflict.[23]

In response to comments, the SEC softened the prior language implying that disclosure is *per se* insufficient to address conflicts in certain circumstances and focused instead on how to obtain informed consent. However, the Interpretation retains the concept that, if a conflict of interest cannot be fully and fairly disclosed, advisers should either "*eliminate* the conflict or adequately *mitigate* (i.e. modify practices to reduce) the conflict such that full and fair disclosure and informed consent are possible."

4. HOW DOES AN ADVISER KNOW IF IT HAS OBTAINED INFORMED CONSENT?

According to the SEC, advisers must make full and fair disclosure of conflicts of interest such that they obtain the informed consent of clients. The Interpretation clarifies that "informed consent" is not a subjective standard that would require advisers to make an affirmative determination that each particular client understood the disclosure. According to the SEC, the focus for advisers is whether their disclosure is designed to put clients in a *position* to be able to understand and provide informed consent to the conflict of interest. Further, informed consent does not need to be explicit in all cases. The SEC believes informed consent can be implicit,

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[22] *SEC v. Capital Gains Research Bureau*, 375 US 180 at 191–92 (Dec. 9, 1963) (stating that the Advisers Act reflects "a congressional intent to eliminate, or at least expose, all conflicts of interest which might incline an adviser—consciously or unconsciously [sic]—to render advice which was not disinterested"). Following a detailed analysis of the legislative history, the Court in *Capital Gains* did not require that investment advisers avoid conflicts of interest, but rather required that they provide appropriate disclosure of conflicts of interest so that clients can evaluate the conflicts. "An investor seeking the advice of a registered investment adviser must, if the legislative purpose is to be served, be permitted to evaluate such overlapping motivations, through appropriate disclosure, in deciding whether an adviser is serving 'two masters' or only one, 'especially . . . if one of the masters happens to be economic self-interest.'" *Id.* at 196 (quoting *United States v. Mississippi Valley Generating Co.*, 364 US 520, 549 (1961)).

[23] *See* Chairman Jay Clayton, Testimony Before the Financial Services and General Government Subcommittee of the House Committee on Appropriations (Apr. 26, 2018) (stating in public congressional testimony that it would "misstate the law and could mislead investors to suggest [that] investors currently have a legal right to conflict-free advice from an investment adviser").

including through a client's continued receipt of advisory services following full and fair disclosure.

5. DOES THE INTERPRETATION IDENTIFY SPECIFIC CONFLICTS WHERE INFORMED CONSENT WOULD BE DIFFICULT?

Yes, but the guidance is minimal. The SEC believes that such conflicts are "of [such] a nature and extent that it would be difficult to provide disclosure to clients that adequately conveys the material facts or the nature, magnitude, and potential effect of the conflict" such that the client would be able to consent to or reject it. The Interpretation identifies "complex or extensive conflicts" as an area where understandable and sufficiently specific disclosure to retail investors may be difficult, on the theory that institutional investors "have a greater capacity and more resources [...] to understand" complex conflicts as compared to retail investors.

> **Observations:** The net effect of the Interpretation with respect to the disclosure of conflicts seems to be that the SEC is attempting to restate the standard for when disclosures are sufficient to produce informed consent. Accordingly, to the extent they have not already done so, investment advisers should revisit disclosure around significant conflicts to determine whether they need to more clearly articulate the material facts of the conflict and have an appropriate level of detail in their disclosure to put clients in a position to understand the nature of the conflict and provide informed consent.

May advisers use conditional "may"-based disclosure? In the SEC's view, "may"-based disclosure could be appropriately used only in cases where the disclosure identifies a potential conflict that does not currently exist but might "reasonably present itself in the future." Otherwise, the Interpretation formalized the view—first articulated in various enforcement actions—that disclosing that an adviser "may" have a particular conflict, is not adequate when that conflict actually exists. According to the SEC, investment advisers should not use "may" to explain that a conflict exists only with respect to a subset of clients or services it provides, unless the "may"-based disclosure specifies the subset of clients or services where the conflict applies. In the SEC's view, "may"-based disclosure that precedes a list of all possible or potential conflicts regardless of likelihood has the effect of "obfuscating" actual conflicts to a point that clients cannot provide informed consent. ***

> **Observations:** Advisers that have not already done so should revisit their disclosures and client agreements to consider and—to the extent appropriate—eliminate "may"-based disclosures. The SEC continues to attack "may"-based disclosure, perhaps emboldened by a recent federal court decision that upheld findings of inadequate "may"-based disclosure.[24] However, in so doing, the SEC neither acknowledged nor reconciled federal court precedent cited by commenters that has rejected differences between "will" and "may" in the disclosure context as "semantic quibbling" and not material omissions in and of themselves under the federal securities law.[25]

D. INTERPRETATION OF "SOLELY INCIDENTAL"

Section 202(a)(11)(C) of the Advisers Act excludes from the definition of "investment adviser" any broker-dealer whose advice is "solely incidental" to its brokerage business and who does not receive "special compensation" for that advice. In this interpretation,[26] the SEC sought to clarify its views as to the "solely incidental" prong in light of Reg. BI.

The SEC stated that it interprets the "solely incidental" prong to mean that a broker-dealer's provision of advice does not make it an investment adviser if the advice is "provided in connection with and is reasonably related to the broker-dealer's *primary business of effecting securities transactions*." (Emphasis added.) According to the SEC, whether such advice is provided on a solely incidental basis is based on the facts and circumstances surrounding the broker-dealer's business, the specific services offered, and the relationship between the broker-dealer and the customer. The SEC stated that the "quantum or importance" of investment advice provided by a broker-dealer is not determinative of whether it is "solely incidental" to brokerage activity, affirming that even consequential broker-dealer investment advice can fall within the exclusion provided it meets the standard above. The SEC provided guidance for two applications of investment advisory activity, as detailed below, but noted that it will consider further comment on its interpretation of the "solely incidental" prong to evaluate whether to issue additional guidance.

- *Exercise of Investment Discretion:* The SEC stated that it views a broker-dealer's exercise of "unlimited discretion" – defined as the ability or authority to buy and sell securities on behalf of a customer without consulting the customer – as indicating that the client relationship is primarily advisory in nature, and therefore outside of the solely incidental prong. However, the SEC carved out certain instances of investment discretion granted by a customer on a temporary or limited basis. The SEC defined discretion in such situations as limited in "time, scope, or other manner" and lacking "the comprehensive and continuous character of investment discretion." For example, the SEC pointed to (among others) discretion over time and price of execution, the isolated or infrequent purchase or sale of a security or type of security when the customer is unavailable for a limited period of time, cash management such as the exchange of money market funds or other cash equivalents, the sale of specific bonds "or other securities" in order to permit a customer to realize a tax loss on the original position, and the purchase or sale of securities to satisfy margin requirements or other customer obligations "specified" by the customer. The "primarily advisory in nature" test is troubling in that it is both new and not clearly articulated.

- *Account Monitoring*: The SEC also provided some guidance around whether monitoring of customer accounts (as discussed in Regulation Best Interest) is advice that is solely incidental to brokerage. The SEC disagreed with commenters who suggested that any account monitoring is necessarily outside of the solely incidental prong, and stated that "[a] broker-dealer that agrees to monitor a retail customer's account on a periodic basis for purposes of providing buy, sell, or hold recommendations may still be considered to

[26] Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser, Investment Advisers Act Rel. No. 5249 (June 5, 2019), 84 Fed. Reg. 33681 (July 12, 2019).

provide advice in connection with and reasonably related to effecting securities transactions." (Emphasis added; citations omitted.) The SEC also made clear that broker-dealers would not generally be acting in a primarily advisory nature if they voluntarily and without any agreement review customer account holdings for purposes of determining whether to provide a securities recommendation. In contrast, the SEC said that if a broker-dealer separately contracts for or charges a separate fee for account monitoring, that activity would likely fall outside the solely incidental prong and require investment adviser registration.

Observation: The SEC's reformulation of the broker exclusion as permitting only advice that is "provided in connection with and is reasonably related to the broker-dealer's *primary business of effecting securities transactions*" and the corresponding test looking to whether a broker's services are "*primarily advisory in nature*"—as well as the SEC's positions on agreed account monitoring—reflect changes that were not explicitly proposed or articulated in the Proposed Interpretation or past SEC or staff guidance, and are murky. The SEC's reformulated broker exclusion appears lifted from dicta in *Thomas v. Metropolitan Life Insurance Co.*,[27] where the US Court of Appeals for the Tenth Circuit affirmed the SEC's prior interpretation of the broker exclusion but incorrectly paraphrased the SEC's prior interpretation. The new interpretation appears inconsistent with the point validated in the *Thomas* decision, and repeated by the SEC, that "the solely incidental prong does not hinge upon 'the quantum or importance' of a broker-dealer's advice." Although the SEC addressed exercise of discretion in prior guidance (including in Rule 202(a)(11)-1, which was vacated by the US Court of Appeals for the District of Columbia Circuit in *Financial Planning Association v. SEC*[28]), the "primary business of effecting securities transactions" and "primarily advisory in nature" tests are entirely new. Similarly, although the SEC requested comments on account monitoring, it did not articulate a proposed interpretation of when agreed account monitoring would fall outside the "solely incidental" prong. As such, the SEC's reformulated interpretation of the broker exception raises significant questions, especially given recent Supreme Court and other federal court decisions rejecting agency interpretations absent notice and comment.[29]

E. ADDITIONAL RULEMAKING UNDER CONSIDERATION

We note that in the Proposed Interpretation, the SEC requested comment on three potential areas of new rulemaking for SEC-registered investment advisers. The areas identified were also discussed in the SEC staff's 2011 Study on Investment Advisers and Broker-Dealers conducted

pursuant to Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[30] These areas include federal licensing and continuing education requirements for personnel of SEC-registered investment advisers; rules requiring investment advisers to provide account statements; and SEC-registered investment advisers being subjected to a financial responsibility program similar to those that apply to broker-dealers. The SEC also requested comment on a number of subsidiary issues relating to these topics. The Interpretation does not address these issues, and notes that the SEC is continuing to evaluate the comments that it has received in response to its request.

III. SEC Form CRS

To help retail investors better understand the services, fees, costs, conflicts of interest, and required standards of conduct that apply to relationships with broker-dealers, federally registered investment advisers and dual registrants, the SEC is requiring firms to deliver a Form CRS customer or client relationship summary at certain points in the customer or client relationship.

A. What Firms are Subject to Form CRS Requirements?

The Form CRS requirements are broad and apply to (1) any broker-dealer that offers services to a "retail investor", (2) any investment adviser that enters into advisory contracts with "retail investors," and (3) dual registrants offering services to, or entering into advisory contracts with, "retail investors."

For purposes of Form CRS, "retail investor" is defined as: "a ***natural person***, or the legal representative of such natural person, who ***seeks to receive*** or ***receives*** services primarily for ***personal, family or household purposes***."

> **Observations:** The Form CRS definition of "retail investor" is aligned with the definition under Reg. BI. However, Reg. BI's "best interest" obligations are triggered when a broker-dealer ***provides a recommendation*** to a retail investor, while Form CRS's requirements are triggered when a retail investor ***seeks or receives services***, which is not clearly laid out in the SEC's guidance. This is significant because Form CRS encompasses brokerage and advisory services beyond simply recommendations and advice. The obligation to send Form CRS can occur well before a firm makes a recommendation.

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[30] Staff of the US Securities and Exchange Commission, Study on Investment Advisers and Broker-Dealers (Jan. 2011).

1. What is a personal, family, or household purpose?

The SEC clarified in the release adopting Form CRS that (as with Reg BI) "personal, family or household purposes" include "retirement, education and other personal, family or household saving and investing objectives," but do not include commercial or business purposes.[31]

> **Observations:** A retail investor's purposes for seeking services may not always be clear. Therefore, firms may want to consider an approach under which they ***assume that a retail investor is generally seeking*** services that are in at least some respect for personal, family, or household purposes, and then determine if certain types of relationships with retail investors are clearly excluded from Form CRS's delivery requirements, recognizing that a retail investor's purpose for seeking services could change over the course of his or her relationship with a firm.

2. Is there an exception for high net worth individuals?

No. As with Reg. BI and unlike under the suitability rules of Financial Industry Regulatory Authority (FINRA) which contain a high net worth exception for certain natural persons with $50 million in assets,[32] there is no exception from the Form CRS delivery requirement for retail investors based on high net worth or other factors indicating investor sophistication.

3. Do the Form CRS delivery requirements apply to employer-sponsored retirement plans?

Plan fiduciaries, no. Plan participants, yes. According to the SEC, Form CRS should be delivered to plan participants seeking services for retirement accounts, such as advice about whether to take a distribution, or how to invest distributed assets, but not when plan participants are making "ordinary plan elections that do not involve selecting or retaining a firm to provide brokerage or advisory services."[33] The SEC clarified that Form CRS does not need to be delivered to workplace retirement plan service providers, such as plan sponsors, trustees, and fiduciaries.

4. Who is a "legal representative"?

As with Reg. BI, the SEC clarified that a "legal representative of a natural person" includes only "non-professional legal representatives," such as non-professional trustees, executors, conservators, and persons with powers of attorney. This excludes financial services firms and

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[31] Form CRS Relationship Summary; Amendments to Form ADV, Advisers Act Release No. 5247 (June 5, 2019) at 192-3, 84 Fed. Reg 33492 (July 12, 2019) ("CRS Release").

[32] See, e.g., FINRA Rule 2111 provides certain exceptions when broker-dealers deal with institutional accounts that can include persons with $50 million or more in assets. See also FINRA Rule 4512(c), which defines an institutional account.

[33] *CRS Release* at 198.

corporate fiduciaries.[34] As the SEC explained, the term "non-professional legal representatives" is intended "to capture persons who are acting on behalf of natural persons and are not regulated financial services professionals retained by natural persons to exercise independent professional judgment."[35]

> **Observations:** Firms may want to consider whether to develop systems and processes to identify non-professional legal representatives and how best to deliver Form CRS to such persons (e.g., some firms' onboarding portals initially ask an investor to identify themselves as investors or institutions with appropriate explanation of these terms).

5. ARE ANY FIRMS EXCLUDED FROM THE FORM CRS REQUIREMENTS?

Yes, clearing and limited purpose underwriting firms. While the Form CRS requirements broadly apply to firms that offer services to retail investors, the SEC specifically stated that the following services by themselves would generally not trigger Form CRS requirements:[36]

- Broker-dealers serving solely as principal underwriter to a mutual fund, variable annuity, or variable life insurance contract issuer
- Clearing and carrying broker-dealers that are solely providing services to third party or affiliated introducing broker-dealers.

The SEC made clear, however, that "[t]o the extent such broker-dealers interact with a retail customer in a different capacity . . . , Form CRS's obligations would apply in those instances."[37] In this regard, we note that Form CRS applies to all broker-dealers registered with the SEC under Section 15 of Exchange Act, which would capture Capital Acquisition Brokers (a category of limited purpose broker under FINRA rules) and, arguably, broker-dealers that are notice-registered with the SEC under Section 15(b)(11) of the Exchange Act to transact in security futures products.

> **Observations:** Firms will want to consider whether other services that are not offered directly to retail investors (e.g., investment advisory models and management services provided to another investment adviser that uses the models in its own clients' advisory accounts) would require compliance with Form CRS's requirements, or whether further clarification on this point from the SEC would be helpful.

B. DELIVERY, FILING, UPDATING, AND RECORDKEEPING REQUIREMENTS

The Form CRS delivery, filing, updating, and recordkeeping requirements are complex and will require that firms assess their current operations, systems, policies, and procedures to

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[34] *Id.* at 195.

[35] *Id.* at 195.

[36] *Id.* at 224-225.

[37] *Id.* at 225.

determine whether they can leverage existing structures or whether modifications or new structures are needed.

1. DELIVERY REQUIREMENTS

a. *What are the delivery requirements for new and prospective customers and clients?*

The ***initial delivery*** requirements depend on whether the firm is a broker-dealer, investment adviser, or dual registrant.

Required Timing Initial Form CRS Delivery Requirements

Broker-Dealers	**Investment Advisers**	**Dual Registrants**
Earliest of: • A ***recommendation provided to a "retail investor" of a—*** a) Securities transaction, b) Account type, or c) Investment strategy involving securities, • Placing ***an order*** for the retail investor, or • Opening ***a brokerage account*** for the retail investor	***Before or at the time*** of entering into an investment advisory contract with a "retail investor" (i.e., the required timing of Form ADV Part 2 delivery)	***Before or at the time*** of the ***earliest*** of any of the events in the preceding columns

Observations: Firms will want to consider how best to streamline and automate Form CRS delivery to avoid delivery failures and errors. For example, the initial delivery requirements for investment advisers may generally be satisfied by integrating Form CRS into account opening documents and agreements and onboarding process. Note, however, that if Form CRS is delivered in paper format as part of a package of documents, it must be the first document in the package – which could pose challenges.[38]

Whether a broker-dealer can satisfy the delivery requirements by including Form CRS in account opening documents will depend on whether the retail investor receives account opening documents before the broker-dealer provides a recommendation, places an order, or even discusses the types of the services the broker-dealer offers to retail

[38] *Id.* at 213.

investors. Broker-dealers that make recommendations and place orders before accounts are formally opened should consider how to deliver Form CRS to retail investors before or at the time of such activities. The SEC specifically declined to mandate a delivery requirement based on first contact or inquiry because there may be instances of first contact where the retail investor is not seeking investment services, but instead is seeking services "such as business interactions for other purposes or social interactions." [39] Mandating delivery at first contact could create compliance uncertainty.

b. *After initial delivery, at what other times must firms deliver Form CRS?*

A firm must deliver Form CRS to existing customers or clients before or at the time the firm:

- Opens a new account that is different from the retail investor's existing accounts;
- Recommends that the retail investor roll over assets from a retirement account into a new or existing account or investment; or
- Recommends or provides a new brokerage or investment advisory service or investment that does not necessarily involve the opening of a new account and would not be held in an existing account (e.g., a first time investment in a direct-sold mutual fund or variable annuity or adding margin or options trading authorization to an existing account).

The SEC did not explain when a new account would be viewed as "different from the retail investor's existing accounts," including whether firms should look to differences in account type (e.g., cash versus margin), program type, account owners, account investment objectives or similar aspects and did not explain how the requirement applies to master and sub-accounts.

Observations: Many firms will have to implement operational changes to address the ongoing delivery requirements. This will especially impact firms that do not currently deliver new documents or agreements in connection with these events. Firms will want to evaluate their processes for opening accounts, rollovers, and direct investments, and whether systems can be developed to automate Form CRS delivery and recordkeeping to avoid errors.

Firms may also want to consider their current policies and procedures for retirement account rollovers. If a firm does not permit rollover recommendations and limits communications to investment education, a new Form CRS may not need to be delivered in connection with a retirement account rollover. Nonetheless, firms should consider whether Form CRS may be a helpful supplement to their current investment education materials for rollovers.

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[39] *Id.* at 218.

c. *What delivery requirements apply to existing customers and clients on the Form CRS compliance date?*

Firms must deliver Form CRS to existing customers who are retail investors within 30 days after the date the firm first files its updated Form CRS with the SEC. Currently, the date firms must first file Form CRS with the SEC is between May 1, 2020, and June 30, 2020.

d. *What methods of delivery are permitted?*

Form CRS can be delivered in paper or electronic format. If a firm delivers Form CRS electronically, it must follow the SEC's guidance on electronic delivery,[40] which requires the following:

1. Notice to the retail investor that Form CRS is available electronically;

2. Access to Form CRS comparable to what would have been provided in paper form that is not so burdensome as to prevent investors from effectively accessing it;

3. Evidence to show delivery (or consent to electronic delivery after receiving certain disclosures).

Firms may also deliver Form CRS in a manner that is consistent with how the retail investor requested guidance about the firm or financial professional (e.g., if the customer requested information by email, the firm can deliver Form CRS by email). If Form CRS is delivered electronically, it must be presented "prominently" as a direct link or in the body of an email or message, and must be "easily accessible" for retail investors.

Form CRS must also be posted prominently on the firm's public website in a location and format that is easily accessible.

2. FILING REQUIREMENTS

Investment advisers must file Form ADV, Part 3 (Form CRS) electronically with the Investment Adviser Registration Depository (IARD) and broker-dealers must file Form CRS electronically through the FINRA Central Registration Depository (Web CRD®). Dual registrants must file with both IARD and Web CRD. Filings must be text searchable with machine readable headings. Firms must begin filing Form CRS between May 1, 2020 and June 30, 2020.

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[40] See, e.g., Use of Electronic Media by Broker- Dealers, Transfer Agents, and Investment Advisers for Delivery of Information; Additional Examples Under the Securities Act of 1933, Securities Exchange Act of 1934, and Investment Company Act of 1940, Exchange Act Release No. 37812 (May 9, 1996), 61 Fed. Reg. 24644 (May 15, 1996). The SEC did not acknowledge the Electronic Signatures in Global and National Commerce Act signed into law in 2000, which preempts other laws with some exceptions. However, the SEC did note that, "[r]ecognizing the growth of different forms of electronic media, other technological developments, and the passage of time since these releases were issued, the Commission plans to revisit its existing guidance regarding electronic delivery."
CRS Release at 207.

Observations: Form CRS is a filing subject to potential liability for false or misleading statements of material fact under Section 207 of the Advisers Act and Section 15(b)(4) of the Exchange Act.

3. UPDATING REQUIREMENTS

A firm must update its Form CRS and file it with the SEC within 30 days of any information becoming "materially inaccurate" and must notify existing retail investor clients and customers within 60 days after the updates are required to be made (i.e., within 90 days after any information becomes materially inaccurate). The amended Form CRS should include an attached exhibit highlighting the most recent changes, such as a summary of material changes (i.e., the approach in Item 2 of Form ADV Part 2A) or marked revised text.

Observations: Firms should consider how they will determine when information would be viewed as "materially inaccurate" (a complicated process), requiring an update. Firms should also keep the update requirement in mind when drafting their initial Form CRS and consider maintaining a degree of generality (consistent with full and fair disclosure requirements) to minimize the need for frequent updates. Where information contained in Form CRS is also contained in other documentation, firms will need to ensure that changes are accurately and timely reflected on all such documents.

4. RECORDKEEPING REQUIREMENTS

Firms must keep copies of Form CRS and records of each date that Form CRS is provided (in the case of a broker-dealer) or given (in the case of an investment adviser) to a retail investor, including dates prior to the date the retail investor opens an account or becomes a client.

Observations: Maintaining records of delivery dates prior to account opening or becoming a client will require operational changes for many firms. Note that while the rules speak to delivery of Form CRS, the recordkeeping provisions speak to when Form CRS was provided or given to the retail investor. While these nuances may be innocuous, it is unclear whether examiners would ascribe any meaning to these differences. Firms may wish to consider adding a client acknowledgement of receipt of Form CRS to customer agreements (as is often done with Form ADV Part 2A).

C. FORMAT AND STYLE REQUIREMENTS

According to the SEC, Form CRS is "designed to be a short and accessible disclosure for retail investors that helps them to compare information about firms' brokerage and/or investment advisory offerings and promotes effective communication between firms and their retail investors."[41] The SEC intends that "through the use of layered disclosure, [Form CRS] will facilitate investors' access to additional, more detailed, information."[42]

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[41] *Id.* at 29.

[42] *Id.* at 327.

Certain elements of Form CRS are prescribed, such as page limits, ordering of topics, headings, and certain disclosures and "conversation starters," but the SEC has left each firm with some flexibility to develop and customize its Form CRS to better reflect the firm and its business, as well as to be reader friendly and accessible to retail investors. As firms prepare Form CRS (consistent with the format and style requirements discussed below) they will want to consider how best to leverage this flexibility. Firms also should consider how Form CRS might interact with, and complement, their existing disclosures and those developed in connection with Reg. BI (as applicable).

1. LENGTH

In paper format:

- Broker-dealers' and investment advisers' Form CRS may not exceed two (2) pages.
- A dual registrant is limited to four pages if brokerage and investment advisory services are covered in one Form CRS, or two pages each if covered in separate Forms CRS.
- Firms with affiliates can include multiple affiliates in one Form CRS or prepare separate Forms CRS for each affiliate.

Firms must use "reasonable" paper size, font size, and margins. The SEC noted that it believes 8½" x 11" paper size, at least 11 point font size, and a minimum of 0.75" margins could be considered reasonable, but that other parameters could also be considered reasonable.[43] The Form CRS instructions also require firms to include white space and other design elements and graphics to make Form CRS easier to read.

In electronic format, Form CRS may not exceed the equivalent of two or four pages as applicable.

> **Observations:** Mark Twain said, "I didn't have time to write a short letter, so I wrote a long one instead." Crafting a reader-friendly Form CRS that includes all of the required content, prescribed language, white space and other design elements, and fits within the two- or four-page limits will be no easy task. Firms will likely need to devote significant time and resources and, where feasible, consider whether to establish a multidisciplinary working group (with personnel from business, legal, compliance, marketing, communications, investor relations, technology, web design, and others as applicable) for initial drafting and later updates.

2. PLAIN ENGLISH AND FAIR DISCLOSURE

Form CRS must be written in "***plain English***" and should be concise and direct, taking into account retail investors' financial experience. In particular, firms are encouraged to:

1. Use short sentences and paragraphs;

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[43] *Id.* at 48.

2. Use definite, concrete, everyday words;
3. Use active voice;
4. Avoid legal jargon or highly technical business terms, unless clearly explained;
5. Avoid multiple negatives; and
6. Use "you," "us," "our firm," etc. as if speaking to the retail investor.

The SEC has developed a "Plain English Handbook" available at www.sec.gov/news/extra/handbook.htm, which it encourages firms to consider reviewing in drafting Form CRS.

Information and disclosures in Form CRS must also be consistent with ***full and fair disclosure*** and specifically must:

1. Be true and not omit any material facts so that the disclosures are not misleading;
2. Be factual and provide balanced descriptions; and
3. Not include unsubstantiated claims, vague and imprecise "boilerplate" explanations, or disproportionate emphasis on investments or activities that are not offered to retail investors.

   Observations: Form CRS (including any linked information) is generally subject to the antifraud rules under both the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940.[44] Firms should be mindful in crafting Form CRS to avoid unintentionally tripping over these rules.

We also urge firms to consider reviewing existing disclosures and disclosures developed in connection with Reg. BI to ensure consistency across all client communications, as well as to determine where linking or cross-referencing other disclosures in Form CRS may be appropriate to ensure full and fair disclosure.

Additionally, firms may want to consider developing processes or work streams to ensure that disclosures remain consistent as updates are made over time.

3. GRAPHICAL AND DIGITAL FORMATS

With the goal of making Form CRS more visibly appealing and accessible to retail investors, and to enhance understanding of the information in Form CRS, the Form CRS instructions *encourage* firms to use graphical and digital formats, including:

- charts;

[44] *Id.* at 58-59.

- graphs;
- other graphics;
- text features;
- text colors;
- graphical cues, such as dual-column charts to compare elements;
- online tools that populate information in comparison boxes based on investor selections,
- access to video or audio messages or other information (by hyperlink, web address, Quick Response Code or other method);
- mouse-over windows;
- pop-up boxes;
- chat functionality;
- fee calculators; and
- other forms of electronic media, communications, or tools.

Form CRS encourages the use of links or other means of accessing other online information referenced in the Form CRS.

> **Observations:** Although the SEC stated that it is encouraging rather than requiring firms to use these elements, encouraged practices can often become *de facto* practices over time or during the course of regulatory examinations. Firms may want to consider how best to use these elements to enhance Form CRS and its usability for retail investors. When incorporating these elements, firms must consider the page length and other content limitations. In some cases, firms may decide to include these features in Form CRS itself, but in other cases these features may be better suited as supplemental materials that support the Form CRS disclosures, but are not included in the two- to four- page limits. In deciding what should be included in Form CRS, firms should heed the guidance by the SEC that while layered disclosure is anticipated. supplemental materials incorporated by reference will not, by themselves, satisfy disclosure requirements. Firms must also be attentive to the volume of supplemental materials in order to avoid overwhelming investors with disclosures or creating disclosures that will need to be updated and monitored for consistency over time. Thus, coordination between a firm's legal, communications and compliance teams will be imperative.

D. CONTENT REQUIREMENTS

Form CRS requires firms to complete the following five sections:

1. Introduction

2. Relationships and Services

3. Fees, Costs, Conflicts, and Standards of Conduct

4. Disciplinary History

5. Additional Information

Several sections include so-called "***conversation starters***" that are intended to spark discussions between retail investors and financial professionals.

> **Observations:** In general, firms should review and catalog existing disclosures and client communications to determine what can be leveraged to develop Form CRS. We note that many of Form CRS's disclosures are similar and consistent with disclosures that the DOL has required firms to complete, including Service Provider Fee Disclosures and disclosures many firms prepared (or were in the process of preparing) to satisfy the since-vacated Best Interest Contract Exemption. Leveraging these disclosure and work streams may be helpful here. Firms should also consider developing this disclosure in conjunction with disclosures newly required under Reg. BI.

Advisers can use the term "fiduciary" in describing the standard of conduct they owe to their client in Form CRS. Even though firms are required to use the exact language specified in Form CRS's instructions, which does not include "fiduciary", the SEC confirmed that their modification of the final language was an attempt to provide firms with more flexibility in their descriptions to client.

With respect to "conversation starters," firms should develop training programs for financial professionals and consider whether to develop scripts for financial professionals to use.

E. Titling Restrictions

Along with the Form CRS rule proposal, the SEC proposed a rule that would have prohibited broker-dealers and their financial professionals from using the titles "Advisor" and "Adviser", unless dually registered as an investment adviser. Though final Form CRS did not include the titling rule, the SEC stated in the release for final Reg. BI that the SEC presumes a broker-dealer's use of such titles would violate Reg. BI's disclosure obligation, subject to certain limited circumstances in which the broker-dealer provides advisory services in other capacities (e.g., as a municipal bond advisor).

F. Correcting Form CRS Errors

The SEC did not prescribe procedures for correcting substantive or delivery errors related to Form CRS.

> **Observations:** Firms may want to consider requesting additional guidance on how to correct errors related to Form CRS (as well as the new disclosure requirements under Reg. BI). Given the complexity of the delivery requirements, and the potential for errors in the disclosures themselves (particularly in cross-referenced or linked documents with additional information), a correction methodology for good faith errors would be

beneficial and consistent with other regulatory disclosure regimes (e.g., DOL Service Provider Fee Disclosures).

G. NEXT STEPS

Given the current ***compliance deadline of June 30, 2020***, firms have little time to make the operational changes and technology builds needed to comply with the Form CRS requirements. We suggest considering the following next steps as firms begin to develop Form CRS compliance processes:

1. ***Assemble your team.*** Consider the disciplines needed to achieve optimal results. In our experience, firms that combine input from business, marketing, communications, investor relations, legal, compliance, and other personnel have well-thought-out disclosures. Your DOL Fiduciary Rule teams may provide helpful insight and experience when it comes to implementation.

2. ***Review Form CRS delivery, filing, recordkeeping, updating, and content requirements.*** Make sure you and your team have a good grasp of all of the elements of Form CRS's delivery and content requirements.

3. ***Review existing disclosures and delivery, filing, recordkeeping, and updating systems.*** Consider what can be leveraged from what is already in place, what needs to be modified, and how best to maintain consistency across all layers of disclosure and communication you have with retail investors.

4. ***Consider requesting additional guidance from the SEC on requirements that are unclear or difficult to operationalize.*** If you have questions or think clarification may yield better, more efficient results, consider asking the SEC for additional guidance, whether directly or through trusted counsel.

5. ***Draft your Form CRS disclosures.*** Keep the big picture in mind—Form CRS is intended to help retail investors better understand and compare firms and their services. Try not to draft yourself into a corner by providing too many specifics that will require frequent updating and monitoring for consistency across your firm's other disclosures and communications. At the same time, make sure you provide balanced, full, and fair disclosures that are not misleading to investors. And don't forget to draft and edit with the goal of "plain English" disclosure.

6. ***Make any changes to systems, policies, and procedures for delivering, filing, and updating Form CRS and keeping records.*** Certain Form CRS delivery, filing, updating, and recordkeeping requirements are likely to require firms to develop new compliance structures. Technology lead times will be challenging here. Firms should consider upper management of the technological needs in order to ensure that Form CRS implementation timetables will be given adequate resources and priority.

7. ***Train your financial professionals so that they can appropriately handle retail investor questions regarding Form CRS, including with respect to conversation starters.*** Financial professional training will be important to ensuring timely delivery of Form CRS (to the extent not automated) and to help financial

professionals address retail investor questions about the information disclosed in Form CRS, including those raised in response to “conversation starters”. Firms may want to consider providing financial professionals with scripts to facilitate these discussions.