STRADLEY RONON

Fiduciary Governance

Risk&Reward

June 6, 2019

fiduciarygovernanceblog.com

SEC Adopts Regulation Best Interest, Form CRS, and Advisers Act Interpretations

The Securities and Exchange Commission ("SEC") has adopted a package of rules and interpretations governing the standards of conduct of broker-dealers and investment advisers and their associated persons, along with related disclosure requirements. The controversial actions were adopted on June 5, 2019, by a vote of 3 – 1, with Commissioner Robert Jackson dissenting on each vote. The rulemaking package consists of four separate actions:

- Regulation Best Interest ("Regulation BI") establishes a code of conduct for broker-dealers when making recommendations to retail customers.[1]

- Registered broker-dealers and registered investment advisers will be required to provide a standardized relationship summary to retail investors on Form CRS.[2]

- The SEC published an interpretation of the standard of conduct for investment advisers under the Investment Advisers Act of 1940 ("Advisers Act").[3]

- The SEC also published an interpretation of Section 202(a)(11)(C) of the Advisers Act, which excludes from the definition of "investment adviser" any broker-dealer that provides advisory services when such services are "solely incidental" to the conduct of the broker-dealer's business.[4]

© 2019 Stradley Ronon Stevens & Young, LLP | www.stradley.com | Philadelphia | Washington | Chicago | New York

Information contained in this publication should not be construed as legal advice or opinion or as a substitute for the advice of counsel. The enclosed materials may have been abridged from other sources. They are provided for educational and informational purposes for the use of clients and others who may be interested in the subject matter.

This Client Alert provides our initial, high level summary of the SEC actions. We will be following up in the near future with a much more detailed analysis. In addition, as discussed below, we will be participating next month in a webinar that will examine the actions more thoroughly. In the meantime, please feel free to contact one or more of the individuals identified at the end of this Alert if you have specific comments or questions.

Overview

At a high level, the SEC's final actions are consistent in content and scope with what it proposed.[5] Consistent with its approach in the proposing releases, the SEC ultimately chose not to impose a uniform fiduciary duty on broker-dealers and investment advisers. Instead, it elected to enhance the obligations of broker-dealers to bring them more closely in line with those of investment advisers. These enhanced obligations are derived in part from fiduciary principles, but the SEC did not characterize them as imposing actual fiduciary status on broker-dealers.

Despite the SEC's efforts to harmonize the obligations of broker-dealers and investment advisers, they will continue to be subject to different standards of conduct. Consequently, broker-dealers and investment advisers and their counsel will continue to have to consider and address the complexities associated with these different regulatory regimes.

Much of what is expected under the rules and forms, particularly Regulation BI, is not in the rules or forms themselves. Instead, important guidance is set forth in the releases. A thorough and detailed review of the SEC releases is critical to understanding the SEC actions and complying with them.

Regulation BI

The most prominent element of the rulemaking package is Regulation BI, which is Rule 15l-1 under the Securities Exchange Act of 1934. This "regulation" (really just a single rule) enhances the existing standard of conduct applicable to broker-dealers (and their associated persons who are natural persons) at the time they recommend to a retail customer a securities transaction or investment strategy involving securities. Notably, this includes recommendations of account types and rollovers or transfers of assets (e.g., to roll over or transfer assets in a workplace retirement plan to an individual retirement account). "Recommendations" also include implicit hold recommendations resulting from agreed-upon account monitoring.

General

Regulation BI requires that a broker-dealer, when making a recommendation, act in the retail customer's best interest and not place its own interests ahead of the customer's interests. This general obligation is satisfied only if the broker-dealer complies with four specified component obligations, referred to as the Disclosure Obligation, the Care Obligation, the Conflict of Interest Obligation, and the Compliance Obligation (collectively, the "Obligations").

A customer's "best interest" is not expressly defined. Whether a broker-dealer has acted in the customer's best interest will turn on an objective assessment of the facts and circumstances of how the specific components of Regulation BI, including the Obligations, are satisfied at the time that the recommendation is made (and not in hindsight).

The Regulation BI standard is not a fiduciary standard, but it includes key elements that are similar to key elements of the fiduciary standard for investment advisers. The SEC's intention is that, regardless of whether a retail investor chooses a broker-dealer or an investment adviser, the retail investor will be entitled to a recommendation or advice that is in the best interest of the retail investor and that does not place the interests of the firm or the financial professional ahead of the interests of the retail investor.

Regulation BI does not apply to advice provided by a broker-dealer that is dually registered as an investment adviser ("dual registrant") when acting in the capacity of an investment adviser. A dual registrant acts in the capacity of an investment adviser solely with respect to accounts for which the dual registrant provides advice and receives compensation that subjects it to the Advisers Act.

SEC Chairman Jay Clayton noted that he anticipates that FINRA will need to review and revise its rulebook and examination program in light of the enhanced broker-dealer standard of conduct reflected in Regulation BI.[6]

The Department of Labor has already indicated informally that it will pursue rulemakings and other guidance that "align" with Regulation BI. We expect that to occur this year, most likely in the Fall.

It is too early to tell whether these new rules will assuage the concerns of those states that have already introduced legislation or regulations aimed at governing broker-dealer and investment adviser standards of conduct (although the initial reaction is not promising). New Jersey and Nevada are the most notable examples to date.

Disclosure Obligation

Under the Disclosure Obligation, before or at the time of the recommendation, a broker-dealer must disclose, in writing, all material facts about the scope and terms of its relationship with the customer. This includes a disclosure that the firm is acting in a broker-dealer capacity; the material fees and costs the customer will incur; and the type and scope of the services to be provided, including any material limitations on the recommendations that could be made to the retail customer.

The broker-dealer must also disclose all material facts relating to conflicts of interest that are associated with the recommendation. A conflict of interest is defined as an interest that might incline a broker-dealer or associated person – consciously or unconsciously – to make a recommendation that is not disinterested.

In connection with its proposal of Form CRS, the SEC initially proposed a rule specifically prohibiting the use of "adviser" or "advisor" by brokerage personnel not subject to the Advisers Act. The SEC did not adopt this rule, but it states that the use of these terms in a name or title by a broker-dealer (that is not also an investment adviser) or associated person (that is not also a supervised person of an investment adviser) would be a violation of the capacity disclosure requirement.[7] The SEC recognizes that there are exceptions to this general rule, such as for municipal advisors, commodity trading advisers, and advisors to special entities.

© 2019 Stradley Ronon Stevens & Young, LLP

Care Obligation

Under the Care Obligation, a broker-dealer must exercise reasonable diligence, care, and skill when making a recommendation to a retail customer. The broker-dealer must understand potential risks, rewards, and costs associated with the recommendation. The broker-dealer must then consider those risks, rewards, and costs in light of the customer's investment profile and have a reasonable basis to believe that the recommendation is in the customer's best interest and does not place the broker-dealer's interest ahead of the retail customer's interest. While costs must always be considered, they should be considered in light of other factors and the retail customer's investment profile; the standard does not necessarily require the "lowest cost option."

A broker-dealer should consider reasonable alternatives, if any, offered by the broker-dealer in determining whether it has a reasonable basis for making the recommendation. This does not require an evaluation of every possible alternative (including those offered outside the firm), nor does it require broker-dealers to recommend one "best" product. However, when a broker-dealer materially limits its product offerings to certain proprietary or other limited menus of products, it must still comply with the Care Obligation and cannot use its limited menu to justify recommending a product that does not satisfy the obligation to act in a retail customer's best interest.

When recommending a series of transactions, the broker-dealer must have a reasonable basis to believe that the transactions taken together are not excessive, even if each is in the customer's best interest when viewed in isolation.

Conflict of Interest Obligation

Under the Conflict of Interest Obligation, a broker-dealer must establish, maintain, and enforce reasonably designed written policies and procedures addressing conflicts of interest associated with its recommendations to retail customers. These policies and procedures must be reasonably designed to identify all such conflicts and at a minimum disclose or eliminate them.

The policies and procedures must be reasonably designed to mitigate conflicts of interests that create an incentive for an associated person to place his or her interests or the interest of the firm ahead of the retail customer's interest. The SEC revised the mitigation requirement in the proposing release to focus on mitigating conflicts arising from associated persons' incentives and to eliminate the distinction between financial incentives and all other conflicts of interest.

In addition, when a broker-dealer places material limitations on recommendations (e.g., offering only proprietary or other limited range of products), the policies and procedures must be reasonably designed to disclose the limitations and associated conflicts and to prevent the limitations from causing the associated person or broker-dealer to place the person's or the firm's interests ahead of the customer's interest.

The policies and procedures must also be reasonably designed to identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation (such as merchandise, gifts and prizes, travel expenses, meals and lodging) that are based on the sale of specific securities or specific types of securities within a limited period of time. The requirement is designed to eliminate such incentives when they create pressure (i) to sell a specifically identified type of security (ii) within a

© 2019 Stradley Ronon Stevens & Young, LLP

limited period of time. Other incentives and practices that are not explicitly prohibited are permitted, provided that the broker-dealer establishes reasonably designed policies and procedures to disclose and mitigate the incentive created to the representative, and the Care and Disclosure Obligations are complied with.

Compliance Obligation

Under the Compliance Obligation, a broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation BI as a whole. Thus, a broker-dealer's policies and procedures must address not only conflicts of interest but also compliance with its Disclosure and Care Obligations.

Other Issues

The SEC will not have to show scienter (bad intent) to establish a violation of Regulation BI.

Although commenters urged the SEC to take a position that Regulation BI preempts or does not preempt state laws, the SEC chose not to do so. Instead, the SEC states that the preemptive effect of Regulation BI on any state law governing the relationship between regulated entities and their customers would be determined in future judicial proceedings based on the specific language and effect of that state law. In the open meeting, Chairman Clayton indicated that he hoped that states would work with the SEC going forward.

A broker-dealer will not be able to waive compliance with Regulation BI, nor can a retail customer agree to waive his or her protections under Regulation BI.

The SEC does not believe Regulation BI creates any new private right of action or right of rescission, nor does it intend such a result.

Compliance with Regulation BI will not alter a broker-dealer's obligations under the general antifraud provisions of the federal securities laws. Regulation BI applies in addition to any applicable securities laws and regulations.

Form CRS Relationship Summary

The SEC has adopted rule and form amendments to require registered investment advisers and registered broker-dealers to provide a brief relationship summary to retail investors.[8] The relationship summary is intended to inform retail investors about (i) the types of client and customer relationships and services the firm offers; (ii) the fees, costs, conflicts of interest, and required standard of conduct associated with those relationships and services; (iii) whether the firm and its financial professionals currently have reportable legal or disciplinary history; and (iv) how to obtain additional information about the firm. The relationship summary will have a standardized question-and-answer format and must be no longer than two pages (four pages for dual registrants). Under certain standardized headings, firms will generally use their own wording to address the required topics. Firms are encouraged to use graphics, hyperlinks, and electronic formats. If a firm uses electronic formats, there are requirements for embedded hyperlinks to facilitate layered disclosure.

© 2019 Stradley Ronon Stevens & Young, LLP

The relationship summary is designed to help retail investors select or determine whether to remain with a firm or financial professional by providing better transparency and summarizing in one place selected information about a particular broker-dealer or investment adviser. The format of the relationship summary is intended to allow for comparability among the two different types of firms in a way that is distinct from other required disclosures.

The relationship summary includes a required introductory paragraph that provides a link to Investor.gov/CRS, a page on the SEC's Office of Investor Education website that will offer educational information about investment professionals. This page currently summarizes the final release and promises future tailored information to educate retail investors about financial professionals, including tools to research firms and financial professionals, information about brokers and advisers, and information about brokers' and advisers' different services and fees. It also currently links to other resources that already were available on the Office of Investor Education website.

The relationship summary includes prescribed wording to describe the standard of conduct applicable to investment advisers and broker-dealers. In contrast to the proposed Form CRS, the standard of conduct is described as a "best interest" standard in all cases.[9]

As proposed, investment advisers must deliver a relationship summary to each new or prospective client who is a retail investor before or at the time of entering into an investment advisory contract with the retail investor. In a change from the proposal, broker-dealers must deliver the relationship summary to each new or prospective customer who is a retail investor before or at the earliest of (i) a recommendation of an account type, a securities transaction, or an investment strategy involving securities; (ii) placing an order for the retail investor; or (iii) the opening of a brokerage account for the retail investor. Broker-dealers and investment advisers must update the relationship summary and file it within 30 days whenever any information in it becomes materially inaccurate, and any changes must be communicated to existing clients or customers within 60 days.

In the adopting release, the SEC provides for a review of the effectiveness of Form CRS. In particular, the SEC directs the staff to review a sample of relationship summaries and provide the SEC with results of this review. The directions do not include a description of the scope of the review, the timing of the review, or what the SEC will do with the staff's report once it is provided.

Fiduciary Duty Interpretation

The SEC has issued an interpretive release on the standard of conduct for investment advisers under the Advisers Act. The release brings together in one place the SEC's views on the fiduciary duty that investment advisers owe their clients. These views for the most part are long-standing, although the release does "clarify" certain aspects, as the SEC puts it.

The interpretation explains that an investment adviser's obligation to act in the best interest of its client is an overarching principle that encompasses both the duty of care and the duty of loyalty. This fiduciary duty is made enforceable by the antifraud provisions of the Advisers Act. The fiduciary duty may not be waived, although it will apply in a manner that reflects the agreed-upon scope of the relationship, and the relationship may be shaped by agreement, provided that there is full and fair disclosure and informed consent.

© 2019 Stradley Ronon Stevens & Young, LLP

The SEC clarified that in shaping its agreement with a client, and in considering full and fair disclosure and informed consent, an investment adviser may consider whether the client is institutional or retail. In particular, in describing full and fair disclosure, the SEC recognized that institutional clients "generally have a greater capacity and more resources than retail clients to analyze and understand complex conflicts and their ramifications." Similarly, in describing an adviser's duty of care, the interpretive release distinguishes between institutional and retail clients. In providing advice to institutional clients, the interpretive release recognizes that "the nature and extent of the reasonable inquiry into the client's objectives generally is shaped by the specific investment mandates from those clients."

An adviser's fiduciary duty applies to all investment advice the investment adviser provides to clients, including advice about investment strategy, engaging a sub-adviser, and account type. Similar to Regulation BI and in a clear reference to the fiduciary duty rulemaking efforts of the Department of Labor, the interpretive release clarifies that account type includes "advice about whether to roll over assets from one account (e.g., a retirement account) into a new or existing account that the adviser or an affiliate of the adviser manages."

In the proposal of this interpretation last year, the SEC stated that an adviser must seek to avoid conflicts of interest with its clients. The interpretation as adopted explains that an adviser may satisfy its duty of loyalty by making full and fair disclosure of conflicts of interest and obtaining the client's informed consent. The SEC stated that the requirement to obtain informed consent "does not require advisers to make an affirmative determination that a particular client understood the disclosure and that the client's consent to the conflict of interest was informed. Rather, disclosure should be designed to put a client in a position to be able to understand and provide informed consent to the conflict of interest. *A client's informed consent can be either explicit or, depending on the facts and circumstances, implicit."* (Emphasis added.) Nonetheless, the interpretation, as adopted, still takes the position that there are some conflicts that cannot be cured through disclosure without providing examples of what such conflicts might be. In particular, the interpretation states that some conflicts "may be of 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 sufficient for a client to consent to or reject it," particularly with regard to retail clients where "it may be difficult to provide disclosure regarding complex or extensive conflicts that is sufficiently specific, but also understandable." In such instances, the interpretation makes clear that disclosure alone is not sufficient, and the adviser should either eliminate the conflict or adequately mitigate it.

Rick Fleming, the SEC's Investor Advocate, released a statement strongly criticizing the interpretive release, arguing that the SEC has taken a step in the wrong direction in its interpretation of the fiduciary duty that investment advisers owe to their clients. In particular, the statement indicates that the final interpretive release "weakens the existing fiduciary standard by suggesting that liability for nearly all conflicts can be avoided through disclosure."[10]

The proposed interpretive release requested comment on several areas of enhanced investment adviser regulation. In particular, the SEC asked for comment on whether to harmonize areas such as licensing and continuing education, provision of account statements, and financial responsibility. The interpretive release indicates that the SEC is continuing to evaluate the comments received in response.

© 2019 Stradley Ronon Stevens & Young, LLP

Solely Incidental Interpretation

The SEC also issued an interpretive release on the "Solely Incidental" prong of Section 202(a)(11)(C) of the Advisers Act. That provision excludes from the definition of investment adviser – and thus from the application of the Advisers Act – a broker-dealer "whose performance of such advisory services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation" for those services. The SEC did not propose this interpretation when it issued its other proposals last year, but it did request comment on the subject in the release proposing Regulation BI.

The SEC interprets the statutory language to mean that a broker-dealer's provision of advice as to the value and characteristics of securities or as to the advisability of transacting in securities is consistent with the solely incidental prong if the advice is provided in connection with and is reasonably related to the broker-dealer's primary business of effecting securities transactions. If a broker-dealer's primary business is giving advice as to the value and characteristics of securities or the advisability of transacting in securities, or if the advisory services are not offered in connection with or are not reasonably related to the broker-dealer's business of effecting securities transactions, the broker-dealer's advisory services are not solely incidental to its business as a broker-dealer. Whether advisory services provided by a broker-dealer satisfy the solely incidental prong is assessed 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 explains that a broker-dealer's exercise of unlimited discretion (i.e., having responsibility for a customer's trading decisions) would not be solely incidental to the business of a broker-dealer. However, there are situations where a broker-dealer may exercise temporary or limited discretion without being an investment adviser. The SEC also explains 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 provide advice in connection with and reasonably related to effecting securities transactions.

Compliance Date

The fiduciary duty and "solely incidental" interpretations will be effective upon publication in the Federal Register. Regulation BI and Form CRS generally will have a compliance date of June 30, 2020.

Even before adoption, press reports indicated that certain constituencies were already considering challenging Regulation BI in court. To the extent that there is a court challenge, it could affect the compliance phase-in timetable.

For Further Information

The foregoing provides our initial, high level summary of the new SEC rulemaking package. We will be following up next week or shortly thereafter with a more detailed analysis.

© 2019 Stradley Ronon Stevens & Young, LLP

In addition, various members of Stradley's Fiduciary Governance Group will be hosting a webinar, "***Impact of New SEC Regulation Best Interest and Other Standards of Conduct Rules on Broker-Dealers, Investment Advisers and Investment Companies***," on July 31 at 1:00 pm Eastern time. Those interested may register at https://www.straffordpub.com/products/regulation-best-interest-and-other-new-sec-standards-of-conduct-impact-on-broker-dealers-investment-advisers-and-investment-companies-2019-07-31.

In the meantime, feel free to direct any questions you may have about the SEC actions as follows:

Regulation BI
Larry Stadulis (https://www.stradley.com/professionals/s/stadulis-lawrence-p)
Peter Hong (https://www.stradley.com/professionals/h/hong-peter-m)
John Baker (https://www.stradley.com/professionals/b/baker-john-m)

Form CRS
Sara Crovitz (https://www.stradley.com/professionals/c/crovitz-sara)
John Baker (https://www.stradley.com/professionals/b/baker-john-m)

Section 202(a)(11)(C) "solely incidental" Interpretive Release
Larry Stadulis (https://www.stradley.com/professionals/s/stadulis-lawrence-p)
Peter Hong (https://www.stradley.com/professionals/h/hong-peter-m)

Advisers Act Interpretive Release
Larry Stadulis (https://www.stradley.com/professionals/s/stadulis-lawrence-p)
Sara Crovitz (https://www.stradley.com/professionals/c/crovitz-sara)
John Baker (https://www.stradley.com/professionals/b/baker-john-m)
Alan Goldberg (https://www.stradley.com/professionals/g/goldberg-alan)

State developments impacting broker-dealer and investment adviser conduct, particularly arising from the SEC rulemaking package
Larry Stadulis (https://www.stradley.com/professionals/s/stadulis-lawrence-p)
George Michael Gerstein (https://www.stradley.com/professionals/g/gerstein-george)

Questions relating to the interrelationship between the SEC rulemaking package and ERISA
George Michael Gerstein (https://www.stradley.com/professionals/g/gerstein-george)

Litigation
Bill Mandia (https://www.stradley.com/professionals/m/mandia-william-t)

---

[1] Regulation Best Interest: The Broker-Dealer Standard of Conduct, Release No. 34-86031 at https://www.sec.gov/rules/final/2019/34-86031.pdf (June 5, 2019).

[2] Form CRS Relationship Summary; Amendments to Form ADV, Release Nos. 34-86032, IA-5247 at https://www.sec.gov/rules/final/2019/34-86032.pdf (June 5, 2019); *see also* Appendix B: Form CRS at https://www.sec.gov/rules/final/2019/34-86032-appendix-b.pdf.

© 2019 Stradley Ronon Stevens & Young, LLP

[3] Commission Interpretation Regarding Standard of Conduct of Investment Advisers, Release No. IA-5248 at https://www.sec.gov/rules/interp/2019/ia-5248.pdf (June 5, 2019).

[4] Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser, Release No. IA-5249 at https://www.sec.gov/rules/interp/2019/ia-5249.pdf (June 5, 2019).

[5] *See* SEC Rulemaking Package Would Impose Best Interest Standard of Conduct at https://www.stradley.com/-/media/files/publications/2018/04/riskrewardapril202018-pdf.pdf (April 20, 2018).

[6] Jay Clayton, Chairman, SEC, Statement at the Open Meeting on Commission Actions to Enhance and Clarify the Obligations Financial Professionals Owe to our Main Street Investors at https://www.sec.gov/news/public-statement/statement-clayton-060519-iabd (June 5, 2019).

[7] In other words, Regulation BI requires a broker-dealer to disclose the capacity in which the broker-dealer is acting. By using "adviser" or "advisor" in a name or title, the broker-dealer (or associated person) would be falsely disclosing its capacity unless it also is registered as an investment adviser (or is a supervised person of an investment adviser).

[8] "Retail investor" is defined for purposes of Form CRS 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." Thus, there is no exception for sophisticated natural person investors.

[9] In particular, broker-dealers that provide recommendations subject to Regulation Best Interest must provide the following disclosure: "When we provide you with a recommendation, we have to act in your best interest and not put our interest ahead of yours." Investment advisers must provide this disclosure: "When we act as your investment adviser, we have to act in your best interest and not put our interest ahead of yours." Dual registrants that prepare a single relationship summary and provide recommendations subject to Regulation Best Interest must disclose the following: "When we provide you with a recommendation as your broker-dealer or act as your investment adviser, we have to act in your best interest and not put our interest ahead of yours."

[10] Rick Fleming, Investor Advocate, SEC, Statement Regarding the SEC's Rulemaking Package for Investment Advisers and Broker-Dealers at https://www.sec.gov/news/public-statement/statement-regarding-sec-rulemaking-package-investment-advisers-broker-dealers (June 5, 2019).

© 2019 Stradley Ronon Stevens & Young, LLP