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The Practical Effects of Regulation Best Interest, Form CRS, and Advisers Act Interpretations on Broker-Dealers, Investment Advisers and Investment Companies

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Outline

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

Regulation Best Interest (BI)

Purpose of Regulation BI

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

General Obligation

- 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, which 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.

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.
- The broker-dealer must also disclose all material facts relating to conflicts of interest that are associated with the recommendation.

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.

Care Obligation (cont.)

- 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."
- 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

- 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.

Conflict of Interest Obligation (cont.)

- 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.

Conflict of Interest Obligation (cont.)

- 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, and (ii) within a 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

- 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 Takeaways

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

Other Takeaways (cont.)

- Regulation BI applies to recommendations to retail customers. Recommendations include 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.
- A retail customer is a natural person (or legal representative) who receives a recommendation and uses it primarily for personal, family or household purposes. There is no carve-out for wealthy individuals, so Warren Buffett is a retail customer, assuming his brokerage services are not for commercial or business purposes.
- When limited exceptions (e.g., for commodity trading advisers), a broker-dealer or Representative cannot use the title "adviser" or "advisor" unless that person is also an investment adviser or a supervised person of an investment adviser. The rationale is that the title would be inconsistent with the disclosure of the capacity in which the person acts.

SEC Approach: Potential Impact on the Investment Company Industry

Minimal Impact Areas

- The manner in which investment companies are regulated under the 1940 Act.
- The manner in which investment companies are managed and operated under the 1940 Act.
- Board oversight of Investment companies.

SEC Approach: Potential Impact on the Investment Company Industry (cont.)

Moderate Impact Areas

- Prospectus and shareholder communication disclosures.

SEC Approach: Potential Impact on the Investment Company Industry (cont.)

Major Impact Areas

- IRA Rollovers.
- Potential confusion and inconsistent treatment of investors, particularly plan participants, arising out of proposed "retail investor" definition.
- Non-cash compensation in connection with sales contests and promotions.

SEC Approach: Potential Impact on the Investment Company Industry (cont.)

Major Impact Areas (cont.)

- General confusion over acceptable sales compensation arrangements.
- SEC's apparent focus on cost may cause brokers to be more hesitant to recommend smaller or more actively managed funds.
- May discourage broker-dealers from recommending closed-end fund IPOs based on subsequent trading discount concerns.

SEC Approach: Potential Impact on the Investment Company Industry (cont.)

Major Impact Areas (cont.)

- Increased emphasis on sales materials that do not include a "recommendation."
- May discourage broker-dealers from recommending proprietary products or a limited range of products, even when in a retail customer's best interest.

SEC Approach: Potential Impact on the Investment Company Industry (cont.)

Major Impact Areas (cont.)

- The recommendation of complex investment company products to certain retail customers.
- Continued migration from BD to IA Model.
- Potential definitions of new standard through enforcement action.

Form CRS

Form CRS

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

Form CRS: Pathway to Adoption

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

Form CRS: Plan for Review

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

Form CRS: Presentation and Format I

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

Form CRS: Presentation and Format II

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

Form CRS: Contents of the Relationship Summary

- The final instructions require a question-and-answer format, with standardized questions serving as the headings in a prescribed order. Firms will generally use their own wording to address the required topics, although some specific disclosures are prescribed.
- In particular, the required headings address:
  i. identifying information about the firm and a link to the SEC's website;
  ii. the types of client and customer relationships and services each firm offers;
  iii. the fees, costs, conflicts of interest and required standard of conduct associated with those relationships and services;
  iv. whether the firm and its financial professionals currently have reportable legal or disciplinary history; and
  v. how to obtain additional information about the firm.
- Firms will be required to link to additional information, which for investment advisers will be to their Form ADV Part 2A brochures or equivalent information and for broker-dealers will be to their Regulation Best Interest disclosures.
- Firms must also include prescribed "conversation starters" to encourage further dialogue (e.g., "How might your conflicts of interest affect me, and how will you address them?").

Form CRS: Standards of Conduct Disclosure

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

Form CRS: Applicability

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

Form CRS: Delivery to "Retail Investors"

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

Form CRS: Delivery Requirements I

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

Form CRS: Delivery Requirements II

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

Form CRS: Filing and Updating

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

Form CRS: Recordkeeping

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

Form CRS: Compliance Date

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

SEC Interpretive Release on Investment Adviser Standard of Conduct

Overview of SEC Interpretive Release on Investment Adviser Standard of Conduct

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

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

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

What is the Duty of Care?

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

What is the Duty of Care? (cont.)

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

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

What is the Duty of Care? (cont.)

3. *Duty to Seek Best Execution:*

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

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

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

What is the Duty of Loyalty?

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

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

     - *Full and fair disclosure will depend on, among other things, the nature of the client, the scope of services rendered, and the material fact or conflict.
       - SEC clarified that this disclosure just requires that the client was put in a position to understand the disclosure and provide informed consent.

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

What is the Duty of Loyalty? (cont.)

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

Consequences of the Adoption of the Interpretive Release

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

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