Background & Analysis on SEC's New Standard of Conduct Rules

Regulation Best Interest, Form CRS and Interpretive Guidance under the Advisers Act

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Overview

– Regulation Best Interest
– Form CRS
– Advisers Act Standard of Conduct Interpretive Release
– Advisers Act “Solely Incidental” Interpretive Release
Regulation Best Interest
Background on the Final Rule

— On June 5, 2019, the SEC adopted Reg. BI by a 3-1 vote
  • Commissioners in favor: Clayton, Peirce, Roisman
  • Commissioner against: Jackson

— Retains the same basic structure of proposed Reg. BI (general obligation, component obligations, and definitions), but with a new component obligation and significant changes to various parts of the rule text

— The SEC’s version of the Reg. BI adopting release (not the Federal Register version) spans 771 pages
  • About 115 pages of text discussing the Disclosure Obligation alone, and then about 115 pages of text combined for the remaining three component obligations
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The General Obligation

— Substantially similar to the General Obligation in proposed Reg. BI, with one notable difference

— Requires a broker-dealer (or associated person), when recommending a securities transaction or investment strategy involving securities, to act in the retail customer’s best interest and not place its (or his or her) own interests ahead of the retail customer’s interests

— Satisfied through fulfillment of the four component obligations
  • Disclosure Obligation
  • Care Obligation
  • Conflict of Interest Obligation
  • Compliance Obligation
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Transaction and Account Recommendations

— As noted above, the final rule has one notable difference from proposed Reg. BI

— An “investment strategy” recommendation includes recommendations of account types and rollovers or transfers of assets

— It also covers implicit hold recommendations resulting from agreed-upon account monitoring
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Defined Terms

— No best interest definition
  • Instead, the SEC opted to explain in Reg. BI and through the Adopting Release what “acting in the best interest” means

— New definition of “conflict of interest”
  • Tracks the definition that has developed under the Advisers Act

— Changes to definition of “retail customer”
  • Focus on natural persons
  • Narrow interpretation of “legal representative”

— No change to definition of “retail customer investment profile”
  • SEC did not accept commenter suggestions to include factors relevant to annuities, such as longevity protection needs, but does say in the Adopting Release that the list of factors is non-exhaustive and broker-dealers can (and maybe should) consider factors beyond those set forth in this definition
The General Obligation is satisfied by meeting the following four component obligations:

- **Disclosure Obligation**: providing certain prescribed disclosure before or at the time of the recommendation, about the recommendation and the relationship between the retail customer and the broker-dealer;
- **Care Obligation**: exercising reasonable diligence, care, and skill in making the recommendation;
- **Conflict of Interest Obligation**: establishing, maintaining, and enforcing policies and procedures reasonably designed to address conflicts of interest; and
- **Compliance Obligation**: establishing, maintaining, and enforcing policies and procedures reasonably designed to achieve compliance with Reg. BI.
Disclosure Obligation – must provide the retail customer, in writing, at or before a recommendation is made, full and fair disclosure of all material facts relating to conflicts of interest that are associated with the recommendation and all material facts relating to the scope and terms of the relationship with the retail customer, including:

- that the broker, dealer, or such associated natural person is acting as a broker, dealer, or an associated natural person of a broker or dealer with respect to the recommendation,
- the fees and costs that apply to the retail customer’s transactions, holdings, and accounts, and
- the type and scope of services provided to the retail customer, including any material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer.

Adopting Release explains that the capacity disclosure effectively prohibits a broker-dealer and its associated persons from using the term “advisor” or “adviser” if the broker-dealer is not a registered investment adviser or the associated person is not a supervised person of a registered investment adviser.
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Care Obligation - Overview

In making a recommendation, must exercise reasonable diligence, care, and skill to:

• Understand the potential risks, rewards, and costs associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers

• Have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer’s investment profile and the potential risks, rewards, and costs associated with the recommendation and does not place the financial or other interest of the broker, dealer, or such associated natural person ahead of the interest of the retail customer

• Have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer’s best interest when viewed in isolation, is not excessive and is in the retail customer’s best interest when taken together in light of the retail customer’s investment profile and does not place the financial or other interest of the broker, dealer, or such associated natural person making the series of recommendations ahead of the interest of the retail customer
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Care Obligation – Reasonable Basis Component

- This component essentially requires a product due diligence or quality control function
- Unlike proposed Reg. BI, this component now expressly requires broker-dealers to understand and consider the potential costs associated with a recommendation
- Note the two elements – “understand” and “reasonable basis to believe” – both must be fulfilled
  - SEC suggests certain important factors broker-dealers should consider as part of fulfilling these two elements:
    - Security’s or investment strategy’s investment objectives, characteristics (including special or unusual features), liquidity, volatility, likely performance in a variety of market and economic conditions, expected return, and any financial incentives to recommend it
- SEC emphasizes the importance of this process with respect to securities or investment strategies that are complex or risky, specifically calling out inverse or leveraged exchange-traded products
  - SEC acknowledges that variable products are complex or more costly, but in the context of its discussion of such products, it says it does “not intend to limit or foreclose broker-dealers from recommending complex or more costly products or investment strategies where the broker-dealer has a reasonable basis to believe that a recommendation could be in the best interest of at least some retail customers and the broker-dealer has developed a proper understanding of the recommended product or strategy.”
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Care Obligation – Customer Specific Component

- This component essentially requires consideration of whether a recommendation to a particular customer is in the customer’s best interest
- Also unlike proposed Reg. BI, this component now expressly requires broker-dealers to understand and consider the potential costs associated with a recommendation
  - But cannot satisfy this component by merely recommending the lowest cost or least remunerative security or investment strategy
- Note the two elements – “best interest of a particular retail customer” and “does not place the broker-dealer’s interest ahead” – both must be fulfilled
- Risks, rewards, and costs are a non-exhaustive list of considerations, and certain factors may less relevant than others or irrelevant altogether
  - An example in the variable product context – could also consider whether the customer will benefit from certain features of these products, such as tax-deferred growth, annuitization, or a death or living benefit
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Care Obligation – Customer Specific Component (cont.)

- Documentation of basis for recommendation – not necessarily required, but may be appropriate in certain circumstances
- Must obtain and analyze a sufficient amount of customer profile information to believe the recommendation is in the customer’s best interest
- A broker-dealer should document its rationale when it chooses to not collect or analyze a particular profile factor
- Should consider “reasonably available alternatives,” and should have a reasonable process for establishing and understanding the scope of reasonably available alternatives
- This customer specific component also applies to account type and rollover recommendations
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Care Obligation – Quantitative Component

— This component applies irrespective of whether a broker-dealer has actual or *de facto* control over a customer’s account, representing an enhancement over existing FINRA standards
— It also applies across multiple associated persons at the firm who may act independently
— What does “series of recommended transactions” mean?
  • Depends on facts and circumstances, but to be evaluated in concert with existing guideposts, such as turnover rate, cost-to-equity ratio, and use of in-and-out trading
Must establish, maintain, and enforce written policies and procedures reasonably designed to:

- Identify and at a minimum disclose, in accordance with the Disclosure Obligation, or eliminate, all conflicts of interest associated with such recommendations
- Identify and mitigate any conflicts of interest associated with such recommendations that create an incentive for an associated natural person to place its/his/her interest ahead of the retail customer’s interest
- Identify and disclose any material limitations placed on the securities or investment strategies involving securities that may be recommended to a retail customer and associated conflicts of interest
- Prevent such limitations and associated conflicts of interest from causing the broker-dealer or associated natural person from making recommendations that place its/his/her interest ahead of the retail customer’s interest
- Identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time
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Conflict of Interest Obligation – Associated Person Compensation

– Significant change from proposed Reg. BI, which would have required broker-dealers to have policies and procedures to mitigate so-called “financial incentive” conflicts, regardless of whether they exist at the firm or the associated person level

– Only applies to those 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
  • Examples: Compensation that varies based on the advice given, such as commissions, markups/markdowns, revenue sharing, 12b-1 fees

– The SEC provides a list of six non-exhaustive mitigation methods that are not required, but could be used
Conflict of Interest Obligation – Material Limitations

— Covered material limitations would include arrangements in which recommendations are limited to:
  • Proprietary products
  • A specific asset class
  • Products with third-party arrangements (such as revenue sharing)
— Could also include arrangements in which the broker-dealer recommends only products from a select group of issuers
Conflict of Interest Obligation – Elimination of Sales Contests

- Another significant change from proposed Reg. BI, which did not contain this elimination requirement
- Designed to address high-pressure situations to sell a specifically identified type of security within a limited period of time
- “Limited period of time” not defined
- Does not apply to compensation practices based on total products sold, asset growth or accumulation or customer satisfaction
- Would not prevent firms from offering only proprietary products, placing material limitations on the menu of products, or incentivizing the sale of such products through its compensation practices, so long as the incentive is not based on the sale of specific securities or types of securities within a limited period of time
- Also carved out are production requirements for insurance company captive insurance agents that must be met for them to qualify as statutory employees eligible for certain employee benefits such as participation in a 401(k) plan and health insurance
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Compliance Obligation

- Must establish, maintain and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest
- Explicit obligation under the Exchange Act
- Flexibility to design policies and procedures that are reasonable for the scope, size and risks associated with firm operations and business type
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Recordkeeping Requirements

— New Rule 17a-3(a)(35): A record of all information collected from and provided to the retail customer pursuant to Reg. BI, as well as the identity of each natural person who is an associated person, if any, responsible for the account
  • Neglect, refusal, or inability of the retail customer to provide or update any information described above excuses the broker-dealer from obtaining it

— New Rule 17a-4(e)(5): Requires the broker-dealer to maintain the information collected pursuant to new Rule 17a-3(a)(35) until at least six years after the earlier of the date the account was closed or the date on which the information was collected, provided, replaced, or updated
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Effective Date

– Implementation date for Reg. BI is June 30, 2020
  • The SEC believes this is “sufficient” time to come into compliance
  • The SEC did recognize that the new rules will require changes to operations, including mandatory disclosures, marketing materials and compliance systems
– SEC is establishing an inter-Divisional Standards of Conduct Implementation Committee and encourages firms to “actively engage” with this committee as questions arise
– Questions can be sent to: IABDQuestions@sec.gov
Form CRS
Form CRS Relationship Summary

– Overview of the CRS and the SEC’s goals

– What we’re going to cover:
  • Instructions and Definitions
  • Form Fundamentals
  • Delivery of the Form; Timing
  • Who Gets a Form?
  • Updates to the Form
  • Filing the Form with the SEC and FINRA; Recordkeeping
Form CRS Relationship Summary Instructions and Definitions

— General Instructions
— Item Instructions
— Definitions
  • Affiliate
  • Dually licensed financial professional
  • Dual registrant
  • Relationship summary
  • Retail investor*

*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.
Form CRS Relationship Summary – Form Fundamentals

- Requires a question-and-answer format, with standardized questions serving as the headings in a prescribed order covering:
  - Introduction
  - Relationships and services
  - Fees, costs, conflicts and standard of conduct
  - Disciplinary history
  - Where to find more information

- “Conversation starters” must be included

- Use of charts, graphs, tables, and other graphics or text features encouraged

- Dual registrants can use a single relationship summary that discusses both brokerage and investment advisory services
Item 2. Relationships and Services

– The heading must read “What investment services and advice can you provide me?”

– The heading must be followed by a Description of Services, which must address:
  • Monitoring
  • Investment Authority
  • Limited Investment Offerings
  • Account Minimums and Other Requirements

– Additional Information

– Conversation Starters
“Item Instructions” – Item 3

Item 3. Fees, Costs, Conflicts, and Standard of Conduct

- The heading must read “What fees will I pay?”

- The heading must be followed by a **Description of Principal Fees and Costs**, which must address:
  - The principal fees and costs that retail investors will pay for your services
  - How frequently those fees and costs are assessed
  - Conflicts of interest created by the principal fees and costs

- Investment advisers must align their fee disclosure in CRS with their Form ADV disclosure
Item 3. Fees, Costs, Conflicts, and Standard of Conduct

— A firm must also describe:
  • Other fees and costs that the retail investor will pay directly or indirectly (e.g., custody and product-level fees)
  • Additional information (identify where more detailed information can be located)
  • Conversation starter (if I give you $10,000 to invest, how much will go to fees and costs, and how much will be invested for me?)

— Add another heading asking: “What are your legal obligations to me when providing recommendations?” How else does your firm make money and what conflicts of interest do you have? (BD version; adjust for IAs and dual registrants)
“Item Instructions” – Item 3, continued

Item 3. Fees, Costs, Conflicts, and Standard of Conduct

– Recite the applicable standard of conduct – this is the “best interest” standard (“When we provide you with a recommendation, we have to act in your best interest and not put our interest ahead of yours. At the same time, the way we make money creates some conflicts with your interests. You should understand and ask us about these conflicts because they can affect the recommendations we provide you. Here are some examples to help you understand what this means.”)

– There are variations for: broker-dealers that do not provide recommendations subject to Reg. BI; investment advisers, and dual registrants
“Item Instructions” – Item 3, continued

Item 3. Fees, Costs, Conflicts, and Standard of Conduct

— You must discuss *Examples of Ways You Make Money and Conflicts of Interest* (including proprietary products, third-party payments, revenue sharing, and principal trading)

— You must ask: “How might your conflicts of interest affect me, and how will you address them?”

— You must describe how your financial professionals are compensated (including cash and non-cash and differential product compensation) and the conflicts of interest those payments create
Initial Delivery of Broker-Dealer Form CRS Relationship Summary

— Form CRS must be delivered to retail customers at the earliest of:
  • A recommendation of an account type, a securities transaction; or an investment strategy involving securities;
  • Placing an order for the retail investor; or
  • The opening of a brokerage account for the retail investor

— Dual registrants are required to deliver the relationship summary when recommending an account type to the retail investor if it is the earliest occurrence among the initial delivery triggers for broker-dealers and investment advisers

— Dually Registered Firms, associated natural persons who are dually registered or associated natural persons who only offer broker-dealer services through a dually registered firm – in the adopting release the SEC explicitly states the information contained in Form CRS will not be sufficient to disclose their capacity in making a recommendation
Initial Delivery of Investment Adviser Form CRS Relationship Summary (New Rule 204-5)

Form CRS must be delivered:
- To retail investors - before or at the time an adviser enters into an investment advisory contract
- To existing clients – before or at the time an adviser
  - Opens a new account for the existing client that is different from the retail investor’s existing account(s);
  - 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 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
Ongoing Form CRS Relationship Summary Delivery Requirements

— If changes are made to its Form CRS, a firm must communicate the change to each retail investor who is an existing client within 60 days after the amendments are required to be made and without charge
  • The communication can be made by delivering the amended Form CRS or by communicating the information through another disclosure that is delivered to the retail investor

— A firm must post Form CRS on its website and deliver a current Form CRS to each retail investor within 30 days upon request
Filing and Recordkeeping Requirements
For Form CRS Relationship Summary

Broker-Dealer Filing & Recordkeeping

– The initial Form CRS must be filed with CRD no later than June 30, 2020
  • Firms can file their initial Form CRS starting May 1, 2020

– A broker-dealer must record the date a form CRS is provided to a retail customer, including those provided before an account is opened – see new Rule 17a-3(a)(24), Exchange Act

– Records must be kept for at least 6 years – see new Rule 17a-4(e)(10), Exchange Act

Investment Adviser Filing & Recordkeeping

– Form CRS is included in Form ADV as new Part 3 of Form ADV

– The initial Form CRS must be filed electronically with IARD no later than June 30, 2020
  • Firms can file starting May 1, 2020

– An investment adviser must record the date when a Form CRS is provided to a retail client – see amended Rule 204-2, Advisers Act

– Records must be kept for at least 5 fiscal years
Advisers Act Standard of Conduct Interpretive Release
The SEC’s Standard of Conduct for Investment Advisers

— On June 5, in a 3-1 vote, the SEC adopted an interpretation regarding the standard of conduct for investment advisers
  • Final interpretive guidance differs in some aspects from the proposal
  • The SEC reaffirmed – and in some cases clarified - certain aspects of the fiduciary duty owed to clients under §206
  • The duty of care requires advice be in the best interest of a client based on the client’s investment objectives
  • The duty of loyalty requires eliminating or making full and fair disclosure of all conflicts that could incline an investment adviser – consciously or unconsciously – to render advice which is not disinterested so that a client can provide informed consent
  • If an investment adviser cannot fully and fairly disclose a conflict, it should either eliminate or adequately mitigate (i.e., modify practices to reduce) the conflict, so that full and fair disclosure and informed consent are possible
The SEC’s Standard of Conduct for Investment Advisers (cont.)

- The SEC slightly altered the investment advisory fiduciary landscape
  - The interpretation delineated between the scope of an investment adviser’s duty of care when advising a retail client as opposed to an institutional client
    - A reasonable basis for understanding the client’s objectives generally includes understanding the investment profile of a retail client and the investment mandate of an institutional client
  - The Heitman Capital Management No-Action Letter was rescinded
    - The SEC believed the letter’s guidance was being applied incorrectly
    - Whether a hedge clause violates §206(1) and §206(2) depends on the surrounding facts and circumstances
    - There are few, if any, circumstances where a hedge clause in a retail client agreement is consistent with §206(1) and §206(2)
  - The SEC clarified that §206 applies to advice about “account types” and advice about whether to roll over assets from one account to another
Advisers Act “Solely Incidental” Interpretive Release
The SEC’s Interpretation of the Solely Incidental Prong of the Broker-Dealer Exclusion

— The SEC reaffirmed and clarified the exclusion’s scope
  • The “Broker-Dealer Exclusion” excludes from the investment adviser definition – and thus from the Advisers Act – a broker or dealer whose advisory services are solely incidental to its conduct as a broker or dealer and who receives no special compensation for those services
    • Advice must be provided in connection with and reasonably related to the broker-dealer’s primary business of effecting securities transactions
    • Whether services satisfy the solely incidental prong depend on the facts and circumstances surrounding the broker-dealer’s business, the specific services offered, and the relationship with the customer
The SEC’s Interpretation of the Solely Incidental Prong of the Broker-Dealer Exclusion (cont.)

— The interpretation clarifies the distinction between limited or temporary discretion and unlimited discretion
  • Unlimited discretion is not solely incidental to a broker-dealer’s business
  • Temporary or limited discretion in time, scope or other manner lacks “comprehensive and continuous character” that would suggest a primarily advisory relationship

— The SEC advised broker-dealers to consider adopting policies and procedures that, if followed, would demonstrate that agreed-upon account monitoring is “in connection with and reasonably related to” the broker-dealer’s primary business of effecting securities transactions
  • Monitoring that is not continuous could help demonstrate the broker-dealer’s primary business purpose of effecting securities transactions
Questions?