WILMERHALE

JUNE 17, 2019

Securities Alert

SEC's Final Rules and Guidance on the Standards of Conduct for Broker-Dealers and Investment Advisers

By **Yoon-Young Lee**, **Stephanie Nicolas**, **Amy R. Doberman**, **Cristina Jaramillo** and **Joseph M. Toner**

On June 5, 2019, the Securities and Exchange Commission ("SEC" or "Commission") in a divided 3-1 vote, approved a package of rulemakings and interpretations designed to enhance the quality and transparency of investors' relationships with broker-dealers and investment advisers while preserving access to a variety of types of advice relationships and investment products. Adopted pursuant to a grant of rulemaking authority in Section 913(f) of the Dodd-Frank Act,[1] this long overdue package reflects almost two decades of study and engagement and thousands of comment letters. These rules and interpretations are:

1. **Regulation Best Interest: The Broker-Dealer Standard of Conduct ("Reg BI").** Reg BI establishes a new standard of conduct for broker-dealers when making a recommendation of a securities transaction or investment strategy involving securities (including account recommendations) to a retail customer. To satisfy Reg BI's requirement that broker-dealers act in the "best interest" of the customer without placing their own financial or other interests ahead of the customer's interest, broker-dealers must comply with four component obligations when making such recommendations: a disclosure obligation, a care obligation, a conflict of interest obligation, and a compliance obligation.

2. **Form CRS Relationship Summary; Amendments to Form ADV ("Form CRS").** Form CRS requires both broker-dealers and investment advisers to provide retail investors with a short relationship summary document that provides certain information about the firm and the brokerage and/or investment advisory services it offers, including its fees and costs, conflicts of interest, and whether or not the firm and its financial professionals have any disciplinary history.[2] While the final Form CRS allows firms more flexibility than the initial proposal, Form CRS instructions include specific requirements as to content, formatting, and length.

3. **Commission Interpretation Regarding Standard of Conduct for Investment Advisers ("Fiduciary Interpretation").** The Commission issued an interpretation to reaffirm and, in some parts, clarify its views of the fiduciary duty that investment advisers owe to their clients. This interpretation applies to all investment advisers regardless of whether they

[1] Section 913(f) of the Dodd-Frank Act provides the Commission discretionary authority to "commence a rulemaking, as necessary or appropriate to the public interest and for the protection of retail customers (and such other customers as the Commission may by rule provide), to address the legal or regulatory standards of care for brokers, dealers . . . [and] persons associated with brokers or dealers. . . for providing personalized investment advice about securities to such retail customers." Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 913, 124 Stat. 1376, 1827-28 (2010).

[2] For investment advisers, Form CRS would be a new Part 3 of Form ADV.

are registered and/or have retail customers. Among other things, it clarifies that an investment adviser "must not place its own interest ahead of its client's interest."[3]

4. **Commission Interpretation Regarding the "Solely Incidental" Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser ("Solely Incidental Interpretation").** Finally, the Commission issued an interpretation to clarify the scope of the broker-dealer exclusion from the definition of "investment adviser" in the Investment Advisers Act of 1940 ("Advisers Act"). In doing so, the Commission acknowledged that reliance on this exclusion permits broker-dealers to provide substantial amounts of investment advice. The interpretation also sets out clear limits to this exclusion, such as when a broker-dealer agrees to provide continuous monitoring of a customer's account.[4]

Compliance and Effective Dates: The compliance date for Reg BI and Form CRS is June 30, 2020. For Form CRS, firms that are registered or have an application for registration pending must file their initial relationship summaries with the SEC from May 1, 2020 until June 30, 2020; on or after June 30, 2020, newly registered firms have to file the relationship summary by the date on which their registration becomes effective. The effective date for the interpretations is the date of publication in the federal register. The effective date for Reg BI and Form CRS is 60 days after publication in the federal register, although the actual date of publication does not alter the June 30, 2020 compliance date.

I. Regulation Best Interest

A. Overview of the Best Interest Standard

Reg BI, which is codified in new Rule 15*l*-1 under the Securities Exchange Act of 1934 ("Exchange Act") ("Final Rule"),[5] establishes a new standard of conduct for broker-dealers ("BDs") and their natural person associated persons ("APs")[6] when making a recommendation of a securities transaction or investment strategy involving securities to a retail customer. The Commission chose not to impose a standard of conduct from another regulatory regime (such as the Advisers Act) on BDs and instead tailored the best interest standard to the BD model by building on the existing BD regulatory regime. The Commission also declined to impose a new uniform standard on BDs and investment advisers ("IAs") because "adopting a 'one size fits all' approach would not appropriately reflect the fact that broker-dealers and investment advisers play distinct roles in providing recommendations or advice and services to investors, and may ultimately harm retail investors."[7] In that regard, the Commission emphasized throughout the Reg BI Adopting Release the importance of adopting a standard of conduct that preserves different types of investment services and products for retail investors, including the kind of transaction-based relationship offered by BDs.

The Commission also pointed out that, at the time a recommendation is made, key elements of the new best interest standard are substantially similar to key elements of the standard of conduct applicable to IAs under their fiduciary duty. That said, the Commission deliberately refrained from using the term "fiduciary" to describe the best interest standard because it did not want to create confusion about the breadth of the BD's responsibility under Reg BI and that of IAs.[8] The Commission also observed that Reg BI reflects important principles underlying the now-vacated Department of Labor's ("DOL") "conflict of interest" rule ("DOL Fiduciary Rule"),[9] but purposely declined to use the same "without regard to" language from that rule because the Commission did not want to create confusion and legal ambiguities arising from differences between ERISA and the federal securities laws.[10]

By adopting a standard that prohibits BDs from placing their interests ahead of the retail customer's interest, the Commission expressly noted its intent to recognize that "a broker-dealer will inevitably have some financial interest in a recommendation."[11] Instead of prohibiting a BD from making a recommendation when it has a conflict of interest, Reg BI imposes four component obligations that

---

[3] *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Investment Advisers Act Release No. 5248, 21 (Jun. 5, 2019), *available at* https://www.sec.gov/rules/interp/2019/ia-5248.pdf ("Fiduciary Interpretation Adopting Release").

[4] *Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser*, Investment Advisers Act Release No. 5249, 21 (Jun. 5, 2019), *available at* https://www.sec.gov/rules/interp/2019/ia-5249.pdf ("Solely Incidental Interpretation Adopting Release").

"are designed to promote recommendations that are in the best interest of the retail customer despite the existence of these conflicts of interest."[12] Reg BI does not define "best interest," but the SEC observed that whether a BD has satisfied its best interest obligation "will turn on an objective assessment of the facts and circumstances of how the specific components of Regulation Best Interest are satisfied at the time the recommendation is made (and not in hindsight)."[13] The four component obligations of Reg BI are summarized below and discussed in more detail in Section C.

- **Disclosure Obligation** – Rule 15*l*-1(a)(2)(i). Prior to or at the time of a recommendation, the BD must provide the retail customer, *in writing*, full and fair disclosure of (A) all *material* facts relating to the scope and terms of the relationship, including the BD capacity in which the BD is acting, the fees and costs, and the type and scope of services provided, as well as (B) all *material* facts relating to conflicts of interest associated with the recommendation.
    - In a change from the Reg BI proposal, the SEC adopted the standard of materiality articulated by the Supreme Court in *Basic v. Levinson*[14] for all references to "material" in Reg BI, such as "material facts."
    - The SEC also observed that a BD violates the Disclosure Obligation if it were to use the titles "advisor" or "adviser" when it is not dually-registered.
- **Care Obligation** – Rule 15*l*-1(a)(2)(ii). The BD must exercise reasonable diligence, care and skill to (A) understand the 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; (B) have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on the customer's investment profile and the potential risks, rewards, and *costs* associated with the recommendation; and (C) have a reasonable basis to believe that a series of recommended transactions is not excessive and is in the retail customer's best interest.
    - In a change from the Reg BI proposal, the Care Obligation expressly requires the BD to consider cost in evaluating a recommendation.
- **Conflict of Interest Obligation** – Rule 15*l*-1(a)(2)(iii). The BD must establish, maintain, and enforce written policies and procedures reasonably designed to: (A) identify and at a minimum *disclose* or eliminate all conflicts of interest associated with such recommendations; (B) identify and *mitigate* any conflicts of interest that create an

---

[5] *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, Securities Exchange Act Release No. 86031 (Jun. 5, 2019), *available at* https://www.sec.gov/rules/final/2019/34-86031.pdf ("Reg BI Adopting Release" or "Adopting Release"); *see also Regulation Best Interest*, 83 Fed. Reg. 21574 (proposed May 9, 2018), *available at* https://www.gpo.gov/fdsys/pkg/FR-2018-05-09/pdf/2018-08582.pdf ("Reg BI Proposing Release").

[6] In this summary, any reference to "associated persons" refers to natural persons who are associated persons of the broker-dealer.

[7] Reg BI Adopting Release at 56.

[8] *Id.* at 70-71.

[9] *See Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice*, 81 Fed. Reg. 20946 (Apr. 8, 2016), *available at* https://www.govinfo.gov/content/pkg/FR-2016-04-08/pdf/2016-07924.pdf; *Best Interest Contract Exemption*, 81 Fed. Reg. 21002 (Apr. 8, 2016), *available at* https://www.gpo.gov/fdsys/pkg/FR-2016-04-08/pdf/2016-07925.pdf. The DOL Fiduciary Rule was vacated in toto by the United States Court of Appeals for the Fifth Circuit. *See Chamber of Commerce v. U.S. Dep't of Labor*, 885 F.3d 360 (5th Cir. 2018).

[10] Reg BI Adopting Release at 64-65, 71.

[11] *Id.* at 74. The Commission recognized that there are inherent conflicts of interest in the BD-customer relationship just as there are in the IA-customer relationship. *Id.* at 8.

[12] *Id.* at 75.

[13] *Id.* at 73. "This facts-and-circumstances approach recognizes that one size *does not* fit all, and what is in the best interest of one retail customer may not be in the best interest of another." *Id.* (emphasis in original).

[14] *Basic, Inc. v. Levinson,* 485 U.S. 224 (1988).

incentive for an AP to place the interest of the BD, or such AP ahead of the interest of the customer; (C)(i) identify and disclose any *material limitations* placed on the securities or investment strategies that may be recommended and any conflicts of interest associated with such limitations, and (ii) *prevent* such limitations and conflicts from causing the BD or AP to make recommendations that place the interest of the BD or AP ahead of the interest of the customer; and (D) 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.

  - This multi-part conflict of interest obligation replaces the two different conflict of interest obligations that were part of the Reg BI proposal. The Final Rule includes new requirements, such as the elimination of sales contests, sales quotas, bonuses, and non-cash compensation that is based on the sales of specific securities or specific types of securities within a limited period of time.

- **Compliance Obligation** – Rule 15*l*-1(a)(2)(iv). The BD must establish, maintain, and enforce policies and procedures reasonably designed to achieve compliance with Reg BI.

  - The SEC added this new Compliance Obligation to the Final Rule.

When recommending a securities transaction or investment strategy involving securities – including recommendations of account types and rollovers – to a retail customer, a BD must comply with all of the four component obligations above, and APs must comply with both the disclosure and care obligations. To the extent that a BD complies with all of these component obligations, the BD is permitted to:

- Engage in principal trading and recommend a transaction to be executed in a principal capacity;
- Charge commissions or other transaction-based fees;
- Receive or provide differential compensation based on the product sold;
- Receive third-party compensation;
- Recommend proprietary products, products of affiliates, or securities underwritten by the BD or its affiliate;
- Limit recommendations to a limited range of products;
- Allocate trades and research, including investment opportunities among different types of customers and between retail customers and the BD's own account;
- Consider cost to the BD of effecting the transaction or strategy on behalf of the customer (e.g., the effort or cost of buying or selling an illiquid security); or
- Accept a customer's order that is contrary to the BD's recommendation.[15]

The best interest obligation applies at the time the recommendation is made. It does not:

- Extend beyond a particular recommendation;
- Require a BD to have a continuous duty to a retail customer or impose a duty to monitor the performance of the account;
- Require the BD to refuse to accept a customer's order that is contrary to the BD's recommendation; or
- Apply to self-directed or otherwise unsolicited transactions by a retail customer who may otherwise receive other recommendations from the BD.

Finally, we note that Reg BI does not:

- Require a BD to recommend the least expensive or least remunerative security or investment strategy involving a security or to find the single "best" alternative for a customer;

[15] *Id.* at 75 n.148.

- Address or change the standard for other aspects of a BD's obligations – such as best execution, fair pricing, and compensation;
- Alter a BD's obligations under the general antifraud provisions of the federal securities laws or any other obligations under the federal securities laws, rules and regulations, or the Financial Industry Regulatory Authority's ("FINRA") rules; or
- Create any new private right of action or right of rescission.[16]

B. Scope and Key Definitions

Reg BI applies when a BD makes a *recommendation* about any *securities transaction or investment strategy (including account recommendations)* involving a securities transaction to a *retail customer* who *uses* the recommendation primarily for *personal, family, or household purposes*.

1. *Recommendation.* The term "recommendation" in Reg BI generally has the same meaning under FINRA rules. Factors that are considered in determining whether a BD has made a recommendation include whether the communication "reasonably could be viewed as a 'call to action'" and whether it "reasonably would influence an investor to trade a particular security or group of securities."

2. *Securities Transaction or Investment Strategy.* Securities transaction includes a sale, purchase, and exchange, and may include recommendations to roll over or transfer assets from one type of account to another (such as from an ERISA account to an IRA). In the Final Rule, the SEC revised the rule text to make explicit that the obligation applies to recommendations relating to accounts.

The SEC also stated in the Adopting Release that the phrase "any security transaction or investment strategy" includes *implicit* hold recommendations in instances where the BD has agreed to monitor a retail customer's account. In that context, there is an implicit recommendation to hold if the BD does not provide an express recommendation to buy, sell or hold at the time the agreed-upon monitoring occurs. However, if a BD *voluntarily* reviews a customer's account (i.e., without an account monitoring agreement with the customer) in order to determine whether to make a recommendation, the Commission does not consider that action to constitute account monitoring. In contrast to Reg BI, the FINRA suitability rule does not apply to implicit recommendations to hold.[17]

3. *Retail Customer.* In response to comments, the SEC revised the definition of "retail customer" in the Final Rule to limit it to natural persons. The SEC also better harmonized the definition of "retail customer" in Reg BI with the definition of "retail investor" in Form CRS. Additionally, the SEC made clear in the Adopting Release but not the Final Rule that "legal representatives" include persons who are non-professionals and does not include financial services professionals such as registered IAs, BDs, corporate fiduciaries (such as banks, trust companies, and similar financial institutions), insurance companies, and their employees.[18]

The definition of "retail customer" in Reg BI is still inconsistent with the FINRA definition of "retail investor."[19] The Reg BI definition is broader because it includes natural persons with assets under management in excess of $50 million and also narrower than FINRA's definition because it is limited to natural persons.

---

[16] While there is no private right of action, BDs and APs face regulatory liability if they fail to comply with their Reg BI obligations. Scienter is not required to establish a violation of Reg BI.

[17] Reg BI Adopting Release at 104.

[18] *Id.* at 113-14; Form CRS Adopting Release at 195.

[19] FINRA Rule 2210(a)(6) defines a "retail investor" as "any person other than an institutional investor." An "institutional investor," in turn is defined in Rule 2210(a)(4) to include, among others, any "institutional account." The term "institutional account" is defined in Rule 4512(c) as "the account of: (1) a bank, savings and loan association, insurance company or registered investment company; (2) an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act or with a state securities commission (or any agency or office performing like functions); or (3) any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million."

4. *Use for Personal, Family or Household Purposes.* The SEC clarified that Reg BI applies to a retail customer who receives a recommendation and "uses" that recommendation for personal, family or household purposes. The SEC views a retail customer as "using" a recommendation when: (1) the retail customer opens a brokerage account with the BD, regardless of whether the BD receives compensation; (2) the retail customer has an existing account with the BD and receives a recommendation from the BD, regardless of whether the BD receives or will receive compensation; or (3) the BD receives or will receive compensation, directly or indirectly as a result of that recommendation, even if the retail customer does not have an account at the firm.

The SEC interprets "personal, family, or household purposes" to mean any recommendation to a natural person for his or her account, other than recommendations to persons seeking these services for commercial or business purposes (e.g., it would not include an employee seeking services for an employer or an individual who is seeking services for a small business or on behalf of another non-natural person entity such as a charitable trust). It covers retirement accounts, including IRAs and workplace plans such as 401(k) plans, and includes recommendations about whether to take a distribution from such plans and how to invest that distribution. It does not generally include workplace retirement plans and their representatives (e.g., plan sponsors, trustees, or other fiduciaries) and service providers.

5. *New Definition of "Conflicts of Interest."* Reg BI now incorporates the *Capital Gains*[20] definition of "Conflicts of Interest" in its text. Thus, "conflict of interest" is defined 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 inclusion of this open-ended definition is somewhat tempered by the discussion in the Reg BI Adopting Release about materiality and the Commission's view that "[i]t is 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 under the *Basic* standard."[21] However, questions of application are raised by some parts of the Conflict of Interest Obligation that are *not* qualified by a materiality standard or a cross-reference to the Disclosure Obligation.

C. The Elements of the Best Interest Obligation

1. *General Best Interest Obligation.* As noted above, the General Obligation[22] is satisfied if four component obligations are met: (1) Disclosure Obligation; (2) Care Obligation; (3) Conflict of Interest Obligation; and (4) Compliance Obligation.

2. *Disclosure Obligation – Rule 15*l*-1(a)(2)(i).* The Commission observed that unlike an IA's obligations under Form ADV to make disclosures relating to the entire relationship, Reg BI only requires the disclosure of material facts relating to (1) the scope and term of the customer's relationship with the BD and (2) conflicts of interest associated with the recommendation. The Commission repeatedly emphasized in the Adopting Release that Reg BI was carefully designed to avoid giving retail customers overwhelming amounts of information.[23] For that reason, the Commission adopted the *Basic v. Levinson* standard of materiality to determine "material" facts for the Disclosure Obligation.[24]

a. *Material Facts Relating to the Scope and Terms of the Relationship with the Retail Customer.* The text of the Final Rule identifies three non-exclusive categories of

[20] *SEC v. Capital Gains Research Bureau, Inc.,* 375 U.S. 180 (1963).

[21] Reg BI Adopting Release at 202.

[22] Rule 15*l*-1(a)(1) sets forth the General 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."

[23] *See, e.g.,* Reg BI Adopting Release at 214, 217.

[24] *Id.* at 201.

"material facts relating to scope and terms of the relationship" that must be disclosed: (1) that the BD or natural person is acting as a BD or an AP with respect to the recommendation (the "capacity disclosure"); (2) the material fees and costs that apply; and (3) the type and scope of services provided, including any material limitations on the securities or investment strategies that may be recommended.

- *With respect to the capacity disclosure*, the SEC determined that the use of the terms "adviser" and "advisor" could "undermine the objectives of the capacity disclosure requirement by potentially confusing a retail customer as to the type of firm and/or professional they are engaging."[25] Although a restriction on the use of the terms "adviser" and "advisor" as part of a name or title was originally part of the Form CRS proposal, the SEC observed that "we do not believe that adopting a separate rule restricting these terms is necessary, because we presume that the use of the term 'adviser' and 'advisor' in a name or title by (1) a broker-dealer that is not also registered as an investment adviser or (2) an associated person that is not also a supervised person of an investment adviser, to be a violation of the capacity disclosure requirement under the Disclosure Obligation."[26]
- *With respect to the fees and costs disclosure*, the Adopting Release states that the disclosure should explain why and when a material fee or cost would be imposed, such as an account minimum. The Adopting Release also clarifies that the disclosure of fees and costs does not need to be individualized for each retail customer. Instead, standardized numerical and other non-individualized disclosure may be used.
- *With respect to the type and scope of services disclosure*, the Adopting Release explains that the disclosure should include whether or not the BD is monitoring the performance of the account (and if so, the scope and frequency of those services) and any material limitations on the securities or investment strategies that may be recommended.[27] The Adopting Release also states that the disclosure should include "the basis for a broker-dealer's recommendations as a general matter (i.e., what might commonly be described as the firm's investment approach, philosophy, or strategy) and the risks associated with a broker-dealer's recommendations in standardized (as opposed to individualized) terms."[28]

Because this is a non-exhaustive list of material facts, BDs will need to consider, based on the facts and circumstances, whether there are other material facts that need to be disclosed.

b. *All Material Facts Relating to Conflicts of Interest that Are Associated with the Recommendation.* As discussed above, Reg BI includes a definition of "conflict of interest" drawn from the description of "conflict of interest" for IAs under *Capital Gains*. The Adopting Release makes clear that only those conflicts that are material need to be disclosed and the materiality standard is that of *Basic v. Levinson*. Of particular note are conflicts relating to how the BD and its APs are compensated, such as conflicts created by variable compensation, payment from third parties (such as for shelf space), differences in compensation for proprietary products, and revenue sharing.[29]

The Disclosure Obligation does not require specific written disclosure of the amounts of compensation received by BDs or financial representatives. Specifically, the Adopting Release notes that: "disclosure regarding conflicts must reasonably inform investors so that the investor

[25] *Id*. at 157.

[26] *Id.* at 149.

[27] "For purposes of this requirement, a 'material limitation' placed on the securities or investment strategies involving securities could include, for example, recommending only proprietary products (e.g., any product that is managed, issued, or sponsored by the broker-dealer or any of its affiliates), a specific asset class, or products with third-party arrangements (e.g., revenue sharing, mutual fund service fees). Similarly, the fact that the broker-dealer recommends only products from a select group of issuers, or makes IPOs available only to certain clients, could also be considered a material limitation. To cite another example, if an associated person of a dually registered broker-dealer only offers brokerage services, and is not able to offer advisory services, the fact that the associated person's services are materially narrower than those offered by the broker- dealer would constitute a material limitation." *Id.* at 179. Note that even if such material limitations are disclosed, broker-dealers still must comply with the Care Obligation when making a recommendation to a retail customer.

[28] *Id.* at 37-38. *See also* discussion at 173, 183, 185.

[29] *Id.* at 202-208.

may use the information to evaluate the recommendation, and that can be done without specific disclosure of the amount of the compensation. Although disclosure of specific compensation amounts is not required, depending on facts and circumstances, full and fair disclosure may require disclosure of the general magnitude of the compensation."[30]

c. *Form and Manner of Written Disclosure.* The Final Rule does not mandate a single standard written document nor a specific form (e.g., narrative v. graphical/tabular, number of pages, etc.) or manner (e.g., relationship guide or other written communication). Instead, the disclosure will depend on the frequency and level of advice services provided (i.e., one-time, episodic or more frequent basis). The Adopting Release also states that some forms of disclosure may be standardized and provided at the beginning of a relationship, but other disclosures may need to be tailored to the particular recommendation. The Disclosure Obligation can also be satisfied using a combination of existing disclosures and standardized documents (e.g., product prospectuses, relationship guides, account agreements, fee schedules, and trade confirmations).[31]

Disclosures may be provided to retail customers electronically consistent with existing SEC guidance on electronic delivery of documents. Disclosures must generally be in writing, but the Adopting Release discusses scenarios when oral disclosure or disclosure after a recommendation may be appropriate. For example, the SEC notes that some flexibility with respect to the provision of written and oral disclosure, as well as with respect to the timing that disclosure is made, is appropriate in certain circumstances, such as when a BD updates its written disclosures orally in order to reflect facts not reasonably known at the time the written disclosure is provided. In such circumstances, a BD may satisfy its Disclosure Obligation by making supplemental oral disclosure not later than the time of the recommendation, provided the BD maintains a record of the fact that oral disclosure was provided.[32] While not requiring it, the SEC encouraged BDs to adopt a best practice of following up any oral disclosure with a written disclosure to the customer.[33]

d. *Timing and Frequency of Disclosure.* The disclosures should be provided early enough that the investor has adequate time to consider the information and understand it to make an informed investment decision, but not so early that the disclosure fails to provide meaningful information. Examples of different approaches that BDs may use include providing the written disclosure:

- At the beginning of a relationship (e.g., in a relationship guide, such as or in addition to Form CRS, or in written communications with the customer, such as the account opening agreement);
- On a regular or periodic basis (e.g., on a quarterly or annual basis, when previously disclosed information becomes materially inaccurate or when there is new relevant information);
- At other points, such as before making a particular recommendation or at the point of sale; and/or
- At multiple points in the relationship or through a layered approach to disclosure (i.e., general disclosure first, followed by more specific information in a subsequent disclosure which may be at the time of the recommendation or even after the recommendation (e.g., in a trade confirmation)).

As noted above, the Adopting Release also states that a BD may satisfy certain disclosure obligations for information that is required in prescribed documents (e.g., trade confirmations and prospectuses) after the recommendation is made. In such cases, BDs must provide an initial disclosure in writing that identifies the material fact and describes the process through which such fact may be supplemented, clarified, or updated.[34]

---

[30] *Id.* at 205.

[31] *Id.* at 223-224.

[32] *Id.* at 137-38. *See* additional discussion at 228-229.

[33] *Id*. at 229.

[34] *Id*. at 138.

Because the Disclosure Obligation is recommendation-specific, a BD must update the disclosures if there have been any material changes. Without imposing a specific timeframe for updating disclosures, the Adopting Release notes the SEC generally encourages BDs to update their disclosures to reflect material changes or inaccuracies as soon as practicable, which should be no later than 30 days after the material change. In the meantime, BDs are encouraged to provide, supplement, or correct any written disclosure with oral disclosure as necessary prior to or at the time of the recommendation.[35]

3. *Care Obligation – Rule 15l-1(a)(2)(ii).* Like the FINRA suitability rule, the Care Obligation has three components: a general "reasonable basis" suitability obligation, meaning the recommendation must be suitable for at least some customers, a customer-specific obligation, meaning the recommendation must be suitable for a particular customer, and a quantitative suitability obligation, meaning a series of recommended transactions must be reasonable even if in the customer's best interest when viewed in isolation.

The Care Obligation is stronger than the FINRA suitability standard in at least four ways:

- it explicitly requires that the recommendation be in the customer's best interest and that the BD does not place its interests ahead of the customer;
- it applies the quantitative suitability requirement *irrespective of* whether the BD has actual or de facto control over the customer's account;
- it requires the BD to consider "reasonably available alternatives" as part of having a "reasonable basis to believe" that the recommendation is in best interests of the customer, and
- it explicitly requires that cost be a consideration.[36]

Although costs are now expressly part of the Final Rule, the Adopting Release makes clear that this does not mean the lowest cost option is necessary or will satisfy the Care Obligation. Cost is a factor but it is not dispositive. To this point, the SEC notes "the evaluation of cost would be more analogous to a broker-dealer's best execution analysis, which does not require the lowest possible cost, but rather looks at whether the transaction represents the best qualitative execution for the customer using cost as one factor."[37]

While a BD must consider reasonably available alternatives, this does not mean that a BD must consider every possible alternative. At the same time, if the BD materially limits its product offerings to certain proprietary products, it still must comply with the Care Obligation even if it has disclosed the limitation pursuant to the Disclosure Obligation.

a. *Reasonable Basis Suitability.* The requirement to "understand the potential risks, rewards, and costs of the recommended transaction or strategy, and have a reasonable basis to believe that the recommendation could be in the best interest of *at least some* retail customers" is intended to incorporate a BD's existing obligation under FINRA "reasonable basis suitability" requirements. The Commission observed that "[w]hile we stress the importance of understanding the potential risks, rewards, and costs associated with a recommended security or investment strategy, as well as other factors depending on the facts and circumstances of each recommendation, we do 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 investment strategy."[38]

b. *Customer-Specific Suitability.* The requirement to "have a reasonable basis to believe the recommendation is in the best interest of a particular retail customer based on

[35] *Id.* at 244.

[36] *Id.* at 253-254.

[37] *Id.* at 250.

[38] *Id.* at 266.

that customer's investment profile and the potential risks, rewards, and costs associated with the recommendation" is intended to incorporate and enhance the existing "customer-specific suitability" requirements under FINRA rules. The BD is required to exercise "reasonable diligence" to ascertain the customer's investment profile and to consider "reasonably available alternatives offered by the broker-dealer."

With respect to consideration of reasonably available alternatives, the Commission noted that "we are not requiring a natural person who is an associated person of the broker-dealer to be familiar with every product on a broker-dealer's platform, particularly where a broker-dealer operates in an open architecture framework or otherwise operates a platform with a large number of products or options."[39] Notably, the Reg BI Adopting Release states that "[c]onsistent with the Compliance Obligation discussed below, a broker-dealer should have a reasonable process for establishing and understanding the scope of such 'reasonably available alternatives' that would be considered by particular associated persons or groups of associated persons (e.g., groups that specialize in particular product lines) in fulfilling the reasonable diligence, care, and skill requirements under the Care Obligation."

The definition of "retail customer investment profile" in the Final Rule is the same as in the proposal. It includes the customer's "age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the retail customer may disclose to the broker, dealer, or a natural person who is an associated person of a broker or dealer in connection with a recommendation." The Adopting Release observed that if a BD is unable to obtain sufficient information for the retail customer investment profile, the BD must consider whether it has a sufficient understanding of the customer to know whether a recommendation is in the customer's best interest. If the BD does not have a sufficient understanding, then the recommendation is not in the customer's best interest.

c. *Quantitative Suitability.* While based on FINRA's "quantitative suitability" rule, this obligation extends beyond the FINRA rule because it is not limited to situations where a BD has actual or *de facto* control over a customer's account. The SEC also rejected the industry's request not to apply quantitative suitability to recommendations by multiple, different personnel within a firm. "If we took this commenter's suggestion, we are concerned we would potentially create a loophole and a perverse outcome that would allow for the avoidance of the Care Obligation . . . by encouraging recommendations across a number of associated persons."[40] What would constitute a "series" of recommended transactions depends on the facts and circumstances and needs to be evaluated with respect to a particular retail customer. A "broker-dealer would need to reasonably believe that the level of trading (series of recommended transactions) is appropriate for a particular retail customer, and thus a bright line definition across all retail customers would be unworkable."[41]

4. *Conflict of Interest Obligation – Rule 15l-1(a)(2)(iii).* The Final Rule made several substantive changes to the Conflict of Interest Obligation. In addition to adopting an open-ended definition of conflict of interest, the Final Rule eliminated the distinction between material conflicts of interest arising from financial incentives and "other" material conflicts at the firm level that were part of the proposal. Instead, the Final Rule has a general requirement to identify and disclose firm conflicts of interest and adds two provisions addressing specific types of firm conflicts that must be identified and mitigated or identified and eliminated. A fourth category relates to AP-related conflicts that must be identified and mitigated.

[39] *Id.* at 284-285.

[40] *Id.* at 300.

[41] *Id.* at 301.

a. *Overarching Firm-Wide Conflicts.* This category of conflicts is closely tied to the Disclosure Obligation which requires the disclosure of material facts relating to conflicts of interest. Although the provision does not use the term "material," the specific reference in this provision to the Disclosure Obligation suggests that the only conflicts that must be identified under this provision are material conflicts. Nevertheless, the deletion of the "material" qualifier in the text raises concerns that the identification requirement could apply to all conflicts.

b. *Associated Person Related Conflicts.* With regard to conflicts at the individual AP level, the SEC clarified that, for purposes of determining which incentives must be identified and mitigated, BDs do not need to consider "external interests of the associated person not within the control of or associated with the broker-dealer's business."[42] So, for example, the fact that an AP's family member is the CEO of an issuer would not be a "conflict" that is in scope for purposes of the Conflict of Interest Obligation. Examples of disclosable conflicts would be variable compensation and employee incentives. Although this provision also lacks a materiality qualifier, any conflict that could create an incentive that needs to be mitigated is likely to be a material conflict. The Commission asserted that "broker-dealers are most capable of identifying and addressing the conflicts that may affect the obligations of their associated persons with respect to the recommendations they make, and therefore are in the best position, to affirmatively reduce the potential effect of these conflicts of interest such that they do not taint the recommendation."[43]

c. *Material Limitations*. Any material limitations placed on security or investment strategy recommendations and any conflicts of interest associated with such limitations must be identified and disclosed, and steps must be taken to "prevent" such limitation or conflict from causing the BD or AP from making a recommendation that places their interests ahead of the customer's. As discussed above, the fact that a material limitation has been disclosed pursuant to the Disclosure Obligation and mitigated pursuant to this Conflict of Interest Obligation does not mean that a recommendation subject to the material limitation will satisfy the customer-specific suitability obligation. In addition to providing examples of mitigation measures, the Adopting Release notes that the SEC's intent is not to prevent firms from offering proprietary products or other limited range of products so long as firms comply with the Disclosure, Care, and Conflict of Interest Obligations: "[i]n fact, we believe that these limitations can be beneficial, such as by helping ensure that a broker-dealer and its associated persons understand the securities they are recommending, as required by the Care Obligation."[44]

d. *Conflicts to Be Eliminated.* In a significant change from the proposal, the Final Rule requires BDs to identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sale of specific securities or specific types of securities within a limited period of time. The Commission explained that these types of product-based incentives combined with a time limitation create "high-pressure situations" where conflicts of interest are "so pervasive such that they cannot be reasonably mitigated and must be eliminated in their entirety, as we believe they create too strong of an incentive for the associated persons to make a recommendation that places their financial or other interest ahead of the interest of retail customers' interests and therefore would be inconsistent with Regulation Best Interest."[45] The elimination requirement does not apply to incentives or compensation relating to total products sold, asset growth or accumulation or customer satisfaction.[46] It also does not apply to incentives or compensation relating to sales of general categories of securities (mutual funds, variable annuities, bonds, equities) as long as they do not create high pressure situation to sell a specifically identified type of security (e.g., stocks of a particular sector or bonds with a specific credit rating) within a limited period of time.[47]

e. *Risk-Based Compliance Policies and Procedures and Conflict Mitigation.* The Reg BI Adopting Release reiterates that it is acceptable to use a risk-based compliance and

[42] *Id.* at 329.

[43] *Id*. at 326.

[44] *Id.* at 344-346.

[45] *Id.* at 351-352.

[46] *Id.* at 352-354.

[47] *Id.*

supervisory system rather than requiring a detailed review of each recommendation. As noted in the Adopting Release: "we believe that broker-dealers should have flexibility to tailor their policies and procedures to their particular business model, focusing on specific areas of their business that pose the greatest risk of noncompliance and greatest risk of potential harm to retail customers as opposed to a detailed review of each recommendation."[48]

Both the Proposing and Adopting Release provided examples of methods for mitigating conflicts which firms may consider in designing policies and procedures for the conflict of interest provisions – both firm-wide and individual conflicts. The Commission clarified that the examples described, including the reference to neutral factors as an example of a mitigant in the Proposing Release, are not required elements, and were only provided as a non-exhaustive list.[49]

5. *Compliance Obligation – Rule 15l-1(a)(2)(iv).* In addition to the policies and procedures required by the Conflict of Interest Obligation, the Final Rule added a new Compliance Obligation which requires BDs to establish, maintain, and enforce written policies and procedures *reasonably* designed to achieve compliance with Reg BI. According to the Adopting Release, the Compliance Obligation "creates an affirmative obligation under the Exchange Act with respect to the rule as a whole, while providing sufficient flexibility to allow broker-dealers to establish compliance policies and procedures that accommodate a broad range of business models."[50] As with other policies and procedures requirements, whether policies and procedures are reasonably designed will depend on the facts and circumstances of a given situation.

The new Compliance Obligation does not present a substantive change from a practical policies and procedures perspective because BDs are already subject to supervisory obligations under Section 15(b)(4)(E) of the Exchange Act and FINRA rules. It is, however, meaningful from an enforcement perspective because this provision allows the SEC to bring Reg BI charges against BDs for policies and procedures violations even in the absence of an underlying violation of Reg BI.

D. Recordkeeping and Retention

The Final Rule includes a few amendments to the BD recordkeeping rules to address the creation and retention of records relating to Reg BI. As discussed above, the Care Obligation requires BDs to develop a "retail customer's investment profile" that includes certain customer information that is not currently required pursuant to Exchange Act Rule 17a-3(a)(17) or FINRA rules. Reg BI defines "retail customer's investment profile" to include "the retail customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the retail customer may disclose" to the BD or AP in connection with a recommendation. The Disclosure Obligation also requires BDs to disclose in writing certain material facts relating to the scope and terms of their relationship and conflicts of interest associated with their recommendations. The Adopting Release explains that "the purpose of the new record-making provision is to allow broker-dealers to demonstrate their compliance with the substantive requirements of Regulation Best Interest."[51]

The Final Rule amends Exchange Act Rule 17a-3 to add a new paragraph (a)(35), which requires for each retail customer to whom a recommendation of any securities transaction or investment strategy involving securities is or will be provided, a record of all information collected from and provided to the retail customer pursuant to Reg BI. The SEC clarified that while the substantive requirements of Reg BI apply on a recommendation-by-recommendation basis, Reg BI does not require that broker-dealers create and maintain records to evidence best interest determinations on a recommendation-by-recommendation basis. The SEC also noted that BDs are not required to provide information to retail customers regarding the basis for each particular recommendation, and thus did not envision this information would be in scope for purposes of Rule 17(a)(35).[52]

---

[48] *Id.* at 306-7.

[49] *Id.* at 331 and 335-336.

[50] *Id.* at 358-59.

[51] *Id.* at 365.

[52] *Id.* at 366-367.

This new recordkeeping requirement specifies that the neglect, refusal, or inability of a retail customer to provide or update any such information will excuse the BD from obtaining that information. The Final Rule also amends Exchange Act Rule 17a-4(e)(5) to require BDs to retain these records for six years after the earlier of the date the relevant account was closed or the date on which the information was replaced or updated.[53] The SEC observed that other records created in connection with Reg BI may constitute records covered by existing books and records rules, including "business as such" communications and written policies and procedures.[54]

II. Form CRS Relationship Summary

A. Overview

The SEC adopted new rules and forms as well as amendments to its rules and forms, under both the Advisers Act and Exchange Act to require registered IAs and registered BDs (together, "firms") to provide a brief relationship summary to retail investors ("CRS Final Rules and Forms").[55] The Form CRS relationship summary ("relationship summary") 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. The proposed instructions included requirements on length, formatting, and content.

The relationship summary is intended to inform retail investors about: (1) the types of client and customer relationships and services the firm offers; (2) the fees, costs, conflicts of interest, and required standard of conduct associated with those relationships and services; (3) whether the firm and its financial professionals currently have reportable legal or disciplinary history; and (4) how to obtain additional information about the firm. The relationship summary is in addition to, and not in lieu of, current disclosures and reporting requirements, and delivery of this document will not satisfy other disclosure obligations.[56]

New Rule 17a-14 under the Exchange Act requires SEC-registered BDs that offer services to retail investors to file the relationship summary with the SEC and deliver it to retail investors at the earliest of: (1) a recommendation of an account type, a securities transaction, or an investment strategy involving securities to the retail investor; (2) placing an order for the retail investor; or (3) opening a brokerage account for the retail investor.

It also requires delivering to each retail investor who is an existing customer the current relationship summary before or at the time the BD: (1) opens a new account that is different from the retail investor's existing account(s); (2) recommends that the retail investor roll over assets from a retirement account into a new or existing account or investment; or (3) recommends or provides a new brokerage service or investment that does not necessarily involve the opening of a new account and would not be held in an existing account.

New Rule 204-5 under the Advisers Act requires that SEC-registered IAs: (1) deliver to each retail investor their current relationship summary before or at the time they enter into an investment advisory contract with that retail investor; (2) deliver to each retail investor who is an existing client their current relationship summary before or at the time they: (a) open a new account that is different from the retail investor's existing account(s); (b) recommend that the retail investor roll over assets from a retirement account into a new or existing account or investment; or (c) recommend or provide 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.

---

[53] *Id.* at 369.

[54] *Id.* at 370-371.

[55] *Form CRS Relationship Summary; Amendments to Form ADV*, Securities Exchange Act Release No. 86032 and Investment Advisers Act Release No. 5247 (June 5, 2019), *available at* https://www.sec.gov/rules/final/2019/34-86032.pdf ("Form CRS Adopting Release"); *see also Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles*, 83 Fed. Reg. 21416 (proposed May 9, 2018), *available at* https://www.gpo.gov/fdsys/pkg/FR-2018-05-09/pdf/2018-08583.pdf ("Form CRS Proposing Release").

[56] Form CRS Adopting Release at 232-233.

B. Key Changes from Proposal

In the CRS Final Rules and Forms, the SEC made a number of key changes to the relationship summary and instructions in response to concerns raised by commenters. In addition, the SEC did not adopt the title restriction on the use of the term "adviser" or "advisor,"[57] nor did it adopt the requirements for firms to affirmatively disclose their regulatory status and for financial professional to disclose their association with a firm in all print or electronic advertising and communications.[58]

The key changes to the proposed format and instructions of the relationship summary include the following:

- *"Retail Investor" Definition.* "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." This definition was largely conformed to the definition of "retail customer" in Reg BI. As with Reg BI, the Form CRS Adopting Release clarifies that legal representative does not include regulated financial services professionals, such as registered IAs, BDs, corporate fiduciaries (e.g., banks, trust companies, and similar financial institutions), insurance companies, and their employees.[59]
- *Format and Length*. As described below, the format has been changed and the length has been shortened. At the same time, firms are provided with greater flexibility in wording and the use of graphics and links.
- *Disclosures*. The section detailing the differences between IAs and BDs was eliminated. Instead, the introductory paragraph must provide a link to Investor.gov/CRS, a page on the SEC's investor education website with educational information. The discussion of fees has been expanded, and firms must include disclosure about financial professionals' compensation. In addition, there is a separate disciplinary history section where firms are required to indicate whether or not they or any of their financial professionals have reportable disciplinary history and where investors can conduct further research on these events.
- *Key Questions*. The "key questions" section that was original proposed has now been integrated into the separate sections as either question-and-answer headings or "conversation starters." Of note, the "do the math for me" question that the proposal would have required was converted into a "conversation starter" question to help retail investors understand how fees and costs might affect their investments and the potential impact of fees and costs on a hypothetical $10,000 investment.[60]
- *Scope*. Because Form CRS applies only to BDs that offer services to retail investors, the Commission clarified that the regulation excludes: (1) clearing and carrying BDs that solely provide services to third party or affiliated introducing BDs; and (2) BDs that serve solely as a principal underwriter to a mutual fund, variable annuity, or variable life insurance contract issuer.[61]

C. Content of Relationship Summary

1. *Length and Form.* The relationship summary must be limited to two pages for IAs and BDs, and four pages for dual registrants (if describing both their investment advisory and BD services). Dual registrants can also choose to have standalone documents limited to two pages

[57] Although as noted above, this restriction now falls under the Disclosure Obligation of Reg BI.

[58] "After considering the comments received and the obligations we are adopting under Regulation Best Interest and Form CRS, we have concluded that the capacity disclosure requirement in Regulation Best Interest and Form CRS are sufficient to achieve the objectives of the proposed Affirmative Disclosures." Form CRS Adopting Release at 251.

[59] *Id.* at 195.

[60] The Form CRS Adopting Release observed that this question was never intended to require firms to generate individualized cost estimates for each particular retail investor. *Id.* at 65.

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

each. Relationship summaries that are delivered electronically must not exceed the equivalent of two or four pages, as applicable.

2. *Items that Must Be Addressed*. The relationship summary must include the following items: (1) introduction; (2) relationship and services; (3) fees, costs, conflicts, and standard of conduct; (4) disciplinary history; (5) additional information. Firms are not allowed to include additional disclosure other than the one required or permitted by the instructions.

3. *Language*. The language must: (1) be in plain language, taking into consideration the retail investor's level of financial experience; (2) be concise and direct; (3) use short sentences and definite, concrete, every day words; (4) use active voice; (5) avoid legal jargon or highly technical business terms; (6) avoid multiple negatives; and (7) be written addressing the investor, using "you," "us," "our firm," etc.

4. *Full and Truthful Disclosure*. All information must be true and may not omit any material facts necessary to make the disclosures required not misleading "in light of the circumstances under which they were made." This qualification recognizes that Form CRS is a summary and that it provides links with additional information. The SEC notes that "[a]ny information contained in the relationship summary or omitted facts will not be viewed in isolation in respect of determining whether such information would have been viewed by a reasonable investor as having significantly altered the total mix of information available."[62] Firms are allowed to modify required disclosures or "conversation starters" if they are inapplicable to the Firm.

5. *Electronic and Graphical Formats*. Firms are encouraged to use charts, graphs, tables, and other graphics or text features to respond to the required disclosures. They are also encouraged to use text features, text colors, and graphical cues, such as dual-column charts, to compare services, account characteristics, investments, fees, and conflicts of interest. For a relationship summary posted on a website or provided electronically, hyperlinks and online tools that populate information in comparison boxes based on investor selections are encouraged. Firms can also include: (1) a means of facilitating access to video or audio messages, or other forms of information; (2) mouse-over windows; (3) pop-up boxes; (4) chat functionality; (5) fee calculators; or (6) other forms of electronic media, communications, or tools designed to enhance a retail investor's understanding of the material in the relationship summary.

D. Delivery and Filing

1. *Initial Delivery*. As proposed, IAs 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. IAs must deliver the relationship summary even if the agreement with the retail investor is oral. In a change from the proposal, BDs must deliver the relationship summary to each new or prospective customer who is a retail investor before or at the earliest of: (1) a recommendation of an account type, a securities transaction, or an investment strategy involving securities; (2) placing an order for the retail investor; or (3) the opening of a brokerage account for the retail investor. This includes retail investors who place an unsolicited order without opening an account, such as in a "check-and-application" arrangement. For dual registrants, initial delivery must be made at the earlier of the above.

In addition, when Form CRS becomes effective on June 30, 2020, firms must deliver the relationship summary to all of their existing customers who are retail investors on a one-time basis within 30 days after the date the firm is first required to files its relationship summary with the Commission.[63]

2. *Additional Delivery*. Firms also must deliver the relationship summary to a retail investor who is an existing customer: (1) upon request, within 30 days of request; (2) before or at the time the firm opens a new account that is different from the retail investor's existing account(s); (3) before or at the time the firm recommends that the retail investor roll over assets from a retirement account into a new or existing account or investment; or (4) before or at the time the firm

[62] *Id.* at 42-43.

[63] *Id.* at 242.

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., the first-time purchase of direct-sold mutual fund or insurance product that is a security through a "check and application" arrangement).

3. *Updating the Relationship Summary.* When the relationship summary becomes materially inaccurate, firms must update and post on their website the latest version of the relationship summary, and electronically file it with the SEC within 30 days. Firms must deliver the updated the relationship summary to each retail investor who is an existing customer within 60 days after the update and without charge. The SEC noted that this time period will generally allow firms to include the update in one of its quarterly disclosure deliveries with other disclosures. [64] In a change from the proposal, the SEC added a requirement that firms delivering updated relationship summaries to existing clients or customers also 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 summary, and it would not be counted toward the two-page or four-page limit, as relevant.

4. *Electronic Delivery.* Firms may deliver the relationship summary electronically, including updates, consistent with SEC guidance regarding electronic delivery of documents. The Commission clarified that "delivery of the relationship summary to new or prospective clients or customers in a manner that is consistent with how that retail investor requested information about the firm or financial professional would be consistent with the Commission's electronic delivery guidance"[65]

5. *Filing with the SEC.* Firms must electronically file the relationship summary and any updates with the SEC (specifically, through EDGAR or the IARD; dual registrants only need to file once through either EDGAR or the IARD). As proposed, firms must file the relationship summary in a text-searchable format. The CRS Final Rules and Forms also require the filings contain machine-readable headings to enhance the ability to compare information submitted by different firms.

6. *Electronic Posting and Telephone Number.* Firms must prominently post the relationship summary on their websites, if they have one. Firms must also provide a telephone number where retail investors can request up-to-date information and a copy of the relationship summary.

E. Preserving Records

The SEC amended Exchange Act Rule 17a-3 by adding paragraph (a)(24) and amended Advisers Act Rule 204-2(a)(14) to require BDs and IAs to maintain a record of the date that each Form CRS was provided to each retail investor, including any relationship summary provided before such retail investor opens an account or enters an investment advisory agreement. Firms will need to maintain a copy of each version of the relationship summary. Under new paragraph (e)(10) of Exchange Act Rule 17a-4, BDs must retain these records and a copy of each relationship summary until at least six years after such record or relationship summary is created. Under Rule 204-2(e)(1), IAs are required to retain these records until at least five years after such record is created.

III. Commission Interpretation Regarding Standard of Conduct for Investment Advisers

The Commission adopted its interpretation regarding the standard of conduct for IAs ("Fiduciary Interpretation") largely as proposed with a few key changes and expanded discussion regarding certain elements in response to comments. This Fiduciary Interpretation of section 206 of the Advisers Act applies to all IAs, including those that are exempt from registration or are subject to a prohibition on registration under the Advisers Act and regardless of whether the IA has retail or institutional customers. In explaining the purpose of the Fiduciary Interpretation, the Commission reiterated its statement from the proposing release that, "we continue to believe[] that it is appropriate and beneficial to address in one release and reaffirm—and in some cases clarify—

[64] *Id.* at 237.

[65] *Id.* at 212, 220.

certain aspects of the fiduciary duty that an investment adviser owes to its clients under section 206 of the Advisers Act."[66]

In the Fiduciary Interpretation, the Commission plainly states that an IA is a fiduciary under federal law. The Commission notes that while an IA's fiduciary duty is not specifically defined in the Advisers Act or in Commission rules, it reflects Congressional intent.[67] The fiduciary duty that IAs owe their clients under the Advisers Act comprises a (1) duty of care, and (2) duty of loyalty. Accordingly, each IA must always "serve the best interest of its client and not subordinate its client's interest to its own."[68] However, in contrast to a BD's "best interest" obligations under Reg BI, an "investment adviser's fiduciary duty is broad and applies to the entire customer relationship."[69]

Below is a summary of the discussion of these duties under the Fiduciary Interpretation (which cites case law, prior Commission releases, and other guidance in support of these duties).

A. Application of Duty Determined by Scope of Relationship

The Commission noted that several commenters asked for clarification regarding the ability to tailor the scope of the relationship to which the fiduciary duty applies. Accordingly, the Commission stated that the "fiduciary duty follows the contours of the relationship between the adviser and its client, and the adviser and its client may shape that relationship by agreement, provided that there is full and fair disclosure and informed consent."[70] This statement acknowledges the different scope and types of services firms may offer—one-time financial planning compared to ongoing portfolio management and a narrow mandate for an institutional client versus comprehensive wealth management for an individual. The Commission's interpretation allows for the nature of the fiduciary duty to vary depending on the scope of the relationship. However, the applicable fiduciary duty may not be waived. The Commission affirmed that "the principles-based fiduciary duty imposed by the Advisers Act has provided sufficient flexibility to serve as an effective standard of conduct for investment advisers, regardless of the services they provide or the types of clients they serve."[71]

B. Duty of Care

The components of the duty of care include, among other things, the following:

1. Duty to Provide Advice that is in the Best Interests of the Client. IAs must "provide investment advice that is in the best interest of the client, including a duty to provide advice that is suitable for the client."[72] For an adviser to satisfy this obligation it must have "a reasonable understanding of the client's objectives."[73] How an adviser develops this reasonable understanding depends on the facts and circumstances and will likely differ between a retail client and an institutional client, especially if the latter has a more limited investment mandate. An adviser is expected to make a "reasonable inquiry" into a client's objective, which for a retail client, would at a minimum include "a reasonable inquiry into the client's financial situation, level of financial sophistication, investment experience, and financial goals."[74] Obviously for financial planning the minimum elements would be different and include information such as "income, investments,

---

[66] Fiduciary Interpretation Adopting Release at 3; *see also Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation*, 83 Fed. Reg. 21203 (proposed May 9, 2018), *available at* https://www.gpo.gov/fdsys/pkg/FR-2018-05-09/pdf/2018-08679.pdf ("Proposed Fiduciary Interpretation").

[67] *See Capital Gains*, 375 U.S. at 194.

[68] Fiduciary Interpretation Adopting Release at 8.

[69] *Id.* at 6.

[70] *Id.* at 9.

[71] *Id.*

[72] *Id.* at 12.

[73] *Id.* at 13.

[74] *Id.* This language is relatively consistent with the Proposed Fiduciary Interpretation, with the exception of "financial goals" replacing "investment objective."

assets and debts, marital status, tax status, insurance policies, and financial goals."[75] An IA must update a client's profile of such information as appropriate. The frequency of updates is facts and circumstances dependent "including whether the adviser is aware of events that have occurred that could render inaccurate or incomplete" a client's current investment profile on which the adviser relies.[76]

"An investment adviser must have a reasonable belief that the advice it provides is in the best interest of the client based on the client's objectives."[77] The Commission modified this standard from the Proposed Fiduciary Interpretation to eliminate the reference to "personalized" advice and thus make it applicable to both institutional as well as retail clients. Whether advice is in fact in a client's best interest is dependent on the context of the adviser-client relationship. High risk products may be appropriate for some, but not all, clients, and must be carefully scrutinized before being purchased for retail clients. In making a best interest determination, the cost to the client associated with a particular product would be one of many important factors but is not determinative; the Commission makes clear that the investment that is the lowest cost to the client or the least remunerative to the adviser is not always in the client's best interest. Other factors include, but are not limited to, liquidity of a product, risks and potential benefits, volatility, and likely performance in different market conditions. An adviser must conduct a "reasonable investigation" of potential investments so that its attributes are well understood.

2. Duty to Seek Best Execution. IAs have a duty to seek best execution where the IA is responsible for selecting the executing BD. This means the IA must execute "securities transactions on behalf of a client with the goal of maximizing value for the client under the particular circumstances occurring at the time of the transaction."[78] Maximizing value means more than simply minimizing the cost of a transaction; an IA should consider the full range of brokerage services, including research, execution capability, commission rate, financial responsibility, and responsiveness.

3. Duty to Provide Advice and Monitoring over the Course of the Relationship. An IA has a "duty to provide advice and monitoring at a frequency that is in the best interests of the client, taking into account the scope of the agreed relationship."[79] Although this general duty was included in the Proposed Fiduciary Interpretation, the actual standard has been modified to acknowledge that the scope of the relationship determines what this responsibility entails. An ongoing relationship with a periodic asset-based fee is different than a relationship of limited duration, like one-time financial planning; an advisory agreement also may indicate a limitation or expansion of the duty to monitor. Considering the import of the advisory agreement in defining the relationship it may be important to be explicit about the frequency of review to establish clear expectations (e.g., annual or quarterly). Importantly, the Commission notes that "[a]n adviser's duty to monitor extends to all personalized advice it provides to the client, including, for example, in an ongoing relationship whether a client's account or program type (for example, a wrap account) continues to be in the client's best interest."[80]

C. Duty of Loyalty

Under the duty of loyalty, an IA may "not *subordinate* its clients' interests to its own."[81] This differs from the Proposed Fiduciary Interpretation, which stated that the client's interest must come first. The change to "not subordinate" was made in response to comments that "first" was a different

[75] *Id.* at 12-13.

[76] *Id.* at 14.

[77] *Id.* at 15.

[78] *Id.* at 19.

[79] *Id.* at 20.

[80] *Id.* at 21.

[81] *Id.* (emphasis added).

standard than what the Commission had previously used to describe the duty.[82] The Commission stated that the modification was intended to ensure consistency with the cited precedent.[83]

This duty of loyalty includes the following obligations and requirements, among others:

1. An adviser must make full and fair disclosure of all material facts regarding the relationship, including the capacity in which the firm is acting. This "capacity" requirement is key for dual-registrants that may be acting as either a BD or IA.

2. An adviser cannot favor its own interests ahead of its clients' interests. This includes favoring certain clients that may pay higher fees over other clients.

3. An adviser 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 is not disinterested."[84] The Proposed Fiduciary Interpretation noted that advisers must "seek to avoid" conflicts, but this language was modified to clarify that an adviser may satisfy its fiduciary duty by disclosing conflicts without necessarily having an initial duty to "seek to avoid" a conflict.[85] The Commission still emphasizes that an adviser *should* seek to avoid conflicts.[86]

4. An adviser must make full and fair disclosure of conflicts with the appropriate level of specificity in order to obtain client consent to the relationship. If a conflict *does* exist, it is not sufficient for an IA to simply say that it *may* exist. The appropriate level for full and fair disclosure will depend on the facts and circumstances, such as the sophistication of the client, the services provided, and the material fact or conflict. The disclosure "must be clear and detailed enough for the client to make an informed decision to consent to the conflict of interest or reject it."[87] The Commission acknowledges that effective disclosure may differ depending on the sophistication of the client.

5. An adviser must "eliminate or at least expose" conflicts relating to the allocation of investment opportunities. In the Proposed Fiduciary Interpretation, the Commission had stated that "an adviser must treat all clients fairly."[88] The Commission removed this language to accommodate an allocation of a particular investment to one client instead of another client. Further, the allocation does not need to be *pro rata* and can consider the nature and objectives of different clients. However, an allocation practice "must not prevent [an adviser] from providing advice that is in the best interest of its clients."[89]

6. Informed consent may be explicit or implicit. However, an IA may not infer or accept consent where "the adviser was aware, or reasonably should have been aware, that the client did not understand the nature and import of the conflict."[90]

7. In cases where an adviser "cannot fully and fairly disclose a conflict of interest" to obtain informed consent because of its complexity, the adviser should eliminate the conflict or mitigate it to the extent that it can be properly disclosed to obtain consent. This was a modification from the Proposed Fiduciary Interpretation that stated not all conflicts could be resolved by disclosure alone.

---

[82] *Id.* at 21-22 n.54.

[83] *Id.*

[84] *Id.* at 23.

[85] *Id.* at 23 n.57.

[86] *Id.* at 23 (emphasis added).

[87] *Id.* at 26.

[88] *Id.* at 27 n.66. *See also* Proposed Fiduciary Interpretation at 21208.

[89] Fiduciary Interpretation Adopting Release at 27.

[90] *Id.*

D. Comments on Enhancing Investment Adviser Regulation

The Proposed Fiduciary Interpretation sought comments on three potential enhancements to SEC-registered IAs' legal obligations in areas where the BD framework does not have counterparts in the IA context: (1) federal continuing education and licensing requirements; (2) requirements relating to the provision of account statements; and (3) financial responsibility obligations. The Commission noted that it is continuing to evaluate comments received on these issues and did not adopt any changes at this time.

IV. Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser

The Commission also issued an interpretation regarding what advisory services are "solely incidental" to a BD's business.[91] The Commission noted that to the extent there is inconsistency between this Solely Incidental Interpretation and any prior Commission interpretations relating to the solely incidental prong this latest guidance supersedes those earlier interpretations.[92]

A. Background and General Scope

The Advisers Act defines an "investment adviser" as "any person who, for compensation, engages in the business of advising others" about securities,[93] but excludes from the definition "any broker or dealer whose performance of such services is *solely incidental* to the conduct of his business as a broker or dealer and who *receives no special compensation* therefor."[94] Both conditions must be met. The Commission notes that this exclusion is an acknowledgement that BDs provide certain advisory services as part of the brokerage business.

The Commission explains that the exclusion is designed to address those situations in which advice relates to the BD's business of buying and selling securities.[95] The Commission notes that the "quantum or importance" of the investment advice is not relevant if the BD's primary goal is its brokerage business.[96] Accordingly, "[a]dvice need not be trivial, inconsequential, or infrequent to be consistent with the solely incidental prong."[97]

B. Guidance on Applying the Interpretation of the Solely Incidental Prong

The Solely Incidental Interpretation focuses on two issues: (1) investment discretion and (2) account monitoring.

1. *Investment Discretion.* As discussed above, the Solely Incidental Interpretation makes clear that the Commission, courts, and Congress recognize that BDs provide investment advice in connection with their business to buy and sell securities. However, the investment advice cannot be the primary goal of the transaction.

---

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

[92] *Id.* at 12 n.46.

[93] Advisers Act Section 202(a)(11).

[94] Advisers Act Section 202(a)(11)(C) (emphasis added). We will not discuss the special compensation prong as it was not a topic of the interpretation. The Commission noted that its views on the prong are clear. Solely Incidental Interpretation Adopting Release at 6 n.17.

[95] The Commission addressed a federal appellate court case that interpreted the scope of the exclusion as adopted. The Commission summarized the recent judicial conclusion as "a broker-dealer's investment advice is solely incidental to its conduct as a broker-dealer if the advice is given 'only in connection with the primary business of selling securities.'" *Id.* at 11 (quoting *Thomas v. Metro. Life Ins. Co.*, 631 F.3d 1153, 1164 (10th Cir. 2011)).

[96] *Id.* at 12.

[97] *Id.* at 13.

The Solely Incidental Interpretation provides that when a BD is exercising investment discretion over a client's account it is no longer providing advice to customers and is making investment decisions. Accordingly, a BD relying on the exclusion may not exercise "unlimited discretion" (i.e., "the ability to buy and sell securities on behalf of a customer without consulting the customer").[98]

However, the Commission confirms that a BD may exercise discretion on a "temporary or limited basis" with general limitations in time, scope, or other manner and stay within the "solely incidental" exclusion. A review of what limitations are sufficient to stay within the exclusion depends on the facts and circumstances and the totality of the circumstances, but comprehensive and continuous discretion would be characteristics of full discretion and must be avoided. For example, the Commission notes that limited discretion regarding the price or timing for a specific transaction, or the purchase of a bond with a specified credit rating or maturity would be permissible, but investment discretion for a period of a few months could indicate a primarily advisory relationship.[99]

The Commission expressly clarified that a BD relying on the solely incidental exclusion is permitted (a) to buy or sell securities to "satisfy margin requirements, or other customer obligations that the customer has specified" such as a collateral call and (b) to sell specific bonds or other securities to allow a customer to realize a tax loss on the original position.[100]

2. *Account Monitoring.* The Commission states that an agreement by a BD to monitor a customer's account must be carefully considered because such activity may indicate a primarily advisory relationship. However, the Commission does not consider "voluntary review" of a customer's account by a BD to be "account monitoring."[101] Thus, a BD relying on the exclusion may voluntarily and without any agreement with the customer review the holdings in a customer's account for purposes of deciding whether to make an investment recommendation.

Disagreeing with some commenters who considered any monitoring to be outside the scope of "solely incidental," the Commission notes that a BD may agree to monitor accounts "on a periodic basis for purposes of providing buy, sell, or hold recommendations [and] may still be considered to provide advice in connection with and reasonably related to effecting securities commissions."[102] The key to whether such monitoring would be "solely incidental" to the BD's business depends on the facts and circumstances, including the frequency and nature of the review. The Commission declined to address each circumstance of permitted "agreed-upon monitoring" but indicated that a BD's policies and procedures may outline permitted practices.

Any agreement to monitor a retail customer's account, including on a periodic basis (e.g., quarterly), would trigger the implicit hold recommendation obligations under Reg BI.[103] The scope and frequency of a BD's monitoring would also be a material fact that should be disclosed in the Form CRS relationship summary and pursuant to Reg BI's Disclosure Obligation.

---

[98] *Id.* at 14-16. The Commission stated that "unlimited discretion to effect securities transactions possesses ongoing authority over the customer's account indicating a relationship that is primarily advisory in nature" such that the relationship could not be primarily to buy and sell securities and would not be incidental to the brokerage business. *Id.* at 16.

[99] *See id.* at 17-18 for discussion of examples of temporary or limited discretion.

[100] *Id.* at 18.

[101] *Id.* at 20.

[102] *Id.* at 19-20. "A broker-dealer disclosing to a customer that the broker-dealer will provide monitoring constitutes an agreement to monitor." *Id.* at 21 n.70.

[103] "[B]y 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. For example, if a broker-dealer agrees to monitor the retail customer's account on a quarterly basis, the quarterly review and each resulting recommendation to purchase, sell, or hold, will be a recommendation subject to Regulation Best Interest. This is the case even in instances where the broker-dealer does not communicate any recommendation to the retail customer. We believe that such an "implicit" recommendation to hold in this context should be covered under Regulation Best Interest in addition to "explicit" recommendations to hold." Reg BI Adopting Release at 103 (footnotes omitted). *See also* discussion *supra* at 6.

V. Conclusion

The SEC's new Reg BI, Form CRS relationship summary, and Advisers Act interpretations, collectively, will significantly change the regulatory landscape for financial professionals providing services to retail customers. For almost two decades, the SEC has been considering standards of conduct for investment professionals, and the new rules and interpretations represent the culmination of those efforts. Going forward, firms will need to evaluate and, as appropriate, enhance their compliance and supervisory regimes, as well as their operational processes, for compliance with Reg BI and Form CRS. While the standard of conduct concept of Reg BI and the disclosure concept of Form CRS are, themselves, straightforward, the practical aspects of implementation will be challenging for firms. There is no doubt there will be many questions and a need for clarification as firms analyze the new regulations over the coming months. The SEC has set forth a very aggressive schedule – approximately one year – for firms to complete this assessment and implement policies and procedures to comply with the new regulations. It remains to be seen how aggressively and quickly FINRA and the SEC will review firms for compliance with these new regulations.

For more information on this or other securities matters, contact:

Yoon-Young Lee +1 202 663 6720 yoon-young.lee@wilmerhale.com

Stephanie Nicolas +1 202 663 6825 stephanie.nicolas@wilmerhale.com

Amy R. Doberman +1 212 295 6270 amy.doberman@wilmerhale.com

Bruce H. Newman +1 212 230 8835 bruce.newman@wilmerhale.com

Andre E. Owens +1 202 663 6350 andre.owens@wilmerhale.com

Tiffany J. Smith +1 212 295 6360 tiffany.smith@wilmerhale.com

Jeremy Moorehouse +1 202 663 6522 jeremy.moorehouse@wilmerhale.com

Mahlet Ayalew +1 202 663 6903 mahlet.ayalew@wilmerhale.com

Joseph M. Toner +1 202 663 6982 joseph.toner@wilmerhale.com

Cristina Jaramillo +1 202 663 6480 cristina.jaramillo@wilmerhale.com