GROOM LAW GROUP

Publications

SEC Adopts Regulation Best Interest And Related Rules

ATTORNEYS & PROFESSIONALS

Jon Breyfogle
jbreyfogle@groom.com
202-861-6641

Jim Cole
jcole@groom.com
202-861-0175

Jennifer Eller
jeller@groom.com
202-861-6604

Michael Kreps
mkreps@groom.com
202-861-5415

Jason Lee
jlee@groom.com
202-861-6649

David Levine
dlevine@groom.com
202-861-5436

Thomas Roberts
troberts@groom.com
202-861-6616

George Sepsakos
gsepsakos@groom.com
202-861-0182

Kevin L. Walsh
kwalsh@groom.com
202-861-6645

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On June 5, 2019, the Securities and Exchange Commission ("SEC") voted, three Commissioners to one, to adopt a package of new rules and interpretations "designed to enhance the quality and transparency of retail investors' relationships with investment advisers and broker-dealers." These include:

- **Regulation Best Interest ("Reg BI" or the "Regulation")** establishes a new standard of conduct for a broker-dealer and natural persons who are associated persons of the broker-dealer when making a recommendation to a retail customer of any securities transaction or investment strategy involving securities – including retirement plan rollover recommendations.

- **New Form CRS Relationship Summary ("Form CRS")** is intended to assist retail investors with their initial selection of, and ongoing decision to maintain an existing relationship with, a financial professional or firm by summarizing in one place certain specified information about the broker-dealer or investment adviser.

- **Investment Adviser Interpretation ("Adviser Interpretation")** clarifies certain aspects of the standard of conduct applicable to registered investment advisers under section 206 of the Investment Advisers Act of 1940 ("Advisers Act").

- **"Solely Incidental" Interpretation** was issued in response to certain comments received by the SEC in connection with the Reg BI proposal, and is intended to clarify the broker-dealer exclusion from the definition of "investment adviser" under section 202(a)(11)(C) of the Advisers Act.

The first three items were first proposed in April, 2018, very shortly after the vacatur of the Department of Labor's Fiduciary Rule and Best Interest Contract Exemption ("BICE"). In many ways, that proposal was designed to be consistent with the vacated Department of Labor ("DOL") guidance, though the final rules also differ in certain important ways. Links to these and related SEC materials may be found on Groom's website at https://www.groom.com/resources/sec-finalizes-regulation-best-interest-form-crs-disclosure-and-interpretive-guidance-compliance-required-by-june-30-2020/

Now that these Rules have been adopted, the industry is waiting to see (and in some cases actively trying to influence) what conforming guidance, if any, DOL will issue with respect to advice to individual retirement plan investors generally, and individual retirement account ("IRA") rollovers in particular.

Below we review each of the new rules as they relate to IRA and other retirement plan advice, and consider, as relevant, how DOL may respond.

Regulation Best Interest

Reg BI provides for a new standard of conduct that is not an explicit fiduciary standard as some have advocated, but as the SEC points out the standard does draw upon certain fiduciary concepts, particularly those found in the Advisers Act. The intent of the SEC was to create a "fiduciary-like" standard for governing firm and representative conduct, while accommodating and preserving the broker-dealer model, which SEC noted is largely transaction-based. The SEC preferred this approach over a uniform fiduciary standard applicable to both broker-dealers and investment advisers.

Of particular interest to the retirement services industry is the inclusion of rollover and account opening advice *even in the absence of specific securities recommendations*. This means that the "best interest" standard of care, all of the disclosure obligations, and the conflict prevention and mitigation obligations discussed below apply to recommendations made by a representative of a broker to open an IRA or to roll over to an IRA.

As a result, with respect to retail customers, a financial services firm will apply (i) Reg BI's standard of conduct when acting as a broker-dealer and (ii) the fiduciary standard under the Advisers Act when acting as an investment adviser. The SEC provides some (but limited) guidance in its rulemaking regarding how dual-registrants should act depending on the "hat" they are wearing, i.e., broker-dealer versus investment adviser. Additionally, a broker-dealer or investment adviser could be subject to the fiduciary duty and prohibited transaction provisions under the Employee Retirement Income Security Act of 1974, as amended ("ERISA") with regard to ERISA-covered plan participants and the prohibited transaction provisions under section 4975 of the Internal Revenue Code of 1986, as amended (the "Code") with regard to IRAs and other non-ERISA tax preferred accounts. SEC Chairman Clayton expressed a desire to minimize inconsistency in between its rulemaking efforts establishing standards of conduct and DOL's and the states' efforts in this area. Only time will tell whether the SEC's efforts in this regard have been successful.

A. Overview

Brokers, dealers, and their associated persons who are natural persons[1] must comply with Reg BI when they make "recommendations" regarding the purchase, sale or exchange of any security or any investment strategy involving securities. Additionally, such recommendations must be made to a retail customer (discussed below).

1. What is a "recommendation"?

The SEC intends that the meaning of the term "recommendation" for purposes of Reg BI be interpreted in accordance with current SEC regulations and guidance under the anti-fraud provisions of the Securities Exchange Act of 1974, as amended ("Exchange Act") and in accordance with the meaning of the term "recommendation" applied by the Financial Industry Regulatory Authority ("FINRA"). Reg BI applies to "recommendations" made on or after June 30, 2020.

The following are examples in the rulemaking of "recommendations" for purposes of triggering Reg BI:

- Recommendations of a securities transaction, which can include distribution recommendations from a workplace plan;
- Implicit hold recommendation if a broker agrees to monitor a customer's account and subsequently makes no subsequent recommendation to buy or sell a security; and
- "Account recommendations" which the preamble states include recommendations to roll over or transfer assets from one type of account to another (e.g., workplace retirement plan to an IRA).

2. Which recommendations are covered?

A broker-dealer must comply with Reg BI when it makes a recommendation to a "retail customer." A retail customer means a natural person, or the legal representative of such natural person, who:

- Receives a recommendation of any securities transaction or investment strategy involving securities from a broker-dealer; and
- Uses the recommendation primarily for personal, family, or household purposes.

In the preamble, the SEC made clear that a retail customer does not include the representative, e.g., the named fiduciary, to an ERISA-covered plan, even if the representative is a natural person, so long as the representative is acting on behalf of the *plan* (emphasis added). However, Reg BI applies to participants in ERISA-covered plans and other retirement plans, including governmental plans, with regard to "recommendations" involving investment of plan assets in an individual account plan, e.g., a 401(k), 403(b) or 457 plan, *and* with regard to rollover distributions from such plans. Additionally, Reg BI applies to "recommendations" with regard to the investment of retail customer IRAs, health savings accounts, Coverdell education savings accounts, and Archer medical savings accounts as well as accounts that are not tax-favored, e.g., taxable accounts, nonqualified accounts.

3. What does Reg BI require of brokers?

When a broker-dealer makes a recommendation to a retail customer, they must comply with the standard of conduct set forth in Reg BI. Reg BI requires that the broker-dealer comply with the "General Obligation," which requires that the broker-dealer act in the best interest of the retail customer. Moreover, the broker-dealer must 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 ahead of the interest of the retail customer. The SEC does not define the term "best interest" in the final Reg BI, just as it did not do so in the original proposal. Rather, the SEC sets forth four component parts with which a broker-dealer must apply in order to comply with the standard:

- **Disclosure Obligation.** The broker-dealer, prior to or at the time of the recommendation, provides the retail customer, in writing, full and fair disclosure of:
  - The scope and terms of the relationship, including the material fees and costs that apply to the retail customer's transactions, holdings, and accounts;
  - Material limitations on the securities or strategies that may be recommended including, for example, that the broker-dealer may only be able to recommend proprietary products; and
  - All material facts relating to conflicts of interest associated with the recommendation.

The SEC emphasized the need to disclose particularly important information to the retail customer. Such information includes the capacity in which the broker-dealer is acting, and not using the term "adviser" or "advisor" when only acting as a broker-dealer. Clear disclosure of materials costs is also required.

- **Care Obligation**. The broker-dealer, in making the recommendation, exercises reasonable diligence, care, and skill to do the following:
  - **Reasonable basis that a recommendation is in the best interest of retail customers generally**. 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;
  - **Reasonable basis that a recommendation is in the best interest of the specific customer**. Reasonably 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 ahead of the interest of the retail customer; and
  - **Reasonable basis to believe that a series of recommendations is the best interest of the specific customer**. Reasonably believe that a series of recommended transactions, even if each recommendation is in the retail customer's best interest when viewed in isolation, is not excessive (e.g., churning) 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 making the series of recommendations ahead of the interest of the retail customer.

The Care Obligation in the final rule largely mirrors the language in the SEC's proposal except that the final rulemaking does not use the term "prudence," thus eliminating some of the confusion caused by the use of that term, which is often associated with fiduciary conduct under ERISA. Additionally, the final rule emphasizes the requirement that the broker-dealer may not put its own financial or other interest ahead of the interest of the retail customer and that "costs" should be considered. However, the SEC clarifies that the Care Obligation does not require that a broker-dealer consider every security available in the marketplace or that a broker-dealer only recommend the lowest cost or least remunerative security or strategy.

- **Conflict of Interest Obligation**. The broker-dealer must establish, maintain, and enforce written policies and procedures reasonable designed to do the following:

- Identify and at a minimum disclose in accordance with the Disclosure Obligation or eliminate all conflicts of interest, whether or not material;
- Identify and eliminate sales contests, quotas, bonuses, and non-cash compensation based upon the sales of specific securities or specific types of securities within a limited period of time;
- Identify and mitigate any conflicts of interest that create an incentive for a natural person associated with the broker or dealer to put the interest of the broker, dealer or associated person ahead of the interest of the retail investor; and
- Identify and disclose material limitations securities and investment strategies and prevent them from causing a recommendation that places the interest of the broker, dealer or associated person ahead of the interest of the retail investor.

The SEC emphasized that some conflicts may be mitigated by disclosures and others may not. Additionally, while it stated in Reg BI that certain sales contests, quotas, bonuses, and non-cash compensation are outright prohibited because the conflicts involved are so acute, there could be other practices that give rise to conflicts which are so acute that elimination of the practice is also required under Reg BI. Additionally, the SEC pointed to conflict mitigation strategies regarding the payment of compensation to representatives that are the same as those that most firms adopted or considered adopting for purposes of complying with DOL's BICE.

- **Compliance Obligation.** The broker-dealer must establish, maintain, and enforce policies and procedures reasonably designed to achieve compliance with Reg BI.

Each of these Obligations is discussed in more detail below under B. "Reg BI Standard of Conduct."

4. How will broker-dealer firms comply with Reg BI?

The answer to this question is complex and will vary by firm. However, all firms should consider taking the following steps in the coming weeks and months:

- Identify the firm's retail customers.
- Determine when the firm and its representatives make recommendations versus engaging in other activity not subject to Reg BI, e.g., investment education.
- Identify conflicts that the firm or associated persons may have with regard to compensation.
- Identify conflicts that a firm or associated persons may with regard to the firm's offering of securities such as limitations on the types of securities or strategies available to recommend, classes of securities, or securities that only pay the firm revenue, e.g., revenue sharing.
- Identify all sales contests, quotas, bonuses, and non-cash compensation and eliminate those that are outright prohibited by Reg BI.
- Determine how the firm will address conflicts, e.g., disclosure, mitigation, or a combination thereof.
- Draft policies and procedures designed to allow the firm and its representatives to comply with Reg BI including the Disclosure and Care Obligations.
- Create disclosures or determine what change to current disclosure will be necessary to meet the requirements of Reg BI.
- For dual-registrants, determine how the firm and its representatives will clearly establish and communicate when they are acting as broker-dealers versus investment advisers.

We note that the SEC states in the preamble that "…we believe Reg BI is consistent with many of the key components of the DOL's Impartial Conduct Standards. Reg BI incorporates principles underlying the DOL Fiduciary Rule—such as the concept of conflict mitigation—that, based on our expertise in regulating the broker-dealer industry, we believe would further our goal of reducing the effect of conflicts on recommendations and would promote recommendations in the best interest of the retail customer even where conflicts continue to exist." Therefore, firms should consider the steps they took or that they intended to take to comply with the BICE when they consider what needs to be done to comply with Reg BI.

5. How does Reg BI impact how a firm complies with ERISA and the Code?

Now that the SEC has adopted Reg BI as final, the next question is how Reg BI will impact compliance with the requirements of ERISA and the Code. DOL provides in its 2019 regulatory agenda that EBSA will issue a proposed regulation with regard to the definition of "investment advice" under section 3(21)(A)(ii) of ERISA (https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201904&RIN=1210-AB82). DOL has also publicly stated that it will synchronize DOL's regulation with the SEC's rulemaking; exactly what this means remains to be seen. DOL's efforts could involve a change to the definition of "investment advice," the issuance of exemptive relief, or a combination thereof. Firms should take the opportunity to discuss with DOL how it might best coordinate its own regulatory efforts with those of the SEC. Additionally, firms should consider whether compliance with Reg BI may result in fiduciary status under DOL's current "five-part test."

B. Reg BI Standard of Conduct

As discussed above, the General Obligation to make recommendations in the best interest of the retail customer and to not put the interests of the firm or associated person ahead of the interests of the retail customer consists of four component parts. We explain below each of these in further detail:

1. Disclosure Obligation

Under the Disclosure Obligation, a broker-dealer, prior to or at the time of the recommendation, must provide the retail customer, in writing, full and fair disclosure of:

- All material facts relating to the scope and terms of the relationship with the retail customer including: (a) that the broker, dealer, or such natural person is acting as a broker, dealer or an associated person of a broker-dealer with respect to the recommendation, (b) the material fees and costs that apply to the retail customer's transactions, holdings and accounts and the type and (c) the 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; and
- All material facts relating to conflicts of interest that are associated with the recommendation.

The SEC chose to adopt the materiality standard articulated by the Supreme Court in *Basic v. Levinson*, 485 U.S. 224 (1988): if there is "a substantial likelihood that a reasonable shareholder would consider it important," it needs to be disclosed.

a. Scope of services.

With respect to the type and scope of services, at a minimum a broker-dealer needs to disclose whether or not account monitoring services will be provided, including the scope or frequency of such monitoring, account minimums, and any material limitations on the securities or investment strategies involving securities that may be recommended. Material facts also include the firm's investment approach, philosophy or strategy, and the risks associated with the strategy, as well as any account balance requirements. The SEC retained the new marketing rule from the proposed regulation prohibiting broker-dealers from holding themselves out as an "adviser" or advisor" when it is not registered as one. This requirement is intended to reduce confusion among retail investors about the differences between broker-dealers and investment advisers, the obligations that they owe and how they are compensated.

b. Fee disclosure.

The disclosure of material fees and costs relating to a customer's transactions, holdings and accounts does not include the requirement to include individualized disclosure. Reasonable dollar or percentage ranges are permissible. The disclosure of material limitations on the securities or investment strategies involving securities include recommending only proprietary products or products from a select group of issuers. Since all broker-dealers limit their offerings of securities and investment strategies to a greater or lesser degree, disclosing that a broker-dealer does not offer the entire possible range of securities and strategies is not considered a material limitation.

c. Conflicts of interest disclosure.

Prior to Reg BI, broker-dealers were not required to disclose material conflicts of interest. Under the Regulation, a "conflict of interest" associated with a recommendation means "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 disclosure needs to include the sources and types of direct and indirect compensation. The specific amount of compensation need not be disclosed but such disclosure should be "full and fair" and may require disclosure of the general magnitude of the compensation. While it would not be a violation to recommend a more expensive product, full and fair disclosure of the variable compensation schemes need to be disclosed. The standard is similar to that applicable to investment advisers under the Advisers Act.

d. Disclosure form and timing.

While broker-dealers may choose to standardize their disclosure and use existing disclosures such as prospectuses, account agreements, or fee schedules to satisfy their disclosure obligations, whether such materials would be sufficient depends upon the facts and circumstances. Consistent with the proposed regulation, the SEC noted that compliance to the standard will be measured against a negligence rather than strict liability standard.

A broker-dealer may supplement, clarify, or update written disclosure orally. When making such an oral disclosure, firms must maintain a record of the fact that oral disclosure was provided to the retail customer.

The SEC chose not to provide any prescriptive requirements for the timing and frequency of disclosure other than that broker-dealers need to provide disclosures prior to or at the time of the recommendation. A broker-dealer may decide to provide initial more general disclosure and specific information regarding the material fact or conflict in interest subsequently, but the initial disclosure needs to address when and how a broker would provide the more specific information. Disclosure after the recommendation such as in a trade confirmation alone would not satisfy the disclosure obligation because the disclosure would not be prior to, or at the time of the recommendation, however it can be used to supplement, clarify or update the initial general disclosure.

If there any material changes or inaccuracies, updates to the disclosure should be provided no later than 30 days after the material change. The disclosure can be delivered electronically with the client's consent; paper delivery needs to be available upon request.

2. Care Obligation

Reg BI's Care Obligation has not been significantly changed from the SEC's proposed regulation and continues to generally track the three prongs of FINRA's existing suitability standard (i.e., reasonable-basis suitability, customer-specific suitability, and quantitative suitability). Specifically, the Care Obligation requires that broker-dealers exercise reasonable diligence, care, and skill to:

- Understand the potential risks, rewards, and costs associated with a 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 the retail customer's investment profile and the potential risk, rewards, and costs associated with the recommendation, and does not place the financial or other interest of the broker or dealer, or associated person ahead of the interest of the retail customer; and
- 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 or dealer, or associated person making the series of recommendations, ahead of the interest of the retail customer.

There are three notable changes to the Care Obligation. First, Reg BI removes (as compared to the proposed regulation) the requirement that a broker-dealer exercise "prudence" to meet the Care Obligation. The SEC found the term "prudence" could create legal uncertainty and confusion, and would be redundant where there is already a requirement to exercise "diligence, care, and skill."

Second, the final regulation adds an explicit requirement for broker-dealers to consider costs associated with a recommendation, including costs that may be incurred in the purchase and future sale or exchange of the security. The SEC clarified that cost should be considered as one factor among many. As a result, the SEC states a broker-dealer would not satisfy the Care Obligation by "simply" recommending the least costly or remunerative security, and may recommend a more costly or remunerative security if there are other factors indicating such security would be in the best interest of the retail customer.

Third, the SEC added an explicit requirement that a broker-dealer have a reasonable basis to conclude a recommendation would not place the interest of the broker-dealer ahead of the retail customer. SEC explained this change was made to impose an obligation not found under current FINRA suitability obligations and thereby provide "stronger" protections to retail customers than under the FINRA rules.

We note the SEC stated that if a broker-dealer is not able to obtain information regarding a retail customer's investment profile, it would be required to "carefully consider" whether it has sufficient understanding to properly evaluate whether the recommendation is in the best interest of that retail customer. The SEC also clarified that broker-dealers would not be required to create records to evidence best interest recommendations on a recommendations-by-recommendation basis. Rather, the SEC explained that broker-dealers should be able to explain in "broad terms" the process by which the firm determines what recommendations are in its customers' best interests, and then to explain how that process was applied to any particular recommendation. Additionally, the SEC noted firms should look to FINRA Regulatory Notice 11-25, which permits firms to take a risk-based approach with regard to suitability determinations, when deciding to document determinations made in accordance with the Care Obligation.

3. Conflict of Interest Obligation

The SEC noted that its purpose in proposing the Conflict of Interest Obligation was to "address[] conflicts of interest that may harm investors while providing flexibility to establish systems tailored to broker-dealers' business models." The SEC defines a "conflict of interest" as "an interest that might incline a broker-dealer – consciously or unconsciously – to make a recommendation that is not disinterested." To that end, the Conflict of Interest Obligation requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to identify, disclose, and mitigate or eliminate:

- All conflicts of interest associated with recommendations covered by the Disclosure Obligation under the Reg BI; and
- Conflicts of interest associated with such recommendations that create an incentive for a natural person who is an associated person of a broker-dealer to place the interest of the broker or dealer, or such natural person, ahead of the interest of the retail customer.

The Final Rule also requires policies and procedures reasonably designed to:

- Identify and disclose any material limitations placed on the securities or investment strategies involving securities that may be recommended to a retail customer and any conflicts of interest associated with such limitations, in accordance with the Disclosure Obligation;
- Prevent such limitations on securities or investment strategies and associated conflicts of interest from causing the broker or dealer, or a natural person who is an associated person of the broker or dealer, to make recommendations that place the interest of the broker, dealer, or associated person ahead of the interest of the retail customer; and
- Identify and eliminate any sales contests, sale 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.

The SEC's intent in finalizing the Conflict Obligation, in contrast to the proposed version of Reg BI, was to place a greater focus on conflicts that prohibit a firm and its representatives from placing the retail customer's interest before their own. The SEC, in its view, did so by eliminating the distinction between material conflicts of interest and material conflicts of interest arising from financial incentives as originally proposed and removing the affirmative mitigation requirement at the firm level as originally proposed.

a. Conflict policies and procedures

In recognizing the "importance of the brokerage model as a potentially cost-effective option for investors," the SEC aims not to "eliminate compensation structures and arrangements," but to require broker-dealers to "establish reasonably designed policies and procedures . . . critical to identifying and addressing conflicts of interest." Indeed, the preamble to the final Reg BI makes clear that the "design of policies and procedures should [not] be measured against a standard of strict liability, but should instead be measured against a standard of reasonableness." The SEC reiterates in the preamble the principles set forth in its proposal regarding "reasonably designed" policies and procedures designed to identify conflicts of interest. Such principles include, for example, establishing a structure for identifying the types of conflicts that the broker or dealer (and associated persons of the broker-dealer) may face and providing for an ongoing and regular, periodic (e.g., annual) review for the identification of conflicts associated with the broker-dealer's business. The firm should also establish training procedures designed to help firm representatives identify conflicts of interest, as well as define employees' roles and responsibilities with respect to identifying conflicts of interest.

b. Types of incentives to be mitigated

The final Regulation requires broker-dealers to implement "policies and procedures reasonably designed to" "[i]dentify and mitigate any conflicts of interest associated with . . . recommendations that create an incentive for a natural person who is an associated person of a broker or dealer to place the interest of the broker or dealer, or such natural person ahead of the interest of the retail customer." The SEC notes that this requirement only applies to "incentives provided to the associated person, whether by the firm or third-parties that are within the control of or associated with the broker-dealer's business," and not to "external interests of the associated person not within the control of or associated with the broker-dealer's business." Additionally, the SEC focused on types of incentives that "varie[d] based on the advice given."

Incentives that the SEC generally considers Reg BI to cover include: "(i) compensation from the broker-dealer or from third-parties, including fees and other charges for the services provided and products sold; (ii) employee compensation or employment incentives. . . (e.g., incentives tied to asset accumulation and not prohibited [under the Final Rule such as] special awards, differential or variable compensation, incentives tied to appraisals or performance reviews); and (iii) commissions or sales charges, or other fees or financial incentives, or differential or variable compensation, whether paid by the retail customer, the broker-dealer or a third-party."

c. General flexibility allowed in developing mitigation methods

Notably, the SEC declined to mandate specific mitigation measures so that firms would have the flexibility to develop and tailor reasonably designed policies and procedures applicable to the firm's particular circumstances. The litmus test is whether the policies and procedures "reduce the incentive for the associated person to make a recommendation that places the associated person's or firm's interests ahead of the retail customer's interest."

Even though the SEC did not undertake a "one-size fits all" approach, it did provide the following "non-exhaustive list of practices" that could be used as potential mitigation method:

- Avoid compensation thresholds that disproportionately increase compensation through incremental increases in sales;
- Minimize compensation incentives for employees to favor one type of account over another or one type of product over another by establishing differential compensation based on neutral factors;
- Eliminate compensation incentives within comparable product lines by, for example, capping the credit that an associated person may receive across mutual funds or other comparable products across providers;
- Implement supervisory procedures to monitor recommendations that are near compensation thresholds or for firm recognition or involve the roll over or transfer of assets from one type of account to another (such as recommendations to roll over or transfer assets in an ERISA account to an IRA);
- Adjust compensation for associated persons who fail to adequately manage conflicts of interest"; and
- Limit the types of retail customer to whom a product, transaction or strategy may be recommended.

Interestingly, these potential mitigation methods largely reflect those found in DOL's BICE. The SEC stresses in the preamble that it is not requiring compensation based upon "neutral factors" or any of the other above-described mitigation methods. Each firm needs to determine what mitigation strategies it will employee to address conflicts.

d. Elimination of certain conflicts

Instead of an absolute elimination of all conflicts, the SEC "identif[ied] certain practices that may be more appropriately avoided for certain categories of retail customers." For example, the final Regulation states that broker-dealers are to "establish[], maintain[], and enforce[] written policies and procedures reasonably designed to… [i]dentify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time." The SEC adopted this requirement to eliminate these particular incentives because it "believe[s] these [types of] incentives cannot be adequately mitigated, and are likely to result in recommendations that place the interest of the broker-dealer or associated person ahead of the interests of the retail customer."

In response to commenters' questions regarding which incentives and practices would be prohibited, the SEC clarified that broker-dealers may still provide compensation or other incentives related to sales of "certain general categories of securities (e.g., such as mutual funds, variable annuities, bonds, or equities." Additionally, firms may, for example, base compensation upon total products sold, asset growth or accumulation, and customer satisfaction. Further, a broker-dealer can still offer only proprietary products, place material limitations on the menu of products, and incentivize representatives to sell 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. Similarly, broker-dealers can still offer "training[s]… education meetings… company-sponsored meetings" to representatives provided that such events are not based on the sale of specific securities or type of securities within a limited time period. However, while these incentives and practices are not outright prohibited, a firm should be prepared to demonstrate that the firm and its representatives comply with Reg BI notwithstanding such incentives and practices.

e. Mitigation of conflicts involving material limitations on recommendations

Unlike the original proposal, there is no longer language containing an affirmative mitigation requirement at the *firm* level, as the SEC has "determined to refine [its] approach by generally allowing firm-level conflicts to be generally addressed through disclosure." However, as a result of both this firm-level mitigation change and concerns from commenters relating to the "magnitude of conflicts of interest when broker-dealers recommend, among other things, proprietary products and a limited range of products," the SEC adopted a new requirement mandating broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to (1) identify and disclose any material limitations broker-dealers place on their securities offerings or investment strategies involving securities and any associated conflicts of interest and (2) prevent such limitations and associated conflicts of interest from causing the broker-dealer to make recommendations that place the broker-dealer's interest ahead of the interest of the retail customer.

The SEC notes that broker-dealers, when drafting such policies and procedures, should "consider establishing product review processes for products that may be recommended, including establishing procedures for identifying and mitigating the conflicts of interests associated with the product, or declining to recommend a product where the firm cannot effectively mitigate the conflict, and identifying which retail customers would qualify for recommendations from this product menu." The SEC, however, emphasizes that firms can still offer "proprietary products or other limited range of products so long as they comply with final Reg BI.

4. Compliance Obligation

In addition to the policies and procedures required to comply with the Conflict Obligation, the broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Reg BI, which is called the Compliance Obligation. A separate Compliance Obligation was not part of the SEC's original proposal. The SEC added this obligation to make clear that firms must have in place policies and procedures intended to aid the firm and its representatives to comply with Reg BI overall. In other words, in addition to policies and procedures designed to allow compliance with the Conflicts of Interest Obligation, the firm should also have policies and procedures designed to promote compliance with the Disclosure Obligation and the Care Obligation. The SEC does not mandate how a firm should develop these policies and procedures, but rather states that "[a] firm's compliance policies and procedures should be reasonably designed to address and be proportionate to the scope, size, and risks associated with the operations of the firm and the types of business in which the firm engages."

C. Conclusion

Reg BI will impact the way that brokers, dealers, and their representatives interact with retail consumers, including retirement plan participants and IRA owners, in a profound way. Covered service providers in the retirement industry will want to allocate resources towards reviewing their practices, particularly their rollover practices, and bringing those practices in line with both the SEC guidance and any obligations imposed by ERISA. Firms should also be looking to see how Reg BI will impact future guidance issued by DOL regarding the definition of "investment advice" and exemptive relief on which firms and their associated persons may have to rely if they act as a fiduciary under the "five-part test" or otherwise act as a fiduciary per future regulations or other guidance issued by DOL.

Form CRS

Accompanying Reg BI is a significantly revised Form CRS Relationship Summary. Form CRS is intended to assist retail investors with their initial selection of, and ongoing decision to maintain an existing relationship with, a financial professional or firm by summarizing in one place certain specified information about the broker-dealer or investment adviser.

The Form CRS is intended to be less prescriptive, shorter, and easier for investors to understand than the proposed Form CRS released on April 18, 2018. To that end, the SEC has imposed a two-page (or an equivalent length for electronic disclosure) limit on Form CRS (four pages for dual registrants) in which the financial professional or firm must describe: "(i) the types of client and customer relationships and services the firm offers; (ii) the fees, costs, conflicts of interest, and required standard of conduct associated with those relationships and services; (iii) whether the firm and its financial professionals currently have reportable legal or disciplinary history; and (iv) how to obtain additional information about the firm."

The Form CRS must be organized under a question and answer format, which the SEC refers to as "conversation starters." The SEC expects that retail investors will be able to use these conversation starters to engage in a "dialogue with their financial professionals about their individual circumstances."

A. Definition of "Retail Investor"

For purposes of the Form CRS, a "retail investor" is 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." The definition does not include any limitation or distinction on the basis of net worth. It is essentially consistent with the definition of "retail customer" for purposes of Reg BI.

As with Reg BI, the SEC clarified that a "retail investor" includes "a natural person seeking to select and retain a firm to provide brokerage or advisory services for his or her own retirement account, including but not limited to IRAs and individual accounts in workplace retirement plans, such as 401(k) plans and other tax-favored retirement plans." Therefore, a Form CRS must be delivered to a retirement plan participant that is seeking advice regarding the distribution of their retirement account assets or the investment of the proceeds of that distribution. However, the SEC clarified that neither retirement plan participants "when making certain ordinary plan elections" nor plan representatives seeking services for a retirement plan will generally be retail investors for purposes of the Form CRS delivery obligation.

B. Delivery of Form CRS

1. Broker-Dealers

A broker-dealer must deliver an initial Form CRS to each new or prospective customer who is a retail investor before or at the earliest of:

- recommending an account type, a securities transaction, or an investment strategy involving securities;
- placing an order for the retail investor;
- the opening of a brokerage account for the retail investor;
- opening a new account that is different from the retail investor's existing account(s);
- recommending that the retail investor roll over assets from a retirement account into a new or existing account or investment;or
- recommending or providing a new brokerage service or investment that does not necessarily involve the opening of a new account and would not be in an existing account.

For broker-dealers registered with the SEC prior to June 30, 2020, the initial Form CRS must be filed with the SEC by June 30, 2020 and furnished to existing clients and customers within 30 days of the date on which it is required to be filed.

Thereafter, a broker-dealer must post a current copy of the Form CRS on its website, deliver an updated copy of the broker-dealer's Form CRS within 30 days of a request and deliver and communicate any changes to the Form CRS to its existing clients or customers within 60 days of the date that the Form CRS must be updated.

2. Registered Investment Advisers

An investment adviser must deliver an initial Form CRS to each new or prospective customer who is a retail investor before or at the time of entering into an investment advisory contract with the retail investor. Additionally, an investment adviser must deliver an updated Form CRS to an existing client before or at the time of:

- opening a new account that is different from the retail investor's existing account(s);
- recommending that the retail investor roll over assets from a retirement account into a new or existing account or investment;or
- recommending or providing a new investment advisory service or investment that does not necessarily involve the opening of a new account and would not be in an existing account.

An investment adviser is required to furnish its initial Form CRS to its existing clients within 30 days of the date on which it is required to file its Form CRS with the SEC.

Thereafter, an investment adviser must post a current copy of the Form CRS on its website, deliver an updated copy of the adviser's Form CRS within 30 days of a request and deliver and communicate any changes to the Form CRS to its existing clients or customers within 60 days of the date the update to the Form CRS are required to be made.

Dual registrants are required to deliver a Form CRS at the earlier of the requirements for investment advisers or broker-dealers.

C. Notable Content Requirements

The Form CRS "should be concise and direct, and firms must use plain English and take into consideration retail investors' level of financial experience." Notably, the Form CRS's requirements can be tailored to what is applicable to a particular firm. Therefore, firms or financial professionals "may omit or modify required disclosures or conversation starters that are inapplicable to their business, or specific wording required by the final instructions that is inaccurate."

1. Introductory Paragraph with Link to SEC Investor Website

Form CRS requires that the introductory paragraph "(i) state the name of the broker-dealer or investment adviser and whether the firm is registered with the Securities and Exchange Commission as a broker-dealer, investment adviser, or both; (ii) indicate that brokerage and investment advisory services and fees differ and that it is important for the retail investor to understand the differences; and (iii) state that free and simple tools are available to research firms and financial professionals at the SEC's investor education website, https://www.investor.gov/CRS, which also provides educational materials about broker-dealers, investment advisers, and investing."

The required link to the SEC's website will direct investors to various investor education information, including information about "investment advisers, broker-dealers, and individual financial professionals and other materials," including general investing information and guidance on fees.

2. Description of Services

The Form CRS requires firms to state whether they offer "brokerage services, investment advisory services, or both" and "to summarize the principal services, accounts, or investments the firm makes available to retail investors" as well as any "material limitations" that may inhibit the firm from providing such services. The Form CRS no longer requires – as was originally proposed – that the firm provide affirmative disclosures, including the requirement that standalone investment advisers state that they do not provide brokerage services, and vice versa.

Instead, the final Form CRS requires that all firms address the following four aspects of their services:

- **Monitoring**. Both broker-dealers and investment advisers are required "to explain whether or not they monitor retail investors' investments, including the frequency and any material limitations of that monitoring, and if so, whether or not the monitoring services are part of the firm's standard services."
- **Investment Authority**. Discretionary investment advisers are required to describe those discretionary services and delineate any material limitations on the discretionary authority that they will accept. On the other hand, broker-dealers "may, but are not required, to state whether they accept limited discretionary authority." In addition, "[b]oth investment advisers that offer non-discretionary services and broker-dealers must explain that the retail investor makes the ultimate decision regarding the purchase or sale of investments."
- **Limited Investment Offerings**. Firms must explain "whether or not they make available or offer advice only with respect to proprietary products, or a limited menu of products or types of investments. If so, they must also describe the limitations."
- **Account Minimums and Other Requirements**. Firms must explain "whether or not the firm has any requirements for retail investors to open or maintain an account or establish a relationship, such as minimum account size or investment amount."

3. Description of Fees, Conflicts of Interest, and Standard of Conduct

a. Fees and Conflicts

The Form CRS requires firms to "summarize the principal fees and costs that retail investors incur with respect to their brokerage and investment advisory accounts, and the conflicts of interest they create." However, the SEC did not prescribe specific wording about conflicts, rather it requires that firms "discuss the conflicts of interest created by their principal fees and costs." The Form CRS also requires that firms "describe other fees and costs related to their brokerage and investment advisory services and investments, in addition to the firm's principal fees and costs, that the retail investor will pay directly or indirectly," such as "custodian fees, account maintenance fees, fees related to mutual funds and variable annuities, and other transactional fees and product-level fees."

In addition, the final rule requires that the Form CRS include the following affirmative statement and "conversation starter" regarding fees:

"You will pay fees and costs whether you make or lose money on your investments. Fees and costs will reduce any amount of money you make on your investment over time. Please make sure you understand what fees and costs you are paying."

"Help me understand how these fees and costs might affect my investments. If I give you $10,000 to invest, how much will go to fees and costs, and how much will be invested for me."

"How might your conflicts of interest affect me, and how will you address them?"

b. Use of the term "fiduciary" when describing standard of conduct

The Form CRS retains the Proposal's requirement that broker-dealers, investment advisers, and dual registrants include a brief statement describing the standard of conduct to which they are subject. Significantly, however, the Form CRS does not require using "fiduciary" when describing the standard of conduct. Instead, the Form CRS requires that both broker-dealers and investment advisers describe that they must act in the "best interest" of the retail investor. The SEC notes that requiring broker-dealers and investment advisers to use the term "best interest" will clarify for retail investors their firm's legal obligations "regardless of whether that obligation arises from Regulation Best Interest or an investment adviser's fiduciary duty under the Investment Advisers Act."

Investment Adviser Interpretation

The third part of the SEC's June 5 package is the "final interpretation" (the Adviser Interpretation) regarding investment advisers' standard of conduct under Section 206 of the Advisers Act. While the Adviser Interpretation tracks the 2018 proposed interpretation (the "Proposed Interpretation") closely, it also contains some changes in response to comments submitted to the SEC by the regulated community and other stakeholders. Below, we summarize certain aspects of the Adviser Interpretation.

A. Key Provisions

Like the Proposed Interpretation, the Adviser Interpretation affirms that investment advisers have fiduciary duties of care and loyalty. These duties apply to the entire adviser-client relationship. Both duties require an investment adviser to "serve the best interest of its client and not subordinate its client's interest to its own. In other words, the investment adviser cannot place its own interests ahead of the interests of its client." An investment adviser must provide investment advice in the best interest of its client based on the client's objectives. And the adviser must eliminate or make full and fair disclosure of all conflicts of interest which might cause the adviser to give advice that is not disinterested so that a client can provide informed consent to the conflict.

Importantly, the Adviser Interpretation does not itself create any new legal obligations for investment advisers. Nor is the Adviser Interpretation the exclusive source of an investment advisers' fiduciary duties – the SEC acknowledged that ERISA and other statutes also impose obligations on investment advisers. Moreover, the SEC declined some commenters' requests to codify investment advisers' fiduciary duties in rule text, preferring that a "principles-based approach should continue as it expresses broadly the standard to which investment advisers are held while allowing them flexibility to meet that standard in the context of their specific services."

B. Contracting Flexibility and Client Needs

The Adviser Interpretation clarifies that investment advisers and their clients can determine the scope of their advisory relationship, and that the fiduciary duty owed by investment advisers "follows the contours of the relationship between the adviser and its client." The Adviser Interpretation also acknowledges that an investment adviser's obligations may differ depending on whether the client is a retail investor or an institutional investor. This flexible approach to shaping the advisory relationship and the recognition that different clients have different needs are themes that run throughout the Adviser Interpretation.

C. Fiduciary Duty of Care

Like the Proposed Interpretation, the Adviser Interpretation affirms that the duty of care comprises three components: (i) the duty to provide advice in the best interest of clients; (ii) the duty to seek best execution of client transactions; and (iii) the duty to provide advice and monitoring over the course of the advisory relationship. The duty applies to *all* investment advice, including advice about whether to roll over assets from a retirement plan into a new account that the adviser or its affiliate manages, advice regarding investment strategy, advice to engage a subadvisor and advice about account type (whether commission-based or fee-based).

In providing "best interest" advice, an investment adviser must make a reasonable inquiry into its client's financial situation, level of financial sophistication, investment experience, and financial goals. The SEC notes that the nature and extent of this inquiry, and the obligation to update the client's profile, *may differ for retail clients and institutional clients*. The SEC further notes that advisers should generally apply "heightened scrutiny" to their assessment of high-risk products for retail clients. Importantly, as under Reg BI, cost is only one factor in the best interest analysis. An investment adviser is not required to recommend the lowest cost investment product or strategy, nor would it satisfy its fiduciary duty by simply advising clients to invest in the lowest cost or least remunerative product or strategy.

In seeking "best execution," the determinative factor is not the lowest possible commission cost; rather, the important inquiry is "whether the transaction represents the best qualitative execution." In providing advice and monitoring over the course of the advisory relationship, the scope of the agreed relationship is the driving consideration. For example, ongoing advisory relationships generally will require relatively extensive advice and monitoring, while relationships of limited duration are unlikely to trigger a monitoring duty.

D. Fiduciary Duty of Loyalty

The duty of loyalty requires an adviser to not subordinate his client's interests to its own, and to make full and fair disclosure of all material facts relating to the advisory relationship, including the capacity in which the advisor or firm is acting. Importantly, investment advisers must eliminate *or* expose through full and fair disclosure all conflicts which might cause them to render advice that is not disinterested. However, while disclosure and informed consent are necessary conditions of the duty of loyalty, they are not sufficient. (As noted, advisers must act in the "best interest" of their clients, *in addition to* discharging their disclosure obligation.)

Disclosures must be sufficiently specific so that clients can understand material facts or conflicts of interest and make informed decisions regarding consent. Full and fair disclosure may differ for retail clients and institutional clients. Moreover, investment advisers are not required to make affirmative determinations that particular clients understood the disclosure and that the client's consent to the conflict was informed. Nor must disclosures be in writing. However, the SEC cautions that some conflicts may be incapable of full and fair disclosure and consent. In those cases, conflict elimination or mitigation is required.

E. Potential Implications for the ERISA Market

There are a few circumstances in which an investment adviser could be subject to fiduciary obligations under the Advisers Act but not under ERISA. For example, an adviser could agree to provide a one-time financial plan, or advice with respect to investment strategy broadly, to a plan participant and arguably avoid ERISA fiduciary status under DOL's 5-part test for advice fiduciary status. In this regard, we understand that the DOL is coordinating with the SEC and intends to issue its own rule or exemption complementing the SEC's recently-released Reg BI. We expect that DOL's rulemaking will include some effort to harmonize the SEC's interpretation of the Advisers Act's fiduciary standards with those imposed by ERISA. For now, investment advisers must be mindful of both standards in advising ERISA plan clients, including areas where there is not complete overlap of the two standards.

The Solely Incidental Interpretation

The SEC's regulatory package also included a relatively short, but critically important, interpretation of the broker-dealer exclusion from the definition of "investment adviser" under Section 202(a)(11)(C) of the Advisers Act. The Solely Incidental Interpretation is a response to the SEC's observation that comments it had received on the Reg BI proposal indicated a certain level of confusion and disagreement concerning when the provision of investment advice by broker-dealers is consistent with the "solely incidental" prong of the Section 202(a)(11)(C) exclusion. Under the Solely Incidental Interpretation, whether a recommendation is "solely incidental" turns on the primary business purpose of the recommendation. In short, broker-dealers can meet on the "solely incidental" prong of the exclusion "if the advice is provided in connection with and is reasonably related to the broker-dealer's primary business of effecting securities transactions." The Solely Incidental Interpretation includes two examples of its application concerning, respectively, exercises of broker-dealer discretion over customer accounts and certain types of account monitoring.

Section 202(a)(11)(C) provides that a broker-dealer whose performance of advisory services is (1) "solely incidental to the conduct of its business as a broker or a dealer" and who (2) "receives no special compensation" for those services is excluded from the statute's definition of "investment adviser." With respect to the first prong of the exclusion, the SEC expressed concern with the view asserted by some commenters that only the provision of "very limited advice" or advice that would not give rise to an "advice relationship" with a retail customer would be consistent with the notion of "solely incidental" advice.[2]

In the Interpretation, the SEC clarified that the scope of the "solely incidental" prong is actually quite broad. Referring to its 2005 interpretive guidance on fee-based brokerage accounts and earlier constructions of the term, the SEC indicated the neither the importance nor the frequency of any investment advice furnished by broker-dealers has any bearing on whether the solely incidental prong is satisfied. Further, the SEC unequivocally rejected the view that only minor, insignificant or infrequent advice qualifies for the broker-dealer exclusion. The SEC also cites the 2011 Tenth Circuit case, *Thomas v. Metropolitan Life Insurance Company,* where the court, having indicated that it had found prior Commission guidance on the scope of the solely incidental prong persuasive, determined that "[t]he quantum or importance of the broker-dealer's advice is relevant only insofar as the advice cannot supersede the sale of the product as the 'primary' goal of the transaction or the 'primary' business of the broker-dealer."[3]

Drawing from the *Thomas* decision and its prior interpretive guidance, the SEC crystallized its interpretation of the "solely incidental" prong as follows –

"We interpret the statutory language [of Section 202(a)(11)(C)] to mean that a broker-dealer's provision of advice as to the value and characteristics of securities or as to the advisability of transacting in securities is consistent with solely incidental prong if the advice is provided in connection with and is reasonably related to the broker-dealer's primary business of effecting securities transactions. If a broker-dealer's primary business is giving advice as to the value and characteristics of securities or the advisability of transacting in securities or are not reasonably related to the broker-dealer's business of effecting securities transactions, the broker-dealer's advisory services are not solely incidental to its business as a broker-dealer. Whether advisory services provided by a broker-dealer satisfy the solely incidental prong is assessed based on the facts and circumstances surrounding the broker-dealer's business, the specific services offered, and the relationship between the broker-dealer and the customer."[4]

For purposes of demonstrating the application of the Solely Incidental Interpretation, the SEC furnished guidance on the exercise of investment discretion by broker-dealers over customer accounts and account monitoring by broker-dealers. In this respect, the SEC expressed the view that some limited exercise of discretionary authority could be considered solely incidental to the broker-dealer's business. On the other hand, where a broker-dealer exercises broader discretionary authority over customer securities holdings, it is not providing advice solely incidental to effecting securities transactions and is outside of the exception. The Interpretation identifies the following seven examples of temporary or limited discretion that would not, in and of themselves, support the conclusion that a relationship is primarily advisory and therefore outside of the solely incidental prong –

- The price at which or the time to execute an order by a customer for the purchase or sale of a definite amount or quantity of a specified security;
- On an isolated or infrequent basis, to purchase or sell a security or type of security when a customer is unavailable for a limited period of time;[5]
- As to cash management, such as to exchange a position in a money market fund for another money market fund or cash equivalent;
- To purchase of sell securities to satisfy margin requirements, or other customer obligations as specified by the customer;
- To purchase a bond with a specified credit rating and maturity; and
- To purchase or sell a security or type of security limited by specific parameters established by the customer.

With respect to account monitoring, the Interpretation indicates that monitoring is not necessarily inconsistent with the solely incidental prong so long as the purpose of the monitoring activity is to provide recommendations that are in connection with and reasonably related to effecting securities transactions. Such solely incidental monitoring activity may either be performed voluntarily, without any agreement with the customer, or by agreement so long as the monitoring occurs periodically for purpose of providing buy, sell or hold recommendations at regular intervals.[6] Where, however, a broker-dealer monitors an account in a manner that effectively results in the provision of advisory services not in connection with or reasonably related to the broker-dealer's primary business of effecting securities transactions, such as the provision of continuous monitoring, the activity would fall outside of the solely incidental prong.

The SEC indicated that it will consider further comment on the Solely Incidental Interpretation and its application to other brokerage activities and will evaluate the possibility of supplementing the Interpretation based on any comments received.