

SEC's Standards of Conduct for Investment Professionals Rulemaking Package¹

On April 18th, the Securities and Exchange Commission (“SEC” or “Commission”) voted to propose a package of three rulemakings and interpretations designed to enhance the quality and transparency of investors’ relationships with investment advisers and broker-dealers while preserving access to a variety of types of advice relationships and investment products. These proposals are:

1. Proposed Regulation Best Interest (“Reg BI”). Under Reg BI, a broker-dealer would be required to act in the best interest of a retail customer when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer.
2. Proposed Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the Use of Certain Names or Titles. To help address investor confusion about the nature of their relationships with investment professionals, the Commission also proposed Form CRS Relationship Summary, which is a new short-form disclosure document that would provide retail investors with information about the nature of their relationships with their investment professionals, and would supplement other more detailed disclosures. For an investment professional registered as an investment adviser, additional information would be found in Form ADV. For broker-dealers, disclosures of the material facts relating to the scope and terms of the relationship would be required under a new rule. Investment advisers and broker-dealers also would need to disclose their registration status with the Commission in certain retail investor communications. In addition to the new disclosure requirements, the Commission proposed to restrict certain broker-dealers and their financial professionals from using the terms “adviser” or “advisor” as part of their name or title with retail investors.
3. Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers. Finally, the Commission proposed an interpretation to reaffirm and, in some cases, clarify the Commission’s views of the fiduciary duty that investment advisers owe to their clients.

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I. Proposed Regulation Best Interest

A. Overview

1. Reg BI would be codified in new Rule 15l-1 under the Securities Exchange Act of 1934 (“Exchange Act”).² This rule would establish a standard of conduct for broker-dealers and their natural person associated persons when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer.
 - a) The proposed standard of conduct would be to act in the “best interest” of the retail customer at the time a recommendation is made without placing the financial or other interest of the broker-dealer or natural person who is an associated person making the recommendation ahead of the interest of the retail customer.
 - b) Reg BI applies only with respect to the making of certain recommendations. It does not address or change the standard for other aspects of a broker-dealer’s obligations – such as best execution, fair pricing, and compensation.
2. The general best interest obligation would be satisfied if the following specific obligations are met:
 - a) Disclosure Obligation – Proposed Rule 15l-1(a)(2)(i). The broker-dealer or a natural person who is an associated person of a broker-dealer, before or at the time of such recommendation reasonably discloses to the retail customer, in writing, the material facts relating to the scope and terms of the relationship, and all material conflicts of interest associated with the recommendation;
 - b) Care Obligation – Proposed Rule 15l-1(a)(2)(ii). The broker-dealer or a natural person who is an associated person of a broker-dealer, in making the recommendation, exercises reasonable diligence, care, skill, and prudence;
 - c) Conflict of Interest Obligation – Material Conflicts Associated with the Recommendation – Proposed Rule 15l-1(a)(2)(iii)(A). The broker-dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with such recommendations; and
 - d) Conflict of Interest Obligation – Material Conflicts Arising from Financial Incentives Associated with the Recommendation – Proposed Rule 15l-1(a)(2)(iii)(B). The broker-dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations.

² SEC Proposed Regulation Best Interest (Apr. 18, 2018), *available at* <https://www.sec.gov/news/statements/2018/annex-a-reg-bi-regtext.pdf>. *Regulation Best Interest*, Securities Exchange Act Release No. 83062 (Apr. 18, 2018), *available at* <https://www.sec.gov/rules/proposed/2018/34-83062.pdf> (“Reg BI Proposing Release”).

Failure to comply with any of the four requirements when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer would violate Reg BI.

The SEC observed that in proposing Reg BI, it was “not proposing to amend or eliminate existing broker-dealer obligations, and compliance with Regulation Best Interest would not alter a broker-dealer’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.³ The SEC also made clear that while a broker-dealer would face regulatory liability if it failed to meet its obligation to act in a retail customers’ best interest, Reg BI does not create any new private right of action or right of rescission.

3. What the SEC Means by “Best Interest”

- a) “Best interest” encompasses and goes beyond a broker-dealer’s suitability obligation. The key differences between the Care Obligation and the suitability obligation include the following:
 - The suitability obligation is derived from the antifraud provisions of the federal securities laws, which require an element of fraud or deceit; Reg BI does not require fraud or deceit.
 - The Care Obligation cannot be satisfied by disclosure.
 - The SEC’s interpretation of the Care Obligation would make the cost of the security or strategy, and any associated financial incentives, more important factors (of the many factors that should be considered) in understanding and analyzing whether to recommend a security or an investment strategy involving a security.
 - The Disclosure and Conflict of Interest Obligations are intended to manage the potential impact that broker-dealer conflicts of interest may have on recommendations.
- b) The SEC is not proposing to define “best interest” at this time. Instead, whether a broker-dealer has satisfied its best interest obligation turns on the facts and circumstances of the particular recommendation and the particular retail customer, along with facts and circumstances of how the four specific components of Reg BI are satisfied.
- c) A broker-dealer is not required to recommend the least expensive or least remunerative security or investment strategy involving a security, provided that the broker-dealer complies with the Disclosure, Care, and Conflict of Interest Obligations. Additionally, broker-dealers are not required to find the single “best” alternative for a customer; they are only required to consider reasonably available alternatives offered by the broker-dealer.

³ Reg BI Proposing Release at 42.

- d) Factors to consider when making a recommendation include cost (fees, compensation, and other financial incentives), the product's or strategy's investment objectives, characteristics, (including any special or unusual features), liquidity, risks and potential benefits, volatility and likely performance in a variety of market and economic conditions.
- Cost and financial incentives might be outweighed by the other factors. Thus, a broker-dealer would not satisfy its Care Obligation by simply recommending the least expensive or least remunerative security without any further analysis of the other factors.
- e) If a recommendation is primarily motivated by a broker-dealer's self-interest (e.g., self-enrichment, self-dealing, self-promotion), it violates the Care Obligation and the Conflict of Interest Obligation.
- f) Reg BI would not *per se* prohibit the following (note, however, that does not mean they are necessarily always consistent with Reg BI or other federal securities laws):
- Charging commissions or other transaction-based fees;
 - Receiving or providing differential compensation based on the product sold;
 - Receiving third-party compensation;
 - Recommending proprietary products, products of affiliates or a limited range of products;
 - Recommending a security underwritten by the broker-dealer or an affiliate, including initial public offerings ("IPOs");
 - Recommending a transaction to be executed in a principal capacity;
 - Recommending complex products;
 - Allocating trades and research, including allocating investment opportunities (e.g., IPO allocations or proprietary research or advice) among different types of customers and between retail customers and the broker-dealer's own account;
 - Considering cost to the broker-dealer 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
 - Accepting a retail customer's order that is contrary to the broker-dealer's recommendations.
- g) The proposed approach differs from the recommendations of the Study on investment advisers and broker-dealers mandated by Section 913 of the Dodd-Frank Act in certain respects.
- The Study recommended the adoption of a uniform standard for investment advisers and broker-dealers when providing personalized investment advice to retail investors that was no less stringent than the one that currently

applies to investment advisers, which includes a duty of care (suitability) and a duty of loyalty (disclosure and potential prohibition and mitigation of certain conflicts).

- Rather than creating a new standard or adopting wholesale the obligations and duties that have developed under a separate regulatory regime that address a different type of advice relationship, the proposed approach builds on the current broker-dealer regulatory regime.
- Reg BI draws upon the duties of loyalty and care as interpreted under Section 206(1) and (2) of the Investment Advisers Act of 1940 (“Advisers Act”) to create a standard tailored to broker-dealers.

B. Scope and Key Definitions

1. Natural Associated Persons. Reg BI applies to broker-dealers and any “natural person who is an associated person” of the broker-dealer. For this purpose, the proposal uses the definition of “associated person” under Section 3(a)(18) of the Exchange Act.
2. At the Time Recommendation is Made. Reg BI applies when a broker-dealer is making a recommendation about any securities transaction or investment strategy involving a securities transaction to a retail customer. Although Section 913(f) of the Dodd-Frank Act provides the SEC rulemaking authority to address the standard of care “for providing personalized investment advice about securities to such retail customers,” the term “recommendation” is used instead of “personalized investment advice” because “recommendation” is a term that is interpreted under broker-dealer regulation, whereas “personalized investment advice” is not. In Reg BI, the term recommendation has the meaning it has under FINRA rules and broker-dealer regulation generally. Factors that are considered when determining whether a broker-dealer 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.”⁴
3. Duration of Obligation. The best interest obligation applies at the time the recommendation is made. The best interest obligation does not: (a) extend beyond a particular recommendation or generally require a broker-dealer to have a continuous duty to a retail customer or impose a duty to monitor the performance of the account; (b) require the broker-dealer to refuse to accept a customer’s order that is contrary to the broker-dealer’s recommendation; or (c) apply to self-directed or otherwise unsolicited transactions by a retail customer who may otherwise receive other recommendations from the broker-dealer. The scope of Reg BI cannot be reduced by contract. If the broker-dealer agrees contractually to hold itself to a higher standard, Reg BI still only applies to recommendations.
4. Any Securities Transaction or Investment Strategy. Securities transaction includes sale, purchase, and exchange, and may include recommendations to roll over or

⁴ See FINRA Notice to Members 01-23, Suitability Rule and Online Communications (April 2001), available at <http://www.finra.org/industry/notices/01-23>.

transfer assets from one type of account to another (such as from an ERISA account to an IRA). It currently does not include recommendations of account types generally.

5. **Retail Customer**. The proposed definition is: “a person, or the legal representative of such person, who: (1) receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer or a natural person who is an associated person of a broker or dealer, and (2) uses the recommendation primarily for personal, family, or household purposes.”⁵
 - a) The proposed definition includes institutional investors if they use the recommendation primarily for personal, family, or household purposes.
 - b) The proposed definition is different and in some respects broader than the definition of “retail investor” for purposes of Form CRS.
 - c) The proposed definition is broader than the definition under Section 913(a) of the Dodd-Frank Act because it extends beyond natural persons. It is also broader and different from the definition in FINRA rules.

C. The Elements of the Best Interest Obligation

1. **General Best Interest Obligation**. Proposed Rule 15l-1(a)(1) sets forth the general best interest 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 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.

As noted above, this best interest obligation is satisfied if four specific obligations are met: (i) Disclosure Obligation; (ii) Care Obligation; and (iii) two Conflicts of Interest Obligations.

2. **Disclosure Obligation – Proposed Rule 15l-1(a)(2)(i)**. The broker-dealer or natural person that is an associated person of the broker-dealer, prior to or at the time of such recommendation, reasonably discloses to the retail customer, in writing: (a) material facts relating to the scope and terms of the relationship; and (b) material conflicts of interest that are associated with the recommendation. The rule contemplates a flexible “layered disclosure” model rather than requiring specific disclosures at specified times.
 - a) **Material Facts Relating to the Scope and Terms of the Relationship with the Retail Customer**. The Reg BI Proposing Release provides a non-exhaustive, illustrative list of examples of material facts, including the following.

⁵ Reg BI Proposing Release at 83-84.

- That the broker-dealer is acting in a broker-dealer capacity with respect to the recommendation;
 - Fees and charges that apply to the retail customer’s transactions, holdings, and accounts; and
 - Type and scope of services provided by the broker-dealer, including monitoring (or not monitoring) the performance of the account. Other services not included as part of Form CRS may also be material facts, such as margin, cash management, discretionary authority, access to research, disciplinary history of firms and financial professionals, etc. Broker-dealers are required to determine, based on the facts and circumstances, whether other material facts must be disclosed.
- b) Material Conflicts of Interest that Are Associated with the Recommendation. A “material conflict of interest” is “a conflict of interest that a reasonable person would expect might incline a broker or dealer—consciously or unconsciously—to make a recommendation that is not disinterested.”⁶
- This definition includes, among others, conflicts of interest: (i) arising from financial incentives; or (ii) otherwise associated with the recommendation.
 - Examples include recommending: (i) proprietary products, products of affiliates, or a limited range of products; (ii) one share class versus another share class of a mutual fund; (iii) securities underwritten by the firm or a broker-dealer affiliate; (iv) the rollover or transfer of assets from one type of account to another (e.g., from an ERISA account to an IRA when the recommendation involves a securities transaction); and (v) allocation of investment opportunities among retail customers (e.g., IPO allocation).⁷
- c) Guidance on Reasonable Disclosure. The broker-dealer must “reasonably” disclose material facts, including material conflicts. In order to “reasonably disclose,” a broker-dealer would need to give sufficient information to enable a retail customer to make an informed decision with regard to the recommendation. Compliance will be measured against a negligence standard, and not strict liability.
- “[W]e preliminarily believe that while some forms of disclosure may be standardized, certain disclosures may need to be tailored to the particular recommendation, and some disclosures may be addressed through an initial more generalized disclosure about the material fact or conflict, followed by specific disclosure at another point.”⁸
- d) Form and Manner of Written Disclosure. The proposal 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

⁶ *Id.* at 110.

⁷ *Id.* at 112.

⁸ *Id.* at 116.

communication). Instead, the disclosure will depend on the frequency and level of advice services provided (i.e., one-time, episodic or more frequent basis).

- Some disclosures may be effectively provided in a standardized document at the beginning of the relationship (such as Form CRS), whereas others may need to be tailored to a particular recommendation.
 - Disclosures should be concise, clear, and understandable. They should be provided in plain English, with short sentences and active voice, and avoid legal jargon, highly technical business terms, or multiple negatives. The use of graphics is allowed (and encouraged if helpful).
 - Broker-dealers can deliver the disclosure required consistent with the SEC's guidance regarding electronic delivery of documents.
 - Disclosures must generally be in writing, but the proposal contemplates some situations where prior written disclosure could be supplemented or updated by oral disclosures.
- e) 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 broker-dealers 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)).

Because the Disclosure Obligation is recommendation-specific, a broker-dealer must update the disclosures if there have been any material changes. If a significant amount of time passes between recommendations, the broker-dealer should disclose again, unless it determines the customer should reasonably be expected to be on notice of the disclosure. The broker-dealer must also update Form CRS as appropriate.

3. Care Obligation – Proposed Rule 15l-1(a)(2)(ii). A broker-dealer must exercise reasonable diligence, care, skill, and prudence in making the recommendation to: (a) understand the potential risks and rewards 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; (b) have a reasonable basis to believe the recommendation is in the best interest of a particular retail customer based on that customer's investment profile and the potential risks and rewards associated with the recommendation; and (c) have a reasonable basis to believe a series of recommended transactions is not excessive even if they are in the retail customer's best interest when viewed in isolation.

a) Reasonable Basis Suitability. The requirement to "understand the potential risks and rewards 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 broker-dealer's existing obligation under FINRA "reasonable basis suitability" requirements. This obligation relates to the particular security or investment strategy involving a security recommended rather than to any particular customer. This requires the broker-dealer to consider questions such as:⁹

- Can less costly, complex, or risky products available at the broker-dealer achieve the objectives of the product?
- What assumptions underlie the product, and how sound are they? What market or performance factors determine the investor's return?
- What are the risks specific to retail customers? If the product was designed mainly to generate yield, does the yield justify the risk to principal?
- What costs and fees for the retail customer are associated with this product? Why are they appropriate? Are all of the costs and fees transparent? How do they compare with comparable products offered by the firm?
- What financial incentives are associated with the product, and how will costs, fees, and compensation relating to the product impact an investor's return?
- Does the product present any novel legal, tax, market, investment, or credit risks?
- How liquid is the product? Is there a secondary market for the product?

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 that customer's investment profile and the potential risks and rewards associated with the recommendation" is intended to incorporate and enhance the existing "customer-specific suitability" requirements under FINRA rules. The proposed rule enhances the current obligation by requiring the broker-dealer to have a reasonable basis to believe the recommendation is in the customer's "best interest" rather than "suitable for" the customer. This means, among other things, that the broker-dealer must put the interests of the retail customer ahead of its own.

- The broker-dealer is required to exercise "reasonable diligence" to ascertain the customer's investment profile. If the broker-dealer is unable to obtain

⁹ See *id.* at 139-140.

sufficient information, the broker-dealer 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 broker-dealer does not have a sufficient understanding, then the recommendation is not in the customer's best interest.

- The SEC will interpret the customer-specific obligation consistent with existing precedent, rules, and guidance but subject to the enhanced "best interest" (rather than "suitability") standard.
 - The Care Obligation cannot be met through disclosure alone. For example, a broker-dealer cannot recommend the more expensive of two otherwise identical securities or investment strategies involving a security even if the broker-dealer disclosed that the recommended product or strategy was higher in cost.
- c) Quantitative Suitability. The requirement to "have a reasonable basis to believe a series of recommended transactions is not excessive even if they're in the retail customer's best interest when viewed in isolation" is based on, but is broader than, a broker-dealer's existing obligations under FINRA's "quantitative suitability." Whereas FINRA's obligation applies only if a broker-dealer has actual or *de facto* control over a customer's account, Reg BI would extend this obligation to all recommendations, regardless of whether the broker-dealer exercises such control.
- d) "Prudence." The term "prudence" conveys the importance of conducting a proper evaluation of any securities recommendation in accordance with an objective standard of care. A broker-dealer must consider reasonable alternatives that it offers when determining whether it has a reasonable basis for making a recommendation. This standard does not: (i) require a broker-dealer to consider all possible securities or all other products or investment strategies involving securities to recommend the single "best" security or investment strategy; (ii) necessarily require a broker-dealer to recommend the least expensive or least remunerative security or investment strategy involving a security; nor (iii) prohibit recommending from a limited range of products or recommendations of proprietary products, products of affiliates, or principal transactions, provided all other requirements of Reg BI are met.
4. Conflict of Interest Obligations – Proposed Rule 15c-1(a)(2)(iii). A broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to: (a) identify and disclose, or eliminate, all material conflicts of interest that are associated with recommendations covered by Reg BI; and (b) identify, and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations.
- a) "Material conflicts of interest" has the same definition as it does under the Disclosure Obligation: "[A] conflict of interest that a reasonable person would

expect might include a broker-dealer—consciously or unconsciously—to make a recommendation that is not disinterested.”¹⁰

b) “Material conflicts of interest arising from financial incentives associated with a recommendation” include, but are not limited to: (i) compensation practices established by the broker-dealer, including fees and other charges for the services provided and products sold; (ii) employee compensation or employment incentives (e.g., quotas, bonuses, sales contests, special awards, differential or variable compensation, incentives tied to appraisals or performance reviews); (iii) compensation practices involving third-parties, including both sales compensation and compensation that does not result from sales activity, such as compensation for services provided to third-parties (e.g., sub-accounting, sub-transfer agency, recordkeeping, or other administrative services provided to a mutual fund); (iv) receipt of commissions or sales charges, or other fees or financial incentives, or differential or variable compensation, whether paid by the retail customer or a third-party; (v) sales of proprietary products or services, or products of affiliates; and (vi) transactions that would be effected by the broker-dealer (or an affiliate thereof) in a principal capacity.¹¹

- Broker-dealers are required to disclose and take other additional steps to mitigate or eliminate the conflict (in the case of financial incentives, mitigation is required).
- The Reg BI Proposing Release references the 2013 FINRA Conflict of Interest Report¹² and the 1995 Tully Report¹³ to draw examples of potential practices that would promote compliance by mitigating the conflict, including avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales, minimizing compensation incentives for employees to favor one type of product over another, eliminating compensation incentives with comparable product lines, and implementing supervisory procedures to monitor recommendations involving such potential financial conflicts.
- The Reg BI Proposing Release specifically notes that certain material conflicts arising from financial incentives may be difficult to mitigate and questions whether broker-dealers can ever satisfy their best interest obligation when such conflicts involve recommendations to retail customers or certain categories of retail customers. Such conflicts include certain non-cash compensation such as sales contests, trips, prizes, and other similar bonuses based on sale of certain securities or accumulation of assets under management.

¹⁰ *Id.* at 169.

¹¹ *Id.*

¹² See FINRA Report on Conflicts of Interest (Oct. 2013), available at <https://www.finra.org/sites/default/files/Industry/p359971.pdf> (“FINRA Conflicts Report”).

¹³ See Report of the Committee on Compensation Practices (Apr. 10, 1995), available at <https://www.sec.gov/news/studies/bkrcomp.txt> (“Tully Report”).

- c) Reasonably Designed Policies and Procedures. A broker-dealer must have adequate compliance and supervisory policies and procedures in place (and a system for applying such procedures) to identify and at a minimum disclose (and mitigate in the case of financial incentives) or eliminate material conflicts of interest.
- There is no “one-size-fits all” expectation. Whether a broker-dealer’s policies and procedures are reasonably designed to meet its Conflict of Interest Obligations depends on the facts and circumstances of each case.
 - It is reasonable to use a risk-based compliance and supervisory system rather than conducting a detailed review of each recommendation.
 - Reasonably designed policies and procedures generally should include doing the following:¹⁴
 - define such material conflicts in a manner that is relevant to a broker-dealer’s business and in a way that enables employees to understand and identify conflicts of interest;
 - establish a structure for identifying the types of material conflicts that the broker-dealer (and natural persons who are associated persons of the broker-dealer) may face, and whether such conflicts arise from financial incentives;
 - establish a structure to identify conflicts in the broker-dealer’s business as it evolves;
 - provide for an ongoing and regular, periodic review for the identification of conflicts associated with the broker-dealer’s business; and
 - establish training procedures regarding the broker-dealer’s material conflicts of interest, including material conflicts of natural persons who are associated persons of the broker-dealer, how to identify such material conflicts of interest (and material conflicts arising from financial incentives), as well as defining employees’ roles and responsibilities with respect to identifying such material conflicts of interest.

D. Recordkeeping and Retention

As part of developing a “retail customer’s investment profile,” Reg BI would require broker-dealers to seek to obtain certain retail customer information that is currently not required pursuant to Exchange Act Rule 17a-3(a)(17). Reg BI defines “retail customer’s investment profile” to “include[], but [] not limited to, 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 broker,

¹⁴ See Reg BI Proposing Release at 172-73.

dealer, or a natural person who is an associated person of a broker or dealer in connection with a recommendation.”¹⁵ In addition, it would require broker-dealers to reasonably disclose in writing the material facts relating to the scope and terms of their relationship and all material conflicts of interest that are associated with the investment recommendations. Accordingly, the SEC is proposing certain amendments to Exchange Act Rules 17a-3 and 17a-4, noted below.

1. Exchange Act Rule 17a-3 would be amended to add a new paragraph (a)(25), which would require, 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, as well as the identity of each natural person who is an associated person of a broker-dealer, if any, responsible for the account. The new paragraph would specify that the neglect, refusal, or inability of a retail customer to provide or update any such information would excuse the broker-dealer from obtaining that information.
 - a) Note that this is not the same definition of “retail customer” that Rule 17a-3 currently uses for 17a-3(a)(17), as that provision only applies to natural persons.
2. Exchange Act Rule 17a-4(e)(5) would be amended to require broker-dealers to retain any information that the retail customer provides to the broker-dealer or the broker-dealer provides to the retail customer pursuant to Rule 17a-3(a)(25), in addition to the existing requirement to retain information obtained pursuant to Rule 17a-3(a)(17).
 - a) Broker-dealers would be required to retain all of the information collected from or provided to each retail customer pursuant to Reg BI for six years after the information was collected, provided, replaced, or updated.

E. Scope of Broker-Dealer Exclusion Under Section 202(a)(11)(C) of the Advisers Act

The SEC is revisiting the scope of the broker-dealer exclusion under Section 202(a)(11)(C) of the Advisers Act and soliciting comment on whether the exercise of investment discretion by a broker-dealer should continue to be viewed as solely incidental to the business of a broker-dealer. Citing back to its 2007 rule proposal, the SEC requests comment on a number of questions relating to discretionary services offered by broker-dealers. The SEC also expressed their belief that “much of the financial industry has treated broker-dealers as not excluded from the Advisers Act for any accounts over which they exercise more than temporary or limited investment discretion.”¹⁶

¹⁵ See Exchange Act proposed Rule 15l-1(b)(2); Reg BI Proposing Release at 144.

¹⁶ Reg BI Proposing Release at 204.

II. Proposed Form CRS Relationship Summary and Title Restrictions

A. Form CRS Relationship Summary

1. The SEC proposed two new rules under the Exchange Act and Advisers Act, respectively, that would require SEC-registered investment advisers and broker-dealers to deliver a “relationship summary” to retail investors via Form CRS (in addition to, and not in lieu of, current disclosures and reporting requirements).¹⁷
 - a) New Rule 17a-14 under the Exchange Act would require SEC-registered broker-dealers that offer services to a retail investor to file Form CRS with the SEC and deliver it to: (i) each retail investor before or at the time the retail investor first engages the broker-dealer’s services; and (ii) each retail investor that is an existing client before or at the time a new account is opened that is different from the client’s existing account or changes are made to the client’s existing account that would materially change the nature and scope of the relationship with the retail investor.
 - b) New Rule 204-5 under the Advisers Act would require SEC-registered investment advisers to deliver Form CRS, which would be Part 3 of Form ADV, to: (i) each retail investor before or at the time the investment adviser enters into an investment advisory contract with that retail investor; and (ii) each retail investor that is an existing client before or at the time a new account is opened that is different from the client’s existing account or changes are made to the client’s existing account that would materially change the nature and scope of the relationship with the retail investor.
 - c) In addition, Form CRS would need to be posted prominently on the broker-dealer’s or investment adviser’s website. Changes to Form CRS would need to be communicated to each retail investor who is an existing customer within 30 days after the amendments are required to be made.
 - d) Delivery of this document will not satisfy other disclosure obligations.
2. Key Definitions.
 - a) “Relationship summary” is defined as “a written disclosure statement that firms must provide to retail investors.”¹⁸
 - b) “Retail investor” is defined as “a customer or prospective customer who is a natural person (an individual). This term includes a trust or other similar entity that represents natural persons, even if another person is a trustee or managing agent of the trust.”¹⁹ It includes all natural persons regardless of net worth.

¹⁷ *Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles*, Securities Exchange Act Release No. 83063 and Investment Advisers Act Release No. 4888 (Apr. 18, 2018), available at <https://www.sec.gov/rules/proposed/2018/34-83063.pdf> (“Form CRS Proposing Release”). The instructions to Form CRS are available at <https://www.sec.gov/rules/proposed/2018/34-83063-appendix-b.pdf> (“Form CRS Instructions”).

¹⁸ Form CRS Proposing Release at 15.

¹⁹ See Exchange Act proposed Rule 17a-14(e)(2); Form CRS Proposing Release at 463.

- c) “Current Form CRS” is defined as “the most recent version of the Form CRS.”²⁰
3. Content of Relationship Summary.
- a) Sample Disclosures. The SEC provided sample disclosures or mock-ups, but noted that merely copying these mock-ups may not provide sufficient information to satisfy the disclosure obligations.²¹
- b) Length and Form. The disclosures should be “as short as practicable” (limited to four pages or equivalent if in electronic format, with font and margin size specifications), with a mix of tabular and narrative information. For dual registrants, tabular form is mandatory for certain items.
- c) Items that Must Be Addressed. The following items must be addressed in the disclosures: (i) introduction; (ii) the relationships and services the firm offers to retail investors; (iii) the standard of conduct applicable to those services; (iv) the fees and costs that retail investors will pay; (v) comparisons of brokerage and investment advisory services (for standalone broker-dealers and investment advisers); (vi) conflicts of interest; (vii) where to find additional information, including whether the firm and its financial professionals currently have reportable legal or disciplinary events and who to contact about complaints; and (viii) key questions for retail investors to ask the firm’s financial professional.
- The key questions include ten required questions, and up to four additional questions that a broker-dealer or investment adviser may add. The required questions include ones relating to specific fees and costs associated with the specific customer’s account, conflicts of interest, services provided by the broker-dealer or investment adviser, and disciplinary history.
- d) Additional Disclosures. The relationship summary may not include disclosures other than those that are required or permitted by the Form CRS Instructions.
- e) Language. The language must: (i) be in plain language, taking into consideration the retail investor’s level of financial experience; (ii) be concise and direct; (iii) use short sentences and definite, concrete, every day words; (iv) use active voice; (v) avoid legal jargon or highly technical business terms; (vi) avoid multiple negatives; and (vii) be written addressing the investor, using “you,” “us,” “our firm,” etc.
- f) Full and Truthful Disclosure. All information must be true and may not omit any material facts necessary to make the disclosures required not misleading.
4. Frequency of Delivery.
- a) Initial Delivery. As noted above, broker-dealers and investment advisers must provide initial delivery and ongoing delivery. For investment advisers, initial delivery must be made before or at the time the firm enters into an investment

²⁰ See Exchange Act proposed Rule 17a-14(e)(1); Form CRS Proposing Release at 462.

²¹ For a mock-up for a dual registrant, see <https://www.sec.gov/news/statements/2018/annex-b-1-dual-registrant-mock-up.pdf>. For a mock-up for a standalone broker-dealer, see <https://www.sec.gov/news/statements/2018/annex-b-2-bd-registrant-mock-up.pdf>. For a mock-up for a standalone investment adviser, see <https://www.sec.gov/news/statements/2018/annex-b-3-ia-registrant-mock-up.pdf>.

advisory agreement with the retail investor. For broker-dealers, initial delivery must be made before or at the time the retail investor first engages the firm's services. For dual registrations, initial delivery must be made at the earlier of the above. Note that Form CRS must be provided even if the agreement with the retail investor is oral.

- b) Additional Delivery. Broker-dealers and investment advisers also must deliver Form CRS: (i) upon request, within 30 days of request; and (ii) to each retail investor who is an existing customer before or at the time a new account is opened that is different from the retail investor's existing account(s) or if changes are made to the retail investor's existing account(s) that would materially change the nature and scope of the relationship with the retail investor. Whether a change would require delivery of Form CRS would depend on the specific facts and circumstances.
 - c) Amendments. Broker-dealers and investment advisers must communicate any changes made to Form CRS to each retail investor who is an existing customer within 30 days after amendments are required to be made and without charge. The communication can be made by delivering the current Form CRS or by communicating the information in another way to the retail investor.
 - d) Format of Delivery. Broker-dealers and investment advisers may deliver Form CRS electronically, including updates, consistent with SEC guidance regarding electronic delivery of documents.
5. Filing with the SEC. Broker-dealers and investment advisers 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).
 6. Electronic Posting. Broker-dealers and investment advisers must prominently post Form CRS on their websites (if there is no website, a firm must include in Form CRS a toll-free number that investors can call to request documents).
 7. Updating the Relationship Summary. Broker-dealers and investment advisers must update Form CRS within 30 days whenever any information in it becomes materially inaccurate.
 8. Preserving Records. The proposal would amend Exchange Act Rule 17a-3 by adding paragraph (a)(24) and amend Advisers Act Rule 204-2 by amending paragraph (a)(14)(i) to require broker-dealers and investment advisers to maintain a record of the date that each Form CRS was provided to each retail investor, including any Form CRS provided before such retail investor opens an account or enters an investment advisory agreement. Broker-dealers and investment advisers would need to maintain a copy of each version of Form CRS.

New paragraph (e)(10) would be added to Exchange Act Rule 17a-4 to require broker-dealers to retain these records and a copy of each Form CRS until at least six years after such record or Form CRS is created. Under Rule 204-2(e)(1), investment advisers will be required to retain these records until at least five years after such record is created.

B. Required Disclosures in Retail Communications and Restrictions on the Use of Certain Names or Titles

1. Use of the Term “Adviser” or “Advisor.” Exchange Act proposed Rule 15l-2 would restrict a broker-dealer or an associated natural person from using as part of a name or title the term “adviser” or “advisor” when communicating with a retail investor unless:
 - a) The broker-dealer is also an investment adviser registered under Section 203 of the Advisers Act or with a State; or
 - b) The natural person is also a supervised person of an investment adviser registered under Section 203 of the Advisers Act or with a State, and such person provides investment advice on behalf of such investment adviser.
2. The term “retail investor” has the meaning set forth above in Exchange Act proposed Rule 17a-14 (i.e., a customer or prospective customer who is a natural person, including a trust or other similar entity that represents natural persons, even if another person is a trustee or managing agent of the trust).
3. The SEC is not proposing at this time to restrict the use of other titles (e.g., “financial consultant”).²²

C. Disclosures About a Firm’s Regulatory Status and a Financial Professional’s Association

1. The SEC is proposing rules under the Exchange Act and Advisers Act to require SEC-registered broker-dealers and investment advisers to prominently disclose in print or electronic retail communications that they are registered with the SEC as broker-dealers or investment advisers, as applicable.²³
2. The Exchange Act proposed rule also would require an associated natural person of a broker-dealer to prominently disclose in print or electronic retail communications that he or she is an associated person of a broker-dealer registered with the SEC. As part of the Advisers Act proposed rule, supervised persons would be required to prominently disclose in print or electronic retail communications that he or she is a supervised person of an SEC-registered investment adviser. Dually registered firms (and the above-noted personnel) would be required to prominently disclose both registration statuses.
3. These disclosures would need to be provided as follows.
 - a) For print communications, the status must be displayed in a type size at least as large as and of a font style different from, but at least as prominent as, that used in the majority of the communication. In addition, such disclosure must be presented in the body of the communication and not in a footnote.

²² See Form CRS Proposing Release at 459-60.

²³ See Exchange Act proposed Rule 15l-3(a) and Advisers Act proposed Rule 211h-1(a). For purposes of these disclosures, “retail investor” has the same meaning as Exchange Act proposed Rule 17a-14, discussed above.

- b) For electronic communications, or in any publication by radio or television, such disclosure must be presented in a manner reasonably calculated to draw retail investor attention to it.

III. **Proposed Interpretation Regarding the Standard of Conduct for Investment Advisers and Request for Comment on Enhancing Investment Adviser Regulation**

A. **Purpose of Proposed Interpretation**

As noted above, at the same time the SEC proposed Reg BI and Form CRS, the SEC proposed an interpretation regarding the standard of conduct of investment advisers and also requested comment on enhancements to investment adviser regulation.²⁴ In explaining the purpose of the proposed interpretation and request for comment, the SEC's proposal notes that in light of the comprehensive nature of proposed Reg BI and Form CRS, "we believe it would be appropriate and beneficial to address in one release and reaffirm – and in some cases clarify – certain aspects of the fiduciary duty that an investment adviser owes to its clients under section 206 of the Advisers Act."²⁵

The proposal further notes that an investment adviser's fiduciary duty: (1) is not explicitly included or defined in the Advisers Act or in Commission rules, but has evolved under common law; and (2) depends, in part, on the nature of the relationship between the investment adviser and client as detailed in the advisory contract. Note that the proposed interpretation of Section 206 of the Advisers Act applies to all investment advisers, including those who are exempt from registration.

B. **Elements of the Fiduciary Duty**

Because investment advisers are fiduciaries in their client relationships, they are "held to the highest standard of conduct and must act in a client's best interest."²⁶ To this end, the proposal addresses the two fundamental fiduciary duties that investment advisers owe their customers under the Advisers Act: (1) Duty of Care; and (2) Duty of Loyalty. Below is a summary of the discussion of these duties under the proposed interpretation (which cites case law, SEC releases, and other guidance in support of these duties).

1. **Duty of Care.** The components of the Duty of Care include, among other things, the following.
 - a) **Duty to Provide Advice that Is in the Client's Best Interest.** Investment advisers must "make reasonable inquiry into a client's financial situation, level of financial sophistication, investment experience, and investment objectives" and must provide personalized investment advice that is "suitable for and in the best

²⁴ *Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation*, Investment Advisers Act Release No. 4889 (Apr. 18, 2018), available at <https://www.sec.gov/rules/proposed/2018/ia-4889.pdf> ("Investment Advisers Proposing Release").

²⁵ Investment Advisers Proposing Release at 5.

²⁶ *Id.* at 3.

interest of the client based on the client's investment profile."²⁷ An investment adviser must update a client's profile of such information as appropriate. The depth of inquiry and frequency of updates is facts and circumstances dependent and "would turn on many factors, including whether the [investment] adviser is aware of events that have occurred that could render inaccurate or incomplete" a client's current investment profile.²⁸ "An investment adviser must also have a reasonable belief that the personalized advice is suitable for and in the best interest of the client, based on the client's investment profile,"²⁹ taking into account the client's investment objectives, risk tolerance and financial sophistication. The cost (including fees and compensation) associated with investment advice and products, although not determinative, is one of many factors for an investment adviser to consider when determining whether the purchase of a security or strategy is in a client's best interest. Other factors include liquidity, risks and potential benefits, volatility, and likely performance in different market conditions.

- b) Duty to Seek Best Execution. Investment advisers have a duty to seek best execution when the investment adviser is responsible for selecting the executing broker-dealer. This means the investment adviser must execute "securities transactions on behalf of a client with the goal of maximizing value for the client under the particular circumstances at the time of the transaction."³⁰ This obligation applies to each of its clients, in each transaction. Maximizing value means more than simply minimizing the cost of a transaction; an investment adviser should consider the full range of brokerage services, including research, execution capability, commission rate, financial responsibility, and responsiveness.
 - c) Duty to Act and to Provide Advice and Monitoring Over the Course of the Relationship. An investment adviser has a duty to provide ongoing advice and services over the course of the relationship. The frequency of such advice should be consistent with a client's best interest and the scope of services agreed upon between the investment adviser and the client, and is particularly important where an investment adviser has an ongoing services relationship with a client. "An [investment] adviser's duty to monitor extends to all personalized advice it provides the client, including an evaluation of whether a client's account or program type [] continues to be in the client's best interest."³¹
2. Duty of Loyalty. Under the Duty of Loyalty, an investment adviser is required "to put its clients' interests first."³² This includes the following obligations and requirements, among others.
- a) An investment adviser cannot favor its own interests ahead of its clients'. This includes favoring certain clients that may pay higher fees over other clients.

²⁷ *Id.* at 9-10.

²⁸ *Id.* at 10.

²⁹ *Id.* at 11.

³⁰ *Id.* at 13-14.

³¹ *Id.* at 15.

³² *Id.*

- b) An investment adviser cannot favor certain clients over others (e.g., trade allocation must be fair and the process fully disclosed).
- c) An investment adviser is required to avoid conflicts of interest, and fully and fairly disclose conflicts that do exist (as well as other material details of the advisory relationship). The full and fair disclosure “must be clear and detailed enough for a client to make a reasonably informed decision to consent to such conflicts and practices or reject them.”³³ If a conflict *does* exist, it is not sufficient for an investment adviser to simply say that it *may* exist.
- d) Informed consent may be explicit or implicit. However, an investment adviser may not infer or accept consent where (i) facts and circumstances indicate a client does not understand the conflict, or (ii) there was not full and fair disclosure of material facts.
- e) In some cases, disclosure is not always sufficient to cure a conflict. The scope and importance of this statement by the SEC is unclear.

C. Request for Comment on Enhancing Investment Adviser Regulation

While the SEC is not proposing a uniform standard of conduct for broker-dealers and investment advisers in light of their different relationship types and models, the proposal notes that the SEC continues to consider whether they can improve protection of investors through potential enhancements to the legal obligations of investment advisers. In this regard, the proposal identifies and requests comment on three potential enhancements to SEC-registered investment advisers’ legal obligations in areas where the current broker-dealer framework provides investor protections that may not have counterparts in the investment adviser context: (1) federal continuing education and licensing requirements; (2) requirements relating to the provision of account statements; and (3) financial responsibility obligations.

³³ *Id.* at 17.