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# SEC REGULATION BEST INTEREST


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## I. Overview of SEC's Standards of Conduct for Investment Professionals Rulemaking Package[1/]

**A.** On June 4, 2019, the Securities and Exchange Commission ("SEC" or "Commission") voted 3-1 in favor of a package of 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 new rules and interpretations are:

**1.** Regulation Best Interest ("Reg BI").[2/] Reg BI establishes a new standard of conduct for broker-dealers when making a recommendation of a securities transaction or investment strategy involving securities (including account recommendations) to a retail customer. Reg BI does not define "best interest." Instead, to satisfy Reg BI's requirement that broker-dealers act in the "best interest" of the customer without placing their own financial or other interests ahead of the customer's interest, broker-dealers must comply with four component obligations when making such recommendations: a disclosure obligation, a care obligation, a conflicts of interest obligation, and a compliance obligation.

**2.** Form CRS Relationship Summary; Amendments to Form ADV ("Form CRS").[3/] Form CRS requires both broker-dealers and investment advisers to provide retail investors with a short relationship summary document that provides certain information about the firm and the brokerage and/or investment advisory services it offers, including its fees and costs, conflicts of interest, and whether or not the firm and its financial professionals have disciplinary history. While the final Form CRS allows firms more flexibility than the initial proposal, Form CRS instructions include specific requirements as to content, formatting, and length.

**3.** Commission Interpretation Regarding Standard of Conduct for Investment Advisers. ("Fiduciary Interpretation").[4/] The Commission issued an interpretation to reaffirm and, in some parts, clarify its views of the fiduciary duty that investment advisers owe to their clients. This interpretation applies to all investment advisers regardless of whether they are registered and/or have retail customers. Among other things, it clarifies that an investment adviser "must not place its own interest ahead of its client's interest."

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1/ This outline was prepared by Yoon-Young Lee and Stephanie Nicolas, partners, and Aaron Friedman, associate, at the law firm of Wilmer Cutler Pickering Hale and Dorr LLP ("WilmerHale"). The views expressed in the outline are those of the authors and do not necessarily reflect those of the panelists, their firms, companies, organizations, clients, or colleagues. This outline is for general information purposes only and does not represent legal advice regarding any particular set of facts. The outline speaks as of February 28, 2020. Portions of this outline have been used in other presentations.

2/ *Regulation Best Interest: The Broker-Dealer Standard of Conduct,* 84 Fed. Reg. 33318 (July 12, 2019), https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12164.pdf ("Reg BI Adopting Release").

3/ *Form CRS Relationship Summary; Amendments to Form ADV*, 84 Fed. Reg. 33492 (July 12, 2019), https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12376.pdf ("Form CRS Adopting Release").

4/ *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, 84 Fed. Reg. 33669, 33675 (July 12, 2019), https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12208.pdf

**4.** Commission Interpretation Regarding the "Solely Incidental" Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser ("Solely Incidental Interpretation").[5/] Finally, the Commission issued an interpretation to clarify the scope of the broker-dealer exclusion from the definition of "investment adviser" in the Investment Advisers Act of 1940 ("Advisers Act"). In doing so, the Commission acknowledged that reliance on this exclusion permits broker-dealers to provide substantial amounts of investment advice. The interpretation also sets out clear limits to this exclusion, such as when a broker-dealer agrees to provide continuous monitoring of a customer's account.

## II. Regulation Best Interest

### A. Overview

**1.** Reg BI's General Obligation requires that a broker-dealer or a natural person who is an associated person of a broker-dealer act in the best interest of a retail customer when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer, 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. Securities Exchange Act of 1934 ("Exchange Act") Rule 15*l*-1.

**2.** The General Obligation is satisfied if four component obligations are met: (1) Disclosure Obligation; (2) Care Obligation; (3) Conflict of Interest Obligation; and (4) Compliance Obligation. Exchange Act Rule 15*l*-1.

**3.** Reg BI does not define "best interest." Instead, whether a broker-dealer has satisfied its best interest obligation depends on the facts and circumstances of how the four component obligations of Reg BI are satisfied at the time the recommendation is made (and not in hindsight).[6]

### B. Key Definitions

**1.** Recommendation has the same meaning as under FINRA rules. Factors that are considered in 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."[7/]

**2.** Securities Transaction or Investment Strategy includes a sale, purchase, or exchange, as well as recommendations about account types or whether to roll over or transfer assets from one type of account to another (such as from an ERISA account to an IRA).[8/]

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[5/] *Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser*, 84 Fed. Reg. 33681 (July 12, 2019), https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12209.pdf ("Solely Incidental Interpretation").

[6] Reg BI Adopting Release at 33333-34.

[7/] *Id.* at 33335.

[8/] *Id.* at 33361.

**3.** Retail Customer is defined as "a natural person, or the legal representative of such natural person, who: (A) 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 (B) uses the recommendation primarily for personal, family, or household purposes."[9/]

**a)** "Legal representatives" include persons who are non-professionals and do not include financial services professionals such as registered investment advisers, broker-dealers, corporate fiduciaries (such as banks, trust companies, and similar financial institutions), insurance companies, and their employees.[10/]

**b)** Reg BI's definition is largely consistent with the definition of "retail investor" in Form CRS. However, Reg BI's definition is inconsistent with the FINRA definition of "retail investor" because Reg BI's definition includes natural persons with assets under management in excess of $50 million and is limited to natural persons.

**4.** Use for Personal, Family or Household Purposes. A retail customer "uses" a recommendation when: (1) the retail customer opens a brokerage account with the broker-dealer, regardless of whether the broker-dealer receives compensation; (2) the retail customer has an existing account with the broker-dealer and receives a recommendation from the broker-dealer, regardless of whether the broker-dealer receives or will receive compensation; or (3) the broker-dealer receives or will receive compensation, directly or indirectly as a result of that recommendation, even if the retail customer does not have an account at the firm. "Personal, family, or household purposes" means any recommendation to a natural person for his or her account, other than recommendations to persons seeking these services for commercial or business purposes.[11/]

**5.** Conflicts of Interest is defined as "an interest that might incline a broker, dealer, or a natural person who is an associated person of a broker or dealer—consciously or unconsciously—to make a recommendation that is not disinterested."[12/]

**a)** The SEC noted that "[i]t is difficult to envision a 'material fact' that must be disclosed pursuant to the Disclosure Obligation that is not related to a conflict of interest that is also material under the *Basic* standard."[13/]

**C.** Compliance date. The compliance date for Reg BI and Form CRS is June 30, 2020.

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[9/] *Id.* at 33341-42.
[10/] *Id.* at 33342.
[11/] *Id.* at 33344.
[12/] *Id.* at 33347.
[13/] *Id.* at 33362.

## III. Complying with New Standard of Care Obligation

**A.** What is the Care Obligation?

**1.** The Care Obligation of Reg BI requires broker-dealers to exercise reasonable diligence, care and skill to: (1) understand the 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; (2) have a reasonable basis to believe that a recommendation is in the best interest of a particular retail customer based on the customer's investment profile and the potential risks, rewards, and costs associated with the recommendation; and (3) have a reasonable basis to believe that a series of recommended transactions is not excessive and is in the retail customer's best interest.

**a)** Reasonable Basis Suitability. The requirement to "understand the potential risks, rewards, and costs of the recommended transaction or strategy, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers" is intended to incorporate a broker-dealer's existing obligation under FINRA "reasonable basis suitability" requirements. It is not intended to limit a broker-dealer's ability to recommend complex or more costly products or investment strategies where the broker-dealer has developed a proper understanding of the recommended product or investment strategy and has a reasonable basis to believe that a recommendation could be in the best interest of at least some retail customers.

**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, rewards, and costs associated with the recommendation" is intended to incorporate and enhance the existing "customer-specific suitability" requirements under FINRA rules. The broker-dealer is required to exercise "reasonable diligence" to ascertain the customer's investment profile and to consider "reasonably available alternatives offered by the broker-dealer." Associated persons do not need to be familiar with every product on a broker-dealer's platform.

**c)** Quantitative Suitability. The requirement to "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" is based on FINRA's "quantitative suitability" rule but it extends beyond FINRA's rule because it is not limited to situations where a broker-dealer has actual or de facto control over a customer's account. What would constitute a "series" of recommended transactions depends on the facts and circumstances and needs to be evaluated with respect to a particular retail customer.

**2.** The Care Obligation is stronger than the FINRA suitability standard in at least four ways: (1) it explicitly requires that the recommendation be in the retail customer's best interest and that the broker-dealer does not place its interests ahead of the customer; (2) it applies the quantitative suitability requirement irrespective of whether the broker-dealer has actual or de facto control over the customer's account; (3) it requires the broker-dealer to consider "reasonably available alternatives" as part of having a "reasonable basis to believe" that the recommendation is in the best interest of the customer, and (4) it explicitly requires that cost be a consideration.[14/]

**B.** What are the differences between product recommendations and account type recommendations?

**1.** Reg BI broadly applies to both product recommendations and account type recommendations.

**2.** Product Recommendations include recommendations of sales, purchases, and exchanges and any "investment strategy" involving securities. The phrase "any security transaction or investment strategy" includes implicit hold recommendations in instances where the broker-dealer has agreed to monitor a retail customer's account.[15/] In that context, there is an implicit recommendation to hold if the broker-dealer does not provide an express recommendation to buy, sell or hold at the time the agreed upon monitoring occurs.

**3.** Account Recommendations include recommendations of securities types generally (e.g., to open an IRA or other broker account), as well as recommendations to roll over or transfer assets from one type of account to another (such as a workplace retirement plan account to an IRA). Account recommendations will be subject to Reg BI, even if the account type recommendations do not result in transactions or generate transaction-based compensation.[16/]

**a)** As described above, the Care Obligation will require a broker-dealer to have a reasonable basis to believe that a recommendation or a security account type is in the retail customer's best interest at the time of the recommendation and does not place the financial or other interest of the broker-dealer ahead of the interest of the retail customer.

**b)** While the broker-dealer will need to consider various factors, the SEC enumerated five specific factors that should generally be considered in analyzing the Care Obligation in relation to account recommendations. These are :(i) the services and products provided in the account; (ii) the project costs to the retail customer of the account; (iii) alternative account types available; (iv) the services requested by the retail customer; (v) the retail customer's investment profile.[17/]

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[14/] *Id.* at 33374.
[15/] *Id.* at 33336.
[16/] *Id.* at 33339.
[17/] *Id.* at 33382-83.

**C.** Does the SEC recognize that certain communications are "education" rather than "recommendations" for purposes of Reg BI?

**1.** Yes. The SEC generally views the following types of communications as "education" rather than "recommendations" as long as they do not include a recommendation of a particular security or securities or particular investment strategy involving securities.[18/] These include:

**a)** General financial and investment information, which encompasses basic investment concepts, such as risk and return, diversification, dollar cost averaging, compounded return, and tax differed investment, historic differences in the return of asset classes based on standard market indices, effects of inflation, estimates of futures retirement income needs, and assessment of a customer's investment profile.

**b)** Descriptive information about an employer-sponsored retirement or benefit plan, participation in the plan, or the benefits of plan participation, and the investment options available under the plan.

**c)** Certain asset allocation models that are based on generally accepted investment theory; accompanied by disclosures of all material facts and assumptions that may affect a reasonable investor's assessment of the asset allocation model or any report generated by such model, and in compliance with FINRA Rule 2214 (Requirements for the Use of Investment Analysis Tools) if the asset allocation model is an "investment analysis tool" covered by FINRA Rule 2214.

**D.** What factors will broker-dealers need to consider in recommending a security or investment strategy?

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

**a)** According to the rule, when making a recommendation to a particular retail customer, broker-dealers must weigh the potential risks, rewards, and costs of a particular security or investment strategy, in light of the particular retail customer's investment profile. The importance of each factor in determining the customer-specific component of the duty of care obligation will depend on the facts and circumstances of each recommendation and one or more factors may have more or less relevance (or may not be analyzed at all) if the broker-dealer has a reasonable basis for determining that the factors are not relevant.[19/]

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[18/] *Id.* at 33337.

[19/] *Id.* at 33378.

**b)** Although costs are now expressly part of the rule, the Reg BI Adopting Release makes clear that this does not mean the lowest cost option is necessary or will satisfy the Care Obligation. Cost is a factor but it is not dispositive. To this point, the SEC notes "the evaluation of cost would be more analogous to a broker-dealer's best execution analysis, which does not require the lowest possible cost, but rather looks at whether the transaction represents the best qualitative execution for the customer using cost as one factor.[20/]

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

**E.** What factors will broker-dealers need to analyze in connection with a "retail customer's investment profile?"

**1.** The definition of "retail customer investment profile" includes the customer's "age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the retail customer may disclose to the broker, dealer, or a natural person who is an associated person of a broker or dealer in connection with a recommendation." Exchange Act Rule 15*l*-1(b)(2). The Reg BI Adopting Release observed that if a broker-dealer is unable to obtain sufficient information for the retail customer investment profile, 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.[21/]

**F.** Are there any new recordkeeping or retention requirements?

**1.** Yes. Reg BI amends Exchange Act Rule 17a-3, adding new paragraph (a)(35), which requires for each retail customer to whom a recommendation of any securities transaction or investment strategy involving securities is or will be provided, a record of all information collected from and provided to the retail customer pursuant to Reg BI.

**2.** The SEC clarified that while the substantive requirements of Reg BI apply on a recommendation-by-recommendation basis, Reg BI does not require that broker-dealers create and maintain records to evidence best interest determinations on a recommendation-by-recommendation basis.[22/] The SEC also noted that broker-dealers are not required to provide information to retail customers regarding the basis for each particular recommendation, and thus

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[20/] *Id.* at 33373.
[21/] *Id.* at 33378-79.
[22/] *Id.* at 33399.

did not envision this information would be in scope for purposes of Rule 17(a)(35).[23/]

## IV. Disclosure Obligation

**A.** Prior to or at the time of a recommendation, the broker-dealer must provide the retail customer, *in writing*, full and fair disclosure of: (1) all *material* facts relating to the scope and terms of the relationship, including (a) that the broker-dealer is acting in its capacity as a broker-dealer, (b) the fees and costs that apply, and (c) the type and scope of services provided, including any material limitations on the securities or investment strategies that may be recommended; and (2) all *material* facts relating to conflicts of interest associated with the recommendation. Exchange Act Rule 15*l*-1(a)(2)(i).

**B.** Materiality is determined based on the *Basic v. Levinson* standard.[24/]

**C.** Material Facts Relating to the Scope and Terms of the Relationship with the Retail Customer. The three categories identified in the text of the rule are non-exhaustive; broker-dealers will need to consider whether there are other material facts that need to be disclosed based on the facts and circumstances.

**1.** Acting in a Broker-Dealer Capacity Disclosure. The use of the term "adviser" or "advisor" in a name or title by a broker-dealer that is not also registered as an investment adviser violates the Disclosure Obligation.[25/]

**2.** Fees and Costs Disclosure. The disclosure should explain why and when a material fee or cost would be imposed, such as an account minimum. The disclosure of fees and costs does not need to be individualized for each retail customer; instead, standardized numerical and other non-individualized disclosure may be used.

**3.** Type and Scope of Services Disclosure. The disclosure should include whether the broker-dealer is monitoring the performance of the account (and if so, the scope and frequency) and any material limitations on the securities or investment strategies that may be recommended (e.g., recommending only proprietary products, a specific asset class, or products with third-party arrangements).[26/] The disclosure should also include the firm's investment approach, philosophy, or strategy and the risks associated with a broker-dealer's recommendations in standardized terms.

**D.** All Material Facts Relating to Conflicts of Interest that Are Associated with the Recommendation. Only those conflicts that are material need to be disclosed. Of particular note are conflicts relating to how the broker-dealer and its associated persons are compensated, such as conflicts created by variable compensation, payment

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[23/] *Id.*

[24/] *See Basic, Inc. v. Levinson*, 485 U.S. 224 (1988); *see* Reg BI Adopting Release at 33362.

[25/] Reg BI Adopting Release at 33350-51, 33352.

[26/] Note that even if such material limitations are disclosed, broker-dealers still must comply with the Care Obligation when making a recommendation to a retail customer.

from third parties (such as for shelf space), differences in compensation for proprietary products, and revenue sharing.

**E.** Form and Manner of Written Disclosure. The disclosure depends on the frequency and level of advice services provided (i.e., one-time, episodic, or more frequent basis) – neither a single standard written document, a specific form, or manner are mandated. Disclosures must generally be in writing, but in certain scenarios oral disclosure may be appropriate. Some forms of disclosure may be standardized and provided at the beginning of a relationship, but other disclosures may need to be tailored to the recommendation. A combination of existing disclosures and standardized documents (e.g., product prospectuses, relationship guides, account agreements, fee schedules, and trade confirmations) may be used. Disclosures may be provided electronically consistent with existing SEC guidance on electronic delivery of documents.

**F.** Timing and Frequency of Disclosure. The disclosures should be provided early enough that the customer 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 include: (1) 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); (2) 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); (3) at other points, such as before making a particular recommendation or at the point of sale; and/or (4) 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 after the recommendation (e.g., in a trade confirmation)).

**G.** Broker-dealers must update the disclosures if there have been any material changes (must be done as soon as practicable, no later than 30 days after the material change).

## V. Conflict of Interest Obligation

**A.** The broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to: (1) identify and at a minimum *disclose*, in accordance with the Disclosure Obligation, or eliminate, all conflicts of interest associated with such recommendations; (2) identify and *mitigate* any conflicts of interest that create an incentive for an associated person to place the interest of the broker-dealer, or such associated person ahead of the interest of the customer; (3) identify and disclose, in accordance with the Disclosure Obligation, any *material limitations* placed on the securities or investment strategies that may be recommended and any conflicts of interest associated with such limitations, and *prevent* such limitations and conflicts from causing the broker-dealer to make recommendations that place the interest of the broker-dealer ahead of the interest of the customer; and (4) identify and *eliminate* any sales contests, sales quotas, bonuses, and non-cash compensation that are based on

the sales of specific securities or specific types of securities within a limited period of time.[27/]

**1.** Overarching Firm-Wide Conflicts. Although the provision does not use the term "material," the specific reference to the Disclosure Obligation suggests that the only conflicts that must be identified under this provision are material conflicts.

**2.** Associated Person Related Conflicts. Broker-dealers do not need to consider "external interests of the associated person not within the control of or associated with the broker-dealer's business."[28/] Examples of disclosable conflicts would be variable compensation and employee incentives.

**3.** Material Limitations. The fact that a material limitation has been disclosed pursuant to the Disclosure Obligation and mitigated pursuant to this Conflict of Interest Obligation does not mean that a recommendation subject to the material limitation will satisfy the customer-specific suitability obligation.

**B.** Conflicts to Be Eliminated. The elimination requirement does not apply to incentives or compensation relating to total products sold, asset growth or accumulation, or customer satisfaction. It also does not apply to incentives or compensation relating to sales of general categories of securities (mutual funds, variable annuities, bonds, equities) as long as they do not create high pressure situations to sell a specifically identified type of security (e.g., stocks of a particular sector or bonds with a specific credit rating) within a limited period of time.

**C.** It is acceptable to use a risk-based compliance and supervisory system rather than requiring a detailed review of each recommendation. Both the Reg BI proposing and Adopting Releases provided examples of methods for mitigating conflicts which firms may consider in designing policies and procedures for the conflict of interest provisions – both firm-wide and individual conflicts. The examples described (e.g., neutral factors) are not required elements, and are a non-exhaustive list.[29/]

## VI. Compliance and Supervisory Implications

**A.** The Compliance Obligation of Reg BI requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Reg BI. Exchange Act Rule 15*l*-1(a)(2)(iv). It provides flexibility such that broker-dealers can establish compliance policies and procedures that accommodate their business models. Whether policies and procedures are reasonably designed will depend on the facts and circumstances of a given situation.

**1.** This component of Reg BI is meaningful from an enforcement perspective because it allows the SEC to bring Reg BI charges against broker-dealers for policies and procedures violations in the absence of an underlying Reg BI violation.

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[27/] Exchange Act Rule 15*l*-1(a)(2)(iii).
[28/] Reg BI Adopting Release at 33390-91.
[29/] *Id.* at 33391 and 33392.

**B.** Supervisory requirements imposed by other statutory and regulatory provisions

**1.** Section 15(b)(4)(E) of the Exchange Act creates possible liability for a failure to supervise by authorizing the Commission to impose a sanction on an associated person who "has failed reasonably to supervise, with a view to preventing violations of ... [federal securities] statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision."

**a)** Implicit in § 15(b)(4)(E) are two express elements of failure to supervise liability: "supervision," and failure to act "reasonably." In addition, by virtue of the safe harbor set forth below, regulators also have an obligation to show causation, i.e., that the alleged supervisor's failure enabled the supervised person to engage in another violation.

**b)** Neither "supervision" or "reasonably" is defined in the Exchange Act.

**c)** Section 15(b)(4)(E) also establishes a so-called "safe harbor" under which no person can be liable for failure to supervise if:

i) there have been established procedures and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person; and

ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

**2.** FINRA Rule 3110 requires member firms to "establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules."

## VII. Navigating the Solely Incidental Broker-Dealer Exemption

**A.** Broker-Dealer versus Investment Adviser. As part of its package of rulemakings and interpretations, the SEC published an interpretation regarding what advisory services are "solely incidental" to a broker-dealer's business.[30/] The Advisers Act defines an "investment adviser" as "any person who, for compensation, engages in the business of advising others" about securities, but excludes from the definition "any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor."[31/]

**B.** The Solely Incidental Interpretation focuses on two issues: (i) investment discretion and (ii) account monitoring.

**1.** Investment Discretion.

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30/ *See* Solely Incidental Interpretation, *supra* note 5.

31/ Advisers Act Section 202(a)(11)(C).

**a)** Unlimited investment discretion. A broker-dealer that is exercising unlimited investment discretion over a client's account is no longer providing advice to customers and is instead making investment decisions. The Commission stated that "unlimited discretion to effect securities transactions possesses ongoing authority over the customer's account indicating a relationship that is primarily advisory in nature" such that the relationship could not be primarily to buy and sell securities and would not be incidental to the brokerage business.

**b)** Limited investment discretion. If, however, the broker-dealer's discretion is limited in time, scope, or other manner, and lacks the comprehensive and continuous characteristics of full discretion, then such broker-dealer's advice may be deemed solely incidental and thus, the broker-dealer would not be subject to the Advisers Act. This is a totality of the facts and circumstances test.

**2.** Account Monitoring.

**a)** Continuous monitoring. An agreement by a broker-dealer to monitor a customer's account must be carefully considered because such activity may indicate a primarily advisory relationship.

**b)** Agreed-upon limited monitoring. Limited monitoring is permissible. Consistent with the exclusion, a broker-dealer may agree to monitor accounts "on a periodic basis for purposes of providing buy, sell, or hold recommendations [and] may still be considered to provide advice in connection with and reasonably related to effecting securities transactions." The Commission declined to delineate every circumstance where agreed-upon monitoring is solely incidental and generally deferred to a firm's policies and procedures to set appropriate boundaries.

**c)** Voluntary monitoring. When a broker-dealer voluntarily, and without any agreement with the customer, reviews the holdings in a customer's account for purposes of whether to make an investment recommendation, such monitoring is "solely incidental," and the SEC staff does not consider it to be "account monitoring."

## VIII. Form CRS Relationship Summary; Amendments to Form ADV

**A.** The SEC adopted a new requirement that investment advisers and broker-dealers file with the SEC and provide to retail investors a Form CRS relationship summary ("relationship summary").[32/]

**1.** The relationship summary is designed to be a short and accessible disclosure for retail investors that helps them compare information about a firm's brokerage and/or investment advisory offerings and promotes effective communication between firms and their retail investors.

[32/] Advisers Act Rule 204-5 and Exchange Act Rule 17a-14.

**2.** The relationship summary is in addition to, and not in lieu of, current disclosures and reporting requirements. Delivery of this document will not satisfy other disclosure obligations.

**3.** An initial relationship summary must be filed with the SEC by June 30, 2020; firms may file their initial relationship summary beginning on May 1, 2020.[33]

**B.** "Retail Investor" Definition.

**1.** "[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."[34/] Legal representative does not include regulated financial services professionals, such as registered investment advisers, broker-dealers, corporate fiduciaries (e.g., banks, trust companies, and similar financial institutions), insurance companies, and their employees.[35/]

**C.** Content of Relationship Summary.[36/]

**1.** Length and Form. Limited to two pages for investment advisers and broker-dealers, and four pages for dual registrants, or the equivalent if in electronic form. Dual registrants may choose to have standalone documents limited to two pages each.

**2.** Items that Must Be Addressed. (1) introduction, with a link to Investor.gov/CRS; (2) types of customer relationships and services the firm offers; (3) fees, costs, conflicts of interest, and standard of conduct related to those relationships and services; (4) disciplinary history of the firm and its financial professionals; and (5) how to obtain additional information about the firm.

**a)** Additional disclosure is not allowed.

**b)** These items each include "conversation starters" to help retail investors better understand the disclosures and encourage engagement with firm representatives.[37/]

**3.** Language. Instructions require language that is plain, concise, and addressed to the investor.

**4.** Full and Truthful Disclosure. All information must be true and may not omit any material facts necessary to make the disclosures required not misleading "in light of the circumstances under which they were made." This recognizes

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[33] A firm must initially deliver its relationship summary to each of its existing clients and customers who are retail investors within 30 days after the date by which it is first required to electronically file its relationship summary with the SEC. If the relationship summary is delivered in paper format as part of a package of documents, a firm must ensure that the relationship summary is the first among any documents that are delivered at that time. *See* Frequently Asked Questions on Form CRS (Feb. 11, 2019), https://www.sec.gov/investment/form-crs-faq.

[34/] Exchange Act Rule 17a-14(e)(2) and Advisers Act Rule 240-5(d)(2).

[35/] Form CRS Adopting Release at 33543.

[36/] *See* Form CRS Appendix B, 84 Fed. Reg. at 33645, Form ADV Part 3: Instructions to Form CRS at 33646 ("Form CRS Instructions").

[37/] *Id.* at 33510. One such example is "how the fees and costs might affect their investments and the potential impact of fees and costs on a hypothetical $10,000 investment."

that Form CRS is a summary and that it provides links with additional information.[38]/

**5.** Electronic and Graphical Formats. Firms are encouraged to use charts, graphs, tables, and other graphics or text features, text colors, graphical cues, hyperlinks, and online tools.[39]/

**D.** Delivery and Filing.

**1.** Initial Delivery.

**a)** Advisers deliver a relationship summary to each new or prospective client before or at the time of entering into an investment advisory contract with the retail investor (even if the agreement with the retail investor is oral).[40]/ Broker-dealers must deliver the relationship summary to each new or prospective customer before or at the *earliest* of: (1) a recommendation of an account type, a securities transaction, or an investment strategy involving securities; (2) placing an order; or (3) the opening of a brokerage account.[41]/

**b)** Dual registrants must deliver at the earliest of the above.

**c)** When Form CRS becomes effective on June 30, 2020, firms must deliver the relationship summary to all their existing retail investor customers within 30 days after they file the relationship summary with the SEC.[42]/

**2.** Additional Delivery.

**a)** For existing customers: (1) upon request, within 30 days of request; (2) before or at the time the firm opens a new account that is different from the existing account(s); (3) before or at the time the firm recommends a rollover of assets from a retirement account into a new or existing account or investment; or (4) before or at the time the firm recommends or provides a new brokerage or investment advisory service or investment that does not necessarily involve the opening of a new account and would not be held in an existing account (e.g., the first-time purchase of direct-sold mutual fund or insurance product that is a security through a "check and application" arrangement).[43]/

**3.** Updating the Relationship Summary.

**a)** When the relationship summary becomes materially inaccurate, firms must: (1) update and post on their website the latest version; (2)

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[38]/ *See also* Form CRS Adopting Release at 33504 ("Any information contained in the relationship summary or omitted facts will not be viewed in isolation in respect of determining whether such information would have been viewed by a reasonable investor as having significantly altered the total mix of information available").

[39]/ Firms can also include video or audio messages, mouse-over windows, pop-up boxes, chat functionality, fee calculators, or other forms of electronic media and communications. Form CRS Instructions at 33647-48.

[40]/ Advisers Act Rule 204-5(b).

[41]/ Exchange Act Rule 17a-14(c).

[42]/ Advisers Act Rule 204-5(e) and Exchange Act Rule 17a-14(f).

[43]/ Advisers Act Rule 204-5(b) and Exchange Act Rule 17a-14(c).

electronically file it with the SEC within 30 days; and (3) deliver it to existing customers within 60 days (without charge).[44/]

**b)** Firms must highlight the most recent changes in the relationship summaries delivered to customers (e.g., marking the revised text or including a summary of material changes).[45/]

**4.** Electronic Delivery. Permissible to deliver electronically consistent with SEC guidance regarding electronic delivery of documents. Firms can deliver the relationship summary to new or prospective customers in the same manner in which the customer requested information.[46/]

**5.** Electronic Posting and Telephone Number. Firms must prominently post the relationship summary on their website and provide a telephone number where retail investors can request up-to-date information and a the most recent copy.[47/]

**E.** Preserving Records.

**1.** Broker-dealers and investment advisers are required to maintain a record of the date that each Form CRS was provided to each retail investor (including *before* such retail investor opens an account or enters an investment advisory agreement).[48/]

## IX. Recent Updates

**A.** Status of litigation/legal challenges

**1.** In September 2019, attorneys general from seven states and the District of Columbia commenced litigation to challenge Reg BI in both the U.S. District Court for the Southern District of New York and the U.S. Court of Appeals for the Second Circuit. A day later, an industry network of fee-only investment advisers filed additional proceedings. The two cases were consolidated.

**a)** The state attorneys general argue that Reg BI is inconsistent with the Dodd-Frank Act. Specifically, the states argue that the SEC was required to adopt a rule that either (i) applies the full panoply of regulations under the Advisers Act, including its fiduciary standard, to broker-dealers' non-incidental advice; or (ii) impose only the fiduciary standard, but not the Advisers Act's other requirements, on broker-dealers' provision of investment advice to retail investors.

**b)** The litigants XY Planning Network, LLC & Ford Financial Solutions, LLC similarly argue that the SEC's failure to adopt a uniform fiduciary

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[44/] This time period will generally allow a firm to include the update in one of its quarterly disclosure deliveries. Form CRS Adopting Release at 33554.

[45/] This additional disclosure must be filed as an exhibit to the unmarked amended relationship summary and does not count toward the page limit. Form CRS Instructions at 33652.

[46/] Form CRS Adopting Release at 33548, 33550.

[47/] Form CRS Instructions at 33652-53.

[48/] Exchange Act Rule 17a-3(a)(24) and Advisers Act Rule 204-2(a)(14).

standard for broker-dealers and investment advisers was inconsistent with Dodd-Frank's statutory mandate.

**2.** On September 24, 2019, the SEC notified the district court of its intent to move to dismiss the complaints on jurisdiction grounds. Specifically, the SEC contended that the U.S. Court of Appeals had exclusive jurisdiction over the matter.

**a)** On September 27, 2019, the district court dismissed the complaints, concluding that the proper jurisdiction is in the Second Circuit. *See* Decision and Order, *State of New York, et al., v. United States Securities and Exchange Commission, et al*, No. 1:19-cv-08365-VM, Docket No. 27 (S.D.N.Y. Sept. 27, 2019), (dismissing the action "on the Court's own motion for lack of subject-matter jurisdiction and in favor of litigation pursuant to the petitions for review filed in the United States Court of Appeals for the Second Circuit.").

**3.** The Second Circuit case is ongoing. *See XY Planning Network, LLC, et. al. v. United States Securities and Exchange Commission, et al.*, No. 19-2886 (2d Cir. Sept. 23, 2019).

**a)** The briefs for the state petitioners and XY Planning Network were filed in the Second Circuit on December 27, 2019.

**b)** The brief for the SEC is due on March 3, 2020.

**B.** Developments on Fiduciary Standards from CFP Board

**1.** The Certified Financial Planner Board of Standards ("CFP Board") have moved forward with their own fiduciary standards which are not consistent with Reg BI.

**2.** The CFP Board first adopted a fiduciary duty in 2007. In March 2018, it proposed enhancements to the standard of conduct applicable to CFP professionals. While the previous standards imposed a fiduciary duty on a CFP professional when providing financial planning, the new standard extended the application of the fiduciary duty to all financial advice. According to the CFP Board, the new Code of Ethics and Standards of Conduct were designed to eliminate any confusion surrounding the applicable standard whenever a CFP professional provides financial planning and financial advice.[49/]

**3.** While the CFP Board initially set an effective date of October 1, 2019, the CFP Board later announced that June 30, 2020, the same date when Reg BI and CRS become effective, will be the date when CFP professionals' compliance with the new Code will be enforced.[50/] The Board Chair observed that: "the alignment of the SEC's enforcement date of Regulation Best Interest (Reg BI) is helpful to our CFP® professionals in that there is significant overlap in the two sets of standards – with a notable exception that CFP® professionals are

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[49/] *See* CFP Board, Code of Ethics and Standards of Conduct (Nov. 2018), *available at* https://www.cfp.net/ethics/code-of-ethics-and-standards-of-conduct ("Code of Ethics").

[50/] *See* CFP Board Press Release (July 16, 2019), https://www.cfp.net/news-events/latest-news/2019/07/16/directors-of-cfp-board-set-enforcement-date-for-new-'code-and-standards'?mod=article_inline.

required to act as a fiduciary whenever they are providing financial advice to clients."[51/]

**4.** Key Definitions from the New Code of Ethics

**a)** "Financial Planning" is defined as "a collaborative process that helps maximize a Client's potential for meeting life goals through Financial Advice that integrates relevant elements of the Client's personal and financial circumstances."

i) "Relevant elements of personal and financial circumstances" vary across clients and include "the Client's need for or desire to: develop goals, manage assets and liabilities, manage cash flow, identify and manage risks, identify and manage the financial effect of health considerations, provide for educational needs, achieve financial security, preserve or increase wealth, identify tax considerations, prepare for retirement, pursue philanthropic interests, and address estate and legacy matters."

**b)** "Fiduciary Duty" is described as follows: "At all times when providing Financial Advice to a Client, a CFP® professional must act as a fiduciary, and therefore, act in the best interests of the Client." To satisfy the best interest obligation, three duties must be fulfilled – (1) duty of loyalty, (2) duty of care, and (3) duty to follow client instructions.

**5.** A CFP professional must comply with the "Practice Standards" when providing "Financial Planning" to a client, and with the "Fiduciary Duty" when providing financial advice to a client.

**a)** Given the broad definition of "Financial Planning," the new standards extend past financial planning activity to cover all investment advice provided by the CFP professional, and the distinction between financial planning and financial advice is essentially eliminated. As a result, broker-dealers and investment advisers who are CFP professionals are subject to all of the new CFP standards of conduct whenever they are making a recommendation or giving investment advice.

**6.** The new Code of Ethics also includes modifications to other standards of conduct, including integrity, competence, diligence, and disclosure and management of conflicts of interest. The new Code of Ethics also imposes new reporting obligations which are similar to those required by FINRA Form U-4/U-5 and BrokerCheck.

**7.** By adding a new regime in addition to the SEC's and FINRA's regime that applies to CFP professionals when providing financial advice and "Financial Planning," broker-dealers will be subject to duplicative and burdensome regulation.

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[51/] *Id.*

**C.** Developments on fiduciary standards from the states.

**1.** On February 21, 2020, Massachusetts adopted a fiduciary conduct standard for broker-dealers and agents. The final rules are significantly more aligned with the requirements of Reg BI than the original proposal. The final rules will be published and effective on March 6, 2010, with an enforcement date of September 1, 2020.

**2.** The following other states have proposed fiduciary laws or agency rulemakings: Iowa, Illinois, Maryland, Nevada, New Jersey and New York.

**D.** Additional resources and guidance.

**1.** SEC resources and guidance

**a)** Frequently Asked Questions on Regulation Best Interest (Feb. 11, 2019), https://www.sec.gov/tm/faq-regulation-best-interest.

**b)** Frequently Asked Questions on Form CRS (Feb. 11, 2019), https://www.sec.gov/investment/form-crs-faq.

**c)** Regulation Best Interest, A Small Entity Compliance Guide (Sept. 23, 2019), https://www.sec.gov/info/smallbus/secg/regulation-best-interest.

**d)** Form CRS Relationship Summary; Amendments to Form ADV, A Small Entity Compliance Guide (Sept. 19, 2019), https://www.sec.gov/info/smallbus/secg/form-crs-relationship-summary.

**e)** Form CRS Instructions (June 5, 2019), https://www.sec.gov/info/smallbus/secg/form-crs-relationship-summary20.

**f)** The SEC's Office of Compliance Inspections and Examinations ("OCIE") stated that its staff will engage with broker-dealers during examinations on their progress on implementing the new rules and questions they may have regarding the new rules. After the compliance dates, OCIE intends to assess implementation of the requirements of Regulation Best Interest, including policies and procedures regarding conflicts disclosures, and for both broker-dealers and registered investment advisers, the content and delivery of Form CRS. Moreover, OCIE has already integrated the Interpretation Regarding Standard of Conduct for Investment Advisers into the investment adviser examination program. 2020 Examination Priorities, Office of Compliance Inspections and Examinations (Jan. 7, 2020), https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf.

**2.** FINRA resources and guidance

**a)** Regulation BI resource webpage, https://www.finra.org/rules-guidance/key-topics/regulation-best-interest.

**b)** FINRA Reg BI and Form CRS Checklist, https://www.finra.org/sites/default/files/2019-10/reg-bi-checklist.pdf

**c)** FINRA Regulatory Notice 19-26 (Regulation Best Interest) (Aug. 7, 2019), https://www.finra.org/rules-guidance/notices/19-26.

**d)** Reg BI and Form CRS occupy a prominent spot on the FINRA 2020 exam priorities letter. 2020 Risk Monitoring and Examination Priorities Letter (Jan. 9, 2010), https://www.finra.org/rules-guidance/communications-firms/2020-risk-monitoring-and-examination-priorities-letter. In the letter, FINRA observed that during the first part of the year, FINRA exam teams will review firms' preparedness for Reg BI to gain an understanding of implementation challenges they face and, after the compliance date, firms' compliance with Reg BI, Form CRS and related SEC guidance and interpretations. In its exams, FINRA may consider the following factors:

i) Does the firm have procedures and training in place to assess recommendations using a best interest standard?

ii) Do the firm and its associated persons apply a best interest standard to recommendations of types of accounts?

iii) If the firm and its associated persons agree to provide account monitoring, does the firm apply the best interest standard to both explicit and implicit hold recommendations?

iv) Do the firm and its associated persons consider the express new elements of care, skill and costs when making recommendations to retail customers?

v) Do the firm and its associated persons consider reasonably available alternatives to the recommendation?

vi) Do the firm and its registered representatives guard against excessive trading, irrespective of whether the broker-dealer or associated person "controls" the account?

vii) Does the firm have policies and procedures to provide the disclosures required by Reg BI?

viii) Does the firm have policies and procedures to identify and address conflicts of interest?

ix) Does the firm have policies and procedures in place regarding the filing, updating and delivery of Form CRS?