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Regulatory Education Program: New SEC Standards

The SEC's Standard of Conduct Rules: What Do They Mean for Compliance?

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

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Overview

- Regulation Best Interest
- Enforcement
- Post Reg BI Causes of Action
- Form CRS
- Advisers Act Standard of Conduct Interpretive Release
- Advisers Act “Solely Incidental” Interpretive Release

Regulation Best Interest



The Broker-Dealer | Best Interest Standard Background on the Final Rule

- On June 5, 2019, the SEC adopted Reg. BI by a 3-1 vote
 - Commissioners in favor: Clayton, Peirce, Roisman
 - Commissioner against: Jackson
- Retains the same basic structure of proposed Reg. BI (general obligation, component obligations, and definitions), but with a new component obligation and significant changes to various parts of the rule text
- The SEC's version of the Reg. BI adopting release (not the Federal Register version) spans 771 pages
 - About 115 pages of text discussing the Disclosure Obligation alone, and then about 115 pages of text combined for the remaining three component obligations

The Broker-Dealer | Best Interest Standard

The General Obligation

- Substantially similar to the General Obligation in proposed Reg. BI
- Requires a broker-dealer (or associated person), when recommending a securities transaction or investment strategy involving securities, to act in the retail customer's best interest and not place its (or his or her) own interests ahead of the retail customer's interests
- Satisfied through fulfillment of the four component obligations
 - Disclosure Obligation
 - Care Obligation
 - Conflict of Interest Obligation
 - Compliance Obligation

The Broker-Dealer | Best Interest Standard Transaction and Account Recommendations

- The final rule has one notable difference from proposed Reg. BI
- An “investment strategy” recommendation includes recommendations of account types and rollovers or transfers of assets
- It also covers implicit hold recommendations resulting from agreed-upon account monitoring

The Broker-Dealer | Best Interest Standard Defined Terms

- No best interest definition
 - Instead, the SEC opted to explain in Reg. BI and through the Adopting Release what “acting in the best interest” means
- New definition of “conflict of interest”
 - Tracks the definition that has developed under the Advisers Act
- Changes to definition of “retail customer”
 - Focus on natural persons
 - Narrow interpretation of “legal representative”
- No change to definition of “retail customer investment profile”
 - SEC did not accept commenter suggestions to include factors relevant to annuities, such as longevity protection needs, but does say in the Adopting Release that the list of factors is non-exhaustive and broker-dealers can (and maybe should) consider factors beyond those set forth in this definition

The Broker-Dealer | Best Interest Standard

Overview of the Component Obligations

- The General Obligation is satisfied by meeting the following four component obligations:
 - **Disclosure Obligation:** providing certain prescribed disclosure before or at the time of the recommendation, about the recommendation and the relationship between the retail customer and the broker-dealer;
 - **Care Obligation:** exercising reasonable diligence, care, and skill in making the recommendation;
 - **Conflict of Interest Obligation:** establishing, maintaining, and enforcing policies and procedures reasonably designed to address conflicts of interest; and
 - **Compliance Obligation:** establishing, maintaining, and enforcing policies and procedures reasonably designed to achieve compliance with Reg. BI.

The Broker-Dealer | Best Interest Standard

The Disclosure Obligation

- Disclosure Obligation – must provide the retail customer, in writing, at or before a recommendation is made, full and fair disclosure of all material facts relating to conflicts of interest that are associated with the recommendation and all material facts relating to the scope and terms of the relationship with the retail customer, including
 - that the broker, dealer, or such associated natural person is acting as a broker, dealer, or an associated natural person of a broker or dealer with respect to the recommendation,
 - the fees and costs that apply to the retail customer’s transactions, holdings, and accounts, and
 - the type and scope of services provided to the retail customer, including any material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer
- Adopting Release explains that the capacity disclosure effectively prohibits a broker-dealer and its associated persons from using the term “advisor” or “adviser” if the broker-dealer is not a registered investment adviser or the associated person is not a supervised person of a registered investment adviser

The Broker-Dealer | Best Interest Standard Care Obligation – Overview

- In making a recommendation, must exercise reasonable diligence, care, and skill to:
 - Understand the potential risks, rewards, and costs associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers
 - Have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks, rewards, and costs associated with the recommendation and does not place the financial or other interest of the broker, dealer, or such associated natural person ahead of the interest of the retail customer
 - Have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile and does not place the financial or other interest of the broker, dealer, or such natural person making the series of recommendations ahead of the interest of the retail customer

The Broker-Dealer | Best Interest Standard Conflict of Interest Obligation – Overview

- Must establish, maintain, and enforce written policies and procedures reasonably designed to:
 - Identify and disclose (in accordance with the Disclosure Obligation) or eliminate, all conflicts of interest associated with recommendations
 - Identify and mitigate any conflicts of interest associated with recommendations that create an incentive for associated persons to place the firm's interest or their interest ahead of the retail customer's interest
 - Identify and disclose any material limitations placed on the securities or investment strategies involving securities that may be recommended to retail customers and associated conflicts of interest
 - Prevent such limitations and associated conflicts of interest from causing the broker-dealer or associated persons from making recommendations that place its/their interest ahead of the retail customer's interest
 - Identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time

The Broker-Dealer | Best Interest Standard Compliance Obligation

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

The Broker-Dealer | Best Interest Standard Recordkeeping Requirements

- New Rule 17a-3(a)(35): A record of all information collected from and provided to the retail customer pursuant to Reg. BI, as well as the identity of each natural person who is an associated person, if any, responsible for the account
 - Neglect, refusal, or inability of the retail customer to provide or update any information described above excuses the broker-dealer from obtaining it
- New Rule 17a-4(e)(5): Requires the broker-dealer to maintain the information collected pursuant to new Rule 17a-3(a)(35) until at least six years after the earlier of the date the account was closed or the date on which the information was collected, provided, replaced, or updated

The Broker-Dealer | Best Interest Standard Effective Date

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

Enforcement



Enforcement

- Historical Enforcement Actions
 - SEC
 - FINRA
 - Statistics
 - Types of cases
- Possible Future Enforcement Actions
 - SEC or FINRA?
 - Disclosure issues
 - Care issues
 - Inadequate or failure to enforce policies and procedures
 - Conflicts
 - Compliance
- Recordkeeping failures

Post Reg BI Causes of Action

Post Reg BI Causes of Action

- Broker-dealers: enhanced suitability requirement and possible replacement of Rule 2111
 - Not a fiduciary duty
 - No duty to monitor; duties attach to specific transactions
 - “Best interest” will be shaped by the facts and circumstances of the particular recommendation and the particular retail customer
 - Reasonable care and diligence in making recommendations
 - Reasonable basis suitability
 - Customer specific suitability
 - Quantitative suitability
 - Hold recommendations

Post Reg BI Causes of Action (cont.)

- Investment advisers: fiduciary duty under the Advisers Act, with a continuing duty to monitor
 - Duty to provide advice that is in the best interest of the client
 - Duty to seek best execution
 - Duty to provide advice and monitoring over the course of the relationship
- Existing state blue sky laws and common law governing broker-dealers (no preemption of state law)
- Newly adopted state rules and regulations (Massachusetts, New Jersey proposals)
- CFP rules of conduct effective October 1, 2019, but will not be enforced until June 30, 2020, to align with the effective date of Reg BI

Form CRS



Form CRS Relationship Summary

- Overview of the CRS and the SEC's goals
- What we're going to cover:
 - Instructions and Definitions
 - Form Fundamentals
 - Delivery of the Form; Timing
 - Who Gets a Form?
 - Updates to the Form
 - Filing the Form with the SEC and FINRA; Recordkeeping

Form CRS Relationship Summary Instructions and Definitions

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

**A natural person, or the legal representative of such natural person, who seeks to receive or receives services primarily for personal, family or household purposes.*

Form CRS Relationship Summary

Form Fundamentals

- Requires a question-and-answer format, with standardized questions serving as the headings in a prescribed order covering:
 - Introduction
 - Relationships and services
 - Fees, costs, conflicts and standard of conduct
 - Disciplinary history
 - Where to find more information
- “Conversation starters” must be included
- Use of charts, graphs, tables, and other graphics or text features encouraged
- Dual registrants can use a single relationship summary that discusses both brokerage and investment advisory services

“Item Instructions”

Item 2. Relationships and Services

- The heading must read “What investment services and advice can you provide me?”
- The heading must be followed by a **Description of Services**, which must address:
 - Monitoring
 - Investment Authority
 - Limited Investment Offerings
 - Account Minimums and Other Requirements
- Additional Information
- Conversation Starters

“Item Instructions”

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

- Arguably the most complex of the form items
- The first heading must read “What fees will I pay?”
- “What are your legal obligations to me when providing recommendations?” How else does your firm make money and what conflicts of interest do you have? (BD version; adjust for IAs and dual registrants)
- Conversation starter (if I give you \$10,000 to invest, how much will go to fees and costs, and how much will be invested for me?)

“Item Instructions”

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

- You must discuss *Examples of Ways You Make Money and Conflicts of Interest* (including proprietary products, third-party payments, revenue sharing, and principal trading)
- You must ask: “How might your conflicts of interest affect me, and how will you address them?”
- You must describe how your financial professionals are compensated (including cash and non-cash and differential product compensation) and the conflicts of interest those payments create

Initial Delivery of Form CRS Relationship Summary

- Form CRS must be delivered to retail customers at the earliest of:
 - A **recommendation** of an account type, a securities transaction; or an investment strategy involving securities;
 - Placing an order for the retail investor; or
 - The opening of a brokerage account for the retail investor
- Investment advisers must deliver Form CRS to new retail investors before or at the time an adviser enters into an investment advisory contract, and to existing clients before or at the time an adviser
 - Opens a new account for the existing client that is different from the retail investor's existing account(s);
 - Recommends that the retail investor roll over assets from a retirement account into a new or existing account or investment; or
 - Recommends or provides a new investment advisory service or investment that does not necessarily involve the opening of a new account and would not be held in an existing account
- **Dual registrants** are required to deliver the relationship summary at the earliest of the broker-dealer/investment adviser triggers

Ongoing Form CRS Relationship Summary Delivery Requirements

- If changes are made to its Form CRS, a firm must communicate the change to each retail investor who is an existing client within 60 days after the amendments are required to be made and without charge
 - The communication can be made by delivering the amended Form CRS or by communicating the information through another disclosure that is delivered to the retail investor
- A firm must post Form CRS on its website and deliver a current Form CRS to each retail investor within 30 days upon request

Filing and Recordkeeping Requirements For Form CRS Relationship Summary

Broker-Dealer Filing & Recordkeeping

- The initial Form CRS must be filed with CRD no later than June 30, 2020
 - Firms can file their initial Form CRS starting May 1, 2020
- A broker-dealer must record the date a form CRS is provided to a retail customer, including those provided before an account is opened – see new Rule 17a-3(a)(24), Exchange Act
- Records must be kept for at least 6 years – see new Rule 17a-4(e)(10), Exchange Act

Investment Adviser Filing & Recordkeeping

- Form CRS is included in Form ADV as new Part 3 of Form ADV
- The initial Form CRS must be filed electronically with IARD no later than June 30, 2020
 - Firms can file starting May 1, 2020
- An investment adviser must record the date when a Form CRS is provided to a retail client – see amended Rule 204-2, Advisers Act
- Records must be kept for at least 5 fiscal years

Advisers Act Standard of Conduct Interpretive Release



Standard of Conduct for Investment Advisers

- As part of the rulemaking package, the SEC adopted an interpretation regarding the standard of conduct for investment advisers
 - The SEC reaffirmed and clarified aspects of the fiduciary duty owed to clients. The final interpretive guidance differs in some aspects from the proposal
 - Fiduciary duty applies to the entire adviser-client relationship (citing cases brought under §206 where fraud arose from the investment advisory relationship, even though the wrongdoing did not involve securities)
 - The adviser and client may shape the scope of the relationship by agreement if there is full and fair disclosure and informed consent; however, the duty cannot be waived
 - The adviser must, at all times, serve the best interest of its client and not subordinate the client's interest to its own
 - The duty of care requires advice be in the best interest of a client based on the client's investment objectives

Standard of Conduct for Investment Advisers

- To meet its duty of loyalty, an adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship
- The duty of loyalty requires eliminating or making full and fair disclosure of all conflicts that could incline an investment adviser – consciously or unconsciously – to render advice which is not disinterested so that a client can provide informed consent to the conflict
 - If an investment adviser cannot fully and fairly disclose a conflict, it should either eliminate or adequately mitigate (i.e., modify practices to reduce) the conflict, so that full and fair disclosure and informed consent are possible
- “[S]uch disclosure and consent do not themselves satisfy the adviser’s duty to act in the client’s best interest

Standard of Conduct for Investment Advisers

- The SEC slightly altered the investment advisory fiduciary landscape
 - The interpretation delineated between the scope of an adviser's duty of care when advising a retail client as opposed to an institutional client
 - A reasonable basis for understanding the client's objectives generally includes understanding the investment profile of a retail client and the investment mandate of an institutional client
- The Heitman Capital Management No-Action Letter was rescinded
 - The SEC believed the letter's guidance was being applied incorrectly
 - Whether a hedge clause violates the Advisers Act's antifraud provisions depends on the surrounding facts and circumstances, including the client's sophistication
 - There are few, if any, circumstances in which a hedge clause in a retail client agreement would be consistent with the Advisers Act's antifraud provisions
- The SEC noted that §206 applies to advice about "account types," advice about whether to roll over assets from one account to another and whether to engage a sub-adviser

Advisers Act “Solely Incidental” Interpretive Release

The SEC's Interpretation of the Solely Incidental Prong of the Broker-Dealer Exclusion

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

The SEC's Interpretation of the Solely Incidental Prong of the Broker-Dealer Exclusion

- The interpretation distinguishes between limited/temporary discretion and unlimited discretion
 - Unlimited discretion is not solely incidental to a broker-dealer's business
 - Temporary or limited discretion in terms of time, scope or other manner lacks "comprehensive and continuous character" that would suggest an advisory relationship
- The SEC advised broker-dealers to consider adopting policies and procedures that, if followed, would help demonstrate that agreed-upon account monitoring is "in connection with and reasonably related to" the broker-dealer's primary business of effecting securities transactions
 - Continuous monitoring is not within the broker-dealer exclusion

Questions?



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