

EVERSHEDS  
SUTHERLAND



# Regulatory Education Program: New SEC Standards

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

Regulation Best Interest – Enforcement and Litigation Risks

**November 20, 2019**

Olga Greenberg, *Partner*

Michael Koffler, *Partner*

Larry Polk, *Partner*

Brian Rubin, *Partner*

Pooja Kohli, *Litigation Specialist*



# Speakers



**Olga Greenberg**  
Atlanta, GA  
+1 404 853 8274  
olgagreenberg@eversheds-  
sutherland.com



**Michael Koffler**  
New York, NY  
+1 212 389 5014  
michaelkoffler@eversheds-  
sutherland.com



**Larry Polk**  
Atlanta, GA  
+1 404 853 8225  
larrypolk@eversheds-  
sutherland.com



**Brian Rubin**  
Washington DC  
+1 202 383 0124  
brianrubin@eversheds-  
sutherland.com



**Pooja Kohli**  
New York, NY  
+1 212 389 5037  
poojakohli@eversheds-  
sutherland.com

# Overview

- Enforcement Landscape
- Enforcement and Litigation Risks
  - Reg BI
  - Form CRS
  - Standard of Conduct for Investment Advisers
  - Solely Incidental Prong of Broker-Dealer Exclusion
  - Post-Reg BI Causes of Action

# Enforcement

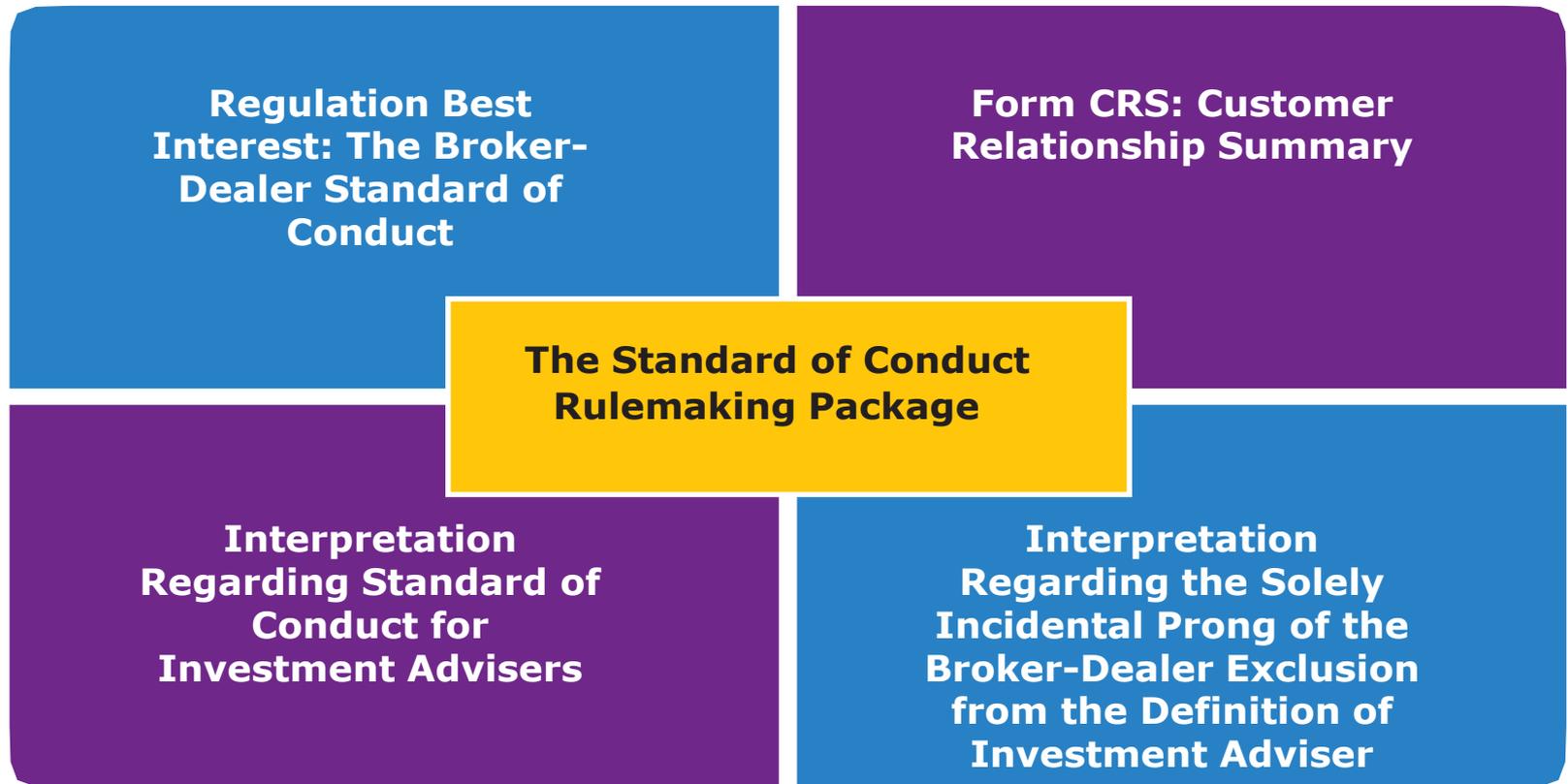


# Enforcement - landscape

- Preparedness reviews
  - FINRA will conduct “preparedness reviews” starting November 2019
- New FINRA Rules?
  - Suitability v. Reg BI
- Exams
  - FINRA expected to lead
  - Coordinated approach between FINRA and OCIE
- Enforcement actions
  - FINRA expected to lead
  - Two to three years
- Historical Enforcement Actions
  - SEC v. FINRA
  - Cases against individuals
  - Supervisory systems/WSPs
  - Documentation
  - Training

# Enforcement and Litigation Risks

# Regulation Best Interest The Rulemaking Package



# Regulation Best Interest | Broker-Dealer Standard of Conduct

# Regulation Best Interest Broker-Dealer Standard of Conduct – Enforcement and Litigation Risks

- Regulation Best Interest
  - No “best interest” definition

Care Obligation	Disclosure Obligation	Conflict of Interest Obligation	Compliance Obligation
Reasonableness standard	Negligence standard	Reasonableness standard	Reasonableness standard

# Regulation Best Interest Enforcement and Litigation Risks – Care Obligation

- **POTENTIAL CHARGE:** Failure to exercise reasonable diligence, care and skill to:
  - understand the potential **risks, rewards, and costs** associated with the recommendation
  - 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 the **particular retail customer** based on that retail customer's investment profile and the potential risks, rewards and costs associated with the recommendation

## Regulation Best Interest Broker-Dealer Standard of Conduct – Enforcement and Litigation Risks – Care Obligation

- **POTENTIAL CHARGE:** Failure to exercise reasonable diligence, care and skill 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 in light of the retail customer's investment profile
  - consider **reasonable alternatives**
  - not place the financial or other interest of the broker-dealer, or such natural person **ahead of the interest** of the retail customer

# Regulation Best Interest Enforcement and Litigation Risks – Disclosure Obligation

- **POTENTIAL CHARGE:** Failure to fully and fairly **disclose material facts** regarding scope and terms of the relationship:
  - Capacity
  - Material fees and costs
  - Type and scope of services
  - Material limitations
  - Material facts regarding conflicts of interest
  - Compensation

# Regulation Best Interest Enforcement and Litigation Risks – Conflicts of Interest Obligation

- **POTENTIAL CHARGE:** Failure to establish, maintain and enforce written policies and procedures reasonably designed to:
  - identify and at a minimum disclose (or eliminate) all **conflicts of interest** associated with a broker-dealer's recommendation to a retail customer
  - identify and mitigate any conflicts of interest associated with recommendations that involve an **incentive** for a natural person who is an associated person of a broker-dealer to place the interest of the broker-dealer or such natural person ahead of the interest of the retail customer

# Regulation Best Interest Enforcement and Litigation Risks – Conflicts of Interest Obligation

- **POTENTIAL CHARGE:** Failure to establish, maintain and enforce written policies and procedures reasonably designed to:
  - prevent **material limitations** and associated conflicts of interest from causing the broker-dealer or a natural person who is an associated person of the broker-dealer to make recommendations that place the interest of the broker-dealer or such natural person ahead of the interest of the retail customer
  - 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

# Regulation Best Interest Enforcement and Litigation Risks – Compliance Obligation

- **POTENTIAL CHARGE:** Failure to establish, maintain and enforce written **policies and procedures** reasonably designed to achieve compliance with Reg BI:
  - A broker-dealer should consider the nature of its operations and how to design policies and procedures to prevent violations from occurring, and detect and correct any violations that have occurred
  - A reasonably designed compliance program should also include controls, remediation of noncompliance, training and periodic review and testing

# Regulation Best Interest Enforcement and Litigation Risks – Training

- **POTENTIAL CHARGE:** Failure to establish **training procedures** reasonably designed to achieve compliance with Reg BI:
  - Reg BI requires firms to establish training procedures regarding the broker-dealer's conflicts of interest, including conflicts of natural persons who are associated persons of the broker-dealer, how to identify such conflicts of interest, as well as defining employees' roles and responsibilities with respect to identifying such conflicts of interest

# Form CRS | Customer Relationship Summary



# Form CRS Customer Relationship Summary – Overview

## POTENTIAL CHARGES:

- Failure to file Form CRS before deadline:
  - Form CRS initial filing required by no later than June 30, 2020
- Failure to deliver Form CRS to an investor at the appropriate time:
  - A broker-dealer must deliver its relationship summary to:
    - each new customer before or at the earliest of (i) a recommendation of an account type, securities transaction or investment strategy involving securities; (ii) placing an order for the customer, or (iii) the opening of a brokerage account and to each existing customer before or at the time the broker-dealer (i) opens a new account, (ii) recommends that the customer roll-over assets, or (iii) recommends or provides a new brokerage service or investment
  - An investment adviser must deliver its relationship summary to:
    - each new client before or at the time the adviser enters into an investment advisory contract and to each existing client before or at the time the adviser (i) opens a new account, (ii) recommends that the client roll-over assets, or (iii) recommends or provides a new investment advisory service

# Form CRS Customer Relationship Summary – Overview

## POTENTIAL CHARGES:

- Failure to **deliver** Form CRS to an investor at the appropriate time:
  - Dual registrants that provide both brokerage and advisory services are required to deliver a relationship summary to each customer or client at the earlier of the delivery trigger for broker-dealers or investment advisers
  
- Failure to provide **prescribed information:**
  - Form CRS must contain certain prescribed information; any inaccuracies or omissions could lead to enforcement action:
    - Introduction
    - Relationships and services
    - Fees, costs, conflicts and standard of conduct
    - Disciplinary history
    - Where to find more information

# Form CRS Customer Relationship Summary – Enforcement and Litigation Risks

## POTENTIAL CHARGES:

- Failure to file or deliver **amended** Form CRS:
  - There is an ongoing obligation to ensure Form CRS is accurate and any material changes should be reflected
    - 30 days to file amendments addressing material inaccuracies
    - 60 days to communicate material changes to investors
  
- Failure to keep **records**:
  - Firms are required to create a record of the date on which each Form CRS was provided to a retail investor and to maintain copies of each Form CRS and each amendment

# Interpretation | Investment Adviser Standard of Conduct

# Interpretation Investment Adviser Standard of Conduct – Enforcement and Litigation Risks

- **POTENTIAL CHARGE:** Failure to obtain and maintain a **reasonable understanding** of client’s investment profile / investment mandate:
  - Must make a reasonable inquiry into the client’s financial situation, level of financial sophistication, investment experience and financial goals
  - Duty of care duty encompasses the duty to provide advice that is in the best interest of the client
  - Duty of care includes a duty to monitor clients’ accounts, taking into account the scope of the agreed relationship
- **No hedge clauses in retail client agreements**
  - SEC’s view is that there are few (if any) circumstances in which a hedge clause in an agreement with a retail client would be consistent with anti-fraud provisions

# Interpretation | Solely Incidental Prong of the Broker-Dealer Exclusions

# Interpretation Solely Incidental Prong of the Broker-Dealer Exclusions – Scope

Solely Incidental	Not Solely Incidental
Discretion as to the price at which or the time to execute an order given by a customer for the purchase or sale of a definite amount or quantity of a specified security	Providing a recommendation that stems from an agreement with a customer to continuously monitor the customer's account
Discretion on an isolated or infrequent basis, to purchase or sell a security or type of security when a customer is unavailable for a limited period of time	Exercising unlimited discretion over a customer's account (including friends and family accounts, trust accounts etc.)
Discretion to purchase or sell securities to satisfy margin requirements or other customer obligations that the customer has specified	
Discretion to purchase or sell a security or type of security limited by specific parameters established by the customer	
Agreeing to monitor a customer's account on a periodic basis for purposes of providing buy, sell or hold recommendations	

# Interpretation Solely Incidental Prong of the Broker-Dealer Exclusions – Enforcement and Litigation Risks

## **POTENTIAL CHARGES:**

- Acting outside of scope of authority
  - Exercising unlimited discretion over account or providing continuous monitoring will be subject to the Advisers Act
- Breach of fiduciary duty
  - A fiduciary duty breach may be alleged where the recommendation is made by a dual registrant acting in its brokerage capacity if the capacity in which the firm was acting is unclear

# 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

- 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, 2019

# Questions?



# Speakers



**Olga Greenberg**  
Atlanta, GA  
+1 404 853 8274  
olgagreenberg@eversheds-  
sutherland.com



**Michael Koffler**  
New York, NY  
+1 212 389 5014  
michaelkoffler@eversheds-  
sutherland.com



**Larry Polk**  
Atlanta, GA  
+1 404 853 8225  
larrypolk@eversheds-  
sutherland.com



**Brian Rubin**  
Washington DC  
+1 202 383 0124  
brianrubin@eversheds-  
sutherland.com



**Pooja Kohli**  
New York, NY  
+1 212 389 5037  
poojakohli@eversheds-  
sutherland.com

The information, analysis, and opinions expressed herein are for informational purposes only and represent the views of the authors, not necessarily the views of Investnet. Nothing contained herein is intended to constitute legal, regulatory, tax, accounting, securities, or investment advice, nor an opinion regarding the appropriateness of any investment, nor a solicitation of any type. The views expressed herein reflect the judgment of the authors as of the date of writing, are subject to change at any time without notice, are not based on the circumstances of a particular firm, and do not constitute legal advice. Information obtained from third-party sources is believed to be reliable but is not guaranteed. Investnet is not a law firm and as such, does not provide legal or regulatory advice or opinions to any party or client. You should always consult your relevant regulatory authorities or legal counsel as applicable. © 2019 Investnet, Inc. All rights reserved. For investment professional use only. The views expressed are those of the individuals and do not necessarily reflect the views of Eversheds Sutherland (US) LLP, its clients or any of its or their respective affiliates. This webcast is for general information purposes and is not intended to be, and should not be, relied upon by the recipient in making decisions of a legal nature. © Eversheds Sutherland 2019. All rights reserved. Eversheds Sutherland (US) LLP is part of a global legal practice, operating through various separate and distinct legal entities, under Eversheds Sutherland. For a full description of the structure and a list of offices, please visit [www.eversheds-sutherland.com](http://www.eversheds-sutherland.com).

© 2019 Investnet, Inc. All rights reserved. For investment professional use only.

[www.Investnet.com](http://www.Investnet.com)

**eversheds-sutherland.com**

© 2019 Eversheds Sutherland (US) LLP  
All rights reserved.

*This communication cannot be used for the purpose of avoiding any penalties that may be imposed under federal, state or local tax law.*

