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June 7, 2019

TO: NAIFA

FROM: Scott Sinder
Kate Jensen

RE: **SEC Final Rule** -- Regulation Best Interest; Form CRS; Interpretation of "Solely Incidental" Broker-Dealer Exclusion from the Advisers Act; and Interpretation of Investment Advisers' Federal Fiduciary Duty Standard

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On June 5, the Securities and Exchange Commission (SEC) voted 3-to-1 to approve its final rule to, among other things, enhance broker-dealers' (BD) and registered representatives' (RR) standard of conduct to a best interest standard. The package includes the following main components:

(1) Regulation Best Interest ("Regulation BI")[1] – a "best interest" standard of conduct for BDs and their associated persons (hereinafter referred to in shorthand as "RRs") with specific disclosure, care, conflict of interest, and compliance obligations; and which effectively incorporates the proposed rule's "adviser/advisor" titling restrictions for non-dual licensed RRs (with some positive modifications);

[1] Securities and Exchange Commission, Final Rule, *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, Release No. 34-86031, available at: https://www.sec.gov/rules/final/2019/34-86031.pdf.

(Continued…)

(2) Form CRS Relationship Summary[2] – a high-level, 2- or 4-page disclosure document for BDs/RRs and Investment Advisers (IAs)/Investment Adviser Representatives (IARs) describing services offered, compensation arrangements, conflicts of interest and standards of conduct owed to clients designed to allow investors to compare the options for financial firms and professionals available to them;

(3) Interpretation of the "Solely Incidental" Exemption for BDs under the Advisers Act of 1940[3] – affirms and clarifies prior guidance regarding BDs' permissible "advice" activities that will not bring them within the IA definition or IA the regulatory structure, and provides examples of the Interpretation as applied to situations in which BDs exercise some discretionary authority over accounts and engage in account monitoring; and

(4) Interpretation of IAs' Federal Fiduciary Duty[4] – a consolidated interpretation of IAs' federal fiduciary standard, including its underlying duties of care and loyalty, which seeks to reaffirm and clarify previous guidance under the Advisers Act and court decisions.

This memorandum describes each of these components in detail.

Regulation BI and Form CRS have a **compliance date of June 30, 2020**. The Interpretations are effective immediately upon publication in the Federal Register.

WHAT IT MEANS FOR NAIFA MEMBERS

The SEC's rule will undoubtedly bring changes to the way financial services businesses and professionals operate. Much of the implementation of the rule will fall to and be led by BDs and IAs, so, as always, NAIFA members should pay careful attention to guidance from their firms. That said, there are parts of the rule that likely will have a meaningful impact on NAIFA members' day-to-day activities.

First, to level set – the SEC has designed its rule to *preserve* consumer choice with respect to products, services, compensation arrangements, business models, and service providers.

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[2] Securities and Exchange Commission, Final Rule, *Form CRS Relationship Summary: Amendments for Form ADV*, Release No. 34-86032, available at: https://www.sec.gov/rules/final/2019/34-86032.pdf.

[3] Securities and Exchange Commission, Interpretation, *Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser,* Release No. IA-5249, available at: https://www.sec.gov/rules/interp/2019/ia-5249.pdf.

[4] Securities and Exchange Commission, Interpretation, *Commission Interpretation Regarding Standard of Conduct for Investment Advisers,* Release No. IA-5248, available at: https://www.sec.gov/rules/interp/2019/ia-5248.pdf.

Recognizing the value of options for consumers, the SEC explicitly *rejected* a one-size-fits-all approach for BDs/RRs and IAs/IARs and is not attempting to drive the market in one direction or another. The SEC also has not, and does not intend to, create any new private causes of action under the rule.

The best interest standard for BDs/RRs is not the same as the fiduciary standard for IAs – it is not a "fiduciary" standard at all. It is, however, designed to be a significant enhancement to the current suitability regime. Although NAIFA members have always acted in the best interest of their clients, there are new substantive obligations under the SEC's rule that will need to be taken into account.

"Best interest" requires that NAIFA members not put their own interests ahead of their clients' interests. The "ahead of" language (unlike the "without regard to" language used in the DOL's former rule) recognizes that financial professionals will inevitably have some interest in the recommendations they make and therefore does not require "conflict free" advice. Also, the standard is evaluated "at the time" of the recommendation, *not* in hindsight.

Importantly, the scope of the best interest standard (what counts as a "recommendation") and its obligations are appropriately tailored to preserve investment education and availability of general investment information – policy objectives strongly supported by NAIFA.

The specific obligations underlying the best interest standard likely will create some changes for NAIFA members' operations. Notably, the disclosure obligation retains for all practical purposes the titling restrictions for non-dual licensed BDs and RRs that were proposed last year. Those BDs/RRs will not be allowed to use "advisor/adviser" in their names or titles. In response to many of the concerns raised by NAIFA and others, however, the SEC has relaxed the restrictions such that those terms may be used by BDs/RRs as descriptors in marketing communications and BDs/RRs may continue to include in business communications (e.g., on letterhead, in promotional materials) their firm names that have "adviser/advisor" if the firm is dual registered.

Additionally, under the best interest obligations, NAIFA members who sell only proprietary products will provide additional disclosures and their firms will design specific policies and procedures surrounding any potential conflicts of interest that may arise out of the sale of limited product options. Also, cost to the consumer of a particular recommendation is now an explicit factor – though not *the* determinative factor – that must be considered in every recommendation.

More generally, as firms implement the conflict of interest obligations and recordkeeping requirements under the best interest standard, NAIFA members may see some changes to compensation structures (though those changes, we understand, are already well underway following the DOL rule). Some compensation models will be barred completely (sales contests, quotas, etc. that are tied to the sale of specific products within a limited timeframe). Expectations from firms may also increase with respect to documenting bases for certain recommendations, like those dealing with particularly complex products.

Form CRS is a new disclosure obligation (in addition to the best interest disclosures), which, again, will likely be driven in design and content by the BD firms, but will become part of the suite of required client disclosures. All of the disclosures in the SEC rule are meant to be part of a common-sense layered disclosure approach that will be meaningful and understandable for consumers, and also tailorable to particular firms' models and clientele.

To complement Regulation Best Interest and Form CRS, the SEC has also provided an interpretation of the "solely incidental" exclusion for BDs under the Advisers Act and an interpretation of IAs' federal fiduciary duty. These interpretations do not seek to substantively change prior guidance, but rather, attempt to clarify and consolidate these rules – ultimately providing a resource and more certainty for financial services professionals.

Finally, the SEC has left the preemptive scope of its rule up to the courts (in other words, courts will have to decide which state laws are allowed to move forward in this space and which are not). NAIFA members must therefore remain mindful of continued efforts in the states to enhance BD/RR standards of care and how new state laws may influence compliance obligations.

Release of the SEC's final rule is the culmination of years of work and input by NAIFA members to help craft a workable, meaningful, and strong standard of conduct for BDs and RRs. This marks the beginning of a long implementation phase during which NAIFA will remain engaged with lawmakers and regulatory officials as they develop additional guidance and details under this new framework.

EXECUTIVE SUMMARY OF THE RULE'S PROVISIONS

The final SEC package does not amend or eliminate any existing obligations or requirements under current federal securities laws (e.g., the suitability standard, disclosure requirements, conflict of interest requirements, reasonable compensation restrictions, duty to supervise, etc.). Instead, it builds upon and adds to the current legal and regulatory structure for BDs/RRs and IAs/IARs.

Additionally, the SEC notes, any preemptive effect of the rule on state law will be "determined in future judicial proceedings based on the specific language and effect of that state law."

A high-level summary of the main substantive features of the final rule follows.

I. Regulation BI for BDs and RRs

Regulation BI enhances the longstanding suitability framework (and, more generally, the anti-fraud provisions of the federal securities laws) for BDs and RRs. It does not apply to IAs or IARs. The structure of the final rule largely mirrors last year's proposal. "Best interest" remains undefined and instead will be fulfilled via a series of obligations to the client that demonstrate what it means to "act in the client's best interest." The final Regulation BI does contain some additions and clarifications (versus the proposal) with respect to those obligations, which are italicized and bolded for emphasis below.

Key points for NAIFA members under the final Regulation BI include:

- The Disclosure and Care Obligations apply directly to RRs and BDs (the latter two obligations apply directly to BDs only);
- The final rule puts more emphasis on proprietary products (in terms of disclosures and conflict procedures) than the proposed version of the rule;
- Cost to the investor is now an explicit factor to be considered in any recommendations to retail clients;
- Recommendations regarding account type (e.g., brokerage versus advisory) and rollovers are now explicitly covered under the best interest standard;
- Certain compensation arrangements (sales contests, quotas, and the like) are to be eliminated entirely, and conflicts related to variable compensation arrangements in general must be mitigated by the BDs; and
- The "adviser/advisor" restrictions from the proposed rule are effectively still in place for names and titles of non-dual registered BDs and RRs, but certain other restrictions from the proposal have been relaxed (e.g., terms may be used as descriptors in marketing materials).

Specifically, the best interest standard requires:

- BDs and RRs,
- when making a recommendation,
- of any securities transaction or investment strategy involving securities (***including account recommendations***)
- to a retail customer
- to 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 BD/RR making the recommendation ahead of the interests of the retail customer.

The best interest standard is satisfied only if BDs/RRs comply with the four obligations described below (i.e., failure to comply with any one of the obligations is a violation of the best interest standard and Regulation BI).

(1) *Disclosure Obligation* –

- Prior to or at the time of the recommendation,
- the BD or RR
- provides to the customer in writing ***full and fair disclosure*** of:

  (a) All material facts relating to the scope and terms of the relationship with the customer (including capacity in which the professional is acting; material fees and costs that apply

to the customer's transactions, holdings and accounts; and type and scope of services being offered, ***including limitations on the products that may be offered such as proprietary products***); and

(b) all material conflicts of interest associated with the recommendation.

The disclosure regarding a professional's capacity is where the SEC has effectively retained "adviser/advisor" titling restrictions for BDs/RRs who are not also licensed as IAs/IARs. The SEC will presume it is a violation of this obligation if a non-dual licensed BD/RR uses "advisor/adviser" in his/her name or title – a presumption that cannot be overcome with additional disclosures. The final package's titling restrictions are, in some respects, relaxed versus the proposal and are discussed in more detail below.

(2) *Care Obligation* –

- In making a recommendation,
- a BD or RR must
- exercise reasonable diligence, care, and skill to:

(a) Understand the potential risks and rewards 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;

(b) Have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on his or her investment profile, the recommendation's potential risks and rewards, ***and the cost associated with the transaction;***

(c) Have a reasonable basis to believe that a series of recommended transactions—even if in the customer's best interest when viewed in isolation—is not excessive and is in the customer's best interest when taken together in light of the customer's investment profile; and

(d) Overall, have a reasonable basis to believe the recommendation is in the best interest of the client (i.e., does not place the BD's/RR's interests ahead of the client's interests).

(3) *Conflict of Interest Obligations* –

- A BD (obligation not directly applicable to RRs) must
- establish, maintain and enforce,
- written policies and procedures
- reasonably designed to:

(a) Identify and at a minimum disclose, or eliminate, all material conflicts of interest associated with recommendations;

(b) ***Identify and mitigate* any conflicts of interest associated with such recommendations that create an incentive for an RR to place their interest ahead of the customer's interests** *(e.g., compensation incentives that may create conflicts)***;**

(c) ***Identify and disclose* any material limitations placed on the securities or investment strategies that may be recommended (e.g., proprietary products) and any conflicts associated with those limitations, *and prevent* any such limitations and associated conflicts from causing the RR to put their interests ahead of the client; and**

(d) ***Identify and eliminate* any sales contests, quotas, bonuses and non-cash compensation based on the sale of specific securities or types of securities within a limited period of time.**

(4) ***Compliance Obligation* –**

- ***In addition to the conflict-related policies and procedures listed above,***
- ***the BD (again, not a direct obligation on RRs) must***
- ***establish, maintain and enforce written policies and procedures reasonably designed to comply with Regulation BI overall.***

The final rule also includes a relatively broad ***definition of "conflict of interest"*** for purposes of Regulation BI – ***"an interest that might incline a [BD or RR] – consciously or unconsciously – to make a recommendation that is not disinterested."***

Additional details about Regulation BI are below, but the following are notable framing points for NAIFA members that have carried over from the proposed rule:

- The SEC does not believe that the new rule does—nor does the SEC intend for it to—create any new private right of action or right of rescission.
- Scienter (e.g., fraud or intentional wrongdoing) is not required to prove a violation of Regulation BI.
- BDs/RRs may not waive compliance with Regulation BI and customers may not waive their protections under Regulation BI.
- The SEC used "ahead of" language, rather than the DOL's "without regard to" terminology, because it recognizes the BDs/RRs will inevitably have some financial interest in a recommendation and does not require "conflict free" advice.
- The best interest standard does not necessarily require BDs/RRs to recommend the least expensive or least remunerative product or strategy, nor does it prohibit BDs/RRs from offering only propriety products, so long as the elements of the Regulation BI obligations are satisfied.
- It does not require consideration of *all* possible alternatives offered outside of the firm or available on the firm's entire platform. It also does not require recommendation of "*the* best" option.

- The standard does not impose a continuous duty or duty to monitor on BDs/RRs, nor does it apply to unsolicited transaction requests by customers or customer orders that are contrary to BD/RR recommendations.

II. Form CRS

The SEC did finalize a new disclosure requirement for BDs/RRs and IAs/IARs – the design and content of which will likely be driven by BD and IA firms. Form CRS is intended to be a comparative and educational tool for consumers to make informed choices regarding hiring and retaining their financial firms and professionals. It is a short (2 pages for BDs and IAs, or 4 pages for dual registrants), concise, and direct disclosure that must be delivered early in the client relationship (and updated to remain relevant for existing clients).

The SEC did make some helpful changes based on stakeholder comments. Firms will now have more flexibility to use their own language in filling out the content and they are specifically encouraged to use graphs, charts, and electronic media and delivery to make the document more consumer-friendly.

Instructions for Form CRS are available here: https://www.sec.gov/rules/final/2019/34-86032-appendix-b.pdf. The instructions contain detailed information about format, delivery, recordkeeping/filing, and content. Generally, the Form covers information in the following categories (somewhat simplified and shortened from the proposed version):

- Services offered and the nature of the relationship between firm/professional and client (e.g., brokerage versus advisory, scope of services, ongoing monitoring, limitations on product offerings, etc.);
- Costs and fees that will be incurred by the investor (provided via general descriptions of compensation types);
- How firms and financial professionals are paid and how compensation arrangements may cause conflicts of interest (e.g., transaction-based compensation may influence recommendations on level of trading; proprietary product-related conflicts; etc.);
- The “best interest” standard of conduct owed to clients; and
- Any legal or disciplinary actions against a firm or its RRs/IARs.

Again, we anticipate that the firms will design and provide these Forms for their RRs and IARs and additional information on the content can be found here: https://www.sec.gov/rules/final/2019/34-86032-appendix-b.pdf.

III. Interpretation Regarding the “Solely Incidental” Prong of the BD Exclusion from the Definition of “Investment Adviser”

This Interpretation, which was not part of the proposed rule, aims to clarify the line of permissible "advice" activities for BDs that will allow them to avoid being defined as IAs regulated under the Advisers Act. The Interpretation was drafted in light of, and as a complement to, the enhanced best interest standard of care for BDs/RRs and Form CRS.

Under current law and guidance, BDs may offer advice "solely incidental" to their primary business of executing securities transactions (if they also do not receive any special compensation for that advice) and not be considered IAs. The Interpretation affirms previous guidance and court decisions on the "solely incidental" line and specifically clarifies that:

- A BD's provision of advice
- as to the value and characteristics of securities or as to the advisability of transacting in securities
- is consistent with the solely incidental test
- if the advice is provided in connection with and is reasonably related to the BD's primary business of effecting securities transaction (i.e., the primary business may not be providing such advice).

The Interpretation further confirms that a BD's/RR's advice need not be "trivial" or "inconsequential" to satisfy the solely incidental test.
The Interpretation also provides specific examples of when BDs with limited discretionary authority over accounts may still satisfy the "solely incidental" test and offers some clarification on when account monitoring will and will not be considered "solely incidental" advice.

IV. Interpretation Regarding Standard of Conduct for Investment Advisers

Finally, the package includes a consolidated interpretation of, and guidance on, IAs' federal fiduciary duty – a duty imposed, but not clearly defined, under the Advisers Act and which has been generally shaped by court opinions over many years. Notably, the Interpretation does not create or impose new duties on IAs. Rather, it seeks to reaffirm and clarify duties that have long existed.

The Interpretation outlines the sub-duties within the broader duties of care and loyalty comprising the IA fiduciary standard:

Under the duty of care –

- Act in the client's best interest;
- Seek best execution of transactions for clients; and
- Unless otherwise agreed upon, duty to monitor and provide ongoing advice; and

Under the duty of loyalty –

- Refrain from putting the IA's interests ahead of clients' interests and do not favor one client over another;
- Provide full and fair disclosure of all material facts relating to the advisory relationship; and
- Seek to avoid conflicts of interest with clients, and at a minimum, make full and fair disclosure of all material conflicts that could affect the relationship (when full and fair disclosure of such material conflicts is not adequate/possible to facilitate clients' informed consent – due to complexities, etc.—IAs have a duty to mitigate or eliminate such conflicts).

The details of the entire final package are discussed below.

DISCUSSION OF THE FINAL RULE

I. Regulation Best Interest

The SEC rejected calls from many stakeholders to establish a uniform "fiduciary" standard for BDs and IAs, reasoning that a "one size fits all" approach risks reducing consumer choice and access to products, services, compensation arrangements, and providers. The SEC does intend, however, for the best interest rule to be a *significantly enhanced* standard of conduct vis-à-vis suitability.

As noted above, this rule does not amend, replace or eliminate existing obligations under the federal securities laws. Therefore, existing requirements/obligations that are not necessarily addressed in Regulation BI do not disappear under the new rule (e.g., no misleading statements under anti-fraud laws, may receive only fair and reasonable compensation, principles of fair dealing and good faith apply to communications, etc.).

Consistent with the proposed rule, the final rule retains several helpful interpretations by the SEC regarding the best interest standard (see pp. 5-6 above for key framing points). Overall, the SEC explicitly intends to preserve different business models and compensation arrangements and does not seek to drive the marketplace in any particular direction with respect to these options.

A. Significant Changes/Clarifications from the Proposed Rule

The final rule retains the same general structure as proposed Regulation BI -- "best interest" is not defined, but rather, will be satisfied via a series of enumerated obligations that demonstrate what it means to "act in the best interest" of the client. That said, the SEC notes what it believes to be the following significant changes or "enhancements" to the general best interest standard under the final rule (changes to the specific underlying obligations are discussed under those subsections below):

- *"Retail Customer" definition* – modified to include *only natural persons* who receive recommendations from BDs for their own account (but not an account for a business for which he or she works), including individual plan participants; and interpreting "legal representative of such natural person" to include *nonprofessional* legal representatives.

- *Implicit "hold" recommendations are subject to the best interest standard* – BDs are still not required to monitor accounts, but in instances where a BD agrees to provide such services, such an agreement will result in buy, sell or hold recommendations subject to Regulation Best Interest, even when the recommendation to hold is implicit and not directly communicated to the client.

- *Recommendations of account types, including rollover recommendations (e.g., ERISA account to IRA) are explicitly covered* – the best interest standard now expressly applies to account recommendations including, among others: recommendations to roll over or transfer assets in a workplace retirement plan to an IRA, recommendations to open a particular securities account (e.g., brokerage or advisory), and recommendations to take a plan distribution for the purpose of opening a securities account.

- *Dual-registrant compliance* – clarifies that Regulation BI does not apply to advice provided by a BD that is dually registered as an IA ("dual-registrant") when acting in the capacity of an IA, and that a dual registrant is an IA solely with respect to accounts for which s/he provides advice and receives compensation that subjects it to the Advisers Act.

B. The General Best Interest Obligation

The best interest standard requires:

- BDs and natural associated persons of BDs (again, referred to throughout as "RRs"),
- when making a recommendation,
- of any securities transaction or investment strategy involving securities (including account recommendations)
- to a retail customer
- to 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 BD/RR making the recommendation ahead of the interests of the retail customer.

These elements of the standard are discussed in turn below.

1. *All BDs and natural associated persons of a BD*

The SEC defines "natural person who is an associated person" as it is defined in section 3(a)(18) of the Exchange Act:

> "Any partner, officer, director or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with

> such broker or dealer, or any employee of such broker or dealer, except that any person associated with a broker or dealer whose functions are solely clerical or ministerial shall not be included in the meaning of such term for purposes of section 15(b) of this title (other than paragraph 6 thereof)."

This definition includes RRs. It does not, however, capture affiliated *entities* (i.e., non-natural persons) of BDs.

2. *When making a recommendation*

The best interest obligation is driven by *each* recommendation, regardless of whether recommendations are episodic, periodic or frequent. "Recommendation"—not specifically defined—will be interpreted as it currently is under SEC precedent and guidance. There is no bright-line rule, but rather, whether a recommendation has been made is interpreted based on the facts and circumstances involved. Factors currently considered in the suitability context include:

- whether the communication "reasonably could be viewed as a 'call to action,'" and
- "reasonably would influence an investor to trade a particular security or group of securities."

Generally, the more tailored a communication is to an individual or specific group of individuals, the more likely it is to be viewed as a recommendation. Additionally, consistent with current rules, "implicit recommendations" (i.e., transactions executed on a customer's behalf without separate authorization in a discretionary account) may trigger recommendation-based obligations.

The SEC recognizes throughout the preamble to the rule the value of investor education and general information regarding investments. The SEC does not view the following types of communications as "recommendations" of securities or investment strategies[5] (unless coupled with a recommendation):

- General financial and investment information, including:
  - basic investment concepts, such as risk and return, diversification, dollar-cost averaging, compounded return, and tax-deferred investment,
  - historic differences in the return of asset classes (e.g., equities, bonds, or cash) based on standard market indices,
  - effects of inflation,
  - estimates of future retirement income needs, and
  - an assessment of a customer's investment profile;

[5] These categories mirror the exceptions in Financial Industry Regulatory Authority (FINRA) Rule 2111.03 (suitability).

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

- 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 Rule 2214 (Requirements for the Use of Investment Analysis Tools) if the asset allocation model is an "investment analysis tool" covered by Rule 2214; and

- Interactive investment materials that incorporate the above.

3. *Of any securities transaction or investment strategy involving securities (including account recommendations and rollovers and implicit "hold" recommendations stemming from account monitoring)*

"Securities transactions" include the sale, purchase and/or exchange of securities, as well as rollovers of securities between accounts. "Investment strategies involving securities" include recommendations to hold a security or the manner in which to buy or sell a security, among other securities-related activities.

Unlike the proposed rule, final Regulation BI does explicitly cover general "account recommendations," which include: securities account types generally (e.g., open an IRA or other brokerage account); rollovers from one type of account to another; and implicit hold recommendations that result from agreed-upon account monitoring. These recommendations are covered regardless of whether they are tied to a specific securities purchase or transaction, or a recommendation for a specific securities transaction.

Regulation BI allows, but does not require, BDs/RRs to contract with customers for ongoing monitoring services for purposes of recommending investment changes. The BD/RR would thus, according to the SEC, take on the obligation to review and make recommendations with respect to the account on some regular basis. If, for example, the BD/RR agrees to quarterly reviews of the account, those reviews will result in some recommendation(s) – explicit or implicit – every quarter to buy, hold, or sell.

Explicit "buy, hold, sell" recommendations are clearly covered under Regulation BI, but now, *if there is an agreement to monitor in place*, *implicit* recommendations to hold, at the time the

agreed-upon monitoring occurs, are also covered – even if they are not communicated to the client.[6]

The SEC has also clarified that making recommendations with respect to retirement accounts – whether to take a distribution, take in-service loans, etc. – are considered recommendations of a securities transaction.

4. *To a retail customer*

"Retail customer" means:

"a *natural* person, or the legal representative of such *natural* person, who:

(1) receives a recommendation of any securities transaction or investment strategy involving securities from [a BD or RR], and

(2) uses the recommendation primarily for personal, family, or household purposes."

As noted above, the definition was modified to cover only "natural" persons in the final rule and to exclude institutions. Also, the SEC is interpreting "representative" to mean non-professional legal representatives (e.g., non-professional trustees, executors, persons holding power of attorney, etc.) to exclude professional/corporate fiduciaries.

"Personal, family, or household purposes" would cover retirement accounts (including those held in a workplace retirement plan) but would not cover, for example, an employee seeking services on behalf of an employer, or a plan representative seeking services for the entire plan.

Under the final rule, a person "uses" a recommendation when, as a result of the recommendation:

- the retail customer opens a brokerage account with the BD, regardless of whether the BD receives compensation;
- the retail customer has an existing account with the BD and receives a recommendation from the BD, regardless of whether the BD receives or will receive compensation, directly or indirectly, as a result of that recommendation; or
- the BD receives or will receive compensation, directly or indirectly as a result of that recommendation, even if that retail customer does not have an account at the firm.

C. Component Obligations to the Best Interest Standard

As noted above, whether a BD/RR "acts in the best interest" of a client will be determined based on fulfillment of all of the obligations discussed below. Importantly, ***only two of the four***

[6] The SEC notes that this is different from FINRA suitability guidance, which does not cover implicit recommendations to hold.

obligations apply directly to RRs: the disclosure and care obligations. The other two obligations pertaining to conflicts of interest and compliance apply directly to the BDs, not RRs.

1. *Disclosure Obligation*

As noted above and discussed below regarding BD/RR "capacity" disclosures, the "advisor/adviser" titling restrictions from the proposed rule have effectively – for most NAIFA members' purposes – been incorporated under this Regulation BI obligation.

Also, the SEC specifically states that RRs may often be able to rely on disclosures provided by their BDs, but if a RR knows or should know that a BD disclosure is insufficient to satisfy the obligation, the RR must supplement the disclosure. The SEC provides the following example: If a RR of a BD that offers a full range of securities products is licensed solely as a Series 6 Registered Representative and can sell only mutual funds, variable annuities and other enumerated products, that limitation on the scope of services provided by that particular RR must be sufficiently clear in the BD's disclosures; otherwise, additional clarifying disclosures by the RR would be necessary.

This obligation does not require a standardized written disclosure (unlike Form CRS). Instead, BDs/RRs are free to create new standalone disclosures or utilize existing disclosures/ documents (e.g., prospectuses, relationship guides, account agreements, fee schedules, etc.) to the extent they already encompass the disclosure items below (keeping in mind that some standardized documents may have to be tailored/supplemented to satisfy this obligation).

Existing SEC guidance on paper and electronic delivery of disclosures will apply here. The SEC is not prescribing the timing or frequency of these disclosures, other than requiring that they be delivered "at or before a recommendation." BDs/RRs have a duty to update these disclosures based on changes in facts and circumstances.

The obligation specifically provides:

- Prior to or at the time of the recommendation,
- the BD or RR must
- provide to the customer in writing *full and fair disclosure* of:

(a) All material facts relating to the scope and terms of the relationship with the customer, including:

- the capacity in which the professional is acting (e.g., as a BD or RR);[7]
- material fees and costs that apply to the customer's transactions, holdings and accounts; and
- type and scope of services being offered, *including limitations on the products that may be offered such as proprietary products,* and whether ongoing monitoring will occur; and

(b) all material conflicts of interest associated with the recommendation.

These items represent the minimum that must be disclosed. Facts are "material" if there is "a substantial likelihood that a reasonable retail customer would consider it important." And again, unlike the proposal, the final Regulation BI ***defines "conflict of interest" broadly as "an interest that might incline a [BD/RR] – consciously or unconsciously – to make a recommendation that is not disinterested."***

The best interest disclosure obligation is meant to be part of a layered disclosure regime. Form CRS (discussed in detail below) provides an initial base of information and this obligation adds a more specific, detailed layer on top. The SEC will also permit the best interest disclosure obligation itself to be a layered disclosure with more general information provided upfront/early and supplemental details delivered later – all of it resulting in full and fair disclosure of material facts known at different points in time (alternatively, firms are welcome to provide more robust details upfront and avoid subsequent or multiple disclosures).

Although the rule officially requires disclosures in writing at or before the time a recommendation is made, the SEC's preamble states that it will accept oral disclosures and post-recommendation disclosures in some situations – for instance, making a supplemental or clarifying oral disclosure based on a prior written disclosure at the time of a new recommendation, provided that the oral disclosure and its delivery are documented; orally supplementing existing disclosures when delivering a recommendation over the phone; or where existing regulations permit disclosure after the recommendation (e.g., trade confirmation, prospectus delivery).

Relatedly, the SEC recognizes that not all material facts may be known at the time of the recommendation, so it suggests that initial standardized disclosures could be made providing general product-level fee percentage ranges, BD capacity language, known conflicts of interest, etc., but could include a statement that additional, more individualized disclosures based on

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[7] This generally can be satisfied by non-dual registrants by delivering Form CRS. For dual registrants, however, more specific information about the capacity in which they are acting will be necessary under this obligation.

subsequent information/developments may be delivered orally later in the process (must say when and how you are going to deliver the supplemental information).

"Full and fair" disclosures give customers enough information to make informed decisions with respect to recommendations – i.e., whether to accept or reject the recommendation. The SEC has avoided being overly prescriptive in terms of level of detail, and instead is leaving it up to BDs/RRs and their specific business practices. Accordingly, the adequacy of the disclosure will depend on the facts and circumstances, but generally should:

- Be truthful and not omit any material facts necessary to make the notice not misleading; and
- Be concise, clear and understandable (e.g., should use plain English, short sentences, active voice, and avoid legal/technical terms and multiple negatives).

Further explanation regarding the facts that must be disclosed is provided below.

a. Material facts relating to BD/RR capacity (***including "advisor/adviser" titling restrictions***)

In general, BDs/RRs must disclose that they are making recommendations in their capacity as registered BDs or RRs. The SEC has wrapped certain "adviser/advisor" titling restrictions into this obligation.

Although the final package does not retain a separate "titling restriction" rule (as the proposal had), the functional restriction on use of "adviser/advisor" in RR names and titles remains in place as a component of Regulation BI's disclosure obligation. However, the restrictions were relaxed somewhat in the final rule to allow "advice" and "adviser/advisor" to be used by BDs/RRs as descriptive terms in marketing communications and in dual licensed firm names, even if the RR is not licensed as an IAR.

The SEC states:

> **"[It] would presume the use of the terms "adviser" and "advisor" by**
>
> **(1) a broker-dealer that is not also registered as an investment adviser or**
>
> **(2) a financial professional that is not also a supervised person of an investment adviser**
>
> **to be a violation of the capacity disclosure requirement under the Disclosure Obligation."**

Moreover, there is no way to overcome this presumptive violation with additional disclosures.

Dual-licensed BD/IAs (and associated persons who also are dual licensed) may use "advisor/adviser" in their titles and names. Under the final rule, the following are also permissible:

- Non-dual licensed BDs and RRs may use "advice" and "advisor/adviser" as descriptors in marketing communications (e.g., "I have provided advice with respect to these products for 20 years."), but BDs/RRs should be mindful of the "solely incidental" advice rules discussed below and be careful not to mislead consumers about the scope of services that may be provided.

- If the RR's firm is dual licensed as a BD/IA, the RR may continue using the firm's materials and the firm's name in professional communications, even if the firm name includes "adviser/advisor" (the RR will have to disclose that s/he is not licensed as, or supervised by, an IA).

- Because the titling limitation only applies to names/titles of registered BDs and RRs, use of trade association names like NAIFA's in business materials (e.g., business cards or promotional items) should not be impacted.

b. Material facts relating to the scope and terms of the relationship

Although the final rule provides specific examples of material facts relating to the relationship (capacity, fees and costs, scope of services), the SEC reminds BDs/RRs that *all* material facts must be disclosed. Therefore, BDs/RRs must assess the circumstances to determine whether other material facts should be disclosed (generally, the SEC notes, this information will build upon Form CRS discussed below as part of the SEC's "layered" disclosure approach).

c. Material facts related to fees and costs

Notably, this obligation does not require individualized product-level disclosures for each customer (i.e., does not require disclosure of a specific fee/cost amount for each product for each customer). Rather, standardized product-level disclosures are permitted, including reasonable dollar or percentage ranges. This may be presented in the form of standardized or hypothetical amounts or percentage ranges, along with explanatory text.

It is not sufficient to rely on Form CRS for this category of material facts. While Form CRS provides general information about "types" of compensation, this disclosure would be expected to be more detailed and include more quantitative information. So, for example, this disclosure should include a description of:

- How and when fees are deducted from an account (e.g., per-transaction, semi-annually);
- Why a fee is being imposed; and

- Any fees or costs that are unique to the BD's/RR's business and may not be captured under the Form CRS's general description.

There is an obligation to supplement any generalized fee disclosures with more individualized information if the BD/RR concludes that material facts have emerged. Here, again, the subsequent information may be delivered through existing documentation, such as trade confirmations or prospectuses. Moreover, BDs/RRs may refer customers to other sources for additional information (e.g., issuers' security disclosures, offering circular, etc.).

As a "best practice," the SEC suggests periodic reviews with clients of fee and cost structures applicable to their holdings and accounts.

d. Material facts related to type and scope of services provided, *including any material limitations on the securities/strategies that may be recommended* (e.g., proprietary products).

The notable addition for NAIFA members in this section is the explicit reference to "limitations on the securities or investment strategies . . . that may be recommended." Here, the SEC is targeting the sale of proprietary products or another limited suite of options like a specific asset class. Under this section, disclosures should include:

- Whether ongoing monitoring will take place;
- Frequency and duration of services;
- Account minimums or similar requirements;
- Proprietary product restrictions and/or limitations related to specific asset classes, issuers, or third-party arrangements;
- If a RR is under a dually-registered BD, but the RR is not him/herself dually-registered, notification that the RR's services are materially narrower than the BD's services (this is related to the titling restriction relaxations discussed above);
- General basis for the recommendation (i.e., investment approach, philosophy, strategy) in standardized/summary form, which does not need to be broken out for each separate recommendation (but should note circumstances under which the standardized summary does not apply and how the BD/RR will notify the customer); and
- Standardized description of the general risks associated with the recommendations, but again, does not need to be broken out for every recommendation (BDs/RRs may rely on existing documentation here – e.g., Reg. S-K, FINRA Rules 2330 and 2210).

Generally, BDs/RRs may rely on existing disclosures to satisfy this element of the obligation, such as account opening agreements, to the extent they already contain this information.

e. Material conflicts of interest associated with a recommendation

To clarify, the standard requires disclosure of *material* conflicts, not all conflicts that may exist (a distinction that should be determined under BDs' conflicts-related policies and procedures, discussed in more detail below). The SEC does provide, however, a list of material conflicts it generally would expect a BD/RR to disclose, including those associated with recommending:

- Proprietary products;
- Products of affiliates;
- A limited range of products (e.g., revenue sharing products);
- One share class versus another share class of a mutual fund;
- Securities underwritten by the BD or one of its affiliates;
- Rollovers or transfers of assets from one type of account to another; and
- Allocation of investment opportunities among retail customers (e.g., IPO allocation).

Additionally, the following compensation-related items should be disclosed (again, no specific amounts are required):

- How a BD/RR is compensated (sources and types of compensation, fees paid directly by customers, etc. – may initially be in standardized form describing, for example, general fund compensation, but should supplement when necessary to disclose material facts, such as revenue sharing that comes with a specific fund family recommendation); and
- Any conflicts related to such arrangements (e.g., variable compensation schemes, any compensation benefits from recommending proprietary products because the BD owns the product).

2. *Care Obligation*

The Care Obligation under the proposed best interest standard is intended to incorporate and enhance existing suitability requirements for BDs and RRs. The SEC adopted this obligation largely as proposed, with a couple of notable changes:

- To avoid confusion and legal uncertainty, the SEC removed reference to a "prudence" standard; and

- Added emphasis that cost (transaction costs and later costs like deferred sales or liquidation charges) must be a consideration when evaluating whether a recommendation is in the best interest of the customer (but notably, retains the clarification that cost is not a dispositive factor).

The Care Obligation cannot be satisfied with full disclosure alone, nor is proof of fraud or misrepresentation required to prove a violation of the Care Obligation, even if proper policies and procedures are in place at the BD level.

Under this obligation –

- In making a recommendation,
- a BD or RR must
- exercise reasonable diligence, care, and skill to:

(a) 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;

(b) Have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on his or her investment profile, the recommendation's potential risks and rewards, *and the <u>cost</u> associated with the transaction;* and

(c) Have a reasonable basis to believe that a series of recommended transactions—even if in the customer's best interest when viewed in isolation—is not excessive and is in the customer's best interest when taken together in light of the customer's investment profile; and

(d) Overall, have a reasonable basis to believe that the recommendation is in the client's best interest and does not put his or her interests ahead of the customer's interests.

The elements of this obligation are detailed further below.

a. Understand the potential risks, rewards and costs associated with the recommendation and have a reasonable basis to believe the recommendation could be in the best interest of at least some retail customers

This element incorporates "reasonable basis suitability" from BDs' current regime, but adds in an explicit reference to understanding/consideration of costs (which carries throughout the elements of this obligation). It focuses on the security or strategy recommended, not on the customer. A BD must satisfy two parts:

- Undertake, with <u>reasonable diligence, skill and care</u> (i.e., reasonable investigation and inquiry), to understand the potential risks, rewards and costs of the recommended security or strategy; and
- Have a <u>reasonable basis</u> to believe that the recommendation could be in the best interest of at least some retail customers based on that understanding.

What constitutes "reasonable diligence, care and skill" varies based on the complexity of the risks, a BD's familiarity with the security/strategy, etc. Generally, in addition to evaluating general risks, rewards, and costs, the SEC suggests that BDs/RRs ask:

- Can less costly, complex, or risky products available through the BDRR 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?

This list of considerations is not exhaustive and should not be used as a substitute for a BD's or RR's own judgment and assessment.

b. Have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on his or her investment profile and the recommendation's potential risks, rewards, and costs

This element incorporates the existing "customer-specific suitability" model, but enhances it with the "best interest" of (rather than "suitable for") analysis/obligation. As with Regulation BI as a whole, recommendations on account types and rollovers must satisfy this obligation.

Generally, to satisfy this obligation, a BD needs to consider:

- Costs;
- Product-related factors (e.g., unusual features, liquidity, risks/benefits, volatility, etc.);
- Alternative account types available (fees and expenses, level of service available, penalties, etc.);
- Financial and other benefits to the BD/RR; and
- The customer's investment profile.

Again, this is not an exhaustive list and BDs/RRs should consider the facts and circumstances of each customer interaction to determine which factors are relevant and how those factors should be weighted. Although it is <u>not</u> required, the SEC suggests that BDs/RRs may want to document the bases for their recommendations in at least some cases (e.g., when recommending particularly complex products or where the recommendation may not appear to be in the customer's best interest on its face), but such documentation will not cure a best interest violation if the recommendation was not actually in the customer's best interest.

Part of this obligation, per the SEC, is considering "reasonably available alternatives *offered by the BD*." It does not require consideration of *all* possible alternatives offered outside of the firm or even all options available on the firm's entire platform, particularly when a BD operates a broad open architecture platform with many product options. It also does not require recommendation of "*the* best" option.

The scope of "reasonably available alternatives" to consider, according to the SEC, could legitimately vary based on, among other things:

- The RR's customer base and the objectives and needs of that customer base;
- The investment and services available to that RR to recommend (e.g., may be limited to proprietary products); and
- Other limitations on product/service offerings such as income thresholds, product geographic limits, and product limits based on account type.

Any recommendation chosen from these alternatives, however, must ultimately be in the best interest of the customer – offering a limited suite of products (or even one type of account like brokerage accounts) will not be an excuse for selling a product or account type that is not in the best interest of the customer.

"Customer Investment Profile" includes, but is 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, dealer, or a natural person who is an associated person of a [BD] in connection with a recommendation."

BDs/RRs need to exercise reasonable diligence to ascertain the investment profile on an "as needed" basis (i.e., should revisit if there is reason to believe the profile has changed). Consistent with FINRA's suitability rule, BDs/RRs generally may rely on information provided by customers, unless there is a "red flag" indicating the information is inaccurate.

c. Have a reasonable basis to believe that a series of recommended transactions (i.e., the level of trading)—even if in the customer's best interest when viewed in isolation—is not excessive and is in the customer's best interest when taken together in light of the customer's investment profile

This element of the care obligation incorporates "quantitative suitability," but without a "control" element. This obligation applies regardless of whether a BD exercises actual or *de facto* control over an account. The proposal also enhances the suitability regime with a requirement that there be a reasonable basis to believe that a recommended series of transactions

is not excessive and is in the customer's best interest (which imports all product, BD/RR compensation, and client considerations noted above).

No single test defines excessiveness with respect to a series of transactions or level of trading, but the following factors—under the SEC's, FINRA's, and courts' historical interpretations—may be indicators:

- Turnover rate;
- Cost-to-equity ratio; and
- Use of in-and-out trading in a customer's account.

3. *Conflict of Interest Obligations*

Unlike the disclosure and care obligations discussed above, which apply directly to BDs and their RRs, the conflict of interest obligations fall on the BDs.

Unlike the proposed rule, the final Regulation BI does not distinguish between material conflicts and material conflicts arising from financial incentives. It does, however, ban sales contests and similar arrangements based on sales of specific products within a limited range of time, and it requires BDs to mitigate (i.e., minimize or reduce) other compensation practices that may incentivize RRs to put their own interests ahead of their customers' interests (discussed in more detail below).

Under the conflict of interest obligations:

- A BD must
- establish, maintain and enforce,
- written policies and procedures
- reasonably designed to:

(a) Identify and at a minimum disclose,[8] or eliminate, all material conflicts of interest associated with recommendations;

(b) Identify and mitigate any conflicts of interest associated with such recommendations that create incentives for RRs to place their interests ahead of customers' interests;

(c) Identify and disclose any material limitations placed on the securities or investment strategies that may be recommended (e.g., proprietary products) and any conflicts

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[8] These disclosures would be made in accordance with the disclosure obligation described above.

associated with those limitations, and prevent any such limitations and associated conflicts from causing the RR to put their interests ahead of the client; and

(d) Identify and **eliminate** any ***sales contests, quotas, bonuses and non-cash compensation (e.g., prizes, lodging, travel, etc.) based on the sale of specific securities or types of securities within a limited period of time***.[9]

The SEC has retained a flexible approach regarding what constitutes "reasonably designed" policies and procedures. Per the rule's interpretation, it likely would be reasonable to use a risk-based compliance and supervisory system, rather than conducting detailed reviews of all recommendations, allowing firms to focus on their greatest risks of non-compliance and harm to customers. The SEC also provides firms with a non-exhaustive list of guidelines for how they should identify conflicts on an ongoing basis – an essential component of all of these obligations.

Under the "at a minimum disclose" standard, if a BD determines that disclosure does not reasonably address a conflict (e.g., where a disclosure cannot be made clear and simple or otherwise does not help the customer's understanding of the conflict under the disclosure obligation) or the BD has difficulty determining whether it is putting its or its RR's interest ahead of the customer's interests, the BD should move to eliminate the conflict or mitigate the conflict until full and fair disclosure is achievable.

a. Mitigation of Certain RR Incentives

The SEC reiterates in this section that elimination of transaction-based compensation (e.g., commissions) is not required under, nor the goal of, Regulation BI. Generally, the incentives addressed under this section would include compensation that varies based on the recommendation given. The SEC gives the following examples:

- Compensation from the BD or third parties for the products sold;
- Employee compensation/incentives tied to asset accumulation, variable compensation, or appraisals or performance reviews; and
- Differential or variable compensation, commissions or sales charges, or other fees or incentives, regardless of who is paying the compensation.

To "mitigate" conflicts arising from these incentives, BDs must have policies and procedures "reasonably designed to reduce the potential effect such conflicts may have on a recommendation given to a retail customer" – in other words, they are to reduce the incentives for RRs to make recommendations that put RRs' interests ahead of customers' interests. Again, here, the SEC has avoided taking a prescriptive approach and will allow BDs to develop mitigation measures based on their own circumstances.

[9] The SEC does not intent with this obligation to reach employee benefits like health insurance or retirement plans, or educational meetings or conferences (as long as the meeting attendance is not based on the sale of specific securities/security types within a limited time period).

Generally speaking, mitigation measures may be calibrated for the particular firm and its clientele, taking into consideration various factors related to the BD's business model (e.g., size of the BD, retail customer base's level of experience and understanding, the nature and significance of the compensation conflict, and the complexity of the product). What is reasonable for a small firm that sells basic products (e.g., setting the tone by the firm owner, plus supervisory controls and compensation structures) may be different from what is reasonable for a large firm selling a broad array of products (e.g., enterprise management and operational risk frameworks).

In other words, mitigation measures may be scaled based on the complexity of the business. It also may be appropriate to have different mitigation measures for different types of retail customers, different products or strategies, or types of incentives (if some incentives are difficult to mitigate, they may have to be eliminated for, for example, certain categories of customers). Finally, mitigation procedures should be informed by BDs' actual experience and may have to evolve over time to remain "reasonable."

The SEC provides the following non-exhaustive list of mitigation measures that BDs should consider adopting; specifically, measures that:

- Avoid compensation thresholds that disproportionately increase compensation through incremental increases in sales;
- Minimize compensation incentives for employees to favor one type of product over another, proprietary or preferred provider products, or comparable products sold on a principal basis – for example, establishing differential compensation criteria based on neutral factors (e.g., the time and complexity of the work involved);
- Eliminate compensation incentives within comparable product lines (e.g., one mutual fund over a comparable fund) by, for example, capping the credit that a RR may receive across comparable mutual funds or other comparable products across providers;
- Implement supervisory procedures to monitor recommendations that are: near compensation thresholds; near thresholds for firm recognition; involve higher compensating products, proprietary products or transactions in a principal capacity; or, involve the rollover or transfer of assets from one type of account to another (such as recommendations to rollover or transfer assets in an ERISA account to an Individual Retirement Account (IRA), when the recommendation involves a securities transaction) or from one product class to another;
- Adjust compensation for registered representatives who fail to adequately manage conflicts of interest; and
- Limit the types of retail customers to whom a product, transaction or strategy may be recommended (e.g., certain products with conflicts of interest associated with complex compensation structures).

b. Mitigation of material limitations on recommendations

Unlike the proposed rule, the final Regulation BI explicitly addresses in this section conflicts presented when a BD puts material limitations on the products or strategies that may be recommended to customers (e.g., only proprietary products, certain asset classes, or products with third-party revenue sharing arrangements). These conflicts pertain to establishment of the firm's product menu. They must be disclosed pursuant to the disclosure obligation and the BD must prevent them from causing RRs to make recommendations that are not in the best interest of the client.

The SEC clarifies again in this section that it is not aiming to prohibit offerings of proprietary products or other limited product options, and suggests the following measures as examples of how this obligation may be handled while retaining these business models:

- Establish ongoing product review processes;
- Identify which customers would qualify for recommendations from the product menu; and/or
- Consider use of "preferred lists" that establish qualifications for both customers who receive recommendations from the menu and RRs who make those recommendations (e.g., minimum knowledge requirements).

4. *Compliance Obligation*

This obligation was not in the proposed rule. Again, it applies directly to BDs, not RRs. It is designed to create an affirmative obligation under the Exchange Act with respect to the rule as a whole and, the SEC believes, will encourage firms to put proper systems and controls in place to prevent violations of Regulation BI.

The obligation specifically requires:

- In addition to the conflict-related policies and procedures listed above,
- the BD (again, not a direct obligation on RRs) must
- establish, maintain and enforce written policies and procedures reasonably designed to comply with Regulation BI overall.

The concepts described above with respect to conflict of interest policies (e.g., flexible based on the characteristics of the firm, its clients, etc.) also apply here. Generally, in addition to written policies and procedures, the SEC believes that a reasonable compliance program would also include controls and remediation for noncompliance, training, and periodic review/testing.

D. BD Regulation BI Records

Finally, the rule establishes new best interest recordkeeping requirements for BDs (not RRs), which should be kept separate from general "business as such" records. Specifically, it amends current Exchange Act recordkeeping requirements to include:

> "for each retail customer, …a record of all information collected from and provided to the retail customer pursuant to Regulation Best Interest, as well as the identity of each natural person who is an associated person of a broker or dealer, if any, responsible for the account"

These records would be kept for six years. Neglect, refusal, or inability of the customer to provide or update information excuses the BD from this obligation.

The SEC states that it is not requiring BDs to record and keep evidence of best interest determinations on a recommendation-by-recommendation basis. However, it "suggests" that firms may want to document the basis for certain recommendations in particular contexts (e.g., dealing with complex products). According to the SEC, BDs should be able to broadly explain their best interest processes and how they were applied to a particular recommendation to a retail customer.

The SEC also clarifies that BDs do not have to maintain records comparing recommendations that could have been made with those that actually were made (the former not being subject to Regulation BI).

II. Form CRS Relationship Summary

Despite many commenters' suggestion that additional disclosures will not benefit retail consumers (who already are overwhelmed by and resistant to disclosures), the SEC has adopted its proposed Form CRS. Unlike Regulation BI, this component of the package applies to BDs/RRs and IAs/IARs. The SEC states that Form CRS has a unique purpose vis-a-via other disclosures – it is designed, as a transparency measure and as a comparison and educational tool, to allow investors to choose (or choose to stay with) a firm or professional.

The instructions for Form CRS, **available here: https://www.sec.gov/rules/final/2019/34-86032-appendix-b.pdf**, contain a detailed description the information that must be included in the Form, as well as delivery, formatting, and recordkeeping requirements.

We anticipate that Form design and content will largely be driven by the BDs and IAs, and therefore this memorandum does not go into great detail on the Form's presentation, content, etc., or reiterate the information that can be found in the instructions. We have, however, included a brief general discussion and a few highlights below.

In response to comments from stakeholders, the SEC made the following notable changes in the final version of Form CRS:

- Headings in the document (still prescribed) will be in the form of standardized questions or prompts, not declarative statements, and firms will have more flexibility to use their own

wording to address the prescribed topics/questions (unlike the proposed rule, which prescribed much of the wording on the Form);[10]

- IAs' and BDs' forms are limited to two pages; dual registrants get 4 pages (allowing more reliance on the layered disclosure approach, hyperlinks, cross-references to existing information, etc.);
- The instructions specifically encourage the use of graphics, charts, etc. (with no duplicative narrative required) and cross-references to additional information, and use of electronic media and delivery is encouraged;
- The Form will link to Investor.gov/CRS – an educational website maintained by the SEC;
- Sections on costs and fees, conflicts of interest, and standards of conduct have been consolidated;
- There is a separate section on the Form for disciplinary actions against firms or RRs/IARs, but the "key questions to ask" section has been eliminated (although, there are still a few prescribed "conversation starters" throughout the Form);
- The section comparing the BD and IA business models has been eliminated (Investor.gov will contain more robust information on this point), but dual registrants are encouraged to cover both in a single Form CRS;
- IAs still must deliver the Form at the time of contracting with a client, but BDs must deliver at the earliest of: a recommendation pertaining to a security, account type, or strategy; placing an order for a retail investor; or opening a brokerage account;
- Affiliates may deliver a single Form CRS and firms may reference in their materials other financial services they provide that are not regulated by the SEC (e.g., insurance, banking, advice pursuant to state licenses);
- The SEC has clarified that Form CRS may not omit any material facts necessary to make the required disclosures, *"in light of the circumstances under which they were made,"* not misleading – intending to clarify that the content should be evaluated in light of the page limit and the opportunity to link to additional information, and omitted information will not be viewed in isolation, but rather, as part of the "total mix" of available information; and
- Any element/disclosure that is not applicable to a particular firm may be omitted, as may any prescribed wording in the instructions that is not accurate for the circumstances.

Generally, however, the final Form CRS retains the following features that are similar to what was proposed:

- The Form is meant to be a clear, concise, easy-to-understand document delivered early in the client relationship (and updated appropriately for existing clients) with no jargon or technical terms;

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[10] The SEC states that it backed off of overly prescribing wording for First Amendment concerns regarding requiring specific speech.

- Although firms now have more flexibility with respect to wording, they are expected to deliver factual, balanced descriptions of the information required;
- The topics to be covered on the Form still are prescribed – although there are fewer of them and they are now generally presented as questions – with a prescribed order:

(1) Standardized introductory paragraph;

(2) Description of relationship and services -- *What investment services and advice can you provide me?*

Includes information on brokerage versus advisory, or both, and monitoring services, investment authority, limited investment offerings such as proprietary products, and account minimums or other requirements to open an account;

(3) Fees, costs, conflicts and standard of conduct (now consolidated into one section) with subsections:

- *What fees will I pay?*

  A description of principal fees and costs that *investors will incur* (commissions, asset-based fees, fixed fees, wrap programs, etc.), including a summary of how frequently fees and charges will be assessed, and a description of the conflicts this may create (firms may use their own wording, but e.g., the investor will be charged more if there are more transactions, so there may be an incentive to encourage the client to trade often).

  Additionally, a short prescribed statement pertaining to fees and costs: "You will pay fees and costs whether you make or lose money on your investments. Fees and costs will reduce any amount of money you make on your investments over time. Please make sure you understand what fees and costs you are paying."

- *What are your legal obligations to me?*

  A statement of the standard of conduct owed to the client, which must include: "we have to act in your best interest and not put our interests ahead of yours" (with some tailoring around other language for BDs, IAs, and dual registrants).

  Also must provide examples of other ways you make money and conflicts related to proprietary products, third-party payments, revenue sharing, and principal trading.

  Also must summarize the manner in which your RRs/IARs are compensated, including cash and non-cash compensation, and conflicts that may be created (must

include whether professionals are compensated based on client asset amount, time and complexity of the work, products sold (i.e., differential compensation), sales commissions, or revenue earned by the firm based on the professional's services).

(4) Disciplinary statement --*Do you or your financial professionals have legal or disciplinary history?*

A statement providing "yes" (with additional details) or "no" answers; and directing clients to Ivestor.gov/CRS where they can search registrant database.

(5) Statement on how to get additional information –

Must state where clients can get more information about services and request a paper copy of Form CRS, and provide a telephone number where clients can request updated information/Form CRS.

III. Interpretation of "Solely Incidental" Exclusion for BDs from Adviser Act

This element of the final package was not in last year's proposal, but was added by the SEC in response to requests from commenters for additional clarification on this issue and to complement the other pieces of the final rule, including Regulation BI and Form CRS (also intended to clarify roles and obligations for BDs/RRs versus IAs/IARs).

By way of background, the Advisers Act of 1940 excludes from the definition of "investment adviser" (and by extension, laws applicable to IAs) – BDs

> "whose performance of such advisory services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation [for those services]."

Certain contours of the "solely incidental" prong have emerged through prior SEC interpretations (from 2005 and 2007) and court decisions. Based on prior guidance and this Interpretation (which does not purport to overturn or change any former interpretations), to satisfy the test:

- Services offered must be in connection with and reasonably related to the brokerage services provided to an account (put another way, offered "only in connection with the primary business of selling securities");
- A BD's "primary business" may not be providing investment advice;
- The importance or frequency of the advice is not determinative (the relationship to the primary business is more relevant), but the advice cannot supersede the product sale as the "primary" goal or business of the BD; and
- Relatedly, the advice offered need not be limited to trivial, inconsequential, or infrequent advice.

Building on these general rules, the current Interpretation specifically confirms:

- A BD's provision of advice
- as to the value and characteristics of securities or as to the advisability of transacting in securities
- is consistent with the solely incidental test
- if the advice is provided in connection with and is reasonably related to the BD's primary business of effecting securities transaction (i.e., the primary business may not be providing such advice).

Ultimately, the SEC adds, whether the test is satisfied is a facts and circumstances analysis based on the BD's business, services offered, and customer relationships.

The Interpretation also contains clarification regarding its applicability in certain real-world situations: exercising investment discretion and account monitoring.

A. Exercising Investment Discretion

The guidance clarifies that a BD's exercise of unlimited "investment discretion" as defined in the Exchange Act does not satisfy the test. However, in situations where the discretion is limited in time, scope, or other manner (i.e., is not comprehensive and continuous), the test may be satisfied.

The analysis will depend on the totality of the facts and circumstances, but examples of discretionary authority that would not, standing alone and based on the parameters described above, generally run afoul of the solely incidental prong include 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;
- 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;
- as to cash management, such as to exchange a position in a money market fund for another money market fund or cash equivalent;
- to purchase or sell securities to satisfy margin requirements, or other customer obligations that the customer has specified;
- to sell specific bonds or other securities and purchase similar bonds or other securities in order to permit a customer to realize a tax loss on the original position;
- to purchase a bond with a specified credit rating and maturity; and
- to purchase or sell a security or type of security limited by specific parameters established by the customer.

The SEC also makes the following "refinements" to its existing guidance regarding discretionary situations:

- It will not include on its list of situations that generally do not violate the solely incidental test discretionary authority for a period "not to exceed a few months;"
- It is consistent with the solely incidental test for BDs to purchase or sell securities to satisfy margin requirements or other customer obligations that the customer has specified (e.g., sale to satisfy a collateral call); and
- It is consistent with the solely incidental test for BDs to sell specific bonds or other securities in order to permit a customer to realize a tax loss on the original position.

B. Account Monitoring

First, the SEC disagrees with commenters who suggested that *any* account monitoring violates the solely incidental prong. The SEC states that a BD who has an agreement with the customer to periodically monitor an account for purposes of providing buy, sell, or hold recommendations may still satisfy the test. But a BD who voluntarily reviews a customer's holdings without an agreement for purposes of deciding whether to make a recommendation is not[11] acting in connection with the primary business of effecting transactions (absent an agreement, the SEC does not even consider this voluntary evaluation to be "account monitoring").

The SEC does not provide a bright-line rule for when account monitoring pursuant to an agreement is or is not within the solely incidental realm. Instead, the SEC leaves it to BDs to establish in their policies and procedures when monitoring is conducted in connection with and is reasonably related to the primary business of transacting (e.g., such policies may say that RRs may only agree to monitor at specific timeframes for the specific purpose of determining whether to recommend buying, selling, or holding securities in the account).

IV. Interpretation Regarding Standard of Conduct for Investment Advisers

The SEC's package includes a consolidated federal interpretation of the fiduciary standard for IAs. IAs' federal fiduciary duty is imposed, but not clearly defined, in the Advisers Act. Its parameters have generally been shaped by court cases and common law fiduciary principles.

According to the Interpretation, the fiduciary standard is comprised of a duty of care and a duty of loyalty, is principles-based, and applies to the entire client relationship.

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[11] Note, there appears to be a typo on page 20 of the Interpretation release, but the context of the Interpretation suggests that the SEC does intend to delineate in this manner between agreed-upon monitoring and voluntary monitoring.

The scope of the adviser-client relationship may be shaped by the adviser and client via contract when full and fair disclosures are made and the client consents. Advisers cannot contract or negotiate away, and the client cannot waive, the federal fiduciary duty, but according to the SEC's Interpretation, the fiduciary duty should be viewed and applied in a manner that reflects the terms of the agreed-upon scope of the relationship (e.g., the functions and level/frequency of services to be performed).

More specifically, the SEC interprets the components of an IAs' federal fiduciary duty as follows:

A. <u>Duty of Care</u>

IAs' duty of care, as interpreted by the SEC, includes three sub-duties.

1. *Duty to act and to provide advice that is in the best interest of the client*

This duty applies to <u>all</u> advice an IA gives to clients (e.g., investments, strategy, engaging a sub-adviser, rollovers, etc.), and in the context of personalized investment advice, this duty entails:

- A duty to make a reasonable inquiry into – and update and maintain understanding of – a client's financial situation, level of financial sophistication, investment experience, and investment objectives (generally, the investment profile); and
- Having a reasonable belief that the advice is in the best interest of the client based on the client's investment profile (which also requires reasonable investigation of the investment).

The extent of a "reasonable inquiry" into the client's investment profile varies based on the circumstances and nature and complexity of the services and advice provided by the IA (and whether the client is a retail customer or an institution). Further, a retail investor's investment profile should be updated to reflect changes in circumstances (e.g., change in tax law, marital status of the client, etc.).

A "reasonable belief," under the Interpretation should take into account and be based on factors such as:

- Costs associated with the investment;
- risk tolerance,
- investment objectives,
- client sophistication, and
- product-specific characteristics (liquidity, risks, benefit, volatility, etc.).

Similar to the proposed best interest standard for BDs discussed above, the SEC does not interpret this IA duty to entail prescriptive requirements or prohibitions with respect to least/highest-cost products or least/most remunerative products.

2. *Duty to seek best execution of a client's transactions where the adviser has responsibility for selecting BDs to execute client trades*

This duty requires IAs to seek to obtain execution of transactions such that the client's total cost or proceeds in each transaction are the most favorable under the circumstances. This duty is fulfilled by maximizing value for the client under the particular circumstances occurring at the time of the transaction. "Maximizing value" entails more than minimizing costs; IAs can and should also consider:

- quality of BD services,
- value of research,
- execution capability,
- commission rate,
- financial responsibility, and
- responsiveness to the adviser.

Execution practices should be "periodically and systematically" evaluated by the IA to ensure this duty is being satisfied.

3. *Duty to provide advice and monitoring over the course of the relationship*

Frequency of advice and services should be both in the best interest of the client and consistent with any agreed-upon advisory services (if there is only an agreement for a one-time financial plan, the adviser is unlikely to have a duty to monitor). This duty extends to all personalized advice provided to the client, including an evaluation of whether a client's account or program/compensation type (e.g., wrap account) continues to be in his or her best interest.

B. Duty of Loyalty

The SEC interprets an IA's duty of loyalty to require an IA to:

- Refrain from putting its own interests ahead of clients' interests and not favor one client over another;
- Provide full and fair disclosure of all material facts relating to the advisory relationship; and
- Seek to avoid conflicts of interest with clients, and at a minimum, make full and fair disclosure of all material conflicts that could affect the relationship (when full and fair disclosure of such material conflicts is not adequate/possible to facilitate clients' informed consent – due to complexities, etc.—IAs have a duty to mitigate or eliminate such conflicts).

Related to the first obligation, in allocating investment opportunities among eligible clients, an IA must treat all clients fairly. The IA does not have to employ pro-rata allocation practices, but to the extent allocation policies are employed, they must be fair and if they present a conflict of interest, the conflict must be fully and fairly disclosed so the client can consent.

"Material facts" about the relationship include the capacity in which the firm is acting when providing the advice (including, for dual registered firms, information about when the adviser will be acting in a brokerage or advisory capacity). "Material conflicts" are defined the same as under Regulation BI: conflicts "which might incline an investment adviser—consciously or unconsciously—to render advice which is not disinterested."

Regarding the second two obligations under the duty of loyalty, disclosures must be "sufficiently specific" to allow the client to understand the conflict and decide whether to provide informed consent to the conflict. For instance, stating that an IA "may" have a conflict is not sufficient disclosure when a conflict is present, nor is disclosure of having "other clients" without describing how any conflicts between clients will be managed (e.g., if the IA has such processes, allocation processes for investment opportunities). "Full and fair" disclosure will ultimately depend on the nature of the client (e.g., retail versus institutional), the scope of services, and the material fact or conflict.

Informed consent by the client may be implicit or explicit, but an IA cannot infer consent when material facts about the conflict have not been disclosed or circumstances show that the client did not understand the nature or import of the conflict. When full and fair disclosure cannot be achieved (e.g., in very complex extensive conflicts), the SEC's expectation is that the IA will mitigate (i.e., modify practices so conflicts can be adequately disclosed) or eliminate the conflict.