On June 5, 2019, the Securities and Exchange Commission adopted Regulation Best Interest (Reg BI) and Form CRS. Reg BI contains long-awaited rules governing the standard of conduct applicable to broker-dealers dealing with retail customers. Form CRS requires additional disclosures by broker-dealers and investments advisers designed to enhance the transparency of their relationships with retail investors.

The SEC also issued two interpretations under the Investment Advisers Act of 1940 (Advisers Act) relating to the fiduciary standard of conduct for investment advisers and the "solely incidental" prong of the broker-dealer exclusion.

The package of rules and interpretations is intended to enhance the quality and transparency of retail investor...
relationships with broker-dealers and investment advisers. The SEC had previously proposed versions of Reg BI, Form CRS, and the interpretation of an investment adviser’s fiduciary duty in April 2018. Our previous client alerts on these proposals can be found here and here.

The adopted rulemaking and interpretations package includes four components:

**Regulation Best Interest**

Reg BI imposes an enhanced standard of conduct for broker-dealers and associated persons of broker-dealers when making any recommendation of a securities transaction or investment strategy involving securities to a retail customer. This enhanced standard does not rise to the level of the fiduciary standard applicable to investment advisers, and SEC Chairman Jay Clayton confirmed in his remarks that the SEC is not applying a uniform standard among investment advisers and broker-dealers. Instead, when making a recommendation of a securities transaction or an investment strategy involving securities, a broker-dealer must now act in the customer's best interest without placing its own interests ahead of those of the customer. The term "best interest" remains undefined in the final rule; compliance will turn on an objective assessment of the facts and circumstances related to how the components of the rule (Disclosure, Care, Conflicts of Interest, and Compliance Obligations) are satisfied at the time a particular recommendation is made to a particular retail customer.

**Initial points of interest on Reg BI**

- The SEC modified the definition of “retail customer” to focus on natural persons and their legal representatives, providing more clarity that institutions and certain professional fiduciaries are not covered by the regulation. Many commenters urged the SEC to exclude high net worth natural persons or align the regulation's definitions with those of the Financial Industry Regulatory Authority (FINRA), but the SEC declined to do so.
- Reg BI will apply not only to recommendations regarding transactions and investment strategies, but also more broadly to “account recommendations” such as a recommendation to take a distribution from, or transfer assets from or to, a retirement account.
- Broker-dealers are not required to monitor accounts, but if they agree to do so, that agreement will result in buy, sell, or hold recommendations being subject to the regulation, even when the recommendation to hold is implicit. Broker-dealers that monitor accounts should be mindful of the SEC’s interpretation of the Advisers Act’s “solely incidental” provision discussed below.
- While the proposed Disclosure Obligation would have required a broker-dealer to reasonably disclose in writing all material conflicts of interest associated with a recommendation, the final rule will require full and fair disclosure in writing of all material facts relating to conflicts of interest associated with the recommendation. The term "conflict of interest" is defined in the regulation as an interest that might incline a broker-dealer or a natural person who is an associated person of a broker-dealer, consciously or unconsciously, to make a recommendation that is not disinterested.
- When a broker-dealer learns facts not reasonably known at the time that the written disclosure is provided, it may satisfy the Disclosure Obligation by making supplemental oral disclosure not later than the time of the recommendation, provided that it maintains a record of the oral disclosure and, where other regulations permit disclosure after a recommendation is made (eg, trade confirmation, prospectus delivery), the broker-dealer may satisfy the Disclosure Obligation regarding information in the document by providing it to the retail customer after the recommendation is made.
- The Care Obligation, as proposed, addressed the consideration of risks and rewards of a recommendation. The final rule added an express requirement that broker-dealers consider costs, although the SEC emphasized that costs should never be the only consideration and there is no requirement that broker-dealers recommend the least expensive product to their clients.
- The SEC revised the Conflict of Interest Obligation by establishing an overarching obligation for broker-dealers to establish written policies and procedures to comply with the regulation; broker-dealers also must identify and, depending on the type of conflict, either disclose, mitigate, or eliminate it.
- The rule as adopted requires broker-dealers to eliminate sales contests, sales quotas, bonuses, and non-cash compensation based on sales of specific securities or types of securities within a limited period of time. Such activities create high-pressure situations for associated persons and compromise retail customers' best interests, and the SEC does not believe such conflicts can be reasonably mitigated.
- The SEC noted that compliance with Reg BI cannot be waived by the broker-dealer or the customer. The SEC also noted that any preemptive effect of Reg BI on state laws governing relationships between regulated entities
and customers would be determined in future judicial proceedings based on the specific language and effect of the particular state laws.

- Reg BI does not create a private right of action for retail customers.

**Form CRS**

Under newly adopted rules and amendments to existing rules, investment advisers and broker-dealers will be required to provide a brief "relationship summary" disclosure – known as Form CRS – to retail investors (defined differently than the Regulation BI definition of retail customer) at the beginning of the relationship. Form CRS uses a standardized Q&A format intended to promote comparisons among firms by retail investors. The Form requires the inclusion of summary information about a firm's services, fees and costs, conflicts of interest, legal standard of conduct, and the disciplinary history of the firm and its financial professionals.

*Initial points of interest on Form CRS*

- Commenters urged the SEC to adopt a single definition of "retail investor" for purposes of Form CRS and "retail customer" under Reg BI. Despite this, the final definition of "retail investor" in Form CRS although similar, differs in its scope from the definition of "retail customer" that applies under Reg BI. Because the delivery of Form CRS is required before the client relationship is established, the concept of "retail investor" includes any natural person (or its representative) that "seeks to receive" services primarily for personal, family, or household purposes.
- In a nod to the feedback received on the proposed Form CRS suggesting that readers want simpler, layered disclosure with more white space, the final instructions to Form CRS include length limitations that are shorter in some cases than the proposal. Firms that are either investment advisers or broker-dealers will be limited to 2 pages; dual registrants that prepare a combined relationship summary will be limited to 4 pages.
- While under the final rule dual registrants will have the flexibility to prepare two separate relationship summaries to describe their brokerage and investment advisory businesses, the SEC encourages such firms to prepare a single relationship summary that discusses both brokerage and investment advisory services. Regardless of the approach, dual registrants must present the information on their two businesses in a manner that delineates and facilitates a comparison between the two.
- The proposed instructions to Form CRS required extensive use of prescribed wording for firms to describe their businesses. Many commenters took issue with this approach, with one suggesting that the requirement to use prescribed speech raised concerns under the First Amendment. In response, although the final instructions require the use of standardized headings and conversation starters, there is more flexibility for firms to use their own wording to describe their businesses. The instructions also include an "escape hatch" so that firms do not feel compelled to include wording in their relationship summaries that is inaccurate or misleading in the context of their businesses.
- Form CRS need not be in paper format. The SEC emphasized that innovation in the distribution of the disclosures is encouraged, so long as all of the required content is included.

*Investment adviser fiduciary duty interpretation*

The SEC's interpretation under the Advisers Act reaffirmed and, in some cases, clarified certain aspects of the fiduciary duty owed by an investment adviser to its clients.

*Initial points of interest on the fiduciary duty interpretation*

- The SEC stated that the duty of loyalty owed by an adviser to its clients is one that does not permit the adviser to "place its own interest ahead of its client's interests." The SEC acknowledged the phrase, widely used by advisers, to the effect that the duty requires the adviser to put the client's interest ahead of its own (or "first") and indicated that this formulation was merely a [plain English formulation commonly used by investment advisers to explain their duty of loyalty in a way that may be more understandable to retail clients."
- The SEC took pains to make clear that an adviser's duty is to "eliminate OR at least expose through full and fair disclosure all conflicts of interest," and in so doing it eliminated a reference (contained in the proposed version of the interpretation) to a requirement that the adviser "seek to avoid" conflicts of interest separately from obtaining informed consent from them via disclosure. The SEC added that it is the adviser's duty, in cases where informed consent via full and fair disclosure cannot be obtained, to either eliminate or adequately mitigate the conflict such that informed consent may be obtained.
• The SEC confirmed that, while an adviser's fiduciary duty "applies to the entire relationship between the adviser and its client," an adviser and its client "can tailor the scope of the relationship to which the fiduciary duty applies" through contract. Thus, the obligations of the adviser in relation to that duty may "depend upon what functions the adviser, as agent, has agreed to assume for its principal." At various points, the SEC acknowledged that the duty of an adviser providing discretionary advice to a retail client "will be significantly different from the obligations of an adviser to a registered investment company or private fund."
• The SEC noted that several commenters had argued that the Heitman Capital Management LLC no-action letter allowed advisers to disclaim their fiduciary duties under state law and suggested that the letter "may have been applied incorrectly." The SEC confirmed that whether a so-called "hedge" clause violates the Advisers Act's anti-fraud provisions "depends on all of the surrounding facts and circumstances," and added that "there are few (if any) circumstances in which a hedge clause in an agreement with a retail client would be consistent with those antifraud provisions." The SEC added that any conflict between the adviser and its client created by such a clause must be addressed by the adviser as part of its duty of loyalty to the client. Having expressed its views about an adviser's obligations under Sections 206(1) and 206(2) of the Advisers Act, the SEC formally withdrew the Heitman letter.
• The SEC stated that an adviser has a duty "to make only suitable recommendations to a client," and noted that an adviser therefore must have a "reasonable understanding of the client's objectives." It acknowledged that the way in which the adviser develops this understanding will vary, and stated that the adviser's obligation to ascertain and update the client's objectives may not be applicable in the case of institutional clients, particularly funds, except as set forth in the advisory agreement.
• The SEC's interpretation addresses high risk and/or high cost products and strategies. After noting that an adviser has an obligation to apply heightened scrutiny to "high risk" products before determining whether they are in a retail client's best interest, the SEC stated that cost, "including fees and compensation," is only one of many important factors. The SEC added that when an adviser is considering "similar" investment products or strategies, its fiduciary duty "does not necessarily require [it] to recommend the lowest cost investment product or strategy." The SEC also confirmed that an adviser is not able to satisfy its fiduciary duty simply by advising its client "to invest in the lowest cost (to the client) least remunerative (to the investment adviser) investment product or strategy." It gave as an example an adviser's decision to recommend a higher cost, less liquid private equity fund to a client rather than a fund investing in publicly traded companies, noting that such a recommendation might be consistent with the client's best interest if it provided exposure to an asset class that was appropriate "in the context of the client's overall portfolio."
• In defining the scope of an adviser's duty, the SEC specifically stated that the duty includes advice to a client about an appropriate account type -- eg, a commission-based brokerage account or a fee-based advisory account -- for the client, and advice, if any, about rolling over assets from one account to a new or existing account managed by the adviser.
• The SEC stated that its interpretation does not take a position on the scope or substance of any fiduciary duty that applies to an adviser under applicable state law.

"Solely incidental" interpretation

The Advisers Act contains an exclusion from the definition of "investment adviser" for a broker-dealer whose conduct of investment advisory services is "solely incidental" to the conduct of its business as a broker and who receives no special compensation for those advisory services. The SEC's interpretation confirms and clarifies the SEC's position on this exclusion and illustrates the practical application of the exclusion in the context where a broker is exercising investment discretion over customer accounts and performing account monitoring services. The interpretation is intended to provide more guidance as to when a broker-dealer's advisory activities causes it to become an investment adviser under the Advisers Act.

Initial points of interest on the "solely incidental" interpretation

• The SEC's interpretation reiterates its prior position that "solely incidental" means advice provided only in connection with the primary business of selling securities, a facts and circumstances assessment that does not hinge on the "quantum" or importance of the broker-dealer's advice but rather on the nature of the broker-dealer's business, the services offered, and the broker-dealer's relationship with its customer.
• Regarding the interpretation's focus on the exercise of investment discretion and account monitoring:

  Account monitoring
The interpretation is less definitive regarding when account monitoring exceeds what is solely incidental to a broker-dealer's business. The SEC specifically declined to identify every circumstance in which agreed-upon account monitoring is or is not solely incidental to the business of effecting securities transactions, although it does note that unilateral broker-dealer reviews of accounts for the purpose of providing buy, sell, or hold recommendations may still constitute advice that is solely incidental and reasonably related to effecting securities transactions.

The SEC suggested that broker-dealers develop policies and procedures that will help demonstrate that any agreed-upon monitoring is solely incidental and reasonably related to the broker-dealer's primary business of effecting securities transactions (e.g., a policy providing that a registered representative may agree to monitor a customer's account at a specific time frame, such as quarterly. The SEC also recommends that dual registrants consider adopting policies and procedures that distinguish the level and type of monitoring in advisory and brokerage accounts.

**The exercise of investment discretion**

- The exercise of investment discretion is not solely incidental unless it is limited in time, scope, or some other manner and lacks the comprehensive and continuous aspect that suggests an advisory relationship. Assessment involves a facts and circumstance analysis. The interpretation provides seven examples of discretion that the SEC would view as solely incidental to a broker-dealer's business.
- In what the SEC called a “refinement” of prior statements, the interpretation cautions that the exercise of discretion lasting only a few months may nonetheless indicate a relationship that is primarily advisory, depending on facts and circumstances.

**What happens next**

The final forms of the rules and interpretations have been published on the SEC’s website and will shortly be published in the Federal Register. See SEC Adopts Rules and Interpretations to Enhance Protections and Preserve Choice for Retail Investors in Their Relationships With Financial Professionals, SEC Press Release (June 5, 2019). Reg BI and Form CRS (and the related rules) will become effective 60 days from publication in the Federal Register. The interpretations issued under the Advisers Act will become effective upon publication in the Federal Register.

More importantly, the compliance date for Reg BI and Form CRS is **June 30, 2020**. By that date, broker-dealers registered with the SEC that provide the covered recommendations must be in compliance with Reg BI. Already registered investment advisers, broker-dealers, and investment advisers with SEC registration pending prior to June 30, 2020 will have to file their initial Form CRS with the SEC by June 30, 2020. After that date, newly registered broker-dealers will have to file Form CRS prior to the date on which their registration becomes effective. The SEC will not accept the initial application for registration for an investment adviser that does not satisfy the requirements of Form ADV, Part 3: Form CRS.

The SEC's rulemaking and interpretations package is well over 1,000 pages. The SEC recognized the complexity of the new standards of conduct, form, and interpretations. In comments during the meeting at which the rule was adopted, the SEC urged registrants to reach out with questions to this dedicated email address: [email protected]. In addition, Commissioner Hester M. Peirce stated in her remarks that the SEC would be open to requests for more time to implement the new rules, especially from smaller firms, if the firm is acting diligently to achieve compliance. Firms with questions should consider raising them soon, as June 30, 2020 will arrive all too quickly.

We will be publishing a more in-depth analysis on the components of the rulemaking and interpretations package in the coming days, including a comparison of changes from the proposed rules and interpretation and practical considerations for those subject to the new rules and updated interpretations.

If you would like to learn more about the rulemaking and interpretation package and what it means for your business, please contact the authors or any member of the Financial Services or Investment Management team.

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