July 5, 2019

SEC Issues Final Rule Establishing Standards of Conduct for Broker-Dealers and Interpretation of the Fiduciary Duty of Investment Advisers

EXECUTIVE SUMMARY

On June 5, 2019, the SEC voted 3 to 1 (Commissioner Jackson dissenting) to approve a package of rules and interpretations designed "to enhance the quality and transparency of retail investors' relationships with investment advisers and broker-dealers." The rules and interpretations finalize proposals that were released by the SEC on April 18, 2018.

The approximately 1,400-page package comprises two rulemakings and two interpretations:

> (1) a new rule under the Exchange Act establishing a standard of conduct for broker-dealers and natural persons who are associated persons of a broker-dealer when making a recommendation to a "retail customer" ("Regulation Best Interest");
>
> (2) an interpretation regarding the standard of conduct for investment advisers under the Advisers Act ("Fiduciary Duty Interpretation");
>
> (3) new and amended rules under the Exchange Act and the Advisers Act that require broker-dealers and registered investment advisers to provide a brief relationship summary to retail investors in a prescribed format ("Form CRS"); and
>
> (4) an interpretation of section 202(a)(11)(C) of the Advisers Act, which excludes from the definition of "investment adviser" any broker or dealer that provides advisory services "solely incidental" to the conduct of the broker-dealer's business for no special compensation ("Solely Incidental Interpretation").

Regulation Best Interest: Regulation Best Interest requires a broker-dealer, or a natural person who is an associated person of a broker-dealer, to act in the best interest of a retail customer when making a recommendation of any securities transaction or investment strategy involving securities (which includes recommendations as to the appropriate type of account and transfers between accounts), without placing

the financial or other interest of the broker-dealer or natural person who is an associated person of a broker-dealer making the recommendation ahead of the interest of the retail customer. "Retail customer" is defined as a natural person (or his or her legal representative) who uses such a recommendation primarily for personal, family or household purposes. This "best interest" standard (or "General Obligation") is met by satisfying certain disclosure, care, conflict of interest and compliance obligations (the "component obligations"). The rule applies in addition to any other obligations under the Exchange Act and any other applicable provisions of the federal securities laws, self-regulatory organization rules and any related rules and regulations. Regulation Best Interest does not, however, create a new private right of action or right of rescission

Fiduciary Duty Interpretation: The Fiduciary Duty Interpretation reaffirms and clarifies certain aspects of an investment adviser's duty to clients under Section 206 of the Advisers Act, emphasizing a principles-based approach that applies to the entire relationship between an investment adviser and its client. The duty, which comprises both a duty of care and duty of loyalty, requires an investment adviser to serve the best interest of a client at all times and not subordinate the client's interest to the adviser's own interest. The SEC states that the application of the duty will be determined by the agreed-upon scope of the relationship with the client. The duty of care specifically requires the investment adviser to provide advice that is in the best interest of the client and, when applicable, obtain the best execution of transactions and provide advice and monitoring. The duty of loyalty requires the investment adviser to make full and fair disclosure to the investment adviser's client of all material facts relating to the advisory relationship and will differ depending on the circumstances, including the nature of the client, the scope of the services, and the material fact or conflict.

Form CRS: The SEC's new and amended rules relating to Form CRS require broker-dealers and investment advisers to deliver a customer relationship summary to retail investors at the beginning of a relationship. The rules require subsequent communications upon material changes to the information disclosed in the customer relationship summary or upon the occurrence of certain events. The requirements of Form CRS set forth, among other things, information about the relationships and services a firm provides to retail investors, disclosures regarding applicable standard of conduct, fees, costs, conflicts of interest and the firm's disciplinary history. Form CRS supplements other more detailed disclosure and reporting requirements required by the securities laws and related rules and regulations.

"Solely Incidental" Interpretation: The Solely Incidental Interpretation states that a broker-dealer's advisory services are "solely incidental" to the conduct of the broker-dealer's business when advice is provided in connection with and is reasonably related to the broker-dealer's primary business of effecting securities transactions. The quantum and importance of the broker-dealer's advice are not determinative. However, if the provision of advice is a broker-dealer's primary business, or if the advisory services are not offered in connection with or are not reasonably related to the broker-dealer's business of effecting

securities transactions, then the broker-dealer's advisory services will not be considered solely incidental to its business as a broker-dealer.

Commissioner Reactions: Chairman Jay Clayton supported the package of rules and interpretations, saying he believes that it will "enhance the quality and transparency of retail investors' relationships with investment advisers and broker-dealers." Commissioner Hester M. Peirce and Commissioner Elad L. Roisman also supported the package. Commissioner Robert J. Jackson, Jr., the sole dissenter, stated his view that the rules "retain a muddled standard that exposes millions of Americans to the costs of conflicted advice." Commissioner Jackson contended that both Regulation Best Interest and the Fiduciary Duty Interpretation required of investment advisers under the Advisers Act "fail to put investors first." Commissioner Jackson also questioned the sufficiency of the economic analysis supporting the package and expressed concern over whether the rules and interpretations "will displace carefully constructed and hard-won state laws."

Congressional Response: Since the SEC's adoption of the package of rules and interpretations on June 5, 2019, the House of Representative has taken steps to block the package of rules and regulations. On June 24, 2019, the House Rules Committee voted to accept for a House floor vote an amendment to a House spending bill that would prohibit the SEC from using funds to implement, administer, enforce or publicize the rules and interpretations. The amendment's sponsor, Rep. Maxine Waters (D-Cal.) said following the passage of Regulation Best Interest that, "The SEC's final rule ignores the explicit will of Congress and fails to require all financial professionals to abide by a strong, uniform fiduciary standard of care when providing investors with investment advice." On June 26, 2019, the House of Representatives passed the bill which contained the amendment by a vote of 224 to 196. The bill will now be considered by the Senate.

This memorandum summarizes the key aspects of the SEC's package of rules and interpretations.

Table of Contents

I. REGULATION BEST INTEREST

In "Regulation Best Interest: The Broker-Dealer Standard of Conduct" ("Regulation Best Interest Release"),[1] the Securities and Exchange Commission ("SEC") approved a new rule under the Securities Exchange Act of 1934 ("Exchange Act") that establishes a standard of conduct for a broker-dealer and natural persons who are its associated persons (together, a "broker-dealer") when making a recommendation of any securities transaction or investment strategy involving securities, to a retail customer ("Regulation Best Interest").[2]

A. BACKGROUND

The Exchange Act and self-regulatory organization ("SRO") rules provide a comprehensive regulatory framework that governs the obligations that attach when a broker-dealer makes a recommendation to a customer. Under federal securities laws and SRO rules existing prior to Regulation Best Interest, broker-dealers have a duty of fair dealing,[3] which requires that a recommendation by a broker-dealer to a customer be "suitable" and that a broker-dealer's compensation be fair and reasonable.

These prior conduct obligations do not require broker-dealers to make recommendations that are in a client's "best interest."

Over the past decade, concerns about the potentially harmful effects of broker-dealer conflicts of interest have led to increasing scrutiny from Congress and various governmental agencies, including the SEC and the U.S. Department of Labor ("DOL") as well as SROs such as the Financial Industry Regulatory Authority ("FINRA").

The table below summarizes the key events leading up to the adoption of Regulation Best Interest. Each key event is subsequently discussed in greater detail.

Date	*Event*	*Outcome*
July 2010	Enactment of Dodd-Frank Act	Section 913 mandates SEC study relating to personalized investment advice and recommendations about securities to retail customers.
January 2011	913 Study	The 913 Study recommended SEC adoption and implementation of a uniform fiduciary standard of conduct for broker-dealers and investment advisers.
March 2013	SEC Request for Comment	The SEC received approximately 250 comments that expressed

Date	Event	Outcome
		general support for proposals of 913 Study.
November 2013	IAC Recommendation	The IAC recommended two options for SEC action in respect of proposals of 913 Study.
April 2016	DOL Rulemaking	The DOL Fiduciary Rule and certain standards of conduct became effective on June 9, 2017; compliance with conditions of certain exemptions to DOL Fiduciary Rule was delayed until July 1, 2019.
June 2017	SEC Request for Comment	The SEC received over 250 comments that were considered in drafting Regulation Best Interest.
March 15, 2018	U.S. Court of Appeals for the Fifth Circuit ruling	The DOL Fiduciary Rule was vacated by the Fifth Circuit in *Chamber of Commerce of the U.S.A., et al.* v. *U.S. Department of Labor, et al.*
April 18, 2018	SEC Open Meeting	SEC Commissioners approved proposed Regulation Best Interest and the request for comments by a vote of 4-1, triggering a 90-day comment period.
June 5, 2019	SEC Open Meeting	SEC Commissioners approved Regulation Best Interest by a vote of 3-1.

Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") required the SEC to undertake a study to evaluate "the effectiveness of existing legal or regulatory standards of care [applicable to broker-dealers and investment advisers] (imposed by the SEC, a national securities association, and other federal or state authorities) for providing personalized investment advice and recommendations about securities to retail customers" and "whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for providing personalized investment advice about securities to retail customers that should be addressed by rule or statute."[4]

The SEC issued the study mandated by Section 913 (the "913 Study")[5] in January 2011. The 913 Study recommended that the SEC adopt and implement a uniform fiduciary standard of conduct for broker-dealers and investment advisers who provide personalized investment advice about securities to retail investors. The 913 Study recommended a standard of conduct that would require firms "to act in the best

interest of the customer without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice."[6] Subsequently, in March 2013, the SEC issued a public request for data and other information in order to evaluate the standards of conduct and regulatory obligations applicable to broker-dealers and investment advisers.[7] The SEC received more than 250 responses that expressed general support for a uniform fiduciary standard of conduct that would apply to both broker-dealers and investment advisers alike, although there was no consensus on what this standard should encompass.[8]

In November 2013, the SEC's Investor Advisory Committee ("IAC") recommended, among other proposals, implementing a uniform fiduciary standard either through (i) a narrowing of the broker-dealer exclusion from the definition of "investment adviser" under the Advisers Act (*see* Section IV) or (ii) new rules under Section 913 of the Dodd-Frank Act to adopt a principles-based fiduciary duty and to permit certain sales-related conflicts only upon full disclosure and appropriate management.[9]

Meanwhile, beginning in 2010, the DOL engaged in rulemaking to specify the definition of "fiduciary" in connection with the provision of investment advice under the Employee Retirement Income Security Act of 1974 ("ERISA") and the Internal Revenue Code of 1986 ("Code").[10] In April 2016, the DOL adopted a rule ("DOL Fiduciary Rule") that would treat as a "fiduciary" any person who provides investment advice or recommendations for compensation with respect to assets of an ERISA plan or an Individual Retirement Account ("IRA").[11] The DOL Fiduciary Rule broadly expanded the circumstances in which broker-dealers would be subject to the prohibited transaction provisions of ERISA and the Code. One of the effects of the broad nature of the DOL Fiduciary Rule was that broker-dealers would be prohibited from engaging in purchases and sales for their own account (*i.e.*, engaging in principal transactions) and from receiving compensation from third parties (including transaction-based fees, a common form of broker-dealer compensation) in connection with transactions involving an ERISA plan or IRA. To avoid this result, which could effectively eliminate a broker-dealer's ability or willingness to provide investment advice with respect to investors' retirement assets, the DOL published two exemptions from the prohibited transaction provisions:

- the Best Interest Contract Exemption ("BIC Exemption"); and
- the Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plan and IRAs ("Principal Transactions Exemption").

The BIC Exemption and the Principal Transactions Exemption would have allowed persons deemed fiduciaries under the DOL Fiduciary Rule to receive compensation and to engage in certain principal transactions that would otherwise be prohibited transactions. Under a two-phase approach, the revised definition of "fiduciary" under the DOL Fiduciary Rule as well as certain standards of impartial conduct under the BIC Exemption[12] became effective on June 9, 2017, while compliance with the remaining conditions of the BIC Exemption and the Principal Transactions Exemption would not have been required until July 1, 2019.[13] However, on March 15, 2018, the United States Court of Appeals for the Fifth Circuit

vacated *in toto* the DOL Fiduciary Rule, citing a conflict with the statutory text of ERISA and the Code and admonishing the DOL for infringing on the SEC's regulatory mandate under the Dodd-Frank Act. The DOL's opportunity to appeal the decision expired on April 30, 2018.[14] On May 7, 2018, the DOL issued a Field Assistance Bulletin describing the DOL's temporary enforcement policy related to the DOL Fiduciary Rule, indicating that "from June 9, 2017, until after regulations or exemptions or other administrative guidance has [*sic*] been issued, the [DOL] will not pursue prohibited transactions claims against investment advice fiduciaries who are working diligently and in good faith to comply with the impartial conduct standards for transactions that would have been exempted in the BIC Exemption and Principal Transactions Exemption, or treat such fiduciaries as violating the applicable prohibited transaction rules."[15]

In June 2017, the SEC had sought public comment on a variety of issues associated with standards of conduct for investment professionals.[16] The SEC received approximately 250 comments which suggested, among other things, that due to the complex and burdensome requirements imposed as part of the BIC Exemption and the associated litigation risk, broker-dealers were changing the types of products and accounts offered to retirement investors. The comments also expressed concerns that retirement investors would be harmed through reduced product choice, increased cost for retirement advice, or lost or restricted access to advice.

On April 18, 2018, the SEC proposed a package of rules and interpretations that included Regulation Best Interest ("Proposed Regulation Best Interest" or the "proposal").[17] SEC Commissioners approved the proposal of the package by a vote of 4-1. During the comment process, the SEC received over 6,000 comment letters, including approximately 3,000 unique comment letters from a wide variety of commenters including individual investors, consumer advocacy groups, financial services firms, investment professionals, industry and trade associations, state securities regulators, bar associations and others.[18]

According to the SEC, Regulation Best Interest is intended to enhance the broker-dealer standard of conduct beyond existing suitability obligations and to align the standard of conduct with retail customers' reasonable expectations.[19] The following describes Regulation Best Interest as adopted by the SEC, and discusses key changes from the proposal.

B. OVERVIEW OF REGULATION BEST INTEREST

Regulation Best Interest establishes a standard of conduct for broker-dealers when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer. The standard of conduct or General Obligation under Regulation Best Interest requires broker-dealers 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 broker, dealer, or natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer.[20]

The "best interest" standard under Regulation Best Interest will be met upon satisfaction by a broker-dealer of the following four component obligations:

- **Disclosure Obligation**: the broker-dealer, prior to or at the time of making a recommendation, provides full and fair disclosure to the retail customer, in writing, of material facts relating to the scope and terms of the relationship, including all material conflicts of interest that are associated with the recommendation.
- **Care Obligation**: the broker-dealer, in making the recommendation, exercises reasonable diligence, care, and skill.
- **Conflict of Interest Obligation**: the broker-dealer establishes, maintains, and enforces written policies and procedures reasonably designed to:
  - identify, and at a minimum disclose (in accordance with the Disclosure Obligation) or eliminate, all conflicts of interest that are associated with recommendations covered by Regulation Best Interest;
  - identify and mitigate any conflicts of interest associated with such recommendations that create an incentive for the broker-dealer to place the interest of the broker-dealer ahead of the interest of the retail customer;
  - identify and disclose any material limitations placed on the securities or investment strategies involving securities that may be recommended to a retail customer and any conflicts of interest associated with such limitations (in accordance with the Disclosure Obligation) and prevent such limitations from causing the broker-dealer to make recommendations that place the interest of the broker-dealer ahead of the interest of the retail customer; and
  - identify and eliminate any sales contests, quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time.
- **Compliance**: the broker-dealer establishes, maintains, and enforces written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.

Further discussion of each of these obligations is set forth in Section I.D below.

The SEC states in the Regulation Best Interest Release that scienter is not required to establish a violation of Regulation Best Interest—thus, any failure to comply with the component obligations will result in a violation.[21] The SEC went on to note "that the preemptive effect of Regulation Best Interest on any state law governing the relationship between regulated entities and their customers would be determined in future judicial proceedings based on the specific language and effect of that state law" and to state that it believes that Regulation Best Interest and the package of other rulemakings and interpretations it had adopted "will serve as focal points for promoting clarity, establishing greater consistency in the level of retail customer protections provided, and easing compliance across the regulatory landscape and the

spectrum of investment professionals and products."[22] The SEC declined to take any actions in an effort to have Regulation Best Interest preempt (or avoid preempting) state law, as some commenters had suggested.[23]

The SEC also states that Regulation Best Interest is not intended to create a new private right of action or right of rescission.[24] A broker-dealer would not be able to waive compliance with Regulation Best Interest, nor could a retail customer agree to waive his or her protections under Regulation Best Interest.[25] In other words, the scope of Regulation Best Interest cannot be reduced by contract. However, a broker-dealer may agree with a retail customer by contract to take on additional obligations beyond those imposed by Regulation Best Interest, such as agreeing to hold itself to a fiduciary standard or provide ongoing monitoring for purposes of recommending changes in investments.[26]

Regulation Best Interest focuses solely on enhancements to the broker-dealer regulatory regime and is intended to be separate and distinct from the fiduciary standard applicable to investment advisers under the Advisers Act. A discussion of the SEC's interpretations of the standard of conduct for investment advisers under the Advisers Act is set forth in Section II below.

C. KEY TERMS AND SCOPE OF BEST INTEREST OBLIGATION

1. "Best Interest"

As in the proposed rule, the SEC did not expressly define "best interest." However, the SEC did indicate that the component obligations under Regulation Best Interest expressly set forth what it means to "act in the best interest" of a retail customer in accordance with the General Obligation.[27] Whether a broker-dealer satisfies Regulation Best Interest's component obligations turns on an objective assessment of the facts and circumstances of the particular recommendation and the particular retail customer at the time the recommendation is made.[28] As shown in the table below, certain practices would not be *per se* prohibited by Regulation Best Interest to the extent broker-dealers satisfy the component obligations thereunder.[29]

Practices Not *Per Se* Prohibited under Regulation Best Interest
• Charging commissions or other transaction-based fees • Receiving or providing differential compensation based on the product sold • Receiving third-party compensation • Recommending proprietary products, products of affiliates or a limited range of products • Recommending a security underwritten by the broker-dealer or a broker-dealer affiliate, including initial public offerings ("IPOs") • Recommending that a transaction be executed in a principal

capacity

- Allocating trades and research, including allocating investment opportunities (*e.g.*, IPO allocations or proprietary research or advice) among different types of customers and between retail customers and the broker-dealer's own account
- Considering cost to the broker-dealer of effecting the transaction or strategy on behalf of the customer (for example, the effort or cost of buying or selling an illiquid security)
- Accepting a retail customer's order that is contrary to the broker-dealer's recommendations

2. "When Making a Recommendation," "At Time a Recommendation Is Made"

Regulation Best Interest applies when a broker-dealer is making a recommendation about any securities transaction or investment strategy to a retail customer. "Recommendation" has the same meaning as the term is currently interpreted under the federal securities laws and SRO rules.[30] Consistent with existing broker-dealer regulation, the SEC's view of whether a recommendation has been given will turn on the facts and circumstances of the particular situation.[31] In evaluating facts and circumstances, the SEC explains that it will look to factors that have historically been considered in the context of broker-dealer suitability obligations, such as whether a 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."[32] Examples of communications that would not rise to the level of a recommendation include providing general investor education (*e.g.*, a brochure discussing asset allocation strategies) or limited investment analysis (*e.g.*, a retirement savings calculator).

Additionally, in a change from the proposal, the SEC added to the scope of Regulation Best Interest implicit hold recommendations, that is, instances where a broker-dealer agrees to perform account monitoring services and does not communicate an explicit recommendation to a retail customer.[33]

The Regulation Best Interest obligation will be triggered each time a recommendation is made by a broker-dealer to a retail customer. The obligation would not:

- extend beyond a particular recommendation or generally require a broker-dealer to have a continuous duty to a retail customer or to impose a duty to monitor the performance of the account;
- require the broker-dealer to refuse to accept a customer's order that is contrary to a broker-dealer's recommendation; or
- apply to self-directed or otherwise unsolicited transactions by a retail customer.[34]

3. "Any Securities Transaction or Investment Strategy"

Regulation Best Interest will apply to recommendations of any securities transaction, whether a sale, purchase or exchange, and to recommendations of any investment strategy involving securities to retail

customers. After considering comments, the SEC expressly modified Regulation Best Interest to apply to account recommendations generally, including, for example, recommendations to select a brokerage or advisory account or to a rollover or transfer of assets to an IRA.[35]

4. "Retail Customer"

"Retail Customer" is defined as "a natural person, or the legal representative of such person, who (1) receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer or a natural person who is an associated person of a broker or dealer, and (2) uses the recommendation primarily for personal, family, or household purposes."[36] Although adopted largely unchanged, in response to comments, the SEC shifted the focus of Retail Customer to "natural persons" rather than "any persons." With this change, the SEC sought to provide more certainty that institutions and certain professional fiduciaries are not covered for purposes of Regulation Best Interest.[37] Notably, however, the definition does not have a net-worth requirement, in contrast to FINRA's definition, which contains an exclusion for certain institutional accounts and institutional investors. The SEC stated its belief that high net-worth individuals would still benefit from the protections of Regulation Best Interest and so chose not to exclude them from the definition of retail customer. The definition tracks the definition of "retail customer" under Section 913(a) of the Dodd-Frank Act and generally conforms with the definition of "retail investor" in Form CRS (*see* Section III below).[38]

5. Application to Investment Advisers and Dual-Registrants

Regulation Best Interest applies only in the context of a brokerage relationship with a brokerage customer.[39] Accordingly, Regulation Best Interest would not apply to the relationship between an investment adviser and its advisory client.

Regulation Best Interest applies to a dually registered broker-dealer/investment adviser only when it is making a recommendation solely in its capacity as a broker-dealer.[40] Regulation Best Interest would not apply to advice provided by a dual-registrant when acting in the capacity of an investment adviser, even if the person to whom the recommendation is made also has a brokerage relationship with the dual-registrant or even if the dual-registrant subsequently executes the transaction in its capacity as a broker-dealer.[41]

Determining whether a recommendation made by a dual-registrant is in its capacity as broker-dealer requires a facts and circumstances analysis.[42] Factors that should be considered include the type of account (*e.g.*, advisory, brokerage or both), how the account is described, the type of compensation, and the extent to which the dual-registrant made clear the capacity in which it was acting to the customer or client.[43] Where a dual-registrant acts in the capacity of an investment adviser, and is therefore not subject to Regulation Best Interest, the adviser would be required to comply with its fiduciary obligations under the Advisers Act, as described in more detail in Section II below.

D. APPLICATION OF THE COMPONENT OBLIGATIONS OF REGULATION BEST INTEREST

As discussed above, the Regulation Best Interest standard may be met by satisfying each of four component obligations: the Disclosure Obligation, the Care Obligation, the Conflict of Interest Obligation and the Compliance Obligation.[44] Failure to satisfy any of the component requirements violates Regulation Best Interest.[45] These component obligations are described below.

1. Disclosure Obligation

The Disclosure Obligation requires that a broker-dealer "*prior to or at the time of [a] recommendation, provide to the retail customer, in writing, full and fair disclosure of: (A) All material facts relating to the scope and terms of the relationship with the retail customer . . . and (B) All material facts relating to conflicts of interest that are associated with the recommendation*."[46] The Disclosure Obligation under Regulation Best Interest and the requirements of Form CRS (discussed in Section III.A below) are designed to complement and build upon each other.[47]

Material Facts Relating to the Scope and Terms of the Relationship with the Retail Customer

Regulation Best Interest expressly requires a broker-dealer to disclose:

- that the broker-dealer is acting in a broker-dealer capacity with respect to the recommendation (the "capacity disclosure requirement");[48]
- the material fees and costs that apply to the retail customer's transactions, holdings, and accounts; and
- the type and scope of services provided by the broker-dealer to the retail customer, including, *e.g.*, monitoring the performance of the retail customer's account.[49]

The material facts above reflect the minimum of what must be disclosed. Broker-dealers must disclose *all* material facts related to the scope and terms of the relationship with the retail customer.[50] This standard is intended to be consistent with the standard articulated by the Supreme Court in *Basic* v. *Levinson* and turns on whether there is a "substantial likelihood that a reasonable [retail customer] would consider [the material fact] important."[51]

Material Facts Relating to Conflicts of Interest Associated with the Recommendation

The SEC defines "conflict of interest" as "an interest that a reasonable person would expect might incline a broker-dealer—consciously or unconsciously—to make a recommendation that is not disinterested."[52] Importantly, while the Conflict of Interest Obligation (*see* Section I.D.3 below) covers all facts relating to conflicts of interest associated with the recommendation, the Disclosure Obligation only covers *material* facts.[53] The SEC states that it views the conflicts of interest identified in the relationship summary (*see* Section III below) as a useful starting point for identification of material facts that need to be disclosed.[54] However, given the brevity of the relationship summary, additional facts may need to be disclosed regarding such conflicts of interest in order to satisfy the Disclosure Obligation of Regulation Best Interest.[55] The SEC also clarifies that compensation associated with recommendations to retail

customers and any variable compensation (*i.e.*, whether the associated person of the broker-dealer would receive higher compensation for the sale of one product versus another) are conflicts of interest about which material facts must be disclosed.[56]

The Disclosure Obligation would apply to the extent that a broker-dealer determines to disclose but not eliminate a material conflict of interest pursuant to the Conflict of Interest Obligation (described in Section I.D.3 below).

Form, Timing and Method of Delivery

In order to provide flexibility to broker-dealers, Regulation Best Interest would not mandate the form, specific timing or method for delivering disclosure pursuant to the Disclosure Obligation, other than the general requirement that the disclosure be made "prior to or at the time" of the recommendation. The SEC is not requiring that broker-dealers make required disclosures within a certain time frame preceding the recommendation. However, it is encouraging broker-dealers to consider whether it would be helpful to repeat or highlight disclosures at the time of the recommendation.

In order to provide "full and fair" disclosure of material facts relating to the scope and terms of the relationship, a broker-dealer would need to give sufficient information to a retail customer to enable him or her to make an informed decision with regard to the recommendation, which would be determined on a case-by-case basis.[57] Compliance with the Disclosure Obligation would be measured against a negligence standard instead of being a matter of strict liability.[58]

2. Care Obligation

The Care Obligation generally draws from principles similar to those underlying the DOL's "best interest" Impartial Conduct Standard, as described by DOL in the BIC Exemption,[59] and echoes the general suitability, customer-specific suitability and series-of-transactions suitability determinations required by FINRA Rule 2111.05.[60]

In making the recommendation, the broker-dealer "*must exercise reasonable diligence, care and skill,*" to satisfy the obligations outlined in the table below.

Care Obligation	Methods of Satisfying Obligation
*"(1) 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**."*	• Undertaking reasonable diligence by considering factors such as the costs, investment objectives, characteristics associated with a product or strategy, liquidity, risks and potential benefits, volatility, likely performance in a variety of market and economic conditions, the expected return of the security or investment strategy, as well as any financial incentives to recommend the security or strategy; and • Having a reasonable basis to believe that the recommendations could be in the best interest of at least some retail customers based on that understanding.

*"(2) Have a **reasonable basis** to believe that the recommendation is in the **best interest of a particular retail customer** based on that retail customer's investment profile and the potential risks, rewards, and **costs** associated with the recommendation and does not place the financial or other interest of the broker, dealer, or such natural person ahead of the interest of the retail customer*."*	• Undertaking reasonable diligence by considering factors such as the costs, investment objectives and characteristics associated with a product or strategy, and the financial and other benefits to the broker-dealer;
	• Undertaking reasonable diligence to ascertain the retail customer's investment profile, which 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
	  • other information disclosed to the broker-dealer in connection with a recommendation; and
	• Having a reasonable basis to believe that the recommendations could be in the best interest of a particular retail customer based on that understanding.

Care Obligation	Methods of Satisfying Obligation
*"(3) Have a **reasonable basis** to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the **retail customer's best interest** when taken together in light of the retail customer's investment profile and does not place the financial or other interest of the broker, dealer, or such natural person making the series of recommendations ahead of the interest of the retail customer."* **The underlined language was added by the SEC to the Care Obligation to clarify that the Care Obligation goes beyond a broker-dealer's existing suitability obligations.*	• Undertaking reasonable diligence by considering factors such as turnover rate, cost-to-equity ratio, and the use of in-and-out trading in a customer's account; • Undertaking reasonable diligence to ascertain the retail customer's investment profile; and • Having a reasonable basis to believe that the series of recommended transactions is not excessive and is in the best interest of a particular retail customer based on that understanding.

The Care Obligation encourages the broker-dealer to consider any reasonable alternatives in determining whether it has a reasonable basis for making the recommendation. Under this approach, a broker-dealer would not be expected to analyze all possible securities, all other products or all investment strategies.[61] Further, as long as the Care Obligation is satisfied and associated conflicts are disclosed or eliminated (*see* Section I.D.3 below discussing the Conflict of Interest Obligation), Regulation Best Interest does not prohibit recommendations from a limited range of products, or recommendations of proprietary products, products of affiliates, or principal transactions.

Further, the Care Obligation goes beyond a broker-dealer's existing suitability obligations derived from the antifraud provisions of the federal securities laws; for instance, a violation of the suitability obligation requires an element of fraud or deceit,[62] whereas the Care Obligation does not. Thus, a key difference resulting from the obligations imposed by Regulation Best Interest as compared to a broker-dealer's existing suitability obligations under the antifraud provisions of the federal securities laws is that a broker-dealer would not be able to satisfy the Care Obligation through disclosure alone.

In a change from the proposal, the SEC explicitly added cost to the text of the Care Obligation. In the proposal, the SEC said the cost of the security or strategy and any associated financial incentives represent important factors (of the many factors that should be considered) in understanding and analyzing whether to recommend a security or an investment strategy under the Care Obligation. However, in response to comments, the SEC decided to add cost as a specific consideration in the rule text, saying that "cost will always be a relevant factor that will bear on the return of a security or

investment strategy involving securities." The SEC notes that the effect of adding cost to the text of the rule is that a broker-dealer, in fulfilling its obligation under the Care Obligation, must *always* take into account cost when making a recommendation.[63] It is not, however, intended to be dispositive nor meant to limit or foreclose the recommendation of a more costly or complex product to a particular retail customer if the broker-dealer determines that the product is in the best interest of the customer. The SEC notes that the recommendation of the lowest cost product without taking into account other considerations could in fact violate Regulation Best Interest.

3. Conflict of Interest Obligation

The Conflict of Interest Obligation requires a broker-dealer to establish, maintain and enforce written policies and procedures reasonably designed to:

- identify, and at a minimum disclose (in accordance with the Disclosure Obligation) or eliminate, all conflicts of interest that are associated with recommendations covered by Regulation Best Interest;
- identify and mitigate any conflicts of interest associated with such recommendations that create an incentive for the broker-dealer to place the interest of the broker-dealer ahead of the interest of the retail customer;
- identify and disclose any material limitations placed on the securities or investment strategies involving securities that may be recommended to a retail customer and any conflicts of interest associated with such limitations (in accordance with the Disclosure Obligation) and prevent such limitations from causing the broker-dealer to make recommendations that place the interest of the broker-dealer ahead of the interest of the retail customer; and
- identify and eliminate any sales contests, quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time.

As discussed above, for the purposes of Regulation Best Interest, a "conflict of interest" means an interest that might incline a broker-dealer — consciously or unconsciously — to make a recommendation that is not disinterested.

A principles-based approach to the Conflict of Interest Obligation allows broker-dealers the flexibility to establish a supervisory system in a manner that best reflects their business practices. For instance, the SEC would deem it reasonable for broker-dealers to use a risk-based compliance and supervisory system to promote compliance with the Conflict of Interest Obligation, rather than conducting a detailed review of each recommendation of a securities transaction or securities-related investment strategy to a retail customer.

In the SEC's view, so long as a broker-dealer's policies and procedures are reasonably designed to meet its Conflict of Interest Obligation, the broker-dealer would be permitted to exercise its own judgment as to whether the conflict can be effectively disclosed (as discussed in Section I.D.1), to determine what conflict mitigation methods may be appropriate and to determine whether or how to eliminate a conflict. Whether

a broker-dealer's policies and procedures are reasonably designed would depend on the relevant facts and circumstances. The SEC is not, however, establishing a safe harbor for broker-dealers that demonstrate compliance with the FINRA conflict of interest rules because Regulation Best Interest establishes a broader obligation to address conflicts at the firm and associated person levels.[64]

In the final rule, the SEC made modifications to the structure of the Conflict of Interest Obligation from proposed Regulation Best Interest. Specifically, in response to comments, it removed the distinction between material conflicts of interest and material conflicts of interest arising from financial incentives. Some commenters expressed concern that the proposed rule text would have imposed a higher standard on broker-dealers than investment advisers, who are typically able to address financial conflicts of interest through disclosure.[65] However, in light of this modification, the SEC added a provision requiring broker-dealers to establish, maintain and enforce written policies and procedures to specifically identify and disclose material limitations and associated conflicts of interest arising from these limitations (*i.e.*, when a broker-dealer only makes recommendations based on restricted or proprietary product menus) and prevent such limitations from causing the broker-dealer to make recommendations that place its interest ahead of the retail customer's.[66]

In one of the most noteworthy changes to Regulation Best Interest from the proposal, the Commission added a provision to the Conflict of Interest Obligation that specifically prohibits quotas, bonuses and non-cash compensation based on the sales of specific securities or specific types of securities within a limited period of time. A number of commenters requested clarification as to which types of conflicts would be explicitly prohibited under the proposed Conflict of Interest Obligation. The SEC adopted the new requirements to provide certainty regarding types of practices where conflicts of interest are "so pervasive" that they cannot be mitigated.[67]

In the Regulation Best Interest Release, the SEC encourages broker-dealers to consider developing policies and procedures outlining:[68]

- how the firm identifies its material conflicts of interest, clearly identifying all such material conflicts of interest and specifying how the broker-dealer intends to address each conflict;
- the firm's compliance review and monitoring systems;
- processes to escalate identified instances of noncompliance to appropriate personnel for remediation;
- procedures that clearly designate responsibility to business lines personnel for supervision of functions and persons, including determination of compensation;
- processes for escalating conflicts of interest;
- processes for a periodic review and testing of the adequacy and effectiveness of policies and procedures; and
- training on the policies and procedures.

4. Compliance Obligation

In response to comments, the SEC added a fourth component obligation to Regulation Best Interest. The Compliance Obligation requires that broker-dealers establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest. The Compliance Obligation creates an affirmative obligation with respect to Regulation Best Interest as a whole. The SEC added the Compliance Obligation in order to ensure that broker-dealers have controls in place to prevent violations of the Disclosure and Care Obligations, in addition to the policies and procedures already required by the Conflict of Interest Obligation. The SEC did not mandate specific requirements for the Compliance Obligation in Regulation Best Interest and instructs firms to consider the nature of their operations and how to "design such polices to prevent violations from occurring, detect violations that have occurred, and to correct promptly any violations that have occurred."[69]

E. RECORDKEEPING AND RETENTION

Exchange Act Section 17(a)(1) requires registered broker-dealers to make and keep for prescribed periods such records as the SEC deems "necessary or appropriate in the public interest, for the protection of investors." Exchange Act Rules 17a-3 and 17a-4 specify minimum requirements with respect to the records that broker-dealers must make, and how long those records and other documents must be kept, respectively.

As shown in the table below, the SEC has adopted certain amendments to Rules 17a-3 and 17a-4 under Regulation Best Interest.

	Current Rule	Amendment under Regulation Best Interest
Rule 17a-3(a)(17)	Requires broker-dealers that make recommendations for accounts with a natural person as customer or owner to create and periodically update customer account information.	Adds new paragraph (a)(35), which requires, for each retail customer to whom a recommendation will be provided, 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.
Rule 17a-4(e)(5)	Requires broker-dealers to maintain and preserve in an easily accessible place all	Would require broker-dealers to retain any information that the retail customer provides to the broker-dealer or the

	Current Rule	Amendment under Regulation Best Interest
	account information required pursuant to Rule 17a-3(a)(17) for six years.	broker-dealer provides to the retail customer pursuant to Rule 17a-3(a)(35), in addition to the existing requirement to retain information obtained pursuant to Rule 17a-3(a)(17).

Thus, the amendments to Rule 17a-3(a)(17) and Rule 17a-4(e)(5) require broker-dealers to retain all of the information collected from or provided to each retail customer pursuant to Regulation Best Interest for six years.

F. OTHER ISSUES

1. Use of Terms "Adviser" or "Advisor"

In the proposal, the SEC stated its view that some broker-dealers use certain names and titles in order to obscure the type of services they provide and considered adopting specific rules prohibiting the use of the terms "adviser" or "advisor" by broker-dealers. However, under the capacity disclosure requirement (*see* Section I.D.1) a broker-dealer must disclose prior to or at the time of the recommendation that they are acting in such a capacity. As a result, rather than adopting new rules, the SEC will presume that the use of the terms "adviser" and "advisor" by a broker-dealer that is not also a registered investment adviser (or an associated person of a broker-dealer that is not also a supervised person of an investment adviser) to be a violation of the capacity disclosure requirement under the Disclosure Obligation requirement to provide "full and fair" disclosure of material facts relating to the scope and terms of the relationship.[70]

2. Disclosures about a Firm's Regulatory Status and a Financial Professional's Association

The SEC in 2018 also proposed rules which would have required regulatory status disclosures by both broker-dealers and investment advisers in many types of communications (including those not directly related to recommendations of securities). After considering comments, the SEC determined that the capacity disclosure requirement and Form CRS are sufficient to achieve its objectives and that its policy concerns were addressed by the rulemaking package it adopted. The SEC did not adopt any additional regulatory status disclosure obligations.[71]

G. COMPLIANCE DATE

The SEC has specified a compliance date of June 30, 2020 for Regulation Best Interest. On and after that date, broker-dealers that provide recommendations of securities transactions or investment strategies that are registered with the Commission will be required to comply with Regulation Best Interest.

This date is meant to be coordinated with the transition period for the implementation of the Form CRS relationship summary requirements described below.

II. INTERPRETATION OF STANDARD OF CONDUCT FOR INVESTMENT ADVISERS

In its release titled "Commission Interpretation Regarding Standard of Conduct for Investment Advisers" (the "Fiduciary Duty Interpretation"),[72] the SEC seeks to "reaffirm and in some cases clarify" certain aspects of the fiduciary duty that an investment adviser owes to its clients under Section 206 of the Advisers Act. The Fiduciary Duty Interpretation generally follows the SEC's earlier proposed interpretation (the "Proposed Interpretation") but includes certain important modifications to address comments the SEC received on the Proposed Interpretation.

An investment adviser owes a fiduciary duty to its clients under Section 206 of the Advisers Act. The Fiduciary Duty Interpretation states that although the fiduciary duty to which investment advisers are subject is not specifically defined in the Advisers Act or in SEC rules, equitable common law principles and Congressional intent reflect a requirement that an investment adviser, at all times, serve the best interest of its clients and not subordinate its clients' interest to its own.[73] The SEC notes that this "principles-based approach should continue as it expresses broadly the standard to which investment advisers are held while allowing them flexibility to meet that standard in the context of their specific services."[74]

In response to commenters questioning whether the Proposed Interpretation appropriately considered the best interest obligation as part of the duty of care, or whether the best interest obligation should instead be considered part of the duty of loyalty, the SEC clarified in the Fiduciary Duty Interpretation that "an investment adviser's obligation to act in the best interest of its clients is an overarching principle that encompasses both the duty of care and the duty of loyalty."[75]

The SEC stated in the Proposed Interpretation that "the investment adviser cannot disclose or negotiate away, and the investor cannot waive, this federal fiduciary duty."[76] Responding to commenters suggesting that this broad statement could potentially limit the ability of investment advisers and clients to contractually negotiate the scope of the adviser's services and duties, the SEC modified this statement in the Fiduciary Duty Interpretation to clarify that: (i) "fiduciary duty must be viewed in the context of the agreed-upon scope of the relationship between the adviser and the client"[77] and (ii) a general waiver of the fiduciary duty would violate that duty (regardless of the sophistication of the client).[78]

The SEC notes that the Fiduciary Duty Interpretation is not intended to be the exclusive resource for understanding the principles relevant to an adviser's fiduciary duty and the Fiduciary Duty Interpretation does not take a position on the scope or substance of any adviser fiduciary duties under U.S. state law.[79]

The table below summarizes the key differences in the standard of conduct that would apply to investment advisers and broker-dealers under the final rules and interpretations.

	Standard of Conduct	***Type of Client to Which Standard Applies***
Investment Advisers	Investment advisers owe a ***fiduciary*** duty to serve the best interest of the client, which includes an obligation not to subrogate the clients' interest to its own[80]	All clients
Broker-Dealers Under Regulation Best Interest	Broker-dealers must act in the ***best interest*** of the client at the time of making a recommendation without placing the financial or other interest of the broker-dealer ahead of the interest of the client by satisfying the component obligations set forth in Regulation Best Interest	"Retail customers" as defined in Regulation Best Interest

A. DUTY OF CARE

As fiduciaries, investment advisers owe their clients a duty of care.[81] The SEC has indicated that the duty of care includes, among other things:

- the duty to provide advice that is in the best interest of the client;
- the duty to seek best execution of a client's transactions where the adviser has the responsibility to select broker-dealers to execute client trades; and
- the duty to provide advice and monitoring over the course of the relationship.

1. Duty to Provide Advice That is in the Client's Best Interest

In the context of providing personalized investment advice, the SEC interprets the duty of care as including a duty to provide advice that is "suitable" for the client,[82] which, according to the Fiduciary Duty Interpretation, requires the adviser to have a "reasonable understanding of the client's objectives."[83] With respect to retail clients, an adviser should, at a minimum, make a reasonable inquiry into a client's financial situation, level of financial sophistication, investment experience, and investment objectives (referred to collectively as the client's "investment profile").[84] The SEC notes that it will also generally be necessary for an adviser to update the investment profile of retail clients in order to fulfill its duty to have a "reasonable understanding of the client's objectives," although the frequency with which such updates must be made will depend on the facts and circumstances of the particular situation.[85] With respect to institutional investors, the SEC is of the view that the nature and extent of an investment adviser's inquiry into such investor's objectives will be shaped by the investment mandate from the client, and the SEC notes that, for advisers acting on specific investment mandates for institutional clients, the obligation to update the client's objectives should be as set forth in the advisory agreement.[86]

An investment adviser must also have a reasonable belief that the personalized advice it provides is in the best interest of the client based on the client's investment objectives. Important factors to consider when determining whether a security or investment strategy involving a security is in the best interest of the client include the cost (including fees and compensation) associated with investment advice, the investment product's or strategy's investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility, likely performance in a variety of market and economic conditions, time horizon and cost of exit.[87] The SEC's interpretation of the duty of care requires that an adviser conduct a reasonable investigation into an investment sufficient that its advice is not based on materially inaccurate or incomplete information.[88]

The Fiduciary Duty Interpretation specifically notes that cost is just one of a number of factors to be considered by advisers and that, while cost is generally an important factor, the fiduciary duty does not necessarily require an adviser to recommend the lowest-cost investment product or strategy to a client and might, in fact, preclude the adviser from doing so without any further analysis of other factors in the context of the portfolio that the adviser manages for the client and the client's investment profile.[89]

Finally, the Fiduciary Duty Interpretation notes that an adviser's fiduciary duty applies to all investment advice that the investment adviser provides, including advice about investment strategy, engaging a sub-adviser and account type (including whether to open or invest in a certain type of account and whether to roll over assets from one account to a new or existing account).[90]

2. Duty to Seek Best Execution

In a situation where an investment adviser has the responsibility to select the broker-dealer(s) to execute client trades, an adviser has the duty to seek best execution of a client's transactions.[91]

In order to meet this obligation, an investment adviser must seek to obtain the execution of transactions for each of its clients such that the client's total cost or proceeds in each transaction are the most favorable under the circumstances. The adviser fulfills this duty by executing securities transactions on behalf of a client with the goal of maximizing value for the client under the particular circumstances at the time of the transaction. In the SEC's view, maximizing value can encompass more than just minimizing cost and the determinative factor for maximizing value is whether the transaction represents the best qualitative execution.[92]

3. Duty to Act and to Provide Advice and Monitoring Over the Course of the Relationship

The Fiduciary Duty Interpretation notes that the Supreme Court has interpreted the duty of care of an investment adviser as including a duty to provide advice and monitoring over the course of a relationship with a client.[93] Advice and services should be provided at a frequency that is both in the best interest of the client and consistent with the scope of advisory services agreed upon between the investment adviser and the client.

B. DUTY OF LOYALTY

The duty of loyalty requires an investment adviser to not subordinate its client's interest to its own.[94] In seeking to meet its duty of loyalty, an adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship, which includes the capacity in which the firm is acting with respect to the advice provided.[95] The Proposed Interpretation appeared to introduce some uncertainty as to whether disclosure alone may be sufficient for an investment adviser to comply with its duties in appropriate circumstances, which would have been at odds with the long-standing principle that an investment adviser must *either* eliminate or expose all conflicts of interest that might incline the investment adviser to render advice that is not disinterested.[96] In the Fiduciary Duty Interpretation, the SEC acknowledges that, consistent with prior SEC interpretations and case law, full and fair disclosure alone may be sufficient in certain cases for an investment adviser to comply with the duty of loyalty.[97]

The SEC also provides guidance in the Fiduciary Duty Interpretation on what it believes constitutes full and fair disclosure. Disclosure must be clear and sufficiently specific for a client to understand the material fact or conflict of interest and to make a reasonably informed decision about whether to provide informed consent to such conflicts. With respect to the appropriate level of specificity required, when a conflict exists with respect to some but not all types or classes of clients, the investment adviser must disclose to which types or classes of clients the conflict exists rather than generally disclosing that a conflict "may exist."[98] It is not adequate for an adviser to disclose that it "may" have a conflict when an actual conflict exists and use of the word "may" would not be appropriate if it merely precedes a list of all possible or potential conflicts and "obfuscates the actual conflicts to the point that a client cannot provide informed consent."[99]

The SEC acknowledges that full and fair disclosure will depend upon the nature of the client (*e.g.*, disclosure for institutional clients will likely differ from disclosure for retail clients), the scope of services and the material fact or conflict itself.

Under the Fiduciary Duty Interpretation, the SEC states that it would not be consistent with an adviser's fiduciary duty to infer or accept client consent if "the adviser was aware, or reasonably should have been aware, that the client did not understand the nature and import of the conflict."[100] The SEC states that, for retail clients in particular, it may be difficult for advisers to adequately describe complex or extensive conflicts with disclosure that is both understandable and specific. Where full and fair disclosure of a conflict of interest to a client such that the client can provide informed consent is not possible, the SEC expects an adviser "to *eliminate* the conflict or adequately *mitigate* (*i.e.*, modify practices to reduce) the conflict such that full and fair disclosure and informed consent are possible."[101]

C. OTHER ISSUES

In the Proposed Interpretation, the SEC requested comment on: (i) licensing and continuing education requirements for personnel of SEC-registered investment advisers; (ii) delivery of account statements to clients with investment advisory accounts; and (iii) financial responsibility requirements for SEC-registered investment advisers along the lines of those that apply to broker-dealers. The Fiduciary Duty Interpretation notes that the SEC is continuing to evaluate the comments it received in response to these questions.[102]

III. FORM CRS – CUSTOMER RELATIONSHIP SUMMARY

In its release titled "Form CRS Relationship Summary; Amendments to Form ADV" (Release No. 34-86032; IA-5247; File No. S7-08-18) (the "Form CRS Release"),[103] the SEC adopted new rules and forms intended to inform investors about the differences between registered investment advisers, registered broker-dealers and dual-registrants (referred to together as "firms"), and the scope, nature and cost of the services each provides ("Form CRS").[104] The final rules and instructions are discussed below.

A. FORM CRS

1. Overview

The SEC will now require registered investment advisers and registered broker-dealers to deliver a relationship summary on Form CRS to retail investors. A relationship summary would be provided to a retail investor at the beginning of his or her relationship with a firm, and updated by the firm following any material change in the relationship or upon the occurrence of certain other events, and is intended to be in addition to (and not in lieu of) current disclosure and reporting requirements or other obligations for firms.

The SEC's stated goal in requiring firms to provide a Form CRS is to inform retail investors about the types of client and customer relationships and services the firm offers, the fees, costs, conflicts of interest, and required standard of conduct associated with those services, whether the firm and its financial professionals currently have reportable legal or disciplinary events and how to obtain additional information about the firm, all with a view to prompting retail investors to ask informed questions when engaging the firm's services.

2. Format

The SEC generally eliminated the prescribed wording contained in the proposed instructions and will allow firms the flexibility to utilize their own wording in many places in the relationship summary. The SEC also modified the format of the headings in response to feedback, altering them from being descriptive to a question-and-answer format and added "conversation starters," which are suggested

questions for retail investors to ask firms' financial professionals. The relationship summary may be a maximum of two pages for standalone broker-dealers or investment advisers. Dual-registrants that wish to deliver a combined relationship summary will be allowed to do so in four pages; however, those who elect to deliver separate relationship summaries will be restricted to two pages for each.[105]

3. "Retail Investors"

"Retail investors" would include all natural persons or any legal representative of such natural persons who seek to receive or receive services primarily for personal, family or household purposes, regardless of an individual's net worth, and thus would cover accredited investors, qualified clients and qualified purchasers.[106] The SEC elected to conform the definition of retail investor to Regulation Best Interest's retail customer definition.[107]

4. Content

In establishing Form CRS, the SEC has indicated that it hopes to create a tool that will facilitate comparisons across firms that offer the same or substantially similar services.[108] Where a prescribed disclosure or "conversation starter" is not applicable to the firm's business, or would be inaccurate, the instructions permit a firm to omit or modify that particular disclosure. All information in Form CRS must be true and may not omit any material facts necessary in order to make the disclosures not misleading in light of the circumstances under which they were made.[109]

The below table summarizes the items that need to be included in a relationship summary that complies with the requirements of Form CRS:

Item	Purpose
Introduction	To briefly highlight the types of accounts and services the firm offers
Relationships and Services	To provide information about the relationships between the firm and retail investors and the brokerage account and/or investment advisory account services the firm provides
Fees, Costs, Conflicts and Standard of Conduct	To provide an overview of the fees and costs borne by retail investors, certain conflicts of interest which may arise in the course of the brokerage/advisory relationship and the standard of conduct to which the firm must adhere
Disciplinary History	To provide retail investors with disclosure regarding a firm's or its associated persons' reportable disciplinary history
Additional Information	To notify investors of additional resources and firm-specific contract information

5. Filing and Delivery Obligations

Firms would have the following filing and delivery obligations with respect to Form CRS:

	Filing Obligation	Delivery Obligation
Investment Adviser	Electronically file on Investment Adviser Registration Depository ("IARD") and on its website before or at the time the firm enters into an investment advisory agreement with a retail investor.	Deliver before or at the time the firm enters into an investment advisory agreement.
Broker-Dealer	Electronically file on the FINRA's Central Registration Depository ("Web CRD") and on its website before or at the time a retail investor first engages the firm's services.	Deliver at the earliest of (i) a recommendation of an account type, (ii) a securities transaction, or (iii) a strategy involving securities.
Dual-Registrant	Electronically file on both IARD and Web CRD and post on its website at the earlier of (i) entering into an investment advisory agreement with a retail investor, or (ii) the retail investor engaging the firm's services.	Deliver at the recommendation of an account type if it is the earliest of the initial delivery triggers for broker-dealers and investment advisers.

6. Additional Delivery and Updating Requirements

A firm would be required to provide a Form CRS to an existing client or customer who is a retail investor: (i) before or at the time a new account is opened that is different from the retail investor's existing account(s); (ii) if the firm recommends that the retail investor roll over assets from a retirement account into a new or existing account or investment; or (iii) if the firm recommends or provides a new brokerage or investment advisory service that does not necessarily involve the opening of a new account and would not be held in an existing account.[110]

7. Compliance Timetable

In order to provide adequate notice and opportunity for firms to comply with the Form CRS filing obligations, the SEC is requiring compliance on the following timetable:

Compliance Dates for Form CRS	
Newly Registered Broker-Dealers and New Applicants for Registration as Investment Advisers	On or after June 30, 2020 newly registered broker-dealers will be required to file their Form CRS by the date on which their registration becomes effective, and applicants for registration as an investment adviser would need to include in their applications a relationship summary that satisfies the requirements of Form ADV, Part 3: Form CRS.

Compliance Dates for Form CRS	
Registered Investment Advisers and Broker-Dealers (as of the effective date of the new rules and amendments)	(i) Initial relationship summaries must be filed with the SEC between May 1, 2020 and June 30, 2020. (ii) Form CRS must be delivered to all existing clients who are retail investors on an initial one-time basis within 30 days after the date the firm is first required to file its Form CRS with the SEC.

IV. INTERPRETATION OF "SOLELY INCIDENTAL" UNDER THE ADVISERS ACT

In a release titled "Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser" (Release No. IA-5249) (the "Solely Incidental Interpretation"),[111] the SEC provided an interpretation of section 202(a)(11)(C) of the Investment Advisers Act of 1940, which excludes from the definition of "investment adviser" any broker-dealer that provides advisory services when such services are "solely incidental" to the conduct of the broker-dealer's business and the broker or dealer receives no special compensation for such services (the "solely incidental prong" of the "broker-dealer exclusion").[112]

In light of both Regulation Best Interest and Form CRS and requests by commenters for additional clarity on the scope of the broker-dealer exclusion and specifically the solely incidental prong, the SEC adopted an interpretation to conform and clarify the Commission's position with respect to the solely incidental prong.

Under the Solely Incidental Interpretation, the SEC states that:

A broker-dealer's provision of advice is consistent with the solely incidental prong if the advice is provided "in connection with and reasonably related to the broker-dealer's primary business of effecting securities transactions."[113]

- If a broker-dealer's primary business is giving advice as to the value and characteristics of securities or if its advisory services are not offered in connection with, or are not reasonably related to, the broker-dealer's business of effecting securities transactions, then such services are not solely incidental to its business as a broker-dealer and are therefore inconsistent with the broker-dealer exclusion.
- The "quantum" or importance of the investment advice provided by the broker-dealer is not solely determinative of whether the advice is consistent with the broker-dealer exclusion.[114] However, a broker-dealer with unlimited discretion to effect securities transactions that possesses ongoing authority over the customer's account indicates a relationship that is primarily advisory in nature.

The SEC also offers additional guidance with respect to investment discretion and account monitoring and the extent to which those services, if offered by a broker-dealer, would be consistent with the solely incidental prong.

- Under certain temporary or limited circumstances, a broker-dealer may exercise investment discretion over a customer's positions in a manner which would not be inconsistent with the solely incidental prong.
    - The SEC offers a number of specific examples of temporary or limited discretion that would not be inconsistent with the broker-dealer exclusion. These include discretion: (i) 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; (ii) 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; (iii) as to cash management, such as to exchange a position in a money market fund for another money market fund or cash equivalent; (iv) to purchase or sell securities to satisfy margin requirements, or other customer obligations that the customer has specified; (v) to sell specific bonds or other securities in order to permit a customer to realize a tax loss on the original position; (vi) to purchase a bond with a specified credit rating and maturity; and (vii) to purchase or sell a security or type of security limited by specific parameters established by the customer.[115]
- Account monitoring is not inherently inconsistent with the Solely Incidental Interpretation but the permissibility of account monitoring would depend on the circumstances. For instance, if the broker-dealer voluntarily elects to review a customer's account in order to determine whether to provide a recommendation, such monitoring of the customer's account would be reasonably related to the broker-dealer's primary business of effecting securities transactions.[116] The SEC suggested the adoption of policies and procedures that would help demonstrate that any agreed-upon monitoring is in connection with and reasonably related to the broker-dealer's primary business of effecting securities transactions.

The SEC stated that it will accept further comment on the Solely Incidental Release and then determine whether to supplement its interpretation.[117]

* * *

ENDNOTES

1 Securities and Exchange Commission, Release No. 34-86031; File No. S7-07-18, Regulation Best Interest: The Broker-Dealer Standard of Conduct (June 5, 2019) ("Regulation Best Interest Release").

2 A "Natural Person who is an associated person" has the meaning given under 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." *See* Regulation Best Interest Release, at 77-78.

3 *See Report of the Special Study of Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 88-95, at 238 (1st Sess. 1963); *In re Richard N. Cea, et al.*, Exchange Act Release No. 8662 at 18 (Aug. 6, 1969) (Commission opinion involving excessive trading and recommendations of speculative securities without a reasonable basis); *In re Mac Robbins & Co. Inc.*, Exchange Act Release No. 6846, 41 S.E.C. 116 (July 11, 1962); *see also* FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade) (requiring a member, in the conduct of its business, to observe high standards of commercial honor and just and equitable principles of trade). *See Richard N. Cea*, Exchange Act Release No. 8662; *F.J. Kaufman and Co.*, Securities Exchange Act Release No. 27535 (Dec. 13, 1989); FINRA Rule 2111.01 (Suitability) ("Implicit in all member and associated person relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of [FINRA's] Rules, with particular emphasis on the requirement to deal fairly with the public. The suitability rule is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct."). *See also* Staff of the U.S. Securities and Exchange Commission, *Study on Investment Advisers and Broker-Dealers As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Jan. 2011) ("913 Study"), *available at* www.sec.gov/news/studies/2011/913studyfinal.pdf, at 51-53, 59; *A Joint Report of the SEC and the CFTC on Harmonization of Regulation* (Oct. 2009), *available at* http://www.sec.gov/news/press/2009/cftcjointreport101609.pdf, at 61-64; FINRA Rules 2121 (Fair Prices and Commissions), 2122 (Charges for Services Performed), and 2341 (Investment Company Securities). *See also* Sections 10(b) and 15(c) of the Exchange Act.

4 Pub. L. 111-203, 124 Stat. 1376 (2010).

5 *See* 913 Study*, supra* note 3.

6 *Id*.

7 *See Request for Data and Other Information: Duties of Brokers, Dealers and Investment Advisers*, Exchange Act Release No. 69013 (Mar. 1, 2013), *available at* http://www.sec.gov/rules/other/2013/34-69013.pdf; *see also SEC Seeks Information to Assess Standards of Conduct and Other Obligations of Broker-Dealers and Investment Advisers* (press release), *available at* http://www.sec.gov/news/press/2013/2013-32.htm.

8 Comments submitted in response to the Request are available at https://www.sec.gov/comments/4-606/4-606.shtml.

9 *Recommendation of the Investor Advisory Committee: Broker-Dealer Fiduciary Duty* (Nov. 2013), *available at* https://www.sec.gov/spotlight/investor-advisory-committee-2012/fiduciary-duty-recommendation-2013.pdf. Established by Section 911 of the Dodd-Frank Act, the Investor Advisory Committee ("IAC") was formed to advise the SEC on its regulatory priorities, the

regulation of securities products, trading strategies, fee structures, the effectiveness of disclosure, to protect investor interests and to promote investor confidence in the integrity of the securities marketplace.

10 *See US Labor Department Proposes Rule Defining "Fiduciaries" of Employee Benefit Plans*, U.S. Department of Labor Release No. 10-1472-NAT (October 21, 2010); *US Labor Department Seeks Public Comment on Proposal to Protect Consumers from Conflicts of Interest in Retirement Advice*, U.S. Department of Labor Release No. 15-0655-NAT (April 14, 2015), *available at* https://www.dol.gov/newsroom/releases/ebsa/ebsa20150655.

11 29 CFR 2510.3-21. *See also* Sullivan & Cromwell LLP, *DOL Releases Final "Investment Advice" Regulation* (April 20, 2016), *available at* https://www.sullcrom.com/dol-releases-final-investment-advice-regulation-final-regulation.

12 As part of the BIC Exemption, broker-dealers would have needed to provide advice in the investor's best interest; charge only reasonable compensation; and avoid misleading statements about fees and conflicts of interest.

13 *See* Definition of the Term ''Fiduciary''; Conflict of Interest Rule—Retirement Investment Advice; Best Interest Contract Exemption (Prohibited Transaction Exemption 2016-01); Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs (Prohibited Transaction Exemption 2016-02) (Apr. 7, 2017), *available at* https://www.gpo.gov/fdsys/pkg/FR-2017-04-07/pdf/2017-06914.pdf.

See Principal Transactions Exemption; 18-Month Extension of Transition Period and Delay of Applicability Dates; Best Interest Contract Exemption (PTE 2016-01); Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs (PTE 2016-02); Prohibited Transaction Exemption 84-24 for Certain Transactions Involving Insurance Agents and Brokers, Pension Consultants, Insurance Companies, and Investment Company Principal Underwriters (PTE 84-24), 82 FR 56545 (Nov. 29, 2017), *available at* https://federalregister.gov/d/2017-25760.

14 *Chamber of Commerce of the U.S.A., et al.* v. *U.S. Dep't of Labor, et al*., No. 17-10238 (5th Cir.) (Mar. 15, 2018). The DOL chose not to file a motion for *en banc* review of the Court's March 15, 2018 decision (the filing deadline was April 30, 2018) or a petition for a writ of *certiorari* to the Supreme Court (the filing deadline was June 13, 2018).

15 U.S. Department of Labor, Employee Benefits Security Administration, *Temporary Enforcement Policy on Prohibited Transactions Rules Applicable to Investment Advice Fiduciaries*, Field Assistance Bulletin No. 2018-02 (May 7, 2018), *available at* https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-02. The DOL went on to state that "investment advice fiduciaries may also choose to rely upon other available exemptions to the extent applicable after the Fifth Circuit's decision, but the Department will not treat an adviser's failure to rely upon such other exemptions as resulting in a violation of the prohibited transaction rules if the adviser meets the terms of this enforcement policy."

16 Chairman Jay Clayton, *Public Comments from Retail Investors and Other Interested Parties on Standards of Conduct for Investment Advisers and Broker-Dealers* (June 1, 2017), *available at* https://www.sec.gov/news/public-statement/statement-chairman-clayton-2017-05-31.

17 Securities and Exchange Commission, Release No. 34-83062; File No. S7-07-18, *Regulation Best Interest* (April 18, 2018); Securities and Exchange Commission, Release No. IA-4889; File No. S7-09-18, *Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation* (April 18, 2018); Securities and Exchange Commission, Release No. 34-83063; IA-4888; File No. S7-08-18, *Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in*

Retail Communications and Restrictions on the Use of Certain Names or Titles (April 18, 2018); *see also* our publication: *SEC Proposes Standard of Conduct for Broker-Dealers and Interpretation Regarding Standard of Conduct for Investment Advisers* dated May 10, 2018, *available at* https://www.sullcrom.com/sec-proposes-standard-of-conduct-for-broker-dealers-and-interpretation-regarding-standard-of-conduct-for-investment-advisers.

18 Regulation Best Interest Release, at 10.

19 *Id.* at 1.

20 *Id.* at 765-66.

21 *Id.* at 43.

22 *Id*.

23 *Id.* at 32 and footnote 61.

24 *Id.* at 44.

25 *Id*.

26 *Id.* at 82.

27 *Id.* at 72-73.

28 *Id.*

29 *Id.* at footnote 148.

30 *Id.* at 78-79; *see, e.g.*, FINRA Regulatory Notice 12-25 at Q2 and Q3 (regarding the scope of "recommendation"); *see also Michael F. Siegel*, Exchange Act Release No. 58737, at *21-27 (Oct. 6, 2008) (Commission opinion, sustaining NASD findings) (applying FINRA's guiding principles to determine that a recommendation was made), *aff'd in relevant part*, *Siegel* v. *SEC*, 592 F.3d 147 (D.C. Cir. 2010), *cert. denied*, 560 U.S. 926 (2010); *In re Application of Paul C. Kettler*, Exchange Act Release No. 31354 at 5, n.11 (Oct. 26, 1992). Some commenters agreed that the Commission should use FINRA's definitions and guidance in establishing a standard of conduct for broker-dealers. *See* AFL-CIO Letter ("Because DOL relied on FINRA guidance with regard to what constitutes a recommendation, the SEC could simply adopt that same definition for its own rulemaking purposes"); Letter from Barbara Roper, Director of Investor Protection, Consumer Federation of America (Sept. 14, 2017) ("CFA") ("While the determination of whether a recommendation has been made will always be based on the particular facts and circumstances, FINRA guidelines provide a sound basis for such a definition."). *See also* Business Conduct Standards Adopting Release.

31 Regulation Best Interest Release, at 79-80.

32 *Id.* This approach is consistent with FINRA rules. *See* FINRA Notice to Members 01-23, Online Suitability (Mar. 19, 2001), and Notice of Filing of Proposed Rule Change to Adopt FINRA Rules 2090 (Know Your Customer) and 2111 (Suitability) in the Consolidated FINRA Rulebook, Exchange Act Release No. 62718 (Aug. 13, 2010), 75 FR 51310 (Aug. 19, 2010), as amended, Exchange Act Release No. 62718A (Aug. 20, 2010), 75 FR 52562 (Aug. 26, 2010) (discussing what it means to make a "recommendation"); FINRA Regulatory Notice 11-02, Know Your Customer and Suitability (Jan. 2011) (discussing how to determine the existence of a recommendation), and FINRA Regulatory Notice 12-25 at n.24 (citing FINRA Regulatory Notices discussing principles on determining whether a communication is a "recommendation"). *See also Michael F. Siegel*, Exchange Act Release No. 58737, at *11 (Oct. 6, 2008) (Commission opinion, sustaining NASD findings) (applying FINRA principles to facts of case to find a recommendation), *aff'd in relevant part*, *Siegel* v. *SEC*, 592 F.3d 147 (D.C. Cir. 2010), *cert. denied*, 560 U.S. 926 (2010).

ENDNOTES (CONTINUED)

33 Regulation Best Interest Release, at 101-02.

34 *Id.* at 77.

35 *Id.* at 93-94.

36 *Id.* at 108.

37 *Id.* at 112. In the Regulation Best Interest Release, the SEC clarifies certain items with respect to the definition of "retail customer" under Regulation Best Interest. For instance, "legal representative" of a natural person only applies to the non-professional legal representatives who "rely directly" on the broker-dealer for the recommendation. The SEC also offers guidance around the "personal, family, or household purposes" prong of the definition, saying it is intended to capture recommendations to natural persons seeking the services of a broker-dealer for anything other than commercial or business purposes. Therefore, it would not include an employee seeking services for an employer or workplace retirement plans and their representatives (though it would cover individual retirement accounts such as 401(k) accounts). Regulation Best Interest Release at 112-15. Finally, the definition also includes a trust or other similar entity that represents natural persons, even if another person is a trustee or managing agent of the trust.

38 *Id.* at 108-12, 122-23.

39 *Id.* at 124-26.

40 *Id.* at 126-28.

41 *Id.*

42 *Id.* at 127.

43 *Id.*

44 *Id.* at 129.

45 *Id.*

46 *Id.* at 766.

47 *Id.* at 134-35; *see also* Section III of the Memorandum. Form CRS requires a brief and general description of the types of fees and expenses that retail investors will pay; the Disclosure Obligation will require more comprehensive disclosure.

48 A standalone broker-dealer will be deemed to have reasonably disclosed the capacity in which it is acting at the time of the recommendation if the broker-dealer has already delivered to the retail customer the Form CRS and Regulatory Status Disclosure as outlined in Section III of this Memorandum. However, a dual-registrant will not be considered to have reasonably disclosed the capacity in which it is acting at the time of the recommendation even if it has already delivered to the retail customer the Form CRS and Regulatory Status Disclosure, as neither disclosure would provide any greater clarity about the capacity in which the dual-registrant is acting in the context of the particular recommendation.

49 Regulation Best Interest Release, at 132.

50 *Id.*

51 *Id.*; *See also Basic, Inc*. v. *Levinson*, 485 U.S. 224 (1988).

52 *Id.*

53 *Id.*

54 Regulation Best Interest Release at 177.

ENDNOTES (CONTINUED)

55 *Id.*at 202-03.

56 *Id.* at 203.

57 *See, e.g.*, *De Kwiatkowski* v. *Bear, Stearns & Co., Inc.*, 306 F.3d 1293 (2d Cir. 2002) ("On a transaction-by-transaction basis, the broker . . . is obliged to give honest and complete information when recommending a purchase or sale."); *see also Arleen W. Hughes*, Exchange Act Release No. 4048 (Feb. 18, 1948) (Commission Opinion), ***aff'd sub nom. Hughes*** v. *SEC*, 174 F.2d 969 (D.C. Cir. 1949) ("Arleen Hughes") (finding duty to disclose material facts "in a manner which is clear enough so that a client is fully apprised of the facts and is in a position to give his informed consent").

The SEC notes that disclosure should be concise, clear and understandable; should apply plain English principles; and should avoid legal jargon, highly technical business terms or multiple negatives. The use of graphics would be permitted.

Further, disclosures must be true and may not omit any material facts necessary to make the required disclosures not misleading. As noted, Regulation Best Interest applies in addition to any obligations under the Exchange Act, along with any rules the SEC may adopt thereunder, and any other applicable provisions of the federal securities laws and related rules and regulations. For example, any transactions or series of transactions, whether or not subject to the provisions of Regulation Best Interest, remain subject to the antifraud and anti-manipulation provisions of the securities laws, including, without limitation, Section 17(a) of the Securities Act [15 U.S.C. 77q(a)] and Sections 9, 10(b), and 15(c) of the Exchange Act [15 U.S.C. 78i, 78j(b), and 78o(c)] and the rules thereunder.

58 Regulation Best Interest Release, at 217. Pursuant to the fiduciary duty under Sections 206(1) and (2) of the Advisers Act, an investment adviser must eliminate, or at least disclose, all conflicts of interest. However, as this duty is derived from the antifraud provisions, strict liability does not apply. In particular, scienter is required to establish violations of Section 206(1) of the Advisers Act, but a showing of negligence is adequate (*i.e.*, scienter is not required) to establish a violation of Section 206(2). The DOL Fiduciary Rule also avoids strict liability through the "good faith" exemption in its BIC Exemption.

59 The BIC Exemption's "best interest" Impartial Conduct Standard would have required that advice be in a retirement investor's best interest, and further defines advice to be in the "best interest" if the person providing the advice acts "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use . . . without regard to the financial or other interests" of the person. BIC Exemption Release, 81 FR at 21007, 21027; BIC Exemption Section II(c)(1); Section VIII(d).

60 *See* FINRA Rule 2111.05 (Suitability).

61 In the Regulation Best Interest Release, the SEC says that in addition to the retail customer's investment profile, the scope of "reasonably available alternatives" considered could depend on (but is not limited to), the associated person's customer base, the investments and services available to the associated person to recommend (including limitations due to licensing of the associated person) and other factors such as specific limitations on the available investments and services with respect to certain retail customers (*e.g.*, product or service income thresholds or geographic limitations). If all reasonably available alternatives considered would be inconsistent with a retail customer's investment profile, then a broker-dealer would not be able to form a reasonable belief that the best of these options is in the best interest of that retail customer. Regulation Best Interest Release, at 288-89.

62 *See, e.g.*, 15 U.S. Code § 77q; 17 CFR 240.10b-5.

63 Regulation Best Interest Release, at 249.

ENDNOTES (CONTINUED)

64 *Id*. at 308.

65 *Id.* at footnote 698.

66 *Id*. at 313.

67 *Id*. at 351.

68 *Id.* at footnote 688.

69 *Id.* at 357-60.

70 In the Regulation Best Interest Release, the SEC notes that there are certain circumstances in which it would not violate the Disclosure Obligation for a broker-dealer to use the term "adviser" or "advisor" as it reflects a business in which the broker-dealer provides advice other than investment advice to retail clients. Some examples noted in the Regulation Best Interest Final Rule are a broker-dealer or associated person who acts on behalf of a municipal advisor or commodity trading advisor or an advisor to a special entity, which are each distinct roles specifically defined by federal statute. Regulation Best Interest Release, at 158.

71 Form CRS Final Rule, at 248-54.

72 Securities and Exchange Commission, Release No. IA-5248; File No. S7-07-18, *Commission Interpretation Regarding Standard of Conduct for Investment Advisers* (June 5, 2019) ("Fiduciary Duty Interpretation").

73 Amendments to Form ADV, Investment Advisers Act Release No. 3060 (July 28, 2010) ("Investment Advisers Act Release No. 3060") (adopting amendments to Form ADV and stating that "under the Advisers Act, an adviser is a fiduciary whose duty is to serve the best interests of its clients, which includes an obligation not to subrogate clients' interests to its own," citing Proxy Voting by Investment Advisers, Investment Advisers Act Release 2106 (Jan. 31, 2003)); *SEC* v. *Tambone*, 550 F.3d 106, 146 (1st Cir. 2008) ("Section 206 imposes a fiduciary duty on investment advisers to act at all times in the best interest of the fund and its investors."); *SEC* v. *Moran*, 944 F. Supp. 286 (S.D.N.Y. 1996) ("Investment advisers are entrusted with the responsibility and duty to act in the best interest of their clients.").

74 Fiduciary Duty Interpretation, at 5.

75 *Id.* at 8.

76 Proposed Interpretation, at 8.

77 Fiduciary Duty Interpretation, at 10.

78 *Id.* at 10-11. The SEC notes specific examples of "general" waivers that would not be consistent with the Advisers Act, including "(i) statements that the adviser will not act as a fiduciary, (ii) blanket waiver of all conflicts of interest, or (iii) a waiver of any specific obligation under the Advisers Act." The SEC notes that the Fiduciary Duty Interpretation does not take a position on the scope or substance of any adviser fiduciary duties under U.S. state law. Additionally, the SEC states that whether a hedge clause—a clause in an advisory agreement that purports to limit an adviser's liability under that agreement—violates the Adviser Act's antifraud provisions depends on the surrounding facts and circumstances, including the client's sophistication. The SEC specifically notes that there are "few (if any) circumstances" in which a hedge clause would be consistent with the antifraud provisions where the hedge clause relieves the adviser of liability for conduct for which the client has a non-waivable cause of action under state or federal law. In an agreement with an institutional client, the particular facts and circumstances must be considered. *See also* footnotes 29-31 of the Fiduciary Duty Interpretation.

79 The Fiduciary Duty Interpretation states that the SEC believes that the interpretations set forth therein are generally consistent with investment advisers' current understanding of the practices

necessary to comply with their fiduciary duty under the Advisers Act; however, the SEC notes that "there may be certain current circumstances where investment advisers interpret their fiduciary duty to require something less, and other current circumstances where they interpret their fiduciary duty to require something more" than the Fiduciary Duty Interpretation. Fiduciary Duty Interpretation, at 31.

80 *See supra* note 30.

81 *See* Proxy Voting by Investment Advisers, Investment Advisers Act Release No. 2106 (Jan. 31, 2003) (the "Investment Advisers Act Proxy Release") (stating that under the Advisers Act, "an adviser is a fiduciary that owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting," which is the subject of the release, and citing *SEC* v. *Capital Gains*, 375 U.S. 180, 194 (1963), to support this point). *See also* Restatement (Third) of Agency, § 8.08 (discussing the duty of care that an agent owes its principal as a matter of common law); Tamar Frankel, Arthur Laby & Ann Schwing, *The Regulation of Money Managers*, (updated 2017) ("Advice can be divided into three stages. The first determines the needs of the particular client. The second determines the portfolio strategy that would lead to meeting the client's needs. The third relates to the choice of securities that the portfolio would contain. The duty of care relates to each of the stages and depends on the depth or extent of the advisers' obligation towards their clients.").

82 The Fiduciary Duty Interpretation clarifies the SEC's view on suitability. Referencing a 1994 proposed rule, the SEC notes that, although the fiduciary duty is not an express standard, it has long held the view that an adviser's fiduciary duty requires the adviser to provide advice that is "suitable" for the client to be acting in the client's best interest. Although never adopted, the proposed rule, according to the SEC, was designed to reflect the Commission's interpretation of an adviser's *existing* suitability obligation under the Advisers Act. Fiduciary Duty Interpretation at footnotes 33 and 34; *see also* Investment Advisers Act Release No. 1406 (Mar. 16, 1994) (stating that advisers have a duty of care and discussing advisers' suitability obligations).

83 Fiduciary Duty Interpretation, at 13. The Proposed Interpretation would have required an adviser to make an inquiry into a client's "investment profile." Several commenters, however, noted that such a duty may not be applicable in the institutional client context. Accordingly, the SEC changed the formulation to describe the duty as a duty to have a reasonable understanding of the client's objectives, which, as discussed above, means something different for retail investors than it does for institutional investors.

84 Fiduciary Duty Interpretation, at 13.

85 An update would not be needed for one-time investment advice. *See Id.*, at footnote 37.

86 Fiduciary Duty Interpretation, at 15.

87 Fiduciary Duty Interpretation, at 17.

88 *See*, *e.g.*, Concept Release on the U.S. Proxy System, Investment Advisers Act Release No. 3052 (July 14, 2010) (stating "as a fiduciary, the proxy advisory firm has a duty of care requiring it to make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information").

89 Fiduciary Duty Interpretation, at 1.

90 Fiduciary Duty Interpretation, at 18.

91 *See* Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Release No. 54165 (July 18, 2006) (stating that investment advisers have "best execution obligations"); Investment Advisers Act Release No. 3060, *supra* note 73 (discussing an adviser's best-execution obligations in the context of directed

brokerage arrangements and disclosure of soft dollar practices); *see also* Advisers Act rule 206(3)-2(c) (referring to adviser's duty of best execution of client transactions).

92 Fiduciary Duty Interpretation, at 19.

93 *See SEC* v. *Capital Gains supra* footnote 81 (describing advisers' "basic function" as "furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments").

94 *See* Investment Advisers Act Release No. 3060, *supra* footnote 73; *see also* 913 Study, *supra* note 3. In the Proposed Interpretation, the SEC stated that the duty of loyalty requires an adviser to "put its client's interest first." In response to a comment letter that noted that the requirement to put a client's interest "first" could be interpreted very differently from a requirement not to "subordinate" or "subrogate" clients' interests, the SEC revised the description of the duty of loyalty in the Fiduciary Duty Interpretation to be more consistent with past descriptions of the duty. The SEC notes, however, that, "in practice, putting a client's interest first is 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." *See* Fiduciary Duty Interpretation, at footnote 54.

95 *See* Investment Advisers Act Release No. 3060, *supra* note 73 (stating that "as a fiduciary, an adviser has an ongoing obligation to inform its clients of any material information that could affect the advisory relationship"); Fiduciary Duty Interpretation, at 22. *See also* General Instruction 3 to Part 2 of Form ADV ("Under federal and state law, you are a fiduciary and must make full disclosure to your *clients* of all material facts relating to the advisory relationship.") (emphasis in original). The SEC states that disclosure may be accomplished through a variety of means, including "written disclosure at the beginning of a relationship that clearly sets forth when a dual registrant would act in an advisory capacity and how it would provide notification of any changes in capacity." Fiduciary Duty Interpretation, at 22. The SEC also notes that it does not interpret an adviser's fiduciary duty to require that full and fair disclosure or informed consent be achieved in a written advisory contract or otherwise in writing. Such disclosures and consents can be obtained, for example, through a combination of Form ADV and other disclosure, and the client could implicitly consent by beginning or continuing an investment advisory relationship with the adviser. *Id*. at footnote 69.

96 In the Proposed Interpretation, the SEC stated that an adviser must seek to avoid conflicts of interest with its clients. The Fiduciary Duty Interpretation explains that the SEC first used the "seek to avoid" phrasing when adopting amendments to the Form ADV Part 2 instructions. See Investment Advisers Act Release 3060, (*supra* note 73) and General Instruction 3 to Part 2 of Form ADV ("As a fiduciary, you also must seek to avoid conflicts of interest between you and your clients, and, at a minimum, make full disclosure of all material conflicts of interest between you and your clients that could affect the advisory relationship."). The release adopting that instruction clarifies the SEC's intent to capture the fiduciary duty described in SEC v. Capital Gains (*supra* note 81) and Arleen Hughes (*supra* note 57), both of which, the SEC says, emphasize that the adviser should seek to avoid conflicts, but at a minimum must make full and fair disclosure of the conflict and obtain the client's informed consent to the conflict. The SEC believes that the reference to "seek to avoid" conflicts in the Form ADV Part 2 instructions is consistent with the Final Interpretation's statement that "an adviser must eliminate or at least expose through full and fair disclosure all conflicts of interest which might incline an adviser—consciously or unconsciously—to render advice which was not disinterested." Fiduciary Duty Interpretation, at 23. Note, however, that the SEC also states that "while full and fair disclosure of all material facts relating to the advisory relationship or conflicts of interest and a client's informed consent prevent the presence of those material facts or conflicts themselves from violating the adviser's fiduciary duty, such disclosure and consent do not themselves satisfy the adviser's duty to act in the client's best interest" since an investment adviser's obligation to act in the best interest of its client is an "overarching principle that encompasses both the duty of care and the duty of loyalty." Id.

ENDNOTES (CONTINUED)

97 Under the Proposed Interpretation, disclosure would not have a prophylactic effect where (i) the facts and circumstances indicated that the client did not understand the nature and import of the conflict or (ii) "the material facts concerning the conflict could not be fully and fairly disclosed." Proposed Interpretation, at 18.

98 For example, the SEC states that it would be inadequate for an adviser to disclose that it has "other clients" without describing how the adviser manages conflicts between clients when they arise, or to disclose that that adviser has "conflicts" without describing what those conflicts are. *See* Fiduciary Duty Interpretation, at 24-25.

99 *Id*.

100 *Id.* at 27.

101 *Id.*, at 28.

102 Fiduciary Duty Interpretation, at footnote 8.

103 Securities and Exchange Commission, Release Nos. 34-86032; IA-5247; File No. S7-08-18, *Form CRS Relationship Summary; Amendments to Form ADV* (June 5, 2019) ("Form CRS Release").

104 The SEC bases its concern on the findings of various studies, *e.g.*, 913 Study, *supra* note 3. *See also* Letter from Barbara Roper, Director of Investor Protection, Consumer Federation of America, *et al.* (Sept. 15, 2010) (submitting the results of a national opinion survey regarding U.S. investors and the fiduciary standard conducted by ORC/Infogroup for the Consumer Federation of America, AARP, the North American Securities Administrators Association, the Certified Financial Planner Board of Standards, Inc., the Investment Adviser Association, the Financial Planning Association and the National Association of Personal Financial Advisors); Siegel & Gale, LLC/Gelb Consulting Group, Inc., Results of Investor Focus Group Interviews About Proposed Brokerage Account Disclosures (Mar. 5, 2005), *available at* http://www.sec.gov/rules/proposed/s72599/focusgrp031005.pdf ("Siegel & Gale Study"); Angela A. Hung, *et al.*, RAND Institute for Civil Justice, Investor and Industry Perspectives on Investment Advisers and Broker-Dealers (2008), *available at* https://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf ("RAND Study").

105 Form CRS Release, at 47-48. The SEC is also encouraging registrants to make use of electronic formatting to respond to required disclosures or to make comparisons among offerings. The SEC believes that use of electronic features can "make the relationship summary more engaging, accessible, and effective in communicating to retail investors." In particular, the instructions encourage firms to use methods such as electronic graphics and hyperlinks that provide "layered disclosure" where an investor is able to access more detailed information if they wish to do so. *Id.* at 56-58.

106 For the purposes of Form CRS, the SEC has interpreted "legal representative" of a natural person to mean a non-professional representative of such natural person. This clarification was made in response to comments arguing that it should not be necessary to deliver a relationship summary to professionals such as registered investment advisers, broker-dealers, corporate fiduciaries and insurance companies. The SEC agreed, saying that it would not further its "objective of facilitating retail investors' understanding of their account choices." Form CRS Release, at 196.

107 Form CRS Release, at 195-96.

108 Form CRS Release, at 16. Firms are required to use "plain language" in their relationship summaries and are explicitly prohibited from the use of legal jargon, highly technical business terms or multiple negatives.

ENDNOTES (CONTINUED)

109 Form CRS Release, at 39-40. The SEC added the "in light of the circumstances under which they were made" wording in response to commenter concerns that given the strict length requirement, it could be difficult to provide the level of disclosure required by the instructions. The SEC indicated that it will not view the disclosures made in the relationship summary "in isolation" and will take into account references or links to additional information, where applicable.

110 Form CRS Release, at 227. Firms must update the relationship summary within 30 days whenever the relationship summary becomes materially inaccurate. Firms will be allowed 60 days to communicate updates to existing clients or customers. Firms will also be required to highlight any updates to the relationship summary by marking the revised text or attaching the changes as an exhibit to the unmarked relationship summary. Form CRS Release, at 237.

111 Securities and Exchange Commission, Release No. IA-5249, *Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser* (June 5, 2019) ("Solely Incidental Release").

112 In 2005, the SEC adopted an interpretive rule that, among other things, provided that broker-dealers are excluded from the Advisers Act for any accounts over which they exercise only temporary or limited investment discretion. In 2007, this rule was vacated by the U.S. Court of Appeals for the District of Columbia Circuit on the grounds that the SEC lacked authority for expanding the exclusion under Section 202(a)(11)(C) of the Advisers Act.

113 Solely Incidental Release, at 12.

114 "Advice need not be trivial, inconsequential, or infrequent to be to be consistent with the solely incidental prong." Solely Incidental Release, at 13.

115 Solely Incidental Release, at 17.

116 Solely Incidental Release, at 20.

117 *Certain Broker-Dealers Deemed Not to Be Investment Advisers*, Investment Advisers Act Release No. 2340 (Jan. 6, 2005)

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 875 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to SCPublications@sullcrom.com.

CONTACTS

New York		
John E. Baumgardner Jr.	+1-212-558-3866	baumgardnerj@sullcrom.com
Whitney A. Chatterjee	+1-212-558-4883	chatterjeew@sullcrom.com
Donald R. Crawshaw	+1-212-558-4016	crawshawd@sullcrom.com
William G. Farrar	+1-212-558-4940	farrarw@sullcrom.com
Joseph A. Hearn	+1-212-558-4457	hearnj@sullcrom.com
Robert W. Reeder III	+1-212-558-3755	reederr@sullcrom.com
Frederick Wertheim	+1-212-558-4974	wertheimf@sullcrom.com
Washington, D.C.		
Paul J. McElroy	+1-202-956-7550	mcelroyp@sullcrom.com