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SEC Proposals – Form CRS Client Relationship Summary for Advisers and Broker-Dealers; Best Interest Standard of Conduct for Broker-Dealers

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On April 18, 2018, the SEC released three sets of proposals that the SEC press release stated were "designed to enhance the quality and transparency of investors' relationships with investment advisers and broker-dealers." Two of these proposals are addressed in this Alert.

The SEC's Relationship Summary proposal (the "CRS Proposal") proposed new and amended rules and forms intended to improve retail investors' understanding of the different investment-related services provided by registered broker-dealers, registered investment advisers and dually registered firms (each, a "firm"). The CRS Proposal would:

- Require firms to deliver to retail investors a four-page customer or client relationship summary ("Form CRS"), disclosing the nature and scope of services provided by the firm, the types of fees customers would incur, the conflicts of interest faced by the firm and the firm's disciplinary history.
- Restrict the use of the terms "adviser" and "advisor" by a broker-dealer and its associated persons, and require a firm and its investment professionals to disclose their SEC registration status in communications with retail investors.

The SEC's Regulation Best Interest proposal (the "Best Interest Proposal") followed years of industry speculation that the SEC would propose a uniform fiduciary standard applicable to broker-dealers and investment advisers alike. However, Regulation Best Interest would not impose a fiduciary standard for broker-dealers—at least not on its face.

- Regulation Best Interest would impose an express "best interest" standard of conduct for broker-dealers when making recommendations to retail customers[1] about securities transactions or investment strategies.
- Regulation Best Interest also would require broker-dealers to provide retail customers with enhanced disclosure relating to material conflicts of interest. Material conflicts of interest that relate to the broker-dealer's financial incentives also would have to be mitigated (if not eliminated).

[1] A "retail customer" would be defined as a person, or the legal representative of such person, who: (i) receives from a broker- dealer a recommendation of any securities transaction or investment strategy involving securities and (ii) uses the recommendation primarily for personal, family, or household purposes.

The CRS Proposal and the Best Interest Proposal are summarized below. The SEC's third proposal, titled *Interpretation Regarding Standard of Conduct for Investment Advisers*, is described in a separate Ropes & Gray Alert.

I. Form CRS – Relationship Summary

The full text of proposed Form CRS is available here. The SEC simultaneously published Form CRS mock-ups for a dual registrant, a stand-alone broker-dealer[2] and a stand-alone investment adviser.[3]

Delivery and Filing. Proposed Advisers Act Rule 204-5 and Proposed Exchange Act Rule 17a-14 would require firms to deliver Form CRS to ***retail investors***.[4] Both proposed rules also would require a firm (i) to post its current Form CRS prominently on its website and (ii) to communicate, without charge, any material change made to its Form CRS to each retail investor who is an existing client within 30 days after the event underlying the change. A firm may deliver its Form CRS and any amendments by electronic means.[5]

An investment adviser would file its Form CRS (as new Part 3 of its Form ADV) on the Investment Adviser Registration Depository ("IARD") (as it files its Form ADV Parts 1A and 2A). A broker-dealer would file its Form CRS on the SEC's EDGAR system, and dual registrants would file on both IARD and EDGAR.

Form CRS Content Summary. In completing a Form CRS, a firm would be required to use "plain language," and to write the disclosure as if the firm were speaking to the retail investor (using "you," "us," "our firm," etc.). Much of the disclosure ***is scripted by Form CRS***, with different scripts for stand-alone broker-dealers, stand-alone investment advisers and dual registrants. A firm's Form CRS could not exceed four pages and would be required to disclose eight items in the order, and using the prescribed headings,below:

1. ***Introduction.*** A firm's name and its SEC registration status.

2. ***Relationships and Services.*** Specific information about the nature of the relationships and services a firm offers to retail investors, including the types of accounts offered. A broker-dealer would typically disclose that brokerage accounts pay transaction-based fees, and an investment adviser would disclose the type(s) of fee it receives if a retail investor opens an investment advisory account.

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[2] A stand-alone broker-dealer includes a dual registrant that does not offer services to retail investors as an investment adviser.

[3] A stand-alone investment adviser includes a dual registrant that does not offer services to retail investors as a broker-dealer.

[4] A "retail investor" would be defined as a "prospective or existing client or customer who is a natural person," and includes a trust or other similar entity that represents natural persons, even if another person is a trustee or manager of the trust.

[5] With respect to firms that interact with retail investors exclusively online, the CRS Proposal stated that "it would be consistent with the Commission's prior guidance if firms that offer only online account openings and account transactions, including robo-advisers and online broker-dealers, made global consent to electronic delivery a condition of account opening, for purposes of delivering the relationship summary."

3. ***Standard of Conduct.*** Using prescribed wording, the standard of conduct applicable to a firm. If a firm offers brokerage accounts to retail investors, the prescribed standard of conduct is derived from proposed Regulation Best Interest and existing obligations of broker-dealers – "We must act in your best interest and not place our interests ahead of yours when we recommend an investment or an investment strategy involving securities. When we provide any service to you, we must treat you fairly and comply with a number of specific obligations." An investment adviser would disclose "We are held to a fiduciary standard that covers our entire investment advisory relationship with you."

4. ***Summary of Fees and Costs.*** Using prescribed wording, the principal types of fees and costs that retail investors incur. For brokerage accounts, a firm would disclose that a retail investor will pay a fee based on specific transactions and not the value of the investor's account. In addition, the following disclosure would be required:

   > "With stocks or exchange-traded funds, [a transaction] fee is usually a separate commission. With other investments, such as bonds, this fee might be part of the price you pay for the investment (called a 'mark- up' or 'mark down'). With mutual funds, this fee (typically called a 'load') reduces the value of your investment."

   An investment adviser that offers investment advisory accounts to retail investors would disclose the principal types of fees and costs that investors would incur. This disclosure would correspond to the types of fee that an investor adviser reports in response to Form ADV Part 1A, Item 5.E. For all firms, this item also would disclose other fees a retail investor pays, including, but not limited to, custodian fees, account maintenance fees and account inactivity fees.

5. ***Comparisons to be provided by stand-alone broker-dealers and stand-alone investment advisers.*** A stand-alone broker-dealer would disclose that a retail investor could open an advisory account with an adviser, "where you will pay an ongoing asset-based fee." A broker-dealer also is required to disclose a specified list of features of "a typical advisory account." For a stand-alone investment adviser, the disclosure is the inverse, disclosing that a retail investor could open a brokerage account with a broker-dealer, "where you will pay a transaction-based fee [for account transactions]." An adviser also is required to disclose a specified list of features of "a typical brokerage account."

6. ***Conflicts of Interest.*** The existence of conflicts arising from financial incentives to offer or to recommend certain investments because (i) they are sponsored or managed by the firm's affiliates or (ii) third parties compensate the firm or its investment professionals for recommendations or sales of theinvestments.

7. ***Additional Information.*** The existence of legal or disciplinary events that are reported on Form ADV, Form BD and/or FINRA Forms U4, U5 and U6. A firm also would disclose that information about its brokerage or investment advisory services is available through BrokerCheck on Brokercheck.Finra.org or IAPD on Investor.gov.

8. ***Key Questions to Ask.*** Questions for retail investors to ask a firm's financial professionals. The CRS Proposal includes ten suggested questions.

II. Restrictions on the Use of Names/Titles and Disclosing SEC Registration Status in Communications with Retail Investors

The CRS Proposal also contained three new rules intended to reduce investor confusion in choosing a firm.

Names and Titles. Proposed Exchange Act Rule 15*l*-2 would prohibit a broker-dealer and its associated persons who are natural persons from using "adviser" or "advisor" as part of a name or title when communicating with a retail investor.

The prohibition would not apply to (i) a broker-dealer that is a SEC- or state-registered investment adviser or (ii) any natural person who is an associated person of a broker-dealer, who is also a supervised person of an SEC- or state-registered investment adviser, if the natural person provides investment advice on behalf of the investment adviser.

Disclosure of Registration Status. Proposed Exchange Act Rule 15*l*-3 would require a broker-dealer to prominently disclose its SEC registration status in printed and electronic retail investor communications. A natural person who is an associated person of a broker-dealer would also be required to prominently disclose his/her status in printed and electronic retail investor communications. Proposed Advisers Act Rule 211h-1 would require analogous disclosure in printed and electronic retail investor communications.

III. Scope of the Best Interest Proposal

The SEC's proposed standard of conduct under Regulation Best Interest would require broker-dealers and natural persons who are associated persons of a broker-dealer to act in the best interest of the retail customer when making a recommendation of any securities transaction or investment strategy involving securities "without placing the financial or other interest of the broker, dealer, or natural person who is an associated person . . . making the recommendation ahead of the interest of the retail customer."[6]

Notably, the term "best interest" is not defined in the Best Interest Proposal. The question of whether a broker-dealer acted in the best interest of its customer instead would be determined by a consideration of the facts and circumstances under which the recommendation was made. In addition, Regulation Best Interest, which would be triggered at the time a recommendation was made to a retail customer, would not:

- Impose a continuous duty for a broker-dealer to monitor customer accounts, nor would it change a broker-dealer's ability to charge commissions, recommend proprietary products or engage in principal trading.
- Require a broker-dealer to find the single best security or investment strategy for a retail customer, but would instead require the broker-dealer to consider reasonably available alternatives offered by the broker-dealer.

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[6] Regulation Best Interest would not apply when a broker-dealer that is also registered as an investment adviser (*i.e.*, a dual registrant) makes a recommendation to a retail customer in its capacity as an investment adviser.

- Create any new private rights of action or rights of rescission. Under Regulation Best Interest, a broker-dealer's obligations could not be modified or disclaimed contractually by the broker-dealer, or waived by a retail customer.
- Alter a broker-dealer's existing obligations under the general anti-fraud provisions of the federal securities laws or a broker-dealer's other obligations under FINRA and other self-regulatory organization rules.

IV. Compliance with Regulation Best Interest

According to the Best Interest Proposal, the best interest standard of conduct for broker-dealers and their natural associated persons would be deemed to have been met if the following obligations are fulfilled:

- ***The Disclosure Obligation.*** At or before the time a recommendation is made, a broker-dealer must disclose (i) the material facts relating to the scope and terms of the relationship between the broker-dealer and the retail customer and (ii) all material conflicts of interests associated with the recommendation.
- ***The Care Obligation.*** In making a recommendation, a broker-dealer must exercise reasonable diligence, care, skill, and prudence to (i) understand the risks and rewards of the recommendation, (ii) have a reasonable basis to believe that the recommendation is in the best interest of the retail customer based on that retail customer's investment profile and the potential risks and rewards associated with the recommendation and (iii) have a reasonable basis to believe that a series of recommended transactions, even if each transaction is 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.[7]
- ***The Conflict of Interest Obligation.*** A broker-dealer must establish, maintain and enforce policies and procedures reasonably designed to either (i) disclose and mitigate or (ii) eliminate all material conflicts of interest relating to financial incentives. In addition, other material conflicts of interest must be disclosed to a retail customer or eliminated.

V. Comment Period

The SEC broadly solicited comments on all of the proposals within the CRS Proposal and the Best Interest Proposal. Comments on both proposals must be received by the SEC by August 7, 2018.

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[7] A recommendation generally would be considered to be in the best interest of a retail customer if the recommendation is suitable for the retail customer *and* if it does not put the broker-dealer's interest ahead of the retail customer's interest. For example, if a broker-dealer offers two differently priced yet otherwise identical products both suitable for a retail customer, it cannot recommend the more costly product to the retail customer. On the other hand, a broker-dealer would not be prohibited from recommending the more remunerative of two reasonably available alternatives, provided that the broker-dealer determines that there is no material difference between the products from the perspective of the retail customer.

VI. Observations

Much of proposed Form CRS is scripted and, therefore, contains a significant amount of information that is not specific to the disclosing firm.[8] The abundance of scripted disclosure suggests that the SEC could accomplish Form CRS's goals if, instead, the SEC were to mandate delivery of one of three generic SEC forms to retail investors. The specifics of each form would depend on the SEC's classification in the CRS Proposal of a firm as a dual registrant, a stand-alone broker-dealer or a stand-alone investment adviser. While this approach may miss firm-to-firm differences within each of the three categories, the SEC form would convey virtually all of the content in Form CRS.

The CRS Proposal would define a "retail investor" as a "prospective or existing client or customer who is a natural person," and would include a trust or other similar entity that represents natural persons, even if another person is a trustee or manager of the trust. The definition would not exclude traditional sophisticated investors, thereby making status as an accredited investor, qualified client or qualified purchaser irrelevant. This definition differs from the Best Interest Proposal's definition of "retail customer," which includes a requirement that the advice provided is for personal, family or household purposes.[9] The difference between the definitions may be largely irrelevant for institutional advisers and stand-alone broker-dealers (which include dual registrants that do not offer services to retail investors as an investment adviser), although these entities should seek confirmation regarding how broadly the terms "trust or other similar entity" and "represents natural persons" are read. We would think that that these terms should be read narrowly, especially in view of the formulaic nature of the Form CRS disclosures intended for non- institutional investors.

Longer-term observers may note that the CRS Proposal is a descendant of the SEC's "Point-of-Sale" 2004 and 2005 proposals[10] that would have required broker-dealers to provide customers with specific information concerning the costs and conflicts of interest that arise from the distribution of mutual fund shares, college savings plan interests and variable insurance products. The Point-of-Sale proposals did not result in final rules. Among many factors, the expected costs of compliance and the physical-delivery requirement were problems that commenters called to the SEC's attention. Nonetheless, Form CRS's relative simplicity compared to the Point-of-Sale proposals suggests that the SEC gained valuable insights from those proposals. In fact, in the CRS Proposal, the SEC stated that the CRS Proposal "also is informed by our experience with the mutual fund summary prospectus, which has illustrated the benefits of highlighting certain information in summary form."

Ultimately, the fate of Form CRS is likely to turn on the fate of Regulation Best Interest. That is, while a Form CRS that includes a standard of conduct different from Regulation Best Interest's proposed standard might still be useful to retail investors, the Form's fate may be tied to whether Regulation Best Interest's standard is adopted.

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[8] A review of the completed Form CRS mock-ups for a dual registrant, a stand-alone broker-dealer and a stand-alone investment adviser reveals this.

[9] *See* n. 1, *supra*.

[10] *See* Rel. Nos. 34-49148 (Jan.29, 2004), 34-51274 (Feb. 28, 2005).

While the SEC voted 4-1 in favor of issuing the CRS Proposal and the Best Interest Proposal, several of the Commissioners have expressed significant reservations about issues such as the meaning of best interest and the difference between a best interest standard and a fiduciary standard. The Best Interest Proposal is likely to receive substantial comments from the industry, and Regulation Best Interest is likely to undergo substantial revisions before a final rule is approved. Thereafter, even a revised final rule may be challenged in court.