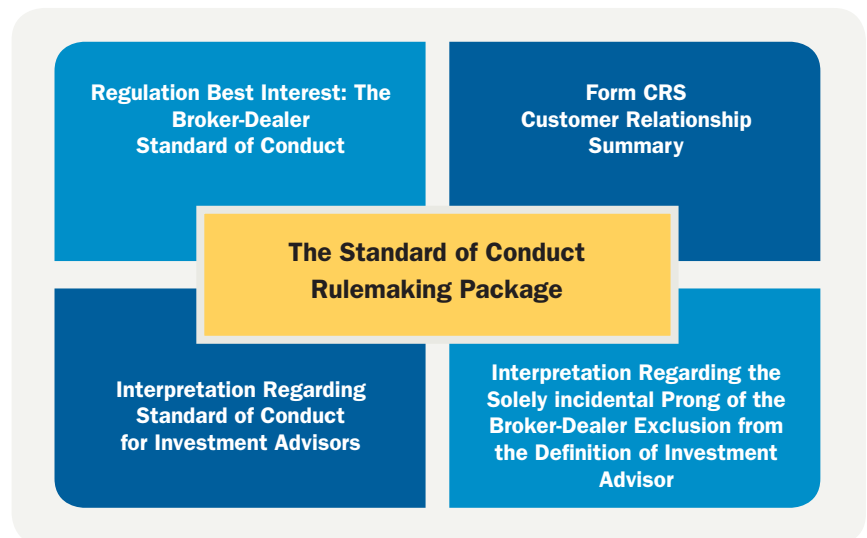


Regulatory Education Program Report: SEC's New Standards

On June 5, 2019, the Securities and Exchange Commission (“SEC”) voted to adopt a comprehensive package of rulemakings and interpretations designed to enhance the quality and transparency of retail investors’ relationships with investment advisors and broker-dealers. The rulemaking package seeks to align the standards of conduct and investor disclosures with investor expectations, while preserving access (in terms of choice and cost) to a variety of investment products and services.

This article provides a high-level summary of the rulemaking package and explores its implications for registered investment advisors and dual registrants.



The Rulemaking Package

The rulemaking package includes two new rules and two interpretations:

Final Rule: “Regulation Best Interest” The Broker-Dealer Standard of Conduct – establishing an enhanced standard of conduct for broker-dealers and their personnel when recommending securities transactions or investment strategies involving securities to customers (including the opening of an account and rollovers)

Final Rule: Form CRS Relationship Summary – requiring registered broker-dealers and investment advisors to provide a concise and direct relationship summary to their customers and clients

Interpretation: Standard of Conduct for Investment Advisors – reaffirming, and in some cases clarifying, the fiduciary duty applicable to SEC-registered investment advisors

Interpretation: The “Solely Incidental” Prong of the Broker-Dealer Exclusion from the Definition of Investment Advisor – clarifying the statutory exclusion from the definition of an investment advisor for broker-dealers that provide investment advice that is solely incidental to their brokerage activities and do not receive any special compensation for such advice

SEC Objectives

Individually and collectively, the SEC designed the new rules and interpretations to:

- Help investors better understand and compare the services offered by broker-dealers and advisors
- Help investors make an informed choice of the relationship best suited to their needs and circumstances
- Provide clarity with respect to the standards of conduct applicable to investment advisors and broker-dealers
- Foster greater consistency in the level of protections provided by the regulatory regimes governing investment advisors and broker-dealers
- Enhance the standard of conduct applicable to broker-dealers at the time they make a recommendation and reduce the potential harm to customers that may be caused by conflicted brokerage recommendations

Summary of the Releases

Final Rule: “Regulation Best Interest” The Broker-Dealer Standard of Conduct

Regulation Best Interest (“Reg BI”) creates an enhanced standard of conduct for broker-dealers (“BDs”) and associated persons when recommending a securities transaction or investment strategy involving securities to a customer. This includes recommendations of account types and rollovers or transfers of assets and also covers hold recommendations resulting from agreed-upon account monitoring.

Reg BI is comprised of a General Obligation, which requires that a broker-dealer or its associated persons act in the best interest of a customer when an applicable recommendation is made by mandating compliance with four component obligations: The Disclosure Obligation, The Care Obligation, The Conflict of Interest Obligation, and The Compliance Obligation.



Reg BI: General Obligation to act in a customer’s best interest when recommending a security or investment strategy involving securities without placing the BD’s or associated person’s interest ahead of the customer’s interest.



Care Obligation

BDs and associated persons must exercise reasonable diligence, care and skill in making a recommendation



Disclosure Obligation

BDs and associated persons must provide certain prescribed disclosure before or at the time of a recommendation, about the relationship between the customer and the broker-dealer



Conflict of Interest Obligation

BDs must establish, maintain, and enforce policies and procedures reasonably designed to address conflicts of interest associated with recommendations



Compliance Obligation

BDs must establish, maintain, and enforce policies and procedures reasonably designed to achieve compliance with Reg BI

Final Rule: Form CRS Relationship Summary

This new Rule requires broker-dealers and investment advisors to file relationship summaries with the SEC (through the CRD and IARD systems, respectively) and deliver relationship summaries to new customers and clients at the beginning of their relationship.

A relationship summary must include prescribed information in a short (two pages for a broker-dealer or investment advisor and four pages for a dual registrant) and accessible format to help investors compare information about a firm's products and services. A relationship summary must also include "conversation starters," which are questions that investors are encouraged to ask their financial professional with the intention of prompting a discussion. Firms are encouraged to use charts, graphs, tables and other visual aids, whereas the use of jargon and technical terms are discouraged.

When to File: A broker-dealer or investment advisor that is already registered with the SEC may electronically file its initial relationship summary as early as May 1, 2020, but must file no later than June 30, 2020.

When to Amend: A broker-dealer's or investment advisor's relationship summary must be amended and filed within 30 days after any information in its relationship summary becomes materially inaccurate.

When to Deliver: A broker-dealer must deliver its relationship summary to a **new customer** before or at the earliest of (i) a recommendation of an account type, securities transaction or investment strategy involving securities; (ii) placing an order for the customer, or (iii) the opening of a brokerage account. An investment advisor must deliver its relationship summary to each **new client** before or at the time the advisor enters into an investment advisory contract.

Additionally, a broker-dealer must deliver its relationship summary to a customer who is an **existing customer** before or at the time the broker-dealer (i) opens a new account, (ii) recommends that the customer roll-over assets, or (iii) recommends or provides a new brokerage service or investment.

Additionally, an investment advisor must deliver its relationship summary to each **existing client** before or at the time the advisor (i) opens a new account, (ii) recommends that the client roll-over assets, or (iii) recommends or provides a new investment advisory service.

Dual registrants that provide both brokerage and advisory services are required to deliver a relationship summary to each customer or client at the earlier of the delivery triggers for broker-dealers or investment advisors.

When to Amend: A broker-dealer or investment advisor must communicate any material changes to its relationship summary to each existing customer or client within 60 days of the change and deliver its updated relationship summary to each existing customer or client within 30 days upon request.

Recordkeeping: Broker-dealers must maintain a record of the date that a relationship summary is provided to each customer as well as a copy of each version of the relationship summary. Similarly, investment advisors must keep a copy of each relationship summary, including a copy of each amendment or revision to a relationship summary and a record of the dates that a relationship summary (or amended or revised relationship summary) is provided to any client or to a prospective client who subsequently becomes a client.

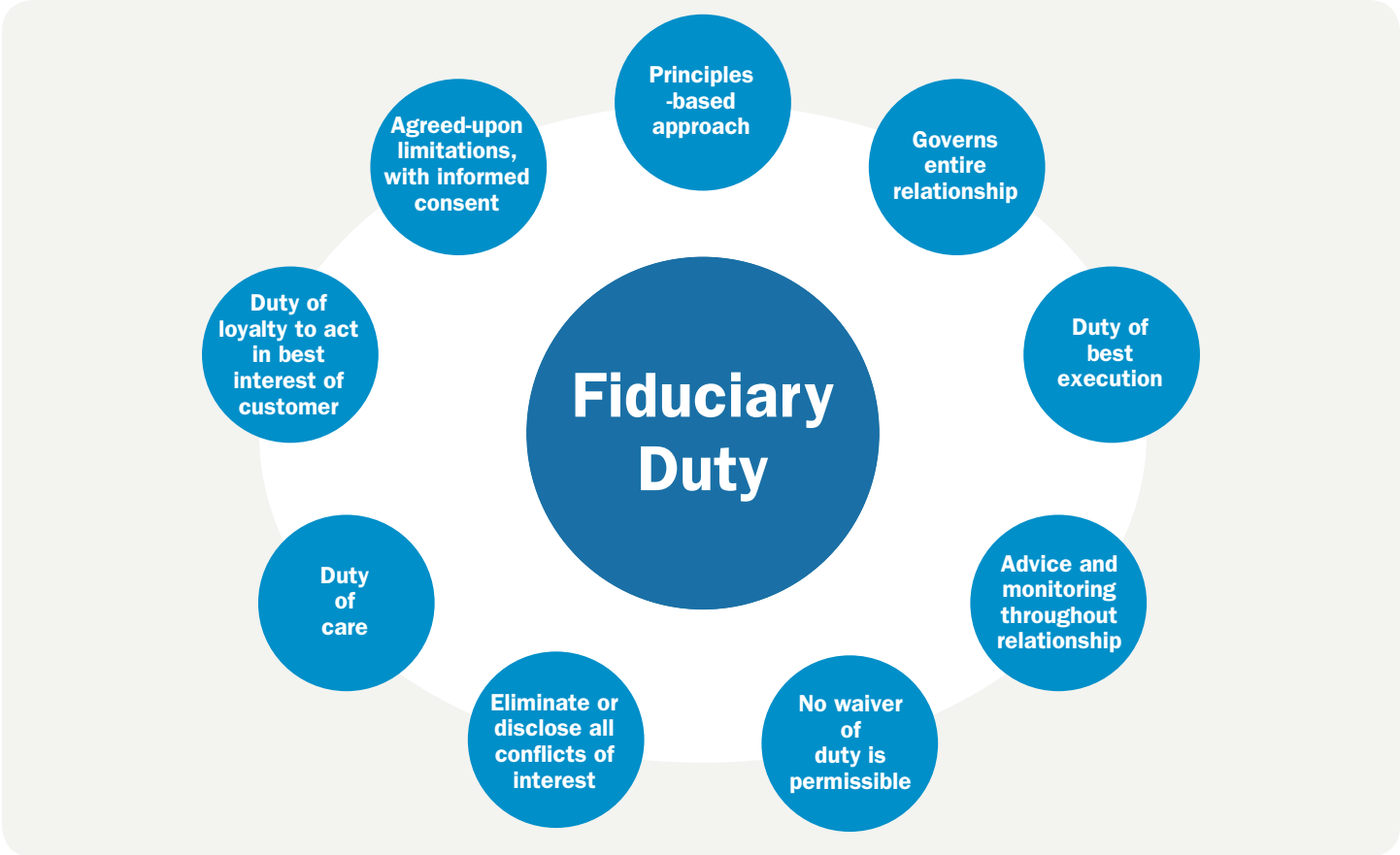
Form CRS Disclosure Items:

- **Introduction:** A firm's name and SEC registration status, an indication that brokerage and investment advisory services and fees differ, and that it is important for an investor to understand the differences between the two types of services and fees. This must include a reference to the SEC's investor education website at www.investor.gov.
- **Relationships and Services:** A description of the relationships and services offered to investors, including a discussion of whether the firm provides monitoring services, its potential investment authority, any limitations on investment offerings, and account minimums.
- **Fees, Costs, Conflicts, and Standard of Conduct:** Under the heading "What will I pay?," the relationship summary must include detailed descriptions about the fees and costs that investors will pay and disclose conflicts of interest and the applicable standard of conduct.
- **Disciplinary History:** Disclose the firm's or its financial professionals' legal or disciplinary history and that the SEC's investor education website /CRS website can be used to research the firm and its financial professionals.
- **Where to Find Additional Information:** A prominent statement of where an investor can find additional information about the brokerage or investment advisory services offered, including a telephone number and information about where an investor can request an up-to-date copy of the current relationship summary.

Interpretation: Standard of Conduct for Investment Advisors

The interpretation underscores that:

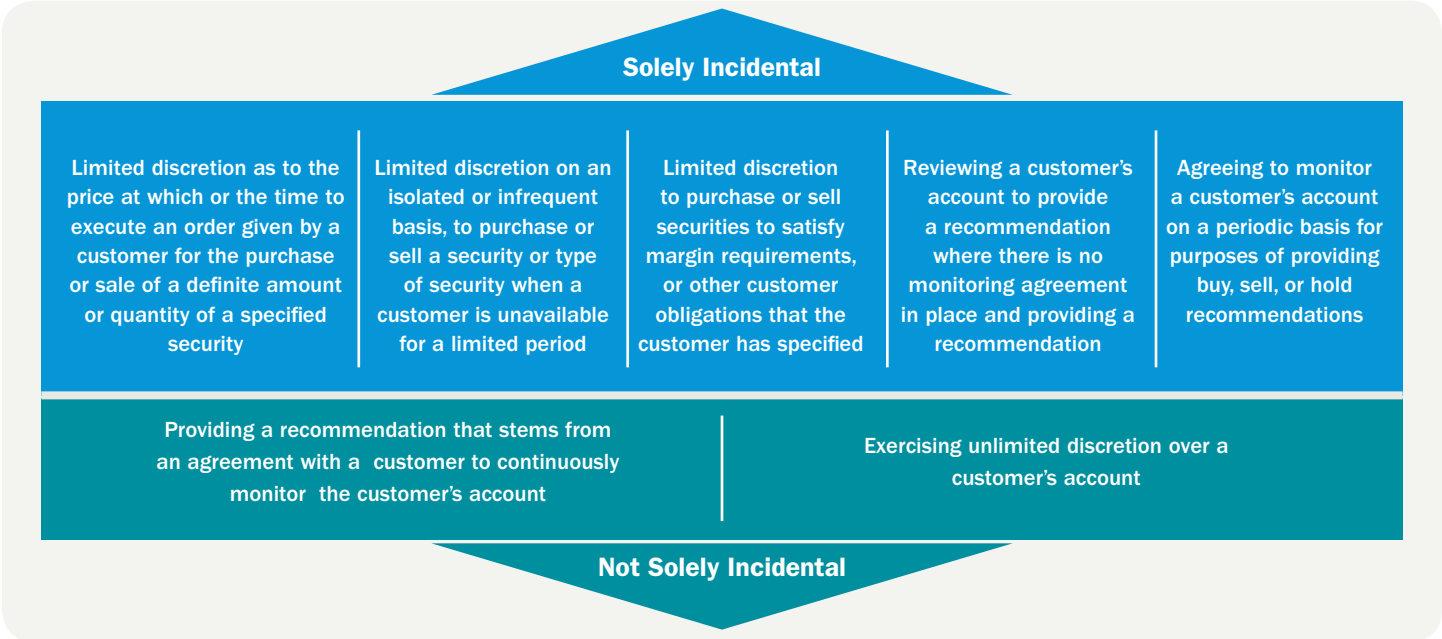
- The scope of the fiduciary duty may be shaped by agreement, provided there is full and fair disclosure and informed consent – but the duty may not be waived
- An advisor must, at all times, serve the best interest of their client and not subordinate the client's interest to its own
- Advice must be in the best interest of a client based on the client's investment objectives. Best interest is measured at the portfolio level
- Whether a hedge clause (a clause that purports to relieve an advisor from liability for conduct as to which the client has a non-waivable cause of action against the advisor) violates the Advisors Act's antifraud provisions depends on the facts and circumstances, including the client's sophistication. There are few, if any, circumstances in which a hedge clause in a retail client agreement would be consistent with the Advisors Act's antifraud provisions
- Advice on high-risk securities requires an advisor to apply heightened scrutiny to whether such securities fall within the client's risk tolerance and objectives
- To meet its duty of loyalty, an advisor must make full and fair disclosure to its clients of all material facts relating to the advisory relationship
- The duty of loyalty requires eliminating or making full and fair disclosure of all conflicts that could incline an investment advisor to render advice which is not disinterested so that a client can provide informed consent to the conflict
 - If an investment advisor cannot fully and fairly disclose a conflict, it must eliminate or adequately mitigate (i.e., modify practices to reduce) the conflict, so that full and fair disclosure and informed consent are possible
- Full and fair disclosure of all material facts relating to the advisory relationship or of conflicts of interest and a client's informed consent do not themselves satisfy the advisor's duty to act in the client's best interest (i.e., the duty of care)
- Disclosure that an advisor "may" have a particular conflict, without more, is not sufficient when the conflict actually exists
- The SEC slightly altered the investment advisory fiduciary landscape
 - The interpretation delineated between the scope of an advisor's duty of care when advising a retail client as opposed to an institutional client



Interpretation: Regarding the “Solely Incidental” Prong of the Broker-Dealer Exclusion from the Definition of Investment Advisor

This interpretation provides that a broker-dealer’s advice as to the value and characteristics of securities or the advisability of transacting in securities falls within the “solely incidental” prong of this exclusion if the advice provided is in connection with, and is reasonably related to, the broker-dealer’s primary business of effecting transactions and selling securities.

Examples:



The Impact on Firms

The rulemaking package will require a review of existing policies and procedures to ensure regulatory compliance with the enhanced standards of conduct and new disclosure obligations. The review should include, but not be limited to:

For investment advisors:

- Review hedge clauses in investment advisory agreements and revising as appropriate
- Conduct an in-depth review of current disclosures, identifying gaps for compliance with Part 2A of Form ADV and Form CRS
- Review all conflicts associated with the provision of investment advice and ensure they are of a nature that they can be adequately disclosed. If the conflicts cannot be adequately disclosed, mitigate the conflicts so that they can be fully and fairly disclosed

If not, mitigate the conflicts so that they can be fully and fairly disclosed

- Review the use of “may” in disclosures and revising such disclosures when a conflict already exists
- Provide training to supervised persons as to what client information must be obtained, how to satisfy the duty of care, and how to document the advice provided
- Enhance policies and procedures to: address Form CRS disclosure obligations; identify material conflicts and map them to mitigation practices and appropriate disclosures; enhance processes relating to the formulation of investment advice to ensure consistency with firm standards and disclosures and the duty of care; ensure compliance with recordkeeping obligations; and test for compliance with the firm’s fiduciary obligations (e.g., design appropriate exception reports and audit processes)

For dual registrants:

- Comply with the above requirements for investment advisors with respect to the firm’s investment advisory activities
- Ensure clear disclosure when the firm is acting as a broker-dealer and when it is acting as an investment advisor
- Conduct an in-depth review of current disclosures,

identifying gaps for compliance with Part 2A of Form ADV, Form CRS and the Disclosure Obligation in Reg BI

- Review and document product approval processes and communicate appropriate limitations in offerings for inclusion in disclosures
- Identify and eliminate any sales contests, sales quotas, bonuses and non-cash compensation arrangements that are based on the sale of specific securities or types of securities within a limited period of time
- Identify instances of discretion or account monitoring that fall outside the “solely incidental” exclusion from the investment advisor definition, and implement controls to ensure compliance with the Advisors Act in those instances
- Outline the firm’s material fees and costs that apply to retail customers’ transactions, holdings and accounts, the brokerage services provided by the firm and any material limitations on the securities or investment strategies that may be recommended to ensure compliance with the Disclosure Obligation of Reg BI
- Provide training to associated persons as to how to satisfy the Care Obligation of Reg BI (what customer information must be obtained, how to satisfy the Care Obligation, and how to document the advice provided)
- Identify and disclose material conflicts to satisfy the Conflict of Interest Obligation
- Identify and mitigate any conflicts of interest associated with such recommendations that create an incentive for broker-dealer personnel to place the interest of the broker-dealer or its personnel ahead of retail customers
- Prevent any material limitations on the securities or investment strategies involving securities that may be recommended to a retail customer and associated conflicts of interest from causing the broker-dealer or its personnel to make recommendations that place the interest of the broker-dealer or its personnel ahead of the interest of retail customers
- Reviewing training and education for associated persons for compliance with the foregoing obligations
- Enhancing policies and procedures to ensure compliance with the foregoing obligations

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