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Summary of SEC Proposals on Standards of Conduct for Broker-Dealers and Investment Advisers

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April 26, 2018 TO: ICI Members
Investment Company Directors
Broker/Dealer Advisory Committee
Investment Advisers Committee
Pension Committee
Pension Operations Advisory Committee
SEC Rules Committee
Small Funds Committee
Variable Insurance Products Advisory Committee SUBJECTS: Compliance
Disclosure
Distribution
Fees and Expenses
Investment Advisers
Operations
Pension
Transfer Agency RE: Summary of SEC Proposals on Standards of Conduct for Broker-Dealers and Investment Advisers

On April 18, the Securities and Exchange Commission approved a proposed package of rulemakings and interpretations ("Proposals") designed to enhance the quality and transparency of investors' relationships with investment advisers and broker-dealers, while preserving access to a variety of types of advice relationships and investment products.[1] This memorandum summarizes those aspects of the Proposals most relevant to registered funds.[2] The SEC requests comment on every aspect of the Proposals through a series of specific and general requests for comment. Comments on the Proposals are due to the SEC 90 days following publication of the Proposals in the *Federal Register*.

I. Regulation Best Interest

A. Overview of Regulation Best Interest

Proposed Regulation Best Interest would establish an express best interest obligation for

broker-dealers under the Securities Exchange Act of 1934 ("1934 Act"). It would require that all broker-dealers and natural persons who are associated persons of a broker-dealer (unless otherwise indicated, together referred to as "broker-dealer"), when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer, 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 making the recommendation ahead of the interest of the retail customer ("Best Interest Obligation").

Under the Proposal, the Best Interest Obligation is satisfied if three elements are met, which the SEC characterizes as the Disclosure Obligation, the Care Obligation, and the Conflict of Interest Obligations. Each of these are described and discussed in turn below. Many of the elements of proposed Regulation Best Interest are consistent with ICI's recommendations in our letters to the SEC in February and last August.[3]

The SEC explains that Regulation Best Interest is designed to make clear that a broker-dealer may not put the broker-dealer's financial interest ahead of the retail customer's interests when making investment recommendations. The Commission's goal is to enhance investor protection while, to the extent possible, preserving investor choice and access to existing products, services, service providers, and payment options.

B. Applicability and Scope of Best Interest Obligation

Regulation Best Interest would apply to both discretionary and non-discretionary recommendations made by a broker-dealer.[4] The SEC does not propose to define "best interest," but contemplates that the obligation will be satisfied based on the facts and circumstances of the particular recommendation, and how the broker-dealer has satisfied each of the components of the obligation *(i.e.*, Disclosure Obligation, Care Obligation, Conflict of Interest Obligations). It explains that the Best Interest Obligation generally draws from the underlying principles of the Department of Labor's (DOL) best interest standard, as described in DOL's best interest contract exemption, as well as the standard under Section 913 of the Dodd-Frank Act.[5] The SEC believes that the Best Interest Obligation would result in efficiencies for broker-dealers that have already established infrastructure to comply with DOL's Impartial Conduct Standards.

The Best Interest Obligation would apply only when a broker-dealer is making a recommendation to a retail customer about a securities transaction or an investment strategy involving securities. Consistent with ICI's suggestion, the SEC intends that "recommendation" will be interpreted consistent with established broker-dealer concepts, including FINRA Rule 2111, although the SEC does not propose to define the term. Services and communications that do not constitute making a recommendation would not be subject to the Best Interest Obligation. Non-exclusive examples include executing an unsolicited transaction for a retail customer, a dually registered broker-dealer making a recommendation in its investment advisory capacity,[6] and providing general investor education or limited investment analysis tools.

The Best Interest Obligation would apply to a broker-dealer's recommendation of any securities transaction or investment strategy to a retail investor, including an explicit recommendation to hold a security or regarding the manner in which it is to be purchased or sold. Securities transactions include recommendations to roll over or transfer assets from one type of account to another (*e.g.*, IRA rollovers). The Best Interest Obligation would not apply to the recommendation of an account type generally if it is not tied to a

securities transaction. Thus, the obligation would not apply to a broker-dealer's general recommendation of a brokerage account or an advisory account, although the SEC requests comment on this issue.

For purposes of Regulation Best Interest, the SEC proposes to define "retail customer" as "a 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." This definition is similar to ICI's recommended definition but would not limit the scope of the obligation to natural persons. It does require, however, that the recommendation be primarily for personal, family, or household purposes.

Regulation Best Interest would not prohibit a broker-dealer from engaging in transactions involving conflicts of interest, provided the elements of the Best Interest Obligation are satisfied.[7] Rather, the obligation reflects that a broker-dealer inevitably will have a financial interest, but that interest cannot be the predominant motivating factor behind its recommendation.[8]

C. Disclosure Obligation

Regulation Best Interest's Disclosure Obligation would require a broker-dealer or natural person who is an associated person of a broker or dealer, prior to or at the time of the recommendation, to reasonably disclose to the retail customer, in writing, the material facts relating to the scope and terms of the relationship with the retail customer and all material conflicts of interest that are associated with the recommendation.

Examples of material facts relating to the scope and terms of the relationship include, but are not limited to: (i) that the broker-dealer is acting in a broker-dealer capacity with respect to the recommendation; (ii) fees and charges that apply to the retail customer's transactions, holdings, and accounts; and (iii) the type and scope of services provided by the broker-dealer, including, for example, monitoring the performance of the retail customer's account. The disclosure obligations Regulation Best Interest requires are greater than existing disclosure obligations to which broker-dealers are subject.[9]

The Disclosure Obligation applies to any material conflict of interest, including those arising from financial incentives. Examples of material conflicts that should be disclosed include, but are not limited to, those associated with recommending: proprietary products, products of affiliates, or limited range of products; one share class versus another share class of a mutual fund; securities underwritten by the firm or a broker-dealer affiliate; the rollover or transfer of assets from one type of account to another (*e.g.*, a recommendation to roll over assets from an ERISA account to an IRA, when the recommendation involves a securities transaction); and allocation of investment opportunities among retail customers (*e.g.*, IPO allocation).

The SEC contemplates a layered disclosure approach, beginning with the brief, high-level disclosures the SEC proposes in the Form CRS relationship summary and regulatory status disclosure requirements, described below. To fully satisfy the Disclosure Obligation, a broker-dealer may need to follow Form CRS with more detailed information relevant to the customer relationship and account, including quantitative information about fees and expenses, and more comprehensive disclosure of material conflicts.[10] The adequacy of the disclosure will depend on the facts and circumstances.

The SEC does not propose to mandate the form, specific timing, or method of delivering disclosure under the Disclosure Obligation (although there are specific requirements relating to Form CRS, as described below), as long as the disclosure is made in writing, prior to or at the time of a recommendation.[11]

D. Care Obligation

Regulation Best Interest's Care Obligation would require a broker-dealer or natural person who is an associated person of a broker or dealer, in making the recommendation, to exercise reasonable diligence, care, skill, and prudence to: (1) understand the potential risks and rewards associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers; (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[12] and the potential risks and rewards associated with the recommendation; and (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. A broker-dealer could not satisfy its Care Obligation solely through disclosure.

As recommended by ICI, the Care Obligation includes a prudence requirement to convey the importance of the broker-dealer conducting a proper evaluation of any securities recommendation in accordance with an objective standard of care. The Care Obligation requires a broker-dealer generally to consider reasonable alternatives, in determining whether it has a reasonable basis for its recommendation, but it is not required to analyze all possible alternatives to recommend the "best" security or investment strategy, nor is it required to recommend the least expensive or least remunerative security or investment strategy.[13] We discuss below the three primary elements of the Care Obligation.

1. In the best interest of at least some retail customers

The Care Obligation requires that a broker-dealer understand the potential risks and rewards associated with the recommendation and have a reasonable basis to believe that the recommendation could be in the best interest *of at least some retail customers*. This is a facts and circumstances determination based on factors including, but not limited to, costs (including fees, compensation, and other financial incentives), investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility, and likely performance of market and economic conditions, expected return of the security or investment strategy, as well as any financial incentives to recommend the security or investment strategy. This obligation is intended to incorporate and enhance existing broker-dealer obligations relating to "reasonable basis suitability" by, among other things, raising the standard from "suitability" to "best interest."

2. In the best interest of a particular retail customer

The Care Obligation requires that a broker-dealer 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 and rewards associated with the recommendation. A broker-dealer would not satisfy this standard if it put its interest ahead of its customer's interest. This obligation is intended to incorporate and enhance existing broker-dealer obligations relating to "customer specific suitability" by, among other things,

raising the standard from “suitability” to “best interest.”

The SEC explains that, if a broker-dealer is choosing among identical securities, it is inconsistent with the Care Obligation for the broker-dealer to recommend the more expensive security to the customer.[14] If a broker-dealer recommends a more expensive security or investment strategy over another reasonably available alternative the broker-dealer offers, it needs to have a reasonable basis to believe the higher cost is justified and is in the customer’s best interest, in light of the customer’s investment profile.[15] A broker-dealer could recommend a more remunerative security or investment strategy over another reasonably available alternative offered by the broker-dealer if the broker-dealer has a reasonable basis to believe that, putting aside its financial incentives, the recommendation is in the customer’s best interest, in light of the customer’s investment profile.[16]

3. Series of transactions is not excessive and is in the retail customer’s best interest

The Care Obligation also requires a broker-dealer to exercise reasonable diligence, care, skill, and prudence to have a reasonable basis to believe that *a series of recommended transactions is not excessive and is in the retail customer’s best interest*. This obligation is intended to incorporate and enhance existing broker-dealer obligations relating to “quantitative suitability.” Notably, the SEC’s standard would apply a “best interest” standard, rather than the existing “suitability” standard, and would apply this standard regardless of whether a broker-dealer exercises control over a customer’s account.[17] What constitutes a “series” of recommended transactions would depend on the facts and circumstances.

E. Conflict of Interest Obligations

The Conflict of Interest Obligations require a broker-dealer entity[18] to establish, maintain, and enforce written policies and procedures reasonably designed to (1) identify and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with such recommendations; and (2) identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations.

Whether a broker-dealer’s policies and procedures are reasonably designed to satisfy the Conflict of Interest Obligations will depend on the facts and circumstances. The SEC explains that “financial incentives” may include, but are not limited to, compensation practices established by the broker-dealer, including fees and other charges for the services provided and products sold; employee compensation or employment incentives (*e.g.*, quotas, bonuses, sales contests, special awards, differential or variable compensation, incentives tied to appraisals or performance reviews); compensation practices involving third parties, including both sales compensation and compensation that does not result from sales activity, such as compensation for services provided to third parties (*e.g.*, sub-accounting or administrative services provided to a mutual fund); receipt of commissions or sales charges, or other fees or financial incentives, or differential or variable compensation, whether paid by the retail customer or a third party; sales of proprietary products or services, or products of affiliates; and transactions that would be effected by the broker-dealer (or an affiliate thereof) in a principal capacity. While the SEC asserts that it does not expect broker-dealers to mitigate every material conflict, it gives no examples of material conflicts of interest not involving financial incentives that are

associated with a recommendation.

While broker-dealers are subject to existing obligations to maintain policies and procedures reasonably designed to prevent and detect violations of, and to achieve compliance with, the federal securities laws and regulations, and applicable SRO rules, the Care Obligation would enhance existing obligations by requiring policies and procedures reasonably designed to mitigate or eliminate material conflicts of interest arising from financial incentives. The SEC provides limited examples of how a broker-dealer could mitigate or eliminate material conflicts of interest,[19] although it asserts that "financial incentives can create conflicts of interest that may be difficult, if not impossible, to effectively manage through disclosure alone, or to eliminate."[20] A broker-dealer engaging in principal trading could satisfy its Care Obligation by establishing, maintaining, and enforcing written policies and procedures reasonably designed to identify and address the financial incentives presented by such trading.[21]

II. Proposed SEC Interpretation on Standard of Conduct for Investment Advisers and Requests for Comment on Enhancing Existing Regulation

The SEC separately proposed an interpretation to reaffirm and, in some cases, clarify the Commission's views of the fiduciary duty that investment advisers owe to their clients.[22] According to the Commission, by highlighting principles relevant to fiduciary duty, investment advisers and their clients would have greater clarity about advisers' legal obligations. The SEC's interpretation would apply to investment advisers to both retail and institutional clients, although the examples in the Proposal focus on retail client relationships.

The SEC explains that the Advisers Act establishes a "federal fiduciary standard" for investment advisers that is based on common law principles. An adviser's fiduciary duty is made enforceable by the antifraud provisions of the Advisers Act. An adviser's fiduciary duty consists of a duty of care and a duty of loyalty, which the SEC describes as having the obligations summarized below.

A. Duty of Care

The SEC states that the duty of care includes, among other things: (i) the duty to act and to provide advice that is in the best interest of the client, (ii) 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 (iii) the duty to provide advice and monitoring over the course of the relationship.

The Proposal discusses an adviser's duty of care in the context of the provision of personalized investment advice.[23] It asserts that, in that context, the adviser has a duty to make a reasonable inquiry into a client's financial situation, level of financial sophistication, investment experience, and investment objectives and a duty to provide personalized advice that is suitable for, and in the best interest of, the client based on the client's investment profile.[24] It is unclear if, or how, the SEC believes this obligation would apply to advisory relationships with institutional clients. The SEC believes that an adviser must update a client's investment profile in order to adjust its advice to reflect any changed circumstances and discusses the frequency with which it is obligated to do this.

The SEC provides examples of factors an adviser should consider in forming a reasonable

belief that personalized advice is suitable for, and in the best interest of, the client based on the client's investment profile. Factors may include the cost (including fees and compensation) associated with investment advice; and the investment product's or strategy's investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility, and likely performance in a variety of market and economic conditions.

While the SEC states that fiduciary duty does not necessarily require an adviser to recommend the lowest cost investment product or strategy, it believes that an adviser could not reasonably believe a recommended security is in the best interest of a client if it costs more than a security that is otherwise identical, including any special or unusual features, liquidity, risks and potential benefits, volatility, and likely performance.[25]

The SEC states that an adviser has a duty of care to seek best execution of client transactions when the adviser has the responsibility to select broker-dealers to execute client trades. The SEC explains that, to satisfy this duty, the adviser must not just seek to minimize cost, but must consider whether the transaction represents the "best qualitative execution."[26] Further, the adviser should "periodically and systematically" evaluate the execution it obtains for clients.

The SEC asserts that an investment adviser's duty of care includes a duty to provide advice and monitoring over the course of the relationship with the client. While the SEC acknowledges that the scope of an advisory relationship may be defined by contract between the adviser and the client, it suggests that the adviser has a duty to monitor that extends to all personalized advice the adviser provides to the client. Although the SEC provides several examples of how this duty might apply, the basis and scope of this duty are unclear, including if and how it would apply to an advisory relationship with an institutional client.

B. Duty of Loyalty

The SEC describes an investment adviser's duty of loyalty as requiring an adviser to put its client's interests first, and not favor its own interests over those of a client or unfairly favor one client over another. As part of this duty, it must make full and fair disclosure to its clients of all material facts relating to the advisory relationship.

The SEC explains that an adviser must seek to avoid conflicts of interest with its clients and, at a minimum, make full and fair disclosure to clients of all material conflicts of interest that could affect the advisory relationship. It discusses the sufficiency of disclosure required to satisfy this standard, noting that an adviser's disclosure that it "may" have a conflict is not adequate disclosure when the conflict actually exists.[27] While the SEC acknowledges that a client may provide implicit or explicit consent to conflicts, depending on the circumstances, it suggests that disclosure and consent may be inadequate under circumstances where either: (i) the facts and circumstances indicate that the client did not understand the nature and significance of the conflict, or (ii) the material facts concerning the conflict could not be fully and fairly disclosed. In these situations, the SEC expects an adviser to "eliminate the conflict or adequately mitigate it so it can be more readily disclosed."[28]

C. Request for Comment on Potential Areas for Enhanced Adviser Regulation

The SEC also requests comment on three potential enhancements to advisers' existing

fiduciary obligations: (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, including fidelity bonds. The SEC believes these are areas in which the current broker-dealer framework provides investor protections that may not exist in the investment adviser context. The SEC suggests, however, that if it considers these ideas further, it will be in connection with future proposed rules or other proposed regulatory actions.

III. Form CRS Relationship Summary

A. Overview of Form CRS

The Commission also proposed Form CRS to require investment advisers and broker-dealers, and their respective associated persons, to provide retail investors[29] with a customer relationship summary ("Relationship Summary").[30] This standardized, short-form (4-page maximum) disclosure is intended to highlight key differences in the principal types of services offered, the legal standards of conduct that apply to each, the fees a customer might pay, and certain conflicts of interest that may exist. The Relationship Summary also would include a list of suggested key questions for retail investors to ask their financial professional. The Commission intends the Relationship Summary to alert retail investors to important information for them to consider when choosing a firm and a financial professional, and to prompt retail investors to ask informed questions.

Retail investors would receive Form CRS at the beginning of a relationship with an investment adviser or broker-dealer and would receive updated information following any material change. Form CRS would supplement investment advisers' other Form ADV disclosure as well as the separate disclosure that Regulation Best Interest requires broker-dealers to provide in connection with making a recommendation.

A firm's disclosure obligations under Form CRS differ from those under Regulation Best Interest. Both investment advisers and broker-dealers are required to provide retail investors with Form CRS, while Regulation Best Interest only applies to broker-dealers making recommendations to retail investors. Form CRS defines "retail investor" more broadly than Regulation Best Interest.[31] The Form CRS delivery obligation is not tied to the making of a recommendation as it is under Regulation Best Interest. Rather, a broker-dealer must deliver Form CRS before or at the time the retail investor first engages the firm's services. Form CRS's disclosure of fees and conflicts also is broader and less specific than the Regulation Best Interest disclosure requirement. Conversely, Form CRS prescribes specific disclosure items, language, and order of information, while Regulation Best Interest does not impose specific form requirements or mandate the use of particular language.

The Proposal includes mock-ups of a Relationship Summary for an investment advisory firm, a brokerage firm, and a dual registrant, in Appendices C-E to the release.[32] The Commission's Office of the Investor Advocate plans on conducting investor testing related to Form CRS.

B. Presentation and Format

The Relationship Summary includes eight separate items: (i) introduction; (ii) relationships and services the firm provides to retail investors; (iii) standard of conduct applicable to those services; (iv) the fees and costs that retail investors will pay; (v) comparisons of

brokerage and investment advisory services (for standalone broker-dealers and investment advisers); (vi) conflicts of interest; (vii) where to find additional information, including whether the firm and its financial professionals currently have reportable legal or disciplinary events and who to contact about complaints; and (viii) key questions for retail investors to ask the firm's financial professional.

Firms would present this information under prescribed headings in the same order and could not include any additional information in the Relationship Summary. Form CRS requires firms to use prescribed wording to respond to some items, although other items permit more flexible responses.[33] If a statement is inapplicable to a firm's business or would be misleading to a reasonable retail investor, Form CRS permits the firm to omit or modify that statement. The Commission proposes requiring firms to use "plain language" principles for the organization, wording, and design of the entire Relationship Summary, taking into consideration retail investors' level of financial sophistication.

The Commission also encourages firms to create online versions of the Relationship Summary that are user-friendly, concise, easy-to-read, and more interactive than paper, and requests comment on ways to do so. The Commission intends to facilitate a layered approach to disclosure in which firms would include certain information in the Relationship Summary, along with references and links to other disclosure where interested investors can find additional information.[34]

1. Introduction

The introduction to the Relationship Summary would include a firm's name, whether it is registered with the Commission as a broker-dealer, investment adviser, or both, and date of the Relationship Summary. An introductory paragraph would briefly explain the types of accounts (brokerage accounts and/or investment advisory accounts) and services the firm offers.

2. Relationships and services

Each firm must discuss specific information about the nature, scope, and duration of its relationships and services, including the types of accounts and services the firm offers and whether the firm monitors the account. Form CRS would require firms that significantly limit the types of investments available to retail investors in any accounts to include the following disclosure: "We offer a limited selection of investments. Other firms could offer a wider range of choices, some of which might have lower costs."[35]

3. Applicable standard of conduct

Form CRS sets forth prescribed wording to describe the firm's legal standard of conduct to the retail investor. The proposed language references the Best Interest Obligation for broker-dealers and the fiduciary standard for investment advisers. It clarifies a financial professional's duty to monitor the investor's account. This item also highlights the potential for conflicts of interest and the applicable requirements for a financial professional to address those conflicts.

4. Fees and costs

This section requires an overview of specified types of fees and expenses that retail investors will pay in connection with their brokerage and investment advisory accounts. Importantly, this item focuses on certain general types of fees, rather than describing all

fees or providing a comprehensive schedule of fees. Specifically, this item highlights certain differences in how broker-dealers and investment advisers charge for their services.

This section also requires a description of the principal type of fees that the firm will charge retail investors as compensation for the firm's advisory or brokerage services, including whether the firm's fees vary and are negotiable, and the key factors that would help a reasonable retail investor understand the fees that he or she is likely to pay.[36]

Although Form CRS does not require personalized fee disclosure, the beginning of the Fees and Costs section of the Relationship Summary would state: "Please ask your financial professional to give you personalized information on fees and costs that you will pay." The proposed Relationship Summary also later prompts the retail investor to ask the financial professional about the amount that they would pay per year for the account, what would make the fees more or less, and the services provided in exchange for those fees. The Commission requests extensive comment on the issue of personalized fee disclosure and recognizes the potential expense and complexity involved.

5. Comparisons of brokerage and investment advisory services

This section requires a standalone broker-dealer or investment advisor to provide information comparing its services with a typical advisory or brokerage account. Specifically, standalone broker-dealers must include the following information about a typical retail investment adviser: (i) the principal type of fee for investment advisory services; (ii) services investment advisers generally provide, (iii) advisers' standard of conduct; and (iv) certain incentives advisers have based on the investment adviser's asset-based fee structure. Investment advisers must disclose comparable categories of information regarding broker-dealers in this section. The SEC intends these disclosures to help retail investors choose among different account types and services.

6. Conflicts of interest

The Relationship Summary requires investment advisers and broker-dealers to summarize their conflicts of interest related to certain financial incentives. Specifically, it requires firms to disclose conflicts relating to (i) third-party compensation or proprietary products, (ii) revenue sharing; and (iii) principal trading.

This item does not require an exhaustive discussion of all conflicts. The Commission notes that investment advisers provide a detailed discussion of conflicts in Form ADV Part 2, and that Regulation Best Interest would require broker-dealers to disclose, in writing, all material conflicts of interest that are associated with a recommendation to a retail customer.

7. Additional information, including legal or disciplinary events

This item requires information on where retail investors can find more information about the firm's disciplinary events, services, fees, and conflicts. It requires firms to state "We have legal and disciplinary events" if they are required to disclose disciplinary information per Form ADV or Form BD.

8. Key questions to ask

The Relationship Summary concludes with a series of questions retail investors may wish to

ask their financial professional. The Commission intends to encourage retail investors to have conversations with their financial professionals about how the firm's services, fees, conflicts and disciplinary events affect them.[37] This proposed item requires the firm to restate the following ten questions:

1. Given my financial situation, why should I choose an advisory account? Why should I choose a brokerage account?
2. Do the math for me. How much would I pay per year for an advisory account? How much for a typical brokerage account? What would make those fees more or less? What services will I receive for those fees?
3. What additional costs should I expect in connection with my account?
4. Tell me how you and your firm make money in connection with my account. Do you or your firm receive any payments from anyone besides me in connection with my investments?
5. What are the most common conflicts of interest in your advisory and brokerage accounts? Explain how you will address those conflicts when providing services to my account.
6. How will you choose investments to recommend for my account?
7. How often will you monitor my account's performance and offer investment advice?
8. Do you or your firm have a disciplinary history? For what type of conduct?
9. What is your relevant experience, including your licenses, education, and other qualifications? Please explain what the abbreviations in your licenses are and what they mean.
10. Who is the primary contact person for my account, and is he or she a representative of an investment adviser or a broker-dealer? What can you tell me about his or her legal obligations to me? If I have concerns about how this person is treating me, who can I talk to?

Firms are permitted to modify or omit portions of these questions, as applicable to their business. In addition, firms can include additional questions, not to exceed a total of fourteen questions.

C. Delivery, Updating, and Filing Requirements

1. Delivery requirements

The Proposal requires firms to deliver the Relationship Summary to each retail investor. The Proposal lays out different triggers for initial delivery of the Relationship Summary by investment advisers (before or at the time the firm enters into an investment advisory agreement with the retail investor) and by broker-dealers (before or at the time the retail investor first engages the firm's services). A dual registrant would deliver the Relationship Summary at the earlier of entering into an investment advisory agreement with the retail investor or the retail investor engaging the firm's services. The delivery requirement applies to investment advisers even if the investment advisory agreement is oral, and to broker-dealers even if a transaction is executed outside of an account or without an account opening agreement.

The timing of the delivery obligation for investment advisers is consistent with current requirements for investment advisers to deliver the Form ADV Part 2 brochure. The Commission intends the broker-dealer delivery requirement to capture the earliest point in time at which a retail investor engages the services of a broker-dealer, including instances when a customer opens an account with the broker-dealer, or effects a transaction through

the broker-dealer in the absence of an account, for example, by purchasing a mutual fund through the broker-dealer via "check and application."[38]

Importantly, the obligation for a broker-dealer to deliver a Relationship Summary extends beyond the scope of proposed Regulation Best Interest, which would apply when a broker-dealer provides a recommendation. The Form CRS delivery requirement would not apply, however, where a broker-dealer makes a recommendation to a retail investor who does not already have an account with that broker-dealer, if that recommendation does not lead to a transaction with that broker-dealer.

In addition, the Proposal would require a firm to provide the Relationship Summary when an existing client or customer opens a new account or makes changes to an existing account that would materially change the nature and scope of the firm's relationship with the retail investor.[39]

The Commission also is proposing to require delivery of the Relationship Summary on an initial one-time basis to all of a firm's existing retail investor clients and customers within 30 days after the date the firm is first required to file the Relationship Summary with the Commission.

2. Updating requirements

The Proposal requires a firm to update its Relationship Summary whenever the Relationship Summary becomes materially inaccurate and communicate this information to existing retail investor clients or customers within 30 days. Firms may communicate this information by delivering the amended Relationship Summary or by communicating the information another way to the retail investor, such as by delivering amended Form ADV information.

3. Filing requirements

Firms must electronically file the Relationship Summary and any updates with the Commission.[40]

IV. Disclosures and Restrictions Regarding the Use of Certain Names or Titles

A. Restrictions on Certain Uses of "Adviser" and "Advisor"

The Commission's Proposal also restricts standalone broker-dealers from using, as part of their name or title, the terms "adviser" and "advisor."[41] This aspect of the Proposal addresses the Commission's concern that the use of these titles may mislead retail customers into believing their firm or professional is a registered investment adviser when it is not. The Proposal does not apply to communications with institutions, as the Commission believes institutions generally are less likely to be misled by such names or titles.

The Proposal permits dually registered firms to use the term "adviser" or "advisor" in their name or title. A financial professional that only offers brokerage services to retail investors, however, cannot use the title "adviser" or "advisor" even if he or she is associated with a dually registered firm.

B. Regulatory Status Disclosure

The Commission also is proposing rules that would require an SEC-registered broker-dealer or investment adviser to prominently disclose its registration status in print or electronic retail investor communications.[42] The Proposal requires a firm and its financial professionals to disclose their registration status in print communications in a type size at least as large as, and in a font style different from, but at least as prominent as, that used in the majority of the communication.[43]

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endnotes

[1] *Regulation Best Interest*, Securities Exchange Act Release No. 83062, *available at* https://www.sec.gov/rules/proposed/2018/34-83062.pdf ("Best Interest Proposal"); *Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation*, Investment Advisers Act Rel. No. 4889, *available at* https://www.sec.gov/rules/proposed/2018/ia-4889.pdf ("Adviser Interpretation Proposal"); Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles, Securities Exchange Act Release No. 83063, *available at* https://www.sec.gov/rules/proposed/2018/34-83063.pdf ("Disclosure Proposal").

[2] For our initial summary of the Proposals, please *see* ICI Memorandum No. 31175 (Apr. 19, 2018), *available at* https://www.ici.org/my_ici/memorandum/ci.memo31174.idc.

[3] *See* Letter to the Honorable Jay Clayton, Chairman, Securities and Exchange Commission, from Paul Schott Stevens, President and CEO, Investment Company Institute, dated Feb. 5, 2018, *available at* https://www.sec.gov/comments/ia-bd-conduct-standards/cll4-2997611-161894.pdf; Letter to the Honorable Jay Clayton, Chairman, Securities and Exchange Commission, from Dorothy M. Donohue, Acting General Counsel, Investment Company Institute, dated Aug. 7, 2017, *available at* https://www.sec.gov/comments/ia-bd-conduct-standards/cll4-2188873-160255.pdf.

[4] ICI's recommended best interest standard was limited to broker-dealers making recommendations with respect to *non-discretionary* accounts. The SEC explains that Regulation Best Interest is not intended to supersede case law holding that broker-dealers that exercise discretion or control over customer assets, or have a relationship of trust and confidence with customers, owe them a fiduciary duty. Best Interest Proposal, *supra* note 1, at n.143. The SEC requests comment on whether a broker-dealer's exercise of

investment discretion should be viewed as "solely incidental" to the broker-dealer's business, for purposes of the broker-dealer exclusion from the definition of "investment adviser" under Section 202(a)(11)(C) of the Investment Advisers Act of 1940 ("Advisers Act"), or whether broker-dealers with discretion should be deemed to meet the definition of "investment adviser." *Id*. at 199-209.

[5] The Best Interest Obligation does not include the other requirements of DOL's Impartial Conduct Standards—that the broker-dealer not make misleading statements and receive no more than reasonable compensation—because these requirements already apply to broker-dealers under the federal securities laws and SRO rules. Nor does the Best Interest Obligation establish a uniform fiduciary duty standard for both investment advisers and broker-dealers, as the SEC's study under Section 913 of the Dodd-Frank Act recommended.

[6] The SEC explains that Regulation Best Interest would not apply to the relationship between an investment adviser and its advisory client, and that dual registrants would only be subject to Regulation Best Interest when making a recommendation in their capacity as broker-dealer. The SEC has, however, also proposed an interpretation of an investment adviser's fiduciary duty. *See* Adviser Interpretation Proposal, *supra* note 1, and summary below.

[7] The SEC provides examples including, among others: 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; recommending a transaction to be executed in a principal capacity; and recommending complex products. Best Interest Proposal, *supra* note 1, at 53-54.

[8] Regulation Best Interest requires that a broker-dealer act in the best interest of the retail customer without placing the financial or other interest of the broker-dealer *ahead* of the customer's interest, while the DOL's Impartial Conduct Standards and the uniform fiduciary standard under Section 913 of the Dodd-Frank Act both use the phrase "*without regard to* the financial or other interest . . ." *Id.* at 47.

[9] The SEC notes that a broker-dealer's obligation to disclose material conflicts of interest under Regulation Best Interest is similar to the duty that has been imposed on broker-dealers acting in a fiduciary capacity. *Id*. at n.173.

[10] *Id.* at 103.

[11] The SEC notes, however, that a broker-dealer's disclosure of the capacity in which it is acting at the time of a recommendation is not required to be in writing. *Id.* at n.213.

[12] Regulation Best Interest defines "Retail Customer Investment Profile" to include, but not be limited to, the retail customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the retail customer may disclose to the broker, dealer, or a natural person who is an associated person of a broker or dealer in connection with a recommendation.

[13] Regulation Best Interest does not prohibit recommendations from a limited range of products, recommendations of proprietary products or products of affiliates, or principal

transactions, as long as the Care Obligation is satisfied, and associated conflicts are disclosed and eliminated or mitigated, as appropriate.

[14] The SEC references mutual funds with different share classes as an example of identical securities with different cost structures. Best Interest Proposal, *supra* note 1, at n.106. The broker-dealer also could not make a recommendation to the retail customer in order to maximize its compensation, further its business relationships, satisfy firm sales quotas or other targets, or win firm-sponsored sales contests.

[15] Factors that may be relevant to this analysis include the product's or strategy's investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility and likely performance in a variety of market and economic conditions.

[16] A broker-dealer could recommend the more remunerative of two alternatives if the broker-dealer determines the products otherwise both are in the best interest of, and there is no material difference between them from the perspective of, the customer. Best Interest Proposal, *supra* note 1, at 148-149. In its request for comment, however, the SEC asks if "commenters agree with our view that recommending a more expensive or more remunerative alternative for identical securities would be inconsistent with Regulation Best Interest?" *Id.* at 69.

[17] FINRA recently proposed to eliminate the "control" requirement in its existing rule. *See* FINRA Regulatory Notice 18-13 (Apr. 20, 2018), *available at* http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-18-13.pdf.

[18] Unlike the Disclosure and Care Obligations, which apply both to the broker-dealer entity and to associated (natural) persons of the entity, the Conflict of Interest Obligations would apply solely to the broker-dealer entity.

[19] For example, in the case of conflicts related to affiliated mutual funds, the broker-dealer could eliminate the effect of a conflict by crediting advisory fees against other broker-dealer charges. Best Interest Proposal, *supra* note 1, at 175.

[20] *Id.* at 177.

[21] *Id.* at 178.

[22] Adviser Interpretation Proposal, *supra* note 1.

[23] The SEC recognizes that advisers also may provide impersonal investment advice and states that this Proposal does not address how the Advisers Act applies to different types of impersonal investment advice. *Id.* at n.8.

[24] The SEC asserts that the obligation to provide advice that is in the client's best interest stems, in part, from its proposed 1994 rule addressing suitability obligations for investment advisers. That rule was never adopted. *Id.* at n.26.

[25] The SEC gives the example of an adviser advising its client to invest in a mutual fund share class with higher costs than other available options, where the adviser receives more compensation with respect to that share class. The SEC states that the adviser may violate its fiduciary duty and the antifraud provisions of the Advisers Act if it does not, at a minimum, provide full and fair disclosure of the conflict and its impact on the client, and

obtain informed client consent to the conflict.

[26] Adviser Interpretation Proposal, *supra* note 1, at 14. The SEC believes an adviser should consider "the full range and quality of a broker's services in placing brokerage including, among other things, the value of research provided as well as execution capability, commission rate, financial responsibility, and responsiveness" to the adviser.

[27] *Id.* at 18.

[28] *Id.* at 19.

[29] The Proposal defines a "retail investor" as "a prospective or existing client or customer who is a natural person," regardless of the individual's net worth. The definition would include a trust or other similar entity that represents natural persons, even if another person is a trustee or managing agent of the trust.

[30] Disclosure Proposal, *supra* note 1. Form CRS would be required by Form ADV Part 3 and rule 204-5 of the Advisers Act for investment advisers, and by Form CRS and rule 17a-14 of the 1934 Act for broker-dealers. The Commission proposes to amend Form ADV to include a new Part 3: Form CRS that would describe the requirements for the Relationship Summary.

[31] Form CRS defines a "retail investor" as "a prospective or existing client or customer who is a natural person," regardless of the individual's net worth. The definition would include a trust or other similar entity that represents natural persons, even if another person is a trustee or managing agent of the trust. We describe Regulation Best Interest's definition of "retail customer" in Section II.B of this memorandum. That definition would not limit the scope of the obligation to natural persons.

[32] *See* Appendix C, Dual Registrant Mock-up, *available at* https://www.sec.gov/rules/proposed/2018/34-83063-appendix-c.pdf; Appendix D, Broker-Dealer Mock-up, *available at* https://www.sec.gov/rules/proposed/2018/34-83063-appendix-d.pdf; and Appendix E, Investment Adviser Mock-up, *available at* https://www.sec.gov/rules/proposed/2018/34-83063-appendix-e.pdf.

[33] The Relationship Summary prescribes the use of graphical formats in specified circumstances and broadly permits the use of explanatory charts, graphs, tables, and other graphics or text features.

[34] Form CRS requires firms to include cross-references to where investors can find additional information, such as in the Form ADV Part 2 brochure and brochure supplement for investment advisers or on the firm's website or in the account opening agreement for broker-dealers. For electronic versions of the Relationship Summary, Form CRS requires firms to use hyperlinks to the cross-referenced document if it is available online. Disclosure Proposal, *supra* note 1, at 20.

[35] *Id.* at 39.

[36] A broker-dealer must describe transaction-based fees as its principal type of fee, using prescribed wording. An investment adviser must summarize the principal fees and costs that align with the type of fee(s) the adviser reports in response to Item 5.E. of Form ADV Part 1A that are applicable to retail investors.

[37] Robo-advisers or online-only broker-dealers can include a section or page on their website that answers each of the above questions, and provide a hyperlink in the Relationship Summary to that section or page.

[38] The Proposal requests comment on whether execution-only and clearing broker-dealers should be excluded from the requirement to provide a Relationship Summary. *Id.* at 149.

[39] The Proposal provides examples such as a recommendation that the retail investor transfer from an investment advisory account to a brokerage account or from a brokerage account to an investment advisory account; asset transfers due to an IRA rollover; deposits of or the investment of monies based on infrequent events or unusual size, such as an inheritance or receipt from a property sale; or a significant migration of funds from savings to an investment account. *Id*. at 140-141.

[40] Investment advisers would file on the Investment Adviser Registration Depository (IARD), broker-dealers would file on the Commission's Electronic Data Gathering, Analysis and Retrieval System (EDGAR), and dual registrants would file on both IARD and EDGAR.

[41] *Id.* at 162. This includes names or titles which include, in whole or in part, the term "adviser" or "advisor" such as financial advisor (or adviser), wealth advisor (or adviser), trusted advisor (or adviser), and advisory (*e.g.*, "Sample Firm Advisory") when communicating with any retail investor. The proposed rule, however, does not restrict a broker-dealer's use of the terms "adviser" or "advisor" when acting on behalf of a bank or insurance company.

[42] *Id.* at 193.

[43] For example, the SEC believes a financial professional must include the registration status disclosure on the front of a business card.
