

MEMO# 32219

February 19, 2020

SEC Staff Issues Additional Questions on Reg BI and Form CRS

[32219]

February 19, 2020 TO: ICI Members
Investment Company Directors
Broker/Dealer Advisory Committee
Investment Advisers Committee
Operations Committee
Pension Committee
SEC Rules Committee
Transfer Agent Advisory Committee SUBJECTS: Compensation/Remuneration
Compliance
Disclosure
Fees and Expenses
Investment Advisers
Operations RE: SEC Staff Issues Additional Questions on Reg BI and Form CRS

The SEC staff recently issued additional “frequently asked questions” (FAQs) on Regulation Best Interest (“Reg BI”) and Form CRS, which were adopted last June as part of the SEC’s standards of conduct rulemakings.[\[1\]](#) The staff’s recent FAQs supplement the FAQs the staff issued in January 2020[\[2\]](#) and November 2019.[\[3\]](#) The staff plans to update the FAQs periodically. While the recent FAQs do not have direct relevance to registered investment companies, we have summarized them below, by topic, for your information.

Retail Customer/Investor

The SEC staff addresses several key issues related to the definitions of “retail customer” under Reg BI and “retail investor” under Form CRS. As background, Reg BI defines a retail customer as a natural person, or the legal representative of a natural person, who: (A) receives a recommendation of any securities transaction or investment strategy involving securities from a broker-dealer; and (B) uses the recommendation primarily for personal, family, or household purposes. Similarly, a “retail investor” for purposes of Form CRS is a natural person, or the legal representative of that person, who seeks to receive or receives services primarily for personal, family or household purposes. A “legal representative” of a natural person includes only non-professional legal representatives.

The SEC staff addresses what it means to “use” a recommendation for purposes of Reg BI. The staff explains that a retail customer “uses” a recommendation when, as a result of the

recommendation: (1) the customer opens a brokerage account with the broker-dealer, regardless of whether the broker-dealer receives compensation; (2) the customer has an existing account with the broker-dealer and receives a recommendation from the broker-dealer, regardless of whether the broker-dealer receives or will receive compensation, directly or indirectly, as a result of the recommendation; or (3) the broker-dealer receives or will receive compensation, directly or indirectly, as a result of the recommendation, even if the customer does not have an account at the firm. Importantly, the staff notes that when a retail customer has or opens an account with a broker-dealer, the customer has a relationship with that broker-dealer and is able to “use” the broker-dealer’s recommendation by accepting or rejecting it.

The SEC staff confirms that Reg BI applies to limited purpose broker-dealers that make recommendations of private offerings to accredited investors, if such investors meet the definition of “retail customer.”

The staff also addresses who will be considered a non-professional legal representative for purposes of the definitions of “retail investor” under Reg BI and “retail customer” under Form CRS. The staff explains that non-professional legal representatives for these purposes do not include regulated financial services industry professionals such as registered investment advisers and broker-dealers; corporate fiduciaries, such as banks, trust companies, and similar financial institutions; insurance companies; and the employees and representatives of any of these firms. The staff notes, however, that a former financial services industry professional, who is not currently regulated, would be treated as a non-professional legal representative who would be covered by the definition of “retail investor” or “retail customer.”

The SEC staff confirms that a retail customer cannot “waive” the protections afforded by Reg BI. Thus, a broker-dealer would remain subject to the requirements of Reg BI even if a retail customer, whether a natural person or that person’s non-professional legal representative, certified or otherwise represented that he or she was not relying solely on the broker-dealer’s advice.

Recommendation

The SEC staff confirms that Reg BI applies to account recommendations to retail customers, including recommendations to open self-directed brokerage accounts, even if the broker-dealer does not intend to provide subsequent recommendations subject to Reg BI in that account.

Reg BI’s Disclosure Obligation

The SEC staff addresses when broker-dealers or their associated persons can rely on the Form CRS relationship summary to satisfy their capacity disclosure obligation. The staff explains that stand-alone broker-dealers generally will be able to meet the capacity disclosure requirement by delivering the relationship summary to retail customers. For dually registered broker-dealers and their associates that are dually registered or, who are not dually registered but only offer broker-dealer services through a firm that is dually registered, the relationship summary alone will not be sufficient to disclose their capacity. The staff also provides other examples where the relationship summary alone would be insufficient to disclose the capacity in which the broker-dealer or its associated person is acting.

Reg BI's Conflict of Interest Obligation

The SEC staff addresses whether forgivable loans from broker-dealer firms to their associated persons create conflicts of interest for purposes of Reg BI. The staff explains that, under most circumstances, a forgivable loan would create a conflict that would be subject to Reg BI's Conflict Obligation. Firms that offer such loans would need to establish and maintain written policies and procedures to identify and address the conflicts they create. To the extent forgivable loans are incentives to associated persons, the broker-dealer would be required to have policies and procedures reasonably designed to mitigate any conflicts of interest associated with the incentives. The SEC staff also notes that, if a firm offers forgivable loans based on the sale of specific securities or specific types of securities within a limited period of time, the firm's policies and procedures would be required to reasonably identify and eliminate this incentive. The staff reminds firms that just because certain compensation practices are not subject to Reg BI's prohibition on certain sales contests does not mean they are "presumptively compliant" with the rule.

Reg BI's Compliance Obligation

The SEC staff addresses whether firms must build "new systems of controls and compliance" to satisfy Reg BI's Compliance Obligation. The staff explains that firms are required to establish and maintain written policies and procedures reasonably designed to achieve compliance with Reg BI, that are proportionate to the scope, size, and risk associated with the firm and the types of business in which it engages. Importantly, the staff notes that broker-dealers may satisfy Reg BI's Compliance Obligation by adjusting or building upon their current systems of supervision and compliance, rather than creating entirely new systems.

Form CRS Preparation and Delivery Requirements

The SEC staff addresses the Form CRS delivery obligation of an investment adviser that provides advisory services to an unaffiliated adviser that, in turn, provides advisory services to the unaffiliated adviser's retail investor clients. The staff confirms that the investment adviser in this situation is not required to provide a relationship summary to the unaffiliated adviser's retail investor clients, absent other facts or circumstances indicating that the investment adviser provides advisory services to those retail clients.

The SEC staff confirms that a dually registered broker-dealer would have to provide a retail investor client with a new relationship summary if the client converts an investment advisory account into a brokerage account, even if the relationship summary already provided to the investor detailed both the advisory and brokerage services offered by the firm. The staff stated it would not object, however, if a firm that amends an existing account agreement solely to add another account holder or beneficiary does not deliver a new relationship summary under those circumstances.

The SEC staff also addresses the ability of affiliated investment advisers and broker-dealers to prepare a joint relationship summary. The staff confirms that the ability to prepare a single relationship summary is not limited to affiliated broker-dealers and investment advisers, and that affiliated advisers or affiliated broker-dealers may prepare a joint Form CRS, provided it is limited to four pages. Similarly, a firm may include multiple affiliated investment advisers and broker-dealers in a single combined relationship summary, provided it is limited to four pages. The staff reminds firms that they must present brokerage and advisory information with equal prominence and "in a manner that clearly distinguishes and facilitates comparison of the two types of services." Affiliated firms also may choose to prepare separate relationship summaries. Each firm, however, can only

have one relationship summary—either a joint relationship summary with its affiliate, or a separate relationship summary (for each affiliated firm)—not both versions.

The staff would not object if a broker-dealer providing services solely as a “qualified custodian” with respect to a retail investor client of a registered investment adviser, pursuant to Rule 206(4)-2 under the Investment Advisers Act of 1940, does not provide a relationship summary to that retail client. The staff notes that custodians serving solely in that capacity typically do not establish the type of relationship with retail investors that Form CRS was intended to address.

The staff also addresses the timing of delivery of the initial relationship summary for a state-registered investment adviser transitioning to SEC registration, permitting such an adviser to deliver its relationship summary to existing retail investor clients within 30 days after the effective date of the SEC order granting its registration.

Finally, the staff confirms that firms can provide Form CRS to retail investors in a language other than English, provided they deliver a separate English version at the same time, and do not translate the term “U.S. Securities and Exchange Commission.”

Amendments to Form CRS

The SEC staff takes the position that, where a firm offers advisory accounts that are managed by a subadviser and the subadviser changes, the firm need not amend its relationship summary if there are no changes to the advisory agreement, services, investments, or conflicts of interest that would make the information in the relationship summary materially inaccurate.

Form CRS Disciplinary History Disclosure

The SEC staff confirms that the disciplinary history question in the relationship summary extends to affiliates of the firm. For investment advisers, consistent with Form ADV, this includes “advisory affiliates”—persons directly or indirectly controlling or controlled by the firm. For broker-dealers, this includes “control affiliates”—any individual or organization that directly or indirectly controls, or is under common control with, the applicant. For both investment advisers and broker-dealers, this includes parent companies.

Sarah A. Bessin
Associate General Counsel

Donald Song
Legal Intern

endnotes

[1] The FAQs, which were prepared by the staffs of the SEC’s Divisions of Investment Management and Trading and Markets, are *available at* <https://www.sec.gov/tm/faq-regulation-best-interest>; <https://www.sec.gov/investment/form-crs-faq#delivery>. For a detailed summary of the SEC’s rulemakings, *please see* the attachments to ICI Memorandum No. 31815 (June 19, 2019), *available at* https://www.ici.org/my_ici/memorandum/ci.memo31815.idc.

[2] For a summary of the January FAQs, *please see* ICI Memorandum No. 32164 (Jan. 21, 2020), *available at* https://www.ici.org/my_ici/memorandum/memo32164.

[3] For a summary of the November FAQs, *please see* ICI Memorandum No. 32068 (Nov. 27, 2019), *available at* https://www.ici.org/my_ici/memorandum/memo32068.

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.