

SEC Adopts New Rules to Enhance Protections for Retail Investors

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On June 5, 2019, the United States Securities and Exchange Commission (“Commission”) adopted [Rule 15l-1](#) (“[Regulation Best Interest](#)” or “[Reg. BI](#)”) under the Securities Exchange Act of 1934 (“Exchange Act”). The Commission also adopted [Form CRS](#) and new rules as well as amendments to its rules and forms, under both the Investment Advisers Act of 1940 (“Advisers Act”) and the Exchange Act. This alert provides general guidance on Regulation Best Interest and Form CRS.

Reg BI requires broker-dealers^[1] and their associated persons^[2] to act in “the best interest” of a retail investor when recommending a securities transaction or investment strategy. Regulation Best Interest enhances the broker-dealer standard of conduct beyond existing suitability obligations and aligns the standard of conduct with retail customers’ reasonable expectations.

Form CRS and its related rules require investment advisers and broker-dealers (“firms”) to deliver a short, plain language relationship summary to retail investors at the beginning of their relationship (“[Form CRS](#)” or “[Client Relationship Summary](#)”). The Client Relationship Summary is designed to help retail investors select or determine whether to remain with a firm or financial professional by providing better transparency and summarizing, in one place, specific information about the broker or adviser.

The Commission began implementation of Reg. BI and Form CRS on June 30, 2020. Regulatory examinations of firms are expected to continue for at least one year following the implementation date.

Background

Regulation Best Interest has two components.

- First, it establishes a general obligation that requires broker-dealers, to act in the best interest of the retail customer at the time the associated person of a broker-dealer makes a recommendation, without placing the financial or other interest of the broker-dealer ahead of the interests of the retail customer.
- Second, Reg. BI establishes record-making and recordkeeping requirements, building upon existing record-making and recordkeeping requirements, to satisfy the general obligation. This general obligation is satisfied only if a broker-dealer complies with four specified component obligations:
 - Disclosure Obligation: requires a broker-dealer to provide certain required disclosures before or at the time of the recommendation, about the recommendation and the relationship between the

broker-dealer and the retail customer;

- Care Obligation: requires a broker-dealer to exercise reasonable diligence, care, and skill in making the recommendation;
- Conflict of Interest Obligation: requires a broker-dealer to establish, maintain, and enforce written policies and procedures reasonably designed to address conflicts of interest; and
- Compliance Obligation: requires a broker-dealer to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.

In addition, Form CRS and its related rules require firms to deliver to retail investors a brief customer or client relationship summary that provides information about the firm. Firms must file their relationship summaries with the Commission.

Generally, whether Form CRS satisfies a broker-dealer's Disclosure Obligation in full, as required under Reg. BI, will depend on facts and circumstances. In most instances a broker-dealer will need to provide additional information beyond the summary information contained in the Client Relationship Summary in order to satisfy the Disclosure Obligation.

Key Definitions in Regulation Best Interest

Retail Customer

Reg. BI defines a retail customer as a "a natural person, or the legal representative of such 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." High-net worth natural persons and natural persons that are accredited investors are considered retail customers for the purpose of Reg. BI.

Legal Representative

A "legal representative" of a natural person include non-professional trustees, executors, conservators and persons holding power of attorney who represent natural persons.

Recommendation and Investment Strategy

Reg. BI is intended to improve investor protection by enhancing the quality of broker-dealer recommendations to retail customers and reducing the potential harm to retail customers that may be caused by conflicts of interest.

In this vein, Reg. BI expressly applies to account recommendations related to securities account types generally, (e.g. education accounts, retirement accounts, and/or specialty accounts), as well as recommendations to roll over or transfer assets from one type of account to another. The type of securities account recommended is an investment strategy that has the potential to affect retail customers' costs and investment returns owing to the different features, products, or services, some of which may—or may not—be in the best interest of certain retail customers. Accordingly, the Commission interprets the term "investment strategy" (which includes account recommendations) broadly. Further, account recommendations will almost always involve a "securities

transaction” (such as a securities purchase, sale, or exchange), and thus would generally be subject to Regulation Best Interest in any case.

Whether a “recommendation” has been made to a retail customer triggering Reg. BI obligations is determined in line with precedent under the anti-fraud provisions of the federal securities laws as applied to broker-dealers, and pursuant to application of the term under the rules of self-regulatory organizations. Under this existing framework, a factor to consider when determining whether a communication is a recommendation is whether the communication “reasonably could be viewed as a ‘call to action.’” The more individually tailored the communication to a specific customer or a targeted group of customers, the greater the likelihood that the communication may be viewed as a “recommendation.”

Nonetheless, whether a communication is a recommendation is a fact sensitive inquiry.

Dually registered financial professionals (i.e., an associated person of a broker-dealer and a supervised person of an investment adviser) making account recommendations are required to make recommendations in the best interest of the retail investor taking into consideration the full spectrum of account types that that dually registered professional may offer.

When does a retail customer “use” a recommendation?

A retail customer “uses” a recommendation of a securities transaction or investment strategy involving securities when, as a result of the recommendation:

- the retail customer opens a brokerage account with the broker-dealer, regardless of whether the broker-dealer receives compensation;
- the retail 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 that recommendation; or,
- the broker-dealer receives or will receive compensation, directly or indirectly as a result of that recommendation, even if that retail customer does not have an account at the firm.

An associated person of a broker-dealer is obligated to comply with Reg. BI, when making a recommendation to an existing retail customer, even if the retail customer decides to execute the recommended securities transaction in a self-directed account away from the broker-dealer that recommended the securities transaction.

Personal, Family, or Household Purposes

The phrase “primarily for personal, family, or household purposes” covers any recommendation to a natural person for his or her account, other than recommendations to a natural person seeking these services for commercial or business purposes. Reg BI would not cover, for example, an employee seeking services for an employer or an individual seeking services for a small business or on behalf of another non-natural person entity, such as a charitable trust.

New Customer or Client Relationship Summary (Form CRS)

Form CRS requires all firms that offer services to retail investors to deliver to retail investors a brief customer or client relationship summary that provides information about the firm. Firms must file their initial relationship summaries (and any amendments) with the Commission, using the Central Registration Depository (“Web CRD”) or Investment Adviser Registration Depository (“IARD”), as applicable, and post the current client relationship summary on the firm’s public website, if the firm has one.

Firms will be required to provide information about their relationship and services, fees and costs, conflicts of interest, standard of conduct, and whether or not the firm and its financial professionals have legal or disciplinary history. This disclosure will have a standardized question-and-answer format to promote comparability across firms.

Firms must generally use their own wording to address the required items, as well as prescribed language in some instances. Firms are prohibited from including disclosures in the relationship summary other than the disclosure that is required or permitted by the instructions and applicable items.

Firms must update Form CRS and file it with the Commission within 30 days whenever any information becomes materially inaccurate. Firms must communicate any changes in the updated Client Relationship Summary to retail investors who are existing clients or customers within 60 days after the updates are required to be made and without charge. Firms can make the communication by delivering the amended Client Relationship Summary or by communicating the information through another disclosure that is delivered to the retail investor.

The relationship summary requirements are in addition to, and not in lieu of, current disclosure and reporting requirements for broker-dealers and investment advisers. Delivery of the Client Relationship Summary will not necessarily satisfy the additional requirements that firms have under the federal securities laws and regulations or other laws or regulations.

Investment Advisers

Investment advisers must deliver a Client Relationship Summary to each retail investor before or at the time the firm enters into an investment advisory contract with the retail investor, even if the agreement is oral.

Broker Dealers

Broker-dealers must deliver a Client Relationship Summary to each retail investor, before or at the earliest of (i) a recommendation of an account type, a securities transaction, or an investment strategy involving securities; (ii) placing an order for the retail investor; or (iii) the opening of a brokerage account for the retail investor.

Dual Registrants

For purposes of Form CRS and its instructions, a dual registrant is defined as a firm that is dually registered as a broker-dealer under section 15 of the Exchange Act and an investment adviser under section 203 of the Advisers Act and offers services to retail investors as both a broker-dealer and an investment adviser. The Commission encourages, but does not require, dual registrants to prepare a single relationship summary discussing both its brokerage and investment advisory services. Alternatively, dual registrants may prepare two separate relationship summaries—one for brokerage services and another for investment advisory services. Dual

registrants must deliver the relationship summary to the retail investor at the earlier of the delivery requirements for the investment adviser or broker-dealer.

Regulator Examinations

Since June 30, 2020, Commission staff have been reviewing firms' compliance efforts. Review has progressed on two fronts. First, staff from the Office of Compliance Inspections and Examinations ("OCIE") have been conducting initial examinations focused on assessing whether firms have made good faith efforts to implement the requirements of both Reg. BI and Form CRS. Second, staff from the Divisions of Trading and Markets and Investment Management, as part of the staff Standards of Conduct Implementation Committee, have been reviewing filings of Form CRS. Thus far, they have reviewed relationship summaries from a cross-section of firms to assess compliance with the content and format requirements of Form CRS.

Initial examinations are expected to continue during the first year after the compliance date. These examinations will evaluate whether firms have established policies and procedures reasonably designed to achieve compliance with Regulation Best Interest. OCIE will also evaluate whether firms have made reasonable progress in implementing those policies and procedures as necessary or appropriate, including making such modifications as may be necessary or appropriate, in light of information gained from the implementation process and other facts and circumstances.

As it relates to Form CRS, OCIE may review whether the firm has filed its relationship summary, including any amendments, with the Commission and whether the relationship summary is posted on the firm's public website, if any. Further, OCIE is expected to evaluate the process for delivering the relationship summary to existing and new retail investors; and review policies and procedures to assess whether they address the required relationship summary delivery processes and dates. In particular, the staff may review records of the dates that each relationship summary was provided to retail investors to validate whether the firm has complied with its delivery obligations.

Conclusion

Reg BI codifies the fundamental principle that investment professionals should not put their interests ahead of the interests of their clients and customers. Form CRS enables investors to better understand the services they can receive and how they will be charged for those services.

Firms should seek to develop the appropriate policies and procedures to address these new requirements.

For more information on a firm's obligations under these and other regulations, or any other financial regulatory related issue, feel free to contact James G. Ryan at (516) 357-3750 or via email at jryan@cullenllp.com, Thomas S. Baylis at (516) 357-3748 or via email at tbaylis@cullenllp.com, Nicholas J. Faso at (518) 788-9416 or via email at nfaso@cullenllp.com, or Seema Rambaran at (516) 296-9104 or via email at srambaran@cullenllp.com.

Please note that this is a general overview of developments in the law and does not constitute legal advice. Nothing herein creates an attorney-client relationship between the sender and recipient.

Footnotes

[1] Section 3(a)(4)(A) of the Exchange Act defines a "broker" broadly as any person engaged in the business of effecting transactions in securities for the account of others. Unlike a broker, who acts as agent, a dealer acts as principal. Section 3(a)(5)(A) of the Exchange Act defines a "dealer" as any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise. Broker-dealers offer a wide variety of brokerage (i.e., agency) services and dealer (i.e., principal) services and products to both retail and institutional customers. Specifically, the brokerage services provided to retail customers range from execution-only services to providing personalized investment advice in the form of recommendations of securities transactions or investment strategies involving securities to customers.

[2] Associated persons are individuals who work for a registered broker-dealer. These individuals may also be called "registered representatives."

Practices

- Commercial Litigation

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