FORM CRS: PRACTICAL CONSIDERATIONS

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OVERVIEW

On June 5, 2019, the Securities and Exchange Commission (the "SEC") adopted a series of new rules and interpretations designed to enhance the protection of retail investors and to improve the quality and transparency of investors' relationships with investment advisers and broker-dealers. [1] This article summarizes the Form CRS portion of those regulatory measures and provides practical guidance for investment advisers and broker-dealers serving retail investors.

In brief, in an effort to reduce investor confusion regarding investment services, fees, conflicts of interest and standards of conduct, the SEC will require investment advisers and broker-dealers to provide relationship summaries on new Form CRS to existing and prospective retail investor clients and customers. [2] Creating the new Form will require each broker-dealer and investment adviser that offers services to "retail investors" (as defined below) to conduct a review of its business, including products and services offered, compensation, and conflicts of interest, and to create new disclosures within the constraints of a specifically-designed format. While certain of these disclosures may already be effected via other means (such as in an advisory firm's Form ADV), they must still be provided in the Form CRS. Creating a compliant Form CRS will entail significant effort, and securities firms should prioritize internally coordinated efforts to ensure that their relationship summaries are fully informed and accurate.

The definition of "retail investor" is set out below under *Definition of Retail Investor*. Firms must comply with the new requirements by June 30, 2020.

FORM CRS - KEY CONSIDERATIONS

- Form CRS requires discussion of five items: (i) an introduction of the firm; (ii) the relationships and services the firm provides; (iii) the firm's fees, costs, conflicts and standards of conduct; (iv) the firm and its financial professionals' disciplinary history; and (v) how to get additional information about the firm.
- Each item is comprised of standardized headings and questions in a prescribed order to help promote consistency across all relationship summaries and to facilitate comparisons to other firms' Forms CRS. In response to comments criticizing the SEC's proposed plan to use nearly all prescribed wording in Form CRS, the adopted Form CRS requires the use of standardized headings and conversational questions, but firms are permitted to articulate their answers using their own language. This change should alleviate concerns that some firms would be forced to inaccurately or insufficiently describe their services.
- Form CRS contains "conversation starters" and follow-up questions for retail investors to discuss with their financial professionals. The Form also contains a link to the SEC's investor education website. The

SEC acknowledged that charts or graphs in addition to text may be the most efficient method for firms to satisfy their Form CRS obligations.

- In the adopting release, the SEC clarified that dual-registrants are permitted to prepare a single Form CRS for both their advisory and broker-dealer businesses, but stated they must present the information in a manner that enables the reader to easily compare the services offered by the firm. Dual-registrants may also elect to prepare separate Forms CRS for their investment advisory and broker-dealer businesses.
- Investment advisers and broker-dealers must limit their disclosure to two pages. Dual-registrants will be limited to four pages.

WHO MUST FILE AND DELIVER FORM CRS?

All registered investment advisers and broker-dealers that offer services to retail investors (including execution-only broker-dealers) will be required to file customer relationship summaries with the SEC and deliver copies to their current and prospective clients and customers. Applicants for registration will have to file customer relationship summaries with their applications, and deliver them after registration is granted.

Broker-dealers will be required to complete Form CRS and file it with the Financial Industry Regulatory Authority, Inc. ("FINRA"). Form CRS for investment advisers will become new Part 3 of Form ADV. [3]

WHO DOES NOT HAVE TO FILE AND DELIVER FORM CRS?

Form CRS does not need to be completed by exempt reporting advisers.

Investment advisers and broker-dealers that do not offer services to retail investors are not required to prepare, deliver or file a Form CRS. Because the definition of retail investor does not include clients or prospective clients that are not natural persons, advisers and broker-dealers whose sole clients are pooled investment vehicles, including registered funds and private funds, will not be required to prepare Form CRS, even if the funds have investors that are retail investors. [4]

DEFINITION OF "RETAIL INVESTOR"

Form CRS defines a "retail investor" as "a natural person or legal representative of such natural person, who seeks to receive or receives services primarily for personal, family, or household purposes." This is similar to the definition of "retail customer" in new Regulation Best Interest, [5] but differs in one important respect: it includes both existing and ***prospective*** clients and customers. Thus, a broker-dealer or adviser expecting to provide services to retail investors will be required to deliver a Form CRS to existing retail clients and to prospective retail clients before a formal relationship is established (as noted under *Delivering and Updating Form CRS*, below). Firms should also note that all natural persons, regardless of net worth or sophistication, are included in the definition of "retail investor," and that Form CRS must be provided to a retail investor who invests for personal, family, or household purposes. Thus, the relationship summary requirement applies when retail investors seek services as to retirement accounts, including IRAs and accounts in workplace retirement plans, such as 401(k) plans, and other tax-favored retirement plans. On the other hand, firms will not have to deliver Form CRS when plan participants make certain ordinary elections that do not involve selecting a brokerage or advisory firm.

Finally, employer-sponsored retirement plans and plan representatives (*e.g.*, plan sponsors, trustees, and other fiduciaries) are generally not within the definition of "retail investor."

RELATIONSHIP SUMMARY

The relationship summary must include a standardized introductory paragraph in which a firm is required to:

- State the name of the firm and whether it is registered with the SEC as a broker-dealer, investment adviser, or both;
- Indicate that brokerage and investment advisory services and fees differ and that it is important for the retail investor to understand the differences; and
- State that free and simple tools are available to investors in order to research firms and financial professionals at the SEC's investor education website (Investor.gov/CRS). The summary may, but is not required to, reference FINRA or Securities Investor Protection Corporation ("SIPC") membership in a manner consistent with other rules or regulations.

The relationship summary must be concise and direct, use plain English, and take into consideration retail investors' level of financial experience. Firms may not use multiple negatives, legal jargon, or highly technical business terms unless clearly explained in the relationship summary. A firm must use wording that is factual and provide balanced descriptions to help retail investors evaluate its services. The summary is not meant to serve as marketing material and firms may not include exaggerated or unsubstantiated claims, vague and imprecise "boilerplate" explanations, or disproportionate emphasis on possible investments or activities that are not available to retail investors.

The instructions encourage, rather than simply permit, firms to use graphics or text features to provide the required disclosures, or to make comparisons among offerings. Such graphics or features might include charts, graphs, tables, text colors, and graphical cues. Dual-column charts may be used to compare services, account characteristics, investments, fees, and conflicts of interest. Firms may also use video or audio messages, mouse-over windows, pop-up boxes, chat functionality, fee calculators, and other electronic tools. For a relationship summary provided electronically, the instructions further encourage online tools that populate information in comparison boxes based on investor selection.

Firms may, and in some cases must, [6] provide detail and context through the use of "layered disclosure," which is disclosure that includes cross-references or links to additional information and supplements. For example, for relationship summaries delivered in paper format, firms may include URL addresses, QR codes, or other means of facilitating access to such information. Firms may also use layered disclosure through paper disclosures and hybrid paper and electronic deliveries. The instructions to Form CRS replace the term "hyperlink" with a more evergreen concept of "a means of facilitating access" which is meant to include hyperlinks, website addresses, QR codes, or other equivalent methods or technologies.

The information in the Form CRS may not omit any material fact necessary in order to make the disclosures, in light of the circumstances under which they are made, not misleading. This requirement recognizes that the disclosure is meant to be a summary on a form with a strict page limit and that links will be provided to additional information. While this standard is drawn from general anti-fraud principles of the securities laws, it is not meant to create a private right of action.

RELATIONSHIP SUMMARY CONVERSATION STARTERS

Each section of the relationship summary must include suggested follow-up questions for retail investors to ask their financial professional. Firms must use text features to make each conversation starter more noticeable and prominent in relationship to other text—such as larger or different font, text boxes, bolded, italicized, or underlined text, etc.

Broker-dealers and investment advisers that are not dual registrants must include, respectively, "Given my financial situation, should I choose a brokerage service? Why or why not?" or "Given my financial situation, should I choose an investment advisory service? Why or why not?" Dual-registrants will include "Given my financial situation, should I choose an investment advisory service? Should I choose a brokerage service? Should I choose both types of services? Why or why not?" All firms will include the questions "How will you choose investments to recommend to me?" and "What is your relevant experience, including your licenses, education, and other qualifications? What do those qualifications mean?"

Investment advisers that provide only automated advisory services or broker-dealers that provide services only online without a particular individual with whom a retail investor can discuss the conversation starters must include a section or page on their website with answers for each of these questions and must provide a means of facilitating access to that section or page in their relationship summary. Firms that provide both automated investment advisory and brokerage services, but also make a financial professional available to discuss the firm's services with retail investors, must make a financial professional available to discuss the conversation starters with the retail investor.

Firms may wish to establish guidelines and training for financial professionals with respect to how to respond to the conversation starters.

DESCRIPTION OF SERVICES

Firms are required to state that they offer brokerage services, investment advisory services, or both and to summarize the principal services, accounts, or investments they offer. Broker-dealers must state the types of principal brokerage services that they offer, such as buying and selling securities, whether or not they offer recommendations, or whether they only provide execution services. Investment advisers must state the principal types of advisory services they offer, such as financial planning or wrap fee programs.

All firms are required to address the following topics in their description of services:

- *Monitoring* - Firms must describe whether or not they monitor retail investors' investments, the frequency of monitoring, any material limitations on monitoring, and whether or not monitoring is part of their standard services.
- *Investment authority* - Investment advisers that accept discretionary authority must describe those services, the circumstances that would trigger that discretionary authority and any material limitations on that authority. [7] Broker-dealers may, but are not required to, state whether they accept limited discretionary authority. Both investment advisers that offer nondiscretionary services and broker-dealers must explain that the retail investor makes the ultimate decision regarding the purchase or sale of an investment.

- *Limited investment offerings* - Firms are required to explain whether or not they make available or offer advice only with respect to proprietary products, or a limited menu of products or types of investments and describe any such limitations. Significant limitations on the types of investments would include offering only one type of asset such as mutual funds, exchange traded funds, or variable annuities, or offering only mutual funds or other investments sponsored or managed by the firm or an affiliate or only a small number of investments. Other examples include limitations on products that involve third-party arrangements, such as revenue sharing and mutual fund service fees.
- *Account minimums and other requirements* - A firm must explain whether or not it has any requirements for retail investors to open or maintain an account or establish a relationship, such as minimum account size or investment amount. The SEC stated that it is important for retail investors to understand that many firms offer a number of services that are only available to investors with higher account balances and that fee schedules may be tiered based on account balances.

Firms must also provide specific references to more detailed information about their services that, at a minimum, include the same or equivalent information required by provisions of Form ADV and Regulation Best Interest, as applicable. This information can be provided through hyperlinks, mouse-over windows, or other electronic means. Execution-only broker-dealers are not subject to Regulation Best Interest and would not have to provide more details about their services.

DESCRIPTION OF PRINCIPAL FEES AND COSTS AND OTHER FEES

Using the heading "What fees will I pay?", a firm must summarize the principal fees and costs that retail investors will incur for brokerage or advisory services, including how frequently such fees are assessed and the conflicts of interest they create. Broker-dealers must describe their transaction-based fees (e.g., commissions) and investment advisers must describe their ongoing asset-based fees, fixed fees, wrap fee program fees, or other direct fee arrangements. The fees described by investment advisers should be consistent with the types of fee(s) disclosed in Form ADV but should be summarized in a way that provides a high-level overview.

Investment advisers that offer wrap fee programs should include disclosure about the relevant fees and conflicts of interest and explain the program. The instructions encourage investment advisers with wrap fee programs to explain that asset-based fees associated with the wrap fee program will include most transaction costs and fees to a broker-dealer or bank that has custody of assets, and therefore are higher than a typical asset-based advisory fee.

The adopting release and instructions provided several more examples of fees and the potential conflicts they present. A broker-dealer could disclose its conflicts related to transaction-based fees by stating that a retail investor would be charged more when there are more trades in his or her account and this may motivate the firm to encourage the investor to trade more often. Advisers that charge asset-based fees could disclose related conflicts of interest by stating that the more assets in an investor's advisory account, the more the investor will pay in fees, and the firm may therefore have an incentive to encourage the investor to increase the assets in the account. Firms that offer variable annuity and variable life insurance products could disclose that they have a financial incentive to offer a contract that includes optional benefit features, which may entail additional fees in addition to the base fee associated with the contract, that they may encourage contract owners to select

investment options with relatively higher fees, or that they may offer the contract owner a new contract in place of the one that he or she already owns.

In addition to the firm's principal fees and costs, firms must describe other related fees and costs that the retail investor will pay directly or indirectly. Firms must list examples of the most common fees and costs, which may include, for example, custodian fees, account maintenance fees, account inactivity fees, fees related to mutual funds and variable annuities, transactional fees and product-level fees. Product-level fees would include distribution fees, platform fees, shareholder servicing fees and sub-transfer agency fees.

Identifying the most common fees and costs will vary and depend on particular products and services that a firm offers and the associated fee arrangements. Firms should consider the amount of the fee (including whether the fee varies based on investor selected options such as optional benefits and investment options in the context of variable annuities and variable life insurance products), the likelihood that the fee will be applicable, whether the fee is ordinarily assessed on a significant number of the firm's clients, whether the fee is associated with a product or service that the firm frequently recommends or provides, whether the fee is contingent upon certain events the investor should be made aware of, the effect on returns, and the magnitude of the conflict of interest it may create. For example, a firm that commonly offers products that feature surrender fees (such as variable annuities or variable life insurance contracts) should consider disclosing that a retail investor may be required to pay fees when such investments are sold.

Firms are also required to include the following statement: "You will pay fees and costs whether you make or lose money on your investments. Fees and costs will reduce any amount of money you make on your investments over time. Please make sure you understand what fees and costs you are paying." Firms are encouraged to fully explain any technical terms they use to describe fees and to include specific cross-references to detailed information about fees and costs.

FEES AND COSTS CONVERSATION STARTER

Firms must also include the following conversation starter for the retail investor to ask his or her financial professional: "Help me understand how these fees and costs might affect my investments. If I give you $10,000 to invest, how much will go to fees and costs, and how much will be invested for me?" The SEC expects this question will prompt financial professionals to tailor the conversation to each particular investor. Firms should provide training to ensure that professionals can explain the fees and costs relevant to each particular retail investor choosing certain types of accounts and investments, even if the professional provides examples and estimated ranges rather than a precise prediction. The financial professional must be able to explain how those fees and costs will work (i.e., whether they are upfront charges, taken out of the initial investment amount, taken out over time, future charges, etc.) and how fees and costs could impact investment returns over time. Firms may include calculators, charts, graphs, tables, or other graphics or text features to enhance an investor's understanding of fees. Firms may also consider reviewing with their retail investors the impact of fees on the retail investor's account on a periodic basis.

REQUIRED STANDARD OF CONDUCT

Form CRS will require firms to use the term "best interest" to describe how broker-dealers, investment advisers, and dual registrants must act with respect to retail investors when providing recommendations as a broker-dealer

or acting as an investment adviser. In contrast to the proposed version of the Form, the SEC chose not to require use of the word "fiduciary," due to the chance that investors would not understand such terminology. However, as the adopted Form CRS allows firms to use prescriptive language in responding to the items in the form, firms may use the term "fiduciary" in describing the standard of conduct. [8]

The standard of conduct disclosure also requires broker-dealers, investment advisers, and dual registrants to state that conflicts of interest will remain despite the existence of these legal obligations, and to provide examples of these conflicts. Execution-only broker-dealers are to disclose that they "do not provide recommendations" and to provide examples of those conflicts that do exist.

EXAMPLES OF THE WAY A FIRM MAKES MONEY AND CONFLICTS OF INTEREST

Firms must summarize the ways in which they (and their affiliates) make money from brokerage or investment advisory services and the incentives created by the following activities:

- Proprietary Products: investments that are issued, sponsored, or managed by the firm or its affiliates;
- Third-Party Payments: compensation received from third parties when a firm recommends or sells certain investments;
- Revenue Sharing: investments where the manager or sponsor of investments or another third party (such as an intermediary) shares revenue with the firm; and
- Principal Trading: investments the firm buys from, or sells to, a retail investor, for or from the firm's own accounts.

Firms must describe these four enumerated conflicts of interest or, if none apply, at least one material conflict, and a specific cross-reference to more detailed information about conflicts.

A firm is not permitted to state that it has fewer conflicts than other firms.

Under the required heading, "How do your financial professionals make money?," a firm must summarize how its professionals are compensated (to include cash and noncash compensation) and the related conflicts. Firms must disclose whether compensation is based on such factors as: the amount of client assets the financial professional services; the time and complexity required to meet a client's needs; the product sold (i.e., differential compensation); product sales commissions; or revenue the firm earns from the professional's advisory services or recommendations.

Finally, firms must include the following conversation starter question in the conflict of interest section: "How might your conflicts of interest affect me, and how will you address them?"

DISCIPLINARY HISTORY

The relationship summary must include a separate section about whether a firm or its professionals have reportable disciplinary history and where investors can conduct further research on these events under the heading: "Do you or your financial professionals have legal or disciplinary history?". Firms will answer "yes" or "no," depending upon the existence of an enumerated triggering event. Regardless of whether firms report a

"Yes" or "No" answer, the relationship summary will direct the retail investor to visit Investor.gov/CRS to research the firm and its financial professionals. Firms must also include the following conversation starter: "As a financial professional, do you have any disciplinary history? For what type of conduct?"

HOW TO GET ADDITIONAL INFORMATION

At the end of the relationship summary, firms must state where the retail investor can find additional information about their brokerage or advisory services. The SEC did not adopt a proposed requirement for firms to include information about how retail investors should report complaints about their investments, accounts, or financial professionals. Instead, firms must include a conversation starter: "Who is my primary contact person? Is he or she a representative of an investment adviser or a broker-dealer? Who can I talk to if I have concerns about how this person is treating me?".

DUAL REGISTRANTS

For purposes of Form CRS, a "dual registrant" is a firm that is registered with the SEC as a broker-dealer and as an investment adviser, and that offers services to retail investors in both capacities. Thus, a firm with both registrations would not be deemed a "dual registrant" for Form CRS purposes if it did not offer both services to retail investors, as in the case of a firm that offers brokerage services, but not advisory services, to retail investors. Such a firm would only be required to prepare, file, and deliver the broker-dealer Form CRS.

Dual registrants may file a single four-page Form CRS or two separate Forms. However, the SEC indicated its preference and encourages dual registrants to prepare a single disclosure designed to facilitate a comparison between the firm's brokerage and advisory services. The SEC did recognize that depending on the nature of the services, separate disclosure may be appropriate such as where financial professionals with licenses to offer services as a representative of a broker-dealer and investment adviser may offer services through a dual registrant, affiliated firms, or unaffiliated firms, or only offer one type of service notwithstanding their dual status.

Firms that provide two separate relationship summaries must provide a way to access each, and must deliver both with equal prominence and at the same time, whether or not the retail investor qualifies for those services or accounts. The rationale behind this is that retail investors should be able to learn about and compare the range of options even if the financial professional does not believe that the investor qualifies or is interested in all services. For instance, an investor opening a brokerage account may not initially meet the standards for certain accounts such as account minimums but may qualify in the future or with the transfer of additional assets.

DELIVERING AND UPDATING FORM CRS

Initial Filing and Delivery of Form CRS

Registered investment advisers and broker-dealers, including firms with pending SEC registrations, must file their Form CRS by June 30, 2020. Investment advisers and broker-dealers will be able to file their Form CRS between May 1, 2020, and June 30, 2020. A firm must deliver the Form CRS to existing clients or customers within 30 days of its initial Form CRS being filed with the SEC.

Where to File Form CRS

Investment advisers must file Form ADV, Part 3 (Form CRS) electronically with the Investment Adviser Registration Depository (IARD). Broker-dealers must file Form CRS electronically through the Central Registration Depository (Web CRD), and dual-registrants must file Form CRS using both IARD and Web CRD.

Delivery to Investors and Website Posting

Investment advisers must deliver their Form CRS to new and prospective clients before entering into an advisory relationship. Broker-dealers will be required to deliver the Form CRS before or at the earliest of: (i) making a recommendation; (ii) placing an order; or (iii) opening a brokerage account. Dual-registrants must deliver their Form CRS at the earliest of any of these events.

Firms will be able to electronically deliver their Form CRS and subsequent updates to clients in a manner consistent with current SEC guidance. [9] To deliver the Form electronically, the firm must: (i) notify the investor that information is available electronically; (ii) ensure access to the electronic copy is not overly burdensome and is similar to the paper form; and (iii) confirm the information delivered to retail investors satisfies electronic delivery requirements under the federal securities laws. If an investor requests a paper copy, the firm must provide one free of charge.

Investment advisers and broker-dealers that maintain a website are required to post the most up-to-date version of their Form CRS on their website. With respect to a relationship summary posted on a firm's website or otherwise provided electronically, firms must provide a means of access (e.g., hyperlinking) to any information referenced in the relationship summary if the information is available online, including for example links to fee schedules, conflicts disclosures, the firm's narrative brochure required by Part 2A of the Form ADV (for investment advisers), or other regulatory disclosures.

Updating Form CRS

Firms must file a revised Form CRS within 30 days after it becomes materially inaccurate. However, firms have 60 days after the updates are required to be made to communicate the updates to existing clients.

Additionally, firms must communicate material updates to retail investors either by delivering the updated Form CRS or by communicating the amended information through an alternative method. Firms may choose this alternative method because it gives them greater flexibility and cost savings. The SEC rejected some commentators' requests to limit the delivery burden by requiring a firm to merely provide notice of, or access to, another disclosure document. If a firm chooses to deliver its amended Form CRS to retail investors, it must highlight the most recent updates. By way of example, a firm could mark the revised text in its Form CRS or include a summary of the updates as an exhibit to the unmarked amended Form CRS.

NOTES

[1] The K&L Gates Financial Professional Standards Hub includes our analyses of the SEC's other recently adopted customer protection measures and a recorded briefing describing their impact.

[2] *See Form CRS Relationship Summary; Amendments to Form ADV* ("Form CRS"), Release Nos. 34-86032 & IA-5247, SEC, https://www.sec.gov/rules/final/2019/34-86032.pdf.

[3] *See id*. For purposes of this article, we are referring to Form CRS for both broker-dealers and investment advisers.

[4] Where the client is a single-investor pooled investment vehicle that operates as a means to provide individualized investment advice directly to a natural person investor in the fund, however, it may be necessary to look through and treat the "fund of one" as a retail investor.

[5] *See Regulation Best Interest: The Broker-Dealer Standard of Conduct* ("Regulation Best Interest"), Release No. 4-86031, SEC, https://www.sec.gov/rules/final/2019/34-86031.pdf.

[6] Firms must include specific references to more detailed information as to fees and costs consistent with Form ADV and Regulation Best Interest, as applicable to investment advisers and broker-dealers respectively.

[7] For example, investment advisers may explain whether they seek the retail investor's approval before implementing or changing investment strategies or executing certain transactions.

[8] Senior staff of the SEC confirmed this to the Investment Advisers Association on June 19, 2019, as noted in a letter to members from the IAA on June 20, 2019.

[9] *See Use of Electronic Media for Delivery Purposes*, SEC Rel. No. 7233 (Oct. 6, 1995); *Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information*, SEC Rel. No. 7288 (May 9, 1996); and *Use of Electronic Media*, SEC Rel. No. 7856 (Apr. 28, 2000).

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