

The logo for K&L GATES is displayed in white, bold, sans-serif capital letters on a dark blue rectangular background. The background of the entire slide features a complex financial data visualization with a world map, various line and bar charts, and scattered numerical values in shades of blue and white.

K&L GATES

2019 SEATTLE INVESTMENT MANAGEMENT CONFERENCE

SEC Investment Adviser and Broker-Dealer Standards of Conduct

Sasha Burstein, Partner, K&L Gates LLP

Ruth E. Delaney, Partner, K&L Gates LLP

SEC ADOPTS RULES AND INTERPRETATIONS RELATED TO IA AND BD STANDARDS OF CONDUCT

- On June 5, 2019, the SEC formally adopted four measures for the protection of retail investors.
 - Regulation BI (“Best Interest”).
 - Form CRS (“Customer Relationship Summary”).
 - Interpretation of investment advisers’ fiduciary duties.
 - Interpretation of the “solely incidental” prong of the broker-dealer exclusion from definition of “investment adviser.”



SEC ADOPTS RULES AND INTERPRETATIONS RELATED TO IA AND BD STANDARDS OF CONDUCT

- Compliance Dates:
 - Regulation BI and Form CRS: June 30, 2020.
 - Interpretations reflect restatements of existing SEC views, and were effective July 12, 2019 on publication in the Federal Register.



GENERAL OBLIGATIONS OF REGULATION BI

- Broker-dealers and their natural person APs, when recommending securities and investment strategies to a retail customer, must act in the “best interest” of the customer, and not place their own interest ahead.
 - “Retail customer” = a natural person (or legal representative) who receives and uses a recommendation primarily for personal, family, or household purposes.
 - No exceptions based on wealth, experience, etc.
 - “Recommendation” = not defined but derived from current principles. “A call to action.”
 - Includes account recommendations, such as recommendations to roll over / transfer assets from one account to another, IRAs, retirement annuities, education accounts, etc.



REGULATION BI: FOUR OBLIGATIONS

- General Obligation is met by satisfying four key obligations.
 - 1. Disclosure.** Fully and fairly disclose in writing the material facts regarding relationship and recommendations, including capacity, material fees and costs, and types and scope of services (including material limits).

Example: Disclose when AP is solely Series 6 licensed, or firm only offers proprietary products.
 - 2. Care.** Exercise diligence, care and skill to understand risks, rewards and costs and establish a reasonable basis to believe, based on customer's investment profile, that a recommendation is in the customer's best interest, is not excessive, and does not place the broker-dealer's or AP's interests ahead of the customer.



REGULATION BI: FOUR OBLIGATIONS (II)

3. **Conflicts**. Written policies and procedures reasonably designed to identify and, at a minimum, disclose or eliminate conflicts of interest associated with recommendations. Specific policies and procedures must:

 - Mitigate conflicts that may motivate the broker-dealer's APs to place their interests, or the interests of the broker-dealer, ahead of the customer's;
 - Prevent material limits on offerings, such as a limited or proprietary-only product menu, from causing the firm or its associated persons to make recommendations that place their interests ahead of the customer's; and
 - Eliminate sales contests, quotas, bonuses, and non-cash compensation based on the sale of specific securities or types of securities within a limited time period.
4. **Compliance**. Written policies and procedures reasonably designed to achieve overall compliance with Regulation BI.



FORM CRS

- Investment advisers and broker-dealers will be required to provide relationship summaries on Form CRS to retail investors, and to post Form CRS on websites.
 - Firms will have to file Form CRS with the SEC through Web CRD or IARD (both if dually registered).
 - Forms must be updated within 30 days of information becoming outdated or inaccurate. Must communicate changes to investors within 60 days.
 - Forms will be in a uniform, machine-readable format in order to assist with comparisons.



FORM CRS

- Forms must include descriptions of services, standards of conduct, summaries of conflicts, and discussions of fees.
 - Must list examples of the most common fees and costs applicable to retail investors (e.g., custody, account maintenance, fees related to mutual funds and variable annuities, and other transactional / product-level fees).
 - Form CRS is required for all broker-dealers and investment advisers who provide services to retail customers, regardless of whether they provide recommendations



INVESTMENT ADVISER FIDUCIARY STANDARD INTERPRETATION

- Reaffirms an investment adviser's nonwaivable fiduciary duty to clients
 - Clarifies that with full and fair disclosure, investment advisers and their clients are free to negotiate individualized terms which may shape the scope of the fiduciary duty
 - Clarifies that the fiduciary duty is comprised of a duty of care and duty of loyalty and provides the SEC's views as to the elements of such duties
 - Provides guidance as to how the duty may be applied different in the context of retail customers and institutional customers
- Clarifies SEC's views with respect to the use of hedge clauses in investment advisory agreement
 - Heitman no-action letter withdrawn



SOLELY INCIDENTAL INTERPRETATION

- Solely Incidental Interpretation.
 - A broker-dealer whose advisory services are “solely incidental” to its broker-dealer business and that does not receive special compensation is not deemed to be an investment adviser.
 - Account discretion that is limited in time, scope, or other manner (time / price discretion, infrequent or isolated discretion, or discretion to purchase any bond with a specified credit rating and maturity) and not comprehensive and continuous would be “solely incidental.”
 - Account monitoring would not automatically fail the “solely incidental” prong, but agreements to monitor would result in a recommendation to buy, sell, or hold each time monitoring occurs and would be covered by Regulation BI. Consider account monitoring policies and procedures that are tailored to registration status of personnel.



GENERAL OBSERVATIONS

- What does “best interest” mean?
 - Reg BI does not legally define the term “best interest.”
 - Facts and circumstances test that is meant to enhance standards that already apply to broker-dealers and APs (e.g., suitability, fair dealing, best execution) with fiduciary concepts.
 - Does not mean “least expensive.” Cost is a factor.
- What about using the term “adviser” or “advisor”?
 - No specific rule, but may violate the Reg BI disclosure obligation unless the firm is a dual registrant, municipal adviser or commodity trading advisor.
- Expect revision to FINRA rules to delete suitability standard and replace with best interest standard
- State Actions Still Possible
 - Massachusetts and New Jersey considering action.



K&L GATES