

SEC Standards of Conduct Rulemaking

What It Means for RIAs

IAA Legal Staff Analysis – July 2019

After two decades of deliberations, the SEC on June 5, 2019 issued its Standards of Conduct rulemaking package, which is intended to raise the standard of conduct for broker-dealers, reaffirm the fiduciary duty under the Advisers Act, and reduce investor confusion as to the services offered by and standards applicable to their financial professional.

The four parts to the rulemaking include:

- **Advisers Act Fiduciary Duty Interpretation** for investment advisers
- **Regulation Best Interest (Reg BI)** for broker-dealers when they make recommendations to retail customers
- **Form CRS** (Part 3 of Form ADV), required for investment advisers, broker-dealers, and dually-registered firms to deliver to retail investors
- **Solely Incidental Interpretation** regarding the broker exclusion from the definition of investment adviser

Effective Dates. The Advisers Act fiduciary duty and “solely incidental” interpretations became effective on July 12, 2019, when they were published in



the *Federal Register*. Regulation Best Interest and Form CRS will be effective on September 10, 2019 and compliance will be required by June 30, 2020.

Interpretation on the Advisers Act Fiduciary Duty

The final interpretation, intended by the Commission to reaffirm, and in some places clarify, the fiduciary duty under the Advisers Act, reflects many

of our comments and reaffirms the special relationship of trust and confidence an adviser has with its clients. It underscores that, as fiduciaries, investment advisers have an overarching duty to act in their clients’ best interest, as well as the affirmative duties of care and loyalty. Notably, while the interpretation highlights principles relevant to an adviser’s fiduciary duty, it is expressly *not* intended to be the exclusive resource on it, and advisers should continue to think about the principles-based fiduciary duty broadly.

General Statements on the Fiduciary Duty. The final interpretation includes several

general statements about the fiduciary duty. It emphasizes that an adviser’s obligation to act in the best interest of its client is an overarching principle that encompasses both the duty of care and the duty of loyalty. It also stresses that the duty is broad and applies to the entire adviser-client relationship.

Scope of the Relationship and Waivers. In a change from the pro-

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posal and responding to concerns that the proposed interpretation was too retail-focused, the final interpretation includes a discussion recognizing the wide variety of services and clients that advisers have, including institutional clients, and affirms that the fiduciary duty must be viewed in the context of the agreed-upon scope of the relationship. The interpretation makes clear, however, that while an adviser's fiduciary duty may be shaped by agreement, it may not be waived. Whether limitations on liability in agreements would violate the Advisers Act will depend on the applicable facts and circumstances, including the client's sophistication.

Duty of Care. As with the proposal, the duty of care section of the final interpretation includes three separate elements: (i) the duty to provide advice that is in the best interest of the client, including a duty to provide advice that is suitable for the client; (ii) the duty to seek best execution; and (iii) the duty to provide advice and monitoring over the course of the relationship.

(i) Duty to provide advice in the best interest of the client. The final interpretation is updated to distinguish between retail and institutional clients. It includes a new discussion on assessing whether high risk and complex products are in a retail client's best interest and the need for daily monitoring of products such as inverse or leveraged exchange-traded products. It also includes more discussion about the fact that an adviser's fiduciary duty applies to advice about account types and roll-overs.

(ii) Duty to seek best execution. Like the proposed interpretation, the final interpretation emphasizes that an adviser "must seek to obtain the

"The duty of loyalty applies to all advice an investment adviser provides to its clients, including about investment strategy, engaging a sub-adviser, or account type..."

execution of transactions for each of its clients such that the client's total cost or proceeds in each transaction are the most favorable under the circumstances."

(iii) Duty to provide advice and monitoring over the course of the relationship. An adviser must provide advice and monitoring that is in the best interest of the client, taking into account the scope of the agreed relationship. The final interpretation adds that the frequency of monitoring is a material fact about which the adviser must make full and fair disclosure and obtain informed consent from the client, and that advisers may consider whether written policies and procedures regarding monitoring would be appropriate.

Duty of Loyalty. The duty of loyalty requires that an adviser not subordinate its clients' interests to its own. "In other words, an investment adviser must not place its own interest ahead of its clients' interests." The proposal had included the additional formulation of this duty that the adviser must put its clients' interests first, but, in response to comments, the final interpretation

was "revised . . . to be more consistent with how [the SEC has] previously described the duty." However, in a footnote and consistent with the IAA's view, the Commission notes that, in practice, referring to putting a client's interest first is a plain English formulation advisers use to explain their duty of loyalty in an understandable way. We believe that this change from the proposal will have no practical effect and that advisers need not change the way they view or describe their duty of loyalty.

The duty of loyalty applies to all advice an investment adviser provides to its clients, including about investment strategy, engaging a sub-adviser, or account type. It also requires that advisers make full and fair disclosure to their clients of all material facts relating to the advisory relationship, including disclosure of the capacity in which the firm is acting.

Advisers must eliminate or make full and fair disclosure of all conflicts of interest which might incline an adviser, consciously or unconsciously, to render advice which is not disinterested, and clients must be able to provide informed consent. Disclosure and informed consent themselves are not sufficient, however, as advisers still have an overarching duty to act in their client's best interests.

Advisers are not required "to make an affirmative determination that a particular client understood the disclosure and that the client's consent to the conflict was informed," but, depending on the facts and circumstances, consent may be inferred. There may, however, be situations where conflicts may be of a nature or extent that it would be difficult to provide adequate disclosure to clients or infer consent. In the Commission's view, "where an investment adviser cannot fully and fairly disclose

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The IAA has established a members-only web page with resources for understanding and navigating the new Standards of Conduct rulemaking and selected news articles about the new rules and their impact on advisers. The page also includes links to recordings of IAA webinars and member briefings focused on the new rules. You will find that page at <https://www.investmentadviser.org/resources/new-conduct-rules-resources>.

Member login is required to access the page.

We have created a Form CRS Implementation Group to assist members in developing their forms and addressing related issues. Members interested in joining the group should contact IAA Associate General Counsel Sanjay Lamba at sanjay.lamba@investmentadviser.org.

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a conflict of interest to a client such that the client can provide informed consent, the adviser should either *eliminate* the conflict or adequately *mitigate* (i.e., modify practices to reduce) the conflict such that full and fair disclosure and informed consent are possible.”

The final interpretation, like the proposal, also addresses advisers’ use of the word “may,” an issue that is at the heart of the SEC’s recent Share Class Selection Disclosure Initiative, discussed most recently in the June 2019 *IAA Newsletter*. As the IAA requested, the interpretation acknowledges that the word “may” “could be used appropriately to disclose to a client a potential conflict that does not currently exist but might reasonably present itself in the future.”

The interpretation also addresses how allocation of investments fits into the duty of loyalty, confirming that “as with other conflicts and material facts, the adviser’s allocation practices must not prevent it from providing advice that is in the best interest of its clients.”

SEC’s Request for Comment on Possible Additional Investment Adviser Regulation. In the proposed interpretation, the SEC requested comment on whether it should consider three additional areas of investment adviser regu-

lation, specifically relating to financial responsibility requirements, account statements, and licensing and continuing education. In a win for advisers, the rulemaking package does not include further action on these items.

Client Relationship Summary – Form CRS

A central element of the rulemaking package is a new relationship summary – Form CRS – that, beginning in July 2020, advisers and broker-dealers will need to provide to retail investors. The form is intended to be delivered primarily to individuals investing for personal, family, or household purposes and must briefly address certain key information about the adviser or broker.

As proposed, Form CRS would have been a standalone, lengthier (four pages) disclosure document using highly prescribed language. Final Form CRS is a shorter (two pages) document that permits more flexibility and is more closely integrated with disclosures already provided (e.g., the adviser brochure). With the assistance of members, we prepared and submitted to the SEC mock-up relationship summaries that integrated each of our recommendations. The final rule reflects many of our recommendations.

Presentation and Format

Form CRS utilizes standardized headings in a question format and is significantly more streamlined than the proposed form. It also relies more heavily on layered disclosure with increased use of hyperlinks and other cross-references to more detailed disclosure.

Disclosure Items

Form CRS requires disclosures regarding: (i) the types of client relationships and services being offered; (ii) the fees, costs, conflicts of interest, and required standard of conduct associated with those relationships and services; (iii) whether the firm and its financial professionals currently have reportable legal or disciplinary history; and (iv) how to obtain additional information about the firm.

The Commission made some substantial changes from the proposal. Most notably, it eliminated the proposed comparison section that would have required broker-dealers and investment advisers to describe how the services of investment advisers and broker-dealers, respectively, differ from the firm’s services. Many IAA members were extremely troubled by this aspect of the proposal citing the inappropriateness of requiring firms to include statements

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about business models other than their own. Consistent with our recommendation, Form CRS will instead reference an [investor.gov/CRS](https://www.investor.gov/CRS) page on the SEC's investor education website.

Other notable changes include removing the “Key Questions to Ask” section and replacing it with certain “conversation starters” integrated throughout Form CRS. New to Form CRS is a section that will require disclosures highlighting how financial professionals are compensated and the conflicts of interest those payments create. This disclosure will distinguish firm-level from financial professional-level conflicts.

Firms will be required to disclose conflicts related to issues such as proprietary products, third-party payments (shelf space and revenue sharing arrangements), and principal trading. But for firms without these conflicts, disclosure will be required about “at least one material conflict.” Firms will also be required to include cross-references to more detailed information about the firm's conflicts of interest, a specific recommendation made by the IAA.

Filing, Delivery, and Updating Requirements

For advisers, Form CRS will be required by new Part 3 of Form ADV and will be in addition to Parts 1 and 2 of Form ADV. Consistent with the adviser brochure, Form CRS must be delivered to retail investors before or at the time of entering into an investment advisory contract. Advisers may begin filing their **initial** Form CRS on May 1, 2020 and by no later than June 30, 2020. For existing clients, Form CRS will need to be de-

livered on an initial one-time basis within 30 days after the date the firm is first required to file. Firms will be required to update Form CRS within 30 days of it becoming materially inaccurate.

Existing clients must receive the form when they open new and different accounts, or when an adviser recommends a rollover of assets from retirement accounts, or provides a new advi-



sory service that does not necessitate opening a new account.

Use of the Word “Fiduciary” and other Interpretive Issues

The Form CRS instructions require advisers, brokers, and dual-registrants to include a brief statement, using prescribed language, of the applicable standard of conduct. The Commission opted to focus on the term “best interest,” and eliminated the word “fiduciary” from the prescribed statement to be provided by advisers. The IAA sought and received confirmation from senior SEC staff that, indeed, advisers are permitted to use the word “fiduciary” in Form CRS. Firms will have the flexibility to provide accurate information to investors including that they are fiduciaries.

The IAA will continue to work with our

members and SEC staff on additional interpretive and implementation challenges as they arise.

Regulation Best Interest

The primary purpose of the SEC's rulemaking was to raise the standard of conduct for broker-dealers when they recommend securities or investment strategies to retail customers. Whether the new standard will in fact protect broker-dealer customers or alleviate investor confusion will depend on how the SEC and FINRA interpret, implement, and enforce it.

Legal Standard of Conduct: The General “Best Interest” Obligation

Under Reg BI, a broker and its associated persons have a “best interest” obligation that applies when they make a recommendation of any securities transaction or investment strategy involving securities (including account recommendations and rollovers) to a retail customer. The broker must “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 ahead of the interests of the retail customer.”

Scope of Reg BI and General Obligation

Reg BI applies to recommendations to a “retail customer,” which is defined the same as in Form CRS. Unlike the advisers' fiduciary duty, Reg BI applies to brokers only at a specific moment in

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time, *i.e.*, at the time the recommendation is made. In an important change from the proposal, the standard now applies to implicit recommendations to “hold” as well, provided that the broker has explicitly agreed with a customer to monitor that customer’s account.

Elements of the “Best Interest” Obligation

A broker must satisfy the following elements to comply with the rule’s general obligation. Although the Commission asserts that these specific elements are mandatory and therefore do not function as a safe harbor, if each of these elements is met, the broker will have satisfied its best interest obligation.

(i) **Disclosure Obligation.** Brokers must provide “full and fair” disclosure – stronger than the proposed “reasonable disclosure” – before or at the time of the recommendation, of:

- Material facts about the scope and terms of the relationship including any material limitations on the recommendation, the material fees and costs related to the recommendation, and the relationship between the customer and the broker; and
- Material facts about the conflicts of interest associated with the recommendation.

(ii) **Care Obligation.** Brokers must exercise reasonable diligence, care, and skill in making the recommendation. In a change from the proposal, the Commission added that the recommendation must not place the broker’s financial interest ahead of the customer’s interest.



The IAA has created a dedicated web page to provide members with resources for understanding the new Standards of Conduct rules and interpretations and for discussing their impact with clients and potential clients. The page is available to members on the IAA website under **Resources>>New Conduct Rules Resources.**

(iii) **Conflict of Interest Obligation.** Explicitly recognizing (a) the “particular concerns” raised by conflicts associated with incentives at the associated person level, and (b) the “high-pressure situations” for associated persons raised by incentives such as sales contests and quotas, Reg BI requires brokers to adopt written policies and procedures reasonably designed to:

- Identify and at a minimum disclose, or eliminate, all conflicts of interest associated with the recommendation;
- Identify and mitigate any conflicts of interest associated with the recommendation that create an incentive for an associated person to place his or her or the broker’s interest ahead of the retail customer’s interest; and

- Eliminate sales contests, quotas, bonuses, and non-cash compensation that are based on sales of specific securities within a limited period of time. This is a change from the proposal.

(iv) **Compliance Obligation.** A requirement that was not in the proposal calls for brokers to adopt written policies and procedures reasonably designed to achieve compliance with Reg BI. This requirement could allow the SEC to bring an enforcement action against a broker-dealer for failure to have adequate policies and procedures.

Limits on Use of the Terms “Adviser” and “Advisor.” Although the SEC did not adopt a separate rule to limit a broker-dealer or its registered representatives from calling themselves an “adviser” or “advisor,” Reg BI is intended to effectively prohibit a standalone broker or a registered representative not acting under the supervision of an investment adviser from calling themselves “adviser” or “advisor.” Where a firm is a dually-registered IA/BD, and the registered representative is a supervised person of the SEC-registered adviser, the firm or representative may use those terms.

Limits on Broker’s Misleading Holding Out in Marketing. While the IAA supported the titling limitation, we urged the SEC to go further and address the larger issue of broker marketing communications. While the final release did not go as far as we requested, it emphasizes that brokers should make sure that they do not market themselves in a misleading manner.

Contributing to this Analysis were:

Interpretation of “Solely Incidental”

The fourth and final piece of the SEC’s rulemaking package is an interpretation addressing an exclusion from the definition of “investment adviser” under the Advisers Act for brokers whose advice is “solely incidental” to the conduct of their business as a broker-dealer and for which they do not receive “special compensation.” Release of this interpretation was unexpected since the Commission had not issued a proposed interpretation, although it had requested comment on various aspects of the exclusion in its Reg BI proposal.

The interpretation reads “solely incidental” extremely broadly, stating that “a broker-dealer’s provision of advice about securities is consistent with the solely incidental prong if the advice is provided in connection with and reasonably related to its primary business of effecting securities transactions.”

While the Commission confirmed that unlimited investment discretion is not solely incidental, it appears to allow brokers broad latitude for temporary or limited discretion and ongoing monitoring of customer accounts. The Commission will consider comment on this interpretation and we are considering whether to provide comments. [IAA](#)

For more information about IAA membership please contact IAA Director of Member Marketing Alain Taylor at alain.taylor@investmentadviser.org or 202-507-7200.

Gail Bernstein **IAA General Counsel**



Ms. Bernstein joined the IAA from the law firm of WilmerHale in Washington, DC, where she was a Special Counsel in the Securities Department.

Earlier, she was first an associate and then a partner at Wilmer, Cutler & Pickering (now WilmerHale). In private practice, Ms. Bernstein counseled clients on all aspects of financial and securities regulation, with a specific focus on the Dodd-Frank Act and securities and derivatives law and compliance. She earned her law degree from Harvard University School of Law.

Sanjay Lamba **IAA Associate General Counsel**



Prior to joining the IAA, Mr. Lamba served for 10 years at the SEC, beginning his service in the rulemaking office of the Division

of Investment Management before transferring to the Office of Chief Counsel (Legal Branch) in the Office of Compliance Inspections and Examinations. Earlier, Mr. Lamba was an associate in the investment management practice groups at Morrison & Foerster LLP and Dechert LLP. He earned his law degree from the Boston University School of Law.

Sarah Buescher **IAA Associate General Counsel**



At the IAA, Ms. Buescher handles ERISA and pension issues as well as core Investment Advisers Act issues. Earlier, she served as a Branch Chief in the

Investment Adviser Regulation Office in the SEC’s Division of Investment Management and worked in the Office of the General Counsel. Ms. Buescher also worked at Vanguard, first in the Legal Department and later as Manager of International Compliance in Vanguard’s Compliance Department. She earned her J.D. from the University of Notre Dame Law School.

Monique Botkin **IAA Associate General Counsel**



Before joining the IAA, Ms. Botkin was an associate attorney in the financial services groups of Dechert LLP and Alston & Bird LLP. She also

served as an attorney in the SEC’s Division of Investment Management disclosure review office. In private practice, Ms. Botkin represented investment advisers, registered investment companies, private funds, and broker-dealers in corporate, securities, and investment management matters. She earned her J.D., cum laude, from Southwestern School of Law in Los Angeles.

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You can learn more about the benefits of belonging to the IAA — and hear what our members have to say — by visiting our YouTube channel at <https://www.youtube.com/c/InvestmentAdviserOrg> or on our website at www.investmentadviser.org.

The Value of Fiduciary Advice Stands Strong

After decades of intermittent debate, the SEC has finally adopted its standards of conduct rulemaking package. The package was expected to raise the standard of conduct for broker-dealers and clear up confusion among investors about the services they could expect from brokers and investment advisers. The final rules, however, have drawn a wide range of disparate and sometimes heated reactions – from jeers to cheers – depending on one’s perspective. Our initial takes:

At first blush, the package appears to have made some modest enhancements to the standard of conduct for brokers. Only time will tell whether new Reg BI has effectively or sufficiently raised the standard, depending on how it is interpreted, implemented, and enforced.

The SEC’s rulemaking did not alter the investment adviser’s special relationship of trust and confidence with its clients. As fiduciaries, investment advisers continue to have an affirmative duty of care, loyalty, and the utmost good faith to act in the best interests of their clients. Investment advisers must not put their own interests ahead of their clients – or, in plain English, *must put their clients’ interests first*. Investment advisers must continue to make full and fair disclosure of their conflicts of interest and also ensure that their conflicts do not compromise their advice. These high standards remain at the core of an investment adviser’s relationship with its clients. They have served investors, the capital markets, the economy, and our profession well for decades and will continue to do so.

The rulemaking package presents a number of potential challenges. First, brokers will market themselves as being required to act in their customers’ best



Karen Barr,
IAA President & CEO

“The SEC’s rulemaking did not alter the investment adviser’s special relationship of trust and confidence with its clients.”

interest. The package has made this easier for brokers by using similar language in Reg BI and the Advisers Act fiduciary duty interpretation. But brokers are not fiduciaries and Reg BI is not the same as a fiduciary duty. It is a transaction-by-transaction standard, limited both in time and scope.

Second, the SEC’s approach to the “solely incidental” interpretation and “holding out” concepts did not fully address these issues. While we are pleased that some brokers will not be able to use the “adviser/advisor” titles, the SEC did not go as far as we requested with respect to brokers holding themselves out as providing ongoing advice. And the SEC has now interpreted the brokers’ exclusion from the Advisers Act in such a broad way that brokers may be

able to provide more than transaction-by-transaction advice without having to register as an investment adviser.

As a result, investors are likely to be as confused as before – if not more so. We must continue to educate the public about the key differences between brokers and advisers and the services they provide, including:

- Investment advisers are fiduciaries to their clients throughout their entire relationship, and with respect to all agreed-upon advisory services.
- Investment advisers generally provide ongoing advice over the long term, as opposed to transaction-by-transaction recommendations or product sales.
- Investment advisers’ business models and compensation structures typically align more closely with clients’ interests, while brokers and their reps’ financial structures are dependent on sales and commissions and therefore present more acute conflicts.

Investors increasingly recognize the value of fiduciary advice and have been gravitating toward investment advisers to help them meet their financial objectives, including investing for retirement, homeownership, or education. That trend is not likely to change.

We appreciate our members’ substantial feedback and engagement on these issues – both in the current rulemaking process and for the past two decades. Please reach out to us with any questions or concerns. We look forward to working closely with you on implementation and to ensure that this new rulemaking package serves investors’ best interests. [IAA](#)