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An overview of the Regulation Best Interest Rule Package

By: Christine Lazaro

On June 5, 2019, the SEC adopted the Regulation Best Interest Rule Package. The package consists of Regulation Best Interest: The Broker-Dealer Standard of Conduct;¹ Form CRS Relationship Summary and Amendments to Form ADV;² Commission Interpretation Regarding Standard of Conduct for Investment Advisers;³ and Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser.⁴ This article will summarize each of the releases.

I. Regulation Best Interest

a. General Obligation

Regulation Best Interest requires that brokerage firms and their brokers must act in the best interests of their retail customers when making recommendations of securities or investment strategies.⁵ The brokerage firm and the broker may not place their own interests ahead of the customers' interests.⁶

For purposes of this standard, the term "recommendation" has the same meaning it currently has under FINRA rules.⁷ It is a fact-based determination. The SEC recognizes that factors to consider are "whether the communication 'reasonably could be viewed as a 'call to action'' and 'reasonably would influence an investor to trade a particular security or group of securities.'"⁸

The SEC provides some guidance as to what would not be considered a recommendation, including communications such as general financial and investment information; descriptive information about an employer-sponsored retirement plan; certain asset allocation models; and interactive investment materials.⁹

Recommendations include advice about the type of securities account to open, as well as advice to roll over or transfer assets from one account to another.¹⁰ Additionally, a broker may be

¹ Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318 (July 12, 2019) (to be codified at 17 C.F.R. pt. 240).

² Form CRS Relationship Summary; Amendments to Form ADV, 84 Fed. Reg. 33,492 (July 12, 2019) (to be codified at 17 C.F.R. pts. 200, 240, 249, 275, and 279).

³ Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fe. Reg. 33,669 (July 12, 2019).

⁴ Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion From the Definition of Investment Adviser, 84 Fed. Reg. 33,681 (July 12, 2019).

⁵ 17 C.F.R. §240.15l-1(a)(1) (2019).

⁶ *Id.*

⁷ 84 Fed. Reg. 33,318, 33,337.

⁸ *Id.* at 33,335.

⁹ *Id.* at 33,337 – 33,338.

¹⁰ *Id.* at 33,338.

deemed to have made an implicit hold recommendation, triggering the obligations of the Rule, if the broker has agreed to perform periodic account monitoring.¹¹

Brokerage firms and brokers owe this obligation to “retail customers.” The SEC defines retail customer to focus on natural persons and their legal representatives, seeking advice for personal, family, or household purposes.¹²

b. Component Obligations

Regulation Best Interest is comprised of four components: (i) the Disclosure Obligation; (ii) the Care Obligation; (iii) the Conflict of Interest Obligation; and (iv) the Compliance Obligation.¹³

i. Disclosure Obligation

The Disclosure Obligation requires that a broker or brokerage firm make full and fair disclosure in writing of “material facts relating to the scope and terms of the relationship” with the customer; and “material facts relating to such conflicts of interest that are associated with the recommendation.”¹⁴ “Materiality” has the same meaning the Supreme Court articulated in *Basic v. Levinson*.^{15,16}

Material facts related to the scope of the relationship explicitly include the following types of information: (i) the capacity in which the broker is acting (as a broker-dealer or investment adviser); (ii) fees and costs associated with the transactions and the accounts more generally; and (iii) the type and scope of the services the brokerage firm will offer, including any limitations on those services.¹⁷

Regardless of whether the firm and individual is dually-registered, both still have to disclose the capacity in which they are acting. If the firm or individual is not dually-registered but uses the term “advisor” or “adviser”, they will likely be in violation of this obligation because their disclosure about capacity will not be accurate.¹⁸

With respect to fees and costs, the SEC expects that brokerage firms will build on the disclosure of fees and costs which are set forth in Form CRS (to be discussed in further detail below).¹⁹ The obligation does not require that the brokerage firm provide “individualized” costs and fees,

¹¹ *Id.* at 33,340.

¹² *Id.* at 33,343.

¹³ 17 C.F.R. §240.15l-1(a)(2) (2019).

¹⁴ 84 Fed. Reg. at 33,347.

¹⁵ *Id.*

¹⁶ *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

¹⁷ 84 Fed. Reg. at 33,349.

¹⁸ *Id.* at 33,352.

¹⁹ *Id.* at 33,354.

but rather may provide standardized or hypothetical amounts or percentage ranges.²⁰ Brokerage firms may also satisfy this part of their disclosure obligations by providing mandated disclosure documents, such as prospectuses, and trade confirmations.²¹

With respect to the type of services the brokerage firm offers, the firm must disclose whether it monitors transactions and strategies.²² As part of this disclosure, the brokerage firm must be specific as to the frequency and duration of the services offered.²³ The brokerage firm may rely on information disclosed in the Form CRS (as will be discussed below), but will likely need to expand on that information to meet this disclosure obligation.²⁴ However, the brokerage firm may rely on other documents, including account agreements, to make these disclosures.²⁵ As part of this disclosure, brokerage firms must also disclose whether they have any account minimums.²⁶

The brokerage firm must also disclose any limitations on its offerings.²⁷ Limitations include for example, if the brokerage firm only offers proprietary products.²⁸ Additionally, if the brokerage firm is dually registered but the broker is not, the broker must disclose that he cannot offer advisory services.²⁹

The conflicts of interest disclosure obligation should summarize how the brokerage firm and the brokers are compensated for their recommendations as well as the conflicts that the compensation arrangements create.³⁰ These conflicts need not be disclosed on a recommendation by recommendation basis.³¹

The disclosure obligation does require that the disclosures be made in writing, however, the SEC recognizes that it may be necessary to supplement, clarify, or update written disclosures with oral disclosures.³² However, if the brokerage firm does supplement the written disclosures, the brokerage firm must keep a record of the fact that an oral disclosure was provided.³³

²⁰ *Id.* at 33,355.

²¹ *Id.*

²² *Id.* at 33,356.

²³ *Id.*

²⁴ *Id.* at 33,357.

²⁵ *Id.*

²⁶ *Id.* at 33,358.

²⁷ *Id.* at 33,357.

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.* at 33,363.

³¹ *Id.*

³² *Id.* at 33,368.

³³ *Id.*

ii. Care Obligation

The Care Obligation in many ways mirrors the FINRA Suitability Rule. It requires that the broker, when making a recommendation, exercise “reasonable diligence, care, and skill to:”

- (A) Understand the potential risks, rewards, and costs associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers;
- (B) Have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer’s investment profile and the potential risks, rewards, and costs associated with the recommendation and does not place the financial or other interest of the broker, dealer, or such natural person ahead of the interest of the retail customer; and
- (C) Have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer’s best interest when viewed in isolation, is not excessive and is in the retail customer’s best interest when taken together in light of the retail customer’s investment profile and does not place the financial or other interest of the broker, dealer, or such natural person making the series of recommendations ahead of the interest of the retail customer.³⁴

The first prong is similar to the “reasonable basis” obligation under the FINRA Suitability Rule.³⁵ As a threshold issue, the broker must understand the security or investment strategy recommended before being capable of determining whether the recommendation is in the best interest of a particular customer.³⁶ The SEC sets forth factors the broker or brokerage firm should consider when investigating the security or investment strategy: “the security’s or investment strategy’s investment objectives, characteristics (including any special or unusual features), liquidity, volatility, and likely performance in a variety of market and economic conditions; the expected return of the security or investment strategy; as well as any financial incentives to recommend the security or investment strategy.”³⁷

The SEC has included “costs” as a factor in evaluating securities or strategies because it recognizes that cost will always be a relevant factor.³⁸ “Costs” includes both costs associated with purchasing a security, as well as future costs associated with exchanging or selling a security.³⁹ However, the SEC cautions that cost is not a dispositive factor. The Rule does not require that a broker recommend the lowest cost option.⁴⁰

³⁴ 17 C.F.R. §240.151-1(a)(2)(ii) (2019).

³⁵ See FINRA Rule 2111.05(a).

³⁶ 84 Fed. Reg. at 33,375 – 33,376.

³⁷ *Id.* at 33,376.

³⁸ *Id.* at 33,373.

³⁹ *Id.*

⁴⁰ *Id.*

The second prong incorporates the “customer specific” prong of the FINRA Suitability Rule,⁴¹ but enhances it by replacing “suitable” with a best interest standard.⁴² In sum, the broker must determine that a recommendation is in the customer’s best interest based on that customer’s investment profile. The customer’s investment profile includes “age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance,” and any other information that may be disclosed.⁴³ This is the same information that firms must currently consider as part of the investor’s profile under the FINRA Suitability Rule.⁴⁴ If a customer does not provide the information, the SEC cautions that a firm may not have sufficient information to make a best interest determination.⁴⁵

In evaluating whether a recommendation is in the customer’s best interest, the broker should consider reasonably available alternatives offered by the broker’s firm.⁴⁶ The broker need not recommend the “best” of all possible alternatives.⁴⁷ The Rule also does not require that the broker be familiar with every product available by the brokerage firm.⁴⁸ The scope of the reasonably available alternatives that are considered with respect to any particular recommendation will depend on several factors, including, the broker’s customer base; the products available to the broker to recommend; and specific limitations on the available products, including that products may only be available in certain geographical locations or to particular types of accounts.⁴⁹

For dually registered brokers, the options with respect to account type must be considered as reasonably available alternatives.⁵⁰ If the broker may only offer brokerage accounts, the broker must consider the customer’s objectives before recommending a brokerage account.⁵¹ For example, if the customer is requesting that the broker have unlimited discretion, a brokerage account would not be appropriate.⁵²

When recommending a roll over, the broker must consider a number of factors, including, “fees and expenses; level of service available; available investment options; ability to take penalty-free withdrawals; application of required minimum distributions; protection from creditors and legal judgments; holdings of employer stock; and any special features of the existing account.”⁵³ A

⁴¹ See FINRA Rule 2111.05(b).

⁴² 84 Fed. Reg. at 33,377.

⁴³ 17 C.F.R. §240.151-1(b)(3) (2019).

⁴⁴ See FINRA Rule 2111(a).

⁴⁵ 84 Fed. Reg. at 33,379.

⁴⁶ *Id.* at 33,381.

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.* at 33,382.

⁵⁰ *Id.* at 33,383.

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.*

broker may not just consider whether the roll over may offer additional options beyond the customer's current plan.

The final component is similar to the "quantitative suitability" requirement,⁵⁴ except that the "control" element has been eliminated.⁵⁵ This component is intended to prevent trading that is so excessive that a positive return is virtually impossible.⁵⁶

iii. Conflict of Interest Obligation

The Conflict of Interest Obligation requires a firm to adopt policies and procedures designed to identify and, at a minimum, disclose all conflicts associated with a recommendation.⁵⁷ The obligation further requires that a brokerage firm mitigate or eliminate certain types of conflicts.⁵⁸

With respect to the content of the policies and procedures, the SEC contemplates that brokerage firms will have flexibility to design policies and procedures that are risk-based rather than requiring a detailed review of each recommendation.⁵⁹ The SEC suggests certain components a brokerage firm should consider when adopting policies and procedures including:

[P]olicies and procedures outlining how the firm identifies conflicts, identifying such conflicts and specifying how the broker-dealer intends to address each conflict; robust compliance and monitoring systems; processes to escalate identified instances of noncompliance for remediation; procedures that designate responsibility to business line personnel for supervision of functions and persons, including determination of compensation; processes for escalating conflicts of interest; processes for periodic review and testing of the adequacy and effectiveness of policies and procedures; and training on policies and procedures.⁶⁰

Under this obligation, the brokerage firm has a duty to, at a minimum, disclose all conflicts of interest.⁶¹ Disclosure must be full and fair; if it is not possible to fully and fairly disclose a conflict, it must be mitigated such that full and fair disclosure is possible.⁶²

Brokerage firms have a duty to identify and mitigate conflicts of interest that create an incentive for the broker to place the interests of the broker or the firm ahead of the interests of the customer.⁶³ The SEC has chosen to primarily limit the duty to mitigate to broker-level conflicts,

⁵⁴ See FINRA Rule 2111.05(c).

⁵⁵ 84 Fed. Reg. at 33,384.

⁵⁶ *Id.*

⁵⁷ *Id.* at 33,385.

⁵⁸ *Id.*

⁵⁹ *Id.* at 33,386.

⁶⁰ *Id.* at note 688.

⁶¹ *Id.* at 33,388.

⁶² *Id.*

⁶³ *Id.* at 33,390.

allowing the brokerage firms to generally deal with firm-level conflicts through disclosure.⁶⁴ The requirement to identify and mitigate broker-level conflicts applies only to incentives provided to the broker, either by the firm or third parties that are within the control of or associated with the firm.⁶⁵ Accordingly, the requirement does not create an obligation with respect to private securities transactions.⁶⁶ The SEC does provide examples of conflicts that must be mitigated: (i) compensation from the brokerage firm or third parties, including fees and other charges associated with the service or recommendation provided; (ii) employment incentives, including those tied to asset accumulation, special awards, variable compensation, and compensation tied to performance reviews; and (iii) commissions, sales charges, or other fees whether paid by the customer, the brokerage firm, or a third party.⁶⁷

Mitigation measures should be based on the nature and significance of the incentive, as well as other factors related to the brokerage firm's business model, such as the size of the firm, the types of customers, and the complexity of the security product or strategy.⁶⁸

The SEC provides a list of best practices for brokerage firms developing policies and procedures for mitigation methods:

- Avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales;
- Minimizing compensation incentives for employees to favor one type of account over another; or to favor one type of product over another, proprietary or preferred provider products, or comparable products sold on a principal basis, for example, by establishing differential compensation based on neutral factors;
- Eliminating compensation incentives within comparable product lines by, for example, capping the credit that an associated person may receive across mutual funds or other comparable products across providers;
- Implementing supervisory procedures to monitor recommendations that are: near compensation thresholds; near thresholds for firm recognition; involve higher compensating products, proprietary products or transactions in a principal capacity; or, involve the roll over or transfer of assets from one type of account to another (such as recommendations to roll over or transfer assets in an ERISA account to an IRA) or from one product class to another;
- Adjusting compensation for brokers who fail to adequately manage conflicts of interest; and

⁶⁴ *Id.*

⁶⁵ *Id.* at 33,391.

⁶⁶ *Id.* at note 744.

⁶⁷ *Id.* at 33,391.

⁶⁸ *Id.*

- Limiting the types of retail customer to whom a product, transaction or strategy may be recommended.⁶⁹

If a brokerage firm materially limits its securities offerings or investment strategies, the brokerage firm must prevent such limitations from causing the firm to put its interests ahead of the customers'.⁷⁰ The SEC considers that recommending only proprietary products, products with revenue sharing arrangements, or a specific asset class would be material limitations.⁷¹ The SEC recommends that brokerage firms offering limited menus consider establishing a "product review process" which includes evaluating the use of preferred lists; restrictions on the customers to whom a product may be sold; requiring brokers selling certain products to have minimum knowledge requirements; as well as period product reviews to further evaluate conflicts.⁷²

Certain practices are completely prohibited pursuant to this obligation. Brokerage firms must eliminate "sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited time."⁷³ Non-cash compensation includes merchandise, gifts and prizes, travel expenses, meals and lodging.⁷⁴ This obligation is not intended to eliminate all incentives, only those that create high-pressure situations to sell specific securities within a limited period of time.⁷⁵ It likely will not capture contests or other incentives tied to total products sold or asset accumulation and growth.⁷⁶ Brokerage firms may also continue to hold annual conferences, so long as attendance is not premised on the sale of specific securities within a limited period of time.⁷⁷

iv. Compliance Obligation

The Compliance Obligation is an overarching requirement to adopt policies and procedures that are reasonably designed to achieve compliance with the Rule as a whole.⁷⁸ The Rule does not specify which policies and procedures must be adopted. The SEC expects brokerage firms to design policies and procedures that "prevent violations from occurring, detect violations that have occurred, and to correct promptly any violations that have occurred."⁷⁹ Brokerage firms are

⁶⁹ *Id.* at 33,392.

⁷⁰ *Id.* at 33,393.

⁷¹ *Id.*

⁷² *Id.* at 33,394.

⁷³ 17 C.F.R. §240.15l-1(a)(2)(iii)(D) (2019).

⁷⁴ 84 Fed. Reg. at 33,396.

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ *Id.* at 33,397.

⁷⁹ *Id.*

expected to tailor their policies and procedures to account for the “scope, size, and risks associated with the operations of the firm and the type of business in which the firm engages.”⁸⁰

II. Form CRS Relationship Summary

In addition to adopting a new standard of conduct for brokers and brokerage firms, the SEC also adopted a new disclosure obligation for both brokerage firms and investment advisers.⁸¹ The SEC will require that both brokerage firms and investment advisers create and deliver a relationship summary to prospective and existing customers. This section will describe the relationship summary and the firms’ delivery obligations.

a. Presentation and Format

The SEC allows firms to use a mix of prescribed wording along with firm-authored wording in drafting the relationship summary.⁸² For example, firms will be able to describe their services, investment offerings, fee, and conflicts of interest.⁸³ However, firms will be required to use prescribed headings, conversation starters, and statement describing their standard of conduct when providing investment advice.⁸⁴

The SEC requires that headings be in the form of prescribed questions, in a set order.⁸⁵ The relationship summary may not exceed four pages for a dual registrant that includes both its brokerage and advisory services in a single summary.⁸⁶ Otherwise, the relationship summary may not exceed two pages for brokerage firms and investment advisers that are describing one of their services.⁸⁷

The SEC is encouraging the use of graphics to facilitate comprehension, including using charts, graphs, tables, text colors, and graphical cues such as dual-column charts.⁸⁸ Additionally, firms may include QR codes and hyperlinks to facilitate layered disclosure.⁸⁹ However, a firm may not satisfy its disclosure obligations of the relationship summary through the use of “incorporation by reference.”⁹⁰

⁸⁰ *Id.*

⁸¹ 84 Fed. Reg. 33,492.

⁸² *Id.* at 33,502.

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ *Id.* at 33,504.

⁸⁶ *Id.* at 33,505.

⁸⁷ *Id.*

⁸⁸ *Id.* at 33,507.

⁸⁹ *Id.*

⁹⁰ *Id.* at 33,508.

b. Content

i. Introduction

Firms are required to open the relationship summary with a standardized introduction that includes (i) the name of the firm and whether it is a brokerage firm or investment adviser; (ii) a statement that brokerage and advisory services and fees differ; and (iii) a statement that research tools are available at Investor.gov/CRS.⁹¹

ii. Relationships and Services

Following the introduction, firms must summarize the relationships and services they offer under the heading, “What investment services and advice can you provide me?”⁹² Additionally, firms must include any material limitations on the services they offer to investors.⁹³ In the description of services, firms must address (i) monitoring; (ii) investment authority; (iii) limited investment offerings; and (iv) account minimums and other requirements.⁹⁴

With respect to monitoring, firms must explain whether they monitor an investor’s accounts, including the frequency of the monitoring and any limitations on the monitoring.⁹⁵ If an investment adviser accepts discretionary authority, the firm must describe how the authority will be exercised.⁹⁶ For example, if the firm requires investor input before exercising discretion in certain circumstance, the firm must explain that.⁹⁷ Both investment advisers and brokerage firms that offer non-discretionary services must explain that the investor is the ultimate decision maker.⁹⁸ If a firm has a limited menu of offerings, such as only proprietary products or a specific asset class, the firm must explain those limitations.⁹⁹ Firms must also disclose whether there are minimums to open an account or place a trade, or if there is a tiered fee schedule.¹⁰⁰

In the relationship and services section of the form, firms must also provide additional information which further explains the firms’ services.¹⁰¹ This section should provide the information about services that would be available in an investment adviser’s Form ADV, Part 2A brochure, or that a brokerage firm otherwise has to provide under Reg. BI.¹⁰² This section of

⁹¹ *Id.* at 33,513.

⁹² *Id.* at 33,515.

⁹³ *Id.* at 33,516.

⁹⁴ *Id.* at 33,517.

⁹⁵ *Id.* at 33,518.

⁹⁶ *Id.* at 33,519.

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ *Id.* at 33,520.

¹⁰⁰ *Id.* at 33,521.

¹⁰¹ *Id.*

¹⁰² *Id.*

the disclosure may be layered, providing hyperlinks or other ways of directing the investor to the source of the information.¹⁰³

The relationship and services section will also contain three conversation starters.¹⁰⁴ The first conversation starter will be tailored to the nature of the firm's business. For firms that are not dual registrants, the firm will include, "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?"¹⁰⁵ 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?"¹⁰⁶

Additionally, firms will also include the following two questions: (i) "How will you choose investments to recommend to me?;" and (ii) "What is your relevant experience, including your licenses, education and other qualifications? What do these qualifications mean?"¹⁰⁷

iii. Summary of Fees, Costs, Conflicts, and Standards of Conduct

Firms will begin the discussion of fees, costs, conflicts, and standards of conduct with the heading, "What fees will I pay?"¹⁰⁸ In this section, the firm must summarize the principal costs and fees that investors will incur, including how frequently they are assessed and what conflicts of interest the fees may create.¹⁰⁹ Additionally, firms must describe other fees and costs associated with their services or investments, whether paid directly or indirectly.¹¹⁰ The SEC provides some examples of the other fees and costs that may need to be disclosed, including: custodial fees; account maintenance fees; fees related to mutual funds and variable annuities; distribution fees; platform fees; and shareholder servicing fees.¹¹¹

Finally, firms are 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 investment over time. Please make sure you understand what fees and costs you are paying."¹¹²

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ *Id.* at 33,524.

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² *Id.* at 33,527.

Firms must also include a conversation starter about fees: “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?”¹¹³

Following the fees and costs discussion, firms must discuss the standard of conduct that applies, using prescribed language.¹¹⁴ Additionally, this section must include a summary of certain firm-level conflicts.¹¹⁵

The disclosure that firms have to make will vary based on whether it is [a broker making a recommendation], [an investment adviser], or [a dual registrant]:

[When we provide you with a recommendation,] [When we act as your investment adviser,] [When we provide you with a recommendation as your broker-dealer or act as your investment adviser,] we have to act in your best interest and not put our interest ahead of yours. At the same time, the way we make money creates some conflicts with your interests. You should understand and ask us about these conflicts because they can affect the [recommendations] [investment advice] [recommendations and investment advice] we provide you. Here are some examples to help you understand what this means.¹¹⁶

Following the prescribed wording, the firms must summarize the following ways the firm makes money which involve conflicts: (i) from proprietary products; (ii) from third-party payments; (iii) by revenue sharing; and (iv) by principal trading.¹¹⁷ If the firm does not have any of these conflicts, it must describe one material conflict of interest that will affect retail investors.¹¹⁸

In this section, firms must include the following conversation starter: “How might your conflicts of interest affect me, and how will you address them?”¹¹⁹ Finally, firms must include the heading, “How do your financial professionals make money?” and include a description of how their financial professionals are compensated, including both cash and non-cash compensation, as well as the conflicts that the payments create.¹²⁰

iv. Disciplinary History

The relationship summary will also include a section about whether the firm or its financial professionals have any disciplinary history, as well as where an investor may find additional

¹¹³ *Id.* at 33,528.

¹¹⁴ *Id.* at 33,530.

¹¹⁵ *Id.* at 33,529.

¹¹⁶ *Id.* at 33,532 – 33,533, notes 507 – 509.

¹¹⁷ *Id.* at 33,533.

¹¹⁸ *Id.*

¹¹⁹ *Id.* at 33,535.

¹²⁰ *Id.* at 33,536.

information.¹²¹ This section will begin with the following question: “Do you or your financial professionals have legal or disciplinary history?” Firms will have to answer yes if they have any of a number of disclosable events as set forth in the instructions.¹²² For example, firms will have to answer yes if a broker has any items disclosed pursuant to question 14 A through M on the Form U4.¹²³

This section must also include the following conversation starter: “As a financial professional, do you have any disciplinary history? For what type of conduct?”¹²⁴

v. Additional Information

The final section of the relationship summary will state where the investor can find additional information.¹²⁵ This section will also include the following conversation starters: “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?”¹²⁶ Finally, this section must include a phone number where investors can request up-to-date information as well as a copy of the relationship summary.¹²⁷

c. Filing, Delivery, and Updating Requirements

Firms must file the relationship summary with the SEC; and the SEC will make the forms publicly available through the website, Investor.gov.¹²⁸ Additionally, firms must make the forms available on their own websites.¹²⁹

Firms may deliver the relationship summary electronically, so long as the firm complies with the SEC’s rules regarding electronic delivery.¹³⁰ Essentially, the firm must make the investor aware that the form is available electronically; the access to the information must be comparable to that which would have been provided in paper form; and the firm must maintain evidence of delivery.¹³¹

Brokerage firms must deliver the relationship summary before or at the earliest of: (i) a recommendation as to account type, a securities transaction, or an investment strategy; (ii)

¹²¹ *Id.*

¹²² *Id.* at 33,537 – 33,538.

¹²³ *Id.* at 33,538.

¹²⁴ *Id.* at 33,539.

¹²⁵ *Id.*

¹²⁶ *Id.* at 33,540.

¹²⁷ *Id.*

¹²⁸ *Id.* at 33,545.

¹²⁹ *Id.*

¹³⁰ *Id.* at 33,546.

¹³¹ *Id.* at 33,547.

placing an order; or (iii) opening a brokerage account.¹³² Investment advisers must deliver the relationship summary before or at the time of entering into an investment advisory contract with an investor.¹³³

After the initial delivery of the form, firms must re-deliver the relationship summary whenever: (i) an account is opened that is different than the investor's existing account(s); (ii) there is a recommendation to roll over assets; or (iii) there is a recommendation for a new service or product that would not be held in an existing account.¹³⁴ This last item contemplates recommendations for investments such as direct-sold mutual funds or insurance products.¹³⁵

Finally, firms must update the relationship summary within 30 days whenever the relationship summary becomes materially inaccurate.¹³⁶ At that time, the revised relationship summary must be filed with the SEC and posted to the firm's website.¹³⁷ Firms will have 60 days to deliver the revised relationship summary to existing clients.¹³⁸ When delivering the revised relationship summary, firms must highlight any changes by either marking the revised text or including a summary of the changes.¹³⁹

III. Investment Adviser Interpretation

As part of the Regulation Best Interest Rule package, the SEC issued an interpretation of the investment adviser standard of conduct.¹⁴⁰ The SEC recognized that the investment adviser's fiduciary duty follows the contours of the relationship with the client.¹⁴¹ Further, an investment adviser can shape that relationship by agreement, so long as there is full and fair disclosure, and informed consent by the client.¹⁴² The specific duties an investment adviser owes a client will depend on the services the adviser has agreed to perform for the client.¹⁴³ However, an investment adviser cannot have a client waive the fiduciary duty.¹⁴⁴

a. Duty of Care

An investment adviser's fiduciary duty includes a duty of care. This duty includes: (i) the duty to provide advice that is in the best interest of the client; (ii) the duty to seek best execution of a client's transactions where the adviser has the duty to select the broker-dealer that will execute

¹³² *Id.* at 33,550.

¹³³ *Id.* at 33,551.

¹³⁴ *Id.* at 33,552.

¹³⁵ *Id.*

¹³⁶ *Id.* at 33,554.

¹³⁷ *Id.*

¹³⁸ *Id.*

¹³⁹ *Id.*

¹⁴⁰ 84 Fed. Reg. 33,669.

¹⁴¹ *Id.* at 33,671.

¹⁴² *Id.*

¹⁴³ *Id.*

¹⁴⁴ *Id.* at 33,672.

the client's trades; and (iii) the duty to provide advice and monitoring over the course of the relationship.¹⁴⁵

The duty to provide advice that is in the best interest of the client is a duty to provide advice that is suitable for the client.¹⁴⁶ To be able to satisfy this duty, the investment adviser must make a reasonable inquiry into the client's financial situation, financial sophistication, investment experience, and financial goals, among other things.¹⁴⁷ Further, the investment adviser must determine that the client can and is willing to tolerate the risks of any recommended investment, and that the potential benefits of the investment recommendation justify the risks.¹⁴⁸

Next, the investment adviser must conduct a reasonable investigation into the investment being recommended.¹⁴⁹ As part of the investigation, the investment adviser must consider a number of factors relating to the investment, including the cost associated with the investment advice; as well as the investment product's or strategy's investment objectives, characteristics, liquidity, risks and potential benefits, volatility, likely performance in a variety of market and economic conditions, time horizon, and cost of exit.¹⁵⁰ This duty applies to advice about investment strategy, engaging a sub-adviser, and account type.¹⁵¹ Accordingly, advice to open a particular type of account (brokerage or investment advisory) as well as advice about rolling over assets would trigger this duty.¹⁵²

In seeking best execution, an investment adviser must try to execute trades such that the costs or proceeds from each transaction are the most favorable for the client.¹⁵³

The duty to monitor means the investment adviser must monitor a client's account at a frequency that is in the best interest of the client.¹⁵⁴ However, if the investment adviser has been engaged for a limited duration, the investment adviser is unlikely to have a duty to monitor.¹⁵⁵

b. Duty of Loyalty

In simple terms, an investment adviser has a duty of loyalty, which prohibits the investment adviser from subordinating its clients' interests to its own.¹⁵⁶ As part of this duty, the investment

¹⁴⁵ *Id.* at 33,672.

¹⁴⁶ *Id.*

¹⁴⁷ *Id.* at 33,673.

¹⁴⁸ *Id.*

¹⁴⁹ *Id.* at 33,674.

¹⁵⁰ *Id.*

¹⁵¹ *Id.*

¹⁵² *Id.*

¹⁵³ *Id.*

¹⁵⁴ *Id.* at 33,675.

¹⁵⁵ *Id.*

¹⁵⁶ *Id.*

adviser must make full and fair disclosure of any material facts relating to the advisory relationship.¹⁵⁷

Additionally, the investment adviser must eliminate or at least expose through full and fair disclosure all conflict of interest which might incline an adviser to render advice that is not disinterested.¹⁵⁸ For disclosure to be full and fair, the disclosure must be specific enough so that the client can understand the material fact or the conflict of interest and be able to make an informed decision as to whether to provide consent.¹⁵⁹

As part of its disclosure, an investment adviser may not state that the adviser “may” have a conflict if the conflict actually exists; however, “may” could be appropriate if the conflict does not currently exist but might reasonably present itself in the future.¹⁶⁰ In other words, disclosure will not be full and fair if the adviser states that a conflict “may” exist if the conflict already does exist.

Investment advisers do not have to determine whether the client actually understood the disclosure made.¹⁶¹ The investment adviser merely has to put the client into the position to be able to understand the disclosure.¹⁶² However, if the investment adviser actually knows, or reasonably should know, that the client does not understand the disclosure, the adviser cannot accept the client’s consent.¹⁶³

If the conflict is of a nature and to an extent that it would be difficult to be able to fully explain the conflict in a way that it could be understood by a client, the investment adviser must eliminate or mitigate the conflict.¹⁶⁴

IV. Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser

In the last item of the Regulation Best Interest Rule package, the SEC provided an interpretation of the “solely incidental” prong of the broker-dealer exclusion from the definition of “investment adviser.”¹⁶⁵ In this interpretation, the SEC clarified that if a broker exercises unlimited discretion, such conduct would not be “solely incidental” to the business of the broker-dealer, and accordingly, the brokerage firm would meet the definition of “investment adviser.”¹⁶⁶

¹⁵⁷ *Id.*

¹⁵⁸ *Id.* at 33,676.

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*

¹⁶¹ *Id.* at 33,677.

¹⁶² *Id.*

¹⁶³ *Id.*

¹⁶⁴ *Id.*

¹⁶⁵ 84 Fed. Reg. 33,681.

¹⁶⁶ *Id.* at 33,686.

However, discretion that is limited in scope would not necessarily turn a brokerage firm into an investment adviser.¹⁶⁷

With respect to monitoring a customer's account, if the monitoring is at specific intervals for the purpose of determining whether to provide a buy, sell, or hold recommendation, such conduct would be considered "solely incidental" to the broker-dealer's primary business of effecting securities transactions.¹⁶⁸ It would not turn the brokerage relationship into an advisory relationship.

¹⁶⁷ *Id.*

¹⁶⁸ *Id.* at 33,687.