



Morgan Lewis

**SEC SETS
STANDARDS**

FOR RETAIL ADVICE

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Overview

- Background
- Rules and Interpretations
 - Regulation Best Interest
 - Interpretation of Standard of Conduct for Investment Advisers
 - Interpretation of “Solely Incidental” Prong of Broker-Dealer Exclusion
 - Form CRS Relationship Summary
- Impact and Next Steps

Background

- DOL Rule Fifth Circuit Decision (Mar. 15, 2018)
 - Federal court of appeals vacates DOL Rule, finding it to be “unreasonable” (case brought by US Chamber of Commerce, SIFMA, and other BD/insurance groups); DOL exceeded its statutory authority (2-1 decision)
 - “Rather than infringing on SEC turf, DOL ought to have deferred to Congress’s very specific Dodd-Frank delegations and conferred with and supported SEC practices to assist IRA and all other individual investors.”
 - June 21, 2018 – 5th Circuit issues mandate vacating the fiduciary rule in toto
- SEC issues proposed standards for retail advice (Apr. 18, 2018)
- State proposals to subject broker-dealers to fiduciary standard (e.g., Nevada, New Jersey)
- SEC adopts final rules and interpretations on standards for retail advice (June 5, 2019)
- Still to come:
 - Possible litigation over preemption of state laws
 - DOL expected to issue prohibited transaction exemption aligned with Regulation Best Interest

Overview of Rule Package

Regulation Best Interest

- Best interest obligation for broker-dealers
- Satisfied through
 - Disclosure obligation
 - Care obligation
 - Conflict of interest obligation
 - Compliance obligation
- Compliance Date: June 30, 2020

Form CRS

- Standardized disclosures about firm's services, fees, costs, and conflicts of interest
- Filed with SEC
- Delivered to retail investors
- Compliance Date: June 30, 2020

Investment Adviser Interpretation

- Overarching "obligation to act in the best interest of its clients"
- Duty of Care
 - Provide advice in the best interest of the client
 - Seek best execution
 - Provide advice over the course of the relationship
- Duty of Loyalty
- Effective upon publication in the *Federal Register*

"Solely Incidental" Interpretation

- Advice "is provided in connection with and is reasonably related to the broker-dealer's primary business of effecting securities transactions"
 - Exercise of investment discretion, other than on a temporary or limited basis
 - Certain account monitoring
- Effective upon publication in the *Federal Register*

Regulation Best Interest

- Best Interest Obligation
 - “A broker, dealer, or a natural person who is an associated person of a broker or dealer, when making a recommendation of any securities transaction or investment strategy involving securities (*including account recommendations*) to a retail customer, shall 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, or natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer” (emphasis added).
- “Best interest” is not defined
- Designed to enhance standard for broker-dealers, but does not make it identical to that of investment advisers
- Obligation is triggered at the time of a recommendation, and there is no ongoing obligation unless otherwise agreed with the retail customer
 - Implicit hold recommendations where a broker-dealer agrees to monitor a retail customer’s account
- Components:
 - Disclosure Obligation
 - Care Obligation
 - Conflict of Interest Obligation
 - Compliance Obligation

Regulation Best Interest

- Disclosure Obligation

- Prior to or at the time of the recommendation, the broker-dealer provides, in writing, full and fair disclosure of:
 - All material facts relating to the scope and terms of the relationship with the retail customer, including
 - Capacity
 - Material fees and costs that apply to transactions, holdings and accounts
 - Type and scope of services provided, including any material limitations on the securities or investment strategies that may be recommended
 - All material facts relating to conflicts of interest associated with a recommendation.

- Care Obligation

- In making the recommendation, the broker-dealer exercises reasonable diligence, care, and skill in satisfying three obligations:
 - Reasonable-basis obligation
 - Customer-specific obligation
 - Quantitative obligation

Regulation Best Interest

- Conflict of Interest Obligation
 - Broker-dealer establishes, maintains, and enforces written policies and procedures reasonably designed to
 - Identify and at a minimum disclose (in accordance with the Disclosure Obligation) or eliminate all conflicts of interest associated with the recommendation
 - Identify and mitigate conflicts of interest that create an incentive for a broker-dealer's financial professionals to place either their interests or the broker-dealer's interest ahead of the retail customer's interest
 - Identify and disclose any material limitations on offerings (e.g., proprietary or other limited range of products) and any conflicts associated with the limitations, and prevent the limitations and associated conflicts from causing the broker-dealer or its financial professionals to place their interests ahead of the retail customer's interests
 - Eliminate sales contests, sales quotas, bonuses, and non-cash compensation based on the sale of specific securities or specific types of securities within a limited period of time
- Compliance Obligation
 - Broker-dealer required to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Reg. BI

Regulation Best Interest

- Examination considerations
- Enforcement considerations
- Litigation risks

Investment Adviser Standard of Conduct

- Fiduciary duty not specifically defined in the Advisers Act
- Duty of Care
 - Provide investment advice that is in the best interests of the client, including a duty to provide advice that is suitable for the client, based on a reasonable understanding of the client's objectives (i.e., a retail client's investment profile, an institutional client's investment mandate)
 - Seek best execution of a client's transactions where the adviser has the responsibility to select broker-dealers to execute client trades
 - Provide advice and monitoring at a frequency that is in the best interest of the client, taking into account the scope of the agreed relationship

Investment Adviser Standard of Conduct

- Duty of Loyalty
 - Requires 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 client's interests
 - Full and fair disclosure of all material facts relating to the advisory relationship, including capacity and conflicts of interest
 - Eliminate or at least expose through full and fair disclosure all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested
 - Disclosure and informed consent do not themselves satisfy the adviser's duty to act in the client's best interest
 - Disclosure should be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent
 - Disclosure that an adviser "may" have a particular conflict, without more, is not adequate when the conflict actually exists

“Solely Incidental” Interpretation

- Broker-dealer’s advice would be viewed as “solely incidental” where it is “provided in connection with and is reasonably related to the broker-dealer’s primary business of effecting securities transactions”
- Exercise of investment discretion (as defined in Exchange Act §3(a)(35)), other than on a temporary or limited basis, would not be viewed as solely incidental, including discretion:
 - “as to the price at which or the time to execute an order given by a customer for the purchase or sale of a definite amount or quantity of a specified security”
 - “on an isolated or infrequent basis, to purchase or sell a security or type of security when a customer is unavailable for a limited period of time”
 - “as to cash management, such as to exchange a position in a money market fund for another money market fund or cash equivalent”
 - “to purchase or sell securities to satisfy margin requirements, or other customer obligations that the customer has specified”
 - “to sell specific bonds or other securities and purchase similar bonds or other securities in order to permit a customer to realize a tax loss on the original position”
 - “to purchase a bond with a specified credit rating and maturity”
 - “to purchase or sell a security or type of security limited by specific parameters established by the customer”
- Account Monitoring
 - Limited, agreed-upon monitoring and voluntary monitoring (i.e., without an agreement) might be solely incidental
 - Agreement to provide continuous monitoring might be subject to Advisers Act

Form CRS

- Required form with five items and “conversation starters”
 - Introduction
 - Name
 - Capacity
 - Highlight investor.gov/CRS
 - Relationships and Services
 - Description of services (including monitoring, investment authority, limited investment offerings, account minimums and other requirements)
 - References to additional information about services
 - Fees, Costs, Conflicts, and Standard of Conduct
 - Principal fees and costs
 - Other fees and costs
 - Standard of conduct
 - Examples of ways you make money and conflicts of interest (including proprietary products, third-party payments, revenue sharing, principal trading)
 - Description of how financial professionals make money
 - Disciplinary History
 - Additional Information

Form CRS

- Filed through CRD and/or IARD
- Initial delivery
 - Investment adviser: before or at the time of entering into an advisory contract
 - Broker-dealer: before or at the earliest of: (i) a recommendation of an account type, a securities transaction, or an investment strategy involving securities, (ii) placing an order for the retail investor, or (iii) the opening of a brokerage account for the retail investor
 - Dual registrant: at earlier of investment adviser or broker-dealer delivery requirement
- Additional delivery requirements
 - Open a new account that is different from the retail investor's existing account(s)
 - Recommend that the retail investor roll over assets from a retirement account into a new or existing account or investment
 - Recommend or provide a new brokerage or investment advisory service or investment that does not necessarily involve the opening of a new account and would not be held in an existing account (e.g., securities sold through a "check and application" process)

More to Come

- You can find more analysis, materials, and information about events in our [Regulation of Retail Investment Advice resource center](https://www.morganlewis.com/topics/regulation-of-retail-investment-advice) at <https://www.morganlewis.com/topics/regulation-of-retail-investment-advice>.

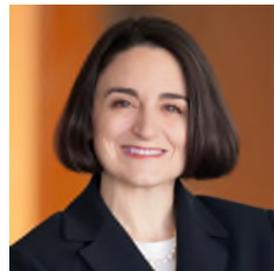
Thank you



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