

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 WASHINGTON, DC INVESTMENT MANAGEMENT CONFERENCE

Financial Professional Standards for Broker Dealers and Investment Advisers

C. Dirk Peterson, Partner, Washington, DC
Andrew Shipe, Counsel, Washington, DC



Financial Professional Standards for Broker Dealers and Investment Advisers



BACKGROUND

- On June 5, 2019, the SEC formally adopted four measures for the protection of retail investors:
 1. Form CRS
 2. Regulation Best Interest (“Regulation BI”)
 3. Interpretation of investment advisers’ (“IAs”) fiduciary duties
 4. Interpretation of the “solely incidental” prong of the broker-dealer exclusion from definition of “investment adviser” under the Investment Advisers Act of 1940



BACKGROUND

CONTINUED

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





Regulation BI



REGULATION BI

General obligations

- Broker-dealers and their natural person associated persons (e.g., registered representatives), 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 (note that this includes family office/family trust, etc.)
 - No exceptions based on wealth, experience, etc.
 - “Recommendation” = account recommendations, such as recommendations to roll over / transfer assets from one account to another, IRAs, retirement annuities, education accounts, etc.



REGULATION BI

CONTINUED

General Obligation is met by satisfying four key obligations:

1. Disclosure
2. Care
3. Conflicts
4. Compliance





Type of Broker-Dealers – *Does Regulation BI Apply?*



TYPES OF BROKER-DEALERS – *DOES REGULATION BI APPLY?*

- Whether Regulation BI applies depends on:
 - Whether the Broker-Dealer makes a recommendation; and
 - Whether the Recommendation is made to a Retail Customer?
- Let's talk about the roles that different types of broker-dealers play



TYPES OF BROKER-DEALERS

Does Regulation BI Apply?

1. Retail Brokerage Business

- Regulation BI applies to registered sales professionals who solicit orders, recommend securities/investment strategies with respect to retail customers.

2. Execution-Only Business

- Regulation BI doesn't apply to firms that:
 - Engage solely in an discount brokerage/execution-only business
 - Execute customer's request contrary to a previous recommendation
 - Form CRS obligations may apply



TYPES OF BROKER-DEALERS *CONTINUED*

3. Alternative Trading Systems (ATS)

- If institutional customers only, then Regulation BI will not apply.
- If retail investors are permitted, whether Regulation BI applies will depend on how the ATS interacts with them.

4. Clearing Firm

- Regulation BI may apply to self-clearing firms if they make recommendations to retail customers.
- Regulation BI will not apply to clearing firms that perform purely back-office functions on a fully disclosed/omnibus basis.



TYPES OF BROKER-DEALERS *CONTINUED*

5. Institutional Business

- Regulation BI does not apply to firms that engage in an institutional-only business.
- Important to confirm that entities typically considered “institutions” do not constitute “retail customers” under Regulation BI.

6. Wholesale Business

- Regulation BI does not apply firms that conduct wholesale business unless the firms make recommendations of securities/investment strategies to retail customers.

7. Fund Principal Underwriter

- Regulation BI does not apply to broker-dealers who passively act as a fund’s principal underwriters or distributors.



TYPES OF BROKER-DEALERS *CONTINUED*

8. Placement Agent Business

- Whether Regulation BI applies to a placement agent depends on the types of investors eligible to invest in an unregistered offering; and
- The conduct of the BD in communicating with potential investors.

9. Dual Registrant

- Employees need to be aware of the capacity they are acting in.
- Regulation BI applies to dual registrants that make recommendations to retail customers through brokerage accounts.
- Regulation BI doesn't apply to dual registrants acting in advisory capacity.



TYPES OF BROKER-DEALERS *CONTINUED*

10. Wrap Business

- Wrap account is presumably an investment strategy.
- Regulation BI may apply to broker-dealers who recommend a “wrap account” to retail customers.

11. Financial Planning Business

- Regulation BI applies to firms that provide financial planning services to retail investors.

12. Funding Portal

- Regulation BI does not apply to funding portals because they are not permitted to make recommendations.



TYPES OF BROKER-DEALERS *CONTINUED*

13. Research Provider

- The SEC has taken the position that the delivery of research is a “solicitation.”
- Institutional research to non-natural persons would not trigger Regulation BI.
- Research to natural persons for the purpose of executing securities transaction could be deemed a “recommendation.”





Regulation BI Litigation



REGULATION BI LITIGATION

State of New York, State of California, State of Connecticut, State of Delaware, District of Columbia, State of Maine, State of New Mexico, State of Oregon v. United States Securities and Exchange Commission and Walter “Jay” Clayton III, in his official capacity as Chairman of the United States Securities and Exchange Commission, 1:19-cv-08365, Sept. 9, 2019

- Eight Attorneys General of states and the District of Columbia (“DC”) sued the SEC to block the implementation of Regulation BI.
- The States and DC claimed that Regulation BI does not comply with Section 913(g) of the Dodd-Frank Act.
- The States and DC asserted that the retirement savings of their constituents would decrease because of purportedly conflicted investment advice, which would, in turn, lower tax revenues.



REGULATION BI LITIGATION *CONTINUED*

XY Planning Network, LLC and Ford Financial Solutions, LLC v. United States Securities and Exchange Commission and Walter “Jay” Clayton III, in his official capacity as Chairman of the United States Securities and Exchange Commission, 1:19-cv-08415, Sept. 10, 2019

- An investment adviser and an association of investment advisers also filed suit against the SEC claiming that Regulation BI gives brokers a competitive advantage over investment advisers and exceeds the agency’s rulemaking authority.
- Plaintiffs in the state case and the investment adviser case sought appellate review supported by the SEC. The SDNY consolidated both cases and dismissed them pending review by the Second Circuit.



Form CRS



FORM CRS

- IAs and BDs 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

CONTINUED

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)
- Required for all BDs and IAs who provide services to retail investors, regardless of whether they provide recommendations





Interpretation of Investment Adviser's Fiduciary Duty



SEC FINAL INTERPRETATION

- On June 5, 2019, the SEC adopted a final interpretation (the “Interpretation”) of the standard of conduct applicable to IAs
- Does not purport to modify existing IA standard of conduct



INVESTMENT ADVISER'S FIDUCIARY DUTY

- Principles-based
- Enforceable under the anti-fraud provisions of the Investment Advisers Act of 1940
- IA's fiduciary duty includes:
 - Duty of care
 - Duty of loyalty



NO WAIVER OF FIDUCIARY DUTY

- The Interpretation reaffirms the SEC's belief that an IA's fiduciary duty may not be **waived**
 - But may be **shaped and altered** by the underlying advisory agreement
- The Interpretation withdraws the *Heitman* no-action letter
- The Interpretation also discusses “hedge clauses”
 - Retail v. institutional clients

FIDUCIARY DUTY – DUTY OF CARE

- The Interpretation states that duty of care includes:
 1. The duty to provide advice that is in the client's best interest;
 2. The duty to seek best execution; and
 3. The duty to provide advice and monitoring over the course of the relationship



PRACTICAL CONSIDERATIONS

- Thinking about the fiduciary duty based on the type of client
 - Duty of care
 - Retail
 - Institutional
 - Duty of loyalty
 - Retail
 - Institutional
- Thinking about the fiduciary duty for dual registrants (both an IA and a BD)



PRACTICAL CONSIDERATIONS *CONTINUED*

- Other general considerations for IAs
 - Reviewing and updating existing policies and procedures
 - Adopting new policies and procedures
 - Reviewing and updating Form ADV disclosures
 - Reviewing and updating template investment advisory agreements





Interpretation of the “Solely Incidental” Prong of the Broker-Dealer Exclusion



SOLELY INCIDENTAL INTERPRETATION

- A BD whose advisory services are “solely incidental” to its BD business and that does not receive special compensation is not deemed to be an IA
 - 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”



SOLELY INCIDENTAL INTERPRETATION *CONTINUED*

- 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





Questions?



K&L GATES