

The Proposed Interpretation on the Standard of Conduct for Investment Advisers and Regulation Best Interest

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Agenda

- Current Standards for Broker-Dealers and Investment Advisers*
- Proposed Standard for Broker-Dealers
- SEC's Interpretation of Current Standard for Investment Advisers
- Form CRS
- Requests for Comment on Areas of Enhanced Investment Adviser Regulation

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Defined Terms

- RIA – investment advisers registered with the U.S. SEC
- IARs – investment adviser representatives
- BD – broker-dealers

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Current BD and RIA Standards

- Retail customer confusion between RIAs and BDs
- BD
 - Duty of fair dealing (FINRA Rule 2010)
 - Suitability (FINRA Rule 2111)
 - Fair and reasonable compensation (FINRA Rules 2121, 2122 and 2341)
- RIAs
 - Fiduciary Duty
 - Duty of Care
 - Duty of Loyalty

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What is Regulation Best Interest

- Regulation Best Interest - a BD would have “a duty to 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 a natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the **retail customer**.”
- What constitutes the **best interest**?
 - Undefined
 - Specific point in time
 - facts and circumstances test

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What Isn't Regulation Best Interest

- Does not prohibit:
 - Charging commissions
 - Receiving differential compensation based on the product sold
 - Receiving third-party compensation
 - Recommending proprietary products
 - Recommending self-underwritten products
- Does not:
 - Require continuous monitoring of account
 - Require BD to recommend the “least expensive” security or strategy provided the BD complies with the Best Interest Obligations
 - Alter a BD’s obligations under the general antifraud provisions of the federal securities laws
 - Create any new private right of action or right of rescission (“nor do we intend such a result”)

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Three Obligations to Satisfy Best Interest

The Disclosure Obligation

- Requires BDs, prior to or at the time of the recommendation, to reasonably disclose to the retail customer, in writing, material facts about the scope and terms of its relationship with the BD and all material conflicts of interest associated with the recommendation.

The Care Obligation

- The BD would be required to exercise “reasonable diligence, care, skill, and prudence” to:
 1. understand potential risks and rewards of the recommendation and have a reasonable basis to believe that the recommendation could be in the “best interest” of at least some retail customers;
 2. have a reasonable basis to believe that the recommendation is in the “best interest” of the particular retail customer based on the retail customer’s investment profile and the risks/rewards associated with the recommendation; and
 3. 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.

The Conflict of Interest Obligations

- Requires BDs to establish, maintain and enforce written policies and procedures reasonably designed to identify and at a minimum disclose, or eliminate, all material conflicts of interest:
 - associated with the recommendation; and
 - arising from financial incentives associated with such recommendations.

Form CRS

Form CRS - Background

Proposed to require BDs and RIAs to provide a brief relationship summary to **retail investors** to inform them about the relationships and services the firm offers, the standard of conduct and the fees and costs associated with those services, specified conflicts of interest, and whether the firm and its financial professionals currently have reportable legal or disciplinary events.

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FORM CRS – Filing and Delivery Obligations

- Delivery
 - Initial
 - BDs and RIAs would be required to deliver Form CRS to **retail investors** before or at the time the **retail investor** first engages the firm's services or enters into an advisory agreement
 - Upon Request
 - Within 30 days, if requested by the client
 - Material Changes
- Filing
 - RIAs to file on the IARD
 - BDs to file on EDGAR
 - Dual Registrants to file on both systems

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Regulation Best Interest vs. Form CRS “Retail Customer” vs. “Retail Investor”

Regulation Best Interest

- Applies to “retail customers”
 - a person, or the legal representative of such person, who:
 - receives a recommendation of any securities transaction or investment strategy involving securities from a BD or natural person who is an associated person of a BD, and
 - uses the recommendation primarily for personal, family, or household purposes.

Form CRS

- Applies to “retail investors”
- as a prospective or existing client or customer who is a natural person (i.e., an individual), including a trust or similar entity that represents natural persons, regardless of the individual’s net worth (i.e., their status as accredited investors, qualified clients, or qualified purchasers).

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FORM CRS – Presentation and Format

- The proposed Form CRS items include:
 - Introduction
 - Relationships and Services
 - Obligations to the Retail Investor – Standard of Conduct
 - Summary of Fees and Costs
 - Comparisons
 - Conflicts of Interest
 - Additional information
 - Key Questions

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FORM CRS – Presentation and Format

- 3 Illustrative and Hypothetical Form CRS Provided by SEC
 - BD
 - RIA (Excerpts provided in following slides)
 - Dual Registrant
- They do not provide a safe harbor and are provided for illustrative purposes only

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Relationships and Services

- If you open an advisory account, you will pay an on-going asset-based fee at the end of each quarter for our services, based on the value of the cash and investments in your advisory account.
- We will offer you advice on a regular basis. We will discuss your investment goals, design with you a strategy to achieve your investment goals, and regularly monitor your account. We will contact you (by phone or e-mail) at least quarterly to discuss your portfolio.
- You can choose an account that allows us to buy and sell investments in your account without asking you in advance (a “discretionary account”) or we may give you advice and you decide what investments to buy and sell (a “non-discretionary account”).
- Our investment advice will cover a limited selection of investments. Other firms could provide advice on a wider range of choices, some of which might have lower costs.

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Fees and Costs

- The amount paid to our firm and your financial professional generally does not vary based on the type of investments we select on your behalf. The asset-based fee reduces the value of your account and will be deducted from your account.
- Some investments (such as mutual funds and variable annuities) impose additional fees that will reduce the value of your investment over time. Also, with certain investments such as variable annuities, you may have to pay fees such as “surrender charges” to sell the investment.
- Our fees vary and are negotiable. The amount you pay will depend, for example, on the services you receive and the amount of assets in your account.
- You will pay a transaction fee when we buy and sell an investment for you. You will also pay fees to a broker-dealer or bank that will hold your assets (called “custody”).
- The more assets you have in the advisory account, including cash, the more you will pay us. We therefore have an incentive to increase the assets in your account in order to increase our fees. You pay our fee quarterly even if you do not buy or sell.

Compare with Typical Brokerage Accounts – You can receive advice in either type of account, but you may prefer paying:

- A transaction-based fee from a cost perspective, if you do not trade often or if you plan to buy and hold investments for longer periods of time.
- An asset-based fee if you want continuing advice or want someone to make investment decisions for you, even though it may cost more than a transaction-based fee.

Key Questions to Ask

1. Given my financial situation, why should I choose an advisory account?
2. Do the math for me. How much would I pay per year for an advisory account? What would make those fees more or less? What services will I receive for those fees?
3. What additional costs should I expect in connection with my account?
4. Tell me how you and your firm make money in connection with my account. Do you or your firm receive any payments from anyone besides me in connection with my investments?
5. What are the most common conflicts of interest in your advisory accounts? Explain how you will address those conflicts when providing services to my account.
6. How will you choose investments to recommend for my account?
7. How often will you monitor my account's performance and offer investment advice?
8. Do you or your firm have a disciplinary history? For what type of conduct?
9. What is your relevant experience, including your licenses, education, and other qualifications? Please explain what the abbreviations in your licenses are and what they mean.
10. Who is the primary contact person for my account? What can you tell me about his or her legal obligations to me? If I have concerns about how this person is treating me, who can I talk to?

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FORM CRS – Other Important Details

- Limited to 4 pages, 11 point font
- Prohibited from including extraneous information not required by the Instructions
- Plain English
- Would not replace existing BD and RIA disclosures. RIAs still required to prepare and deliver Form ADV.
- Form CRS is proposed to be Form ADV Part 3

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Restrictions on the Use of Certain Names and Titles

- Investor Confusion
 - BD vs. RIA
- Restriction on using the term “adviser” or “advisor”
- Required disclosures by firms disclosing their regulatory status in retail investor communications

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Proposed Commission Interpretation of Standard of Conduct for RIAs

Proposed Standard of Conduct for RIAs*

- Not specifically defined under the Investment Advisers Act of 1940
 - *SEC v. Capital Gains Research Bureau*
 - Section 206 - Anti-fraud provision
- Based on common law*
- Comprised of duty of care and duty of loyalty

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Proposed Standard of Conduct for RIAs*

- **Duty of Care**
 - Duty to Provide Advice that is in the Client's Best Interest
 - Investment Profile
 - Advice that is the best interest of the client based on the Investment Profile
 - Prohibition against recommending more expensive mutual fund share class*
 - Applies to all advice – including engaging a sub-adviser or recommendation to rollover a retirement account
 - Duty to Seek Best Execution
 - Duty to Act and to Provide Advice and Monitoring over the Course of the Relationship

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Proposed Standard of Conduct for RIAs*

- **Duty of Loyalty**
 - Requires an investment adviser to put its client's interests first.
 - Full and fair disclosure
 - Avoid conflicts or obtain informed consent
- **Disclosure is not always enough**
 - Use of the term "may" when disclosing conflicts
 - Instances where disclosure may not be sufficient?
 - Facts and circumstances indicate that the client did not understand the nature or import of the conflict?
 - Material facts concerning the conflict could not be fully and fairly disclosed?

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Request For Comment on Areas of Enhanced RIA Regulation

Federal Licensing and Continuing Education

- The federal securities laws do not require IARs to become licensed or to meet qualification requirements.
- Most states impose registration, licensing, or qualification requirements on IARs who have a *place of business* in the state, regardless of whether the investment adviser is registered with the SEC or the state.
- The Section 913 Study recommended that the SEC consider requiring IARs to be subject to federal continuing education and licensing requirements.

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The SEC requested comment on the following areas regarding federal licensing and continuing education requirements for personnel of RIAs:

- Should IARs be subject to federal continuing education and licensing requirements?
- Which advisory personnel should be included in these requirements?
- How should the continuing education requirement be structured? How frequent should the certification be? How many hours of education should be required? Who should determine what qualifies as an authorized continuing education class?
- Should these individuals be required to register with the Commission?
- Should such registration requirements apply to individuals who provide advice on behalf of RIAs but fall outside the definition of "IAR" in rule 203A-3 (because, for example, they have five or fewer clients who are natural persons, they provide impersonal investment advice, or ten percent or less of their clients are individuals other than qualified clients)?

Provision of Account Statements

- To what extent do retail clients of RIAs already receive account statements?
- To what extent do those account statements specify the dollar amounts charged for advisory fees and other fees (e.g., brokerage fees) and expenses?
- Would retail clients benefit from a requirement that they receive account statements from RIAs?
- If clients are uncertain about what fees and expenses they will pay, would they benefit from a requirement that, before receiving advice from a RIA, they enter into a written (including electronic) agreement specifying the fees and expenses to be paid?
- Should any requirement to provide account statements have prescriptive requirements as to presentation, content, and delivery?

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Financial Responsibility

- BD Regime - Extensive rules regarding financial solvency - Net Capital Rule; segregation of customer assets; audited balance sheets; members of Securities Investor Protection Corporation; fidelity bond coverage
- RIAs – Minimal rules regarding financial solvency.
 - Custody Rule – Generally requires RIAs to maintain client assets with a “qualified custodian”; undergo surprise examination by an independent public accountant
- Should investment advisers be subject to net capital or other financial responsibility requirements in order to ensure they can meet their obligations, including compensation for clients if the adviser becomes insolvent or advisory personnel misappropriate clients’ assets?
- Should investment advisers be subject to an annual audit requirement? To provide this information on Form ADV?
- Should advisers be required to obtain a fidelity bond from an insurance company?

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Thank You

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