

Investment Management

October 17, 2019

FINRA Provides Guidance on Regulation Best Interest and Form CRS

Holidays arrive early as FINRA makes a list

By **Ethan L. Silver**, **Lauren A. Schwartz**, and **Alexander D. Zozos**

What You Need To Know:

- **Who is Affected:** Registered broker-dealers, investment advisers and dual registrants
- **What Customers are in Scope:** Retail investors
- **Compliance Date:** June 30, 2020

The holidays arrived early for broker-dealers, investment advisers, and dual registrants as the Financial Industry Regulatory Authority, Inc. ("FINRA")¹ published a Regulation Best Interest ("Reg. BI") and Form Client Relationship Summary ("Form CRS") Firm Checklist (the "Checklist"). FINRA provided guidance, including best practices, for broker-dealers and investment advisers, including those that are dual registrants, to comply with Reg. BI and Form CRS. This Alert summarizes the primary themes identified within the Checklist. It is in the best interests of broker-dealers ("BDs"), investment advisers ("IAs"),² and dual registrants to check this list twice as they prepare for the June 30, 2020, compliance date (the "Compliance Date").

I. Overview of Reg. BI:

On June 5, 2019, the SEC adopted Reg. BI, which alters the standard of conduct a BD, including dual registrants acting in the capacity of a BD, and its associated persons must maintain when making recommendations to retail investors.

Currently BDs must abide by a suitability standard codified in FINRA Rule 2111. This standard requires BDs to have a reasonable basis, after conducting reasonable diligence, that their recommendation is suitable for their customers. Reg. BI builds upon this standard, requiring BDs to act in the "best interest" of their customers when making a recommendation. To effectuate this goal, Reg. BI creates four interrelated obligations, as defined by Reg. BI: (1) Disclosure; (2) Care; (3) Conflict of Interest; and (4) Compliance. The Conflict of Interest and Compliance Obligations apply solely to the BD, whereas Disclosure and Care Obligations apply jointly to the BD and its associated persons.

Reg. BI applies to BDs interacting with retail investors whenever they are recommending any account type, security, or investment strategy. This differs from the current standard by explicitly including account type recommendations (e.g., IRAs, brokerage, advisory). A BD must take into account factors such as cost, alternatives, and the

¹ FINRA is a self-regulatory organization that regulates all U.S. registered broker-dealer firms, including those dually registered as investment advisers. Entities that are solely investment advisers are not regulated by FINRA, but are regulated by the U.S. Securities and Exchange Commission ("SEC") or the appropriate state regulator.

² Reg. BI only applies to BDs; those entities that are solely IAs retain a fiduciary duty and are not subject to Reg. BI. IAs with retail investors are required to file Form CRS, as described in Section II below.

customer investment profile in making this recommendation. While what constitutes a recommendation remains consistent with current FINRA guidance, new express elements of consideration have been added, including care, skill, and cost. A BD must now always consider cost, both at the time of the recommendation and at potential liquidation.

In the recently released Checklist, FINRA clarified expectations related to the implementation of Reg. BI, as described below. However, FINRA has been silent regarding how Reg. BI will interplay with its existing rules, including FINRA Rule 2111.

A. Policies and Procedures and Training

A BD's policies and procedures will need to be reviewed to ensure that the Reg. BI requirements are incorporated throughout its operations—from account opening, where a more robust set of information is required for the investment profile, to ongoing disclosure and monitoring requirements.

A BD is obligated to consider reasonably available alternatives when making a recommendation. This does not mean a BD must evaluate every possible alternative or even recommend what the best product is. Rather, a BD should have a reasonable process to gather and analyze reasonable alternatives.

BDs must maintain a record of all material provided to retail customers as part of their recommendations. Firms should update their training to highlight how to address the new Disclosure, Care, and Conflict of Interest Obligations.

B. Disclosure and Conflicts of Interest

Reg. BI requires BDs to provide disclosures regarding capacity (e.g., acting as a BD or dual registrant), material limitations (e.g., products offered), fees, monitoring, and maintenance requirements associated with a customer's account. Disclosures must be presented at the time of, or before, a recommendation is "used," which happens in three instances: (1) if a customer opens an account with the BD as a result of the recommendation; (2) if a customer has an account at the BD and receives compensation for the account, regardless whether the BD will receive compensation based on the recommendation; or (3) if a BD will receive compensation directly or indirectly from the recommendation, regardless of whether the

customer has an account at the BD. Reg. BI's Disclosure Obligation is independent from, and builds upon, a BD's Form CRS requirement. Please see Section II below for additional information regarding Form CRS.

Conflicts of Interest ("COI") are broadly defined in Reg. BI as those material facts that may consciously or unconsciously incline a BD to make a recommendation that is not disinterested. Reg. BI's COI Obligations require a review of policies and procedures as well as disclosures. Depending on the COI, BDs are required to identify and: (1) address, (2) mitigate, or (3) disclose the COI. For example:

- Identify and address: A BD must identify and eliminate sales contests based on specific securities within a limited period of time. Practices that provide compensation on asset growth or customer satisfaction are still permitted; however, the structure and incentives should be mitigated to limit COI.
- Identify and mitigate: A BD should consider a variety of factors, such as business model and customer base when reviewing its COI and how to best mitigate their impact on providing brokerage and securities recommendations.
- Identify and disclose: A BD should review its material limitations and disclose these to customers. Material limitations include only offering products to a select group of customers (such as IPOs) or certain third-party arrangements (e.g., mutual funds and other asset class specific offerings).

C. Account Monitoring

Reg. BI does not impose a duty to monitor customer accounts. However, if a BD agrees to monitor an account, then it must disclose the scope and frequency of such services. Further, if a BD is monitoring an account and remains silent with regard to the account, this silence will be interpreted as an implicit recommendation to hold the current securities, similar to an explicit buy or sell recommendation.

A BD is permitted to voluntarily review a customer's account for the purpose of determining whether to make a recommendation. This voluntary review does not create an implied agreement to monitor or implied recommendations.

Reg. BI requires that a BD guard against excessive trading regardless of the degree

of monitoring or control it has over the account, expanding the quantitative suitability requirement under FINRA Rule 2111.05(c).

II. What Is Form Client Relationship Summary (“CRS”)?

The SEC also recently adopted Form CRS that will require IAs, BDs, and dual registrants to provide retail investors with a brief summary regarding their relationship. Unlike Reg. BI, which only applies to BDs and dual registrants, Form CRS applies to IAs, BDs, and dual registrants with retail customers, irrespective of whether they provide recommendations. The relationship summary is intended to inform retail investors about the types of client and customer relationships and services the IA and/or BD offers, as well as the fees, costs, conflicts of interest, and applicable standards of conduct associated with those relationships and services.

A. Form CRS Content

The Form CRS is meant to be read, as it must be written in plain English, with a strict two-page limit for IAs or BDs and a four-page limit for dual registrants. Use of electronic and graphical formatting is encouraged, and if an IA and/or BD has a website, it must prominently feature the Form CRS.

The Form CRS is required to include the following information:

- Introduction to the IA and/or BD (such as name and capacity of registration; it should be noted most BDs with the term “advisor” or “adviser” in their name and that are not dual registrants, will most likely need to change their name);
- Description of services and advice that can be provided (even if not offered to the specific customer);
- Description of fees and costs, required standard of conduct, and examples of how the firm makes money and conflicts of interest they create;
- Relevant disciplinary history of the IA and/or BD and its financial professionals;
- Where retail investors can obtain additional information about IA and/or BD services as well as a link to the SEC’s investor education website; and
- Conversation starters for investors to ask, if applicable.

B. Delivery of Form CRS

Form CRS must be filed through Web CRD for BDs and IARD for IAs. Dual registrants must file through both systems. IAs and/or BDs must provide the Form CRS to new or prospective customers prior to a recommendation being provided, order placed, or account opening. If a prospective client is physically presented with informational materials, then the Form CRS must be placed first, and if information is delivered electronically, then it must be prominently presented, either through a direct link or in the body of the message.

Existing retail customers must be provided Form CRS consistent with SEC’s electronic delivery guidance before or at the time (1) an IA and/or BD opens a *new* account that is different from the retail investor’s existing account; (2) an IA and/or BD recommends that a retail investor roll over assets from a retirement account; or (3) an IA and/or BD recommends a new service or investment outside of a formal account.

IAs and BDs are required to update their Form CRS within 30 days of any information becoming materially inaccurate. Following a Form CRS update, the IA and/or BD has 60 days to communicate the changes to all existing customers. Form CRS filing and delivery requirements include an exhibit that highlights changes to an updated relationship summary.

C. Policies and Procedures

A firm’s compliance procedures should be updated to account for the processes it has or will be putting in place to file, update, and deliver the Form CRS to regulators as well as its prospective, new, and existing retail customers.

BDs are also required to make and keep current a record of the date that the Form CRS was provided to prospective, new, and existing retail investors. This information, along with each relationship summary, must be maintained and preserved in an easily accessible place, for at least six years after it is created, in accordance with recordkeeping requirements of Securities and Exchange Act Rule 17a-4.

III. Takeaways

Reg. BI and Form CRS will require BDs, IAs, and dual registrants with retail customers to conduct a comprehensive review of their existing policies and procedures, training, disclosures, and conflicts of interest in order to adequately prepare and ensure adherence to the Rules prior to the Compliance Date. All BDs, IAs, and dual registrants that have retail customers will be required to draft and file the Form CRS with the SEC and FINRA on Web CRD and IARD, as applicable, and to provide a copy of the Form to prospective, new, and existing retail customers.

For additional information regarding Reg. BI, Form CRS, and the Checklist, you can reference the following resources:

- [FINRA Reg. BI Website](#)
- [SEC Reg. BI: A Small Entity Compliance Guide](#)
- [SEC Form CRS: A Small Entity Compliance Guide](#)
- [SEC Form CRS: Instructions](#)

Please contact one of the listed authors of this Alert or your regular Lowenstein Sandler contact if you have any questions with respect to Reg. BI or Form CRS or would like assistance reviewing and updating your compliance policies and procedures, training, and/or disclosures as well as drafting a Form CRS in response to this Checklist.

Contacts

Please contact the listed attorneys for further information on the matters discussed herein.

ETHAN L. SILVER

Partner

T: 212.419.5862

esilver@lowenstein.com

LAUREN A. SCHWARTZ

Associate

T: 646.414.6933

lschwartz@lowenstein.com

ALEXANDER D. ZOZOS

Associate

T: 646.414.6868

azozos@lowenstein.com

NEW YORK

PALO ALTO

NEW JERSEY

UTAH

WASHINGTON, D.C.

This Alert has been prepared by Lowenstein Sandler LLP to provide information on recent legal developments of interest to our readers. It is not intended to provide legal advice for a specific situation or to create an attorney-client relationship. Lowenstein Sandler assumes no responsibility to update the Alert based upon events subsequent to the date of its publication, such as new legislation, regulations and judicial decisions. You should consult with counsel to determine applicable legal requirements in a specific fact situation. Attorney Advertising.