

CLIENT ALERT

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SEC PROVIDES GUIDANCE TO BROKER-DEALERS AND INVESTMENT ADVISERS REGARDING EXAMINATIONS FOR COMPLIANCE WITH REGULATION BEST INTEREST AND FORM CRS

by Frank Borger Gilligan

On April 7, 2020, the Securities and Exchange Commission's Office of Compliance Inspections and Examinations ("OCIE") issued two risk alerts providing guidance to broker-dealers and investment advisers regarding forthcoming examinations, focusing on compliance with Regulation Best Interest ("Reg BI") and Form CRS. The SEC adopted Reg BI and Form CRS on June 5, 2019 as part of a larger package of rules and interpretations designed to increase the standard of care broker-dealers owe to their clients and enhance the transparency of fees, products, and other pertinent information. The compliance date for both Reg BI and Form CRS is June 30, 2020.

REGULATION BEST INTEREST

Reg BI imposes an enhanced standard of conduct for broker-dealers and associated persons of broker-dealers when making recommendations to retail investors regarding transactions of securities and investment strategies. Under this new standard, a broker-dealer must act in the best interest of the retail customer at the time the recommendation is made, without placing its own interests ahead of the retail customer's interest. This general obligation contains four primary components: (1) a Disclosure Obligation, (2) a Care Obligation, (3) a Conflict of Interest Obligation, and (4) a Compliance Obligation. Additional information on Reg BI can be found [here](#).

OCIE will begin conducting initial examinations of broker-dealers after June 30, 2020 to evaluate whether firms have established policies and procedures reasonably designed to be in compliance with Reg BI and to assess the operational effectiveness of the new regulation. In its Risk Alert, OCIE provides guidance to firms regarding the expected focus of the initial examinations for Reg BI compliance. Below is a summary of the information and documentation that OCIE is likely to request that relates to the general obligations of care under the best interest standard.

DISCLOSURE OBLIGATIONS

The Disclosure Obligation requires a broker-dealer, prior to or at the time of the recommendation, to provide a retail customer full and fair disclosure of certain material facts relating to the scope and terms of the firm's relationships with their clients. To assess compliance with this obligation, OCIE will look to determine whether the firm's disclosures provide the information required under the regulation. Examples of documents likely to be requested and reviewed by OCIE include:

- Schedules of fees and charges including custodian fees, account maintenance fees, fees related to mutual funds and variable annuities, and other transactional fees and product-level fees;
- Disclosures of such fees and costs;
- Methods of compensation;

- Disclosures related to monitoring of retail customers' accounts;
- Disclosures on material limitations on accounts or services recommended to retail customers; and
- Lists of proprietary products sold to retail customers.

CARE OBLIGATIONS

The Care Obligation requires a broker-dealer to exercise reasonable diligence, care, and skill when making a recommendation to a retail customer. In order to assess compliance with this obligation, OCIE will likely assess the following:

- Information collected from retail customers to develop their investment profiles;
- The firm's process for having a reasonable basis to believe that recommendations it makes are in the best interest of the firm's retail customer;
- How recommendations are made in regards to significant investment decisions; and
- How the broker-dealer makes recommendations related to more complex, risky or expensive products.

CONFLICTS OF INTEREST OBLIGATIONS

The Conflict of Interest Obligation requires a broker-dealer to establish, maintain, and enforce written policies and procedures reasonably designed to address conflicts of interest associated with its recommendations to retail customers. OCIE is likely to examine policies and procedures to assess whether and how the broker-dealers addresses certain conflicts of interests, including:

- The elimination of 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;
- How the firm identifies and assesses conflicts of interest;
- How the firm discloses conflicts of interest; and
- What steps the firm has taken to mitigate or eliminate conflicts of interest.

COMPLIANCE OBLIGATIONS

The Compliance Obligation requires a broker-dealer to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Reg BI. Firms must also file their initial relationship summaries with the SEC, and post the current relationship summary on its website.

The SEC's Risk Alert can be found here: [Risk Alert: Regulation Best Interest](#).

FORM CRS

In addition to the requirements of Reg BI, broker-dealers and investment advisers will be required to provide a brief “relationship summary” disclosure (Form CRS) to retail investors. Information required in Form CRS includes a summary of information about a firm’s services, fees and costs, conflicts of interest, legal standard of conduct, and the disciplinary history of the firm and its financial professionals. More detailed information on the requirements of Form CRS can be found [here](#).

OCIE will likely examine the firm’s controls, remediation of noncompliance, training, and periodic review and testing of its policies and procedures. This will include a review of: (1) whether the firm has filed its relationship summary and whether it is posted on its website; (2) the process for delivering the relationship summary to existing and new retail investors; and (3) the policies and procedures to assess whether they address the required relationship summary delivery processes and dates.

OCIE will also likely review a firm’s relationship summary to assess whether it includes all required information and contains true and accurate information and does not omit any material facts necessary in order to make the required disclosures, in light of the circumstances under which they were made, not misleading.

A more comprehensive list of the information likely to be requested by OCIE can be found here: [Risk Alert: Form CRS](#).

SEC’S STATEMENT ON COVID-19

In the alerts, the SEC issued a brief statement on the effect of the COVID-19 pandemic on the industry and regulators alike, and acknowledges that COVID-19 has created challenges for many firms. The SEC notes that it continues to monitor the effects of COVID-19 on market participants, including investment advisers and broker-dealers; however, it has not extended the compliance date for Reg BI or Form CRS.

For more information on this release, the requirements of Regulation Best Interest and Form CRS, or other securities law matters, please contact Dickinson Wright, PLLC.

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