SEC Enforcement Actions Highlight Regulatory Focus on Form CRS and Regulation Best Interest

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Introduction

The importance of investment advisers and broker-dealers to comply with obligations under Regulation Best Interest and Form CRS was highlighted by the recent filing of 27 enforcement actions by the Securities and Exchange Commission (SEC).

On July 26, the SEC announced that 21 investment advisers and six broker-dealers agreed to settle charges that they failed to timely file and deliver their client or customer relationship summaries — Form CRS — to their retail investors. In each settlement, the SEC noted that the investment adviser or broker-dealer failed to comply with the requirements by the SEC's regulatory deadlines, and began complying only after the SEC's exam team or the Financial Industry Regulatory Authority (FINRA) instructed the firm regarding the failure to file its Form CRS.

With the SEC's Division of Enforcement's signaling through enforcement actions a focus on this space, and as further emphasized by the SEC's Division of Examinations' and FINRA's 2021 Enforcement Priorities,[1] it is well advised that investment advisers and broker-dealers understand and fulfill their required obligations under Regulation Best Interest and Form CRS.

Requirements of Regulation Best Interest Background

Regulation Best Interest establishes a standard of conduct under the Securities Exchange Act of 1934 (Exchange Act) for broker-dealers and associated persons of a broker-dealer (collectively, "broker-dealers" or "firms").[2] When making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer, a broker-dealer must act in the best interest of the retail customer at the time the recommendation is made, without placing its own financial or other interest ahead of the retail customer's interest.[3] This general obligation is satisfied only if a broker-dealer complies with four component obligations: a Disclosure Obligation, a Care Obligation, a Conflict of Interest Obligation, and a Compliance Obligation.[4] Under Regulation Best Interest, a "retail customer" is "a natural person, or the legal representative of such natural person, who: (A) receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer, or a natural person who is an associated person of a broker or dealer; and (B) uses the recommendation primarily for personal, family, or household purposes."[5]

[1] SEC Division of Examinations, 2021 Examination Priorities, https://www.sec.gov/files/2021-exam-priorities.pdf; 2021 Report on FINRA's Examination and Risk Monitoring Program, https://www.finra.org/rules-guidance/guidance/reports/2021-finras-examination-and-risk-monitoring-program.

[2] Exchange Act Release No. 86031 at p. 19 (June 5, 2019).

[3] Exchange Act Rule 15l-1(a)(1).

[4] Exchange Act Rule 15l-1(a)(2).

[5] Exchange Act Rule 15l-1(b)(1).

1. **Disclosure Obligation.** The Disclosure Obligation requires a broker-dealer, prior to or at the time of the recommendation, to provide a retail customer — in writing — full and fair disclosure of all material facts relating to the scope and terms of the relationship with the retail customer; as well as conflicts of interest that are associated with the recommendation.[6]

2. **Care Obligation.** The Care Obligation requires a broker-dealer to exercise reasonable diligence, care and skill when making a recommendation to a retail customer. The broker-dealer must understand potential risks, rewards and costs associated with the recommendation. The broker-dealer must then consider these factors in light of the retail customer's investment profile and make a recommendation that is in the retail customer's best interest.[7]

3. **Conflict of Interest Obligation.** 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.[8]

4. **Compliance Obligation.** The Compliance Obligation requires a broker-dealer to establish, maintain and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest as a whole.[9]

Requirements of Form CRS Background

Form CRS and its related rules require both investment adviser and broker-dealer firms to deliver to retail investors a brief customer or client relationship summary that provides information about the firm. Under Form CRS, a "retail investor" is defined as "a natural person, or the legal representative of such natural person, who seeks to receive or receives services primarily for personal, family or household purposes."[10]

Note that on December 23, 2020, the SEC issued a No Action letter exempting certain Institutional Family Offices from the definition of retail investor. https://www.sec.gov/divisions/marketreg/mr-noaction/2020/sifma-122320-regbi.pdf. *See also* https://katten.com/the-sec-clarifies-status-of-institutional-family-offices-for-purposes-of-regulation-best-interest.

[6] Exchange Act Rule 15l-1(a)(2)(i) ("The broker, dealer, or natural person who is an associated person of a broker or dealer, prior to or at the time of the recommendation, provides the retail customer, in writing, full and fair disclosure of: (A) All material facts relating to the scope and terms of the relationship with the retail customer, including: (1) That the broker, dealer, or such natural person is acting as a broker, dealer, or an associated person of a broker or dealer with respect to the recommendation; (2) The material fees and costs that apply to the retail customer's transactions, holdings, and accounts; and (3) The type and scope of services provided to the retail customer, including any material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer; and (B) All material facts relating to conflicts of interest that are associated with the recommendation.").

[7] Exchange Act Rule 15l-1(a)(2)(ii) ("The broker, dealer, or natural person who is an associated person of a broker or dealer, in making the recommendation, exercises reasonable diligence, care, and skill to: (A) Understand the potential risks, rewards, and costs associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers; (B) Have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks, rewards, and costs associated with the recommendation and does not place the financial or other interest of the broker, dealer, or such natural person ahead of the interest of the retail customer; and (C) 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 and does not place the financial or other interest of the broker, dealer, or such natural person making the series of recommendations ahead of the interest of the retail customer.").

[8] Exchange Act Rule 15l-1(a)(2)(iii) ("The broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to: (A) Identify and at a minimum disclose, in accordance with paragraph (a)(2)(i) of this section, or eliminate, all conflicts of interest associated with such recommendations; (B) Identify and mitigate any conflicts of interest associated with such recommendations that create an incentive for a natural person who is an associated person of a broker or dealer to place the interest of the broker, dealer, or such natural person ahead of the interest of the retail customer; (C)(1) Identify and disclose any material limitations placed on the securities or investment strategies involving securities that may be recommended to a retail customer and any conflicts of interest associated with such limitations, in accordance with subparagraph (a)(2)(i), and (2) Prevent such limitations and associated conflicts of interest from causing the broker, dealer, or a natural person who is an associated person of the broker or dealer to make recommendations that place the interest of the broker, dealer, or such natural person ahead of the interest of the retail customer; and (D) Identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time.").

[9] Exchange Act Rule 15l-1(a)(2)(iv) ("In addition to the policies and procedures required by paragraph (a)(2)(iii) of this section, the broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.").

[10] Exchange Act Rule 17a14(e)(2); Advisers Act Rule 204-5(d)(2).

The goal under Form CRS and its related rules is similar to the Disclosure Obligation under Regulation Best Interest to provide the investor with information to make an informed decision whether to invest with a particular firm. Specifically, Form CRS includes fields that provide retail customers with information about:

- the types of services the firm offers;
- the fees, costs, conflicts of interest and required standard of conduct associated with those services;
- whether the firm and its investment professionals have a reportable legal or disciplinary history; and
- how to get more information about the firm.

Under Rule 204-5(b) of the Investment Advisers Act of 1940 (Advisers Act), an investment adviser must deliver its Form CRS: (1) to each retail investor client before or at the time the firm enters into an investment advisory contract with that client; and (2) to each existing retail investor client before or at the time the firm:

- opens a new account that is different from the retail investor client's existing account(s);
- recommends that the retail investor client roll over assets from a retirement account into a new or existing account or investment; or
- recommends or provides a new 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.

Similarly, under Rule 17a-14 of the Exchange Act, a broker-dealer must deliver its Form CRS to each retail investor it provides services. Importantly, this Form CRS disclosure requirement is broader than Regulation Best Interest's applicability that applies to broker-dealers that make recommendations to an investor. Specifically, under Rule 17a-14 of the Exchange Act, the broker-dealer must deliver the Form CRS:

1. to each retail investor before or at the earliest of:
    - a recommendation of an account type, a securities transaction or an investment strategy involving securities;
    - placing an order for the retail investor; or
    - the opening of a brokerage account for the retail investor.
2. to each existing retail investor before or at the time the firm:
    - opens a new account;
    - recommends that the retail investor customer roll over assets from a retirement account into a new or existing account or investment; or
    - recommends or provides a new brokerage service or investment that does not necessarily involve the opening of a new account and would not be held in an existing account.

Key Takeaways From the SEC's Recent Actions

There are several relevant takeaways from the SEC's recent Form CRS actions. First and foremost, the regulators are prioritizing the mandatory obligation regarding the delivery of Form CRS where an investment adviser or broker-dealer services retail customers. Any expectation that a new administration will pay less attention to Form CRS and Regulation Best Interest is misplaced.

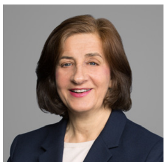
Second, the SEC and FINRA expect compliance when their examination teams advise firms to issue and file Forms CRS. Disciplinary action and sanctions may result where the regulators feel their instructions are ignored or delayed.

Finally, both investment advisory and brokerage firms may have misunderstood the breath of the new regulations. The definition of "retail customer," is quite broad under both Regulation Best Interest and Form CRS. Regulation Best Interest defines a "retail customer" as "a natural person, or the legal representative of such natural person who receives a recommendation of any transaction or investment strategy involving securities and uses the recommendation primarily for person, family, or household purposes." Form CRS similarly defines a "retail investor" as a "natural person, or the legal representative of such natural person, who seeks to receive or receives services primarily for personal, family, or household purposes." These definitions diverge from the traditional concept of a wealthy institutional investor who, until Regulation Best Interest and Form CRS, has not been considered a retail investor.

When an investment adviser or broker-dealer services retail customers, it is crucial that they comprehensively consider their obligations under Regulation Best Interest (for broker-dealers) and Form CRS (for both financial firms), as well as the administrative requirements to satisfy the delivery obligations for any required filing or disclosure. While the sanctions were modest in these actions — with fines ranging from $10,000 to $97,523 — as the 27 enforcement actions suggest, the SEC will likely continue to focus on compliance in this space, requiring firms to have appropriate policies and procedures in place to ensure compliance with their obligations.

CONTACTS

For more information, contact your Katten attorney or any of the following attorneys in the Financial Markets and Funds practice.



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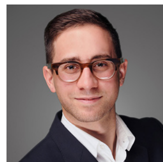

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