

OCIE ISSUES GUIDANCE FOR EXAMINATIONS OF REGULATION BEST INTEREST AND FORM CRS

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U.S. Investment Management Alert

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The June 30 deadline for compliance with Regulation Best Interest¹ and Form CRS² presents new compliance obligations for broker-dealers and investment advisers engaging in a retail business. In anticipation of this compliance date, and for purposes of assessing readiness, the Office of Compliance Inspections and Examinations (“OCIE”) of the Securities and Exchange Commission (“SEC”) recently published two risk alerts addressing the expected scope and content of compliance examinations following the deadline.³ OCIE expects to roll out its examination program in the year following the deadline to examine the reasonable effectiveness of a broker-dealer’s Regulation Best Interest compliance program and the implementation and compliance by broker-dealers and investment advisers of the Form CRS regulatory regime.

The OCIE Risk Alerts provide a useful tool for broker-dealers and investment advisers to prepare for upcoming examinations and to assess their own compliance readiness. The Regulation Best Interest Risk Alert also includes [an appendix with a sample request for information and documents](#) that OCIE may use in its examinations.

REGULATION BEST INTEREST

Last year, the SEC adopted Regulation Best Interest to establish a new standard of conduct for broker-dealers making recommendations of securities transactions and investment strategies to retail customers.⁴ Regulation Best Interest has four basic elements: (i) disclosure, (ii) duty of care, (iii) conflicts management and mitigation, and (iv) implementation of a compliance program. OCIE addressed each element in its Risk Alert, as follows:

Compliance Program

Regulation Best Interest requires a broker-dealer to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with the disclosure, care, and conflicts management prescribed by Regulation Best Interest.

As noted above, OCIE’s examiners will request a firm’s Regulation Best Interest policies and procedures to review their application to disclosure, care, and conflicts-management obligations, as well as their application to a firm’s controls, remediation of noncompliance, training, and periodic review and testing.

Disclosure Obligation

Regulation Best Interest 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 of its customer relationship; and

- all material facts raised by any conflicts of interest relevant to a recommendation.

OCIE's examiners for Regulation Best Interest compliance will review disclosures of: (i) the capacity in which a firm makes a recommendation (i.e., as broker-dealer); (ii) material fees and costs that apply to a retail customer's transactions, holdings, and accounts; and (iii) any material limitations on the securities or strategies that may be recommended.

OCIE examiners will review the content of disclosures, including fee schedules, disclosures of direct and indirect fee charges to retail customers, compensation methods for registered representatives, disclosures of any customer account monitoring, lists of proprietary products, and limitations on accounts or services recommended.

Care Obligation

Regulation Best Interest requires a broker-dealer to exercise reasonable diligence, care, and skill when making a recommendation to a retail customer, which includes a review of a customer's investment profile for purposes of assessing the risks, rewards, and costs associated with a particular recommendation.

According to the Risk Alert, examiners will seek documentation of the following:

- information gathered from retail customers that is used to develop their investment profiles (including any new account forms, correspondence, and any agreements the customer has with the broker-dealer);
- policies and procedures for establishing a reasonable basis to believe a recommendation is in the customer's best interest, including an assessment of risks, rewards, and costs to the customer, especially in light of the financial benefits to the firm;
- policies and procedures addressing significant investment decisions, such as rollover and account recommendations, to support that a recommendation is in a customer's best interest; and
- policies and procedures for recommendations of complex, risky, or expensive products.

Conflict of Interest Obligation

Regulation Best Interest requires a broker-dealer to establish, maintain, and enforce written policies and procedures reasonably designed to address conflicts of interest associated with recommendations to retail customers.

OCIE examiners will review a firm's policies and procedures and the extent to which they identify, assess, disclose, and manage conflicts of interest. Examinations are also expected to include a review of firm policies and procedures and the extent to which they specifically address the following:

- conflicts, such as (but not limited to) compensation plans or sales contests, that may potentially cause a registered representative to consider his or her interests over the customer's interest;
- conflicts associated with material limitations on the breadth of products that may be available to a customer, such as limits on the offering of nonproprietary products or a limited product menu focused on a specific product or account type; and
- the elimination of sales contests, sales quotas, bonuses, and noncash compensation programs based on the sale of specific securities or specific types of securities within a limited period.

FORM CRS

Concurrent with the adoption of Regulation Best Interest, the SEC adopted Form CRS disclosure and delivery obligations for broker-dealers and investment advisers engaging in a retail business.⁵ The Form CRS regulatory regime requires broker-dealers and investment advisers to prepare a disclosure document setting forth basic information about the firm's services and to deliver a Form CRS to existing and new retail investors.⁶

Examiners are expected to review Form CRS delivery obligations, Form CRS content and formatting, updating, and records maintenance. The particular points identified by OCIE are as follows:

Delivery and Filing

Examiners will review the timeliness of filing Form CRS with the SEC, posting a current Form CRS on a firm's public website (if applicable), and compliance with delivery of Form CRS to new and existing retail investors. A firm's policies and procedures addressing availability and delivery of Form CRS, as well as supporting records, will also be within the scope of an examination.

Content

Form CRS prescribes specific content disclosure. Examiners will review the extent to which a Form CRS discloses all material facts and required information in plain English for purposes of conveying material facts truthfully and accurately. Similar to Regulation Best Interest, OCIE is expected to focus on fee disclosures, compensation and incentive plans, potential conflicts, and relevant disciplinary history.

Formatting

Form CRS prescribes narrow formatting obligations in terms of length and scope. According to OCIE, examiners will review a firm's relationship summary to assess plain English drafting and compliance with specific formatting instructions.

Updating

Examiners will review the timeliness of disclosure updating (within 30 days, disclosure becomes materially inaccurate) and delivery and highlighting of updates to retail investors (within 60 days of a required update).

These OCIE Risk Alerts are intended to convey examination matters important to the staff, as firms continue to develop their compliance programs for implementation by June 30, 2020. Although general in nature, and a helpful guide, the OCIE Risk Alerts should not be viewed as the outer limits of any document request or examination scope. They should, however, help firms in their preparedness and readiness for compliance on day one. [The sample document request](#) also should assist broker-dealers in framing their Regulation Best Interest compliance policies and procedures and related records.

We are happy to assist firms in their compliance efforts and invite you to visit our [Financial Professional Standards page](#) on the K&L Gates HUB for our other Regulation Best Interest and Form CRS Alerts.

FOOTNOTES

¹ 17 C.F.R. § 240.15l-1.

² 17 C.F.R. §§ 240.17a-14, 275.204-5.

³ See SEC Office of Compliance Inspections & Examinations, [Examinations that Focus on Compliance with Regulation Best Interest](#) (April 7, 2020). See also SEC Office of Compliance Inspections & Examinations, [Examinations that Focus on Compliance with Form CRS](#) (April 7, 2020).

⁴ See Richard F. Kerr, Pablo J. Man, C. Dirk Peterson, Eden L. Rohrer, Andrew J. Shipe, [SEC Adopts A New Best Interest Standard of Conduct](#), (June 19, 2019). See also Richard F. Kerr, Pablo J. Man, C. Dirk Peterson, Eden L. Rohrer, Andrew J. Shipe, [Triggering Regulation Best Interest: What Are “Retail Customers” and “Recommendations”](#), (June 19, 2019).

⁵ See Richard F. Kerr, Pablo J. Man, C. Dirk Peterson, Eden L. Rohrer & Andrew J. Shipe, [Form CRS: Practical Considerations](#), (July 30, 2019).

⁶ Form CRS defines a “retail investor” as “a natural person or legal representative of such natural person, who seeks to receive or receives services primarily for personal, family, or household purposes.” This is similar to the definition of “retail customer” in new Regulation Best Interest, but it differs in one important respect: It includes both existing and prospective clients and customers.

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