Taking the Pain Out of

Understanding & Compliance

Executive Summary

Regulation Best-Interest is a new SEC initiative requiring Broker-Dealers and Registered Investment Advisors to act in the best interest of their clients. It makes the roles and responsibilities of financial services professionals more dynamic and evolved than ever. BDs and RIAs have until June 2020 to reach compliance and file documents with the Commission. In addition to the new Client Relationship Summary (Form CRS), the general obligation in investment security or strategy recommendation now requires the following five components:

1) *Disclosure Requirement*: brokers-dealers must release facts about their recommendations and their relationship to the products to their clients and potential customers.
2) *Obligation to client care*: broker-dealers must use reasonable due diligence when making investment recommendations. In other words, they understand the risks, rewards, and costs associated with the idea and inform the client.
3) *Avoiding Conflict-of-Interest*: establish, maintain, and enforce written policies and procedures to identify and disclose or eliminate conflicts of interest.
4) *Compliance Obligation*: broker-dealers must establish and continually enforce these policies and procedures.
5) Recordkeeping: You must comply with new record-making and recordkeeping requirements

The SEC aims to give BDs and RIAs discretion to create their own documents and procedures to mitigate these obligations. “Best Interest” and much of Reg-BI’s terminology and contents come from FINRA’s Suitability Rule and the DOL’s nixed Fiduciary Rule. Ultimately, the vague distinction between recommendation and financial education will be decided by court precedents. Now, it is important to review procedures for conflicts and document efforts towards compliance and remain ahead

of minimum standards. Pending lawsuits intending to revoke Reg-BI should not concern professionals because most of the suits argue that it did not go far enough.

This ebook is a primer to make you aware of the Reg-BI's main components and help you get the ball rolling toward compliance. RiXtrema Inc. is dedicated to helping financial professionals prospect, analyze portfolios, and prepare reports to convert prospects to clients. This ebook is an extension of that mission. We are confident that you will find this ebook helpful, but it is not exhaustive.

Groom Law Group, financial industry legal experts, reviewed RiXtrema Inc.'s upcoming compliance software, Reg-BI Optimizer, and its ability to help RIAs document due diligence for Reg-BI compliance. Reg-BI Optimizer "appears to contain information establishing many of the key elements that courts and the DOL have traditionally found important in reaching a prudent decision when presented with a particular set of facts and circumstances." With Reg-BI Optimizer "a financial advisor could reasonably conclude that use and completion of the Report will create a documented record necessary to form a basis for a best interest recommendation."
(Read the full Groom Law letter in the appendix.)

Mark your calendars for the January 27th launch of RiXtrema's Reg-BI optimizer - a software tool that will help RIAs and BDs easily reach Reg-BI compliance. If you have any lingering questions or concerns, then please do not hesitate to directly contact the main writer and Reg-BI researcher, Colin Ward, at cward@rixtrema.com or our Client Success Team at clientsuccess@rixtrema.com.

Thank you.

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Introduction

The Regulation Best-Interest compliance deadline is just around the corner - June 30, 2020. The Securities and Exchange Commission (SEC) adopted a 1,363-page package of rules designed to improve the quality of relationships and transparency between financial professionals.

This is why Reg-BI is changing the industry

In essence, the SEC designed the regulations to direct the attention of broker-dealers (BDs) and registered investment advisors (RIAs) towards retail investor interests.

Regulation Best Interest is the most impactful regulation for Broker-Dealers. Managing $4.3 Trillion assets between 140 million customer accounts, it will have substantial impacts on the nature of the service BDs provide.

Compliance with REG- BI means preparing and delivering a Customer Relationship Summary (CRS) to customers and retail investors and filing it with regulatory agencies by June 30, 2020. But, it is much more than that - financial firms need to prove that they are changing procedures, remaining accountable, and have proper disclosure documents. And they need to document the process.

This mini-ebook will help you begin to become knowledgeable of the new requirements and begin taking action towards compliance. So, let's dive in.

Background

The Fiduciary Rule's Successor

It is important to understand the basics of the DOL's Fiduciary Rule because one could argue that Reg-BI is its offspring. Vacated by the U.S. Fifth Circuit Court of Appeals on June 21, 2018, the DOL Fiduciary Rule intended to make retirement advisors fiduciaries, requiring that they act in the best interest of their clients. The DOL Fiduciary Rule required retirement advisers to provide all information regarding the potential conflict of interest to their clients, fully disclose their retirement planning operation fees, and be responsible for any potential risks and litigations (see more in the Appendix letter). Much of the interpretations of terminology, like "best interest", "recommendation", etc. are shared between the two regulations. Prior to Reg-BI, brokers did not have to put their clients' interests ahead of their own.

There are some distinctions between the DOL Rule and Reg BI. Reg-BI is not as oriented to 401k plans as the Fiduciary Rule nor is it ERISA centered. If assets were coming from ERISA, that put an extra burden on anyone touching those assets and effectively made them a fiduciary. In fact, many see Reg-BI as not as strenuous as the ERISA Fiduciary Standard - A key difference with the DOL Rule. But all of the regulations that brokers and advisors would need to follow are required regardless of whether the assets they rollover come from a qualified plan or not. Essentially, the SEC seems to be going past what the DOL was able to mandate in terms of their regulation, but softening requirements a bit with regards to advisors acting as ERISA fiduciaries.

The DOL Fiduciary Rule was an early attempt to regulate advisers' business by bringing most financial professionals under the fiduciary requirement umbrella activity and protect retirees seeking advice on their retirement accounts. Retirement advisers who provide recommendations on rollovers and retirement accounts management will be subject to the new rules.

DOL has stated that a fiduciary's obligation

to carry out its duties "prudently" generally is met to the extent that fiduciaries follow a "procedurally prudent" process by:

- gathering relevant information,
- considering all available courses of action,
- consulting experts where appropriate, and
- making a reasoned decision based on all relevant facts and circumstances.

Meeting these fiduciary obligations will certainly place most BDs and RIAs within their Reg-BI due diligence standards.

Reg-BI vs FINRA's Suitability Rule

It is more accurate to associate Reg-BI as a replacement and expansion of FINRA's Suitability Standard while bringing it under the umbrella of a government institution. **Reg-BI makes the roles and responsibilities of financial services professionals more dynamic and evolved than ever.** Brokers must currently adhere to FINRA's suitability standard of care with clients, and RIAs must uphold a fiduciary standard of care. But, as the table below shows, Reg-BI is not that different from FINRA's rule. In general, its key distinctions are more vague and interpretable but may become clarified over time. So, somewhat of a wait-and-see approach, but there is much to do in the meantime.

How does Reg BI Compare to FINRA's Suitability Rule

	Regulation Best Interest	Suitability Rule
Customer Specific	Brokers must understand potential risks, rewards, and costs of the recommendation and believe that the recommendation could be in the best interest of some retail customers.	Brokers must have a "reasonable basis" to believe that a recommendation is suitable for at least some investors. Due diligence is described as disclosing risks and rewards of the recommendation.
Reasonable-Basis	Brokers must have a "reasonable basis" to believe that the recommendation - with its risks, rewards, and costs - does not put the firm, dealer, broker or any other agent ahead of the retail customer's interest.	Requires a broker to have a "reasonable basis" for a recommendation's suitability. They are also required to obtain and analyze information specific to that customer to support their determination.
Quantitative	Brokers must have a "reasonable basis" to believe that a series of transactions do not violate the best interest obligation even if one transaction is clearly compliant.	Requires the broker with actual control over the retail customer's account to have a reasonable basis to believe that the recommendation is suitable in isolation.

Key Best Interest Obligations of Reg-BI

First of all, Reg-BI imposes a new standard to act in the best interest of the retail customer without prioritizing the financial or other interest of the broker-dealers (the 'General Obligation'). **This general obligation specifies Broker-Dealers must:**

"Act in the best interest of a retail customer when making a recommendation of any security transaction or investment strategy involving securities to a retail customer"

Where transaction or investment strategy is defined as:

1) Investment securities
2) Investment strategies
3) Types of Advisory-vs-Brokerage Account
4) Whether to Roll Over An Employee Retirement Plan
5) Whether to Take [to invest] a Retirement Plan Distribution

5 elements make up a big umbrella that each recommendation must be underneath:

1) **Disclosure Requirement:** provide certain required disclosure before or at the time of the recommendation, about the recommendation and the relationship between you and your retail customer
2) **Obligation to client care:** exercise reasonable diligence, care, and skill in making the recommendation; (In other words, they understand the risks, rewards, and costs associated with the idea and inform the client.)
3) **Avoiding Conflict-of-Interest:** establish, maintain, and enforce written policies and procedures to identify and disclose or eliminate conflicts of interest.
   - Firms must correct conflicts that create an incentive for broker-dealers to put the client's interest second.
   - Expand the menu of offerings away from offering only proprietary or commissioned products.
   - Eliminate time-period sales incentives that are based on the sale of specific investment products.
4) **Compliance Obligation:** establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.
5) **Record-making and Recordkeeping:** You must also comply with new record-making and recordkeeping requirements.

What does the Disclosure Obligation require?

The Disclosure Obligation (DO) is pretty self-explanatory. In the SEC's own language:

The DO specifies how the Broker, dealer, etc. must "disclose... in writing, the material facts relating

to the scope and terms of the relationship with the customer, including all material conflicts of interest that are associated with the recommendation".

The Disclosure Obligation applies to both Broker-Dealers and RIAs and, as such, it is a deceptively simple requirement. They must provide full and reasonable disclosure of facts related to their relationship with retail investors. This means that advisors or brokers may need to update their Conflicts of Interest disclosures or implement Form CRS - more on Form CRS later.

Reg-BI requires BDs and RIAs to disclose:

1) The fees and costs associated with the retail customer's transactions, holdings, and accounts i.e. the capacity under which the RIA or BD acts;
2) The type and scale of services provided including vulnerabilities and drawbacks of securities or investment strategies that may be recommended to the retail customer; and;
3) Any relationship the BD has with the recommended investment security or strategy. I.e. conflicts of interest.

Broker-Dealers are more affected under the Disclosure Obligation because they must disclose the nature of any relationship with the customer and their investment option.

Broker-Dealers are not allowed to call themselves "advisor" or "adviser" because it will violate Reg BI. (Dual-registered professionals do not fall under this restriction.)

Additionally, the disclosure of fees and costs does not seem to be quite as rigid as the language suggests. The SEC seems to be requiring brokers to disclose that the compensation they receive to sell a security or investment strategy may create conflicts of interest. The magnitude of the conflict does not seem to be necessary for compliance.

What does the Care Obligation require?

RIAs have been held to a fiduciary standard for some time, but Reg BI expands the level of care beyond suitability for brokers and sellers of securities. The Care Obligation is very similar to the FINRA Suitability Rule but it is no longer enough alone. The Care Obligation only applies to the broker-dealer entity, and not to the associated persons of a broker-dealer.

Simply documenting a risk profile questionnaire does not show due diligence because it does not do enough to ensure absolute risk alignment.

Reg-BI and the Suitability rule require a broker, dealer, etc. must exercise "reasonable diligence, care, skill, and prudence" to do three things (SEC Care Obligation):

1) "Understand potential risks and rewards 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;"
2) Have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer. This belief must be based on each retail customer's investment profile and the potential risks and rewards associated with that recommendation; and
3) Have a reasonable basis to believe that a series of transactions remain in the retail customer's best interest when viewed independently. So, each and the combination of all transactions cannot be viewed as excessive but in the retail customer's best interest when taken in light of the retail customer's investment profile.

"Reasonable basis" and compliance with the Care Obligation is assessed only at the time of the recommendation and will vary depending on, "among other things, the complexity of and risks associated with the recommended security or investment strategy and the BD's familiarity with the recommended security or investment strategy" (Read more in the Groom Law letter appendix).

Despite the unique nature of every recommendation, the SEC advises BDs to consider important factors such as:

1) the security or investment strategy's;
   - characteristics;
   - investment objectives
   - likely performance in a variety of economic and market conditions;
   - liquidity; and
   - volatility
2) expected return; and
3) any financial incentives related to the recommendation.

What does the Conflict of Interest Obligation require?

The Conflict of Interest Obligation also only applies to the broker-dealer entity, and not to the associated persons of a broker-dealer. It is, perhaps, one of the most important obligations to heed because the DOL or SEC is likely to scrutinize a recommendation particularly closely when an advisor or the firm has a conflict of interest.

Under the Conflict of Interest Obligation, a broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to identify and disclose and mitigate or eliminate,

material conflicts of interest arising from financial incentives associated with such recommendations

The SEC is a bit sparse in specifying its "written policies and procedures", but, in essence, it must be a good faith effort designed to identify, eliminate, mitigate, or at the very least disclose:

- Conflicts of interest associated with recommendations;
- Material limitations - like a limited product menu or mandate to offer only proprietary products;
- Sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sale of specific securities or specific types of securities within a limited period of time.

The SEC seems to intend to give BDs flexibility to develop these policies and procedures with their own creativity to fit their unique position. The Conflict of Interest Obligation must be continually met - i.e. BDs must be careful to update policies and procedures that are designed well at the beginning but later fall short. Conducting periodic product reviews is essential to make sure conflicts of interest are addressed all the time. Experience should be the measure of successful compliance.

It does not seem that BDs can avoid reviewing their product review processes and still hope to remain compliant. Considering the following is explicitly important:

- Using "preferred lists";
- Restricting the sale of products to specific retail customers; and
- Prescribing minimum knowledge requirements for people who make recommendations.

What does the Compliance Obligation require?

As with the other obligations, the Compliance Obligation applies only to the broker-dealer but not its associated persons.

BDs and RIAs must establish, maintain and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.

The SEC wants to provide flexibility to BDs by giving them the freedom to build their own policies and procedures. Each business model may require a different set and will depend on facts and circumstances of a given situation and be proportionate to the scope, size, and risks of each operation. They do advise that you consider:

- The nature of your operations;

- how to design policies and procedures to prevent violations;
- detect violations that have occurred; and
- correct any violations.

A reasonably designed compliance program will include:

- Controls;
- remediation of non-compliance;
- training; and
- periodic review and testing

Revenue-Sharing Conflicts

Reg-BI represents a significant change in the SEC's regulation target. Revenue Sharing is the practice of an investment fund security sharing money back with broker-dealers who sell it to clients and it was not regulated by the SEC prior to Reg-BI.

Traditionally, though, disclosures are very limited and presented in a way to make summarizing very difficult and disguise conflict of interest. It may not be fair to suggest that Reg-BI's Disclosure and Conflict of Interest Obligations are in response to this, but BDs may be forced to change or explicitly acknowledge revenue sharing arrangements to mitigate Reg-BI.

Morningstar estimates **that Reg-BI may force revenue-sharing to change for BDs.**

- Brokers traditionally followed a suitability standard which did not impose many restrictions on revenue sharing.
- Reg-BI strengthens the standard of conduct for brokers

Revenue-sharing illustrates a potential spectrum of conflict of interest that may be present in other products and fee areas. As Morningstar found, not all revenue-sharing payments create problems, but **brokers should be wary of 3 categories of payment-related conflicts:**

1) Payments based on sales or assets:

- The SEC prohibits sales quotas and bonuses tied to product sales
- These conflicts need to be eliminated because mitigation seems to be impossible to justify.

2) Payments for services:

- Platform or access fees act similarly to distribution fees paid as part of an expense ratio.
- Education, training, and conference expenses to teach brokers about products may not cause conflict unless it is viewed as a reward.
- Training and education could cause

a subconscious bias as BDs tend to recommend products they are more knowledgeable about.
- The SEC's response to these payments will vary based on facts and circumstances.

3) Payments for recommended or preferred funds:
- Those paid for by asset managers or part of Robo-platforms
- These funds will create a conflict if the payment translates into a higher likelihood of recommendation despite the client's needs.

It can not be stated enough; the conditions and circumstances surrounding the facts of each payment and recommendation will affect whether the SEC considers it a violation of the Reg-BI obligations. Fund expenses are a critical but only one consideration of a best-interest recommendation. Simply recommending the lowest-cost security or investment strategy does not necessarily satisfy the Care Obligation.

Figure 1 illustrates common expenses investors pay for mutual funds and advises which payments may create a conflict of interest (Morningstar). Figure 2 shows the common types of revenue-sharing arrangements and the conflicts they can present (Morningstar). Since violations will vary case-by-case, BDS need to tread carefully and conduct a thorough review of their product and services list for conscious and unconscious conflicts of interest.

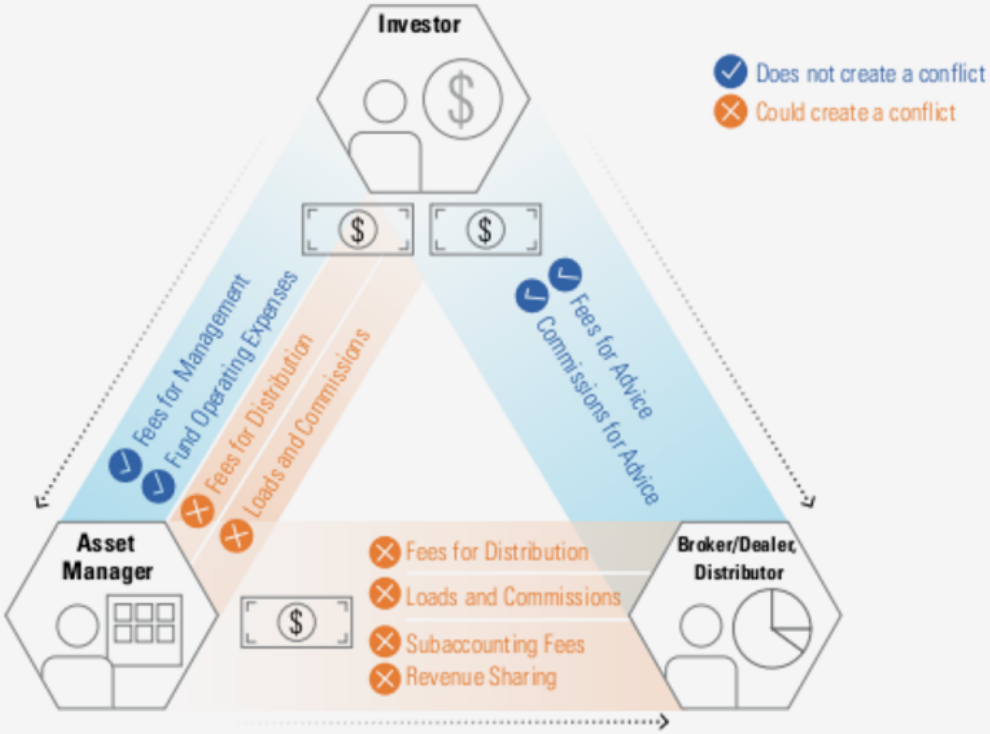

Figure 1:
Disbursement of Common Expenses Investors Pay for Mutual Funds and Advice (Morningstar)

Figure 2:
Common Types of Revenue-Sharing Arrangements and the Conflicts They Can Present (Morningstar)

IRA and Rollover Considerations

The SEC is explicit about what sort of considerations BDs need to make when making account type recommendations, or recommendations to open an IRA, or to roll over assets into an IRA.

Before making an account type recommendation, BDS should consider:

- alternative account types available;
- the projected cost to the retail customer of the account;
- the services and products provided in the account;
- the services requested by the retail customer; and
- the retail customer's investment profile.

Before making recommendations to open an IRA, or to roll over assets into an IRA, BDS should consider:

- any special features of the existing account;
- holdings of employer stock;
- application of required minimum distributions;
- available investment options;
- ability to take penalty-free withdrawals;
- fees and expenses;
- level of services available; and
- protections from creditors and legal judgments.

Document, document, and also document

The SEC believes that it is giving RIAs and BDs freedom to become compliant depending on their unique business practices. Time will tell if this is true, but, regardless, documentation will be essential to prove the best intentions. Reg-BI tries to anticipate this need by requiring new record-making and recordkeeping requirements which build upon existing obligations.

BDs and RIAs are required to keep a record of all information collected from and provided to each retail customer who receives a recommendation of any security transaction or investment strategy. These records must be collected and kept secure for at least six years after the account's closing date.

Who decides "best interest" anyway?

While all readers may have a shared understanding of "best interest" aligning it with the SEC's interpretation is difficult and proving due diligence is the true challenge. Lawsuits filed against fiduciaries for not acting in clients' best interests have been surging the past decade. With a whole new set of obligations to follow, Reg-BI, for BDs and RIAs, clients will be made aware of this change in accepted standards. This could lead to an even larger surge. For anything that isn't clearly outlined enough, we'll have to wait and see how things develop. In the meantime, it's better to document your process now and abide by the SEC's explicit form requirements.

As FINRA's Chief Legal Officer Bob Colby points out, **"Best Interest" is never really defined within the 1,300 pages, but the term is an expansion from FINRA's own suitability standard. The new Reg-BI standard is only satisfied when financial professionals comply with the four-component obligations: Care, Disclosure, Conflict of Interest and Compliance.**

The Reg-BI language sounds vague and subjective concept because it intends to address and update an entire industry. With the new regulation causing many brokers to enter into the "fiduciary" realm, evolving interpretations are something many people are going to consider. As violations and lawsuits occur, the courts and the SEC will decide the interpretation of "best interest" and other key ideas. **Financial firms can remain out of the crosshairs as long as they remain aware of the standards and practices set by court precedents and exceed them.**

Of course, as a general practice, financial professionals need to be sure they aren't putting the needs of the firm ahead of the investor and document this process. If a firm follows all the Best Interest Obligations with proper documentation, then a stronger case can be made that they are acting within the scope of what the SEC considers "the client's best interest".

Based on the more defined interpretations inspiring Reg-BI's terminology, we can assume

the following (read more in the Groom Law appendix):

A recommendation is in the "best interest" when the recommending party acts 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 natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer.

Compliance requirements for Broker-Dealers

Regulation Best Interest brings significant changes to the business model and practices of Broker-Dealers. BDs and their registered representatives are restricted from using the term "adviser" or "advisor" in specific circumstances. **Reg-Bi, though, does not impart full fiduciary duty requirements ffor broker-dealers, but it does significantly increase the requirements compared to the suitability standard of conduct.** In general, it requires BDs to take action to avoid and disclose conflicts of interest that result in an incentive for registered representatives to place the firm's interest, or their own, ahead of the retail investor.

Reg-BI does not require the BD to mitigate its own conflicts of interest even though it does require them to adjust conflicts of interest around their broker incentives. So, some proprietary products may still be permissible products if the conflicts of interest do not result in a change in the broker's compensation.

- Bans "sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sale of specific securities (or types of securities) within a limited period of time".
- Certain products with high commissions may be unjustifiable as a "best interest" recommendation.
- Proprietary and non-proprietary products must be compensated the same.

- All product categories must have the same compensation scheme.

In what will certainly be a broken record in this book, Broker-dealers will need to stay informed about how the SEC's definition of "best interest" evolves over time. After June 2020, Reg BI will become more specific as litigation and, perhaps, clarifying amendments provide additional information about what is deemed "unjustifiable" and what kinds of conflict-of-interest mitigation is appropriate.

Filings for Broker-Dealers:

1) Already registered broker-dealers before June 30, 2020, must file an initial relationship summary on May 1, 2020, and no later than June 30, 2020.
2) Applications for registration or pending applications as a broker-dealer on or after June 30, 2020, must file a relationship summary no later than the date that the registration becomes effective.

Compliance requirements for Registered Investment Advisors

RIAs are not the primary focus of Reg-BI which aims to change the standards of BDs. Form CRS, though, does apply to both BDs and RIAs and will be the main challenge for RIAs.

Filings for Investment Advisors:

1) Registered or applying RIAS (before June 30, 2020) must file the initial relationship summary on May 1, 2020, and no later than June 30, 2020, either as an other-than-annual amendment or part of the initial application or updating amendment.
2) Applications for registration on or after June 30, 2020, will not accept any application without a relationship summary.

Client Relationship Summary (Form CRS)

Form CRS came from an unfortunately common industry practice to muddle the scope of services, fees, conflicts of interest, and legal obligations and duties of financial professionals (Spencer Fane). Instead, **the CRS form intends to establish a level ground upon which retail investors and BDs or RIAs can build a relationship.**

Form CRS is essentially a summary of the relationship between investment advisory firms and retail investors. The summary is intended to be short and only two pages long for either Broker-Dealer or Registered Investment Adviser, and four pages long for dual registrants. Single registrants must file the CRS through Web Central Registration Depository (CRD) and dual registrants must also file with the Investment Advisor Registration Depository (IARD).

(Read the SEC's introduction to Form CRS here.)

Firms need a process to update the CRS Form

Form CRS is an important and timely requirement that investment professionals must comply with because it is always evolving around the history of the firm. The form must be updated within 30 days whenever any information becomes inaccurate. They must also communicate, without charge, any changes in the summary to existing retail investor clients and customers within 60 days after the updates are required to be made. This news can be delivered either through an abridged form or by providing their clients and customers with the entire revised CRS form.

Since many individual investors rely on advice provided by financial professionals when making investment decisions, a brief, precise summary of the firm's business model and their relationship with their clients could be helpful. However, it is a complicated task for financial firms to put their entire business model including fees, services, client relationships, legal standing onto only two pages.

The goal of Form CRS is to disclose this information to retail investors in an easy to understand summary of the investment firm's profile. The two-pager will cover:

1) the types of client relationships and services being offered;
2) the fees, costs, conflicts of interest, and required standard of conduct associated with those relationships and services;
3) whether the firm and its financial professionals currently have reportable legal or disciplinary history; and
4) how to obtain additional information about the firm.

Requirements

First off, BDs, RIAs, etc are required to initially deliver Form CRS to clients before or at the time that the investment adviser and client enter into an investment advisory agreement. Reg-BI also requires firms to deliver Form CRS to clients within 30 days, if requested. With respect to existing clients, Reg-BI requires firms to provide the Form before or at the time (1) a new account is opened that is different from the client's existing account, or (2) changes are made to a client's existing account that materially change the nature and scope of the relationship. Similar to current disclosure requirements, the SEC also proposes that firms update Form CRS within 30 days of a material change to the information in the Form.

Besides disclosing key information to retail investors, Form CRS aims to provide a comparison of financial services provided by financial firms. This will help retail investors find the best match among the financial firms who offer investment advice on the basis of fees, services, client relationships, conflicts of interest, etc.

Form CRS will be added as Part 3 of the annually filed Form ADV. Form CRS will be required to be sent at the beginning of the client relationship and within 30 days after the initial filing for existing clients. It will be subject to SEC filing, updating, and related recordkeeping requirements. Also, Form CRS will be made publicly available by the Security Exchange Commission and on a firm's website, if it has one.

The SEC provided two guides on building the CRS Form: a FAQ and official description

The CRS Form is required to contain the following items:

1) Introduction. Must include:
   - The name of the BD or RIA and the firm's registration with the SEC as a BD, RIA or both
   - The form must state that free and easy tools are available to research firms and financial professionals on the SEC's investor education website (Investor.gov/sec). There, the retail investor can find educational materials about BD's, RIAs and investors.
2) Description of the firm's relationship to clients and services offered to retail investors. The section must include all services offered even if the investor does not qualify for or is not being offered a particular service at the time of the form's delivery.
3) A statement of the applicable conduct standard associated with the services followed by examples of how the firm makes revenue and potential conflicts of interest.
4) Fees and costs associated with BD and RIA accounts and the conflicts they create.

5) A comparison of brokerage and investment advisory services for firms that are not dually-registered
6) Conflicts of interest associated with the firm's relationship to its services, fees, and other BDs and RIAs.
7) Whether the firm or its registered representatives have reportable legal or disciplinary events and contact for complaints. If so, then the summary must include a separate section summarizing the disciplinary history, results, and where investors can further research the action.
8) Conversation Starters: Specifically, **the following seven questions must be prominently featured in Form CRS**. These should be prominently displayed with larger fonts, different typeface, bold, etc. Naturally, they are designed to prompt the retail investor to ask questions, so BDs and RIAs need to have answers prepared.
   - "What is your relevant experience, including your licenses, education and other qualifications? What do these qualifications mean?"
   - "Help me understand how these fees and costs might affect my investments. If I give you $10,000 to invest, how much will go to fees and costs, and how much will be invested for me?"
   - "How will you choose investments to recommend to me?"
   - "Given my financial situation, should I choose an investment advisory service? Why or why not?"
   - "How might your conflicts of interest affect me, and how will you address them?"
   - "As a financial professional, do you have any disciplinary history? For what type of conduct?"
   - "Who is my primary contact person? Is he or she a representative of an investment advisor or broker-dealer? Who can I talk to if I have concerns about how this person is treating me?"

It is important to remember the audience of the Form CRS: the investor client. Unloading legally recommended language or jargon is a good way to seem like you're hiding behind a document. It must be written in plain and easy-to-read narrative text or tables using understandable language and standardized headings in a prescribed order throughout the form. It needs to include the required items by using a mix of language prescribed in the instructions as well as their own wording in describing their services and offerings. Form CRS must use text features to make sections, like the Conversation Starters and Specific References to Additional Information, more noticeable and prominent in relation to other discussion text such as by using a larger or different font, a text box around the heading or questions, **bolded**, *italicized*, or underlined text are some of the examples.

What's Next?

Do not delay compliance because of ongoing lawsuits

Like the DOL Fiduciary Rule, Reg BI quickly faced legal challenges, from states and advisors alike. While most of the suits against the DOL Rule were from the perspective of the rule over-regulating, the early suits against Reg BI are focused on perceived under-regulation. Seven states -New York, California, Connecticut, Delaware, Maine, New Mexico, and Oregon - and the District of Columbia filed a lawsuit against the SEC to block Reg BI.

These plaintiffs argue that the SEC exceeded its statutory authority and unlawfully overruled the regulations established by the Dodd-Frank act. At the same time, however, they claim that the rule makes it easier for BDs to advertise as "trusted advisors" while giving contradictory advice. **It is unlikely, however, that even the abandoning of the regulation will come with a delay. So, firms in these areas should still take steps to become compliant.**

Opportunities in Compliance

In essence, the Reg-Bi is a regulation that forces BDs and advisors to uphold a standard of service they're meant to provide. By highlighting your firm's history of meeting fiduciary standards, you may be able to attract retail investors or plan sponsors who are aware of the Department of Labor regulations and may be suspicious of financial advisors. Plus, financial professionals and firms already compliant with FINRA's Suitability Standard or ERISA's Fiduciary Rule will be close to Reg-BI compliance.

Educating the most economically disadvantaged may make you an attractive fiduciary and aware of a client's personal financial challenges. Millennial investors are already more willing to see a financial professional in person and could be viable prospects if you market your services with a financial education tone rather than with traditional sales strategies.

Simple solutions sell.

Especially with a shift towards financial education, advisors and broker-sellers may see many benefits to reducing the number of products they offer to clients. Not only will offering tailored investment ideas make meetings easier for advisors to prepare and clients to understand, but the real opportunity comes when advisors shift towards more personalized investment ideas rather than simply offer a smaller selection. 40% of millennials will pay more for a product that aligns with their values and half prefer to see their financial advisor or broker in person. So,

adopting a menu of ESG or SRI investment options could meet the Reg-BI obligation and give you a competitive advantage over most advisors who neglect these clients.

Offering a more personalized service with an awareness of a client's demographic-economic challenges may be an opportunity to build lasting and trustworthy relationships with clients. Depending on your recommendations and market, there could be advantages to carving out a niche business to serve specific client demographics. We wrote previously about the need for financial advisors to measure risk capacity in addition to risk tolerance, and that is just one tool to assess the client's unique financial situation. An automatic risk questionnaire and streamlined email marketing campaign could mean adaptations to Reg-BI may lead to efficiency and better service to more clients.

Just as many expected the industry to change after the Fiduciary Rule, the introduction of Reg-BI may fundamentally change the tone and type of relationship between client and broker-seller. Financial advisors who got into the industry to spread financial knowledge and help responsibly build wealth for their clients will prosper as they genuinely exceed the new regulatory standards.

Here's what the SEC is looking for in its first Reg-BI exams

The SEC is sympathetic to COVID-19 efforts

The Commission sees that the big firms who manage the majority of retail investor assets have «made considerable progress» towards reaching compliance. Small, independent advisory firms are a different story, though.

A firm may be behind the compliance deadline if it is not doing the following:

- Analyzing how to adjust business practices;
- supplement and modify policies and procedures; and
- aligning your workflows to prepare for compliance with Reg BI and Form CRS.

Is your firm ready to show a good-faith effort?

First, Reg-BI exams will determine whether a BD or RIA has made a «good-faith effort to implement policies and procedures designed to comply with Reg-BI and be effective.» Beginning June 30th, 2020, the SEC will want documentation and proof that each recommendation an RIA or BD makes is within its «Best Interest» guidelines. In essence, you can read more about what a «Best Interest» recommendation is on our blog.

The Commission will look for the same in their assessment of Form CRS filings. They will «review the filing and posting of the firm's relationship summary as well as its process for delivering the relationship summary to existing and new retail investors.» The Office of Compliance Inspections and Examinations (OCIE) will most likely review filings that occur during the first year after the compliance date. Still, they will be looking for evidence of compliance beginning at the June 30th deadline.

As their April Announcement outlined, the OCIE will be evaluating each RIA and Broker-Dealer to the standards unique to their firm. Not every document listed in the announcement will apply to every firm.

Don't forget these critical compliance steps:

- Deliver Form CRS to retail customers in a «brief customer or client relationship summary that provides information about the firm.»
- File Initial CRS Forms and amendments with the Commission using the Central Registration Depository («Web CRD») or Investment Advisor Registration Depository («IARD»)
- Post the most current CRS Form on the firm's public website, if the firm has one.

5 Components to the Form CRS Examinations

What is the OCIE expecting by June 30th?

Form CRS and its related rules require firms to prepare and deliver a 2-page summary (4-pages for dual registrants) of the relationship between the retail investor and the firm. Don't forget to file it too! BDs and RIAs must file their relationship summaries (with amendments) using the Central Registration Depository ("Web CRD") or Investment Advisor Registration Depository ("IARD"). Firms also need to publish the form on their website, if they have one.

Just as will be done for the other Reg-BI requirements, the OCIE will start to examine firms' compliance after the June 30th deadline. I wrote a concise article outlining those expectations and one thing remains consistent for the Form CRS. The first examination will focus on "assessing whether firms have made a good faith effort to implement Form CRS". Now, that first assessment may have a relatively low bar, but I think it's reasonable to assume that the later reviews will be more strict.

5 Compliance Components in the Form CRS Examinations

1) **Delivery and Filing:** (This is the most lengthy part of the examination but stay with me here.)

First, the SEC Staff will review whether your firm filed its CRS Form and any amendments and posted it on your website if you have one. Second, they will evaluate how your firm plans to deliver the summary to your existing and new retail investors. Third, they will review all your policies and procedures to make sure that they include updating and delivery procedures for the CRS Form. The SEC specifically wants dates to validate when each CRS Form is delivered to every retail investor.

The expectations

Existing Retail Investors: The CRS Form needs to be delivered to your current clients by July 30th, 2020. That's 30 days after the form must be filed (June 30th, 2020). The form must also be delivered before or when:

- A retail investor opens a new account different from their existing one;
- A BD, RIA, or agent makes a recommendation of a rollover of assets from a retirement account into a new or existing account or investment; or
- A recommendation is made of a new brokerage or advisory service or investment (not necessarily involving a new account). (For example, a first time purchase of a direct-sold mutual fund through a "check and application" process.)

New Retail Investors: The CRS Form must be delivered to new retail investors

before or at the earliest of:

- Entering into an advisory contract;
- Making a recommendation of an account type, security transaction, or investment strategy involving securities;
- Placing an order for the retail investor; or
- The opening of a brokerage account for the retail investor.

Phew Enough with Delivery and filing. Hopefully, those expectations are relatively intuitive, but the complexity of the requirement shows that firms need to have proper procedures and accountability to remain compliant.

2) Content:

Ask yourself two questions because the SEC will certainly ask them:
Does your CRS Form contain all the required information?
Is the information true, accurate, and stated clearly without missing any facts necessary to make the disclosures?

3) Formatting:

The SEC is looking for whether the CRS Form is formatted according to the instructions. The specific requirements are outlined in our ebook (linked below). Basically, ask yourself: Is my form written in plain English without an excess of legal jargon or anything the SEC may see as misleading.

4) Updates:

The SEC Staff will look to see whether your firm has proper policies and procedures for updating the CRS Form. The examination really comes down to three questions:

First: Do your procedures ensure that the CRS Form is updated within 30 days of any change to its contents?

Second: How will your firm's policies communicate these changes to your retail investors within 60 days after the updates are made to the CRS Form?

Third: Does your firm's process highlight to retail investors the most recent changes and include an exhibit highlighting and summarizing any filed updates?

5) Recordkeeping: (Last one, here we go!)

The SEC's staff will make sure that your firm records delivery dates of every CRS Form and has policies and procedures for record-making and recordkeeping. These assessments intend to determine how a firm complies with delivery requirements and recordkeeping obligations throughout the lifetime of the firm and employee turnover.

Reg BI Optimizer

This mini e-book is just the first step towards our commitment to helping financial services professionals exceed the new regulatory standards. Hopefully, this report demonstrates the time and effort spent by RiXtrema to become experts in this subject. If you have any questions or concerns regarding Reg BI, then please contact us at clientsuccess@rixtrema.com. We are happy to help financial professionals and firms reach compliance and will deliver more content related to Reg BI in the leadup to the launch of our Reg BI Optimizer (The week of January 27th).

Michael Kreps, with Groom Law, is a Washington DC attorney specializing in public policy, fiduciary responsibility, and plan funding and restructuring. Having led the Committee on Health, Education, Labor, and Pensions from the 110th-114th Congress, he now routinely represents private and public sector clients before federal agencies and Congress. RiXtrema requested his thoughts on Reg-BI and the report produced by the Reg BI Optimizer (See the full letter in the appendix).

Kreps found the report produced by the Reg BI Optimizer to be adequate for financial advisors to meet compliance by containing "many of the key elements that courts and the DOL have traditionally found important" to reach a best interest recommendation. In essence, Reg-BI Optimizer helps financial advisors conduct due diligence by gathering the necessary information to justify a rollover as within the client's best interest.

The SEC also set up a new Commission to help assist with planning for compliance with Reg BI rules. The Commission is establishing an inter-divisional Standards of Conduct Implementation Committee made up of many international and domestic groups within the Inter-American Development Bank (IADB). If you have any questions regarding implementation, then you can send your questions by email to IABDQuestions@sec.gov.

Request Your Demo of RegBIoptimizer Now & Get It for Free Until June 2020

Clarifying Terms

As firms review the SEC's Reg-BI description and prepare compliant forms, it is important to be aware of the SEC's interpretation of certain words and phrases. As the regulation becomes adopted these terms will likely change or become more encompassing, but here are presently defined or assumed interpretations:

Conflict of Interest

Any conscious or unconscious interest that may persuade a BD or associated person (AP) to make a recommendation that is not objective.

Personal, Family, or Household Purposes

This phrase involves any recommendation to a natural person regarding their account, except for recommendations that seek services for commercial or business purposes. As FINRA highlights, "Reg BI would not cover an employee seeking services for an employer or an individual seeking services for a small business or on behalf of another non-natural person entity, such as a charitable trust.

Receives and Uses

The SEC defines "use" as a result of the recommendation:

- The retail customer opens a brokerage account with the BD. Whether the BD receives compensation is irrelevant;
- The retail customer has an existing account with the BD already and receives a recommendation. Again, direct or indirect compensation is irrelevant to the definition;
- The BD "receives" or will receive compensation, directly or indirectly, as a result of the recommendation regardless of if that retail customer has an account at the firm.

Recommendation

The SEC's interpretation of "Recommendation" derives from FINRA's Suitability Rule. It remains difficult to determine the difference between a recommendation and financial literacy because "the determination of the existence of a recommendation has always been based on the facts and circumstances of the particular case." Context and presentation are important aspects. There are some key principles that designate a moment of communication as a

recommendation:

- Individualized presentation with financial planning context are almost always considered recommendations.
- Financial education does not seem to include specific securities or contextualized to investment strategies.
- Aggregated communications may constitute a recommendation even if one instance does not.
- Whether the communication is initiated by a person or computer makes no difference to whether it is considered a recommendation.
- Anything that elicits a “call to action” has been explicitly attached as a recommendation by the SEC.

These guiding principles will become more specific as litigation decisions alongside the facts and circumstances of particular cases inform the definition of communication as a “recommendation”.

Retail Customer

The SEC defines a “retail customer” as any person or legal representative of a person who:

- Receives a recommendation of a security transaction or investment strategy from a broker, dealer, or associated person.
- Uses the recommendation for personal, family, or household purposes.

Retail Customer Investment Profile

This investment profile is defined as any information connected to the investment recommendation the retail customer shares with their broker, dealer, or associated person. It includes but is not limited to:

- Age;
- other investments;
- financial situation and needs;
- tax status;
- investment objectives;
- investment experience;
- investment time horizon;
- liquidity needs;
- risk tolerance; and
- any other information the retail customer may disclose to the broker in connection with a recommendation.

Resources:

A comprehensive guide on Reg-BI vs Fiduciary Rule

FINRA's Reg BI Checklist

FINRA's Reg BI Guidance

FINRA's definition of "recommendation"

The Investment Advisor Registration Depository

InvestmentNews on the ongoing suits against Reg-BI

Morningstar's Reg BI Whitepaper

SEC's Regulation Best Interest

SEC's Cost Estimate (17 CFR Part 240)

SEC's FAQ on CRS form

SEC's CRS form requirements

CRS Form Checklist

RiXtrema's Regulation Best Interest researchers created this checklist to get your gears turning toward compliance. It is not a substitute for consulting a legal or regulatory compliance office, but we feel it's a suitable starting point. You must file the CRS Form with the SEC and freely provide it to all of your firm's customers and clients by June 30, 2020. The CRS Form is essentially the 8 parts below. Before filing ask yourself whether each section in your form contains the outlined components.

1. Introduction:

- ☐ The name of the BD or RIA, and whether the firm is registered and with whom;
- ☐ an explanation as to how BD and RIA services and fees are different and how retail investors can understand the difference;
- ☐ free and simple research tools to investigate firms and financial professionals at the Commission's investor education website (investor.gov/CRS);
- ☐ a list of tools that can guide the client to research firms and financial professionals

2. Description of relationships and offered services:

- ☐ a list of all services and advice offered by the firm, even if the investor does not qualify for some products
- ☐ all relationships with the services offered to retail investors

3. A statement of the applicable conduct standard associated with the services:

- ☐ Do you provide an example of how the firm makes revenue and any relevant conflicts of interest to do so?

4. Fees and Costs:

- ☐ Do you describe the fees and costs associated with BD and RIA accounts and the conflicts they create?

5. A Comparison of BD and RIA services for firms that are not dually registered:

- ☐ Do you state where retail investors can search for more information about their BD and RIA services?

6. Conflicts of Interest associated with the firm's relationship to its services, fees, and other BDs and RIAs.

- ☐ Do you disclose conscious and unconscious conflicts of interest?

7. Legal and disciplinary events:

- ☐ Do you disclose whether your firm has any history of disciplinary action?
- ☐ Do you provide information, like tools or sources, to guide investors who want to research any events further?

8. A list of prescribed "conversation starters" for investors to ask?

- ☐ Do you have answers prepared for the questions, if a retail investor asks?
- ☐ Are the questions prominently displayed with larger fonts, different typeface, bold, etc.?

The SEC requires the following questions to be included in this section:

- ☐ What is your relevant experience, including your licences, education and other qualifications? What do these qualifications mean?
- ☐ Help me understand how these fees and costs may affect my investments. If I give you $10,000 to invest, how much will go to fees and costs, and how much will be invested for me?
- ☐ How will you choose investments to recommend to me?
- ☐ Given my financial situation, should I choose an investment advisory service? Why or Why not?
- ☐ How might your conflicts of interest affect me, and how will you address them?
- ☐ As a financial professional, do you have any disciplinary history? For what type of conduct?
- ☐ Who is my primary contact person? Is he or she a representative of an investment advisor or broker-dealer? Who can I talk to if I have concerns about how this person is treating me?

Other considerations:

- ☐ Is your final CRS Form two-pages (four pages for dual registrants)?
- ☐ Is your document delivered in plain language and shows it considers the retail investor's level of financial knowledge?
- ☐ Do you have a filing process that will provide the form to the SEC before June 30, 2020 and keep it updated?

Appendix: Groom Law Reg-BI and Optimizer Letter

You have asked that we provide our views on financial advisors' use of RiXtrema's Reg. BI Optimizer Report (the "Report") in making rollover recommendations if subject to a fiduciary duty under ERISA or if subject to the Securities and Exchange Commission's ("SEC") "Regulation Best Interest" 17 C.F.R. 240.15l-1 ("Reg. BI"). Below, we discuss the use of the Report in light of the procedural prudence requirements established under section 404 of the Employee Retirement Income Security Act of 1974 ("ERISA"). We also discuss the use of the Report in light of the "best interest" requirements, as explained by SEC in guidance under Reg. BI.

In summary, and as described further below, the Report appears to contain information establishing many of the key elements that courts and the DOL have traditionally found important in reaching a prudent decision when presented with a particular set of facts and circumstances. The Report also appears to contain the information establishing the key elements SEC has suggested are important in reaching a best interest recommendation when presented with a particular set of facts regarding a rollover decision. As such, a financial advisor could reasonably conclude that use and completion of the Report will create a documented record necessary to form a basis for a best interest recommendation to roll over from one account into a brokerage account, which is a vital aspect of a procedurally prudent process and supportive of best interest compliance.

Please note that this memorandum does not constitute a formal legal opinion on whether recommendations relying on the Report are, in fact prudent or in the best interest of a particular person, and courts often look at substantive prudence in addition to procedural prudence, as well as apply a "solely in the interest" standard. Our firm does not provide opinions on whether any particular fiduciary meets a "best interest" standard with respect to a recommendation or whether such decision is "prudent" or otherwise meets the requirements of section 404 of ERISA, decisions which both the DOL and courts recognize as inherently factual in nature. Given there is limited guidance in the area, it is also possible that a court, the SEC, or the DOL could disagree with the analysis and conclusions in the memorandum. In addition, this memorandum relies on the facts and assumptions described below, and, to the extent such facts and assumptions are not true, the conclusions described herein are subject to change. Finally, this memorandum should not be construed as advice to anyone other than the addressee.

I. Factual Background

The Report was built to help financial advisors document that a rollover from one account into a brokerage account (including an IRA) is in clients' best interest. In this respect, the

Report gathers data concerning key elements of a client's existing account. If it is a current 401(k) plan, it compares the data elements against databases of other 401(k) plans and IRAs. It also compares the effect on those elements of a rollover to a brokerage account. The data elements reviewed in the Report include fees, available investment options, investment information, including performance, expense ratios, and risk measurements, and other services available under the current and proposed accounts. The Report also helps the financial advisor gather information concerning the client's individual circumstances that is important to the advisor's analysis of whether the client would benefit from a rollover.

When the current account is a 401(k) account, the Report gathers the total investment, administrative, and other fees paid in the client's current 401(k) plan. The Report pulls this data from the 401(k) plan's most recent Form 5500, but it includes a caveat that the financial advisor should use data from more recent fee disclosures, and prudently attempt to obtain such fee disclosures, before relying on Form 5500 data. The fees paid under the 401(k) plan are compared to the average 401(k) plan fees for 401(k) plans of a similar asset size. The Report then compares the total fees paid by the client within the current and new 401(k) plans against the total fees, including investment advisory, custody, and other fees, that would be paid after a rollover to the destination IRA.

When the current account is a non-401(k) account, such as a brokerage account, the data elements must be those of the account itself compared against the proposed destination account.

The Report can also compares the investment advisory fees the client would bear under the destination IRA against average investment advisory fees, as stated in public Forms ADV. The financial advisor can create an appropriate benchmark to calculate average investment advisory fees by only including the Forms ADV of investment advisory firms that provide the same investment advisory services that would be provided to the destination account.

With regard to investments, the Report includes a list of the investment options available or utilized under the client's current account together with the expense ratios and historical performance of the investment options, as well as a chart comparing their portfolio against a portfolio that could be maintained after rolling over to a destination account[1]. This chart also includes the expense ratios of the investment options in the destination account. The Report details the

[1] You have informed us, and we assume for purposes of this memorandum, that it would be inappropriate to include additional benchmarking information regarding investment performance and fees because such information may be misleading if it were included in the Report.

Sharpe ratio of the portfolio under the current account and what the Sharpe ratio would be following a rollover to a destination account. The Report sets forth a measure of the client's current investment portfolio's susceptibility to the risk of large losses, as well as what the measure would be following a rollover to a destination account, and the Report compares the results under this risk measure against the client's risk tolerance[2].

If the current account is a 401(k) account, the Report lists a number of factors relating to the quality of the client's current 401(k) plan. These include certain plan-related features, such as whether the plan offers a qualified default investment alternative and automatic enrollment. In addition, the Report sets forth whether the current 401(k) plan has failed to meet certain legal requirements, such as whether the plan does not have a sufficient fidelity bond or has experienced loss from fraud or dishonesty.

The Report also compares the availability of services, such as financial planning services, under the current account against services that would be available after a rollover to a destination account. Finally, the Report includes space for the financial adviser to include a rationale for making investment recommendations to the client.

Finally, if the current account is a 401(k) account, the Report includes a questionnaire to help guide the financial advisor's analysis of whether the client's individual circumstances suggest he or she would benefit from a rollover or would benefit from remaining in an ERISA-covered plan. In this regard, among other things, the Report asks whether the client has access to a new 401(k) plan as a result of a change in employment. If the client has access to a new 401(k) plan as a result of a change in employment, the Report will display the same information with regard to the new employer's 401(k) plan as is displayed with regard to the client's current 401(k) plan. The Report includes questions relating to the client's financial position in order to assess whether the client would benefit from the enhanced creditor protection in an ERISA-covered 401(k) plan as opposed to an IRA. The Report asks whether the client makes use of 401(k) plan loans and investment in employer stock, which would not be available following a rollover to an IRA. In addition, the Report includes questions relating to the client's age, investment horizon and investment objectives to assist the financial advisor in determining whether the rollover would fit the client in that respect. The Report also asks whether the client expects to work past age 70 $^{1}/_{2}$, which, if true, could be used as a basis to avoid the required minimum

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[2] The Report refers to this measure as the "Crash Rating." You have informed us that a portfolio's diversification plays a role in the Crash Rating in that an adequately diversified portfolio would be less susceptible to the risk of large losses than a portfolio that is not adequately diversified.

distribution requirements under the Internal Revenue Code of 1986, as amended, if the client remained as a participant in an ERISA-covered plan. The Report also includes space for the financial advisor to describe and analyze other factors that may be relevant to the client's individual circumstances, but are not explicitly referred to in the Report.

II. Legal Background

A. ERISA Fiduciary Duties

Under ERISA, a fiduciary recommendation to rollover from an ERISA-covered 401(k) plan to an IRA must satisfy the prudence and "solely in the interest" standards applicable to ERISA fiduciaries, as set forth in section 404(a) of ERISA. To the extent that a recommendation is not a fiduciary recommendation under ERISA, the duties of prudence and loyalty would not apply.

ERISA generally requires that plan fiduciaries act prudently, solely in the interest of plan participants and beneficiaries, and for the exclusive purpose of providing benefits and defraying plan administrative expenses. ERISA § 404(a)(1). In this regard, courts often measure prudence by focusing on the fiduciary's conduct in arriving at a decision, asking whether the fiduciary used appropriate methods to investigate and determine the merits of a particular decision. *See, e.g., In re Unisys Savings Plan Litigation*, 74 F.3d 420, 434 (3d Cir. 1996). Whether a plan fiduciary acted prudently depends on "whether the fiduciary engaged in a reasoned decision-making process, consistent with that of a prudent man acting in like capacity." *DiFelice v. U.S. Airways, Inc.*, 497 F.3d 410, 420 (4th Cir. 2007); *see also Eyler v. Comm'r of Internal Revenue*, 88 F.3d 445, 454 (7th Cir. 1996) (a court must consider whether a plan fiduciary "employed the appropriate methods"). DOL has stated that a fiduciary's obligation to carry out its duties "prudently" generally is met to the extent that fiduciaries follow a "procedurally prudent" process by (I) gathering relevant information, (II) considering all available courses of action, (III) consulting experts where appropriate, and (IV) making a reasoned decision based on all relevant facts and circumstances. Such a process should be documented and designed to avoid self-dealing, conflicts of interest, or other improper influence. DOL Field Assistance Bulletin 2003-02 (Nov. 22, 2003).

While a procedurally prudent process is necessary to demonstrate prudence, courts also conclude that a decision must be prudent from a substantive standpoint in addition to procedural. *Fish v. GreatBanc Tr. Co*., 749 F.3d 671, 680 (7th Cir. 2014) (holding that, under both 404 and 406, substantive prudence is distinct from procedural prudence.)

Importantly, whether the prudence requirement is met is measured at the time the decision was

made without the benefit of hindsight. ***DiFelice v. U.S. Airways, Inc.***, 497 F.3d 410, 424 (4th Cir. 2007) ("First and foremost, whether a fiduciary's actions are prudent cannot be measured in hindsight. . . ."); ***Chao v. Merino***, 452 F.3d 174, 182 (2d Cir. 2006) (holding that a plan fiduciary's "actions are not to be judged from the vantage point of hindsight.") (internal quotation marks omitted).

ERISA fiduciaries are subject to the duty of loyalty to plan participants and beneficiaries in addition to the fiduciary duty of prudence. ERISA § 404(a)(1)(A). ERISA's fiduciary duty of loyalty requires plan fiduciaries to take all actions within their domain with an eye single to the interests of plan members and beneficiaries and without regard to the interests of any other persons. ***Donovan v. Bierwirth***, 680 F.2d 263, 271 (2d Cir.), cert. denied, 459 U.S. 1069 (1982).

B. SEC's Best Interest Standard & Care Obligation

The "best interest" standard and Care Obligation under the Reg. BI has similar concepts of loyalty and the exercise reasonable diligence, care, and skill. 17 C.F.R. 240.15l-1(a)(2)(ll).The Care Obligation involves providing individualized recommendations based upon the characteristics of the account owner plus the costs, risks and rewards associated with the recommendation. 17 C.F.R. 240.15l-1(a)(2)(ll)(A). Specifically, a recommendation is in the "best interest" when the recommending party acts 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 natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer. 17 C.F.R. 240.15l-1(a)(2)(ll)(B).

The preamble for Reg. BI provides an usually robust description of how the best interest standard applies to rollover recommendations. 84 F.R. 134, at 33383 (July 12, 2019). A reasonable process would not need to consider every alternative that may exist (either outside the broker-dealer or on the broker-dealer's platform) or to consider a greater number of alternatives than is necessary to exercise reasonable diligence, care, and skill in providing a recommendation.

Individualized recommendations under the Care Obligation take into consideration the account owner's investment profile, including:

I. account owner's age,
II. other investments,
III. financial situation and needs,
IV. tax status,
V. investment objectives,
VI. investment experience,
VII. investment time horizon,
VIII. liquidity needs,
IX. risk tolerance, and
X. any other information the account owner may disclose to the broker, dealer, or

a natural person who is an associated person of a broker or dealer in connection with a recommendation)

1) Where account owner's information is unavailable despite a broker-dealer's reasonable diligence, the broker-dealer should carefully consider whether it has a sufficient understanding of the account owner's to properly evaluate whether the recommendation is in the best interest of that retail customer
2) Moreover, under Reg. BI, as with the approach under FINRA's suitability rule, broker-dealers may generally rely on a account owner's responses absent "red flags" indicating that the information is inaccurate
3) Where a broker-dealer determines not to obtain or analyze one or more of the factors specifically identified in the definition of "Retail Customer Investment Profile," the broker-dealer should document its determination that the factor(s) are not relevant components of an account owner's investment profile in light of the facts and circumstances of the particular recommendation.

A "best interest" recommendation will take into consideration the potential risks, rewards, and costs of the IRA or IRA rollover compared to the investor's existing 401(k) account or other circumstances. Taking into consideration, among other relevant factors:

XI. fees and expenses;
XII. level of service available;
XIII. available investment options;
XIV. ability to take penalty-free withdrawals;
XV. application of required minimum distributions;
XVI. protection from creditors and legal judgments;
XVII. holdings of employer stock; and
XVIII. any special features of the existing account.

Each factor generally should be analyzed with respect to a particular retail customer in order for a broker-dealer to form a reasonable belief that the recommendation is in the best interest of that retail customer and does not place the financial or other interest of the broker-dealer ahead of the interest of the retail customer. *Id*. Finally, as described above, certain factors may have more or less relevance, or not be relevant at all, depending on the particular facts and circumstances of each recommendation. With respect to available investment options, SEC cautioned broker-dealers not to rely on, for example, an IRA having "more investment options" as the basis for recommending a rollover. Rather, as with other factors, broker-dealers should consider available investment options in an IRA, among other relevant factors, in light of the account owner's current situation and needs in order to develop a reasonable

basis to believe that the rollover is in the account owner's best interest. *Id*.

Finally, Reg. BI has a record-keeping requirement and encourages disclosing basis for recommendation. For example, the decision to roll over a 401(k) into an IRA may be one of the most significant financial decisions a retail investor could make. 84 F.R. 134, at 33360. Thus, a broker-dealer should discuss the basis of such recommendations with the retail customer. Such a discussion of the basis for any particular recommendation with their retail customers, should include the associated risks, particularly where the recommendation is significant to the retail customer. *Id*.

Similarly, the SECs encourage broker-dealers to record the basis for their recommendations, especially for more complex, risky or expensive products and significant investment decisions, such as rollovers and choice of accounts, as a potential way a broker-dealer could demonstrate compliance with the Care Obligation. Where a broker-dealer determines not to obtain or analyze one or more of the factors specifically identified in the definition of "Retail Customer Investment Profile," the broker-dealer should document its determination that the factor(s) are not relevant components of a retail customer's investment profile in light of the facts and circumstances of the particular recommendation. *Id*.

C. Rollover Recommendations

In summary, in the event of either a SEC or a DOL audit or litigation concerning a financial advisor's rollover recommendation, the DOL or a court would likely look at whether an advisor's ***process*** was designed to be prudent or in the client's "best interest" as defined by ERISA and Reg. BI, respectively. As with any assessment of procedural prudence, a court would likely review whether the advisor had collected the relevant information (as described above), evaluated the information reasonably, made a decision based on the information it collected, documented that decision and had the requisite expertise to engage in this evaluation. In addition, we would expect that the SEC or DOL or a court would evaluate whether the process took into account the investment objectives, risk tolerance, financial circumstances, and needs of the specific client. This is a process that at least to some degree involves a personalized analysis that assesses the client's unique circumstances. We also believe this review is likely not just about the process, but about the actual investment recommendations and whether they were objectively prudent. The DOL or SEC is likely to scrutinize a recommendation particularly closely when an advisor or the firm has a conflict of interest.

III. Analysis

The Report analyzes many types of information that could allow an adviser to reasonably conclude that at rollover recommendation is prudent and/or in the best interest of the account owner. For instance, the Report compares expense information within the client's current account plan, against fees the client would bear following a rollover to a new account. The Report uses Form 5500 data to populate the 401(k) fee information, which the DOL has stated is an acceptable source of data, assuming that the financial advisor has first used prudent efforts to obtain fee information from the plan, explained the data's limitations to the client, and determined that the use is reasonable. When making a recommendation subject to Reg. BI, the financial advisor may determine that it is unable to make a recommendation without the account owner's actual plan information. It is assumed that when recommending a rollover or transfer from a non-401(k) account, the actual data elements will be collected from the account owner for use with the Report. In addition, the Report provides information on the investment options available under the client's current account and compares the investments against those that would be available following a rollover or transfer to a destination account. The information on investments includes certain risk and return measurements.

The Report also assists the financial advisor in gathering information on the client's personal circumstances that is relevant to the analysis of whether a rollover or transfer would be in the client's best interest. This information includes whether the client is making use of, or could make use of, certain ERISA-plan related features, such as loans, investment in employer stock, and the enhanced creditor protection available to ERISA-covered plans. Importantly, the Report directs the financial advisor to consider whether the client could potentially rollover to a new employer plan as a result of a change in employment. FINRA guidance, as incorporated by the SEC under Reg. BI, states that these factors should be incorporated in an analysis into whether a rollover is in the best interests of the client.

In addition, the Report inquires into the client's age, investment horizon, risk tolerance, investment experience, and investment objectives (including liquidity needs) to help the financial advisor analyze whether the client would benefit from a rollover.

Therefore, a financial advisor could reasonably conclude that use and completion of the Report will create a documented record necessary to form a basis for a prudent fiduciary recommendation to rollover from a 401(k) plan to an IRA, which is a vital aspect of a procedurally prudent process, as described above. A financial advisor could also reasonably conclude that use and completion

of the Report will create a documented record necessary to form a basis for a best interest recommendation to rollover or transfer from an existing account to a destination account. In order to satisfy the best interest standard, the financial advisor would also have to analyze all of the information contained in the Report and make a substantively prudent rollover recommendation.

Please note that this memorandum only addresses the ability of the Report to form the basis of a prudent or best interest recommendation. It does not address the various disclosure requirements that may be connected with such a recommendation, such as Form CRS or an ERISA 408(b)(2) disclosure.