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Insights: Alerts

OCIE Issues Risk Alerts Previewing Initial Exams' Focus on Compliance with Reg BI, Form CRS

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On April 7, 2020, the SEC's Office of Compliance Inspections and Examinations ("*OCIE*") issued two risk alerts regarding the expected scope and content of initial examinations for compliance with Form CRS and Regulation Best Interest ("*Reg BI*"),[1] which will be designed to evaluate:

1. Whether the registrant has made a good faith effort to establish policies and procedures reasonably designed to achieve compliance with Form CRS and Reg BI; and

2. Registrant's progress in implementing their policies and procedures.[2]

The alert regarding Reg BI compliance, in particular, is heavily focused on matters of process and testing whether firms are making reasonable progress towards implementing policies and procedures. It also expressly acknowledges an expectation by OCIE that implementation will be (and should be) an iterative process that involves making adjustments as may be necessary and appropriate, in light of information gained from the implementation process and other facts and circumstances.[3]

Key Takeaways from the Form CRS Risk Alert

Form CRS requires broker-dealers ("*BDs*") and investment advisers ("*RIAs*") to deliver a brief customer or client relationship summary to retail investors.[4]

OCIE identified the following five areas as focus areas for initial exams:[5]

1. *Delivery and Filing of Form CRS*. The staff may review:

    - whether the firm timely filed the Form CRS (via CRD/IARD) and posted it on the firm's public website;
    - the firm's policies and procedures for the Form CRS delivery process;
    - the firm's process for delivering Form CRS to investors;
    - records of the dates each summary was delivered, as compared to other firm records, to ensure that the Form CRS was timely delivered to:
        - existing customers or clients before July 30, 2020;
        - at or before:
            - the opening of a new account that is different from the retail investor's existing account;
            - a recommendation of a rollover of assets from a retirement account into a new or existing account or investment; or
            - a recommendation of a new brokerage or advisory service or investment that would not be held in a new or existing account (*e.g.*, a direct sold mutual fund or

alternative investment);

- before or at the earliest of:
  - entering into an investment advisory contract with the retail investor;
  - making a recommendation to a retail investor 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. *Content*. The staff may analyze the content of a firm's Form CRS to assess whether all required information is included and contains true and accurate information, does not omit any material facts, and is not misleading. Specifically, the staff may review descriptions of:

- the firm's relationship and services, including statements regarding details about account monitoring (*i.e.*, whether performance is monitored on an ongoing basis, and if so, at what frequency) and investment authority (*i.e.*, discretionary or non-discretionary);
- conflicts of interest, including incentives related to proprietary products, third-party payments, revenue sharing, and principal trading;
- the firm's and/or its financial professionals' legal or disciplinary history; and,
- financial professionals' compensation, fees and costs, including those related to services and investments that retail investors will pay directly or indirectly, and examples of the categories of the most common fees and costs applicable to retail investors (*e.g.*, custodian fees, account maintenance fees, fees related to mutual funds and variable annuities, and other transactional fees and product-level fees).

  In assessing the quality of compensation and fee disclosures, staff is likely to compare Form CRS disclosures to fee schedules, advisory agreements, brokerage agreements, and/or compensation paid out to representatives.

  For RIAs, a lack of consistency of fees as described in advisory agreements versus as assessed in practice is a recurring deficiency cited by OCIE in various risk alerts and in its exam priorities. As such, this is one area where the addition of Form CRS to the analysis is likely to be fairly seamless for the staff.

3. *Formatting*. The staff may review whether Form CRS is formatted in accordance with the instructions.

4. *Updates*. The staff may review a firm's policies and procedures regarding updates to Form CRS to assess:

- how and whether the firm updates and files its Form CRS within 30 days after any information becomes materially inaccurate;
- how and whether the firm communicates any changes within 60 days after updates are required;
- the firm's process for highlighting most recent changes and material changes to its Form CRS; and
- the firm's testing and controls to ensure the above-described procedures for timely updates operate as designed.

5. *Recordkeeping*. The staff may review a firm's records related to delivery of Form CRS and its policies and procedures on recordkeeping and delivery obligations.

Key Takeaways from the Reg BI Risk Alert

OCIE identified the following areas of focus, relative to each of the four best interest prongs, for review in initial examinations likely to occur during the first year after the compliance date of June 30, 2020:[6]

1. To assess a BD's compliance with the ***Disclosure Obligation***, the staff may review:

- the timing of disclosures to confirm that they were made prior to or at the time of the recommendation; and
- the quality and completeness of disclosures; and
- the content of disclosures to determine if disclosures include:
    - all material facts relating to the scope and terms of the relationship between the BD and the retail customer, and all material conflicts associated with the recommendation, such as:
        - the capacity in which the recommendation is made;
        - fees and costs that apply;
        - material limitations on what is being offered (*e.g.*, if the BD has limited product offerings, or if there are limitations on accounts or services); and
        - disclosures related to monitoring of retail customer's accounts (*i.e.*, whether the BD is or is not regularly monitoring performance of securities within a customer's brokerage account);[7]

In assessing the content, quality, and completeness of the firm's disclosures, the staff is likely to cross reference other firm records, such as:

- schedules of fees and charges;
- compensation methods, including compensation associated with recommendations to retail customers, sources and types of compensation and related conflicts of interest (*e.g.*, higher compensation for proprietary products versus third-party products); and
- lists of proprietary products offered and sold to retail customers.

2. To assess a BD's compliance with the **Care Obligation**, the staff will be looking to understand the BD's processes for ensuring its associated persons both: (a) understand potential risks, rewards, and costs associated with each recommendation; and (b) have considered these factors in light of the retail customer's investment profile in order to make only those recommendations that are in the retail customer's best interest.

To make this assessment, staff may review:

- the BD's process for having a reasonable basis to believe each recommendation is in the best interest of the retail customer, including:
    - any process for establishing, understanding, and implementing the scope of reasonably available alternatives when making a recommendation;
    - factors considered in assessing potential risks, rewards and costs;
    - factors considered and the process for having a reasonable basis to believe that the BD and its registered representatives ("*RRs*") do not place their interests ahead of the retail customer's interests; and
    - processes specific to recommendations related to significant investment decisions, and/or more complex, risky or expensive products.

In assessing the quality and completeness of retail customer investment profile information utilized in the above processes, staff may review information collected from retail customers to develop investment profiles, including any new account forms, correspondence, and any agreements the customer has with the [BD].[8] (Emphasis added.)

3. To assess a BD's compliance with the **Conflict of Interest Obligation**, the staff may review:

- the extent to which and how the BD's policies and procedures address:
    - conflicts that create an incentive for a RR to place the RR's interest ahead of the retail customer's interests;
    - conflicts associated with material limitations on securities offered or investment strategies recommended (*e.g.*, a limited product menu, offering only or predominantly proprietary products, or products with third-party arrangements); and
    - the elimination of certain conflicts (*e.g.*, sales contests, sales quotas, bonuses, non-cash compensation based on the sale of specific types of securities within a limited period of time);
- how the policies and procedures provide for which conflicts are disclosed and mitigated, and which are eliminated, and how; and
- whether and how the policies and procedures establish a structure for identifying and assessing both current conflicts and conflicts as the business evolves.

  In making this latter assessment, the staff may review versions of policies over a relevant time period to see if the policies remained static or were updated and enhanced as the business evolved.

4. To assess a BD's compliance with the **Compliance Obligation**, the staff may review the BD's policies and procedures, controls, processes for remediation of noncompliance, training, and periodic review and testing.

While BDs might expect the Compliance prong to be primarily focused on assessing policies and procedures for achieving compliance with Reg BI, at least in initial examinations, OCIE has indicated that policies, procedures, and processes will largely be the focus of the other three prongs.

The primary focus of the Compliance prong analysis will be determining whether the firm has designed and begun to implement effective controls, remediation and testing processes for ensuring, on an ongoing basis, that Reg BI-related policies and procedures are being implemented, operating as designed, and achieving the desired effect.

The Reg BI Risk Alert provides as an appendix a sample, three-page, Reg BI-focused examination document and information request list.[9] We encourage firms to review the list, as it provides helpful context.

Implementation Deadlines for Reg BI and Form CRS

The compliance date for both Reg BI and Form CRS is June 30, 2020.

The initial delivery deadline for Form CRS to existing customers and clients is July 30, 2020.

While the SEC provided temporary relief for some rules in light of COVID-19, the SEC has not delayed implementation of Reg BI or Form CRS.[10]

If you have any questions about Form CRS, or the regulation of BDs or RIAs, please feel free to contact us, the Investment Management Broker-Dealer Team at Kilpatrick Townsend & Stockton.

Footnotes

[1]SEC Office of Compliance Inspections and Examinations, *Examinations that Focus on Compliance with Regulation Best Interest* (April 7, 2020), available at https://www.sec.gov/files/Risk%20Alert-%20Regulation%20Best%20Interest%20Exams.pdf [hereinafter referred to as "Reg BI Risk Alert"]; SEC Office of Compliance Inspections and Examinations, *Examinations that Focus on Compliance with Form CRS* (April 7, 2020), available at https://www.sec.gov/files/Risk%20Alert%20-%20Form%20CRS%20Exams.pdf [hereinafter referred to as "Form CRS Risk Alert"].
[2]*Id*.
[3]*Id*.
[4]Form CRS Risk Alert.
[5]*Id*.
[6]Reg BI Risk Alert.
[7]In preparing for an examination of disclosures, firms should consider not only the clarity and thoroughness of their disclosures about what the firm does provide, but also about what it does not provide.
[8]Reg BI Risk Alert.
[9]*Id*.
[10]SEC Release, Investors Remain Front of Mind at the SEC: Approach to Allocation of Resources, Oversight and Rulemaking; Implementation of Regulation Best Interest and Form CRS (April 2, 2020), available at https://www.sec.gov/news/public-statement/statement-clayton-investors-rbi-form-crs

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