June 14, 2019

SEC Adopts Form CRS (Client Relationship Summary) for Advisers and Broker-Dealers

On a June 5, 2019, the SEC adopted Form CRS ("relationship summary"), along with new and amended rules and forms, to improve retail investors' understanding of the different investment-related services provided by registered broker-dealers, registered investment advisers and dually registered firms (each, a "firm").

At the same meeting, the SEC also adopted Regulation Best Interest and published two interpretive releases regarding (i) the standard of conduct for investment advisers under the Advisers Act and (ii) the "solely incidental" prong of the broker-dealer exclusion in the Advisers Act Section 202(a)(11)(C). Regulation Best Interest and the two interpretive releases are covered in separate Ropes & Gray Alerts.

The Form CRS rulemaking (the "CRS Release") is described in detail below.

Overview

The CRS Release adopted Advisers Act Rule 204-5 and Exchange Act Rule 17a-14, which will require a firm to deliver to ***retail investors*** its current Form CRS. A firm that does not have any retail investors to whom the firm would be required to deliver a Form CRS is not required to prepare or to file a Form CRS.

In a Form CRS, a firm is required to describe the nature and scope of services provided by the firm, the types of fees customers will incur, the conflicts of interest faced by the firm, and the firm's disciplinary history.

Form CRS has been streamlined compared to the form that the SEC proposed in 2018. A firm's Form CRS cannot exceed two pages (or the equivalent, if provided in electronic format). If a dual registrant – *i.e.*, a dually registered firm that offers services to retail investors as both a broker-dealer and an investment adviser – decides to provide a combined Form CRS, the combined form cannot exceed four pages.[1]

Firms must file their initial Form CRS and post their Form CRS prominently on their websites no later than **June 30, 2020**.

The Appendix to this Alert describes the mechanics of filing, delivering, amending and otherwise satisfying the legal requirements with respect to a firm's Form CRS. This includes a summary of the required contents of the streamlined Form CRS.

Who is a Retail Investor?

The CRS Release defines "retail investor" as "a natural person, or the legal representative of such natural person, who seeks to receive or receives services primarily for personal, family or household purposes." This definition is revised from the definition proposed by the SEC in 2018, which included "a trust or other similar entity that represents natural persons, even if another person is a trustee or managing agent of the trust." The 2018 definition introduced some confusion among industry observers regarding the breadth of the definition, which could be read to include a private fund and its investors. The adopted definition, by narrowing the types of representatives (of natural persons) who can be deemed retail investors, reduces without eliminating this confusion. From the revisions to the definition and from the discussion in the CRS Release, it does not appear that the SEC intended to include private funds and their investors within the adopted definition of retail investor.

[1] Dual registrants also have the flexibility to prepare separate Forms CRS, neither exceeding two pages, for its brokerage services and for its investment advisory services. Affiliated broker-dealer and investment adviser firms have the same flexibility to prepare a single combined Form CRS of up to four pages.

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The CRS Release narrows the types of representatives who can be deemed retail investors by clarifying that a "legal representative" of a natural person, as used in the definition "retail investor," includes only "non-professional" legal representatives, such as a non-professional trustee representing a natural person's assets (as well as analogous representatives such as executors, conservators and persons holding a power of attorney for a natural person). The CRS Release states that the term "non-professional legal representative" is intended to include persons who are acting on behalf of a natural person and "who are not regulated financial services professionals retained . . . to exercise independent professional judgment." Thus, natural persons who participate in a wrap fee program, where the investment adviser sponsor of the program exercises its independent judgment on behalf of the program's participants, should be deemed retail investors only with respect to the investment adviser (and affiliated firms, if any) sponsoring the wrap fee program. On the other hand, a family office that is not required to register as an investment adviser by operation of Rule 202(a)(11)(G)-1 under the Advisers Act could be a retail investor. Other fact patterns may present greater uncertainty.

Consistent with the 2018 proposal, the adopted retail investor definition captures natural persons without regard to a natural person's assets or net worth. The CRS Release states that "all individual investors would benefit from clear and succinct disclosure regarding key aspects of available brokerage and advisory relationships." It follows that even an ultra-high net worth natural person can be a retail investor if the person is unrepresented or the person's legal representative is a non-professional legal representative. This underscores that a natural person's status as a retail investor may depend on the type of representative who stands between the investor and a firm. Consequently, for an institutional manager seeking to determine whether it has a Form CRS delivery obligation to a natural person who might be deemed a retail investor client, the analysis will focus on whether a regulated financial services professional exercising independent professional judgment stands between the institutional manager and the natural person.

With respect to participants in 401(k) plans and other workplace retirement plans,[2] the CRS Release clarifies that the definition of retail investor includes a natural person who is seeking to select or retain a firm for brokerage or advisory services for the person's workplace retirement account (this includes but is not limited to IRAs and individual accounts in workplace retirement plans). However, according to the CRS Release, participants in 401(k) plans and other workplace retirement plans are not retail investors for purposes of a Form CRS delivery obligation when participants are making ordinary plan elections that do not involve seeking to select or retain a firm for brokerage or advisory services.

Observations

1. ***Narrowing "Retail Investor" Definition.*** A firm that does not have any retail investors to whom the firm would be required to deliver a Form CRS is not required to prepare or to file a Form CRS. Therefore, we expect that many of our clients that are registered investment advisers to institutional separate accounts, private funds and registered funds will be able to interpret the revised definition of "retail investor" to avoid Form CRS entirely.

2. ***Disclosure Streamlining.*** To its credit, the SEC recognized that the SEC website is a better place for the abundance of educational and scripted disclosure that the SEC proposed in 2018. Therefore, the new requirement in Form CRS – to include an introductory paragraph with a link to the SEC's investor education website – also is a commendable change.

   In turn, this approach allows for a streamlined, two-page Form CRS that relies more heavily on layered disclosure and a notice-and-access electronic delivery regime. It follows that Form CRS is consistent with other SEC disclosure initiatives and appears to suit retail investors' preferences.[3]

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[2] The CRS Release clarifies that workplace retirement plans also include "any arrangement available at a workplace that provides retirement benefits or allows saving for retirement, including, for example, any 401(k) plan or other plan that meets requirements for qualification under [IRC] section 401(a), deferred compensation plans of state and local governments and tax-exempt organizations described by Code section 457, and annuity contracts and custodial accounts described by [IRC] section 403(b)."

[3] *See e.g.*, Securities Act Rule 498 (layered disclosure); 1940 Act Rule 30e-3 (notice-and-access electronic delivery).

Some caution is justified regarding the ultimate utility of Form CRS. In this vein, the CRS Release stated that "to help ensure that [Form CRS] fulfills its intended purpose, we have directed our staff to review a sample of relationship summaries that are filed with the Commission beginning after June 30, 2020 . . . and to provide the Commission with the results of this review." The staff's conclusions will be of interest to confirm or improve Form CRS's utility.

3. ***Guidance Relevant to Form ADV.*** The CRS Release provides some useful guidance to investment advisers required to make an off-cycle amendment to a Form ADV. Form ADV's instructions require an investment adviser to amend Part 1A, 1B, 2A and 2B (as applicable) of its Form ADV "promptly" upon the occurrence of certain specified events, but the SEC has never provided guidance regarding the meaning of "promptly." An investment adviser's Form CRS is required to be filed (as new Part 3 of its Form ADV) by the Investment Adviser Registration Depository ("IARD") (as it files its Form ADV Parts 1A and 2A).

   The CRS Release provides that an investment adviser is required to amend and file its Form CRS within 30 days whenever any information in the Form CRS "becomes materially inaccurate," by filing the amendment with the SEC by IARD. Discussing the 30-day period, in the CRS Release, the SEC stated that, "[b]ased on our experience with other similar filings, we believe the proposed [30-day] approach is consistent with the current requirements for investment advisers to update the Form ADV Part 2A brochure." This is a helpful express statement about the SEC's expectations regarding the timing of an amendment to a now-in-force Form ADV that is required to be made "promptly."

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The Appendix to this Alert describes the mechanics of filing, delivering, amending and otherwise satisfying the legal requirements with respect to a firm's Form CRS. This includes a summary of the required contents of the streamlined Form CRS.

For further information about how the issues described in this Alert may impact your interests, please contact your regular Ropes & Gray contact.

This alert should not be construed as legal advice or a legal opinion on any specific facts or circumstances. This alert is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. The contents are intended for general informational purposes only, and you are urged to consult your attorney concerning any particular situation and any specific legal question you may have. © 2019 Ropes & Gray LLP

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Form CRS Requirements

Transition Period

No later than **June 30, 2020**, firms must begin to deliver their Forms CRS to new and prospective clients and customers who are retail investors. No later than **July 30, 2020**, firms must deliver, on an initial one-time basis, their Forms CRS to existing clients and customers who are retail investors. Thereafter, the delivery requirements described below will apply.

Delivery in the Ordinary Course

For new clients, an investment adviser is required to deliver to retail investors its current Form CRS no later than the time it enters into an investment management agreement with the retail investor. For new customers, a broker-dealer is required to deliver to retail investors its current Form CRS at the earliest of its (i) making a recommendation of an account type, a securities transaction or an investment strategy involving securities, (ii) placing an order for the retail investor or (iii) opening a brokerage account for the retail investor.

With respect to existing clients and customers, the following delivery triggers apply. For each *existing* client [customer] who is a retail investor, an adviser [a broker-dealer] must deliver its Form CRS no later than the time it:

- opens a new account that is different from the retail investor's existing account(s),
- recommends that the retail investor roll over assets from a retirement account into a new or existing account or investment, or
- recommends or provides a new investment advisory [brokerage] service or investment that does not necessarily involve the opening of a new account and would not be held in an existing account.

Dual registrants, as well as affiliated broker-dealers and investment advisers offering their services to retail investors jointly, are required to deliver a Form CRS at the earlier of the delivery triggers for broker-dealers or investment advisers.

A firm may deliver its Form CRS and any amendment thereto by notice-and-access electronic delivery, if consistent with the existing arrangement with that client or customer and consistent with the SEC's framework regarding electronic delivery.[1] For an initial delivery of a Form CRS, a firm also may deliver the form to a new or prospective client or customer "in a manner that is consistent with how the retail investor requested information" about the firm (*e.g.*, as a direct link or in the body of an email or message).

Filing

An investment adviser is required to file its Form CRS (as new Part 3 of its Form ADV) by the Investment Adviser Registration Depository ("IARD") (as it files its Form ADV Parts 1A and 2A).[2] A broker-dealer is required to file its Form CRS with the SEC by the Central Registration Depository ("Web CRD") operated by FINRA. Dual registrants must file by IARD and Web CRD.

Form CRS Amendments

An investment adviser is required to amend and file its Form CRS within 30 days whenever any information in the Form CRS "becomes materially inaccurate," by filing the amendment with the SEC by IARD. The CRS Release states that the SEC "believe[s] the proposed approach is consistent with the current requirements for investment advisers to update the

[1] The framework consists of (i) notice that information is available electronically, (ii) access to information comparable to that which would have been provided in paper form and (iii) evidence of delivery.

[2] For its initial filing, an investment adviser may add its Part 3 to its Form ADV as an other-than-annual amendment or as part of its annual updating amendment.

Form ADV Part 2A brochure." Similarly, a broker-dealer is required to update and file its Form CRS within 30 days whenever any information in the Form CRS becomes materially inaccurate by filing the amendment with the SEC by Web CRD.

Firms will be required to communicate to retail investors who are existing clients or customers any amendment made to their Form CRS no later than 60 days after the amendment is required to be filed. Each amended Form CRS delivered to a retail investor who is an existing client or customer must highlight the most recent changes by marking the revised text or including a summary of material changes, with the additional disclosure showing revised text or summarizing the material changes attached as an exhibit to the unmarked amended Form CRS.

Form CRS Content Summary

The disclosure required in Form CRS is far less scripted than the disclosure that the SEC proposed in 2018. As adopted, much of the Form CRS disclosure follows standardized questions used as the topic headings, presented in a prescribed order. For the most part, firms may use their own wording to respond to each of the five items prescribed by Form CRS.

1. ***Introduction – Item 1.*** A firm's name and its SEC registration status is required. This item also requires statements to the effect that (a) brokerage and investment advisory services and fees differ, and that it is important for a retail investor to understand the differences and (b) free and simple tools to research firms and financial professionals, as well as educational materials, are available at the SEC's Investor.gov/CRS website.

2. ***Relationships and Services – Item 2***. A broker-dealer must disclose the types of brokerage services offered to retail investors, including whether it also offers recommendations to retail investors. An investment adviser must disclose the types of investment advisory services it offers to retail investors, including, for example, financial planning and wrap fee programs. If the investment adviser accepts discretionary authority, it must describe that authority and any material limitations on that authority. A firm also is required to disclose whether it (i) monitors retail investors' investments, including the frequency and any material limitations on that monitoring and (ii) makes available, or offers advice solely with respect to, proprietary products. Account minimums and other eligibility requirements also must be disclosed.

   Finally, firms must specifically refer to more detailed information about their services that, at a minimum, includes the information required by their Form ADV, Part 2A brochure (Items 4 and 7 of Part 2A or Items 4.A. and 5 of Part 2A Appendix 1) and Regulation Best Interest, if applicable.

3. ***Fees, Costs, Conflicts and Standard of Conduct – Item 3.*** This item covers three areas: (a) fees and costs, (b) standard of conduct and conflicts of interest and (c) financial professional compensation and related conflicts of interest.

   a. *Description of Principal Fees and Costs* requires a firm to summarize the principal fees and costs that retail investors will be charged. Broker-dealers must describe their transaction-based fees. Investment advisers must disclose their ongoing asset-based fees, fixed fees, wrap fee program fees or other direct fee arrangement. The conflicts of interest these fees create also must be disclosed. A firm also must include specific references to the more detailed information about its fees that, at a minimum, includes the information required by their Form ADV, Part 2A brochure (Items 5.A., B., C. and D.) and Regulation Best Interest, as applicable.

   b. *Standard of Conduct and Conflicts of Interest* requires firms to make scripted statements regarding the standard of conduct under which they operate with respect to retail investors, how the firm makes money from the relationship and the conflicts of interest the firm has in connection with the relationship. For example, an investment adviser must state (emphasis required):

      > ***When we act as your investment adviser***, we have to act in your best interest and not put our interest ahead of yours. At the same time, the way we make money creates some conflicts with your interests. You should understand and ask us about these conflicts because they can affect

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the investment advice we provide you. Here are some examples to help you understand what this means.

An investment adviser must describe any other ways in which the firm (or its affiliates) makes money from its services to the retail investor, as well as material conflicts of interest. The firm also must include specific references to the more detailed information regarding its conflicts of interest required in its Form ADV, Part 2A brochure or by Regulation Best Interest (as the case may be).

c. *Description of How Financial Professionals Make Money* requires a firm to summarize how it compensates its financial professionals, including cash and non-cash compensation, and the conflicts of interest those payments create.

4. ***Disciplinary History – Item 4.*** In this item, a firm must disclose whether the firm or its financial professionals have legal or disciplinary history. Disciplinary history includes information disclosed in a Form ADV, Form BD or, for financial professionals, on FINRA Forms U4, U5 or U6. A firm also must disclose that a retail investor may visit the SEC's Investor.gov/CRS website to research the firm and its financial professionals.
5. ***Additional Information – Item 5.*** A firm must disclose where a retail investor can obtain additional information about the firm's brokerage or investment advisory services and request a copy of the firm's current Form CRS.

Recordkeeping

The CRS Release also adopted amendments to the recordkeeping and record retention requirements under Advisers Act Rule 204-2 and Exchange Act Rules 17a-3 and 17a-4. Firms are required to create a record of the date on which each Form CRS was provided to a retail investor and to maintain copies of each Form CRS and each amendment thereto.

This alert should not be construed as legal advice or a legal opinion on any specific facts or circumstances. This alert is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. The contents are intended for general informational purposes only, and you are urged to consult your attorney concerning any particular situation and any specific legal question you may have. © 2019 Ropes & Gray LLP

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