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June 10, 2019

The challenges in embracing FinTech heard in SEC workshop

One of the biggest obstacles preventing investment advisers from investing in FinTech and digital currencies is a familiar nemesis: the custody rule.

"It's mind bogging to think of the challenges ahead" regarding custody and cryptocurrencies, said **Jay Baris**, a partner with **Shearman & Sterling** in New York. It may take regulators and the industry to be "a little creative" in coming up with solutions for assets that aren't physical, he added.

Baris spoke May 31 at the **SEC**'s FinTech forum. He predicted it will be a question of "when and not if" advisers will jump into the crypto pool in great numbers.

Hacking crypto

The SEC's **Jennifer McHugh** of the Division of Investment Management raised the issue of hacks and cryptocurrencies. **John D'Agostino**, global leader, investor engagement at **DMS Governance** in New York, said these risks have already been "priced in" by institutional investors.

"This is a new reality that we're going to have to get used to," Baris said about the risk of hacking. "You can't 100% solve this issue."

Worries about crypto hacks may drive some away from the space but "what's stopping" institutional investors from buying is really "the quality" of the asset class, said D'Agostino.

He ticked off three major challenges preventing a

(Embracing FinTech, continued on page 5)

In party-line vote, SEC commissioners approve fiduciary duty proposals

For decades, the **SEC** has ridden the sword's edge when it comes to balancing the oversight of two very different investment professionals – investment advisers and broker-dealers. On June 5, a divided Commission took a step toward crafting what it means for each to be a fiduciary when serving retail clients.

"This has been long overdue," said SEC Chairman **Jay Clayton** in opening a two-hour meeting that could dramatically reshape how some broker-dealers do business. By 3-1 votes – with the panel's lone Democrat dissenting – the Commission approved four items:

1. Regulation Best Interest that defines a new fiduciary duty standard for broker-dealers (see related story on page 3).

2. Form CRS, which will require IAs and B-Ds to produce new plain-English disclosures designed to help investors choose the right professional for them (see related story on page 3).

(SEC Acts, continued on page 2)

IA interpretation

Few changes made to final IA fiduciary duty interpretation from proposal

At the center of the commissioner disagreement at their June 5 meeting over the **SEC**'s investment adviser fiduciary duty proposal is whether the final version weakens the decades' long standard (see related story above).

The lone dissenter in the Commission's 3-1 vote approving the final interpretation, Commissioner **Robert Jackson**, maintained the standard is weakened. But SEC staff insisted the standard mirrors the one originating from the **Supreme Court**'s 1963 Capital Gains case.

"Fiduciary duty is a principles' approach," said **Dalia Blass**, the director of the Division of Investment Management. She added the final interpretation, which has yet to be released by the Commission, would reaffirm and clarify the IA standard.

"This is not a new fiduciary standard or a watered-down fiduciary standard," Blass continued. The final

(IA Interpretation, continued on page 2)

SEC Acts *(Continued from page 1)*

3. An **investment adviser fiduciary duty interpretation** that clarifies what the duty means for IAs (see related story on page 1).

4. An **interpretation of "solely incidental"** designed to make clearer when a broker-dealer crosses the line to become an IA (see related story on page 4).

With the exception of the two interpretations – which will become effective when they're published in the *Federal Register* – the industry will have until June 30, 2020 to comply with Reg BI and distribute their new Form CRS.

The Commission's territory

"The SEC is uniquely positioned" to take on these changes, said Clayton, even as he acknowledged that the Commission has taken some elements from the **Labor Department**'s ill-fated fiduciary duty rule. However, other parts were left out, such as requiring a best interest contract or permitting a private right to sue.

The Commission passed on creating a uniform fiduciary duty standard for IAs and B-Ds. "I firmly believe this is the right approach," said Clayton. The rules "should reflect these different characteristics" separating IAs and B-Ds, he noted. "A one-size-fits-all approach" would ignore the different regulatory regimes carved out over the decades, raise risks for investors and limit their choices, Clayton continued.

"We've all been waiting for this moment for a long time," said Commissioner **Hester Peirce**, before cutting the tension in the room with a joke that alluded to last week's loss by noted *Jeopardy* game contestant **James Holzhauer**.

Commissioner **Robert Jackson** lamented his colleague's actions. "Rather than requiring Wall Street to put investors first, today's rules maintain a muddled standard," he said, adding American investors are harmed by conflicted advice. Reg BI fails to define the term "best interest" and "enshrines in law the blurred lines between these different business models," he continued.

"Take a fair look at what the release actually says before you declare it a success or a failure," implored Peirce of would-be critics.

A challenging year ahead

"The next year will be an important period" when the industry will implement the changes mandated by the Commission's action, said Commissioner **Elad Roisman**. He encouraged SEC staff to release rolling FAQs to assist the industry with compliance and urged OCIE to work with **FINRA** to examine brokers "in a methodical and consistent way" for compliance with Reg BI.

The Commission also plans a public outreach campaign to educate the 43 million American households affected by the changes, which were reached after SEC staff sifted through thousands of comments and feedback from the industry and investors. ■

This story first appeared as breaking news at www.regcompliancewatch.com on June 5. ■

IA Interpretation *(Continued from page 1)*

interpretation is a "consolidated source that draws together" decades of interpretations about what it means for an adviser to be a fiduciary, she said.

Laying out an IA's duty

Like the proposed interpretation, the final one will emphasize a duty of care and loyalty (**IA Watch**, April

(IA Interpretation, continued on page 3)

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2. Whistleblower Escalation Policy
3. Whistleblower Practice Guide
4. Whistleblower Policy
5. OCIE Whistleblower Sweep Letter ■

IA Interpretation *(Continued from page 2)*

26, 2018). But there are differences, too. The final version will include guidance on how the standard applies when an investor is retail versus institutional. It also now applies to rollovers and retirement plans. An adviser wouldn't be able to waive its fiduciary duty. The interpretation also will include examples of the standard in practice as well as describe what's considered to be full and fair disclosure.

"We don't expect any real fundamental changes," said **Gail Bernstein**, general counsel of the **Investment Adviser Association** in Washington, D.C., while adding she awaits reading the final version. ■

Regulation Best Interest

SEC finalizes 'a new standard of conduct' for broker-dealers

Broker-dealers have one year to ready for the major changes many will have to make to comply with the **SEC**'s new Reg BI after the Commission's 3-1 vote on June 5 to finalize the rule (see related story on page 1).

SEC Chairman **Jay Clayton** contended that the rule "would establish a new standard of conduct" for B-Ds, while preserving "retail investor access in terms of both choice and cost to a variety of investment services and products."

Brett Redfearn, the director of the Division of Trading and Markets, called the new standard "quantitative suitability." Reg BI took "similar elements" from the IA fiduciary duty standard but it's not the same as the IA standard. Reg BI will hold B-Ds to put their clients' interest ahead of their own.

Commissions allowed

While Reg BI would permit commissions and transaction-based compensation, it would ban sales contests, quotas, bonuses and non-cash compensation.

The standard hangs on four elements: 1. Disclosure 2. Care 3. Conflicts of interest and 4. Compliance. These four obligations "culminate in a new, explicit obligation for broker-dealers to act in their customers' best interest," said Redfearn.

Compliance P&Ps "must address not only conflicts of interest but also compliance with its Disclosure and Care Obligations under Regulation Best Interest," reads the final rule.

The rule would apply to rollovers and account transfers and account recommendations, which was a departure from the proposal (**BD Watch**, April 19, 2018). It also would expect B-Ds to consider costs and to weigh alternatives. "Cost will always be a relevant factor," said Redfearn, but it won't be the only factor and a rep wouldn't be mandated to sell only the lowest cost product.

Given this, Commissioner **Robert Jackson** voted against finalizing the rule.

Commissioner **Hester Peirce** said the Commission should track how the rule affects B-Ds in hopes it reverses a trend. "The falling number of broker-dealers is a trend we want to arrest," she said.

Redfearn said the rule will expect that reps understand the products that they sell. It also may be wise for B-Ds to have a product review committee, he added.

Disclosure won't be able to relinquish a broker's fiduciary duty obligations. Disclosures would have to be in writing with limited exceptions. Oral disclosures could come only after the client has received the written variety and the rep would have to document the conversation with the client.

It would have to be disclosed that the rep is monitoring a client's account and the rep would have to have a reasonable belief that she is acting in the client's best interest.

Reg BI also includes a prohibition against a B-D using the term "advisor" or "adviser" unless the firm or rep is connected with an RIA. ■

Form CRS

Form CRS aimed at delivering 'clear and concise' disclosure

Succinct, clear and concise, and Plain-English aren't usually the buzz words affixed to **SEC** disclosures but those are among the goals for the Form CRS Relationship Summary approved by the Commission June 5. Investment advisers and broker-dealers will have to create and deliver their Form CRSs by June 30, 2020, according to the new final rule, which also amends Form ADV (**IA Watch**, April 26, 2018).

The SEC Division of Investment Management's Director **Dalia Blass** characterized Form CRS as an accessible "entry point" for retail investors looking for more information on financial professionals. She foresees "clear and concise" information about investment advisers and broker-dealers being delivered via Form CRS.

The form's elements

IAs and BDs will now be required to deliver a relationship summary to retail investors at the beginning of their relationship. Firms will have to summarize information about their services, fees and costs, conflicts

(Form CRS, continued on page 4)

Form CRS *(Continued from page 3)*

of interest, legal standard of conduct, and whether they and their financial professionals have a disciplinary history.

While facilitating "layered" disclosure, the SEC noted that the format of the relationship summary allows for comparability among the two different types of firms in a way that is distinct from other required disclosures. SEC Chairman **Jay Clayton** hailed Form CRS as an "improvement over existing disclosure."

Standardized format

The relationship summary will have a standardized Q&A format to promote comparison by retail investors. The layered disclosure will allow investors ease of access to additional information from the firm about the topics. Form CRS will also include a link to a dedicated page on the SEC investor education website (www.investor.gov). The relationship summary also encourages investors to ask questions and highlights additional sources of information.

Clayton stated that the relationship summary is designed to help retail investors select or determine whether to remain with a firm or financial professional by providing better transparency and summarizing in one place selected information about a particular broker-dealer or investment adviser. Form CRS advances the SEC's goals of transparency and comparability, he noted.

The final rule doesn't contain sample Form CRS disclosures as the proposed rule did. It also doesn't prohibit a broker-dealer from using the term "advisor" or "Adviser" in its name. Instead, that prohibition has been moved to Reg BI (see related story on page 3).

'Meet clients where they are'

SEC Commissioner **Hester Peirce** was pleased that the Commission was abandoning paper as its default position for disclosure. While Form CRS would not be required to be in paper format—audio, video, chat functionality, etc. would be allowed—it was noted that firms would still need to heed the form's content requirements. Tables and graphs versus text also would be fine, again as long as the content requirements are satisfied. Using different technologies will allow firms to "meet clients where they are," Peirce noted.

SEC Commissioner **Robert Jackson**, however, wasn't enthused. He was chagrined that the final rule gives the industry new "flexibility" to "use their own wording" in describing themselves to investors, and expressly declines to require firms to disclose every material conflict.

SEC Investor Advocate **Rick Fleming** also expressed concern. He believes that Form CRS "likely will not achieve its original goal of preventing the financial harm that results from investor confusion about the differences between investment advisers and broker-dealers."

Clayton reported that as part of a roll out of a Main Street Investor educational campaign, the SEC will create a landing page to click thru Form CRS.

Should you have questions about the new disclosure requirement, the SEC directs you to e-mail them at IABDQuestions@sec.gov. ■

'Solely incidental' interpretation

SEC interpretation of 'solely incidental' to confirm and clarify position

The **SEC**'s approval by a 3-1 vote of the issuance of an interpretation of the "solely incidental" prong of the broker-dealer exclusion under the Advisers Act should deliver for broker-dealers clarity that the industry has long sought (**IA Watch**, May 30, 2019).

While the interpretation was not part of the Commission's original proposed fiduciary duty rulemaking package, disagreement gleaned from comments about when broker-dealer investment advice falls within the solely incidental prong spurred the SEC to act.

Currently, the broker-dealer exclusion under Advisers Act Section 202 excludes from the definition of an investment adviser a broker or dealer whose performance of advisory services is "solely incidental" to the conduct of his business as a broker or dealer and who receives no special compensation for those services.

Clearer delineation

The final interpretation is aimed at more clearly delineating when a broker-dealer's performance of advisory activities causes it to become an investment adviser within the meaning of the Advisers Act. It is hoped that the as-of-yet-unreleased interpretation will help address confusion in the retail investor market for investment advice.

The SEC noted that this interpretation confirms and clarifies the Commission's position and illustrates "the application in practice in connection with exercising investment discretion over customer accounts and account monitoring."

The final interpretation states that a B-D's advice as to the value and characteristics of securities or as to the advisability of transacting in securities falls within the "solely incidental" prong of this exclusion if the advice

('Solely Incidental,' continued on page 5)

'Solely Incidental' *(Continued from page 4)*

is provided in connection with and is reasonably related to the B-D's primary business of effecting securities transactions, the SEC added.

The SEC indicated that a B-D would cross the line and lose the exclusion if it persisted with "unlimited discretion" in a client's account.

Dissension among the ranks

SEC Commissioner **Robert Jackson** cast the lone vote against the interpretation, expressing concern that the new interpretation "simply enshrines into law the blurred lines between two very different business models."

SEC Investor Advocate **Rick Fleming** expressed his belief that the interpretation "merely serves to formalize the Commission's longstanding deference to broker-dealers who engage in conduct that is advisory in nature." ■

Embracing FinTech *(Continued from page 1)*

greater embrace of FinTech and cryptocurrencies: (1) valuation (2) the custody question and (3) concerns about money laundering. Valuation can be addressed through disclosure. Custody is "the most solvable issue" but the money laundering concerns present great difficulty, added D'Agostino. Perhaps greater encryption could address those concerns, he said.

Amy Steele of **Deloitte** spoke of the auditing challenges. Given that an asset isn't physical, "how do you prove it exists?" she asked. "You have to prove that you control the asset in order to have it on your books," she noted. Perhaps a secured message sent via Blockchain could provide proof, she suggested.

As for custody, the "key" to a cryptocurrency could be kept in "very deep cold storage" at a bank, Steele added. "If someone gets that key, they now control" the asset, she said. "That key is so important."

Not an easy fit

At the beginning of the daylong event, SEC Chairman **Jay Clayton** noted that FinTech "doesn't fit neatly into any spot within the Commission" yet the new technology "cuts across" the entire organization. FinTech "presents many challenges," he noted.

Commissioner **Hester Peirce** said both new and old technologies carry risks but that the SEC should encourage change. "FinTech innovations can diversify peoples' portfolios, open life changing doors" for first-generation investors and "connect aspiring entrepreneurs to people with money who live thousands of miles away from them," she said.

The "legacy" the SEC should leave for the next generation "is a robust legal framework from which people can explore, experiment and express themselves in ways that make our society more exceptional," Peirce implored.

Dalia Blass, IM director, reminded the audience that the SEC has requested industry comment on what policy direction the agency should take regarding the aging custody rule in the new milieu (**IA Watch**, March 14, 2019). ■

Justice Department argues Lucia's appeal should be dismissed

The latest episode in the seven-year battle between a former San Diego investment adviser and the **SEC** over allegedly misleading marketing – a case that gave the IA a U.S. **Supreme Court** victory last year – has the **Justice Department** arguing that **Ray Lucia** can't seek to dismiss the continuing ALJ enforcement action against him.

A court filing June 3 by the DOJ in federal court in California asserts that court precedent holds that the SEC's enforcement action must play out.

After the High Court last year found part of the SEC's ALJ system to be unconstitutional and ordered the case against Lucia to be returned to the ALJ setting (albeit with a different judge overseeing the case, **IA Watch**, June 22, 2018), Lucia filed a lawsuit last November seeking to have his case dismissed altogether, claiming the ALJ system remains unconstitutional due to how the judges can be fired (**IA Watch**, Nov. 29, 2018).

"Here, the sole object of Plaintiffs' claim is to prevent the SEC from continuing the enforcement proceedings," argued the DOJ, noting the case remains unfinished. "And Plaintiffs could prevail before the Commission" ultimately, the DOJ continued.

"The SEC has used ALJs since the Commission's early days," the filing reads. The DOJ also disputes Lucia's claims that the Commission took too long to hold a hearing after the case was originally filed in 2012. Also, federal law permits the Commission to remove ALJs, thus not violating the Constitution's separation of powers' provisions, the DOJ argued.

Déjà vu all over again

One of Lucia's attorneys, **Margaret Little** of the **New Civil Liberties Alliance** in Washington, D.C., says should the DOJ's argument prevail "that means that Ray Lucia will be tried a second time" before an SEC ALJ "who is still unconstitutional." Should Lucia lose for a second time, then he would be forced to engage in the

(DOJ Opposes Lucia, continued on page 6)

DOJ Opposes Lucia *(Continued from page 5)*

entire appeals process all over again, she added.

Little noted that Supreme Court Justice **Stephen Breyer** warned last year that the issue of the constitutionality of the SEC ALJ setting could return to the High Court over the hiring and firing issue.

Lucia "is determined to vindicate his constitutional right to only be tried before a constitutional judge," states Little.

A DOJ attorney didn't return **IA Watch** inquiries.

An August hearing is set in U.S. District Court for Southern California. ■

OIG to judge the SEC's cybersecurity when using the cloud

Two years after a noteworthy international hack of the **SEC**'s EDGAR system, the agency's Office of Inspector General will be scrutinizing whether the Commission has adequate protections while using the cloud (**IA Watch**, Jan. 17, 2019).

The revelation appears in the OIG's new *Semiannual Report to Congress*. OIG **Carl Hoecker** notes it has been nine years since the government encouraged federal agencies to move to cloud computing. The OIG "will assess the SEC's strategy" and cybersecurity.

The OIG also stated that it's looking into how the SEC's Division of Economic and Risk Analysis works with OCIE, and how the agency uses DERA's data.

The report, covering October 2018 through March 2019, indicated the OIG received 484 complaints, including 243 via its hotline during the six-month period. The SEC employs 4,355 full-time staffers. During the six months, the OIG closed 12 investigations and made 10 referrals to the **Justice Department**, three of which were accepted for prosecution.

One of the investigations the report summarized concerned two unidentified "senior employees" who each reviewed employment applications for staff positions for which their respective spouses also applied. Such conflicts of interest are "inconsistent with SEC policies," the OIG found.

The DOJ declined to prosecute but management gave one employee a 14-day suspension and the second a 10-day suspension, the OIG stated.

A second investigation began last year when a contractor e-mailed to his personal account a zip file "containing nonpublic SEC information as well as personally identifying information related to several" Enforcement Division investigations. ■

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