What just happened?

On April 18, in a 4-1 vote, the United States Securities and Exchange Commission (the “SEC”) proposed a comprehensive rule set governing the fiduciary duty and standard of conduct applicable to broker-dealers and investment advisers that provide retail investment advice. The proposed rules would:

- Require broker-dealers and investment advisers to summarize their relationship to retail investors in a document not to exceed 4 pages;
- Establish a broker-dealer best interest standard of conduct when recommending securities transactions to retail customers;
- Restrict the use of the term “adviser” or “advisor” by broker-dealers in specified circumstances; and
- Require investment advisers to adhere to a new SEC standard of conduct interpretation.

Commissioner Stein was the lone dissenter, but Commissioners Jackson, Peirce, and Piwowar each made clear that they had significant concerns notwithstanding their votes in favor of releasing the proposals for public comment. Commissioner Jackson also noted that he could not today support the proposals if they were the final rules.

The rule package comprises three parts:

- A Broker-Dealer Standard of Conduct (“Regulation Best Interest”);¹
- New Disclosures for Broker-Dealers, Advisers and Dual-Registrants (the “Form CRS Relationship Disclosure”);² and
- Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers and a Request for Comment on Enhancing Investment Adviser Regulation.³

The broker-dealer standard

What would be required by the broker-dealer’s best interest standard?

Proposed Regulation Best Interest (“Regulation BI”) would require broker-dealers, as well as any persons associated with the broker-dealer, when making recommendations of any securities transaction or investment strategies to retail customers, to act in the best interest of the retail customer at the time the recommendation is made. In addition, the recommendation must not place the interests of the broker-dealer ahead of the retail customer’s interests.⁴

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4 Proposed § 240.15l-1(a)(1).
Although the “best interest” standard is not specifically defined in the proposal, the SEC’s proposal offers a “safe harbor” of sorts, where compliance with each one of the following three conditions would satisfy the “best interest” standard:

- **Disclosure.** At the time the recommendation is made, the broker-dealer must reasonably disclose to the retail customer, in writing, the material facts relating to the scope of the brokerage relationship, including all material conflicts of interest that are associated with the securities recommendation.\(^5\)

- **Care.** In making the recommendation, the broker-dealer must exercise reasonable care. The SEC clarified that reasonable care must be taken to ensure that the recommendation could be in the best interest of at least some retail customers, in the best interest of a particular retail customer based on that customer’s investment profile, and is not excessive and is in the retail customer’s best interest when taken together as a series of recommended transactions.\(^6\)

- **Conflict of interest.** Broker-dealers must establish and maintain written policies and procedures to identify and disclose, or eliminate, material conflicts of interest associated with a recommendation. More specifically, firms are required to establish procedures to identify, disclose, and mitigate (or eliminate) material conflicts of interest arising from financial incentives associated with the recommendation.\(^7\)

What this means for broker-dealers is that Regulation BI would require them to perform enhanced suitability review of recommended securities transactions. Portions of the Regulation BI language is lifted directly from the existing suitability rule administered by the Financial Industry Regulatory Authority, Inc. (“FINRA”), Rule 2111, applicable to broker-dealers.

But, in addition to a broker-dealer’s existing suitability obligations, which in many respects already impose a “best interest” conduct standard for recommended transactions, Regulation BI also imposes separate disclosure and conflict mitigation requirements. For instance, the disclosure requirements would go beyond the summary provided under proposed Form CRS, and would require more specific fee disclosures and a more comprehensive disclosure of material conflicts of interest. In addition, under Regulation BI, broker-dealers would be expected to mitigate conflicts of interest related to their financial incentives, including conflicts associated with sales contests or special trips and awards for selling certain investment products.

**How must broker-dealers address conflicts that create financial incentives?**

As noted above, the third and final prong of Regulation BI relates to broker-dealers’ conflicts of interest. Under this prong, a broker-dealer is required to establish, maintain, and enforce written policies and procedures to deal with two types of conflicts—general conflicts and conflicts arising from financial incentives.

- **General conflicts.** First, Regulation Best Interest acknowledges that a broker-dealer must address general material conflicts of interest that are associated with any recommendations made to retail customers. Regulation BI defines a “material conflict of interest” as “a conflict of interest that a reasonable person would expect might incline a broker-dealer—consciously or unconsciously—to make a recommendation that is not disinterested.” To satisfy this obligation, broker-dealers are required to both identify and disclose such conflicts, or eliminate them entirely.

- **Conflicts arising from financial incentives.** Regulation BI also requires broker-dealers to address material conflicts of interest arising from financial incentives associated with any recommendations made to retail customers. The SEC has provided a non-exhaustive list of material conflicts of interest arising from financial incentives, including: (1) compensation practices established by the broker-dealer; (2) employee compensation or employment incentives; (3) compensation practices involving third parties; (4) receipt of commissions or sales charges or other fees or financial incentives or differential or variable compensation; (5) sales or proprietary products or services or products of affiliates; and (6) principal transactions. To satisfy this obligation, broker-dealers are required to identify, disclose, and mitigate such conflicts arising from financial incentives, or avoid them entirely. In other words, under Regulation BI, disclosure alone is not sufficient for a conflict arising from a financial incentive.

- **Elimination of conflicts.** The SEC also expects broker-dealers to, at minimum, disclose (and mitigate, if necessary) or eliminate material conflicts of interest. While the SEC notes that broker-dealers will not be required to eliminate any particular conflicts of interest, it notes that a firm may choose to do so by removing incentives associated with particular products, by removing products with special incentives, or by negating the effect of the conflict. Furthermore, the SEC notes that there may be instances when elimination is necessary, because any disclosure of such conflict may be insufficient. Examples may include conflicts for which a disclosure cannot be made in a manner that will allow a retail customer to understand the conflict, or where it is not obvious to a broker-dealer that it is not putting its own interest ahead of the retail customer’s interest. The SEC also notes that certain material conflicts of interest arising from financial incentives should be eliminated for certain retail customers. Specifically, Regulation BI suggests eliminating the payment or receipt of non-cash compensation such as sales contests, trips, prizes, and other similar bonuses that are based on sales of certain securities or accumulation of assets under management. The SEC suggests that

\(^5\) Proposed § 240.15l-1(a)(2)(i).
\(^6\) Proposed § 240.15l-1(a)(2)(ii).
\(^7\) Proposed § 240.15l-1(a)(2)(iii).
broker-dealers may not be able to comply with the best interest obligation while participating in conflicts of interest arising from these types of financial incentives.

- **Mitigation of conflicts.** Regulation BI notes that the level of mitigation may vary based on the conflict of interest. Independent of facts or circumstances, Regulation BI requires broker-dealers to mitigate conflicts of interest when engaging in principal trades. For example, “heightened mitigation” may be necessary in situations involving a less sophisticated retail customer. Heightened mitigation may also be necessary if compensation arrangements are less transparent. Additionally, the types of conflicts involved in the recommendation, or the complexity of a product, may warrant heightened mitigation. Regulation BI notes that a broker-dealer could decide to apply the same mitigation measures to similar retail customers, similar products, or similar compensation conflicts. The SEC suggests a list of potential practices that broker-dealers should consider incorporating into their supervisory programs: (1) avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales; (2) minimizing compensation incentives for employees to favor one type of product over another, proprietary or preferred provider products, or comparable products sold on a principal basis; (3) eliminating compensation incentives within comparable product lines; (4) implementing supervisory procedures to monitor recommendations that are near compensation or recognition thresholds; and (5) limiting the types of retail customers to whom a product, transaction or strategy may be recommended.

**What policies and procedures will broker-dealers and investment advisers have to implement to comply with the new obligations?**

Under the proposal, broker-dealers and investment advisers will have to prepare and adopt, and then maintain and enforce on an ongoing basis, certain policies and procedures. As discussed above, Regulation BI would explicitly require broker-dealers to adopt policies and procedures reasonably designed to address material conflicts of interest, including identifying and disclosing (or eliminating) material conflicts of interest associated with recommendations. In addition, broker-dealers would also be required to adopt policies and procedures reasonably designed to identify, disclose, and mitigate (or eliminate) material conflicts of interest arising from the financial incentives associated with recommendations. Since material conflicts arising from financial incentives may include sales contests and other cash or non-cash rewards, broker-dealers will need to think about how they plan to adequately mitigate (or completely eliminate) these conflicts when drafting their policies and procedures.

**Disclosure**

**What information will broker-dealers and investment advisers have to disclose to customers/clients?**

The proposal requires broker-dealers, investment advisers, and dual registrants to provide certain prescribed and narrative disclosures in a new Form CRS (or “Relationship Summary”). Form CRS would need to be provided to investors before or at the time a retail customer engages the services of a broker-dealer, or before or at the time a retail customer enters an advisory agreement with an investment adviser. The Relationship Summary is limited to a maximum of four pages, and must include a total of eight parts: (1) an introduction; (2) a description of the broker-dealer’s, adviser’s, or dual registrant’s relationship with the retail customer and the services provided; (3) the standard of conduct applicable to the relationship; (4) a summary of fees and costs; (5) a comparison of advisory and brokerage services; (6) a disclosure of certain conflicts of interest; (7) additional information, such as disciplinary history and other resources; and (8) key questions that the retail customer should ask the broker-dealer or investment adviser.

- **Introduction.** The introduction to Form CRS requires a broker-dealer, investment adviser, or dual registrant to disclose its registration status and the date of the Form CRS. Broker-dealers, investment advisers, or dual registrants would be required to explain the types of accounts and services its firm offers and the purpose of the Relationship Summary.

- **Relationships and services.** Following the introduction, firms would be required to disclose the relationships between the firms and its retail customers, including a description of services, nature, scope and duration of the services available. Specifically, broker-dealers and advisers would be required to emphasize the differences in compensation (transaction-based versus percentage of assets under management), as well as other services offered for which retail customers might pay additional fees. In addition, firms would be required to disclose limitations on the types of investments available and the frequency and methods of communications with retail customers.

- **Standard of conduct.** Broker-dealers and investment advisers would be required to explain the standard of conduct applicable to their relationship with retail customers, as well as state the existence of conflicts of interest and the duty to disclose, mitigate or eliminate conflicts, as required under Regulation BI or the federal fiduciary standard.

- **Summary of fees and costs.** Firms would be required to disclose the principal type of fees that retail customers will pay for services, as well as other fees that may affect retail customers’ investments over time, such as redemption fees or surrender charges. While the SEC does not intend this section to include personalized fees, this section will include prescribed language prompting

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8 Proposed § 240.15l-1(a)(2)(iii).
retail customers to ask their financial professionals to provide personalized information on fees and costs.

- **Comparisons.** In addition to providing retail customers with an explanation of their relationship with customers and services they provide, broker-dealers are also required to provide a comparison of their services to investment advisers, and investment advisers are required to provide a comparison of their services to broker-dealers. These comparisons must include a tabular chart comparing transaction-based fees and asset-based fees, the standard of conduct applicable to the services of a broker or adviser, and the inherent conflicts of interest based on the principal type of compensation of a broker or adviser.

- **Conflicts of interest.** Aligned with the disclosure requirements of Regulation BI, broker-dealers are required to provide a summary of certain conflicts of interest. Instead of requiring an exhaustive list of all conflicts of interest, Form CRS would focus on “conflicts relating to: (i) financial incentives to offer to, or recommend that the retail investor invest in, certain investments because (a) they are issued, sponsored or managed by the firm or its affiliates, (b) third parties compensate the firm when it recommends or sells the investments, or (c) both; (ii) financial incentives to offer to, or recommend that the retail investor invest in, certain investments because the manager or sponsor of those investments or another third party (such as an intermediary) shares revenue it earns on those products with the firm; and (iii) the firm buying investments from and selling investments to a retail investor for the firm’s own account (i.e., principal trading).”

- **Additional information.** Firms will be required to acknowledge whether the firm or its financial professionals have a record of certain legal or other disciplinary events, and provide information on where investors may find more information about any such events. Broker-dealers and advisers will also be required to include information on where retail customers can find additional information about the firms' services and fees, including additional disclosures on firm, SEC and SRO websites.

- **Key questions.** Form CRS concludes by providing a list of ten questions that are required to be included to the extent applicable to the broker-dealer’s or adviser’s business. The SEC permits firms to extend this list of questions with additional frequently asked questions from customers; however, the total list is limited to a maximum of fourteen total questions.

**How is the proposed interpretation for advisers different from the fiduciary standard that exists today?**

The proposed interpretation for investment advisers is not significantly different from the fiduciary standard that exists today for investment advisers. In the words of the SEC, the proposed interpretation is an attempt to “reaffirm—and in some cases clarify—certain aspects of the fiduciary duty that an investment adviser owes to its clients under section 206 of the Advisers Act.” The interpretation notes that SEC-registered investment advisers are subject to a duty of care and a duty of loyalty and that the fiduciary duty requires each adviser, at all times, to serve the best interest of its clients and not subordinate its clients’ interest to its own.

The interpretation observes that the federal fiduciary duty is imposed through the antifraud provisions of the Advisers Act. The duty follows the contours of the relationship between the adviser and its client, which means an adviser and its client may shape that relationship through contract when the client receives full and fair disclosure and provides informed consent. While the fiduciary duty will vary with the terms of the relationship, in all cases it remains that of a fiduciary to a client. As a result, an investment adviser cannot disclose or negotiate away, and the investor cannot waive, the federal fiduciary duty.

**Duty of care**

As fiduciaries, investment advisers owe their clients a duty of care, which includes: (1) the duty to act and to provide advice that is in the best interest of clients; (2) the duty to seek best execution of clients’ transactions where the advisers have responsibility to select broker-dealers to execute client trades; and (3) the duty to provide advice and monitoring over the course of client relationships.

When an adviser provides personalized investment advice, the duty of care includes a duty to make a reasonable inquiry into a client’s “investment profile” and a duty to provide personalized advice that is suitable for and in the best interest of the client based on the client’s investment profile. Before providing any personalized investment advice and as appropriate thereafter, an adviser must make a reasonable inquiry into the client’s investment profile. The nature and extent of the inquiry turn on what is reasonable under the circumstances, including the nature and extent of the agreed-upon advisory services, the nature and complexity of the anticipated investment advice, and the investment profile of the client. An adviser must update a client’s investment profile in order to adjust its advice to reflect any changed circumstances. The frequency with which the adviser must update the information would turn on many factors, including whether the adviser is aware of events that have occurred that could render inaccurate or incomplete the investment profile on which it currently bases its advice.

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9 SEC, Form CRS, Section II.B.6.
Consistent with prior statements of the SEC, the proposed interpretation notes that whether the advice is in a client’s best interest must be evaluated in the context of the portfolio that the adviser manages for the client and the client's investment profile (and not on a transaction-by-transaction basis). The cost (including fees and compensation) associated with investment advice would generally be one of many important factors to consider when determining whether a security or investment strategy is in the best interest of the client. Accordingly, the fiduciary duty does not require an adviser to recommend the lowest-cost investment product or strategy. Furthermore, an adviser would not satisfy its fiduciary duty to provide advice that is in the client’s best interest by simply advising its client to invest in the least expensive (or least remunerative) investment product or strategy if there is no further analysis of other relevant factors.

The proposed interpretation notes that the duty of care requires that an adviser conduct a reasonable investigation into the investment. The interpretation also provides that the obligation to provide advice that is suitable and in the best interest applies not just to potential investments, but to all advice the investment adviser provides to clients, including advice about an investment strategy or engaging a sub-adviser and advice about whether to rollover a retirement account so that the investment adviser manages that account.

As to the duty to seek best execution, the SEC reiterates its prior guidance that an adviser must seek to obtain the execution of transactions for each of its clients such that the client’s total cost or proceeds in each transaction are the most favorable under the circumstances. An adviser fulfills this duty by executing securities transactions on behalf of a client with the goal of maximizing value for the client under the particular circumstances occurring at the time of the transaction. Maximizing value can encompass more than just minimizing cost. When seeking best execution, an adviser should consider the full range and quality of a broker’s services in placing brokerage. In other words, the determinative factor is not the lowest possible commission cost but whether the transaction represents the best qualitative execution. In addition, the proposed interpretation reiterates prior guidance by the SEC that an investment adviser should “periodically and systematically” evaluate the execution it is receiving for clients.

Finally, the proposed interpretation notes that an investment adviser’s duty of care encompasses the duty to provide advice and monitoring over the course of a relationship with a client. In particular, an adviser is required to provide advice and services to a client over the course of the relationship at a frequency that is in the best interest of the client and consistent with the scope of advisory services agreed upon between the investment adviser and the client. However, the steps needed to fulfill this duty may be limited for an adviser that has agreed to a relationship of limited duration via contract with the client.

**Duty of loyalty**

The duty of loyalty requires an investment adviser to put its clients’ interests first. An investment adviser must not favor its own interests over those of a client or unfairly favor one client over another. As it has stated in prior releases, the SEC notes in the proposed interpretation that in seeking to meet its duty of loyalty, an adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship. In addition, an adviser must seek to avoid conflicts of interest with its clients, and, at a minimum, make full and fair disclosure of all material conflicts of interest that could affect the advisory relationship. The disclosure must be sufficiently specific so that a client is able to decide whether to provide informed consent to the conflict of interest.

The proposed interpretation also repeats prior guidance in observing that since an adviser must serve the best interests of its clients, it has an obligation not to subordinate its clients’ interests to its own. For example, an adviser cannot favor its own interests over those of a client, whether by favoring its own accounts or by favoring certain client accounts that pay higher fee rates to the adviser over other client accounts. Accordingly, the duty of loyalty includes a duty not to treat some clients favorably at the expense of other clients. For instance, in allocating investment opportunities among eligible clients, an adviser must treat all clients fairly.

One new formulation in the proposed interpretation is the statement that “[d]isclosure of a conflict alone is not always sufficient to satisfy the adviser’s duty of loyalty and section 206 of the Advisers Act.” In this respect, the proposed interpretation again emphasizes that any disclosure must be clear and detailed enough for a client to make a reasonably informed decision to consent to such conflicts and practices or reject them and that an adviser must provide the client with sufficiently specific facts so that the client is able to understand the adviser’s conflicts of interest and business practices well enough to make an informed decision. For example, an adviser disclosing that it “may” have a conflict is not providing adequate disclosure if the conflict actually exists.

In an attempt to provide additional guidance to investment advisers, the proposed interpretation provides “it would not be consistent with an adviser’s fiduciary duty to infer or accept client consent to a conflict where either (i) the facts and circumstances indicate that the client did not understand the nature and import of the conflict, or (ii) the material facts concerning the conflict could not be fully and fairly disclosed.” In other words, where conflicts are of a nature and extent that it would not be possible to provide disclosure that adequately conveys the material facts or the nature, magnitude and potential effect of the conflict necessary to obtain informed consent, disclosure alone would not satisfy an adviser’s fiduciary duty. The SEC writes that “[i]n all of these cases where full and fair disclosure and informed consent is insufficient, we expect an adviser to eliminate the conflict or adequately mitigate the conflict so that it can be more readily disclosed.”
Given the foregoing, two of the biggest challenges presented by the proposed interpretation will be the need for advisers to determine if:

- They have any conflicts where the material facts concerning the conflict cannot be fully and fairly disclosed given the complexity or extent of the conflicts; and
- They have “adequately mitigate[d]” such conflicts so that they can be fully and fairly disclosed.

The analysis required to address each of these questions will, by their nature, be very fact-specific. Accordingly, advisers would be well served to list, categorize, and analyze their conflicts and the corresponding disclosure and mitigation practices they have implemented so that they can assess these two questions.

**What is entailed with respect to the sec’s proposed restrictions on the use of the terms “adviser” or “advisor”?**

As part of the Form CRS proposal, the SEC is proposing new rule 15l-2 under the Securities Exchange Act of 1934, as amended. Proposed rule 15l-2 would impose certain restrictions on the use of the terms “adviser” or “advisor” by firms and their associated persons.

The applicability of the SEC’s proposed restrictions would depend upon the registration status of the person seeking to use the terms “adviser” or “advisor.” In particular, applicability would vary as follows:

- **Firms solely registered as broker-dealers and associated natural persons.** Proposed rule 15l-2 would restrict firms solely registered as broker-dealers or their associated natural persons’ use of the term “adviser” or “advisor” as part of a name or title when communicating with a retail investor. The proposed rule, however, would not restrict such a broker-dealer’s or its associated natural persons’ use of the terms “adviser” or “advisor” when acting on behalf of a bank or insurance company, or when acting on behalf of a municipal advisor or a commodity trading advisor.

- **Dually registered firms.** Proposed rule 15l-2 would permit firms that are registered both as investment advisers (including state-registered investment advisers) and broker-dealers to use the term “adviser” or “advisor” in their name or title.

- **Dual hatted financial professionals.** Proposed rule 15l-2 would permit an associated person of a dually registered firm to use these terms only where such person is a supervised person of a registered investment adviser and such person provides investment advice on behalf of such investment adviser. This would limit the ability of natural persons associated with a broker-dealer who do not provide investment advice as an investment adviser from continuing to use the term “adviser” or “advisor” simply by virtue of the fact that they are associated with a dually registered firm.

Notwithstanding the restrictions set forth above, the SEC is not proposing to restrict the use of terms that are similar to or synonymous with “adviser” or “advisor,” such as wealth manager, financial consultant, financial manager, money manager, investment manager, or investment consultant.

Finally, proposed rule 15l-2 does not define the phrase “communicating with a retail investor,” and is thus vague as to which types of communications are within the scope of the rule (i.e., is it co-extensive with FINRA Rule 2210(a)(1)’s definition of “communications,” or does its scope differ?).

**What other new obligations is the SEC considering for investment advisers?**

In the Interpretative Release, the SEC identifies a few discrete areas where the current broker-dealer framework provides investor protections that may not have counterparts in the investment adviser context, and requests comment on those areas. The SEC intends to consider comments it receives in connection with any future proposed rules or other proposed regulatory actions with respect to these matters.

First, the SEC is requesting comment on whether there should be federal licensing and continuing education requirements for personnel of SEC-registered investment advisers. Such requirements could be designed to address minimum and ongoing competency requirements for the personnel of SEC-registered advisers.

Second, the SEC is requesting comment on whether it should propose rules to require registered investment advisers to provide account statements, either directly or via the client’s custodian, regardless of whether the adviser is deemed to have custody of client assets under Advisers Act Rule 206(4)-2 or the adviser is a sponsor (or a designee of a sponsor) of a managed account program relying on the safe harbor in rule 3a-4 under the Investment Company Act of 1940, as amended. The periodic statements could include specific dollar amounts of fees and expenses that would allow clients to readily see and understand the fees and expenses they pay for an adviser’s services and could be required to be delivered close in time to the assessment of periodic account fees.
Third, the SEC is requesting comment on whether SEC-registered investment advisers should be subject to financial responsibility requirements along the lines of those that apply to broker-dealers, such as a net capital rule, a customer protection rule, recordkeeping and reporting requirements, an annual audit requirement, a requirement to make audited balance sheets available to clients, and fidelity bond coverage.

What’s next?

The SEC has provided 90 days for comment. The comment period will begin as of the date of publication of the proposal in the Federal Register, which has not yet occurred at the time of publication of this legal alert. While the comment period is underway, it will be interesting to see what steps, if any, the SEC takes to work with state securities and insurance regulators in order to achieve uniformity.

Contacts

For more resources and commentary regarding the SEC’s proposed rules on the standard of conduct for investment professionals, visit Eversheds Sutherland’s [www.secfiduciaryrule.com](http://www.secfiduciaryrule.com).

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