

The SEC's Regulation Best Interest and Its Impact on Structured Investments

With the compliance date approaching, we will provide an overview of what has become one of FINRA's top priorities, Regulation Best Interest and the Form CRS requirement, focusing specifically on the anticipated effects for market participants in the structured investments sector.

February 18, 2020

Thomas Grygiel

Principal Consultant

ACA Compliance Group

tgrygiel@acacompliancegroup.com

Marlon Paz

Partner

Mayer Brown LLP

mpaz@mayerbrown.com

Agenda

- Overview of the regulation;
- What types of conflicts specific to this market should be disclosed?
- What should you focus on if you do not face retail customers?
- What changes are retail-facing distributors and other intermediaries likely to require from product manufacturers?
- Guidance to date from the SEC and FINRA; and
- Proposed changes to FINRA's suitability rule to conform to Reg. BI.

Overview of Regulation Best Interest

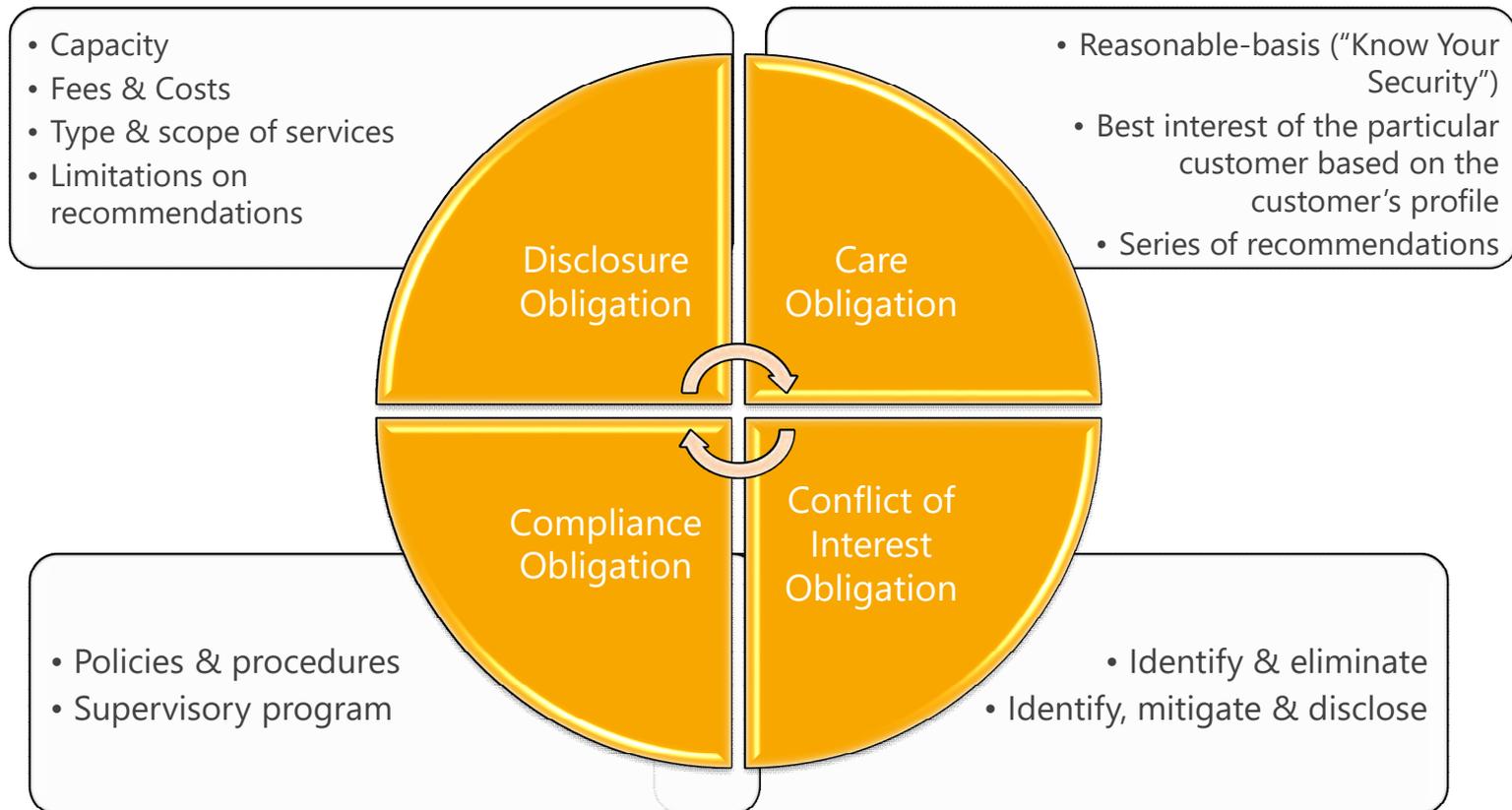
- Regulation Best Interest was adopted by U.S. Securities and Exchange Commission (“SEC”) on June 5, 2019. The new regulation became effective on September 10, 2019, with a compliance date of June 30, 2020.
- Reg. BI applies to a retail customer:
- A natural person, or the legal representative of such natural person, who:
 - receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer, or a natural person who is an associated person of a broker or dealer; and
 - uses the recommendation primarily for personal, family, or household purposes.

Overview of Regulation Best Interest (*cont'd*)

- The term ***recommendation*** is not defined, but is interpreted in a manner consistent with the federal securities laws and the FINRA definition
 - The adopting release includes a list of activities that fall outside the scope of a “recommendation.”
- “Account recommendations” includes recommendations by BDs of securities account types generally, as well as recommendations to roll over or transfer assets from one type of account to another (*e.g.*, workplace retirement plan account to an IRA).
- “Any securities transaction or investment strategy involving securities” not only includes explicit hold recommendations, but also includes implicit hold recommendations that are the result of agreed-upon account monitoring between the BD and retail customer.
- Consequently, account recommendations are subject to Regulation BI even if there is not a recommendation of a securities transaction.

Overview of Regulation Best Interest (cont'd)

In order for a BD to demonstrate its **General Obligation** to provide recommendations that are in a retail customer's "best interest," a broker-dealer must comply with each of the four **Component Obligations** under Reg. BI.



Does Reg. BI apply to me?

- ***“Retail customer”*** encompasses a broad spectrum of accounts not traditionally considered “retail.”
 - Family offices
 - FINRA “institutional accounts”
- Direct contact vs. indirect contact with retail customers
 - Although Reg. BI may not apply directly to your firm, it has the potential to change how your firm does business.
 - Retail-facing firms may require more from the non-retail firms they work with in order to comply with their obligations under Reg. BI.

Disclosure Obligation

The BD or associated person, prior to or at the time of the recommendation, provides the retail customer, in writing, *full and fair disclosure* of:

- *All material facts relating to the scope and terms of the relationship with the retail customer, including:*
 - *That the BD or associated person is acting as a BD or an associated person with respect to the recommendation;*
 - *The material fees and costs that apply to the retail customer's transactions, holdings, and accounts;*
 - *The type and scope of services provided to the retail customer, including any material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer*
- *All material facts relating to conflicts of interest that are associated with the recommendation*
 - Oral disclosures - BD can make supplemental oral disclosures not later than the time of the recommendation, provided that the BD maintains a record that the oral disclosure was provided.

Disclosure Obligation *(cont'd)*

- A ***conflict of interest*** is defined as “an interest that might incline a broker, dealer, or a natural person who is an associated person of a broker or dealer—consciously or unconsciously—to make a recommendation that is not disinterested.”
- The Disclosure Obligation is separate from Form CRS. Each has its own disclosure and delivery requirements.
- Will retail-facing firms expect more information from their non-retail business partners regarding pricing, alternatives and embedded fees?
 - Should non-retail facing firms create disclosures in preparation of the ask?

Care Obligation

- The BD or associated person must exercise reasonable diligence, care and skill to:
 - Understand the potential risks, rewards and costs associated with the recommendation, and have a reasonable basis to believe the recommendation could be in the best interest of at least some retail customers [*FINRA reasonable basis suitability*];
 - Form a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks, rewards and costs associated with the recommendation and does not place the financial or other interest of the BD or associated person ahead of the interest of the retail customer [*FINRA customer specific suitability*]; and
 - Form a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile and does not place the financial or other interest of the BD or associated person making the series of recommendations ahead of the interest of the retail customer [*FINRA quantitative suitability*].

Due Diligence for Structured Investments

- Will distributors be more/less reluctant to sell certain products to retail customers?
- Should products be made available to all customers or should certain products be limited to certain customers? How should this decision be made?
- How should firms evaluate similar/alternative products?

Conflict of Interest Obligation

- The BD must establish, maintain and enforce written policies and procedures reasonably designed to:
 - Identify and, at a minimum, disclose, in accordance with the Disclosure Obligation, or eliminate, all conflicts of interest associated with such recommendations
 - Identify and mitigate any conflicts of interest associated with such recommendations that create an incentive for a natural person who is an associated person of a BD to place the interest of the BD or such natural person ahead of the interest of the retail customer
 - Identify and disclose any material limitations placed on the securities or investment strategies involving securities that may be recommended to a retail customer and any conflicts of interest associated with such limitations, in accordance with the Disclosure Obligation
 - Prevent such limitations and associated conflicts of interest from causing the BD or a natural person who is an associated person of the BD to make recommendations that place the interest of the BD or such natural person ahead of the interest of the retail customer

Conflict of Interest Obligation *(cont'd)*

- Identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or of specific types of securities within a limited period of time
- The requirement to eliminate conflicts arising from financial incentives is gone
- Instead, Regulation BI requires policies and procedures that are reasonably designed to address specific conflicts of interest that may cause an associated person to place his or her interests ahead of those of the customer, such as, but not limited to:
 - Conflicts of interest that create certain incentives to associated persons
 - Conflicts of interest associated with material limitations on the securities or investment strategies involving securities, such as limited product menus or recommending only proprietary products
 - Sales contests, sales quotas, bonuses, and non-cash compensation based on the sales of specific securities or type of security within a limited period of time

Conflict of Interest Obligation *(cont'd)*

- Transaction-based compensation need not be eliminated under Regulation BI.
- Examples of incentives to an associated person that would need to be addressed:
 - Compensation from the BD or from third parties, including fees and other charges for the services provided and products sold
 - Employee compensation or incentives, special awards, differential or variable compensation, incentives tied to appraisals or performance reviews
 - Compensation or sales charges, or other fees or financial incentives, or different or variable compensation, whether paid by the retail customer, the BD or a third party
- Mitigating conflicts of interest:
 - Policies and procedures must be reasonably designed to reduce the potential effect such conflicts may have on a recommendation given to a retail customer

Conflict of Interest Obligation *(cont'd)*

- Whether or not a BD's policies and procedures are reasonably designed to mitigate such conflicts will be assessed in light of whether they are reasonably designed to reduce the incentive for the associated person to make a recommendation that places the associated person's or firm's interests ahead of the retail customer's interest
- If a BD places material limitations on a recommendation (e.g., offering proprietary or only a limited range of products, or products from only a select group of issuers), the policies and procedures must be reasonably designed to disclose the limitations and associated conflicts and prevent the limitations from causing the BD to make a recommendation that puts its interests ahead of those of the customer
- No fixed formula – BDs will need to exercise judgment in determining what policies work for them.

Special Topics Relating to Conflicts of Interest

- How should firms account for affiliated issuers vs. non-affiliated issuers?
- Compensation and Fees: what do they look like in a post-Reg. BI world?
 - Firms may experience pressure from distributors to revamp their compensation structures to facilitate Reg. BI compliance
- Conflicts posed by investment in electronic structured products platforms (e.g., Simon, Luma)
- Moving firms: what if your new firm doesn't support the same products?

Compliance Obligation

- In a new part of the General Obligation, and in addition to the procedures required by the Conflict of Interests Obligation, a BD must also establish, maintain and enforce written policies and procedures designed to achieve compliance with Regulation BI as a whole. These procedures must not only address conflicts of interest, but also compliance with the Disclosure and Care Obligations.
- A reasonably designed compliance program generally would also include controls, remediation of non-compliance, training and periodic review and testing.

PLEASE LISTEN FOR CLE CODE

Form CRS Summary

- The SEC also adopted new rules and forms that require both BDs and RIAs to provide retail investors with information intended to clarify the relationship through a proposed Form CRS Relationship Summary
- The Form CRS
 - Will require a Q&A format, and will be subject to page limits (RIAs and BDs will be limited to two pages, and dual registrants will be limited to four pages)
 - Will encourage the use of charts, graphs, tables, etc.
 - Will include a link to SEC information
 - Will feature a combined section that discusses fees, costs, conflicts of interest and standards of conduct
 - Specific discussion of proprietary products, third-party payments, revenue sharing arrangements, and principal trading is required
 - Must include a section on disciplinary proceedings/record
 - Conversation starters (or “key questions to ask”) may be used to engage retail investors in a dialogue

Form CRS Summary *(cont'd)*

- The proposed comparison section detailing differences between BD and RIA services has been eliminated
- The Form must be delivered by BDs to each new or prospective client before a recommendation, order, or account opening
- The Form CRS would be provided to investors, filed with the SEC and available online
- The retail investor definitions in Regulation BI and in the Form CRS rules have been harmonized
- Firms may file their initial summaries with the SEC beginning on May 1, 2020

Practical Considerations

- Outline Your Program
- Prepare a Timeline
- Identify Conflicts of Interest
 - Disclose
 - Mitigate
 - Eliminate
- Consider a Code of Conduct
- Revise Policies and Procedures
- How to document Best Interest
 - Updates to SEA Rules 17a-3 and 17a-4

Practical Considerations *(cont'd)*

- Cost as a factor in Best Interest
- Cost needs to be considered in determining Best Interest
- Technology Considerations
- Compensation
- Training
- Registered Representatives
- Operations
- Supervision
- Compliance
- State Best Interest/Fiduciary Rules
- Certified Financial Planner – Fiduciary Standard

Recent Developments

- SEC and FINRA Guidance – expect more to come
 - FINRA Reg. BI Compliance and Form CRS Checklist
 - SEC Small Entity Compliance Guides
 - SEC Reg. BI and Form CRS FAQs
 - SEC OCIE and FINRA Annual Priorities Letters
- SEC proposed sales practices rules require additional due diligence with regard to retail customers and leveraged/inverse investment vehicles
 - How does the Proposed Rule comport with Reg. BI?

Are you ready for Reg. BI?

- FINRA suggests tackling the following questions. Any “no” answers will have to be addressed by June 30—the compliance date for Reg. BI.
- Does your Firm have procedures and training in place to assess recommendations using a best-interest standard?
- Do your Firm and your associated personnel apply a best-interest standard to recommendations of types of accounts?
- If your Firm and your associated personnel agree to provide account monitoring, do you apply the best-interest standard to both explicit and implicit hold recommendations?
- Do your Firm and your associated personnel consider the express new elements of care, skill and costs when making recommendations to retail customers?

Are you ready for Reg. BI? *(cont'd)*

- Do your Firm and your associated personnel consider reasonably available alternatives to the recommendation?
- Do your Firm and your registered representatives guard against excessive trading, irrespective of whether the broker-dealer or associated personnel “controls” the account?
- Does your Firm have policies and procedures to provide the disclosures required by Reg BI?
- Does your Firm have policies and procedures to identify and address conflicts of interest?
- Does your Firm have policies and procedures in place regarding the filing, updating and delivery of Form CRS?

[Americas](#) | [Asia](#) | [Europe](#) | [Middle East](#)

mayerbrown.com

Mayer Brown is a global services provider comprising associated legal practices that are separate entities, including Mayer Brown LLP (Illinois, USA), Mayer Brown International LLP (England), Mayer Brown (a Hong Kong partnership) and Tauil & Chequer Advogados (a Brazilian law partnership) (collectively the "Mayer Brown Practices") and non-legal service providers, which provide consultancy services (the "Mayer Brown Consultancies"). The Mayer Brown Practices and Mayer Brown Consultancies are established in various jurisdictions and may be a legal person or a partnership. Details of the individual Mayer Brown Practices and Mayer Brown Consultancies can be found in the Legal Notices section of our website. "Mayer Brown" and the Mayer Brown logo are the trademarks of Mayer Brown. © Mayer Brown. All rights reserved.