Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY:
pwc

# Regulation Best Interest

*Posted by Bradley Berman, Anna T. Pinedo, and Michael D. Russo, Mayer Brown LLP, on Wednesday, June 19, 2019*

**Editor's note:** Bradley Berman is counsel, Anna T. Pinedo is partner, and Michael D. Russo is an associate at Mayer Brown LLP. This post is based on their Mayer Brown memorandum.

On June 5, 2019, the Securities and Exchange Commission (SEC) adopted Regulation Best Interest (Rule 15*l*-1 under the Securities Exchange Act of 1934 (Exchange Act)), which requires broker-dealers and their associated persons who are natural persons to act in the best interest of their retail customers when making a recommendation. The SEC also adopted Form CRS Relationship Summary, which requires registered investment advisers (RIAs) and broker- dealers to deliver to retail investors a succinct, plain English summary about the relationship and services provided by the firm and the required standard of conduct associated with the relationship and services. (Rule 17a-14 and Form CRS under the Exchange Act.)

Regulation Best Interest (Regulation BI), Form CRS and the related rule will become effective 60 days after their publication in the Federal Register. The compliance date for both rules is June 30, 2020.

This post necessarily summarizes the principal aspects of Regulation Best Interest, as the Release runs to 771 pages.

## Regulation Best Interest—the General Obligation

Regulation BI has a "general obligation," which requires that the broker or dealer (BD) comply with four component obligations: the disclosure obligation, the care obligation, the conflict of interest obligation and the compliance obligation (the compliance obligation having been added since the proposing release).

The general obligation requires that BDs and their associated persons who are natural persons, when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer, act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker, dealer, or natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer.

The general obligation remains fundamentally unchanged since the proposing release, without defining "best interest." It does not apply the existing RIA fiduciary standard to BDs, and is not a separate fiduciary standard. The general obligation is not intended to require a BD to make

conflict-free recommendations. BDs must take steps to reduce the effect of (and, in some cases, eliminate) conflicts that would create an incentive to place the BD's interests ahead of those of the retail customer when making a recommendation, and to make a recommendation in the customer's best interest even where conflicts continue to exist. A BD may recommend products that involve higher risks or costs to the retail customer, or that result in greater compensation to the BD, provided that each component obligation is satisfied.

Whether the BD complied with each of the four component obligations will be determined on a principles basis—an evaluation of the facts and circumstances of the particular recommendation and the particular retail customer, at the time that the recommendation was made (not in hindsight).

The general obligation contains a number of defined terms, some of which are defined in Regulation BI, while others are explained in the Release.

A "retail customer" is defined as a natural person, or the legal representative of such natural person, who (A) 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 (B) uses the recommendation primarily for personal, family, or household purposes.

The SEC added the word "natural" to the definition since the proposing release, and the Release explains that the term "legal representatives" is interpreted to mean non- professional legal representatives of a natural person. An example of a non-professional legal representative would be a non-professional trustee that represents the assets of a natural person, and similar representatives such as executors, conservators and persons holding a power of attorney for a natural person. Regulated financial services industry professionals retained by natural persons to exercise independent professional judgment, such as RIAs and BDs, corporate fiduciaries (e.g., banks, trust companies and similar financial institutions) and insurance companies, and the employees or other regulated representatives of such RIAs, BDs, corporate fiduciaries and insurance companies are not within the scope of a "legal representative of such natural person."

"Personal, family or household purposes" includes retirement accounts; accordingly, a retirement plan participant receiving a recommendation about whether to take a distribution from a 401(k) plan and how to invest that distribution would be a "retail customer" for purposes of Regulation BI.

A recommendation is not defined but is interpreted in a manner consistent with current BD regulation under the federal securities laws and FINRA rules.

The adopting release includes a list of activities that fall outside the scope of a "recommendation":

- General financial and investment information;
- Descriptive information about an employer- sponsored retirement or benefit plan;
- Certain asset allocation models; and
- Interactive investment materials that incorporate the exclusions

"Account recommendations" include 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 its retail customer. Consequently, account recommendations are subject to Regulation BI even if there is not a recommendation of a securities transaction.

Regulation BI does not impose a duty to monitor a retail account; however, if the BD agrees to provide account monitoring services, Regulation BI will apply to any recommendations resulting from the account monitoring services. By agreeing to account monitoring services, the BD takes on an obligation to review and make recommendations for the account on a specified, periodic basis. If the BD makes no recommendation on a periodic review, it is an implicit "hold" recommendation, subject to Regulation BI, just as would an explicit "hold" recommendation.

This result is different from the FINRA Rule 2111 interpretation that the suitability rule does not cover an implicit hold recommendation. Absent a BD's agreement to monitor an account, Regulation BI does not apply to implicit hold recommendations, only explicit.

## Discharging the General Obligation

The BD or its associated person would be deemed to have discharged the general obligation by complying with its four component obligations. Complying with these four obligations does not create a "safe harbor." Compliance with each component obligation is necessary, and the failure to comply with any would violate the general obligation.

## Disclosure Obligation

The disclosure obligation requires a BD or associated person, prior to or at the time of the recommendation, to provide 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; and
    - 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; and
- All material facts relating to conflicts of interest that are associated with the recommendation.

The Release provides that the BD can make supplemental oral disclosures not later than the time of the recommendation, provided that it maintains a record that the oral disclosure was provided.

"Material facts" and "material fees and costs" are to be interpreted consistent with the standard of materiality in *Basic v. Levinson*—"a substantial likelihood that a reasonable shareholder would consider it important." For purposes of Regulation BI, the standard is the retail customer rather than a shareholder. Some examples of material facts relating to conflicts of interest include, but are not limited to, conflicts of interest identified in Form CRS, how associated persons are compensated and the benefits to a BD from recommending a proprietary product, such as additional fees.

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."

## Care Obligation

The care obligation requires that the BD, or an associated person of the BD, in making the recommendation, exercises 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;
- Have 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 such natural person ahead of the interest of the retail customer; and
- Have 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 such natural person making the series of recommendations ahead of the interest of the retail customer.

The final rule added "cost" as a consideration; however, although cost will always be relevant to a recommendation and should be a required consideration, the Release points out that costs are not the only consideration.

The care obligation builds upon, but goes beyond, the FINRA Rule 2111 suitability obligation by requiring that the recommendation be in the customer's best interest and that the BD's interests must not be put ahead of those of the customer's. An additional enhancement to the FINRA suitability requirements provided by Regulation BI is that it is the SEC's view that a BD should consider reasonably available alternatives in determining whether it has a reasonable basis to believe that the recommendation is in the best interest of the customer.

In exercising reasonable diligence, care and skill to understand the potential risks, rewards and costs required by paragraph (a)(2)(ii)(A) of Regulation BI (the first bullet point under "Care Obligation" above), the adopting release highlights how the "reasonable basis" component is especially important in the context of recommendations relating to securities that are "complex or risky." The Release mentions complex products, such as inverse or leveraged exchange-traded

products, as an example where a BD's understanding of the features of those products is necessary in order to establish a reasonable basis for a recommendation. According to the Release, these types of products will not be in the best interest of a retail customer absent a short-term, customer- specific investment objective.

With respect to paragraph (a)(2)(ii)(B) of Regulation BI (the second bullet point under "Care Obligation" above), the Release states that, although the care obligation does not require a BD to document the basis for a recommendation, it may wish to document an evaluation of a recommendation and the basis therefor in certain circumstances, such as in connection with the recommendation of a complex product or where a recommendation may seem inconsistent with a retail customer's objectives on its face.

A BD must obtain and analyze enough customer information to have a reasonable basis to believe that the recommendation is in the best interest of the particular retail customer. The significance of any particular type of customer information will be determined based on a facts and circumstances analysis. In forming a reasonable basis belief that a recommendation is in the best interest of a particular customer, a BD does not have to simply recommend the least expensive or least remunerative security without further analysis. A more expensive security or investment strategy may be appropriate, given the mix of factors about the product, based on the customer's investment profile. Reasonably available alternative securities should be considered; however, a BD does not have to conduct an investigation of every possible alternative, either offered outside of the firm or on the firm's platform. Similarly, an associated person of a BD is not required to be familiar with every product on a BD's platform, particularly where the BD operates an open architecture framework or a platform with a large number of products or options.

With respect to paragraph (a)(2)(ii)(C) of Regulation BI (the third bullet point under "Care Obligation" above), the care obligation relating to a series of recommended transactions (quantitative suitability) applies irrespective of whether the BD exercises actual or *de facto* control over the account.

Whether a BD has complied with the care obligation will be evaluated at the time of the recommendation (not in hindsight).

## Conflict of Interest Obligation

To satisfy the 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 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 an associated person of the BD to make recommendations that place the interest of the BD or such associated person ahead of the interest of the retail customer; and
- 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.

Much of this part of Regulation BI was significantly changed since the proposing release. The SEC summarized the revisions to the conflicts of interest obligation as intended to "(1) create an overarching obligation to establish written policies and procedures to identify and at a minimum disclose, pursuant to the Disclosure Obligation, or eliminate all conflicts of interest associated with the recommendation; and (2) require broker- dealers to establish policies and procedures to be reasonably designed to mitigate or eliminate certain identified conflicts of interest."

One significant change from the proposing release is that the requirement to eliminate material conflicts of interest arising from financial incentives associated with recommendations is gone.

The SEC does not want to narrow product choices for retail customers by, as in the proposing release, requiring firms to establish policies and procedures reasonably designed to mitigate all financial incentives, including compensation. Transaction-based compensation need not be eliminated.

As stated in the Release, "while we are not requiring broker-dealers to develop policies and procedures to disclose and mitigate *all* conflicts of interest, we are requiring that broker-dealers develop policies and procedures reasonably designed to '*at a minimum disclose*, or eliminate' all conflicts. We continue to believe that where a broker-dealer cannot fully and fairly disclose a conflict of interest in accordance with the Disclosure Obligation, the broker-dealer should eliminate the conflict or adequately mitigate (i.e., reduce) the conflict such that full and fair disclosure in accordance with the Disclosure Obligation is possible."

Some examples of incentives paid to an associated person that would need to be addressed under the conflict of interest obligation include:

- 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; and
- 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.

The Release also provides a non-exhaustive list of examples of potential methods to mitigate conflicts of interest that would create an incentive for an associated person to place his or her interests ahead of those of the retail customer:

- avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales;
- minimizing compensation incentives for employees to favor one type of account over another, or to favor one type of product over another, proprietary or preferred provider

products, or comparable products sold on a principal basis, for example, by establishing differential compensation based on neutral factors;
- eliminating compensation incentives within comparable product lines;
- implementing supervisory procedures to monitor recommendations that are near compensation thresholds; near thresholds for firm recognition; involve higher compensating products, proprietary products or transactions in a principal capacity; or involve the rollover or transfer of assets from one type of account to another;
- adjusting compensation for associated persons who fail to adequately manage conflicts of interest; and
- limiting the types of retail customer to whom a product, transaction or strategy may be recommended.

With respect to conflicts of interest arising from material limitations on securities or investment strategies that may be recommended to a retail customer, such as recommendations of proprietary or other limited ranges of products or products from a select group of issuers, Regulation BI requires BDs to identify and disclose such limitations and prevent those limitations and associated conflicts of interest from causing BDs or their associated persons to put their interests ahead of those of the retail customers. However, as stated in the Release, it is not the SEC's intent to prevent firms from offering proprietary or other limited ranges of products so long as firms comply with the disclosure, care and conflict of interest obligations.

The reasonably designed policies and procedures required under Rule 15*l*-1(a)(2)(iii)(C) should include product review procedures, and the SEC cites to the FINRA Report on Conflicts of Interest for examples of effective practices.

Under Rule 15*l*-1(a)(2)(iii)(D), sales contents, quotas, bonuses and non-cash compensation based on sales of securities within a specific period of time must be identified and eliminated (in contrast to conflicts of interest arising from material conflicts of interest arising from financial incentives, as in the proposing release).

## Compliance Obligation

In a new part of the general obligation, and in addition to the procedures required by the conflict of interest 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. The SEC believes that, while creating an affirmative obligation with respect to Regulation BI as a whole, the compliance obligation provides sufficient flexibility to establish compliance procedures across a broad range of business models. A reasonably designed compliance program generally would also include controls, remediation of noncompliance, training, and periodic review and testing.

## Recordkeeping

The SEC added a new paragraph (a)(35) to Rule 17a-3 under the Exchange Act, the purpose of which is to allow BDs to demonstrate their compliance with the substantive requirements of Regulation BI. Rule 17a-3(35) requires a BD to retain a record of all information collected from

the retail customer under Regulation BI and to identify the natural person responsible for the account. If the retail customer neglects, refuses, or is unable to provide or update such information, the BD will be excused from obtaining that information. The records must be retained for at least six years after the earlier of the date that the account was closed or the date on which the information was collected, provided, replaced or updated.

## Liability

Regulation BI does not override the general antifraud provisions of the securities laws, which are still applicable. The Release notes that scienter is not required to be established in order to establish a violation of Reg BI. Regulation BI does not expressly preempt any state fiduciary laws; the Release notes that preemption of state laws is left to the courts.

## 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).

Form CRS will also encourage the use of charts, graphs, tables, etc., include a link to SEC information and 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 in the form.

Form CRS 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. The proposed comparison section detailing differences between BD and RIA services has been eliminated from the final form. 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.

## Other Restrictions

With an objective of avoiding investor confusion, BDs and RIAs will be required to prominently disclose their respective registrations in the Form CRS. The SEC also restricted standalone BDs and their professionals from using the term “advisor” or “adviser” in their title.

## Conclusion

The final version of Regulation BI incorporates some significant changes since the proposed version, particularly removal of the requirement to eliminate material conflicts of interest arising from financial incentives, and instead requiring only that certain sales contests be eliminated. It remains to be seen whether the enhanced requirements of the care obligation will make the FINRA Rule 2111 suitability requirements irrelevant.

The complete publication, including footnotes, is available here.