

Legal Update

FINRA Provides New Reg. BI and Form CRS Resource

On October 8, 2019, the Financial Industry Regulatory Authority (FINRA) published a new resource to assist its member firms in their efforts to comply with the US Securities and Exchange Commission's (SEC) Regulation Best Interest (Reg. BI) and Form CRS by the June 30, 2020 compliance date.¹ FINRA's Reg. BI and Form CRS Firm Checklist² (the "Checklist") provides a Q&A outlining the major requirements of the recent rulemaking package and explains some key differences between FINRA rules and the SEC's Reg. BI and Form CRS to help member firms assess their obligations under each.

Reg. BI

Firms will be expected to update their policies and procedures in light of changes provided for in Reg. BI. The application of Reg. BI's "best interest" standard to recommendations used by retail customers³ will require that firms establish and implement policies and procedures designed to fulfill the four "Component Obligations" of Reg. BI: (1) Disclosure, (2) Care, (3) Conflict of Interest and (4) Compliance. The Checklist provides guidelines for firms seeking to fulfill these obligations and warns of potential pitfalls where Reg. BI has created new obligations.

DISCLOSURE

The Checklist instructs that firms should be prepared to give full and fair disclosure of all material facts relating to the scope and terms of their relationship with retail customers and relating to conflicts of interest. As a part of "full and fair" disclosure, firms should be sure to provide sufficient information to enable a retail customer to make an informed decision with regard to a recommendation. The Checklist notes several items that should be the focus of a firm's disclosure, including:

1. the capacity in which the firm is acting (*i.e.*, as a broker-dealer or investment adviser);
2. material fees and costs that apply to a retail customer's transactions, holdings and accounts;
3. the type and scope of services provided (including whether account monitoring is included);⁴
4. minimum account size;
5. material limitations on the securities or investment strategy that may be recommended to a customer;
6. the general basis for a firm's recommendation;
7. risks associated with a recommendation; and

8. conflicts of interest relating to a recommendation.

CARE

Reg. BI's standard of care incorporates and enhances FINRA's suitability requirements for reasonable-basis, customer-specific and quantitative suitability.⁵ The Checklist notes that care, skill and costs are new express elements for consideration when making recommendations to retail customers. A firm should look to these elements, among others, when determining whether it has a reasonable basis for its recommendations. To effectively conduct this analysis, a broker-dealer should establish a process for establishing and understanding the scope of "reasonably available alternatives" that would be considered as a part of fulfilling its standard of care.

Additionally, in a change from FINRA's suitability requirement, Reg. BI applies the best interest standard to a series of recommended transactions, irrespective of whether the broker-dealer exercises actual or de facto control over a customer's account. Firms should therefore safeguard against excessive trading, irrespective of whether it or its associated person "controls" the account.

Although not a requirement, the Checklist notes that firms should consider, as a best practice, applying heightened scrutiny to recommendations of high-risk or complex investments. It is also important to note that firms are not expected to recommend a single "best" product, but need only be able to form the reasonable basis that a recommendation is in the best interest of the customer.

CONFLICTS OF INTEREST

The Checklist advises firms that they must establish policies and procedures to identify and address the firm's conflicts of interest,⁶ disclosing or eliminating them where required. Conflicts that create an incentive for an associated person to place the firm's or such associated person's interest ahead of the retail customer's interest must be mitigated, and

certain other conflicts of interest must be eliminated entirely. Reg. BI prohibits certain practices deemed to create too great of a conflict of interest to disclose away or mitigate, such as sales contests, bonus, non-cash compensation and quotas based on the sale of specific securities or specific types of securities within a limited time. Firms should be certain that their policies and procedures have been updated to reflect the Reg. BI standards for identifying and addressing these conflicts of interest, whether they are required to disclose, mitigate or eliminate them.

COMPLIANCE

Firms should update their policies and procedures to account for Reg. BI updates, such as new defined terms. Additionally, current recordkeeping practices will not fully satisfy Reg. BI, so firms will need to address their recordkeeping policies to ensure they can meet their new obligations. Firms should also implement training to ensure that all associated persons are aware of Reg. BI's requirements and prepared to comply with them upon the compliance date. Although the requirements will vary depending on a firm's size and complexity, a reasonably designed compliance program generally would include: controls, remediation of non-compliance, training, and periodic review and testing. The Checklist provides a helpful "cheat sheet" for firms to look to when establishing these new policies and procedures.

Form CRS

Registered broker-dealers and registered investment advisers (RIAs) who provide services to retail investors⁷ are required to complete a relationship summary on Form CRS. The relationship summary is intended to inform retail investors about the services provided by the broker-dealer or RIA and describe the relationship between the retail investor and the firm. The Checklist highlights several important items relating to Form CRS to ensure that firms are

prepared to complete, file and deliver Form CRS when the compliance date arrives.

The Checklist advises firms of the format and content requirements of Form CRS. Firms should be aware of the page limit (two for a broker-dealer or RIA, four for a dual registrant) and ensure that all required content is available in their relationship summary in plain English. The use of visual aids is also encouraged.

Firms are expected to provide retail investors with:

1. an introduction to the firm;
2. a description of services provided to the retail investor;
3. a description of fees and costs, the applicable standard of conduct, conflicts of interest and examples of how the firm makes money;
4. relevant disciplinary history;
5. a method to obtain additional information; and
6. certain prescribed "conversation starters" for investors to ask their financial professionals.

The Checklist also advises firms to establish processes so they are equipped to file, deliver and update Form CRS when needed. Filers should ensure they are prepared to:

- file Form CRS through Web CRD (or IARD for RIAs – dual registrants will be required to file relationship summaries through both IARD and Web CRD);
- update Form CRS within 30 days of any information becoming materially inaccurate and communicate any changes to retail investor clients or customers within 60 days after updates are required to be made;

- deliver a relationship summary to new or prospective customers who are retail investors before or at the beginning of their relationship;
- deliver a relationship summary to existing customers;
- post a current version of the relationship summary prominently on the firm's public website; and
- maintain and preserve a record of each relationship summary and the date it was provided to each retail investor for a period of at least six years.

Conclusion

Although by no means exhaustive, the Checklist provides a useful summary of a broker-dealer's obligations under Reg. BI and Form CRS. Firms should already be preparing to address how they will update their policies and procedures and otherwise comply with the requirements of Reg. BI and Form CRS by June 30, 2020. Reviewing the Checklist should be an important first step in this process.

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Endnotes

- ¹ Other available resources include the SEC’s Regulation Best Interest, A Small Entity Compliance Guide, available at <http://bit.ly/2NqBNlb> and Form CRS Relationship Summary; Amendments to Form ADV, A Small Entity Compliance Guide, available at <http://bit.ly/36mPZEn>.
- ² The Checklist is available at <http://bit.ly/36lv44M>.
- ³ Reg. BI only applies to recommendations to “retail customers” and their non-professional legal representatives. Reg. BI defines a “retail customer” as a natural person, or the legal representative of such person, who: (a) receives a recommendation for any securities transaction or investment strategy from a broker-dealer or associated person; and (b) uses the recommendation primarily for personal, family or household purposes.
- ⁴ Although Reg. BI imposes no duty to monitor a customer’s account, if a firm agrees to do so, it takes on an obligation to review and make recommendations regarding the account on the specified, periodic basis it has agreed with the customer. In such circumstances, Reg. BI will infer an “implicit” hold recommendation subject to the obligations of other recommendations under Reg. BI.
- ⁵ See FINRA Rule 2111 (Suitability).
- ⁶ A “conflict of interest” is an interest that might incline a broker-dealer or associated person – consciously or unconsciously – to make a recommendation that is not disinterested.
- ⁷ A “retail investor” is a natural person, or the legal representative of such natural person, who seeks to receive or receives services primarily for personal, family or household purposes. This definition mirrors the definition of “retail customer” in Reg. BI.

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