

Legal Update

Regulation Best Interest – SEC Observations from Broker-Dealer Examinations

SEC risk alert highlights areas of deficiencies and examples of weak practices

On January 30, 2023, the Division of Examinations (the "Division") of the US Securities and Exchange Commission ("SEC") published a risk alert (the "2023 Risk Alert") to raise awareness of the most frequently cited deficiencies and weaknesses observed in recent broker-dealer examinations to assess compliance with Regulation Best Interest ("Reg BI").¹ The 2023 Risk Alert mainly includes observations related to the four component obligations of Reg BI: Compliance, Care Obligation, Conflict of Interest and Disclosure.

The 2023 Risk Alert reflects observations from the Division's exams coinciding with the implementation of Reg BI. Those earlier exams focused on firms' establishment of written policies and procedures and effective implementation of those procedures. Many of the observations by the Division are similar to the findings that the Financial Industry Regulatory Authority, Inc. ("FINRA") published last month in its 2023 Report on FINRA's Examination and Risk Monitoring Program.² As the industry enters the third year of the Reg BI compliance requirement and with more guidance provided by the SEC and FINRA, we expect to see more enforcement activity in this area. As such, firms should review the Division's observations and consider any potential enhancements to their policies and procedures related to each of the obligations under Reg BI.

The following is a brief summary of key observations in the 2023 Risk Alert.

Compliance Obligation

Broker-dealers did not have adequate written policies and procedures reasonably designed to achieve compliance with the Disclosure and Care Obligations. The policies and procedures in place to comply with the Disclosure Obligation lacked details on when and how disclosures should be created and delivered to customers as well as proper documentation of the delivered disclosures. In addressing the Care Obligation, the policies and procedures in place were deficient in guidance for their financial professionals on considerations for available alternatives, costs, and documentation of their recommendations. Separately, the Division noted deficiencies related to the Care Obligation involving failure to understand

the recommended product, failure to obtain or consider the customer's investment profile, and failure to understand the potential risks and costs associated with the recommendation.³

In addition, deficiencies and weaknesses were found in compliance controls related to training and periodic reviews and testing. Broker-dealers failed to tailor and amend their policies and procedures, surveillance systems and training programs to the size and complexity of the firm after the SEC adopted Reg BI, resulting in surveillance and monitoring systems failing to capture and prevent violations or capturing only executed transactions rather than all recommendations provided to the retail customers. Some firms maintained documentations locally, making it difficult to conduct timely reviews of recommendations. Also, weaknesses in employee training programs were observed as firms failed to provide sufficient guidance on its processes, including proper use of the systems, tools or methods that employees could utilize to comply with Reg BI.

Conflict of Interest Obligation

Broker-dealers had deficient written policies and procedures that lacked specificity on how conflicts are to be identified or addressed (*e.g.*, assignment of responsibility); failed to prohibit certain types of incentives that could create conflicts (*e.g.*, sales contests, sales quotas, bonuses and non-cash compensation that were based on the sales of specific securities) as required under the Conflict of Interest Obligation;⁴ and limited the identified conflicts to only certain prohibited activities rather than reflecting all conflicts of interest associated with the recommendations made by the firm or its financial professionals. Additionally, broker-dealers did not establish appropriate mitigation measures and relied on disclosure alone to mitigate conflicts.

Disclosure Obligation

Rather than delivering disclosures to retail customers in writing, broker-dealers only posted the relevant disclosures on their websites or referenced the disclosures in other documents delivered to customers. Also, broker-dealers did not sufficiently address or provide specific guidance in their policies and procedures related to the disclosures the financial professionals who have multiple licenses (*e.g.*, registered representatives and investment adviser) should provide to retail customers regarding their capacity in which the professional was acting and potential conflicts that are specific to the professionals that interact with retail customers in multiple capacities.

For more information about the topics discussed in this Legal Update, please contact any of the following authors.

Steffen Hemmerich

+1 212 506 2129

shemmerich@mayerbrown.com

Wonji L. Kim

+1 212 506 2652

wkim@mayerbrown.com

Timothy B. Nagy

+1 202 263 3079

tnagy@mayerbrown.com

Anna T. Pinedo

+1 202 263 3079

apinedo@mayerbrown.com



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Endnotes

¹ See SEC Division of Examinations, [Risk Alert: Observations from Broker-Dealer Examinations Related to Regulation Best Interest](#) (Jan. 30, 2023).

² See FINRA, [2023 Report on FINRA’s Examination and Risk Monitoring Program](#) (Jan. 2023). See our [Legal Update](#).

³ See 2023 Risk Alert at 3 n.8.

⁴ See SEC Rule 15l-1(a)(2)(iii)(D).

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