



Getting the full picture

The emerging best interest and fiduciary duty patchwork

July 12, 2019

Regulation Best Interest: Implementation Considerations

What happened?

On June 5, the US Securities and Exchange Commission (SEC) adopted Regulation Best Interest (Reg. BI), a new rule establishing a “best interest” standard of conduct for broker-dealers and their natural associated persons when making recommendations to retail customers of any securities transaction or investment strategy involving securities or regarding the opening of an account.¹

The compliance effective date of June 30, 2020, for Reg. BI will be upon us before we know it. This legal alert provides an overview of Reg. BI, and offers ten implementation considerations for firms to consider as they start to prepare for compliance with the new rule.

The New and Enhanced Broker-Dealer Standard of Conduct

Reg. BI, codified as Rule 15l-1 under the Securities Exchange Act of 1934 (the Exchange Act), imposes a new best interest standard of conduct on broker-dealers providing retail investment advice. The structure of Reg. BI consists of three parts: a part setting out the general best interest obligation, a part describing the four components of the general best interest obligation, and then a definitions part. To satisfy Reg. BI's general best interest obligation, a broker-dealer must comply with each of the four component obligations. The overall structure of Reg. BI is outlined below:

- **General Obligation:** The first part (Rule 15l-1(a)) imposes the general obligation on a broker-dealer and its associated persons to act in a retail customer's best interest when recommending a security or investment strategy involving securities without placing their interest ahead of the retail customer's interest.
- **Components of the General Obligation:** The second part (Rule 15l-1(a)(2)) provides that the general obligation is satisfied when the following four component obligations are met:
 - » **Disclosure Obligation:** providing certain prescribed disclosure before or at the time of the recommendation, about the recommendation and the relationship between the retail customer and the broker-dealer
 - » **Care Obligation:** exercising reasonable diligence, care, and skill in making the recommendation
 - » **Conflict of Interest Obligation:** establishing, maintaining, and enforcing policies and procedures reasonably designed to address conflicts of interest associated with recommendations
 - » **Compliance Obligation:** establishing, maintaining, and enforcing policies and procedures reasonably designed to achieve compliance with Reg. BI
- **Definitions of Key Terms:** The third part (Rule 15l-1(b)) defines the terms “retail customer,” “retail customer investment profile,” and “conflict of interest.”

¹ See “Regulation Best Interest: The Broker-Dealer Standard of Conduct,” SEC Release No. 34-86031 (June 5, 2019), available at <https://www.sec.gov/rules/final/2019/34-86031.pdf> (the “Reg. BI Adopting Release”). The Reg. BI Adopting Release also covers the adoption of amendments to rules 17a-3 and 17a-4 under the Exchange Act to establish new record-making and recordkeeping requirements for broker-dealers with respect to certain information collected from or provided to retail customers.

The General Obligation

Reg. BI requires a broker-dealer (or associated person), when recommending a securities transaction or investment strategy involving securities, to act in the retail customer's best interest and not place its (or his or her) own interests ahead of the retail customer's interests.² However, in a key change from the version of Reg. BI that the SEC proposed in April 2018 (proposed Reg. BI),³ an "investment strategy" recommendation explicitly includes recommendations of account types and rollovers or transfers of assets. As explained in the Reg. BI Adopting Release, this general obligation also covers implicit hold recommendations resulting from agreed-upon account monitoring, as well as rollover recommendations, i.e., recommendations to rollover assets from a retirement plan into an account with the broker-dealer.

Implementation considerations: Firms that offer more than one type of customer account (e.g., brokerage accounts and direct held accounts) might want to consider adopting policies and procedures for ensuring that account-type recommendations are in the best interests of retail customers. Policies and procedures could, for example, require a comparison of fees and costs, a comparison of features and benefits available, or consideration of the best interest scenario for each account type. Similarly, a firm that recommends rollovers might also want to consider adopting policies and procedures for ensuring that such rollover recommendations are in the best interests of retail customers.

The Disclosure Obligation

Under Reg. BI's Disclosure Obligation, prior to or at the time of a recommendation, a broker-dealer (or associated person) must provide "full and fair" disclosure in writing of all material facts relating to the scope and terms of the relationship with the retail customer, including the following:

- a disclosure that the firm or representative is acting in a broker-dealer capacity
- the material fees and costs the customer will incur
- the type and scope of the services to be provided, including any material limitations on the recommendations that could be made to the retail customer
- all material facts relating to conflicts of interest associated with the recommendation

In the Reg. BI Adopting Release, the SEC explains that "material facts" relating to conflicts of interest associated with a recommendation would include facts that might incline a broker-dealer to make a recommendation that is not disinterested, including, for example, conflicts associated with proprietary products, payments from third parties, and compensation arrangements.⁴

Individualized Fee Disclosure Not Required. The Disclosure Obligation does not mandate individualized fee disclosure particular to each retail customer.⁵ Instead, the SEC makes clear that broker-dealers may disclose material facts about material fees and costs in more standardized numerical and narrative terms, such as standardized or hypothetical amounts, dollar or percentage ranges, and explanatory text where appropriate.⁶ However, a broker-dealer will have to supplement this standardized disclosure with more particularized information if the broker-dealer concludes that such information is necessary to fully and fairly disclose the material facts associated with the fees or charges associated with a recommendation (e.g., through the delivery of a product prospectus).⁷

Capacity Disclosure. While not evident from the text of Reg. BI, the Reg. BI Adopting Release explains that the first disclosure item above—regarding the capacity—effectively prohibits a broker-dealer and its associated persons from using the term "adviser" or "advisor" if the broker-dealer is not a registered investment adviser or the associated person is not a supervised person of a registered investment adviser.⁸ Readers might recall that when the SEC issued the Reg. BI Proposing Release, the SEC also issued another release proposing, among other things, the adoption of a rule that would have restricted broker-dealers and their associated persons, when communicating with a retail customer, from using the term adviser or advisor as part of a name or title, unless they were registered as, or supervised persons of, an investment adviser.⁹ The SEC decided not to adopt that rule, but instead addressed this matter by expressing the view in the Reg. BI

² Rule 15c-1(a)(1).

³ See Regulation Best Interest, Release No. 34-83062 (Apr. 18, 2018) ("Reg. BI Proposing Release").

⁴ See the Reg. BI Adopting Release at the text accompanying n. 17.

⁵ See the Reg. BI Adopting Release at the text accompanying n. 373-4.

⁶ *Id.*

⁷ See the Reg. BI Adopting Release at the text accompanying n. 375.

⁸ See the Reg. BI Adopting Release at the text accompanying nn. 323-24.

⁹ See Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the Use of Certain Names or Titles, Release No. 34-83063, IA-4888 (Apr. 18, 2018) (the "Form CRS Proposing Release").

Adopting Release that such use of the term adviser or advisor would be presumed to be a violation of the capacity disclosure requirement under the Disclosure Obligation.¹⁰

Implementation considerations: Dual registrants or stand-alone broker-dealers who currently permit their associated persons to use the term adviser or advisor in their designation will likely have to revisit this practice if their associated persons are not also registered as an, or supervised by a registered, investment adviser. Moreover, a stand-alone broker-dealer whose business name includes the term adviser or advisor will likely have to consider a change in its name. Firms might also want to consider designations for their associated persons that appear in marketing collateral, such as websites, account agreements, marketing materials, and associated-person stationery.

Integration of Disclosure. The Reg. BI Adopting Release provides extensive guidance regarding the scope of disclosure the SEC expects a broker-dealer to provide, including guidance on the integration of disclosure across various existing documents, such as account documentation, confirmations, and prospectuses, as well as with the relationship summary required to be delivered under a separate rule, Rule 17a-14, adopted by the SEC in conjunction with Reg. BI.¹¹

Implementation considerations: Firms might want to consider whether to integrate new disclosures developed to comply with Reg. BI with disclosures across various existing documents, or create a single stand-alone comprehensive Reg. BI disclosure. Firms might want to consider developing multiple Reg. BI disclosures for different types of recommendations being made—e.g., one disclosure for account-opening recommendations and another for transaction recommendations. Firms should keep in mind, though, their requirement to record the delivery of the Reg. BI disclosures.

The Care Obligation

The Care Obligation in Reg. BI¹² contains a three-part “reasonable basis,” “customer specific,” and “quantitative” best interest requirement based upon FINRA’s suitability rule guidance. It also requires a broker-dealer to exercise *reasonable diligence, care, and skill* when making a recommendation to a retail customer, without mentioning the term “prudence,” which was included in proposed Reg. BI. The Reg. BI Adopting Release explains that, in the SEC’s view, the term prudence was creating legal uncertainty and confusion; the term was redundant regarding what the SEC intended in requiring broker-dealers to exercise diligence, care, and skill; and removal of the term does not change the requirements under the Care Obligation.¹³

Implementation considerations: To meet the customer-specific best interest requirement under Reg. BI, firms want to consider whether their existing suitability standards, training, and suitability rules engines (or other processes for reviewing transactions for suitability) should be enhanced in order to satisfy Reg. BI’s best interest requirements. In addition, firms will want to ensure that their “rules engine” for automated transaction review is able to differentiate between transactions recommended to retail customers and those effected for customers not covered by Reg. BI.

Inclusion of Costs. The Care Obligation requires the broker-dealer to understand potential risks, rewards, and costs associated with the recommendation. Notably, “costs” did not appear in proposed Reg. BI, and was added to the Care Obligation when the SEC finalized Reg. BI. In the Reg. BI Adopting Release, the SEC emphasizes that, “while cost must be considered, it should never be the only consideration,” as it “is only one of many important factors to be considered regarding the recommendation and that the standard does not necessarily require the ‘lowest cost option.’”¹⁴

¹⁰ See the Reg. BI Adopting Release at the text accompanying nn. 323-24.

¹¹ See generally the Reg. BI Adopting Release at Section II.C.1.a., “Disclosure Obligation – Material Facts Regarding Scope and Terms of the Relationship.” The relationship summary rule is described in “Form CRS Relationship Summary; Amendments to Form ADV,” (June 5, 2019) SEC Release No. 34-86032, available at <https://www.sec.gov/rules/final/2019/34-86032.pdf>.

¹² Rule 15l-1(a)(2)(ii).

¹³ See the Reg. BI Adopting Release at the text accompanying nn. 576-85.

¹⁴ See the Reg. BI Adopting Release at the text accompanying n. 73-4.

Reasonably Available Alternatives. The Reg. BI Adopting Release includes an extensive discussion of the SEC’s view that the Care Obligation requires a broker-dealer to consider “reasonably available alternatives,” if any, offered by the broker-dealer in determining whether it has a reasonable basis for making the recommendation.¹⁵ Notably, the SEC’s view in this regard is not reflected in the Reg. BI rule text itself, but only the Reg. BI Adopting Release.

Implementation considerations: Firms might want to consider whether their policies and procedures relating to product due diligence or product review processes require any changes in order to satisfy Reg. BI’s Care Obligation. For example, firms might want to restructure and reframe their policies and procedures to align with the reasonable basis best interest standard in the Care Obligation by incorporating terms like “diligence, care, and skill” and “best interest” in describing processes that are followed. Furthermore, firms might want to consider whether these processes adequately address conflicts presented by each product or service, and a consideration of the costs, risks, and rewards of each product or service.

The Conflict of Interest Obligation

The Conflict of Interest Obligation in Reg. BI¹⁶ requires a broker-dealer to establish, maintain, and enforce reasonably designed written policies and procedures addressing conflicts of interest associated with recommendations to retail customers. These policies and procedures must be reasonably designed to identify all such conflicts and at a minimum disclose (or eliminate) them.¹⁷ But Reg. BI identifies three specific conflicts that must be mitigated, prevented, or eliminated:

- **Associated Person Incentives.** The policies and procedures must be reasonably designed to *mitigate* conflicts of interest that create an incentive for an *associated person* of the broker-dealer to place his or her interests or the interest of the firm ahead of the retail customer’s interest.¹⁸ In this regard, the SEC identified the following as examples of incentives to an associated person that would require mitigation: (i) compensation from the broker-dealer or from third parties, (ii) employee compensation or employee incentives (e.g., incentives tied to asset accumulation and not otherwise prohibited under the sales contest ban discussed below, special awards, differential or variable compensation, and incentives tied to appraisals or performance reviews, and (iii) commissions or sales charges, or other fees or financial incentives, or differential or variable compensation, whether paid by the retail customer, the broker-dealer, or a third party.¹⁹
- **Material Limitations on Products.** If a broker-dealer places material limitations on recommendations that may be made to a retail customer (e.g., offering only proprietary or other limited range of products), Reg. BI requires the broker-dealer’s policies and procedures to be reasonably designed to identify and disclose such limitations, and *prevent* the limitations from causing the associated person or broker-dealer from placing the associated person’s or broker-dealer’s interests ahead of the customer’s interest.²⁰
- **Sales Contests.** Reg. BI requires that a broker-dealer’s policies and procedures must be reasonably designed to identify and *eliminate* sales contests, sales quotas, bonuses, and noncash compensation that are based on the sale of specific securities or specific types of securities within a limited period of time.²¹ The SEC does not provide a bright-line definition of “limited period of time” for these purposes.

Implementation considerations: Firms will likely need to consider how to structure policies and procedures to identify and eliminate sales contests, sales quotas, bonuses, and noncash compensation that are based on the sale of specific securities or specific types of securities within a limited period of time (collectively, sales contests), and make sure that no such contests are in place on June 30, 2020, when Reg. BI takes effect.

15 See *generally* the Reg. BI Adopting Release at Section II.C.2.c., “Application of the Care Obligation—Reasonably Available Alternatives and Otherwise Identical Securities.”

16 Rule 15f-1(a)(2)(iii).

17 Rule 15f-1(a)(2)(iii)(A).

18 Rule 15f-1(a)(2)(iii)(B).

19 See the Reg. BI Adopting Release at the text accompanying n. 745-6.

20 Rule 15f-1(a)(2)(iii)(C).

21 Rule 15f-1(a)(2)(iii)(D).

Examples of Mitigation Methods for Associated Person Incentives. The Reg. BI Adopting Release includes an extensive discussion of the SEC's views on the mitigation of associated person-level conflicts of interest,²² and restates the list of examples of mitigation methods included in the Reg. BI Proposing Release.

Implementation considerations: To the extent not already adopted, firms might want to consider adopting policies and procedures specifically addressing the identification and mitigation of conflicts associated with associated person compensation. Furthermore, firms that already have policies and procedures addressing associated person compensation might want to make sure they adequately address the mitigation of conflicts arising out of such compensation. And finally, firms might want to consider use of some of the illustrative examples of mitigation methods provided in the Reg. BI Adopting Release.²³

The Compliance Obligation

Under the Compliance Obligation in Reg. BI,²⁴ a broker-dealer must also establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Reg. BI as a whole. Thus, a broker-dealer's policies and procedures must address not only conflicts of interest but also compliance with its Disclosure and Care obligations under Reg. BI.

Implementation considerations: Throughout the Reg. BI Adopting Release, the SEC instructs firms that their policies and procedures "should" address certain topics or require a prescribed process. Firms might want to consider whether the guidance the SEC provides is applicable to their respective business models and, if so, whether they should adopt policies and procedures consistent with that guidance.

Definitions

No Best Interest Definition. Despite requests from many commenters that the SEC do so, the SEC did not define best interest in Reg. BI, instead opting to explain in Reg. BI and through the Reg. BI Adopting Release what "acting in the best interest" means. In the SEC's view, "whether a broker-dealer has acted in the retail customer's best interest in compliance with Regulation Best Interest will turn on an objective assessment of the facts and circumstances of how the specific components of Regulation Best Interest—including its Disclosure, Care, Conflict of Interest, and Compliance Obligations—are satisfied at the time that the recommendation is made (and not in hindsight)."²⁵

New Conflict of Interest Definition. Reg. BI adds a new definition for "conflict of interest": 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.²⁶ In the Reg. BI Adopting Release, the SEC explains that it drew upon the description of a conflict of interest that has developed under the Advisers Act.²⁷

Retail Customer. Reg. BI defines "retail customer" as any 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.²⁸

Implementation considerations: Firms that will continue to provide broker-dealer services to customers who are not retail customers (e.g., institutional customers or retirement plan sponsors that are not deemed the legal representative of a natural person) might want to ensure that their systems are able to identify accounts that would not be considered retail customer accounts subject to Reg. BI. Firms will also want to keep in mind that they will need to preserve their existing compliance and operational structure for customer accounts that are not covered by Reg. BI.

²² See generally the Reg. BI Adopting Release at Section II.C.3.e., "Conflict of Interest Obligation – Mitigation of Certain Incentives to Associated Persons."

²³ See the Reg. BI Adopting Release at the text accompanying nn. 753-61.

²⁴ Rule 15c-1(a)(2)(iv).

²⁵ See the Reg. BI Adopting Release at the text accompanying n. 66-7.

²⁶ Rule 15c-1(b)(3).

²⁷ See the Reg. BI Adopting Release at the text accompanying nn. 421-22.

²⁸ Rule 15c-1(b)(1).

Retail Customer Investment Profile. Reg. BI's definition of "retail customer investment profile" includes, but is not limited to, "the retail customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the retail customer may disclose to the broker, dealer, or a natural person who is an associated person of a broker or dealer in connection with a recommendation."²⁹

Recordkeeping Requirements

In connection with adopting Reg. BI, the SEC added new provisions to the record-making and recordkeeping rules under the Exchange Act corresponding to Reg. BI. In particular, new Rule 17a-3(a)(35) under the Exchange Act requires broker-dealers to make and keep a record of all information collected from and provided to retail customers pursuant to Reg. BI, as well as the identity of each natural person, if any, responsible for each account. Neglect, refusal, or inability of a retail customer to provide or update any required information excuses the broker-dealer from obtaining it.

Furthermore, new Rule 17a-4(e)(5) requires broker-dealers to maintain the information collected pursuant to new Rule 17a-3(a)(35) until at least six years after the earlier of the date the account was closed or the date on which the information was collected, provided, replaced, or updated.

Implementation considerations: Given the long lead time that many broker-dealers' information technology and software development teams need to develop and deploy new or modified systems to capture required information, firms will want to notify these teams as soon as possible of the new recordkeeping requirements.

²⁹ Rule 15c-1(b)(2).

Contacts

For more commentary regarding the emerging landscape related to the standards of conduct for investment professionals, visit Eversheds Sutherland's www.fiduciaryregulatory.com.

If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Eversheds Sutherland attorney with whom you regularly work.

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