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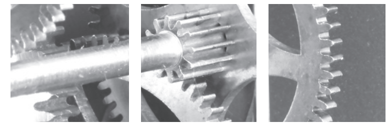

REG BI: Considerations for Interpretation, Implementation and Enforcement

By: Joseph S. Simms

Reg BI establishes a standard of conduct for broker-dealers and their associated persons when recommending a securities transaction or investment strategy to a retail customer. It establishes a "general obligation" that broker-dealers and their associated persons act in the best interests of the retail customer at the time the recommendation is made, without placing financial or other interests of the broker-dealer or associated person ahead of the retail customer. Full compliance is required by June 30, 2020.

Reg BI applies to a retail customer who both receives a recommendation of any "securities transaction" or "investment strategy" involving securities and uses that recommendation primarily for personal, family, or household purposes. While the standard was inspired by "key principles" of the Advisers Act, the SEC has declined to apply the existing fiduciary standard under the Advisers Act to broker-dealers. In addition, the SEC has declined to craft a new uniform standard that would apply to both broker-dealers and investment advisors. In relation to the general obligation to act in a retail customer's best interests, Reg BI does not explicitly define best interest, but rather requires broker-dealers and associated persons to comply with four specific areas: 1) disclosure, 2) care, 3) conflict of interest, and 4) compliance. Whether a broker-dealer has satisfied its best interest obligation turns on the facts and circumstances of the particular recommendation and retail customer along with how the four specific components of Reg BI as described below are satisfied.

The Disclosure Obligation

The "disclosure obligation" requires broker-dealers and associated persons to provide a full and fair written disclosure of all material facts about the scope and terms of their relationship with the retail customer prior to or at the time of the recommendation, including: (1) the scope and type of services and the material fees and costs that apply to the retail customer's transactions, holdings, and accounts; (2) material limitations on the securities or strategies that may be recommended; and (3) all material facts relating to conflicts of interest associated with the recommendation. Included in the disclosure obligation is the requirement to provide retail customers with a Form CRS explaining the nature of the firm's services and relationship, its fees and costs, and its standard of conduct and conflicts of interest.

The SEC has decided not to provide any prescriptive requirements for the form, timing or frequency of written disclosures, other than requiring the Form CRS Relationship Summary and requiring that disclosure be made prior to or at the time of the recommendation. The "in writing" requirement could be satisfied either through paper or electronic means and the disclosure should be concise, clear and understandable to promote effective communication between a broker-dealer and a retail customer. However, the adequacy of the disclosure will depend on the facts and circumstances. The SEC intends to evaluate broker-dealer disclosure practices in response to Reg BI over time to determine whether additional disclosure initiatives may be appropriate.

Pursuant to the disclosure obligation, broker-dealers should build upon their disclosure in the Form CRS Relationship Summary and provide additional information regarding the types of services that will be provided as part of the relationship with the retail customer and the scope of those services. Additional material facts relating to the scope and terms of the relationship include the type of services; fees and costs; account monitoring services offered; account balance requirement; and basis for and risks associated with the recommendation.

The Care Obligation

The care obligation was intended to enhance investor protection by: (1) explicitly prohibiting placing the broker-dealer's interests ahead of the retail customer, and, instead, requiring that recommendations be in the best interests of the retail customer; (2) explicitly requiring the consideration of costs when making a recommendation; and (3) applying the obligations relating to a series of recommended transactions (referred to as "quantitative suitability") irrespective of whether a broker-dealer exercises actual or de facto control over a customer's account.

The care obligation requires that the broker-dealer or associated person making the recommendation exercise reasonable diligence, care and skill to: (1) understand the potential risks, rewards, and costs associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interests of at least some retail customers; (2) have a reasonable basis to believe that the recommendation is in the best interests of a particular retail customer based on that retail customer's investment profile and the potential risks and rewards associated with the recommendation; and (3) have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interests when viewed in isolation, is not excessive and is in the retail customer's best interests when taken together in light of the retail customer's investment profile. In addition, a broker-dealer should consider "reasonably available alternatives" as part of having a "reasonable basis to believe" that the recommendation is in the best interests of the retail customer.

What would constitute reasonable diligence, care, and skill will vary depending on the complexity of and risks associated with the recommended security or investment strategy and the broker-dealer's familiarity with the recommended security or investment strategy. A broker-dealer would violate the obligation by not understanding the potential risks, rewards, or costs of the recommended security or investment strategy, even if the security or investment strategy could have been in the best interests of at least some retail customers. Moreover, even if a broker-dealer understands the recommended security or investment strategy, the broker-dealer must still have a reasonable basis to believe the security or investment strategy could be in the best interests of at least some retail customers, and must have a reasonable basis to believe that it is, in fact, in the best interests of the particular customer, based on that customer's investment profile.

The significance of any particular type of customer information will be determined based on a facts and circumstances analysis that includes, among other things, 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 in connection with a recommendation. A broker-dealer

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does not satisfy its care obligation if it makes a recommendation to a retail customer for whom it lacks sufficient information to have a reasonable basis to believe that the recommendation is in the best interests of that customer based on his/her investment profile.

Conflict of Interest Obligation

To satisfy the conflict of interest obligation, broker-dealers and their associated persons must establish, maintain and enforce written policies and procedures reasonably designed to (1) identify and at least disclose (if not eliminate) conflicts of interest associated with the recommendation; and (2) mitigate and eliminate specified identified conflicts of interest. Sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or types of securities within a limited period are prohibited, although the prohibition only applies to the sales of specific securities or types of securities, and not to compensation practices based on considerations like total products sold, or asset growth or accumulation, and customer satisfaction.

The SEC does not suggest a one-size-fits all framework in the conflict of interest obligation to allow broker-dealers to have the flexibility to reasonably design their policies and procedures tailored to their business model. However, Reg BI suggests that reasonably designed policies and procedures to identify conflicts of interest generally should do the following: (1) define such conflicts in a manner that is relevant to a broker-dealer's business, and in a way that enables employees to understand and identify conflicts of interest; (2) establish a structure for identifying the types of conflicts that the broker-dealer may face; (3) establish a structure to identify conflicts in the broker-dealer's business as it evolves; (4) provide for an ongoing and regular, periodic review for the identification of conflicts associated with the broker-dealer's business; and (5) establish training procedures regarding the broker-dealer's conflicts of interest, including how to identify such conflicts of interest, and how to define employees' roles and responsibilities with respect thereto.

With respect to mitigation, broker-dealers are required to establish policies and procedures reasonably designed to identify and mitigate conflicts of interest associated with such recommendations that create an incentive to place the interests of the broker-dealer or associated person ahead of the interests of the retail customer. Although the goal of Reg BI is to enhance investor protection, it does not call for the elimination of all firm-level financial incentives. The requirement to identify and mitigate any conflicts of interest only applies to incentives provided to the associated person, whether by the firm or third-parties, that are within the control of or associated with the broker-dealer's business (i.e. compensation that varies based on the advice given) including: (1) compensation from the broker-dealer or from third-parties, including fees and other charges for the services provided and products sold; (2) employee compensation or employment; and (3) commissions or sales charges, or other fees or financial incentives, or differential or variable compensation.

The obligation to mitigate also is intended to address the conflicts of interest presented when broker-dealers place any material limitations on the securities or investment strategies that may be recommended to a retail customer (i.e., only make recommendations of proprietary or other limited ranges of products).

The Compliance Obligation

In addition to the procedures required by the conflict of interest obligation, a broker-dealer 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 compliance program should also include controls, remediation of noncompliance, training, and periodic review and testing. However, the compliance obligation does not enumerate specific requirements that broker-dealers must include in their policies and procedures insofar as broker-dealers are too varied in their operations for rules to impose a single set of universally applicable specific required elements. Whether policies and procedures are reasonably designed to comply with Reg BI will depend on the facts and circumstances of a given situation.

Recent Developments

FINRA has publicly stated that it is actively considering revamping its rulebook to facilitate implementation and enforcement of Reg BI in light of questions surrounding the ongoing viability and applicability of certain rules in a post-Reg BI world (particularly FINRA's Commercial Honor Rule (Rule 2010) and its Suitability Rule (Rule 2111)). In connection with the quickly approaching June 30, 2020 compliance date for Reg BI, FINRA has also indicated that it's considering the impact of Reg BI on FINRA's exam programs (which are still undergoing the "consolidation" process the self-regulatory organization began in October 2018). FINRA has also indicated that it will defer to the SEC to interpret Reg BI (although FINRA will retain enforcement responsibility, which raises the question of how FINRA will "enforce" the rule without "interpreting" it).

To add to the confusion and the in-flux nature of the new regulation, on September 9, 2019, seven states (New York, California, Connecticut, Delaware, Maine, New Mexico and Oregon) and the District of Columbia filed a lawsuit against the SEC in the U.S. District Court for the Southern District of New York, alleging that Reg BI does not institute the uniform fiduciary standard as contemplated by the investor-protection provisions of the Dodd-Frank Act, and specifically does not impose a fiduciary standard contemplated by the Investment Advisors Act of 1940. The following day, XY Planning Network filed suit in the Southern District of New York, making similar allegations that the new regulation falls short of the requirements of the 1940 Act and Dodd-Frank.

How the SEC responds to these lawsuits, whether state fiduciary and best interest laws will be preempted by the federal regulation, and how the litigation and FINRA's rulemaking initiatives impact the timing, implementation and enforcement of Reg BI, all remain to be seen. For the time being, firms should continue updating their policies, procedures and documentation, and implement adequate training, to comply with the regulation as currently written.

Comments suggestions or inquiries are welcome and should be directed to:

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