CLIENT ALERT

SEC Adopts Regulation Best Interest

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On June 5, 2019, the Securities and Exchange Commission (the "SEC") adopted rules and interpretations addressing the standards of conduct applicable to broker-dealers and investment advisers and their associated persons. This Alert addresses the new standard of conduct for broker-dealers in Regulation Best Interest ("Reg. BI") under the Securities Exchange Act of 1934 ("Exchange Act") and related rule changes, which have a compliance date of **June 30, 2020.** In conjunction with adoption of Reg. BI, the SEC also adopted (i) disclosure requirements under Form CRS, which apply both to investment advisers registered under the Investment Advisers Act of 1940 ("Advisers Act") when advising retail clients and to broker-dealers making recommendations to retail customers, and (ii) interpretative guidance under the Advisers Act.

Overview

Reg. BI, adopted as new Rule 15l-1 under the Exchange Act,[1] establishes a new standard of conduct for broker-dealers and their associated persons when they make a recommendation to a retail customer involving securities, securities accounts or investment strategies involving securities and the recommendation is used by the retail customer. Under Reg. BI, when making a recommendation, a broker-dealer must act in the best interest of the retail customer and cannot place its financial or other interests ahead of the retail customer's interests. The SEC made clear that the standard

[1] Securities Exchange Act Release No. 86031 (June 5, 2019) ("Adopting Release"). Reg. BI does not establish a "safe harbor"; the requirements are mandatory. *Id.* at 72.

cannot be satisfied solely through disclosure, and a retail customer cannot agree to waive the protections provided by Reg. BI.[2]

To comply with the standard of conduct established in Reg. BI (also referred to as the "General Obligation"), a broker-dealer (and, in some cases, associated persons of the broker-dealer) must meet four separate, component obligations:[3]

1. **Disclosure Obligation**[4] – requires a broker-dealer and its associated persons to disclose fully and fairly in writing, at or before the time of the recommendation, all material facts about conflicts of interest relating to the recommendation (including how a broker-dealer and its associated persons are compensated) and about the scope and terms of the relationship with the retail customer. Minimum required disclosures include the fact that the firm and associated person are acting in a broker-dealer capacity, material fees and costs the retail customer will incur, and the type and scope of services provided to the retail customer, including any material limitations on the securities or investment strategies that may be recommended to the retail customer. Post-recommendation disclosure and oral disclosure are permitted in limited circumstances.

2. **Care Obligation** – requires broker-dealers and their associated persons to exercise reasonable diligence, care, and skill when making a recommendation to a retail customer. The Care Obligation extends to recommendations of individual securities and investment strategies as well as to recommendations regarding specific account types, including Individual Retirement Account rollovers. Compliance with the Care Obligation is determined based on the facts and circumstances of the particular recommendation at the time the recommendation is made. In making a recommendation, broker-dealers and their associated persons must always consider the costs associated with the recommendation and reasonably available alternatives offered by the broker-dealer. The Care Obligation incorporates and expands upon existing suitability obligations in FINRA Rule 2111.

3. **Conflict of Interest Obligation** – requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to identify and at a minimum disclose (pursuant to the Disclosure Obligation) or eliminate all conflicts of interest associated with recommendations to retail customers. The Conflict of Interest

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[2] If a financial professional who is dually registered makes a recommendation to a retail customer, whether Reg. BI or the Advisers Act fiduciary standard applies depends upon the capacity in which the financial professional making the recommendation is acting. Factors to consider in such an analysis include the type of account, how the account is described, the type of compensation, and the extent to which the capacity was made clear to the customer. *See* Adopting Release at 127.

[3] The Disclosure Obligation and the Care Obligation apply to both broker-dealers and associated persons; the Conflict of Interest Obligation and the Compliance Obligation apply only to broker-dealer firms.

[4] Although the Form CRS Relationship Summary may satisfy certain elements of the Disclosure Obligation, Reg. BI's Disclosure Obligation is a separate regulatory requirement that is in addition to the disclosure obligations applicable to broker-dealers in Form CRS.

Obligation specifically requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to identify and

- *mitigate* any conflicts of interest associated with recommendations that create an incentive for an associated person to place the interest of the broker-dealer or the associated person ahead of the interest of the retail customer;

- *disclose* (in accordance with the Disclosure Obligation) 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 *and prevent* such limitations and associated conflicts of interest from causing the broker-dealer or associated person to make recommendations that place the interest of the broker-dealer or the associated person ahead of the interest of the retail customer; and

- *eliminate* any conflicts of interest associated with sales contests, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time.

4. **Compliance Obligation** – requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Reg. BI. Any compliance program should include controls to prevent violations from occurring and detect violations that have occurred, remediation of non-compliance, training, and periodic review and testing.

Recordkeeping – In addition to Reg. BI, the SEC adopted amendments to the recordkeeping requirements in Rules 17a-3 and 17a-4 that require a broker-dealer to keep records of all information collected from and provided to a retail customer pursuant to Reg. BI for six years after the earlier of the date the account was closed or the date on which the information was replaced or updated. The records should be separately retained to demonstrate compliance with Reg. BI rather than included in the "business as such" records category.

Enforcement – The SEC did not establish a new private right of action or rescission right for violations of Reg. BI , and the SEC made clear that private rights of action against broker-dealers alleging breaches of a duty of care must be brought under the general antifraud provisions of the federal securities law.[5] For SEC enforcement actions, scienter will not be required to establish a violation of Reg. BI.[6] Finally, the SEC did not explicitly address whether Reg. BI would preempt state law's law provisions, instead asserting that the preemption of state law "would be determined in future judicial proceedings."[7]

[5] *See* Adopting Release at 43-44.

[6] *See* Adopting Release at 43.

[7] *Id.*

Obligations Not Imposed

In adopting Reg. BI, the SEC specifically identified several obligations that Reg. BI does not impose. Specifically, it *does not*:

- extend beyond a particular recommendation except to the extent it addresses multiple recommended transactions that involve churning or similar conflicts of interest that would violate the Care Obligation;
- require a broker-dealer to have a continuous duty to a retail customer;
- impose a duty to monitor;
- obligate a broker-dealer to refuse to accept a retail customer's order that is contrary to the broker-dealer's recommendation; or
- apply to self-directed or otherwise unsolicited transactions by a retail customer.[8]

Discussion

Terminology

Best Interest

The term "best interest" is not defined in Reg. BI or the Adopting Release, and although the best interest standard is not intended to be a fiduciary standard, it is clear that the SEC drew on key principles underlying fiduciary obligations in crafting Reg. BI.[9] The Adopting Release also makes clear that, although the SEC considered the Department of Labor's now-vacated Fiduciary Rule (the "DOL Rule")[10] in developing the best interest standard, the Reg. BI best interest standard is not the same as that established by the DOL Rule or the "Best Interest Contract" prohibited transaction exemption under the DOL Rule. The SEC noted that adoption of the DOL Rule had led to a significant reduction in retail investor access to brokerage services and higher prices for retail investors.[11] Accordingly, the SEC sought to create a different

8 Adopting Release at 77.

9 *See* Adopting Release at 13.

10 On April 8, 2016, the Department of Labor adopted an expanded definition of "fiduciary" that applied to persons providing investment advice or recommendations for a fee or other compensation with respect to assets of a benefit plan subject to the Employee Retirement Income Security Act of 1984 or an individual retirement account ("IRA"). The rule was vacated in whole by the United States Court of Appeals for the Fifth Circuit. *Chamber of Commerce v. U.S. Dep't of Labor*, 885 F.3d 360 (5th Cir. 2018).

11 *See* Adopting Release at 21.

standard to balance its goal of protecting retail investors while preserving, to the extent possible, access to differing types of investment services and products (in terms of choice and cost).

Recommendation

The term "recommendation" is also not defined in Reg. BI; instead, the meaning of that term will depend on the surrounding facts and circumstances. The SEC noted, however, that it was relying on existing guidance in which a "recommendation" generally includes a "call to action" regarding securities or investment strategies involving securities (including recommendations to take plan distributions or in-service loans from plans).[12] Borrowing from FINRA guidance on the Suitability Rule (FINRA Rule 2111), the SEC stated that "[t]he more individually tailored the communication to a specific customer or a targeted group of customers about a security or group of securities, the greater the likelihood that the communication may be viewed as a 'recommendation.'"[13] Aspects of Reg. BI nevertheless broaden the scope of existing FINRA suitability obligations. For example, the term "recommendation" under Reg. BI includes recommendations regarding account types and rollovers or transfers of assets and, if a broker-dealer agrees to monitor accounts of retail customers, implicit hold recommendations. The term "recommendation" excludes general educational materials, asset allocation models that comply with FINRA Rule 2214, descriptive information about retirement plans, and unsolicited orders.[14] Finally, Reg. BI does not impose liability on a broker-dealer for breach of the best interest standard unless the retail customer "uses" the recommendation.[15]

Retail Customer

The term "retail customer" is defined as a natural person, or the non-professional legal representative of such person, who: (A) receives a recommendation of a securities transaction or investment strategy involving securities from a broker, a 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.[16] The reference to "personal, family or household" purposes covers retirement accounts, including both IRAs and individual accounts in workplace retirement plans, but does not include an employee seeking services for an employer or an individual seeking services for a small business or on behalf of a non-

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12 *See* Adopting Release at 78-81.

13 Adopting Release at 80.

14 *See* Adopting Release at 89-91.

15 Adopting Release at 99 n.202, 120-21. The SEC noted that a retail customer would be deemed to "use" a recommendation when: (1) the retail customer opens a brokerage account with the broker-dealer, regardless of whether the broker-dealer receives compensation; (2) the retail customer has an existing account with the broker-dealer and receives a recommendation from the broker-dealer, regardless of whether the broker-dealer receives or will receive compensation, directly or indirectly, as a result of that recommendation; or (3) the broker-dealer receives or will receive compensation, directly or indirectly as a result of that recommendation, even if that retail customer does not have an account at the firm.

16 Adopting Release at 109.

natural person entity such as a charitable trust. Notably, this definition departs from existing definitions of "retail" customers and includes high net worth individuals (i.e., natural persons with total assets of at least $50 million) excluded from certain aspects of FINRA's suitability rule.[17]

Disclosure Obligation

The Disclosure Obligation requires a broker-dealer and its associated persons to disclose fully and fairly in writing,[18] at or before the time of the recommendation, all material facts about conflicts of interest relating to the recommendation and about the scope and terms of the relationship with the retail customer.[19] The SEC recognized that "in many instances, information necessary to satisfy the Disclosure Obligation may be broadly applicable to a broker-dealer's retail customers, and therefore the use of standardized disclosure may be appropriate."[20] In other instances, however, "disclosures may need to be tailored to a particular recommendation if the standardized disclosure does not sufficiently identify the material facts about a conflict of interest presented by a particular recommendation."[21] If an associated person of a broker-dealer knows "or should have known" that the disclosures provided to the retail customer are insufficient to describe "all material facts," then the associated person has an obligation personally to supplement the disclosures. The SEC noted that such an obligation would arise, for example, when an associated person is licensed solely as a Series 6 registered representative and the existing disclosure by the broker-dealer does not make clear the limited product set that the associated person is authorized to sell.[22] The reference by the SEC to "should have known" appears to impose independent diligence obligations on associated persons in addition to the disclosure mandated by the Disclosure

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17 FINRA Rule 2111(b) provides an exemption to customer-specific suitability for institutional accounts in certain circumstances. The definition of "institutional account" is in FINRA Rule 4512(c) and includes: (i) banks, savings and loan associations, insurance companies, and registered investment companies; (ii) registered investment advisers; and (iii) any other person (including natural persons) with total assets of at least $50 million. Other FINRA rules contain different definitions of "retail investor." *See, e.g.*, FINRA Rules 2210(a)(6); 2242(a)(13).

18 All disclosures may be provided electronically consistent with existing guidance requiring (i) notice that information is available; (ii) access comparable to paper form; and (iii) evidence showing delivery (which may be evidenced through informed consent). If a broker-dealer is providing its customers with electronic delivery, it must make paper delivery available upon request. Adopting Release at 233.

19 The SEC clarified in the Adopting Release that the standard for "materiality" for purposes of the Disclosure Obligation is consistent with the Supreme Court's decision in *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988): a fact is "material" if there is "a substantial likelihood that a reasonable shareholder would consider it important." In the context of Reg. BI, the standard is the retail customer. Adopting Release at 132-33. A broker-dealer's compliance with the Disclosure Obligation will be measured against a negligence standard, not one of strict liability. *See id.* at 217.

20 Although the SEC did not establish a specific time frame in which updates to disclosure must be made, it "encourages broker-dealers to update their disclosures to reflect material changes as soon as practicable, and thus generally should be no later than 30 days after the material change." Adopting Release at 244.

21 Adopting Release at 224.

22 Adopting Release at 141.

Obligation. Although it is not required, the SEC "encourages" broker-dealers to make any required disclosures in "plain English."[23]

Reg. BI does not require disclosure of the basis for each recommendation; however, the SEC stated that "broker-dealers should consider developing policies and procedures that address the circumstances under which the basis for a particular recommendation should be disclosed to a retail customer."[24] Disclosures are generally required to be updated no later than thirty (30) days after changes.[25]

Scope and Terms of the Relationship

The Disclosure Obligation requires that broker-dealers and associated persons disclose all material facts related to the scope and terms of the relationship with the retail customer. At a minimum, required disclosures include the fact that the firm and associated person are acting in a broker-dealer capacity, material fees and costs the retail customer will incur, 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 such as selling only proprietary products).[26] Although not in the rule text itself, the SEC stated that it would consider the following to be material facts relating to the broker-dealer's type and scope of services that must be disclosed:

- whether account monitoring is provided (and, if so, the frequency of any account monitoring);
- account minimums or account balance requirements;
- general investment approach, philosophy, or strategy of the broker-dealer and associated person; and
- the risks associated with a broker-dealer's or associated person's recommendations in standardized terms. [27]

[23] Adopting Release at 230. Compliance with Reg. BI's disclosure requirements is not determinative of a broker-dealer's potential liability under general antifraud laws, nor does compliance with the Disclosure Obligation cure a violation of the Care Obligation.

[24] Adopting Release at 191. As a best practice, broker-dealers should encourage associated persons to discuss the basis for recommendations with retail customers.

[25] Adopting Release at 244.

[26] The SEC noted that a broker-dealer that is not also registered as an investment adviser will generally be able to satisfy the Disclosure Obligation's requirement to disclose the capacity in which the broker-dealer is acting by providing the retail investor with the Form CRS Relationship Summary. *See* Adopting Release at 147.

[27] Adopting Release at 37-38.

Use of the Terms "Adviser" and "Advisor"

In explaining the scope of the Disclosure Obligation's requirement to disclose capacity, the SEC stated that there is a presumption that the use of the terms "advisor" or "adviser" by a broker-dealer that is not a registered investment adviser or by a financial professional that is not a supervised person of an investment adviser violates Reg. BI's Disclosure Obligation. The SEC also suggested that there would not be many circumstances in which incorporation of the term "adviser" or "advisor" into a name of a broker-dealer or associated person who was not otherwise registered as an investment adviser would not violate the Disclosure Obligation[28] and that those few circumstances would involve investment advice other than to retail clients, such as acting as a municipal advisor.[29] A broker-dealer's marketing materials may state that it and its registered persons provide "advice," but only in a manner that is consistent with Reg. BI, Form CRS, and the SEC's interpretation of the "solely incidental" prong of the definition of "investment adviser" in the Advisers Act.[30] The SEC indicated that FINRA would revise FINRA Rule 2210 to conform to these disclosure requirements and that FINRA and the SEC staff would review marketing communications by broker-dealers and dual registrants to consider whether "additional measures may be necessary."

Fees and Costs

The requirement to disclose material fees and costs relating to the retail customer's transactions, holdings and accounts does not necessitate individualized disclosure for each retail customer. Moreover, a broker-dealer can meet its obligation regarding fees and costs assessed at a product level by "describing those fees and costs in initial, standardized terms and providing subsequent particularized disclosure as necessary."[31] The SEC warned, however, that describing a fee that is a commission or mark-up "as a fee for handling services" could inappropriately disguise the fee's true nature, in violation of Reg. BI.[32] The SEC also noted that conflicts of interest arising out of compensation arrangements (including payments by product sponsors, such as payments for shelf space) as well as material facts concerning conflicts of interest raised by variable compensation must be disclosed both in Form CRS and under the Disclosure Obligation.

Material Limitations on Services

The Disclosure Obligation also requires broker-dealers to disclose any material limitations on the securities or investment strategies involving securities that may be recommended to a retail customer. The SEC noted that broker-dealers will "generally need to build upon the disclosures made in the [Form CRS] Relationship Summary as appropriate" to meet this

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28 Adopting Release at 157.

29 Adopting Release at 158.

30 *See* Adopting Release at 162. The SEC's interpretation of the term "solely incidental" was published in SEC Release No. IA-5249 (June 5, 2019).

31 Adopting Release at 169.

32 Adopting Release at 173.

obligation; however, they may be able to rely on existing disclosures included in account opening agreements or other account opening documentation, provided that the disclosure as a whole addresses the material facts related to the type and scope of services.[33] Disclosure of material limitations would require disclosure of, for example, recommending only proprietary products, a specific asset class, or products with third-party arrangements or from a select group of issuers. The SEC made clear, however, that "the fact that a broker-dealer does not offer the *entire* possible range of securities and investment strategies," standing alone, need not be disclosed. In addition, material limitations regarding the particular associated person must be disclosed. For example, associated persons must disclose whether they have a limited registration and dually registered associated persons and associated persons of a dually registered broker-dealer who offer only broker-dealer services, must disclose whether they are acting (or acting only) as an associated person of a broker-dealer. Similarly, an associated person of a dual registrant who does not provide investment advisory services must disclose that fact "as a material limitation."

Conflicts of Interest

Reg. BI requires that broker-dealers and associated persons disclose all material facts regarding conflicts of interest associated with a recommendation and defines a "conflict of interest" 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." Importantly, Reg. BI covers all conflicts of interest (not just material conflicts); however, disclosure is required only of material facts regarding these conflicts of interest.

Material facts relating to conflicts of interest include how a broker-dealer and its associated persons are compensated. This obligation does not necessitate disclosure of specific compensation amounts; however, the SEC stated that, depending upon the facts and circumstances, the obligation may require disclosure of "the general magnitude of the compensation."[34] This obligation may be satisfied by general disclosure pre-recommendation followed by specific information after the recommendation (e.g., in a confirmation) provided that the general disclosure explains when and how that further information will come in the later disclosure. [35]

Oral Disclosure

The SEC recognized that, in certain circumstances, flexibility is necessary and appropriate regarding written and oral disclosure and the timing in which disclosure is made. For example, if a broker-dealer's written disclosure needs to be updated, a broker-dealer may satisfy the Disclosure Obligation by making supplemental oral disclosure no later than the time of the recommendation provided it maintains a record of the fact that the oral disclosure was provided. However,

[33] Adopting Release at 177.

[34] Adopting Release at 205.

[35] Adopting Release at 137.

"[b]efore supplementing, clarifying or updating written disclosure . . . , broker-dealers must provide an initial disclosure in writing that identifies the material fact and describes the process through which such fact may be supplemented, clarified or updated."[36] When making an oral disclosure, the broker-dealer must maintain a record of the fact that oral disclosure was provided, but not, however, of the substance of the oral disclosure itself.[37] In addition, where existing regulations permit disclosure after a recommendation has been made (e.g., trade confirmation, prospectus delivery), a broker-dealer may satisfy the Disclosure Obligation by providing this documentation after the recommendation.

Account Monitoring and Implicit Hold Recommendations

Reg. BI does not impose on a broker-dealer or associated person a duty to monitor a retail customer's account; however, if a broker-dealer agrees to monitor a retail customer's account as part of its services, the terms of these services (including its existence, scope, and frequency) must be disclosed pursuant to the Disclosure Obligation. The SEC made clear that agreed-upon account monitoring also creates an implicit recommendation to hold at the time the agreed-upon monitoring occurs, and this is true even if the hold recommendation is not communicated to the retail customer. Voluntary review of a retail customer's account is not considered agreed-upon account monitoring and would therefore not result in an implicit hold recommendation. Because implicit hold recommendations, which are not covered by existing suitability obligations, are subject to the requirements of Reg. BI, any agreement to monitor a retail customer's account should identify with specificity when monitoring will occur and the scope of the account monitoring.[38]

Care Obligation

The Care Obligation of Reg. BI requires broker-dealers and their associated persons to exercise reasonable diligence, care, and skill when making a recommendation, including considering risks, rewards, and costs. Compliance with the Care Obligation is determined based on the facts and circumstances of the particular recommendation at the time the recommendation is made (and not in hindsight); however, cost must always be considered in connection with making a recommendation. The Care Obligation is based in large measure on existing suitability requirements and includes the same three subsidiary criteria for suitability set forth in FINRA Rule 2111: reasonable basis, customer-specific, and quantitative suitability. Reg. BI, however, expands these requirements in several ways, as described below. In addition, compliance with the Care Obligation requires a broker-dealer or associated person to consider "reasonably available alternatives" when making a recommendation.

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[36] Adopting Release at 138.

[37] Adopting Release at 229. The SEC "encourages" broker-dealers that make oral disclosures to subsequently provide to their retail customers in a timely manner a written disclosure summarizing the information previously conveyed orally. *Id.*

[38] *See* Adopting Release at n.168 and accompanying text. Except in the context of agreed-upon account monitoring, Reg. BI applies to hold recommendations only when they are explicit, which is consistent with existing suitability obligations under FINRA Rule 2111. *See id.* at 84 n.170; 105-06.

Reasonable Basis

The Care Obligation builds upon a broker-dealer's existing "reasonable-basis suitability" obligations and requires that the broker-dealer "undertake reasonable diligence, care, and skill to understand the nature of the recommended account type, security or investment strategy, as well as the potential risks, rewards—and costs—of the recommended account type, security or investment strategy, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers based on that understanding."[39] The SEC stated that this inquiry should generally include such considerations as "the security's or investment strategy's investment objectives, characteristics (including any special or unusual features), liquidity, volatility, and likely performance in a variety of market and economic conditions; the expected return of the security or investment strategy; as well as any financial incentives to recommend the security or investment strategy."[40]

Customer-Specific

In addition to the obligation to conclude that an investment or investment strategy is in the best interest of at least some retail customers, the Care Obligation requires that the broker-dealer or associated person also have a reasonable basis to believe the recommendation is in the best interest of the particular retail customer receiving the recommendation based on the retail customer's investment profile and the potential risks, rewards and costs associated with the recommendation.[41]

One key focus of the SEC's rulemaking as it relates to the Care Obligation is the focus on the broker-dealer's and associated person's analysis of the cost associated with a recommendation. The SEC stressed that while cost is *always* a factor that must be considered, it is not dispositive and should never be the only consideration. The SEC's inclusion of cost in the rule text was not intended to "limit or foreclose the recommendation of a more costly or complex product that a broker-dealer has a reasonable basis to believe is in the best interest of a particular customer."[42]

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[39] Adopting Release at 261.

[40] Adopting Release at 262.

[41] Reg. BI defines "retail customer investment profile" as including, but 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." As is the case with existing obligations under FINRA's suitability rule, broker-dealers may generally rely on a retail customer's responses unless there are "red flags" that indicate the information is inaccurate. Adopting Release at 274 n.612, 277.

[42] Adopting Release at 249. Costs that must be considered would include both costs associated with the purchase of a security in addition to costs that may apply to future sales or exchanges (e.g., deferred sales charges, liquidation costs). *Id.*

Available Alternatives and Complex Products

In meeting this customer-specific obligation, broker-dealers and associated persons must consider "reasonably available alternatives offered by the broker-dealer"[43] as part of forming their reasonable basis to believe that the recommendation is in the best interest of the retail customer; however, not every possible alternative must be reviewed.[44] The standard requires an objective evaluation based on the facts and circumstances of the particular recommendation and the particular retail customer at the time the recommendation is made. In particular, when recommending complex or costly products, broker-dealers must first consider whether less complex or less costly products could achieve the same objectives for retail customers. This does not necessarily require that the associated person be familiar with every product on the broker-dealer's platform or, if the broker-dealer offers only limited products, every product that is offered in the market generally, but the scope of a broker-dealer's offerings is a relevant consideration in determining whether reasonable diligence, care, and skill have been exercised.[45] To that end, a broker-dealer should develop a reasonable process or method for limiting the scope of alternatives considered.[46] Moreover, a recommendation can be in a retail customer's best interest when considered in the context of a retail customer's whole portfolio (rather than in isolation). [47]

Recommending Account Types

The Care Obligation requires broker-dealers and their associated persons to have a reasonable basis to believe that a recommendation to a retail customer that he or she open a particular type of securities account is in the customer's best interest at the time of the recommendation and does not place the financial or other interests of the broker-dealer ahead of the interests of the retail customer. In recommending account types, including an account rollover, broker-dealers must

[43] Adopting Release at 283. The Adopting Release suggests that an associated person may need to consider alternatives offered by other firms in situations in which that person's employer offers only proprietary products or a limited range of products. *See* Adopting Release at 284.

[44] In addition, Reg. BI does not require that a broker-dealer or associated person recommend the "best" alternative. *See* Adopting Release at 283 n.636,

[45] *See, e.g.*, Adopting Release at 286 n.642 ("[W]here a broker-dealer only has a few products, an associated person of the broker-dealer may be expected to understand and consider all of these options when recommending a security or investment strategy.") Broker-dealers may not use a limited product menu to justify recommending a product that does not satisfy the obligation to act in the customer's best interest, and a large platform cannot be used as an excuse for failing to develop a proper understanding of a recommended security or investment strategy.

[46] Adopting Release at 288. The SEC noted that, "where a broker-dealer (or an associated person) limits the securities or investment strategies that are considered as 'reasonably available alternatives' from the universe of securities or investment strategies involving securities offered by the broker-dealer, this limitation may constitute a material limitation placed on the securities or investment strategies involving securities that may be recommended, which the broker-dealer (or an associated person) would need to disclose and address as provided in the Disclosure and Conflict of Interest Obligations." *Id.* at n.645.

[47] *See* Adopting Release at 272.

consider: (i) the services and products provided in the account; (ii) projected costs; (iii) alternative account types available; (iv) the services requested by the retail customer; and (v) the retail customer's investment profile. An associated person would not need to consider an advisory account for a retail customer when the associated person is registered only as an associated person of a broker-dealer (even when the broker-dealer is a dual registrant); however, the associated person would nevertheless still need to have a reasonable basis to believe that the recommended account was in the best interest of the retail customer.[48]

Quantitative

A broker-dealer or associated person also must have a reasonable basis to believe that a series of recommended transactions, even if each transaction is in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest. As part of this determination, the recommendation(s) must be made in light of the retail customer's investment profile. Similar to the other two components of the Care Obligation, this requirement is based on existing FINRA suitability obligations, often referred to as "quantitative suitability." Here again, however, Reg. BI expands the scope of existing requirements and applies the Care Obligation to a series of recommended transactions irrespective of whether a broker-dealer exercises actual or *de facto* control over a customer's account, thus expanding the quantitative suitability obligations from existing requirements that include an element of control.[49]

Conflict of Interest Obligation

To comply with the Conflict of Interest Obligation of Reg. BI, a broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to identify and at a minimum disclose (pursuant to the Disclosure Obligation) or eliminate all conflicts of interest associated with recommendations to retail customers.[50] In addition to this overarching obligation, broker-dealers are required to establish, maintain, and enforce written policies and procedures reasonably designed to:

- identify *and mitigate* any conflicts of interest associated with recommendations that create an incentive for an associated person of a broker or dealer to place the interest of the broker or dealer, or such associated person making the recommendation, ahead of the interest of the retail customer;
- identify *and disclose* (in accordance with the Disclosure Obligation) any material limitations placed on the securities or investment strategies involving securities that may be recommended to a retail customer and any

[48] Adopting Release at 294.

[49] In 2018, FINRA published a *Regulatory Notice* proposing removing the "control" element from its existing suitability rule. *See* FINRA *Regulatory Notice* 18-13 (Apr. 20, 2018).

[50] The design of policies and procedures is not subject to a standard of strict liability, but rather one of reasonableness. *See* Adopting Release at 307.

conflicts of interest associated with such limitations *and prevent* such limitations and associated conflicts of interest from causing the broker, dealer, or associated person of the broker or dealer to make recommendations that place the interest of the broker, dealer, or such associated person ahead of the interest of the retail customer; and

- identify *and eliminate* any conflicts of interest associated with sales contests, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time.[51]

The SEC provided a list of effective practices that broker-dealers should consider when designing their policies and procedures, including: "policies and procedures outlining how the firm identifies conflicts, identifying such conflicts and specifying how the broker-dealer intends to address each conflict; robust compliance and monitoring systems; processes to escalate identified instances of noncompliance for remediation; procedures that designate responsibility to business line personnel for supervision of functions and persons, including determination of compensation; processes for escalating conflicts of interest; processes for periodic review and testing of the adequacy and effectiveness of policies and procedures; and training on policies and procedures."[52]

Identifying Conflicts of Interest

The threshold requirement with respect to addressing conflicts of interest under Reg. BI is to identify them. The SEC listed a number of aspects regarding conflict of interest identification that a broker-dealer's policies and procedures should address:

- define conflicts in a manner that is relevant to a broker-dealer's business (for both the firm and its associated persons), and in a way that enables employees to understand and identify conflicts of interest;
- establish a structure for identifying the types of conflicts that the broker-dealer and associated persons of the broker-dealer may face;
- establish a structure to identify conflicts in the broker-dealer's business as it evolves;
- provide for an ongoing (e.g., based on changes in the broker-dealer's business or organizational structure, changes in compensation incentive structures, and introduction of new products or services) and regular,

[51] The SEC stated that a broker-dealer may use risk-based compliance and supervisory systems in tailoring its policies and procedures to its specific business model. Consequently, a detailed review of each recommendation is not necessary. *See* Adopting Release at 305.

[52] *See* Adopting Release at 308 n.688.

periodic (e.g., annual) review for the identification of conflicts associated with the broker-dealer's business; and

- establish training procedures regarding the broker-dealer's conflicts of interest, including for its associated persons, how to identify conflicts of interest, as well as defining employees' roles and responsibilities with respect to identifying such conflicts of interest. [53]

Mitigation

Although the Conflict of Interest Obligation in Reg. BI generally permits broker-dealers to address firm-level conflicts of interest through disclosure, the SEC cautioned that not all conflicts can be addressed through disclosure. Consequently, any conflicts of interest associated with recommendations that create an incentive for an associated person to place the interest of the broker or dealer, or of such associated person making the recommendation, ahead of the interest of the retail customer must be disclosed *and mitigated*. This mitigation requirement applies only to incentives provided to the associated person—whether by the broker-dealer firm or by third parties—that are within the control of the broker-dealer. With respect to specific mitigation measures, Reg. BI provides broker-dealers with flexibility rather than mandating specific measures, but the SEC noted that the reasonableness of mitigation measures may depend upon the size of the firm. More stringent mitigation measures may be necessary, for example, where an associated person's compensation is less transparent or in situations involving a complex security or investment strategy.[54] The SEC also provided firms with a list of potential (but not required) mitigation measures to consider.[55]

Material Limitations

When a broker-dealer places material limitations on recommendations that may be made to a retail customer, the policies and procedures required under the Conflict of Interest Obligation must be reasonably designed to disclose the limitations

[53] Adopting Release at 315.

[54] Adopting Release at 331-32. The SEC stated further that whether a broker-dealer's policies and procedures are reasonably designed will not be measured against industry practice; however, industry practice may serve as "a useful point of reference." *Id.* at 336.

[55] The list included: (i) avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales; (ii) 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; (iii) eliminating compensation incentives within comparable product lines by, for example, capping the credit that an associated person may receive across mutual funds or other comparable products across providers; (iv) 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 roll over or transfer of assets from one type of account to another (such as recommendations to rollover or transfer assets in an ERISA account to an IRA) or from one product class to another; (v) adjusting compensation for associated persons who fail to adequately manage conflicts of interest; and (vi) limiting the types of retail customer to whom a product, transaction or strategy may be recommended. See Adopting Release at 334-35.

and associated conflicts and to prevent the limitations from causing the associated person or broker-dealer from placing the associated person's or broker-dealer's interest ahead of the customer's interest. Material limitations include recommending only proprietary products, a specific asset class, products with third-party arrangements (i.e., revenue sharing), or products from a select group of issuers.

Prohibited Conflicts

Section 15(l)(2) of the Exchange Act provides the SEC with authority to examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest and compensation schemes for brokers, dealers and investment advisers that the SEC deems contrary to the public interest and protection of investors. Pursuant to its statutory authority, the SEC determined that sales contests, sales quotas, bonuses, and non-cash compensation based on the sale of specific securities or specific types of securities within a limited period of time should be prohibited based on the public interest and consistent with the protection of investors. As a result, Reg. BI requires broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to identify and *eliminate* any sales contests, sales quotas, bonuses, and non-cash compensation based on the sales of specific securities or types of securities within a limited period of time. Notably, this prohibition does not apply to compensation practices based on total products sold, asset growth or accumulation, or customer satisfaction. [56] Broker-dealers may also still sponsor training or education meetings, provided that the meetings are not based on the sale of specific securities or types of securities within a limited time period.

Compliance Obligation

The final of the four obligations in Reg. BI is the Compliance Obligation, which requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Reg. BI. This requirement, although worded as a policies and procedures requirement, is designed to ensure that broker-dealers have strong systems of controls in place to prevent violations of Reg. BI. The SEC stated that, depending on the size and complexity of the firm, a reasonably designed compliance program would include controls to prevent violations from occurring and detect violations that have occurred, remediation of non-compliance, training, and periodic review and testing. Use of a risk-based compliance and supervisory system is acceptable.

Recordkeeping Requirements

In addition to Rule 15l-1, the SEC adopted amendments to Rule 17a-3—new paragraph (a)(35)—that require a broker-dealer to keep records of all know-your-customer information underlying recommendations (whether received in written form or orally) and a record of the associated person responsible for the account(s). More generally, the obligation requires a record of all information collected from and provided to a retail customer pursuant to Reg. BI. The SEC also

[56] *See* Adopting Release at 354.

"encourages" broker-dealers to record the bases for their recommendations, particularly if the recommendation involves a more complex, risky, or expensive product or is a significant investment decision (such as a rollover or choice of account).[57] Information should generally be consistent with current requirements; however, the SEC's expansion of existing suitability obligations in adopting Reg. BI may create additional burdens because of Reg. BI's application to account recommendations, disclosure obligations, and implicit hold recommendations when account monitoring is provided, and the need to show the basis for recommendations of a complex product or a recommendation that may seem inconsistent with a retail customer's investment objectives on its face.

Broker-dealers do not have to maintain records comparing potential investments to one another so long as they are able to demonstrate that each individual recommendation actually made to a retail customer meets the Reg. BI standard. As the SEC stated, "broker-dealers should be able to explain in broad terms the process by which the firm determines what recommendations are in its customers' best interests, and similarly to explain how that process was applied to any particular recommendation to a retail customer. However, we are not mandating that broker-dealers create and maintain a record of each such determination."[58]

The SEC further noted that, although many of the records required under the new recordkeeping provision for Reg. BI may also be "business as such" records under Rule 17a-3, broker-dealers should separately retain records that specifically demonstrate compliance with Reg. BI rather than including them in the "business as such" category. [59] Pursuant to Rule 17a-4, a broker-dealer must keep the records required by Rule 17a-3(a)(35) for six years after the earlier of the date the account was closed or the date on which the information was replaced or updated.

Enforcement

Reg. BI does not establish a new private right of action or rescission right. The Adopting Release makes clear that private rights of action against broker-dealers under federal law alleging breaches of a duty of care must be brought under general antifraud provisions of the federal securities law. Scienter will not be required for SEC actions against a broker-dealer or associated person under Reg. BI. The SEC noted in the Adopting Release that commenters had requested that the final rule preempt or avoid preempting state law. Although the SEC states that "the preemptive effect of Regulation Best Interest on any state law governing the relationship between regulated entities and their customers would be determined in future judicial proceedings based on the specific language and effect of . . . state law," it did not provide any findings that would facilitate a preemption finding, such as evidence that Congress intended federal law to preempt state law, an intent by the SEC itself to "occupy the field," a finding that state rulemaking in respect to broker-dealer conduct directly conflicts with the exercise of federal authority under Section 15 of the Exchange Act, or a discussion of the

[57] Adopting Release at 192.

[58] Adopting Release at 367.

[59] Adopting Release at 370.

applicable federally protected interests that would conflict with those of the states establishing a fiduciary standard. [60] As a result, based on black letter law relating to preemption by a federal agency of state law, it may be difficult for a court to find that Reg. BI preempts state laws that impose a different and higher standard on broker-dealers.[61]

Next Steps

We expect that, to be compliance with Reg. BI by the June 30, 2020 compliance date, broker-dealers will need to, among other things, (i) significantly enhance their current policies and procedures; (ii) review and, if appropriate, remove references to "adviser" or "advisor" in titles of non-investment advisory brokerage personnel; (iii) review all existing conflicts of interest relating to sales practices and, in particular, those relating to third-party and internal compensation arrangements, and change their processes to address these conflicts of interest through disclosure and/or mitigate or eliminate the conflicts entirely; (iv) create additional enhanced disclosures, including those required by Form CRS; and (v) work with internal and external recordkeeping services to ensure that the retention requirements are met.[62] Our expectation is that the SEC staff will provide additional details about Reg. BI in the weeks and months to come through FAQs and other guidance.[63] Meanwhile, as you begin to address the impact to your business of complying with new Reg. BI, please reach out to your relationship lawyers at Willkie Farr & Gallagher to assist with the planning.

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[60] Adopting Release at 43.

[61] *See, e.g., Gade v. National Solid Wastes Mgmt. Ass'n*, 505 U.S. 88, 98 (1992) (explaining that preemption arises when federal legislation occupies a field so expansively that the intent to solely control the field is implied; or when it would be virtually impossible to satisfy both state and federal law or state law would effectively undermine the purpose or objective of a related federal law).

[62] On June 26, 2019, the U.S. House of Representatives passed an amendment to a financial services and appropriations bill (H.R. 3351) that would prevent the SEC from using funds to implement, administer, enforce or publicize Reg. BI or the other rules and interpretations approved by the SEC on June 5, 2019. Even with passage of the amendment in the House, we believe it will be important for broker-dealers to commence reviewing their current policies and procedures to accord with Reg. BI and the SEC's guidance.

[63] The SEC is establishing an inter-Divisional Standards of Conduct Implementation Committee to assist firms with planning for compliance with Reg. BI and the other new rules. The SEC encouraged firms to actively engage with this committee by emailing questions to IABDQuestions@sec.gov.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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