

# Regulation Best Interest Basics

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# Reg BI Overview

# Background

- Why not a uniform standard as opposed to tailored to broker dealers? The SEC has projected the following explanations:
  - Already under regulatory scrutiny
  - SEC wanted to work within current BD model and avoid costs associated with a uniform model
- DOL and IA standards
  - Reg BI provides more flexibility while maintaining protections
  - Conflict resolution versus state court actions
- Reg BI is transactional vs. relationship based
  - **Fiduciary = Ongoing and monitoring (long-term)**
  - **Reg BI = Transactional**

# Background (Cont.)

## Summary:

Commission votes to enact:  
June 5, 2019

Effective as of date:  
June 30, 2020

- Designed to raise the advice standard for brokers above the current FINRA suitability rule
- Will be enforced by both the SEC and FINRA
- Not a fiduciary standard
- Certain states are exploring more stringent standards
- Does not replace FINRA Rule 2111 (suitability rule)
- Increases conflict assessment and disclosure requirements
- No scienter or intent-based requirement-violations may be found in cases where the broker-dealer (BD) or associated person (AP) was negligent
- Does not alone provide a private right of action

# Compliance Timeline

## Reg BI & Form CRS Compliance Implementation Timeline

**JUNE 5, 2019**

SEC adopts Reg BI  
Program requirements  
for BDs

**SEPTEMBER 10, 2019**

Reg BI and Form CRS  
publication

**JUNE 30, 2020**

Compliance date for  
implementing Reg BI and  
Form CRS requirements

**JULY 12, 2019**

Reg BI and Form  
CRS published in the  
Federal Register

**MAY 1–JUNE 30 2020**

Form CRS may be filed  
in searchable text  
format with the SEC

**+30 DAYS**

Compliance date for  
delivering the Form  
CRS to customers

# When Reg BI Applies

- The purpose of Regulation Best Interest (Reg BI), according to the SEC, is to make clear that a BD may not put its own financial interests ahead of the best interests of a retail customer when making recommendations
- Reg BI applies when a BD or an AP of a broker or dealer:
  - Makes a **Recommendation**
  - of any securities transaction or investment strategy involving securities (including account recommendations)
  - to a **Retail Customer**

# When Reg BI Applies (Cont.)

— Definition of **Recommendation** expanded in Reg BI and includes:

- Holding securities
- Monitoring of accounts:
  - Does not have to be directly communicated
  - Does not include voluntary reviews.
  - For example:
    - + Making decisions regarding credit
    - + Determining whether to make a recommendation

— Reg. BI's definitions of **Retail Customer** includes:

- Non-professional legal representatives, trustees, executors, conservators, and persons holding power of attorney that represent natural persons are covered

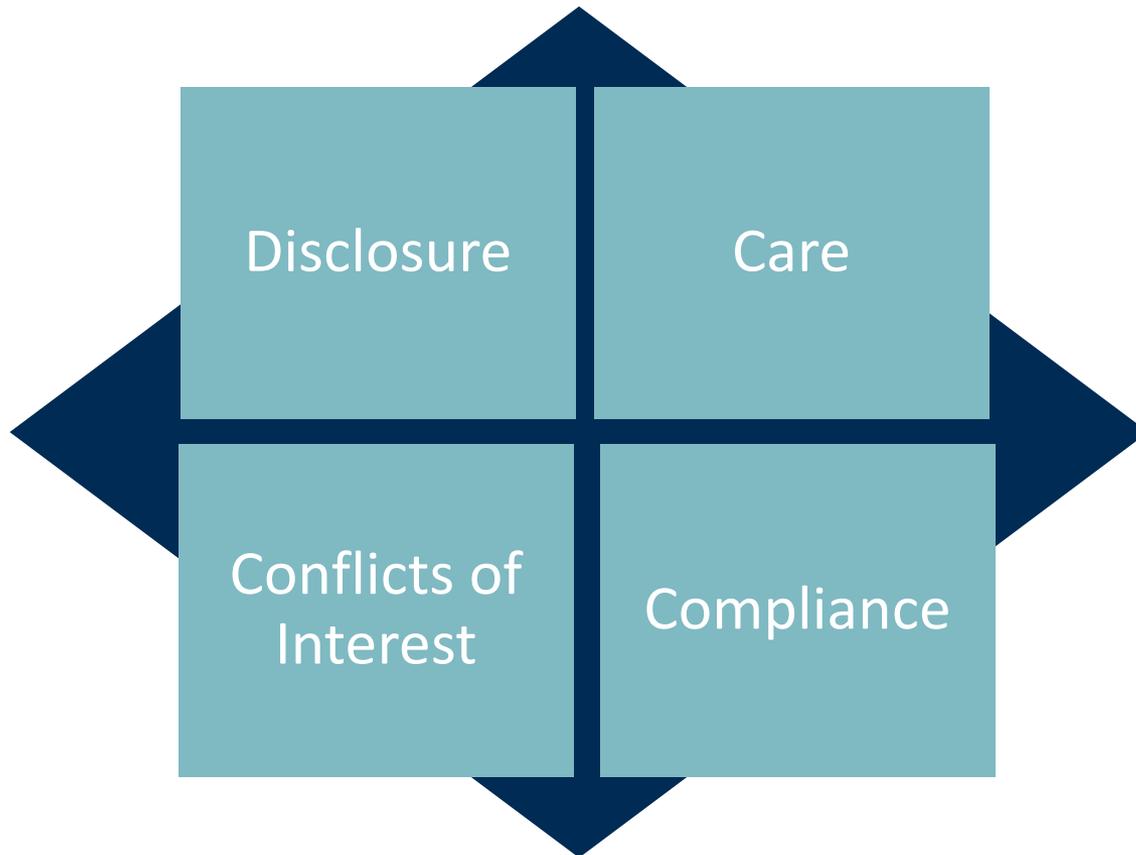
# Suitability

- FINRA has updated its suitability rule to apply when Reg BI doesn't and thus an indicator of when Reg BI may not apply. See FINRA Regulatory Notice 20-18:
  - Entities and institutions (e.g., pension funds)
  - Natural persons who will not use recommendations primarily for personal, family, or household purposes (e.g., small business owners and charitable trusts), and
  - Other FINRA Rules that have suitability/suitability like component
- FINRA's suitability rule therefore does not apply to:
  - Recommendations to “retail customers”—a natural person, or the legal representative of such natural person, who receives a recommendation of any securities transaction or investment strategy **and uses the recommendation primarily for personal, family, or household purposes.** See 17 CFR 240.15/-1(b)

# Obligations

# Standards of Conduct

Reg BI imposes these standards of conduct on BD and its APs when making recommendations to retail customers:



# Disclosure

**Requirement:** prior to or at the time of a recommendation, a BD must provide full and fair disclosure, in writing, of all material facts including the scope and terms of its relationship with a retail customer:

1	Capacity as a broker-dealer
2	Material fees and costs
3	Type and scope of services
4	Any limitations on securities/investment strategy

## Takeaways

### —Retail customers cannot waive obligations

- SEC has said that disclosure is meant to be more explicit and a broader obligation than previously existed for BDs

### —Terms matter – including the capacity in which your acting

- For example, if you use the term advisor and are not dually registered or supervised by a dually registered firm, you may be in violation of the rule

### —Oral disclosures/updates not prohibited when summary provided

- Recommend maintaining a record that an oral disclosure was made

# Care

**Requirement:** a BD to exercise reasonable diligence, care, and skill recommending a security or investment strategy in satisfying:

1	A reasonable-basis obligation
2	A customer-specific obligation
3	A quantitative obligation

## Takeaways

- **Prudence element from the proposed rule was excluded**, but the SEC states that “reasonable diligence, care, and skill” conveys “the fundamental importance of conducting a proper evaluation of any securities... that was intended by the inclusion of prudence”
- Customers receiving advice, whether it is from a BD or an IA, creates an **equal care obligation**

# Conflicts of Interest

**Requirement:** that a BD establishes, maintains, and enforces written policies and procedures reasonably designed to **[i]dentify** and at a minimum **disclose**, or **eliminate**, all conflicts of interest associated with such recommendations and **mitigate** certain identified conflicts (if not otherwise eliminated).

**Disclosure is not enough**

Mitigation and elimination are required

## Takeaways

- To be effective, the SEC states that policies and procedures regarding conflicts should include:
  - How the firm identifies conflicts and intends to address each conflict
  - Systems and processes to escalate identified instances of noncompliance
  - Designate responsibility to business line personnel for supervision
  - Periodic review and testing of adequacy and effectiveness (e.g., training)

# Compliance

**Requirement:** that a BD establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Reg BI:

- These policies and procedures “should consider the nature of that firm’s operations and how to design such policies and procedures” in order to:

1	Prevent violations from occurring
2	Detect violations that have occurred
3	Promptly correct violations

## Takeaway

- The SEC stated that compliance with the care obligation “will be evaluated as of the time of the recommendation (and not in hindsight)”

# Standards of Care Overlap

# Customer Recommendations

Reg. BI's definition of **Retail Customer** is more inclusive than, but does not completely replace, FINRA's suitability rule (i.e., retail customer includes any natural person that uses recommendations for personal use, excluding those that may be used for business purposes)

# Care Obligations

—Components of Suitability and Reg BI care obligation includes:

1	A reasonable-basis determination
2	<b>Customer v. product or account type specifics</b>
3	<b>A quantitative requirement</b>

# Quantitative Obligations

## — Reg BI and FINRA Suitability Requirements:

- FINRA recently adopted the same quantitative requirement as applied under Reg BI, by removing certain elements of control required by the actor over the customer's account. *See* FINRA Regulatory Notice 20-18
- This quantitative requirement applies the best interest and suitability obligations to a series of recommended transactions, **regardless of whether the BD exercises actual or de facto control** over a customer's account

# Obligation Summary

## Obligations

## Reg BI

## Suitability

Includes account type recommendations and monitoring obligations.	✓	
Requires reasonable diligence and fair dealing in making recommendations	✓	✓
Requires BDs and APs to put their customers' interests before their own	✓	
Applies to recommendations <u>not</u> primarily for personal, family, or household purposes		✓
Requires conflict prevention, mitigation and disclosure	✓	
Applies to a series of transactions, covered by the rule, if exercising actual or de facto control over an account	✓	✓

# Oversight Considerations

# Oversight Risks

## —Core areas of the firm’s operations:

- **Business structure** (e.g., a broker-dealer, an RIA):
  - A dual registrant or a financial Institution that has both a registered broker-dealer and a registered investment adviser as separate and distinct legal entities (a hybrid firm)
- **Products and services**, revenue models
- **Conflicts of interests:**
  - Affiliates
  - Registered representatives
- **Titles** used to describe APs:
  - For example the terms “advisor” or “adviser” in marketing materials, legal entities’ documents, customer agreements, and financial advisor licenses)
- **Incentive programs** and their criteria for qualification

# Compliance Risks

## — Policies and procedures for recommendations:

- Beyond Suitability

## — Take inventory of conflicts:

- Conflicts database

## — Technology building:

- Documentation
- Record keeping
- Disclosure delivery (e.g., websites, account opening)

## — Compensation reviews

## — Disclosure/marketing materials:

- Is your marketing undoing or contrary to disclosures?
- Client-facing communications and documentation:
  - Terminology of APs
  - Sweep disclosures/conflicts of interest
- Fair disclosure (Form CRS):

# Procedure and Technology Risks

- Inclusion of operations/compliance analysts in development and or monitoring:
  - On a basic level they should understand what AI and algorithms do and why
  - Ongoing testing
- Increased demand on internal resources:
  - **Internal resources** should provide firm-level insights
  - **External resources** may be needed to bring expertise and industry insights

# Compensation Risks

- Compensation and incentive models should cover these three factors:

## Products

- Affiliated vs. nonaffiliated
- Security type
- Firm
- Share class

## Account Types

- Brokerage
- Advisory
- Annuity
- Retail vs. retirement

## Sources

- IRA rollover
- Etc.

# Regulatory Resources and Updates

# Regulatory Resources

## Where to go with questions?

- SEC's small firm guidance is the "CliffsNotes" version of the Reg BI release
- SEC has established [iabdquestions@sec.gov](mailto:iabdquestions@sec.gov) to field Reg BI-related questions
- *Regulation Best Interest, A Small Entity Compliance Guide* is available at: <https://www.sec.gov/info/smallbus/secg/regulation-best-interest>
- *Form CRS Relationship Summary; Amendments to Form ADV, A Small Entity Compliance Guide* is available at: <https://www.sec.gov/info/smallbus/secg/form-crs-relationship-summary>
- Frequently Asked Questions on Regulations Best Interest <https://www.sec.gov/tm/faq-regulation-best-interest>
- Regulation Best Interest, Form CRS and Related Interpretations <https://www.sec.gov/regulation-best-interest>
- Key topic checklist is available at: <https://www.finra.org/rules-guidance/key-topics/regulation-best-interest>

# Regulatory Updates

- FINRA began preparedness reviews in November 2019
- FINRA has updated its non-cash compensation and suitability obligations to avoid overlap with Reg BI (FINRA Regulatory Notice 20-18)
- FINRA has projected that for the first 6 months, following the date Reg BI goes into effect (June 30, 2020), examinations will focus on a firm's Reg BI systems and testing, policies and procedures and adherence thereto (SIFMA C&L Webinar *Series-Ask FINRA: A Panel of Senior FINRA Officials*, May 19, 2020)
- FINRA's Head of Enforcement, Jessica Hopper, recently stated that Enforcement efforts, at least initially, will be on suitability requirements, such as excessive trading, for which Reg BI expanded available remedies (SIFMA C&L Webinar *Series-Ask FINRA: A Panel of Senior FINRA Officials*, May 19, 2020)

# References:

- SEC Regulatory Release: <https://www.federalregister.gov/documents/2019/07/12/2019-12164/regulation-best-interest-the-broker-dealer-standard-of-conduct>
- Reg BI Final Rule: <https://www.sec.gov/rules/final.shtml>
- FINRA's Key Topic Checklist: <https://www.finra.org/rules-guidance/key-topics/regulation-best-interest>
- FINRA Suitability Rule and Guidance: <https://www.finra.org/rules-guidance/key-topics/suitability>
- See FINRA Rule 2111, *supra* note 3, at Supplementary Material .05, Components of Suitability Obligation.
- FINRA Reg. Notice 18-13, Quantitative Suitability (Apr. 20, 2018), <http://www.finra.org/industry/notices/18-13>
- SIFMA Reg BI Guidance: [\*A Firm's Guide to the Implementation of Reg BI and the Form CRS Relationship Summary\*](#) (September 27, 2019)

# External Resources

# External Resources-The Brattle Group

- Brattle’s securities and finance experts consult and provide testimony on economics, finance, accounting, regulation, and financial services custom and practice
- Our principals and academic advisors have wide-ranging academic qualifications and industry experience, and we draw on a broader network of leading academic and industry experts to meet the needs of particular cases
- Brattle has addressed regulatory compliance, risk management processes, industry custom and practice, standards of care, including Reg BI and suitability obligations, and more

## Areas of expertise

- The duties and responsibilities of broker dealers, securities custodians, and hedge fund administrators
- Class actions
- Regulation
- Market trading activities
- Suitability
- Investment management valuation, due diligence, and disclosure practices
- Financial services risk management processes
- Mortgage banking / securitization
- White collar investigations and litigation

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# Our Practices and Industries

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Electricity Market Modeling & Resource Planning  
Electrification & Growth Opportunities  
Energy Litigation  
Energy Storage  
Environmental Policy, Planning and Compliance  
Finance and Ratemaking  
Gas/Electric Coordination  
Market Design  
Natural Gas & Petroleum  
Nuclear  
Renewable & Alternative Energy

## LITIGATION

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Analysis of Market Manipulation  
Antitrust/Competition  
Bankruptcy & Restructuring  
Big Data & Document Analytics  
Commercial Damages  
Environmental Litigation & Regulation  
Intellectual Property  
International Arbitration  
International Trade  
Labor & Employment  
Mergers & Acquisitions Litigation  
Product Liability  
Securities & Finance  
Tax Controversy & Transfer Pricing  
Valuation  
White Collar Investigations & Litigation

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