

Regulation Best Interest Basics

PRESENTED BY

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THE **Brattle** GROUP



Index

Overview

- Background
- Compliance Timeline
- When does Reg BI apply?
- Suitability

Obligations

- Reg BI Standards of Conduct

Standards of Care

- Best Interest
- Suitability
- Fiduciary Duty

Oversight Considerations

- Operational Focuses

Regulatory Resources and Updates

- SEC and FINRA Guidance
- External Consulting
- Examinations and Enforcement

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

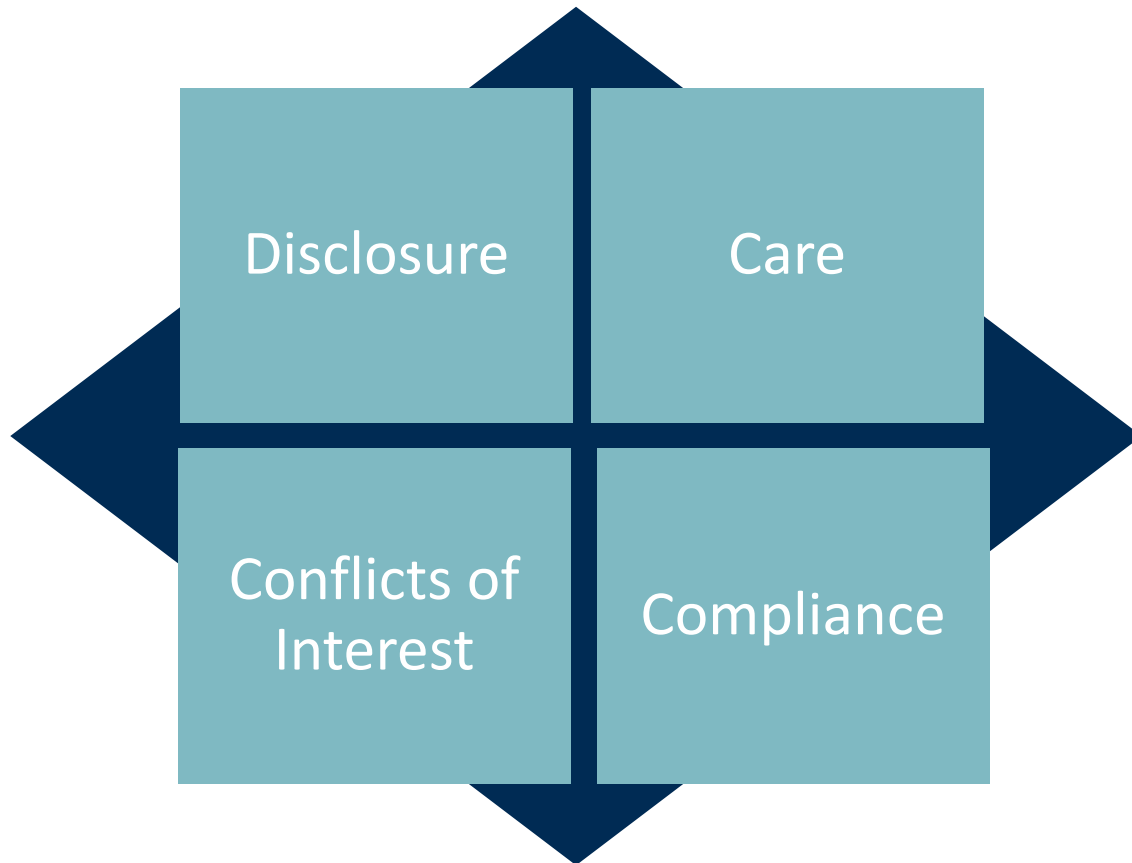
Suitability

- 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	Customer v. product or account type specifics
3	A quantitative requirement

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 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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Ms. Mason has nearly 15 years of experience encompassing broker-dealer and financial institution compliance, trading, markets, risk management, financial regulation & securities litigation.

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International Trade
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