

A man in a dark suit and red patterned tie stands with his arms crossed in front of a large window. The window shows a cityscape with several skyscrapers. A blue semi-transparent overlay covers the left side of the image, featuring a white line graph with several peaks and valleys. The overall color scheme is dominated by blues and greys.

# Highlights of SEC's Regulation Best Interest

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# 1 Synopsis

Amidst regional regulatory overhauls like MiFID II, massive political shifts like Brexit, and increasing sophistication and digitalization of clients, the wealth management industry is undergoing dramatic change and facing new challenges on all fronts. Regulation Best Interest<sup>1</sup> (“Regulation BI” or “Reg BI”), is the next iteration of regulatory change designed to advance alongside this industry evolution.

The Securities and Exchange Commission (the “SEC”) adopted Regulation BI, which requires that broker-dealers act in the “best interest” of their “retail customers.” The SEC concurrently adopted a rule requiring each broker-dealer and investment adviser to send its retail clients and file with the SEC a “Client Relationship Summary” providing information about that broker-dealer or adviser.

As is the case with the fiduciary duty applicable to investment advisers under the Advisers Act, the term “best interest,” is not expressly defined and instead is understood through interpretations, what “acting in the best interest” means.<sup>2</sup> Whether a broker-dealer has acted in the retail customer’s best interest in compliance with Regulation Best Interest will turn on an objective assessment of the facts and circumstances of how the specific components of Regulation Best Interest—including its Disclosure, Care, Conflict of Interest, and Compliance Obligations—are satisfied at the time that the recommendation is made (and not in hindsight).<sup>3</sup>

The best interest obligation is satisfied via a four-prong test. A broker-dealer must satisfy all four obligations<sup>4</sup>: (1) the disclosure obligation; (2) the care obligation, (3) the conflict of interest obligation, and (4) a compliance obligation.

Regulation Best Interest is designed to improve investor protection by:

- requiring broker-dealers to have a reasonable basis to believe that recommendations are in the retail customer’s best interest, which enhances existing suitability obligations by:
  - requiring compliance with the Care, Disclosure, Conflict of Interest, and Compliance Obligations;
  - expressly requiring consideration of cost in evaluating a recommendation as part of the Care Obligation;
  - requiring consideration of reasonably available alternatives when making a recommendation;
  - applying Regulation Best Interest to recommendations of account types and rollovers and to any recommendations resulting from agreed-upon account monitoring services (including implicit hold recommendations); and

<sup>1</sup> See SEC Release No. [34-86031](#) (the “Adopting Release”). Codified as Rule 15l-1 under the Securities Exchange Act of 1934.

<sup>2</sup> Adopting Release at page 35.

<sup>3</sup> *Id.*

<sup>4</sup> Original proposal defined three obligations.

- applying the Care Obligation to a series of recommended transactions (currently referred to as “quantitative suitability”) irrespective of whether a broker-dealer exercises actual or de facto control over a customer’s account;
- requiring broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to mitigate (and in some cases, eliminate<sup>5</sup>) certain identified conflicts of interest that create incentives to make recommendations that are not in the retail customer’s best interest<sup>6</sup>;
- requiring disclosure under the Disclosure Obligation of the material facts relating to the scope of terms of a broker-dealer’s relationship with the retail customer and the conflicts of interest associated with a broker-dealer’s recommendation, which will foster retail customers’ understanding of their relationship with the broker-dealer and help them to evaluate the recommendations received; and
- requiring broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to achieve compliance with regulation as a whole, which will further promote broker-dealer compliance with Regulation Best Interest.<sup>7</sup>

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<sup>5</sup> No duty to require recommendations that ALL are conflict free, but in some cases, they must be eliminated such as “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.” See Adopting Release at page 61.

<sup>6</sup> These new requirements are a significant change as existing requirements under the federal securities laws largely center upon conflict disclosure rather than conflict mitigation or elimination.

<sup>7</sup> See *generally* Adopting Release.

## 2 Who Regulation Best Interest Applies To

Reg BI is a standard of conduct for broker-dealers and natural persons who are associated persons of a broker-dealer when they make a recommendation to a retail customer of any securities transaction or investment strategy involving securities. A broker-dealer is a person or company that is in the business of buying and selling securities—stocks, bonds, mutual funds, and certain other investment products—on behalf of its customers (as broker), for its own account (as dealer), or both. Individuals who work for broker-dealers—the sales personnel whom most people call brokers—are technically known as registered representatives.<sup>8</sup>

A natural person who is an associated person as defined in Section 3(a)(18) of the Exchange Act: “any partner, officer, or director or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions); any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer; or any employee of such broker or dealer, except that any person associated with a broker or dealer whose functions are solely clerical or ministerial shall not be included in the meaning of such term for purposes of Section 15(b) of this title (other than paragraph 6 thereof).<sup>9</sup>

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<sup>8</sup> See FINRA definition of a broker-dealer, Choosing an investment professional, *available at* <https://www.finra.org/investors/brokers>.

<sup>9</sup> Adopting Release at page 78.



### 3 Evidence the Advisors Act is illustrative of how Reg BI will be applied

The Commission has chosen not to create a new uniform standard applicable to both broker-dealers and investment advisers which, among other things, would discard decades of regulatory and judicial precedent and experience with the fiduciary duty for investment advisers that has generally worked well for retail clients and our markets.<sup>10</sup>

Although the SEC specifically states they are not applying the existing fiduciary standard under the Advisors Act to broker-dealers, key elements of the standard of conduct that applies to broker-dealers under Regulation Best Interest will be substantially similar to key elements of the standard of conduct that applies to investment advisers pursuant to their fiduciary duty under the Advisors Act.<sup>11</sup> Moving forward, broker-dealers can likely rely on previously adjudicated precedent in the investment advisor space to illuminate how future enforcement under Reg BI will be conducted.

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<sup>10</sup> Adopting Release at page 56.

<sup>11</sup> Adopting Release at page 58.

## 4 An Investment Adviser vs a Broker-Dealer

Broker-dealers typically involve transaction-based compensation such as trade commissions. By contrast, registered investment advisors often work on asset-based fees, earning a percentage of assets under management regardless of how many transactions a client executes.

The broker-dealer customer relationship is generally event focused, and the retail customer must accept (or reject) each recommendation by a broker-dealer after the broker-dealer has provided full and fair disclosure as required under the Disclosure Obligation. Investment adviser client relationships are generally broader and can include unlimited investment discretion by the investment adviser to conduct securities transactions on behalf of the client.

## 5 What is a Recommendation

The 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.”<sup>12</sup> Factors considered in determining whether a recommendation has taken place include whether the communication “reasonably could be viewed as a ‘call to action’” and “reasonably would influence an investor to trade a particular security or group of securities.”

“Account recommendations” include recommendations of securities account types generally (e.g., to open an IRA or other brokerage account), as well as recommendations to roll over or transfer assets from one type of account to another (e.g., a workplace retirement plan account to an IRA). This includes such recommendations which are “investment strategies involving securities” regardless of whether they are tied to a specific securities transaction.<sup>13</sup>

The treatment of certain communications as “education” rather than “recommendations” is well understood by broker-dealers. The SEC generally views the following types of communications as not being recommendations of any securities transaction or investment strategy involving securities if they do not include, standing alone or in combination with other communications, a recommendation of a particular security or securities or particular investment strategy involving securities<sup>14</sup>:

- General financial and investment information, including:
  - basic investment concepts, such as risk and return, diversification, dollar cost averaging, compounded return, and tax deferred investment;
  - historic differences in the return of asset classes (e.g., equities, bonds, or cash) based on standard market indices,
  - effects of inflation,
  - estimates of future retirement income needs, and
  - assessment of a customer's investment profile;
- Descriptive information about an employer-sponsored retirement or benefit plan, participation in the plan, the benefits of plan participation, and the investment options available under the plan;

<sup>12</sup> Adopting Release at page 80. See Proposing Release at 21592-21593; see also NASD Notice to Members 01-23, Online Suitability – Suitability Rules and Online Communications (Apr. 2001); Notice of Filing Proposed Rule Change to Adopt FINRA Rule 2090 (Know Your Customer) and FINRA Rule 2111 (Suitability) in the Consolidated FINRA Rulebook, Exchange Act Release No. 62718 (Aug. 13, 2010), 75 FR 51310 (Aug. 19, 2010), as amended, Exchange Act Release No. 67218A (Aug. 20, 2010), 75 FR 52562 (Aug. 26, 2010) (discussing what it means to make a “recommendation”).

<sup>13</sup> Existing broker-dealer regulation and guidance stresses that the term “investment strategy” is to be interpreted broadly, and would include, among others, recommendations generally to use a bond ladder, day trading, “liquefied home equity,” or margin strategy involving securities, irrespective of whether the recommendations mention particular securities. See FINRA Rule 2111.03; FINRA Regulatory Notice 12-25 at Q7.

<sup>14</sup> Adopting Release at pages 89-90.



- Asset allocation models that are:
  - based on generally accepted investment theory,
  - accompanied by disclosures of all material facts and assumptions that may affect a reasonable investor's assessment of the asset allocation model or any report generated by such model, and
  - in compliance with FINRA Rule 2214 (Requirements for the Use of Investment Analysis Tools) if the asset allocation model is an “investment analysis tool” covered by FINRA Rule 2214; and
  - Interactive investment materials that incorporate the above.

## 6 Monitoring Services by Broker-Dealers

Reg BI does not impose a duty for Broker-Dealers to actively monitor a customer's account nor compel a Broker-Dealer to monitor a customer's account on an on-going basis. However, when a broker-dealer agrees with a retail customer to monitor that customer's account:

- (1) the broker-dealer is required to disclose the terms of such account monitoring services (including the scope and frequency of those services) pursuant to the Disclosure Obligation and
- (2) such agreed-upon monitoring involves an implicit recommendation to hold (i.e., recommendation not to buy, sell, or exchange assets pursuant to that securities account review) at the time the agreed-upon monitoring occurs, which is a recommendation "of any securities transaction or investment strategy involving securities" covered by Regulation Best Interest.<sup>15</sup>

An example of "monitoring" includes situations where a broker-dealer agrees to monitor the retail customer's account on a quarterly basis, the quarterly review and each resulting recommendation to purchase, sell, or hold, will be a recommendation subject to Regulation Best Interest.

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<sup>15</sup> This position differs from FINRA guidance, which generally states that the FINRA suitability rule does not cover an implicit recommendation to hold. See FINRA Regulatory Notice 11-25 at Q7 ("The rule, for instance, would not apply where an associated person remains silent regarding, or refrains from recommending the sale of, securities held in an account. That is true regardless of whether the associated person previously recommended the purchase of the securities, the customer purchased them without a recommendation, or the customer transferred them into the account from another firm where the same or a different associated person had handled the account.").

## 7 General Obligation

The General Obligation is a threshold, umbrella obligation that sits on top Reg BI. It requires that a broker-dealer “shall act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of [the broker-dealer] ...ahead of the interest of the retail customer.”<sup>16</sup>

As noted above, the provision of recommendations in a broker-dealer relationship is generally transactional and episodic, and therefore the final rule requires that broker-dealers act in the best interest of their retail customers at the time a recommendation is made and imposes no duty to monitor a customer’s account following a recommendation.<sup>17</sup>

The General Obligation<sup>18</sup> is satisfied only if the broker-dealer complies with four specified component obligations:

- (1) the Disclosure Obligation;
- (2) the Care Obligation;
- (3) the Conflict of Interest Obligation; and
- (4) the Compliance Obligation.

The “Compliance Obligation” is directly linked to the General Obligation, requiring broker-dealers to establish policies and procedures to achieve compliance with Regulation Best Interest in its entirety. Each individual obligation is outlined in greater detail below.

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<sup>16</sup> See Paragraph (a)(1) of Regulation Best Interest.

<sup>17</sup> Adopting Release at page 60.

<sup>18</sup> Adopting Release at page 129.

## 8 Disclosure Obligation

The Disclosure Obligation requires a broker-dealer, prior to or at the time of the recommendation, to provide to the retail customer, in writing, *full and fair* disclosure of all *material facts* related to the scope and terms of the relationship with the retail customer and all material facts relating to *conflicts of interest* that are associated with the recommendation.<sup>19</sup> A new form, Form CRS (also known as the Relationship Summary), will include disclosures in that could satisfy the Disclosure Obligation, although in most instances it will not be sufficient.<sup>20</sup>

The Disclosure Obligation explicitly requires broker-dealers to provide “**full and fair**” disclosure of material facts.<sup>21</sup> At a minimum, a broker-dealer needs to disclose:

- whether or not account monitoring services will be provided (and if so, the scope and frequency of those services),
- account minimums, and
- any material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer.<sup>22</sup>

A fact is “**Material**” when there is a substantial likelihood that a reasonable retail customer would consider it important.<sup>23</sup> At a minimum it includes information that relates to:

- (1) the broker, dealer or such natural person is acting as a broker, dealer or an associated person of a broker-dealer with respect to the recommendation;
- (2) the material fees and costs that apply to the retail customer’s transactions, holdings, and accounts<sup>24</sup>; and
- (3) 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.<sup>25</sup>

A “**conflict of interest**” for purposes of Regulation Best Interest is defined as an interest that might incline a broker-dealer—consciously or unconsciously—to make a recommendation that is

<sup>19</sup> Adopting Release at pages 131-132.

<sup>20</sup> Adopting Release at page 135.

<sup>21</sup> Adopting Release at pages 37, 209.

<sup>22</sup> Rule 15l-1(a)(2)(A). See also Section II.C.1 for a discussion of the materiality standard under *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988). See also Adopting Release at page 179.

<sup>23</sup> The standard for materiality for purposes of the Disclosure Obligation is consistent with the one the Supreme Court articulated in *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988). Adopting Release at pages 132, 195.

<sup>24</sup> This includes account balance requirements (which are considered a material fact relating to the terms and scope of the relationship). The Disclosure Obligation therefore includes disclosure of whether a broker-dealer has any requirements for retail customers to open or maintain an account or establish a relationship, such as a minimum account size. If a broker-dealer will only open a brokerage account for a retail customer with a specific account minimum, such a basic operational aspect of the account is a material fact relating to the type and scope of services provided. If dollar thresholds or other requirements apply to a retail customer’s ability to maintain an existing account, or to avoid additional fees when the threshold is crossed (for example, a “low account balance” fee), such requirements also would likely be of importance to a retail customer and considered a material fact.

<sup>25</sup> Adopting Release at page 175.

not disinterested.<sup>26</sup> This includes compensation arrangements, which create a variety of conflicts of interest that must be addressed.<sup>27</sup> Proper disclosure should summarize how the broker-dealer and its financial professionals are compensated (directly or indirectly) for their recommendations and, as importantly, the conflicts of interest that such compensation creates.

Lastly, disclosure is required relating to the basis for a broker-dealer's recommendation as a general matter (i.e., the firm's investment approach, philosophy, or strategy) and the risks associated with a broker-dealer's recommendation in standardized (as opposed to individualized) terms are material facts relating to the scope and terms of the relationship.<sup>28</sup>

## 8.1 Oral Disclosure

Regulation Best Interest requires that the Disclosure Obligation be made "in writing," but recognizes the challenges associated with providing written disclosure in each instance that disclosure may be required.

In instances where a broker-dealer may need to supplement, clarify or update written disclosure it has previously made before or at the time it provides a customer with a recommendation, broker-dealers may provide recommendations by telephone and may need to offer clarifying disclosure orally in some instances subject to certain conditions, such as a dual-registrant informing a retail customer of the capacity in which the dual-registrant is acting in conjunction with a recommendation.

A broker-dealer can orally clarify the capacity in which it is acting at the time of the recommendation if it had previously provided written disclosure to the retail customer beforehand disclosing its capacity as well as the method it planned to use to clarify its capacity at the time of the recommendation. **A broker-dealer may satisfy its Disclosure Obligation by making supplemental oral disclosure not later than the time of the recommendation, provided that the broker-dealer maintains a record of the fact that oral disclosure was provided to the retail customer.**<sup>29</sup> Before supplementing, clarifying or updating written disclosures in the limited circumstances described above, broker-dealers must provide an initial disclosure in writing<sup>30</sup> that identifies the material fact and describes the process through which such fact may be supplemented, clarified or updated.

<sup>26</sup> Adopting Release at page 133. Generally consistent with the fiduciary duty under the Advisers Act.

<sup>27</sup> Adopting Release at page 204. Disclosure of compensation is also required under Form CRS but can be initially accomplished in general terms in writing, then supplemented in writing or orally provided the original disclosure states that option.

<sup>28</sup> Adopting Release at page 188.

<sup>29</sup> Section II.C.1, *Oral Disclosure or Disclosure After a Recommendation*, Adopting Release at page 137.

<sup>30</sup> For example, with regard to the disclosure of a broker-dealer's capacity, a dual-registrant could disclose that recommendations will be made in a broker-dealer capacity unless otherwise expressly stated at the time of the recommendation, and that any such statement will be made orally. Or, a broker-dealer could disclose that its associated persons may have conflicts of interest beyond those disclosed by the broker-dealer, and that associated persons will disclose, where appropriate, any additional material conflicts of interest not later than the time of a recommendation, and that any such disclosure will be made orally.

A broker-dealer may disclose that: “All recommendations regarding your brokerage account will be made in a broker-dealer capacity, and all recommendations regarding your advisory account will be in an advisory capacity. When we make a recommendation to you, we will expressly tell you orally which account we are discussing.”

Similarly, the rule explicitly states the SEC encourages “broker-dealers to record the basis for their recommendations, especially for more complex, risky or expensive products and significant investment decisions, such as rollovers and choice of accounts, as a potential way a broker-dealer could demonstrate compliance with the Care Obligation.”<sup>31</sup>

### **Please Note**

**When making such an oral disclosure, firms must maintain a record of the fact that oral disclosure was provided to the retail customer.** The rule does not explicitly require broker-dealers to create a record documenting the substance of the oral disclosure itself, but rather a record of the fact that such oral disclosure was made. This record should include documentation sufficient to demonstrate that disclosure was made to the retail customer, which could include, for example, **recordings of telephone conversations or contemporaneous written notations.**

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<sup>31</sup> Adopting Release at page 192.



## 9 Care Obligation

The Care Obligation expressly requires a broker-dealer understand and consider the potential costs associated with its recommendation and have a reasonable basis to believe that the recommendation does not place the financial or other interest of the broker-dealer ahead of the interest of the retail customer.

Determining whether a broker-dealer's recommendation satisfies the Care Obligation will be an objective evaluation turning on the facts and circumstances of the particular recommendation and the particular retail customer. Furthermore, the Care Obligation requires broker-dealers to "*exercise reasonable diligence, care, and skill*" to meet the three components.<sup>32</sup>

### Express requirements relating to the Care Obligation<sup>33</sup>

Reg BI requires that a broker-dealer exercise reasonable diligence, care, and skill to:

- (1) understand the risks, rewards and costs of a recommendation;<sup>34</sup>
- (2) have a reasonable basis<sup>35</sup> to believe that the recommendation is in the best interest of a particular retail customer, based on the retail customer's investment profile, and that the recommendation does not place the broker-dealer's interest ahead of the retail customer's interest; and
- (3) have a reasonable basis to believe that a series of transactions is in the best interest of the retail customer and does not place the interest of the broker-dealer ahead of the retail customer's interests.

The Care Obligation significantly enhances the investor protection provided as compared to current suitability obligations<sup>36</sup> by:

- (1) explicitly requiring that recommendations be in the best interest of the retail customer and do not place the broker-dealer's interests ahead of the retail customer's interests;
- (2) explicitly requiring by rule the consideration of costs when making a recommendation; and
- (3) applying the obligations relating to a series of recommended transactions (currently referred to as "quantitative suitability") irrespective of whether a broker-dealer exercises actual or de facto control over a customer's account.

<sup>32</sup> Adopting Release at page 247.

<sup>33</sup> Adopting Release at page 245.

<sup>34</sup> Adopting Release at page 264. Without understanding the terms, features, and risks of a security or investment strategy, a broker-dealer could not establish a reasonable basis to recommend these products to retail customers.

<sup>35</sup> Adopting Release at page 263. This "reasonable-basis" component of the Care Obligation is especially important when broker-dealers recommend securities and investment strategies that are complex or risky. See FINRA Rule 2111 (Suitability) FAQ at Q5.1 ("The reasonable-basis obligation is critically important because, in recent years, securities and investment strategies that brokers recommend to customers, including retail investors, have become increasingly complex and, in some cases, risky.")

<sup>36</sup> Adopting Release at page 254.

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 interest of the retail customer.

## 9.1 Cost as a Factor

Cost—along with potential risks and rewards—will always be a relevant factor that will bear on the return of the security or investment strategy involving securities. Therefore, elevating cost to the rule text clarifies that this factor **must always** be considered when making a recommendation.<sup>37</sup>

This would include both costs associated with the purchase of the security, as well as any costs that may apply to the future sale or exchange of the security, such as deferred sales charges or liquidation costs.

Additionally, firms must specifically address the risk that a broker-dealer’s transaction-based recommendations and compensation could result in a series of recommendations that are not in the best interest of a retail customer—a “churning” risk unique to the broker-dealer model of providing recommendations and transaction-based compensation.<sup>38</sup>

Other factors besides cost may include, but are not limited to:

- the investment objectives,
- characteristics (including any special or unusual features),
- liquidity,
- risks and potential benefits,
- volatility,
- likely performance of market and economic conditions,
- the expected return of the security or investment strategy,
- and any financial incentives to recommend the security or investment strategy.

## 9.2 The Care Obligation Compared to the Former Suitability Standard

The requirements of the Care Obligation of Regulation Best Interest mirror closely but are not identical to the current broker-dealer practices pursuant to the requirements of FINRA’s suitability rule and other applicable legal standards. The former requirements of FINRA’s suitability rule<sup>39</sup> do not reflect the new best interest standard of conduct. FINRA guidance and rule changes are anticipated, however at the time of writing the following applies.

<sup>37</sup> Adopting Release at page 249.

<sup>38</sup> Adopting Release at pages 61, 473. Studies show that commission-based compensation potentially leads to biased advice, including excessive trading in accounts and recommendations to purchase high-commission securities, both of which benefit the financial professional and may lead to lower net returns. See, e.g., Stoughton et al. (2011), *supra* footnote 1048; Roman Inderst & Marco Ottaviani, *Misselling Through Agents*, 99 AM. ECON. REV. 883 (2009); Max Beyer, David de Meza, & Diane Reyniers, *Do Financial Advisor Commissions Distort Client Choice?*, 119 ECON. LETTERS 117 (2013).

<sup>39</sup> See FINRA Rule 2111.

Broker-dealers often make recommendations to retail customers against a backdrop of potential conflicts that may provide them with an incentive to seek to increase their compensation at the expense of the investors they are advising. In addition, other conflicts of interest arise out of business activities that broker-dealers may choose to engage in (including, among others, receipt of third-party compensation, principal trading, and the sale of proprietary or affiliated products). Regulation BI requires material conflicts of interest associated with the broker-dealer relationship to be well understood by the retail customer and, in some cases, mitigated or eliminated.

The former suitability rules require that a broker-dealer or associated person have a reasonable basis to believe that a recommendation or investment strategy is “suitable” for the retail customer. Suitability depended, among other things, on:

- information obtained by the broker-dealer or associated person about the retail customer’s investment profile (e.g., age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, need for liquidity, and risk tolerance).
- In particular, pursuant to the requirements of FINRA’s suitability rule, broker-dealers were expected to make efforts to ascertain the potential risk and rewards associated with a recommendation, given a customer’s investment profile, and to determine whether the recommendation could be in suitable for at least some retail customers.
- Furthermore, broker-dealers are expected to evaluate the information in a retail customer’s investment profile and other relevant information when determining whether a recommendation is suitable or whether a series of recommendations is suitable and not excessive.

The first important difference between Suitability and Reg BI is the requirement that broker-dealers have a reasonable basis to believe that a recommendation is in the best interest of a retail customer and that a series of recommendations is not excessive and in the best interest of the retail customer. The suitability standard does not have an explicit best interest requirement and therefore broker-dealers may be able to make recommendations today that, while suitable, may not meet the Care Obligation proposed as part of Regulation Best Interest. Formally, in theory a broker-dealer could have recommended a security even when a conflict of interest is present, but that recommendation must be suitable. Under Reg BI that is no longer the case even with full disclosure.

The other important difference is the removal of the element of control from the requirement to have a reasonable basis to believe that a series of recommendations is not excessive and in the best interest of the retail customer. This requirement of the Care Obligation applies irrespective of whether a broker-dealer has actual or de facto control over the account of the retail customer. The fact that a customer may have some knowledge of financial markets or some “control” should not absolve the broker-dealer of the ultimate responsibility to have a reasonable basis to believe that any recommendations it makes are in the best interest of the retail customer.<sup>40</sup>

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<sup>40</sup> Adopting Release at page 299, see *also* Proposing Release at 21613-21614.

If, at any time, a broker-dealer that 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 interest of that retail customer based on the retail customer's investment profile would not meet its obligations under the proposed rule.<sup>41</sup> Under Reg BI, Broker-dealers must have a reasonable basis to believe that the recommendation “does not place the financial or other interest of the broker-dealer ahead of the interest of the retail customer.” While a broker-dealer will typically have some interest in a recommendation, the broker-dealer cannot put that interest ahead of the retail customer's interest when making the recommendation.

### 9.3 Reasonable Alternatives

As part of determining whether a broker-dealer has a reasonable basis to believe that a recommendation is in the best interest of the retail customer, a broker-dealer generally should consider reasonably available alternatives offered by the broker-dealer. A reasonable alternative analysis is an inherent aspect of making a “best interest” recommendation and is a heightened standard over existing broker-dealer suitability obligations, which do not necessarily require a comparative assessment among such alternatives.<sup>42</sup> Similarly, this concept has been applied in the context of guidance regarding suitability and heightened supervision of complex products, stating that when broker-dealers are recommending complex or costly products, they should first consider whether less complex or costly products could achieve the same objectives for their retail customers.<sup>43</sup> A broker-dealer should have a reasonable process for establishing and understanding the scope of such “reasonably available alternatives.”

In addition to the particular retail customer's investment profile, the scope of reasonably available alternatives considered could depend upon a variety of factors, including but not limited to:

- the associated person's customer base (including the general investment objectives and needs of the customer base),
- the investments and services available to the associated person to recommend (including limitations due to licensing of the associated person), and
- other factors such as specific limitations on the available investments and services with respect to certain retail customers (e.g., product or service income thresholds; product geographic limitations; or product limitations based on account type, such as those only eligible for IRA accounts).

A reasonable process would not need to consider every alternative that may exist (either outside the broker-dealer or on the broker-dealer's platform) or to consider a greater number of

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<sup>41</sup> See FINRA Regulatory Notice 12-25 at Q16 (outlining what constitutes “reasonable diligence” in attempting to obtain customer-specific information and that the reasonableness of the effort also will depend on the facts and circumstances).

<sup>42</sup> While enforcement actions and related guidance may be construed as interpreting the suitability obligation to include a consideration of available alternatives, it is generally limited to certain circumstances, such as recommendations of mutual funds with different share classes or recommendations of complex or costly products. See *In re Application of Raghavan Sathianathan*, Exchange Act Release No. 54722 at 21 (Nov. 8, 2006).

<sup>43</sup> Adopting Release at page 284.

alternatives than is necessary in order for the associated person to exercise reasonable diligence, care, and skill in providing a recommendation that complies with the Care Obligation.<sup>44</sup>

## 9.4 Reasonable Diligence, Care and Skill

This terminology is familiar to broker-dealers and is well understood under the federal securities laws. While every inquiry will be specific to the broker-dealer and the investment or investment strategy, broker-dealers may wish to consider questions<sup>45</sup> such as:

- Can less costly, complex, or risky products available at the broker-dealer achieve the objectives of the product?
- What assumptions underlie the product, and how sound are they? What market or performance factors determine the investor's return?
- What are the risks specific to retail customers? If the product was designed mainly to generate yield, does the yield justify the risk to principal?
- What costs and fees for the retail customer are associated with this product? Why are they appropriate? Are all of the costs and fees transparent? How do they compare with comparable products offered by the firm?
- What financial incentives are associated with the product, and how will costs, fees, and compensation relating to the product impact an investor's return?
- Does the product present any novel legal, tax, market, investment, or credit risks?
- How liquid is the product? Is there a secondary market for the product?

In sum, broker-dealers generally should consider factors such 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;
- any financial incentives to recommend the security or investment strategy.

With respect to IRAs and workplace retirement plans, broker-dealers should consider a variety of additional factors specifically salient to those accounts, in order to compare the retail customer's existing account to the IRA offered by the broker-dealer. These factors should generally include, among other relevant factors:

- fees and expenses; level of service available;
- available investment options; ability to take penalty-free withdrawals;
- application of required minimum distributions;
- protection from creditors and legal judgments; holdings of employer stock; and
- any special features of the existing account.

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<sup>44</sup> Adopting Release at page 289.

<sup>45</sup> See NASD Notice to Members 05-26, New Products – NASD Recommends Best Practices for Reviewing New Products (Apr. 2005).

With respect to available investment options, specific caution is mentioned not to rely on an IRA having “more investment options” as the basis for recommending a rollover.

This information should allow the broker-dealer to develop a sufficient understanding of the security or investment strategy and to be able to reasonably believe that it could be in the best interest of at least some retail customers.<sup>46</sup>

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<sup>46</sup> See FINRA Rule 2111.05(a). See also Adopting Release at page 262.



## 10 Conflict of Interest Obligation

### 10.1 Definition

A material conflict of interest as a conflict of interest that a reasonable person would expect might incline a broker—consciously or unconsciously—to make a recommendation that is not disinterested. Examples of material conflicts of interest arising from financial incentives associated with a recommendation may include:

- compensation practices established by the broker-dealer, including fees and other charges for the services provided and products sold;
- employee compensation or employment incentives (e.g., quotas, bonuses, sales contests, special awards, differential or variable compensation, incentives tied to appraisals or performance reviews);
- compensation practices involving third-parties, including both sales compensation and compensation that does not result from sales activity, such as compensation for services provided to third-parties (e.g., sub-accounting or administrative services provided to a mutual fund);
- receipt of commissions or sales charges, or other fees or financial incentives, or differential or variable compensation, whether paid by the retail customer or a third-party;
- sales of proprietary products or services, or products of affiliates; and
- transactions that would be affected by the broker-dealer (or an affiliate thereof) in a principal capacity.

### 10.2 Core Requirements

Firms Must:<sup>47</sup>

(1) create an overarching obligation to establish written policies and procedures to identify and at a minimum disclose (pursuant to the Disclosure Obligation), or eliminate, all conflicts of interest associated with the recommendation; and

(2) adopt specific requirements to establish written policies and procedures reasonably designed to mitigate or eliminate certain identified conflicts of interest, specifically:

- *Mitigation of Associated Person Conflicts of Interest*
  - (1) no distinction between financial incentives and all other conflicts of interest; and
  - (2) a focus on mitigating conflicts of interest associated with recommendations that create an incentive for the associated person of the broker-dealer to place the interest of the firm or the associated person ahead of the interest of the retail customer.
- *Address Any Material Limitations on Recommendations to Retail Customers*

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<sup>47</sup> See Adopting Release at page 39-40, see *generally* Adopting Release at page 61, 312.

Broker-dealers are required to establish, maintain and enforce written policies and procedures reasonably designed to:

- (1) identify and disclose any material limitations placed on the securities or investment strategies involving securities that may be recommended and any associated conflicts of interest; and
- (2) prevent the limitations and associated conflicts of interest from causing the broker-dealer or their associated persons to make recommendations that place the interest of the broker-dealer or associated person ahead of the interest of the retail customer (for example, a broker-dealer could establish product review processes or establish procedures addressing which retail customers would qualify for the product menu).

A “material limitation” placed on the securities or investment strategies involving securities would include:<sup>48</sup>

- recommending only proprietary products (i.e., any product that is managed, issued, or sponsored by the financial institution or any of its affiliates),
- a specific asset class, or products with third-party arrangements (i.e., revenue sharing), or
- products from a select group of issuers could also be a material limitation.

A broker-dealer does not need to offer, nor disclose they do not offer, the entire possible range of securities and investment strategies. Consistent with the examples of a “material limitation” provided above, a limitation is material depending on the facts and circumstances of the extent of the limitation.

#### *Elimination of Certain Conflicts*

Broker-dealers are required to establish written policies and procedures reasonably designed to identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sale of specific securities or the sale of specific types of securities within a limited period of time. By explicitly focusing on policies and procedures to eliminate these incentives, it does not mean that all other incentives are presumptively compliant with Regulation Best Interest.

For purposes of this requirement, non-cash compensation can mean any form of compensation received in connection with the sale and distribution of specific securities or specific types of securities that is not cash compensation, including but not limited to:

- merchandise,
- gifts and prizes,
- travel expenses, or
- meals and lodging

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<sup>48</sup> Adopting Release at page 342.

### 10.3 Identifying Conflicts of Interest

In order to comply with the Conflict of Interest Obligation, firms are required to have a process that identifies and appropriately categorizes conflicts of interest. This is highlighted as a mandatory first step to ensure that broker-dealers have reasonably designed policies and procedures that address conflicts of interest.

Reasonably designed policies and procedures to identify conflicts of interest generally should include:<sup>49</sup>

- (1) definitions of such conflicts in a manner that is relevant to a broker-dealer's business (i.e., conflicts of both the broker-dealer entity and the associated persons of the broker-dealer), and in a way that enables employees to understand and identify conflicts of interest;
- (2) an established structure for identifying the types of conflicts that the broker-dealer (and associated persons of the broker-dealer) may face;
- (3) an established structure to identify conflicts in the broker-dealer's business as it evolves;
- (4) provide for ongoing review for the identification of conflicts associated with the broker-dealer's business (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, periodic (e.g., annual); and
- (5) training procedures regarding the broker-dealer's conflicts of interest, including conflicts of natural persons who are associated persons of the broker-dealer, how to identify such conflicts of interest, as well as defining employees' roles and responsibilities with respect to identifying such conflicts of interest.

### 10.4 Overarching Obligation Related to Conflicts of Interest

Subparagraphs (a)(2)(iii)(B)-(D) of the rule text require policies and procedures that are reasonably designed to address specific conflicts of interest in highlighted areas that create an increased risk that the broker-dealer or associated person may place its or his or her own interest ahead of the retail customer's interest.

Highlighted conflicts of interest include conditions<sup>50</sup> that:

- (1) create certain incentives to associated persons;
- (2) conflicts of interest associated with material limitations on the securities or investment strategies involving securities, such as, limited product menus; and
- (3) sales contests, sales quotas, bonuses, and non-cash compensation based on the sales of specific securities or type of security within a limited period of time.

The requirement applies to conflicts of interest that create incentives only 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. The ability to control the compensation of associated person,

<sup>49</sup> See Adopting Release at page 316. See also Proposing Release at 21618.

<sup>50</sup> Adopting Release at pages 318-319.

including incentives, is an important mechanism by which broker-dealers exercise supervisory control over sales practices.<sup>51</sup>

The rule generally considers the following as examples of incentives to an associated person that would need to be addressed under this section:

- (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 incentives (e.g., incentives tied to asset accumulation and not prohibited under (a)(2)(iii)(D), as discussed below, special awards, differential or variable compensation, incentives tied to appraisals or performance reviews); and
- (3) commissions or sales charges, or other fees or financial incentives, or differential or variable compensation, whether paid by the retail customer, the broker-dealer or a third-party.

## 10.5 Mitigation Methods

To “mitigate” conflicts of interest, the rule requires policies and procedures reasonably designed to reduce the potential effect such conflicts may have on a recommendation given to a retail customer. Reasonably designed policies and procedures should include mitigation measures that depend on the nature and significance of the incentives provided to the associated person and a variety of factors related to a broker-dealer’s business model, such as:

- the size of the broker-dealer, retail customer base (e.g., diversity of investment experience and financial needs), or
- the complexity of the security or investment strategy involving securities that is being recommended).

For example,<sup>52</sup> more stringent mitigation measures may be appropriate in situations:

- where the characteristics of the retail customer base in general displays less understanding of the incentives associated with particular securities or investment strategies;
- where the compensation is less transparent (for example, an incentive from a third-party or charge built into the price of the product or a transaction versus a straight commission); or
- in a situation involving a complex security or investment strategy.

The following non-exhaustive list of practices could be used as potential mitigation methods for firms to comply with (a)(2)(iii)(B) of Regulation Best Interest:

- avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales;

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<sup>51</sup> Adopting Release at page 329.

<sup>52</sup> Adopting Release at page 331-332.

- 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;
- 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;
- implementing supervisory procedures to monitor recommendations that are: near compensation thresholds; near thresholds for firm recognition; involve higher compensating products,<sup>53</sup> 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 roll over or transfer assets in an ERISA account to an IRA) or from one product class to another;
- adjusting compensation for associated persons who fail to adequately manage conflicts of interest; and
- limiting the types of retail customer to whom a product, transaction or strategy may be recommended.

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<sup>53</sup> See Adopting Release at page 335. See also Morgan Lewis Letter (suggesting, among other things, that firms can conduct surveillance (whether transactions, periodic, or forensic) to identify activity that appears to be driven by compensation considerations—whether at the representative, team, or business level—rather than a customer’s interest).

## 11 Compliance Obligation

This is the catch all. It requires, in addition to the policies and procedures required by the Conflict of Interest Obligation, that broker-dealer entities establish, maintain and enforce written policies procedures reasonably designed to achieve compliance with Regulation Best Interest. The Compliance Obligation creates an affirmative obligation under the Exchange Act with respect to the rule as a whole, while providing sufficient flexibility to allow broker-dealers to establish compliance policies and procedures that accommodate a broad range of business models.

- Each broker-dealer when adopting policies and procedures should consider:
- the nature of that firm's operations
- how to design such policies and procedures to prevent violations from occurring,
- how to detect violations that have occurred, and
- to correct promptly any violations that have occurred.<sup>54</sup>

A firm's compliance policies and procedures should be reasonably designed to address and be proportionate to the scope, size, and risks associated with the operations of the firm and the types of business in which the firm engages. In addition to the required policies and procedures, depending on the size and complexity of the firm, the rule states a reasonably designed compliance program generally would also include:

- controls;
- remediation of noncompliance;
- training; and
- periodic review and testing.<sup>55</sup>

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<sup>54</sup> See Adopting Release at page. 360. See also Advisers Act Release 2204.

<sup>55</sup> Cf. Questions Advisers Should Ask While Establishing or Reviewing Their Compliance Programs (May 2006), available at [https://www.sec.gov/info/cco/adviser\\_compliance\\_questions.htm](https://www.sec.gov/info/cco/adviser_compliance_questions.htm); FINRA Conflicts Report.



## 12 Books and Records

In addition to adopting Regulation Best Interest, the Commission adopted new record-making and recordkeeping requirements for broker-dealers with respect to certain information collected from or provided to retail customers.<sup>56</sup>

In order to demonstrate compliance with Regulation Best Interest, a broker-dealer must be able to demonstrate that it had a reasonable basis to believe that each particular recommendation made to a retail customer was in the best interest of the customer at the time of the recommendation based on the customer's investment profile and the potential risks, rewards, and costs associated with the recommendation.

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, it is not mandating that broker-dealers create and maintain a record of each such determination.

Broker-dealers are not expected 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 customer meets the requirements of Regulation Best Interest on its own. Regulation Best Interest applies to recommendations made to a retail customer, rather than to potential recommendations considered by the broker-dealer but not actually made to the customer.

Broker-dealers will be required to retain all records of the information collected from or provided to each retail customer pursuant to Regulation Best Interest for at least six years after the earlier of the date the account was closed or the date on which the information was replaced or updated.

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<sup>56</sup> Adopting Release at page 368.

## 13 Interaction with Other Standards, Waivers and Private Right of Action

Compliance with Regulation Best Interest will not alter a broker-dealer's obligation under the general antifraud provisions of the federal securities laws. Regulation Best Interest applies in addition to any obligations under the Exchange Act, along with any rules the Commission may adopt thereunder, and any other applicable provisions of the federal securities laws and related rules and regulations.

Scienter will not be required to establish a violation of Regulation Best Interest.<sup>57</sup> Which in short indicates that firms ignorant of their agents Reg BI violations will still be held liable under Reg BI.

Finally, under Section 29(a) of the Exchange Act, a broker-dealer will not be able to waive compliance with Regulation Best Interest, nor can a retail customer agree to waive her protections under Regulation Best Interest.

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<sup>57</sup> Adopting Release at page 43.

## 14 Additional Materials

Supporting documentation relating to Regulation Best Interest

**Staff of the U.S. Securities and Exchange Commission, Study on Investment Advisers and Broker-Dealers As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act** (Jan. 2011) (“913 Study”), *available at* [www.sec.gov/news/studies/2011/913studyfinal.pdf](http://www.sec.gov/news/studies/2011/913studyfinal.pdf) (discussing the range of brokerage and dealer services provided by broker-dealers).

**Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser** (Jun. 2019), *available at* <https://www.sec.gov/rules/interp/2019/ia-5249.pdf>

Form CRS is a new brief relationship summary that registered investment advisers and registered broker dealers are required to provide to retail investors. The relationship summary, to be provided at the beginning of the relationship, is intended to inform retail investors about:

- (1) the types of client and customer relationships and services that the firm offers;
- (2) the fees, costs, conflicts of interest and required standards of conduct associated with these relationships and services;
- (3) whether the firm and its financial professionals currently have reportable legal or disciplinary history; and (iv) how to obtain additional information about the firm.

**FORM CRS Relationship Summary** *Available at*, <https://www.sec.gov/rules/final/2019/34-86032.pdf>. As discussed in the Relationship Summary Adopting Release, the SEC adopted a requirement in Form CRS for a description of a firm’s applicable standard of conduct using prescribed wording.<sup>58</sup>

**Commission Interpretation Regarding Standard of Conduct for Investment Advisers,** Advisers Act Release No. 5248 (June 5, 2019) (“Fiduciary Interpretation”), *available at* <https://www.sec.gov/rules/interp/2019/ia-5248.pdf>

**Proposed Rule – Regulation Best Interest,** Release No. 34-83062, *available at* <https://www.sec.gov/rules/proposed/2018/34-83062.pdf>

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<sup>58</sup> Adopting Release at page 70. See also Relationship Summary Adopting Release.

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