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Outside Counsel

New 'Regulation Best Interest' Becomes Effective for Broker Dealers

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On June 5, 2019, the Securities and Exchange Commission (SEC) voted to adopt a package of rules and interpretations "designed to enhance the quality and transparency of retail investors' relationships with investment advisers and broker-dealers." U.S. Securities and Exchange Commission, SEC Adopts Rules and Interpretations to Enhance Protections in Their Relationships With Financial Professionals (June 5, 2019). Regulation Best Interest (Reg BI) went into effect on Sept. 10, 2019, with a compliance date of June 30, 2020.

The SEC was mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 to study the feasibility of adopting a fiduciary standard for registered securities representatives. Currently, registered investment advisers are held to a fiduciary standard by the SEC, whereas registered representatives are governed by a suitability standard implemented by the Financial Industry Regulatory Authority (FINRA), which issues their licenses. Investor advocates complained that the dual standards would be confusing to customers, especially since many advisers are dually registered as both registered representatives and IARs.

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Meanwhile, the SEC bided its time, taking over nine years after Dodd-Frank to promulgate its not-fiduciary but fiduciary-like standard. In the meantime, the Labor Department, under the Obama Administration, leapt into the absence left by the SEC, and promulgated its own, highly complex fiduciary regulations, which applied to recommendations by RRs *in retirement accounts only*. Apparently the DOL felt that two standards were not sufficient, and that it would be wise to have a *third standard*, only applicable to retirement savings. The DOL fiduciary standard was short-lived, as it was promptly struck down by the Fifth Circuit Court of Appeals as beyond the agency's authority. See *Chamber of Commerce v. U.S. Department of Labor*, 885 F.3d 360 (5th Cir. 2018).

SEC Reg BI is similar, but not identical to a fiduciary standard. As Michael Kitces writes, for broker-dealers, "the rule requires greater disclosures of their business practices, a requirement to take active steps to mitigate conflicts of interest and an outright ban on certain sales contests, quotas and similar problematic

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incentives." Michael Kitces, "Kitces: Why Reg BI matters for RIAs," Financial Planning (July 29, 2019).

The regulation contains a General Obligation, which requires that broker-dealers "when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer … 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, or natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer." Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318, 33,491, 17 C.F.R. §240.15*l*-1) (hereinafter Reg BI). In order to satisfy the General Obligation, a broker dealer must satisfy the following four component obligations: (1) the Disclosure Obligation, (2) the Care Obligation, (3) the Conflict of Interest Obligation, and (4) the Compliance Obligation. Thus, "whether a broker-dealer has acted in the retail customer's best interest will turn on an objective assessment of the facts and circumstances of whether the specific components of Regulation Best Interest are satisfied at the time that the recommendation is made." Reg BI at n.16. Note that the regulation applies, by its terms, to "the time the recommendation is made," and does not impose an ongoing obligation to monitor the customer's accounts.

Disclosure Obligation

The Disclosure Obligation requires that a broker-dealer provide "in writing, full and fair disclosure of: (A) All material facts relating to the scope and terms of the relationship with the retail customer … [and] (B) All material facts relating to conflicts of interest that are associated with the recommendation." Id. at 33,491. Relative to the "material facts relating to the scope and terms of the relationship," a broker-dealer must disclose that (1) the firm is acting as a broker-dealer, not an investment adviser; (2) the "material fees and costs that apply to the retail customer's transactions, holdings, and accounts;" 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." Id. The phrase "material facts" and "material fees and costs" are interpreted with the standard of materiality set forth in *Basic 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). Moreover, under Reg BI, broker-dealers, like RIAs, are obligated to complete a new Form CRS (Customer/Client Relationship Summary) prior to or contemporaneously with the adviser's recommendation, explaining the types of client/customer relationships and the services the firm offers, the fees, costs, conflicts of interest and required standard of conduct associated with those relationships and services, and the firm's reportable legal or disciplinary history. Kitces, supra.

> If the trade war continues to have a damping effect on the world economy, this may be another factor that influences an increase in IP litigation and licensing activity—both in China and in the United States.

Care Obligation

The Care Obligation has a three pronged suitability requirement. The adviser must first determine that the product is good for someone. Then the adviser must decide that the recommended security is good for the particular individual retail investor to whom she makes the recommendation. Third, the amount recommended must be reasonable for the investor, i.e., the customer must not be overly concentrated in that position. Reg BI at 33,491. The Care Obligation thus builds upon, but goes beyond, FINRA's existing suitability obligation by mandating that a recommendation be in a retail customer's "best interest" and that the broker-dealer must not place its own interest above that of the customer's. Bradley Berman, et al., *Regulation Best Interest*, Harvard Law School Forum on Corporate Governance and Financial Regulation (June 19, 2019). Furthermore, the SEC has noted that broker-dealers should consider reasonably available

alternatives when assessing whether they have a "reasonable basis" that a particular recommendation is in the customer's best interest. Reg BI at 33,381.

Conflict of Interest Obligation

The Conflict of Interest Obligation requires a broker-dealer to establish, maintain and enforce written policies and procedures reasonably designed to:

> (A) Identify and at a minimum disclose, in accordance with [the Disclosure Obligation], or eliminate, all conflicts of interest associated with such recommendations;
> (B) Identify and mitigate all conflicts of interest associated with such recommendations that create an incentive for a natural person who is an associated person of a broker dealer to place the interest of the [broker-dealer] ahead of the interest of the retail customer;
> (C)(1) Identify and disclose 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, in accordance with [the Disclosure Obligation], and
> (2) Prevent such limitations and associated conflicts of interest from causing [the broker-dealer] to make recommendations that place the interest of [the broker-dealer] ahead of the interest of the retail customer …
> Id. at 33,491.

In addition, Reg BI prohibits "sales contests, sales quotas bonuses and non-cash compensation that are based on sales of specific securities or specific types of securities within a limited period of time." Reg BI defines a "conflict of interest" as "an interest that might incline [the broker-dealer]—consciously or unconsciously—to make a recommendation that is not disinterested." Id. at 33,491.

Furthermore, because broker-dealers are required to disclose conflicts of interest in accordance with the Disclosure Obligation, the SEC stated "where a broker-dealer cannot fully and fairly disclose a conflict of interest in accordance with the Disclosure Obligation, the broker-dealer should eliminate the conflict or adequately mitigate (i.e., reduce) the conflict such that full and fair disclosure … is possible." Id. at 33,388-89. The SEC provided a non-exhaustive list of incentives paid to an associated person that would need to be addressed under the Conflict of Interest Obligation, as well as potential methods to mitigate such conflicts. Id. at 33,391-92.

Compliance Obligation

Under the Compliance Obligation, a broker-dealer must also establish, maintain, and enforce "written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest." Id. at 33,491. This newly-added section "creates an affirmative obligation under the Exchange Act with respect to [Reg BI] 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." Id. at 33,397. The Compliance Obligation operates to "ensure that broker-dealers have strong systems of control in place to prevent violations of [Reg BI]." Id. The SEC also noted that "a reasonably designed compliance program generally would also include: Controls; remediation of non-compliance; training; and periodic review and testing," but that an individual firm's program should be "reasonably designed to address and be proportionate to the size, scope and risks associated with the operations of the firm and the types of business in which the firm engages." Id. at 33,397-98.

Conclusion

The SEC has provided a compliance date of June 30, 2020 in order to provide "adequate notice and opportunity for broker-dealers to comply with [Reg BI]." The new regulations require broker-dealers to eschew sales contests which encourage sales of particular products (as notoriously lampooned in the movie "Boiler Room"). It should be noted that the SEC regs require that the recommendations be in the investors' best interest at the time of the recommendation, and do not require continuing monitoring of existing positions.