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GAME CHANGER: WHAT REGULATION BEST INTEREST MEANS FOR RETAIL BROKER-DEALERS

By Steven W. Stone & Brian J. Baltz

Steven W. Stone is a partner and head of the financial institutions practice at Morgan Lewis & Bockius, working out of the firm's Washington, D.C. office. Stone is a securities lawyer who counsels clients on regulations governing broker-dealers, investment advisers and bank fiduciaries, and pooled investment vehicles. He is also a member of the Editorial Advisory Board of Wall Street Lawyer. Brian J. Baltz is an associate in the firm's Washington, D.C. office, and he focuses his practice on the regulation of investment advisers, broker-dealers, and bank fiduciaries. Contact: steve.stone@morganlewis.com.

After nearly nine years of debate, on June 5, the U.S. Securities and Exchange Commission ("SEC") adopted its long-awaited rule governing the standard of conduct for broker-dealers when recommending securities to retail customers. At only four pages long, Regulation Best Interest ("Reg. BI") itself does not initially seem daunting, but once one digs into the nearly 800 pages of guidance on how the SEC interprets Reg. BI, the layers of complexity become apparent, and certain key themes develop:

- The SEC sought to raise the standard of conduct for broker-dealers while maintaining investor choice and access to services.
- The SEC did not pursue an approach of deeming broker-dealers to be fiduciaries, but "crafted Regulation Best Interest to draw on key principles underlying fiduciary obligations." The SEC declined to adopt uniform standards for broker-dealers and investment advisers but made efforts to reconcile and in many ways align the two approaches. As a result, both broker-dealers and investment advisers are required to act in the client's best interest.
- Disclosure alone does not satisfy Reg. BI (a point the SEC made 18 times).
- The SEC did not resolve state preemption issues, instead stating pre-

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emption "would be determined in future judicial proceedings based on the specific language and effect of that state law."

- While the SEC does "not believe Regulation Best Interest creates any new private right of action or right of rescission, [or] intend such a result," whether plaintiffs' attorneys seek creative ways to exploit Reg. BI in pursuing class action or other claims remains to be seen.

Reg. BI includes a best interest obligation that is satisfied by meeting four component obligations: (*i*) disclosure obligation, (*ii*) care obligation, (*iii*) conflict of interest obligation, and (*iv*) compliance obligation:

> **Best Interest Obligation:** "A broker, dealer, or a natural person who is an associated person of a broker or dealer, when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer, 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, or natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer."[1]

Below we discuss when Reg. BI applies and the four component obligations and provide some initial observations on interpretive and operational challenges.

When Does Reg. BI Apply?

Reg. BI applies when a broker-dealer or a natural person who is an associated person of a broker or dealer (*i*) makes a recommendation; (*ii*) of any securities transaction or investment strategy involving securities (including account recommendations); and (*iii*) to a retail customer.

What does the SEC mean by a "recommendation"?

The SEC declined to define "recommendation" for purposes of Reg. BI and instead pointed to existing interpretations under the antifraud provisions of the federal securities laws and FINRA Rule 2111.[2] These interpretations generally look to whether a communication "reasonably could

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West LegalEdcenter
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Eagan, MN 55123

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be viewed as a 'call to action' " and "reasonably would influence an investor to trade a particular security or group of securities." Under these interpretations, the more individually tailored a communication is toward a particular customer or targeted group of customers, the greater the likelihood that it might be viewed as a recommendation.[3]

The SEC stated that general investment education is not, however, subject to Reg. BI as long as it does "not include, standing alone or in combination with other communications, a recommendation of a particular security or securities or particular investment strategy involving securities." The types of general education the SEC identified are (*i*) general financial and investment information, (*ii*) plan information, (*iii*) certain asset allocation models, and (*iv*) interactive investment materials.

Who is a "retail customer"?

Reg. BI defines a retail customer as "a natural person, or the legal representative of such natural person, who: (*i*) Receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer, or a natural person who is an associated person of a broker or dealer; and (*ii*) uses the recommendation primarily for personal, family, or household purposes."[4]

Legal Representative of a Natural Person—As adopted, a retail customer includes only a natural person or a legal representative of one. The SEC stated that it "view[s] a 'legal representative' of a natural person to only cover *non-professional* legal representatives (e.g., a non-professional trustee that represents the assets of a natural person and similar representatives such as executors, conservators, and persons holding a power of attorney for a natural person)." (Emphasis added.) The SEC's illustrations of professional legal representatives cover various types of regulated entities, including "registered investment advisers and broker-dealers, corporate fiduciaries (e.g., banks, trust companies and similar financial institutions), and insurance companies."

Observations: The SEC did not specifically address whether recommendations to family offices, private family trust companies, and other vehicles used to invest family assets would be subject to Reg. BI. These entities may be managed by financial professionals that exercise their own independent professional judgment and do not rely directly on a broker-dealer's recommendation, but that may not be regulated entities. For example, single family offices might not be registered as investment advisers as they are excluded from the definition of investment adviser by Section 202(a)(11)(G) of the Investment Advisers Act and Rule 202(a)(11)(G)-1 thereunder.

No High-Net-Worth Exception—The SEC declined to adopt a high-net-worth test similar to the institutional suitability exception in FINRA Rule 2111(b). As a result, Reg. BI extends to dealings with any natural person who uses a recommendation for personal, family, or household purposes no matter their net worth.

Uses the Recommendation for Personal, Family, or Household Purposes—Reg. BI only applies where a natural person or legal representative of a natural person uses a recommendation for personal, family, or household purposes. The SEC stated it would view a retail customer as having used a recommendation if "(*i*) the retail customer opens a brokerage account with the broker-dealer, regardless of whether the broker-

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dealer receives compensation, (*ii*) the retail customer has an existing account with the broker-dealer and receives a recommendation from the broker-dealer, regardless of whether the broker-dealer receives or will receive compensation, directly or indirectly, as a result of that recommendation, or (*iii*) the broker-dealer receives or will receive compensation, directly or indirectly as a result of that recommendation, even if that retail customer does not have an account at the firm."

The SEC also sought to clarify what it means for a recommendation to be used for personal, family, or household purposes, stating that it would include "any recommendation to a natural person for his or her account. . . other than recommendations to natural persons seeking these services for commercial or business purposes." So framed, whether a natural person or legal representative uses a recommendation for personal, family, or household purposes is determined not by the character of the recommendation, but potentially on a look-back or hindsight basis. The SEC also clarified that personal, family, or household purposes would include retirement accounts, "including but not limited to IRAs and individual accounts in workplace retirement plans, such as 401(k) plans and other tax-favored retirement plans," but generally would not include workplace retirement plans.

What Is an Investment Strategy Involving Securities?

The SEC stated that Reg. BI applies to any recommendation of a securities transaction, including the purchase, sale, or exchange of a security, and to any investment strategy involving securities, including an explicit recommendation to hold a security. The SEC also stated that investment strategy would involve certain account monitoring and account recommendations.

Account Monitoring and Implicit Hold Recommendations—The SEC extended Reg. BI to "any recommendations that result from the account monitoring services that a broker-dealer agrees to provide." This decision introduces the concept of implicit hold recommendations where a broker-dealer agrees—in writing or orally—to provide ongoing account monitoring. According to the SEC, "by agreeing to perform account monitoring services, the broker-dealer is taking on an obligation to review and make recommendations with respect to that account (e.g., to buy, sell or hold) on that specified, periodic basis," and "the quarterly review and each resulting recommendation to purchase, sell, or hold, will be a recommendation subject to Regulation Best Interest. . . even in instances where the broker-dealer does not communicate any recommendation to the retail customer."

The SEC stated that where there is such an agreement, "silence is tantamount to an explicit recommendation to hold and should be viewed as a recommendation to hold the securities for purposes of Regulation Best Interest." In comparison, silence as to a retail customer's account holdings would not appear to be subject to Reg. BI, including where a broker-dealer voluntarily reviews the account, provided that there is no agreement to provide ongoing monitoring.

Observations: While many broker-dealers currently do not formally agree to provide account monitoring, the concept of implicit hold recommendations introduces new considerations for brokerage agreements and policies and procedures. A broker-dealer that does not for-

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mally provide account monitoring services should consider adding explicit provisions to its brokerage agreements whereby a retail customer agrees that the broker-dealer has no obligation to monitor the account and has no obligation to revisit past recommendations or otherwise provide recommendations about the retail customer's account. In addition, broker-dealers that market their services as encompassing holistic or relationship-based advice might evaluate whether such marketing might be construed as an agreement to monitor customer accounts and tweak such marketing accordingly. The broker-dealer might also consider adopting policies and procedures restricting representatives from agreeing—either in writing or orally—to provide ongoing account monitoring.

Account Recommendations—The SEC also extended Reg. BI to "account recommendations," including "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)." The SEC provided examples of different brokerage accounts, such as "education accounts (e.g., 529 Plans and tax-free Coverdell accounts); retirement accounts (e.g., IRA, Roth IRA, or SEP-IRA accounts); and specialty accounts (e.g., cash or margin accounts, and accounts with access to Forex or options trading)."

The SEC also identified factors that broker-dealers should generally consider in recommending an account type, including "(*i*) the services and products provided in the account (ancillary services provided in conjunction with an account type, account monitoring services, etc.); (*ii*) the projected cost to the retail customer of the account; (*iii*) alternative account types available; (*iv*) the services requested by the retail customer; and (*v*) the retail customer's investment profile." With rollover recommendations, the SEC identified the following factors to consider: "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."

Observations: Firms will want to analyze what types of communications would go beyond solicitation or marketing of services and be viewed as a recommendation, and how to apply the best interest obligation in this context, taking into account the factors identified by the SEC. Those firms that developed tools in response to the since-vacated Department of Labor (DOL) fiduciary rule might be able to modify those tools to address Reg. BI. Developing policies and procedures, and related controls, around this new concept of identifying an account type that is in a retail customer's best interest may prove especially challenging for firms with a large number of offerings, and particularly those that are dually registered. For dual registrants, the selected approaches to addressing account recommendations will need to also consider whether a brokerage or advisory account would be in the retail customer's best interest, including what factors distinguish the accounts (e.g., transaction-based charges vs. ongoing fees, one-time or episodic recommendations vs. ongoing advice) and customer preference as to the type of relationship desired.

What Does the Disclosure Obligation Require?

Under Reg. BI, prior to or at the time of a recommendation, a broker-dealer must provide full and fair disclosure, in writing, of all material facts relating to the scope and terms of the relationship with the retail customer, including capacity as a broker-dealer, material fees and costs,

and type and scope of services, as well as "any material limitations on the securities or investment strategies involving securities that may be recommended." The SEC described the disclosure obligation as "a more explicit and broader disclosure obligation" than currently exists and as being designed to "promote broker-dealer recommendations that are in the best interest of retail customers."

What does the SEC mean by "full and fair disclosure"?

The SEC stated that full and fair disclosure requires that a broker-dealer "give sufficient information to enable a retail investor to make an informed decision with regard to the recommendation." The requirement to make full and fair disclosure is a change from the proposed rule's requirement that a broker-dealer "reasonably disclose" material facts that the SEC stated "will more closely align the Disclosure Obligation with existing requirements for investment advisers and is consistent with disclosure standards in other contexts under the federal securities laws."

Observations: Firms might consider undertaking a holistic review of existing disclosures to determine how they fit together, and whether any enhancements are needed, to satisfy the disclosure obligation.

What does the SEC mean by "material facts"?

The disclosure obligation is limited to "material" facts. The SEC looked to the materiality standard in *Basic v. Levinson*, 485 U.S. 224 (1988), in stating that for purposes of Reg. BI, a fact is material if there is a substantial likelihood that a reasonable retail customer would consider it important. In addition, the SEC defined "conflict of interest" as "an interest that might incline a broker, dealer, or a natural person who is an associated person of a broker or dealer—consciously or unconsciously—to make a recommendation that is not disinterested." The SEC stated this is intended to reflect the description of conflicts in *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

Observations: Firms might consider analyzing the impact of the requirement to disclose all material facts about all conflicts. Under longstanding SEC and staff statements, as well as the text of Form ADV, investment advisers have been explicitly required to make full disclosure of *material* conflicts. While the SEC stated in Reg. BI that "it would be difficult to envision a 'material fact' that must be disclosed pursuant to the Disclosure Obligation that is not related to a conflict of interest that is also material," it is unclear how this plays out in practice, including whether the SEC ultimately takes the position that the existence of a conflict is a material fact that must be disclosed without regard to the materiality of the conflict, and how this impacts conflicts that advisers have deemed immaterial and excluded from disclosures.

What material facts did the SEC identify as requiring disclosure?

In many instances, the disclosure obligation builds on disclosures required by Form CRS, as shown in the table below.

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	Form CRS	**Reg. BI**
Capacity	● Broker-dealer ● Investment adviser ● Dual registrant	● Satisfied by Form CRS for broker-dealers that are not dual registrants ● Disclose capacity of representatives that are also associated persons of an investment adviser
Material Fees and Costs	● Principal fees and costs (transaction-based fees), frequency, and conflicts ● Other fees and costs (e.g., custodian fees, account maintenance fees, fees related to mutual funds and variable annuities, and other transactional fees and product-level fees) ● Reference to additional information	● Build upon fees and costs in Form CRS ● Disclose other categories of fees not required by Form CRS ● Explain how and when the fees are charged ● Use narrative or numerical disclosure (e.g., standardized or hypothetical amounts, dollar or percentage ranges) that "reasonably reflect[s] the actual fees to be charged" ● May rely on mandated disclosure document (e.g., prospectus, offering document, 10b-10 confirmation) for specifics of product-level fees
Type and Scope of Services	● Summarize the principal services, accounts, or investments ● Monitoring services ● Limited investment offerings ● Account minimums ● Reference to additional information	● Material limitations on securities and investment strategies ● Proprietary products ● Limited range of products/select group of issuers ● Specific asset class ● Products with third-party arrangements (e.g., revenue sharing, mutual fund service fees) ● Making IPOs available only to certain clients ● Whether broker-dealer will monitor account and scope and frequency of monitoring ● Requirements to open or maintain an account or establish a relationship ● General basis for a recommendation (e.g., firm's investment approach, philosophy, or strategy) and any deviations therefrom ● Risks associated with a recommendation

	Form CRS	Reg. BI
Conflicts of Interest	● Proprietary products ● Third-party payments ● Revenue sharing ● Principal trading ● Reference to additional information	● Build on conflicts in Form CRS ● Summarize how broker-dealer and financial professionals are compensated, sources and types of compensation received, and conflicts the compensation creates ● Receipt of differential compensation ● Other examples of conflicts identified: ● Charging commissions or transaction-based fees ● Recommending a security underwritten by the broker-dealer or an affiliate ● Recommending a transaction to be executed as principal ● Allocating trades and research, including investment opportunities ● Cost to the broker-dealer to effect the transaction ● Accepting an order contrary to the broker-dealer's recommendations

When must disclosure be provided?

The SEC did not specifically mandate the timing of disclosure in relation to a particular recommendation, but did state its belief that disclosure should be provided "early enough" to give retail customers "adequate time to consider the information and promote the investor's understanding in order to make informed investment decisions," but not "so early that the disclosure fails to provide meaningful information (e.g., does not sufficiently identify material conflicts presented by a particular recommendation, or overwhelms the retail customer with disclosures related to a number of potential options that the retail customer may not be qualified to pursue." The SEC also "encourage[d] broker-dealers to consider whether it would be helpful to repeat or highlight disclosures already made pursuant to the Disclosure Obligation at the time of the recommendation." The SEC's principles for timing of disclosures depart from the largely transaction-based timing of broker-dealer disclosures and the prospective disclosure approach for advisers (i.e., on Form ADV, Part 2).

Observations: The SEC's statements raise questions about whether the SEC might second guess whether a retail customer received appropriate disclosures and provided informed consent when the retail customer is not reminded of a relevant disclosure at the time of a recommendation.

When must disclosure be updated?

The SEC stated that disclosures should be updated when they "contain materially outdated, incomplete, or inaccurate information," and that updates should be made "as soon as practicable," but "no later than 30 days after the material change." Until the time written disclosures are updated, the SEC stated that "broker-dealers are encouraged to provide, supplement, or correct written disclosure with oral disclosure as necessary prior to or at the time of the recommendation." The SEC noted that oral disclosure may be necessary in these circumstances, and that broker-dealers "must" maintain a record

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of oral disclosures (e.g., recording of telephone conversations, contemporaneous written notations); the SEC did not mandate that broker-dealers memorialize the substance of the oral disclosures but encouraged doing so as a best practice.

Observations: Firms should consider developing a process to evaluate and review disclosures on an ongoing basis, as well as processes for providing updated disclosures at the time of the recommendation, whether with supplemental materials or oral disclosures.

Can broker-dealers use layered disclosures?

Yes. The SEC did not prescribe the method of satisfying the disclosure obligation (e.g., by mandating a document similar to an investment adviser's Form ADV, Part 2A), and instead is allowing broker-dealers to determine how to provide full and fair disclosure, including through layered disclosures. The SEC stated that electronic delivery is permitted consistent with existing SEC guidance on the use of electronic media (albeit with no acknowledgement of the E-Sign Act).

Observations: The SEC views Form CRS as the first layer in a "layered disclosure" regime that should cross-reference additional disclosures for more detailed information. Firms should consider their approaches to the SEC's "layered disclosure" regime, including its pros and cons. In developing a layered disclosure approach, firms might consider cataloguing and leveraging existing customer disclosures (e.g., account agreements, advisory brochures, guides to services, fee schedules, 408(b)(2) disclosures, prospectuses and other offering documents) and disclosures developed for other purposes (e.g., for the since-vacated DOL Best Interest Contract Exemption). Firms might also keep in mind the challenges in mapping and maintaining consistency among disclosures where changes and updates are made and consider establishing "golden source" disclosures and using technology to make and implement changes.

What disclosures are registered representatives required to make?

The disclosure obligation also applies to a broker-dealer's registered representatives. The SEC stated that a representative may be able to rely on a broker-dealer's disclosure unless the representative "knows or should have known that the broker-dealer's disclosure is insufficient to describe 'all material facts.' "

Observations: Firms should consider developing processes to facilitate representative disclosure, including to address situations where a representative is not a supervised person of an investment adviser, or is not acting as one; a representative does not offer advisory services or can only sell certain products; a representative's conflicts of interest are not disclosed by the firm; or a representative has a distinct investment approach.

What Does the Care Obligation Require?

The care obligation requires a broker-dealer to "exercise[] reasonable diligence, care, and skill" in satisfying three obligations when recommending a security or investment strategy involving securities: a reasonable-basis obligation, a customer-specific obligation, and a quantitative obligation. While the SEC did not include the prudence element from the proposed rule, the SEC stated that "requiring broker-dealers 'to exercise reasonable diligence, care, and skill' conveys 'the fundamental importance of conducting a proper evaluation of any securities recommendation in accordance with an objective standard of care' that was intended by the inclusion

of 'prudence.' " The SEC stated that compliance with the care obligation "will be evaluated as of the time of the recommendation (and not in hindsight)."

What is the reasonable-basis obligation?

The reasonable-basis obligation requires that a broker-dealer and its registered representatives "[u]nderstand the potential risks, rewards, and costs associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers."[5] The SEC stated that what will constitute reasonable diligence "will vary depending on, among other things, the complexity of and risks associated with the recommended security or investment strategy and the broker-dealer's familiarity with the recommended security or investment strategy." The SEC also identified the following factors that "broker-dealers generally should consider": "the security's or investment strategy's investment objectives, characteristics (including any special or unusual features), liquidity, volatility, and likely performance in a variety of market and economic conditions; the expected return of the security or investment strategy; as well as any financial incentives to recommend the security or investment strategy."

What is the customer-specific obligation?

The customer-specific obligation requires that a broker-dealer and its registered representatives "[h]ave a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks, rewards, and costs associated with the recommendation and does not place the financial or other interest of the broker, dealer, or such natural person ahead of the interest of the retail customer."[6] The SEC stated that "what is in the 'best interest' of a retail customer depends on the facts and circumstances of a recommendation at the time it is made, including matching the recommended security or investment strategy to the retail customer's investment profile at the time of the recommendation, and the process for coming to that conclusion."

Observations: As a general matter, firms will want to review the SEC's guidance on the care obligation in light of existing FINRA interpretations of FINRA Rule 2111—which can be expected to change—to identify any differences and evaluate the impact on existing policies and procedures.

Reasonably Available Alternatives—As part of the process in meeting the customer-specific obligation, the SEC believes "a broker-dealer generally should consider reasonably available alternatives offered by the broker-dealer." According to the SEC, this does not require a broker-dealer to evaluate every possible alternative, whether offered by the firm or available outside the firm. The SEC recognized that the scope of reasonably available alternatives will depend on the retail customer's investment profile as well as other factors, such as a registered representative's customer base; the investments and services available to recommend; 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)."

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Observations: The customer-specific obligation requires that a recommendation be in the "best interest" of the retail customer—not just suitable—in light of the retail customer's investment profile and the potential risks, rewards, and costs (an additional consideration in the final rule), and that the broker-dealer and its financial professionals not place their financial or other interests ahead of the retail customer's interests. It is unclear, however, what "best interest" means in this context and whether it requires something beyond not placing the broker-dealer's interest ahead of the retail customer's interest. Developing a process or criteria to identify the "reasonably available alternatives" to be considered in making a recommendation might be an important component of putting registered representatives in a position to satisfy the customer-specific obligation. We will watch how the obligation to consider reasonably available alternatives ultimately impacts choice and product offerings, including whether it results in firms trimming their product offerings as a way to reduce the array of reasonably available alternatives.

Cost—The SEC elevated consideration of costs to the rule text, meaning that cost, along with potential risks and rewards, must always be considered when making a recommendation. Cost, however, is not the only factor, and "the standard does not necessarily require the lowest cost option." In fact, the SEC stated that recommending the lowest cost option might even violate the customer-specific obligation, and that "a broker-dealer would not satisfy the Care Obligation by simply recommending the least expensive or least remunerative security without any further analysis of these other factors and the retail customer's investment profile." Broker-dealers can recommend a more expensive or more remunerative security where "there are other factors about the product that reasonably allow the broker-dealer to believe it is in the best interest of the retail customer, based on that retail customer's investment profile."

Observations: Similar to our discussion of reasonably available alternatives, we will watch the impact on product offerings of elevating cost as a key consideration in making a recommendation. While various statements by the SEC suggest cost is but one factor in making a recommendation, it remains unclear how the SEC will examine a broker-dealer's consideration of cost in connection with the requirement that a broker-dealer not put its interests ahead of the retail customer's interests where cost corresponds to broker-dealer revenues.

Documenting Recommendations—The SEC has not required that broker-dealers or registered representatives document the basis for their recommendations, and instead stated that "broker-dealers may choose to take a risk based approach when deciding whether or not to document certain recommendations," such as for complex products or "where a recommendation may seem inconsistent with a retail customer's investment objectives on its face." The SEC noted that firms might rely on exception reports or other measures in satisfying the care obligation.

What is the quantitative obligation?

The quantitative obligation requires that a broker-dealer and its registered representatives "[h]ave a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile and does not place the financial or other interest of the broker, dealer, or such natural person making the series of recommendations ahead of the interest of the retail customer."[7]

Observations: Reg. BI expands the quantitative obligation to all retail customer relationships, not only to situations where a broker-dealer exercises actual or de facto control over an account, which is the focus on quantitative suitability under current law. Although the core obligation generally is evaluated at the time of the recommendation, the quantitative obligation involves a look back. To the extent they have not already done so, firms will need to expand their controls to review trading across all retail customer accounts.

What Does the Conflict of Interest Obligation Require?

The conflict of interest obligation requires that a broker-dealer "establishes, maintains, and enforces written policies and procedures reasonably designed to. . . [i]dentify and at a minimum disclose, in accordance with [the disclosure obligation], or eliminate, all conflicts of interest associated with such recommendations" and to mitigate certain identified conflicts (if those conflicts were not otherwise eliminated).[8]

According to the SEC, broker-dealers "have flexibility to reasonably design their policies and procedures to tailor them to account for their business model, given the structure and characteristics of their relationships with retail customers, including the varying levels and frequency of recommendations provided and the types of conflicts that may be presented."

The SEC identified certain components of policies and procedures that it views as effective, including "policies and procedures outlining how the firm identifies conflicts, identifying such conflicts and specifying how the broker-dealer intends to address each conflict; robust compliance and monitoring systems; processes to escalate identified instances of noncompliance for remediation; procedures that designate responsibility to business line personnel for supervision of functions and persons, including determination of compensation; processes for escalating conflicts of interest; processes for periodic review and testing of the adequacy and effectiveness of policies and procedures; and training on policies and procedures."

How might broker-dealers go about identifying conflicts of interest?

The SEC identified conflicts of interest as falling into three categories: (*i*) conflicts between the broker-dealer and the retail customer; (*ii*) conflicts between a registered representative and the retail customer; and (*iii*) conflicts between the broker-dealer and its registered representatives. While not included in the SEC's list, another category of conflicts that broker-dealers should consider identifying are conflicts of interest between retail customers, a point reflected in the SEC's examples of conflicts, which included "allocating investment opportunities. . . among different types of customers." The SEC stated that reasonably designed policies and procedures to identify conflicts of interest generally should:

- "define 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";
- "establish a structure for identifying the types of conflicts that the broker-dealer (and associated persons of the broker-dealer) may face";
- "establish a structure to identify conflicts in the broker-dealer's business as it evolves";

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- "provide for an ongoing (e.g., based on changes in the broker-dealer's business or organizational structure, changes in compensation incentive structures, and introduction of new products or services) and regular, periodic (e.g., annual) review for the identification of conflicts associated with the broker-dealer's business"; and
- "establish training procedures regarding the broker-dealer's conflicts of interest, including 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."

Do conflicts need to be eliminated?

With the exception of sales contests, which as discussed below must be eliminated, the SEC has not required that a broker-dealer eliminate any particular conflicts of interest. The SEC did, however, caution that "where a broker-dealer cannot fully and fairly disclose a conflict of interest. . ., the broker-dealer should eliminate the conflict or adequately mitigate (i.e., reduce) the conflict such that full and fair disclosure. . . is possible." In this regard, the SEC stated that "conflicts of interest may be of a nature and extent that it would be difficult to provide disclosure that adequately conveys to a retail customer the material facts or the nature, magnitude and potential effect of the conflict for informed decision-making or where disclosure may not be sufficiently specific or comprehensible for the retail customer to understand whether and how the conflict will affect the recommendations he or she receives."

What about sales contests?

The conflict of interest obligation requires that broker-dealers "[i]dentify and eliminate any sales contests, sales quotas, 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."[9] The SEC stated that it interprets non-cash compensation to 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, meals and lodging except we do not intend it to cover certain employee benefits, including healthcare and retirement benefits."

The SEC recognized that certain production requirements may exist for other reasons, and that the prohibition "does not apply to compensation practices based on, for example, total products sold, or asset growth or accumulation, and customer satisfaction." The SEC declined to define what would constitute a "limited period of time," apparently out of concerns that broker-dealers might game that timeframe by using slightly longer periods. The SEC's focus appears to be on "time limitations that create high-pressure situations for associated persons to increase the sales of specific securities or specific types of securities which compromise the best interests of their customers."

In this regard, the SEC stated its agreement with commenters "that broker-dealers cannot reasonably be expected to make recommendations in a particular retail customer's best interest consistent with the requirements of the Care Obligation, if they are motivated to 'push' certain securities or types of securities in order to win a

contest or reach a target in order to receive a bonus or other non-cash compensation."

What conflicts must be mitigated?

Broker-dealers are required to "[i]dentify and mitigate any conflicts of interest associated with such recommendations that create an incentive for a natural person who is an associated person of a broker or dealer to place the interest of the broker, dealer, or such natural person ahead of the interest of the retail customer."[10] The SEC stated that it interprets this requirement "to only apply to incentives *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" (emphasis added). The SEC provided examples of incentives that would need to be mitigated, including:

- "compensation from the broker-dealer or from third-parties, including fees and other charges for the services provided and products sold";
- "employee compensation or employment incentives (e.g., incentives tied to asset accumulation and not prohibited under [the prohibition on sales contests], special awards, differential or variable compensation, incentives tied to appraisals or performance reviews)"; and
- "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."

How does the SEC expect broker-dealers to mitigate these conflicts?

The SEC has not mandated specific mitigation measures or established a one-size-fits-all approach, and instead is allowing broker-dealers to develop reasonably designed policies and procedures based on each firm's circumstances. The SEC stated it would look to whether policies and procedures are "reasonably designed to reduce the incentive for the associated person to make a recommendation that places the associated person's or firm's interests ahead of the retail customer's interest."

According to the SEC, mitigation measures should reflect "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), and the complexity of the security or investment strategy involving securities that is being recommended), some of which may be weighed more heavily than others."

The SEC identified the following examples of mitigation measures that broker-dealers might consider:

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

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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, 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."[11]

What firm-level conflicts must be mitigated?

The SEC has not required that broker-dealers mitigate all firm-level financial incentives and has instead decided to allow "firm-level conflicts to be generally addressed through disclosure." However, in the rule text the SEC is explicitly requiring that broker-dealers mitigate material limitations on the available product offerings.

The conflict of interest obligation requires that broker-dealers "(*i*) [i]dentify 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 (*ii*) [p]revent such limitations and associated conflicts of interest from causing the broker, dealer, or a natural person who is an associated person of the broker or dealer to make recommendations that place the interest of the broker, dealer, or such natural person ahead of the interest of the retail customer."[12] The SEC stated it would view a material limitation to include "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)," and recommending "only products from a select group of issuers." The SEC is providing firms with flexibility in meeting this obligation.

The SEC stated its belief that "firms should, for example, consider establishing product review processes for products that may be recommended, including establishing procedures for identifying and mitigating the conflicts of interests associated with the product, or declining to recommend a product where the firm cannot effectively mitigate the conflict, and identifying which retail customers would qualify for recommendations from this product menu." The SEC went on to identify additional considerations, including:

- "evaluating the use of 'preferred lists' ";
- "restricting the retail customers to whom a product may be sold";
- "prescribing minimum knowledge requirements for associated persons who may recommend certain products"; and
- "conducting periodic product reviews to

identify potential conflicts of interest, whether the measures addressing conflicts are working as intended, and to modify the mitigation measures or product selection accordingly."

The SEC then identified certain practices that FINRA identified in its 2013 *Report on Conflicts of Interest* as effective in identifying and managing conflicts of interest, including:

- "a product review process to identify and mitigate conflicts of interest that may be associated with a product";
- "evaluation of whether to decline to offer products to customers when the conflicts associated are too significant to be mitigated effectively";
- "differentiation of product eligibility between institutional and retail clients";
- "post-launch reviews of products to identify potential problems";
- "evaluation of registered representatives' ability to understand a product, provide training where necessary, and limit access to products for which they cannot demonstrate sufficient understanding to perform a suitability analysis and effectively explain a product and its risks to customers"; and
- "disclosure of product conflicts and risks."[13]

Observations: Arguably, disclosure that a broker-dealer only provides proprietary products or a limited range of products should suffice to address conflicts of interest, especially given related Advisers Act precedent. It is not immediately clear if the chosen test for limited or proprietary products is based on duty of loyalty concepts (i.e., placing the broker-dealer or its financial professional's interests ahead of the retail customer's interests) versus duty of care concepts, or a combination of the two.

What Does the Compliance Obligation Require?

The compliance obligation requires a broker-dealer to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Reg. BI.[14] According to the SEC, a broker-dealer "should consider the nature of that firm's operations and how to design such policies and procedures to prevent violations from occurring, detect violations that have occurred, and to correct promptly any violations that have occurred."

In this regard, the SEC stated its view that "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." The SEC also stated that, "[i]n addition to the required policies and procedures, depending on the size and complexity of the firm, we believe a reasonably designed compliance program generally would also include: controls; remediation of noncompliance; training; and periodic review and testing."

Observations: As a separate obligation under Reg. BI, it appears the SEC could allege that a broker-dealer violated Reg. BI based solely on having inadequate policies and procedures, as has been the case with policies and procedures on the handling of material nonpublic information required by Exchange Act Section 15(g) and Advisers Act Section 204A, as well as the Advisers Act rule on policies and procedures, Rule 206(4)-7.

Final Thoughts

While only a rule, Reg. BI effectively creates a

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principles-based regime for the provision of recommendations to retail customers that includes a care obligation and obligation not only to disclose conflicts of interest, but also to mitigate certain conflicts. While the SEC's guidance on Reg. BI is extensive, significant questions nonetheless remain in addition to those identified in this article. Broker-dealers will want to evaluate whether any of these questions are ones for which additional guidance would be helpful.

The SEC and its staff have indicated that they want to hear from broker-dealers about issues in implementing Reg. BI. However, decisions to approach the SEC or its staff should be balanced against the prospect that the industry might not like or agree with additional guidance provided, as well as whether broker-dealers can take reasonable approaches based on guidance in the adopting release and longstanding interpretations of broker-dealer obligations under the federal securities laws and FINRA rules. With Reg. BI taking effect June 30, 2020, the next year will be a challenging time for all broker-dealers providing recommendations to retail customers.

The SEC's Regulation Best Interest requires that recommendations be in the retail customer's best interest, creates a more explicit and broader disclosure obligation for broker-dealers, and requires broker-dealers to mitigate certain conflicts of interest.

ENDNOTES:

[1]Rule 15l-1(a)(1).

[2]*See* FINRA Regulatory Notice 12-25 at 4-5 (May 2012) (discussing guiding principles as to what constitutes a recommendation).

[3]*See* NASD Notice to Members 01-23, Online Suitability - Suitability Rules and Online Communications (Apr. 2001).

[4]Rule 15l-1(b)(1).

[5]Rule 15l-1(a)(2)(ii)(A).

[6]Rule 15l-1(a)(2)(ii)(B).

[7]Rule 15l-1(a)(2)(ii)(C).

[8]Rule 15l-1(a)(2)(iii).

[9]Rule 15l-1(a)(2)(iii)(D).

[10]Rule 15l-1(a)(2)(iii)(B).

[11]We submitted a comment letter to the SEC on this issue urging the SEC to "recognize that firms may appropriately employ only some—or various combinations—of these approaches depending on their businesses and business models, compensation structures, and related conflicts of interest, and should not prescribe a one-size-fits-all approach to mitigating compensation-related conflicts." *See* Letter from Steven W. Stone & Brian J. Baltz, Morgan, Lewis & Bockius LLP (May 3, 2019).

[12]Rule 15l-1(a)(2)(iii)(C).

[13]*See* FINRA, Report on Conflicts of Interest (Oct. 2013).

[14]Rule 15l-1(a)(2)(iv).