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A Guide to Regulation Best Interest

The Fiduciary Governance Group has been closely tracking the standard of conduct rulemaking developments out of the Securities and Exchange Commission ("Commission"), Department of Labor ("DOL"), Office of the Comptroller of the Currency, and the states. This new client alert, A Guide to Regulation Best Interest, complements our prior analysis of the SEC rulemaking, particularly our overview of the rulemaking, our analysis of the practical implications of the Investment Adviser Interpretive Release, and our discussion of Form CRS. On July 9 at 2 p.m. (EDT), the Fiduciary Governance Group will host a one-hour webcast where we will examine the SEC rulemaking in its entirety.

On June 5, 2019, the Commission adopted a package of rulemakings and interpretations designed to "enhance and clarify the standards of conduct applicable to broker-dealers and investment advisers, help retail investors better understand and compare the services offered and make an informed choice of the relationship best suited to their needs and circumstances, and foster greater consistency in the level of protections provided by each regime, particularly at the point in time that a recommendation is made."[1] Arguably, the most potentially impactful element of this package is the new Regulation Best Interest, which the Commission adopted as Rule 15*l*-1 under the Securities Exchange Act of 1934 ("Exchange Act").

[1] SEC Adopts Rules and Interpretations to Enhance Protections and Preserve Choice for Retail Investors in Their Relationships With Financial Professionals, Securities and Exchange Commission (June 5, 2019), https://www.sec.gov/news/press-release/2019-89.

Regulation Best Interest imposes a new federal conduct standard on registered broker-dealers and their associated persons who are natural persons ("Representatives") when making securities transaction or related investment strategy recommendations to their retail customers. Specifically, it requires that a broker-dealer or Representative, when making a covered recommendation, act in the retail customer's best interest and not place its own interests ahead of the customer's interests ("General Conduct Obligation"). To satisfy this General Conduct Obligation, a broker-dealer must satisfy each and every one of the following four core component obligations: (1) provide certain prescribed material disclosures before or at the time of the recommendation about the recommendation and the relationship between the retail customer and the broker-dealer ("Disclosure Obligation"); (2) exercise reasonable diligence, care, and skill in making the recommendation ("Care Obligation"); (3) establish, maintain, and enforce policies and procedures reasonably designed to address conflicts of interest ("Conflict of Interest Obligation"); and (4) establish, maintain, and enforce policies and procedures reasonably designed to achieve compliance with Regulation Best Interest ("Compliance Obligation") (collectively, "Component Obligations"). Thus, a failure to satisfy any single one of the Component Obligations constitutes a violation of Regulation Best Interest.

In adopting Regulation Best Interest, the Commission ultimately "declined to subject broker-dealers to a wholesale and complete application of the existing fiduciary standard under the Adviser Act because it is not appropriately tailored to the structure and characteristics of the broker-dealer business model (*i.e.*, transaction-specific recommendations and compensation), and would not properly take into account, and build upon, existing obligations that apply to broker-dealers . . . . "[2] Moreover, in the Commission's view, "this approach would significantly reduce retail investor access to differing types of investment services and products, reduce retail investor choice in how to pay for those products and services, and increase costs for retail investors of obtaining investment recommendations."[3] Instead, the enhancements contained in Regulation Best Interest "are designed to improve investor protection by enhancing the quality of broker-dealer recommendations to retail customers and reducing the potential harm to retail customers that may be caused by conflicts of interest."[4] Together with the other elements of the rulemaking and interpretive package, Regulation Best Interest also was designed to help retail customers better understand and compare the services offered by broker-dealers and investment advisers and make an informed choice of the relationship best suited to their needs and circumstances, provide clarity with respect to the standards of conduct applicable to investment advisers and broker-dealers, and foster greater consistency in the level of protections provided by each regime, particularly at the point in time that a recommendation is made.

This Client Alert provides an overview of Regulation Best Interest. The Alert is divided into five sections. Section I discusses Regulation Best Interest generally. Section II discusses at some length each of the four Component Obligations that must be satisfied to demonstrate compliance with Regulation Best Interest. Section III examines a number of other important collateral issues under and related to Regulation Best Interest. Section IV discusses required records and recordkeeping related to Regulation Best Interest. Finally, Section V provides a suggested framework for ensuring that registered broker-dealers are fully compliant with Regulation Best Interest on or before the fast-approaching compliance date of June 30, 2020.

Key Takeaways

- Regulation Best Interest requires that a broker-dealer or its Representative, when making a recommendation, act in the retail customer's best interest and not place its own interests ahead of the customer's interests, which is satisfied only if the broker-dealer or Representative complies with the four specified component obligations, referred to as the Disclosure Obligation, the Care Obligation, the Conflict of Interest Obligation, and the Compliance Obligation.

[2] Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Rel. No. 34-86031 (June 5, 2019), https://www.sec.gov/rules/final/2019/34-86031.pdf ("Adopting Release").

[3] *Id*.

[4] *Id*. at 16.

- Regulation Best Interest applies to broker-dealers and Representatives that make recommendations of securities transactions and investment strategies to retail customers. Recommendations include recommendations of account types and rollovers or transfers of assets (*e.g.*, to roll over or transfer assets in a workplace retirement plan to an individual retirement account). Recommendations also include implicit hold recommendations resulting from agreed-upon account monitoring.

- A retail customer is a natural person (or legal representative) who receives a recommendation and uses it primarily for personal, family or household purposes. There is no carve-out for wealthy individuals, so Warren Buffett is a retail customer, assuming his brokerage services are not for commercial or business purposes.

- With limited exceptions (*e.g.*, for commodity trading advisors), a broker-dealer or Representative cannot use the title "adviser" or "advisor" unless that person is also an investment adviser or a supervised person of an investment adviser. The rationale is that the title would be inconsistent with the disclosure of the capacity in which the person acts.

- Before or at the time of the recommendation, a broker-dealer or Representative must disclose, in writing, all material facts about the scope and terms of its relationship with the customer and all material facts relating to conflicts of interest that are associated with the recommendation.

- A broker-dealer or Representative must exercise reasonable diligence, care, and skill when making a recommendation to a retail customer. The broker-dealer or Representative must understand potential risks, rewards, and costs associated with the recommendation. While costs must always be considered in making a recommendation, they should be considered in light of other factors and the retail customer's investment profile; there is no requirement to recommend only the lowest cost option.

- When recommending a series of transactions, the broker-dealer or Representative must have a reasonable basis to believe that the transactions taken together are not excessive, even if each is in the customer's best interest when viewed in isolation.

- A broker-dealer must establish, maintain, and enforce reasonably designed written policies and procedures addressing conflicts of interest associated with its recommendations to retail customers. These policies and procedures must be reasonably designed to identify all such conflicts and at a minimum disclose or eliminate them.

- The policies and procedures must be reasonably designed to mitigate conflicts of interests that create an incentive for an associated person to place his or her interests or the interest of the firm ahead of the retail customer's interest.

- Where a broker-dealer places material limitations on recommendations (*e.g.*, offering only proprietary or other limited range of products), the policies and procedures must be reasonably designed to disclose the limitations and associated conflicts and to prevent the limitations from causing the associated person or broker-dealer to place the person's or the firm's interests ahead of the customer's interest.

- Sales contests, sales quotas, bonuses, and non-cash compensation are prohibited if they are based on (1) the sale of specific securities or specific types of securities (2) within a limited period of time. Other incentives and practices that are not explicitly prohibited are permitted, provided that the broker-dealer establishes reasonably designed policies and procedures to disclose and mitigate the incentive created to the Representative, and the Care and Disclosure Obligations are complied with.

- A broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest as a whole. Thus, a broker-dealer's policies and procedures must address not only conflicts of interest but also compliance with its Disclosure and Care Obligations.

- Compliance with Regulation Best Interest will not alter a broker-dealer's obligations under the general antifraud provisions of the federal securities laws. Regulation Best Interest applies in addition to any applicable securities laws and regulations.

I. General Obligation

Regulation Best Interest requires that a broker-dealer or Representative, when making a recommendation, act in the retail customer's best interest and not place the financial or other interest of the person making the recommendation ahead of the customer's interests. Despite requiring broker-dealers to act in the "best interest" of a retail customer, the Commission chose not to expressly define "best interest." Instead, the Commission has stated that whether a broker-dealer has acted in the best interest of a retail customer will turn on an objective assessment of the facts and circumstances of how the specific components of Regulation Best Interest, including the Component Obligations, are satisfied at the time that the recommendation is made (and not in hindsight).

In crafting Regulation Best Interest, the Commission drew upon key principles underlying fiduciary obligations, including those that apply to investment advisers under the Investment Advisers Act of 1940 ("Advisers Act"), but recognized that broker-dealers and investment advisers have different types of relationships with investors, offer different services, and have different compensation models when providing investment recommendations or investment advisory services to customers. Specifically, the Commission recognized that a broker-dealer's recommendations may include recommending transactions where the broker-dealer is buying securities from or selling securities to retail customers on a principal basis or recommending proprietary products, while investment advisers typically provide ongoing, regular advice and services in the context of a broad investment portfolio management and are compensated based on the value of assets under management, a fixed fee, or other arrangement. In adopting Regulation Best Interest, the Commission sought to maintain the difference in offerings that broker-dealers and investment advisers provide so as to offer retail customers with choices regarding the types of relationships they can have, the services they can receive, and how they can pay for those services.

A. Natural Person Who Is an Associated Person

As noted above, the General Obligation applies to recommendations made by a broker-dealer or a "natural person who is an associated person" of a broker-dealer. Section 3(a)(18) of the Exchange Act generally defines "associated person of a broker or dealer" as "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." In limiting the term to only a "natural person" who is an "associated person," the Commission sought to exclude affiliated entities of the broker-dealer that are not themselves broker-dealers, as they are not the intended focus of Regulation Best Interest.

B. Recommendation of Any Securities Transaction or Investment Strategy Involving Securities

1. Recommendation

The imposition of the General Obligation hinges upon whether a "recommendation" has been made of "any securities transaction or investment strategy involving securities."[5] However, despite some commenters' request for a formal definition of "recommendation" that sets out what is and what is not a "recommendation," the Commission determined not to formally define the term but chose instead, consistent with the Proposing Release, to rely on the existing regulatory framework that would provide clarity to broker-dealers and maintain efficiencies for broker-dealers with established infrastructures that already rely on the term. Therefore, a determination of whether a broker-dealer has made a "recommendation" that triggers application of Regulation Best Interest turns on the facts and circumstances of the particular situation. The Commission identified two factors that should be

[5] Adopting Release, *supra* note 2, at 78.

considered, among other facts and circumstances, when determining whether a recommendation has taken place: (1) whether a communication reasonably could be viewed as a "call to action"; and (2) whether a communication "reasonably would influence an investor to trade a particular security or group of securities."[6] In addition, the more individually tailored a communication is to a specific customer or a targeted group of customers about a security or group of securities, the greater the likelihood of the communication being viewed as a "recommendation." However, the Commission generally views the following types of communications as not being recommendations of any securities transaction or investment strategy involving securities:

- Certain 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.
- 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;
  - 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.
- Interactive investment materials that incorporate the above.

2. Any Securities Transaction or Investment Strategy Involving Securities

Regulation Best Interest applies to a recommendation of "any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer." The inclusion of "account recommendations" was one of the key enhancements adopted by the Commission.[7] The Commission interprets "account recommendations" to 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). Such account recommendations are "investment strategies involving securities" for purposes of Regulation Best Interest, regardless of whether they are tied to a specific securities transaction. The Commission believes that because customers may rely on firms' and Representatives' investment expertise and knowledge the broker-dealer should be responsible for such recommendations, regardless of whether those recommendations result in transactions or generate transaction-based compensation.

[6] *Id*. at 79-80.

[7] *Id*. at 85.

Consistent with existing broker-dealer regulation, Regulation Best Interest applies to explicit recommendations to hold a security or securities or to stay in a particular account. The Commission also stated its view that "any securities transaction or investment strategy involving securities" not only includes explicit hold recommendations, but also implicit hold recommendations that are the result of an explicit agreement between the broker-dealer and retail customer. While not required to do so, broker-dealers may enter into an agreement with a retail customer to monitor that customer's account. Such an agreement would constitute "recommendations of any securities transaction or investment strategy" because there is an implicit recommendation not to buy, sell, or exchange assets, *i.e.,* to hold, during the monitoring process; and that hold recommendation is also viewed as a recommendation of an investment strategy. The Commission's position differs from existing FINRA guidance, which generally provides that the FINRA suitability rule does not cover an implicit hold recommendation.[8] The Commission explained that "implicit" hold recommendations in the context of an agreement to monitor a customer's account are similar to explicit hold recommendations that are considered "investment strategies" because they would constitute the type of recommendations that retail customers would likely be deem to be a "call to action," tantamount to an explicit recommendation to hold.[9] Any voluntary review by a broker-dealer in the absence of an express agreement, however, would not be subject to Regulation Best Interest.

C. Retail Customer

Regulation Best Interest defines "retail customer" to mean, a natural person, or the legal representative of such natural person, who receives a recommendation and who uses the recommendation primarily for personal, family, or household purposes. The term "legal representative" means a non-professional legal representative of a natural person. The Commission noted that this change and clarification provides more certainty that institutions and certain professional fiduciaries are not covered for purposes of Regulation Best Interest. It retains, however, coverage of certain legal entities (*e.g.*, trusts that represent the assets of a natural person) specifically identified in the Proposing Release as "retail customers" within the scope of Regulation Best Interest. The term "retail customer" does not exclude certain high-net-worth natural persons, as was suggested by some commenters to match the current FINRA exclusion of such natural persons from customer-specific suitability requirements.

The Commission views 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), thereby excluding certain institutions from Regulation Best Interest's coverage. In capturing non-professional legal representatives within the definition of retail customer, the Commission provided the protections of Regulation Best Interest to non-professional persons who are acting on behalf of natural persons but who are not regulated financial services industry professionals retained by natural persons to exercise independent professional judgment. This definition is intended to capture natural persons and their legal representatives who rely directly on the broker-dealer for the recommendation. The professionals so excluded include registered investment advisers and broker-dealers, corporate fiduciaries (*e.g.,* banks, trust companies and similar financial institutions) and insurance companies, and the employees or other regulated representatives of such advisers, broker-dealers, corporate fiduciaries and insurance companies.[10]

[8] *See* FINRA Rule 2111 (Suitability) FAQ, https://www.finra.org/industry/faq-finra-rule-2111-suitability-faq.

[9] The Commission reiterated that Regulation Best Interest does not change the scope of account monitoring that broker-dealers may agree to provide, nor does it change the scope of activities that would come within the "solely incidental" prong of the broker-dealer exclusion to the definition of "investment adviser" in the Advisers Act. Adopting Release, *supra* note 2, at 106.

[10] *Id.* at 113-14.

The Commission also noted that it interprets "personal, family or household purposes" to mean that *any* recommendation to a natural person for his or her account would be subject to Regulation Best Interest, other than recommendations to natural persons seeking these services for commercial or business purposes. Accordingly, under this interpretation, "personal, family or household purposes" would not include, for example, an employee seeking services for an employer or an individual who is seeking services for a small business or on behalf of another non-natural person entity such as a charitable trust.

The Commission also confirmed that "personal, family or household purposes" would cover retirement accounts, as retirement savings is a personal, household, or family purpose. It would not apply where the recommendation is not made to an individual participant. Accordingly, the definition of retail customer will include a natural person receiving recommendations for his or her own retirement account, including but not limited to IRAs and individual accounts in workplace retirement plans, such as 401(k) plans and other tax-favored retirement plans. Additionally, the Commission stated that it does not believe that workplace retirement plans or their representatives and service providers generally fall within the definition of retail customer for purposes of Regulation Best Interest because the workplace retirement plan is not a natural person. Therefore, a workplace retirement plan representative is not a non-professional representative of a natural person that is receiving a recommendation directly from a broker-dealer for "personal, family, or household purposes." To the extent that a plan representative who decides service arrangements for a workplace retirement plan is a sole proprietor or other self-employed individual who will participate in the plan, the plan representative would be a retail customer for purposes of Regulation Best Interest to the extent the sole proprietor or self-employed individual receives recommendations directly from a broker-dealer primarily for personal, family, or household purposes.

Regulation Best Interest applies to a retail customer that both receives a recommendation of any securities transaction or investment strategy involving securities by a broker-dealer and that uses that recommendation primarily for personal, family, or household purposes, and not simply those recommendations for which a broker-dealer receives compensation. Accordingly, "a retail customer 'uses' a recommendation of a securities transaction or investment strategy involving securities when, as a result of the recommendation (1) the retail customer opens a brokerage account with the broker-dealer, regardless of whether the broker-dealer receives compensation; (2) 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 (3) 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."[11] When a retail customer opens or has an existing account with a broker-dealer the retail customer has a relationship with the broker-dealer and is therefore in a position to "use" (*i.e.*, accept or reject) the broker-dealer's recommendation. In this context, tying "use" solely to a broker-dealer's receipt of compensation would inappropriately result in Regulation Best Interest not applying to the broker-dealer's recommendations to hold securities positions or to maintain an investment strategy (such as account type), recommendations to open an account, or recommendations that may ultimately be rejected by the retail customer.

Whether the recommendation complies with Regulation Best Interest will be evaluated based on the circumstances that existed at the time the recommendation was made to the retail customer. Accordingly, broker-dealers should carefully consider the extent to which Representatives can make recommendations to prospective retail customers (*i.e.*, that have received, but not yet "used" the recommendation as noted above) in compliance with Regulation Best Interest, including having gathered sufficient information that would enable them to comply with Regulation Best Interest at the time the recommendation is made, should the prospective retail customer use the recommendation.[12]

[11] *Id*. at 120-21.

[12] Based on comments received in response to the Proposing Release, the definitions in Form CRS and Regulation Best Interest have been revised to generally conform to each other, consistent with the Commission's respective goals in each of these rulemakings. The definition of "retail customer" for purposes of Regulation Best Interest has been revised to apply only to natural persons, not all persons, in line with the definition of "retail investor" for purposes of Form CRS. In addition, the definition in Form CRS as adopted now includes the "personal, family or household purposes" qualifier. The Commission clarified that the definition of "retail customer" does not apply to prospective customers who do not receive and use recommendations from a broker-dealer. This distinction reflects differences between the point in time the Relationship

D. Treatment of Dual-Registrants

Regulation Best Interest applies to a dual-registrant and its Representatives only when making recommendations in a broker-dealer capacity.[13] Thus, it does not apply, for example, where an investment adviser representative of a dual-registrant provides investment advice to a client in his or her investment advisory capacity. This is so, even if the retail customer has a brokerage relationship with the dual-registrant or the dual-registrant executes the transaction in its brokerage capacity. Similarly, as proposed, the Commission confirmed that a dual-registrant is an investment adviser solely with respect to those accounts for which a dual-registrant provides investment advice or receives compensation that subjects it to the Advisers Act.

Determining the capacity in which a dual-registrant is making a recommendation is a facts and circumstances test, with no one factor being determinative. However, the Commission identified as factors the type of account, how the account is described, the type of compensation and the extent to which the dual-registrant made clear to the customer or client the capacity in which it was acting.

Regulation Best Interest would not apply when a dually registered financial professional of a dually registered broker-dealer and investment adviser, who is acting in the capacity of an investment adviser, recommends a fee-based account. However, the dually registered financial professional would need to comply with the Advisers Act as well as the requirements with respect to Form CRS for the firm. Additionally, the Commission stated that Regulation Best Interest would apply if the financial professional in his or her brokerage capacity (disclosed pursuant to the Disclosure Obligation), provides a recommendation of a securities transaction or investment strategy involving securities to the family in the course of the holistic review.

II. Component Obligations

As adopted, to comply with Regulation Best Interest, each of the four specified Component Obligations must be met. According to the Commission, whether a broker-dealer has acted in the retail customer's best interest under the General Obligation turns on an objective assessment of the facts and circumstances of how these specific Component Obligations are satisfied at the time the recommendation is made.[14] Each of the four Obligation are discussed below.

A. Disclosure Obligation

The Commission determined it was necessary to impose a more explicit and broader disclosure obligation on broker-dealers than that which currently exists under the federal securities laws and SRO rules. To that end, Regulation Best Interest requires a broker-dealer, or a Representative, prior to or at the time of the recommendation, to provide to a 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 associated with the recommendation."[15] A Representative of a broker-dealer may generally rely on the disclosure of their broker-dealer, unless they know or should have known that the broker-dealer's disclosure is insufficient. For example, "if a [Representative] of a broker-dealer that offers a full range of securities products is licensed solely as a Series 6 Registered Representative, and can sell only mutual funds, variable annuities and other enumerated products, that limitation on the scope of services provided by the particular [Representative] must be sufficiently clear in the broker-dealer's

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Summary is delivered to an investor and when the obligations of broker-dealers pursuant to Regulation Best Interest attach. Also of note, fund underwriters are not required to deliver Form CRS so long as they do not make recommendations.

[13] Adopting Release, *supra* note 2, at 126.

[14] Adopting Release at 35-36.

[15] *Id*. at 37.

disclosures; otherwise additional clarifying disclosure by the associated person would be necessary."[16] The standard for materiality for purposes of the Disclosure Obligation is consistent with the familiar standard articulated in *Basic v. Levinson*,[17] where a fact is material if there is "a substantial likelihood that a reasonable shareholder would consider it important."[18] In addition to the new Disclosure Obligation, the Commission now requires broker-dealers and investment advisers to deliver to retail investors a Relationship Summary, the purpose of which is to provide an initial layer of disclosure.[19]

1. Material Facts Regarding Scope and Terms of the Relationship

The Commission identified as a material fact the capacity in which a broker-dealer is acting, which must be affirmatively disclosed as it relates to the scope and terms of the client relationship.[20] Disclosure must include whether the broker-dealer or such natural person is acting as a broker-dealer or a Representative of a broker-dealer with respect to the recommendation. Representatives of a dually registered firm who are not dually licensed but only offer broker-dealer services through the firm must be especially careful to disclose that they are acting in their capacity as a Representative of a broker-dealer to satisfy the Disclosure Obligation. The Commission also noted that use of the terms "adviser" and "advisor" by a broker-dealer not also registered as an investment adviser or by a financial professional that is not also a supervised person of an investment adviser, generally will be considered to be a violation of the Disclosure Obligation under Regulation Best Interest.

Regulation Best Interest explicitly requires the disclosure of all material fees and costs. The Disclosure Obligation does not mandate individualized fee disclosure specific to each retail customer; instead, broker-dealers should disclose facts about material fees and costs in standardized numerical terms and narrative disclosures, "such as standardized or hypothetical amounts, dollar or percentage ranges, and explanatory text" in order to make clear why a fee is being imposed and when the fee is to be charged.

The type and scope of services a broker-dealer provides to its retail customers are also considered by the Commission to be "material facts relating to the scope and terms of the relationship." Regulation Best Interest also explicitly requires that a broker-dealer include "any material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer." Material limitations placed on the securities or investment strategies involving securities could include, for example, "recommend[ing] only proprietary products, recommend[ing] only products from a select group of issuers, or mak[ing] IPOs available only to certain clients."[21] The Commission also considers as material the facts, account monitoring services, account balance requirements, and risks associated with the recommendation.

2. Material Facts Regarding Conflicts of Interest

The Commission defined conflicts of interest that are associated with recommendations 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."[22] The Disclosure Obligation requires the disclosure of "material facts" regarding such

[16] *Id*. at 141-42.

[17] *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

[18] *Id*.

[19] Form CRS Relationship Summary; Amendments to Form ADV, Exchange Act Rel. Nos. 34-86032 (June 5, 2019), https://www.sec.gov/rules/final/2019/34-86032.pdf.

[20] Adopting Release, *supra* note 2, at 178.

[21] *Id*. at 179.

[22] *Id*. at 36.

conflicts of interest. Without giving concrete examples of what they would view as "material facts," the Commission stated that the conflicts of interest identified in the Relationship Summary provide a useful starting point for the identification of material facts that need to be disclosed. In particular, the Commission views how a broker-dealer's investment professionals are compensated, and the conflicts associated with those arrangements, as material facts relating to conflicts of interest.

Regulation Best Interest allows broker-dealers to meet the Disclosure Obligation by making certain required disclosures of information regarding conflicts of interest to their customers at the beginning of a relationship, and this form of disclosure may be standardized. However, any subsequent recommendations must be made with additional disclosure. For example, "with regard to mutual fund transactions and holdings, a broker-dealer might disclose broadly that it is compensated by funds out of product fees or by the funds' sponsors, and that such compensation gives it an incentive to recommend certain products over other products for which the broker-dealer receives less compensation."[23] Later, when a broker-dealer recommends a particular fund, "it could provide more specific detail about compensation arrangements, for example revenue sharing associated with the fund family."[24]

3. Full and Fair Disclosure

The Commission adopted as part of the Disclosure Obligation the requirement of full and fair disclosure of all material facts relating to the scope and terms of a relationship with a retail customer and all material facts relating to conflicts of interest associated with a recommendation.[25] This requirement of broker-dealers is similar to the disclosure standard applicable to investment advisers under the Advisers Act. The Commission decided not to require any standard written disclosures; instead, disclosure can be made to accommodate the structure and characteristics of a particular broker-dealer. The Commission also clarified that broker-dealers' compliance with the Disclosure Obligation will be measured against a negligence standard, not against a standard of strict liability, consistent with the Proposing Release.

4. Oral Disclosure or Disclosure After a Recommendation

Regulation Best Interest requires that the Disclosure Obligation be made "in writing." However, in recognition of the challenges associated with providing written disclosure in each instance that may be required, the Commission clarified that a broker-dealer could orally clarify the capacity in which it is acting at the time of the recommendation if it had already provided written disclosure regarding its capacity as well as the method it planned to use to clarify its capacity at the time of the recommendation. Similarly, as set forth in the Proposing Release, the Commission stated that where a broker-dealer determines to provide an initial, more general disclosure followed by specific information in a subsequent disclosure that is provided after the recommendation, the initial disclosure should address when and how the broker-dealer would provide more specific information regarding the fact or conflict in a subsequent disclosure. The Commission also stated that a broker-dealer may satisfy the Disclosure Obligation by making a 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. In addition, where existing regulations permit disclosure after a recommendation is made (*e.g.*, trade confirmation, prospective delivery), a broker-dealer may satisfy its Disclosure Obligation by providing such document to the retail customer after the recommendation is made. Again, broker-dealers must provide an initial disclosure in writing that identifies the material facts and describes the process through which such fact may be supplemented, clarified, or updated.

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[23] *Id*. at 204.

[24] *Id*.

[25] *Id*. at 205.

B. Care Obligation

The Care Obligation incorporates and enhances existing suitability requirements applicable to broker-dealers under the federal securities laws by, among other things, imposing a "best interest" requirement that will require a broker-dealer to not place its own interest ahead of the retail customer's interest when making recommendations. As adopted, the Care Obligation requires that a broker-dealer or a Representative, in making a recommendation, exercise reasonable diligence, care, and skill to (1) understand 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; (2) have 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 Representative ahead of the interest of the retail customer; and (3) have 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 Representative making the series of recommendations ahead of the interest of the retail customer.[26]

In response to comments, the Commission altered multiple aspects of the Care Obligation as proposed. First, the "prudence" requirement has been deleted as the Commission viewed "prudence" as duplicative and confusing when included with "reasonable diligence, care, and skill." Second, the Commission added a requirement that the broker-dealer exercise reasonable diligence, care, and skill to understand potential costs associated with the recommendation. The Commission noted that the standard does not necessarily require the lowest cost option, and that while cost is an important factor that always needs to be taken into consideration in making a recommendation, it is not the only factor. Finally, the Commission added that 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." This addition is intended to make clear that while a broker-dealer typically will have some interest in a recommendation, the broker-dealer cannot put that interest ahead of the retail customer's interest when making the recommendation.

1. Reasonable Diligence, Care, and Skill

What would constitute reasonable diligence, care, and skill under the Care Obligation varies 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.[27] While every inquiry will be specific to the particular broker-dealer and the recommended security or investment strategy, broker-dealers generally should consider important 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; and the expected return of the security or investment strategy; as well as any financial incentives to recommend the security or investment strategy. Together, this inquiry allows 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.

[26] *Id*. at 15.

[27] *Id*. at 262.

While the Care Obligation does not require broker-dealers to document the basis for a recommendation, broker-dealers may choose to take a risk-based approach when deciding whether or not to document certain recommendations. Similarly, broker-dealers may consider using existing compliance measures, such as generating and reviewing exception reports that identify transactions that fall outside of firm-specified parameters to help evaluate and review for compliance with the Care Obligation.

The Care Obligation also requires a broker-dealer to exercise reasonable diligence, care, and skill to have 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. This requirement incorporates and enhances a broker-dealer's existing "quantitative suitability" obligation by applying the requirement irrespective of whether a broker-dealer exercises actual or *de facto* control over a customer's account, thereby making the obligation consistent with the current requirements for "reasonable basis suitability" and "customer specific suitability."

The Commission noted that 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. Where a retail customer expresses a desire for "active trading," a broker-dealer may take this factor into consideration when evaluating a recommendation; however, the broker-dealer will nevertheless need to reasonably believe that a series of recommended transactions is in the best interest of the retail customer. Regulation Best Interest does not require a broker-dealer to refuse to accept a customer's order that is contrary to the broker-dealer's recommendation. Nor does Regulation Best Interest apply to self-directed or otherwise unsolicited transactions by a retail customer, whether or not he or she also receives separate recommendations from the broker-dealer.

Consistent with the other components of the Care Obligation, when a series of transactions is recommended to a retail customer, a broker-dealer must evaluate whether the series of recommended transactions places the broker-dealer's interest ahead of the retail customer's – this is true for both the Representative making the recommendation, as well as for the firm. This will necessarily depend on the facts and circumstances of each particular recommendation, and of each particular series of transactions; however, the Commission noted that, as part of developing a retail customer's investment profile, a broker-dealer must exercise reasonable diligence to ascertain the retail customer's investment profile, which would include seeking to obtain and analyze a retail customer's other investments.

Finally, whether recommendations constitute a "series" of recommended transactions depends on the facts and circumstances, and needs to be evaluated with respect to a particular retail customer. In other words, a broker-dealer would need to reasonably believe that the level of trading (series of recommended transactions) is appropriate for a particular retail customer, and thus a bright line definition across all retail customers would be unworkable. Moreover, providing a bright line definition could encourage firms to focus on a particular number of transactions rather than focusing on ensuring that a series of recommendations, taken together, are in the best interest of the retail customer. Finally, a "series" of recommended transactions is an established term under the federal securities laws and SRO rules that is evaluated in concert with existing guideposts, such as turnover rate, cost-to-equity ratio, and use of in-and-out trading, which have been developed over time and which serve as indicators of excessive trading.

2. Retail Customer Investment Profile

Regulation Best Interest requires a "Retail Customer Investment Profile" to include, but not be limited to, "the retail customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the retail customer may disclose to the broker, dealer, or a natural person who is an

associated person of a broker or dealer in connection with a recommendation."[28] Broker-dealers are required to exercise "reasonable diligence" to ascertain the retail customer's investment profile in satisfying the Care Obligation, and when retail customer information is unavailable despite a broker-dealer's reasonable diligence to obtain such information, a broker-dealer should consider whether it has sufficient understanding of the retail customer to properly evaluate whether the recommendation is in the retail customer's best interest. Furthermore, a broker-dealer would not meet its Care Obligation if it made 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 such customer's investment profile.

Broker-dealers must obtain and analyze enough customer information to have a reasonable basis to believe that the recommendation is in the best interest of the particular retail customer. The significance of specific types of customer information generally depends on the facts and circumstances of the particular case, including the nature and characteristics of the product or strategy at issue. Where retail customer information is unavailable despite a broker-dealer's reasonable diligence, the broker-dealer should carefully consider whether it has a sufficient understanding of the retail customer to properly evaluate whether the recommendation is in the best interest of that retail customer. In addition, a broker-dealer generally should make a reasonable effort to ascertain information regarding an existing customer's investment profile prior to the making of a recommendation on an "as needed" basis – that is, where a broker-dealer knows or has reason to believe that the customer's investment profile has changed. The reasonableness of a broker-dealer's efforts to collect information regarding a customer's investment profile information depends on the facts and circumstances of a given situation, and the importance of each factor may vary depending on the facts and circumstances of the particular case. Under Regulation Best Interest, as with the approach under FINRA's suitability rule, broker-dealers may generally rely on a retail customer's responses absent "red flags" indicating that the information is inaccurate.

3. Reasonably Available Alternatives and Otherwise Identical Securities

The Commission noted that 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.[29] In terms of conducting such an evaluation, a broker-dealer does not have to conduct an evaluation of every possible alternative, either offered outside of the firm (such as where the firm offers only proprietary or other limited range of products) or available on the firm's platform. A broker-dealer will not be required to recommend the single "best" of all possible alternatives that might exist, in part because many different options may in fact be in the retail customer's best interest.

In particular, the Commission does not require a Representative to be familiar with every product on a broker-dealer's platform, particularly where a broker-dealer operates in an open architecture framework or otherwise operates a platform with a large number of products or options. Consistent with the Compliance Obligation, a broker-dealer should have a reasonable process for establishing and understanding the scope of such "reasonably available alternatives" that would be considered by particular Representatives or groups of Representatives (*e.g.*, groups that specialize in particular product lines) in fulfilling the reasonable diligence, care, and skill requirements under the Care Obligation.

What will be a reasonable determination of the scope of alternatives considered depends on the facts and circumstances at the time of the recommendation, including both the nature of the retail customer and the retail customer's investment profile, and the particular Representatives or groups of Representatives that are providing the recommendations.

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[28] *Id*. at 273.

[29] *Id*. at 283.

4. Application of Care Obligation to Account Type Recommendations

Regulation Best Interest applies to recommendations by a broker-dealer of a securities account type.[30] Thus, the Care Obligation requires a broker-dealer to have a reasonable basis to believe that a recommendation of a securities account type (*e.g.,* brokerage or advisory, or among the types of accounts offered by the firm) is in the retail customer's best interest at the time of the recommendation and does not place the financial or other interest of the broker-dealer ahead of the interest of the retail customer.

The Commission noted that broker-dealers would need to consider various factors in determining whether a particular account is in a particular retail customer's best interest. For example, broker-dealers generally should consider (1) the services and products provided in the account (ancillary services provided in conjunction with an account type, account monitoring services, etc.); (2) the projected cost to the retail customer of the account; (3) alternative account types available; (4) the services requested by the retail customer; and (5) the retail customer's investment profile. Moreover, retail customer-specific factors, such as those identified in the definition of "Retail Customer Investment Profile," may not be applicable or available in every context, and would depend on the facts and circumstances at the time of account type recommendation.

Where the financial professional making the recommendation is dually registered (*i.e.*, a Representative of a broker-dealer and a supervised person of an investment adviser (regardless of whether the professional works for a dual-registrant, affiliated firms, or unaffiliated firms)), the financial professional would need to make this evaluation taking into consideration the spectrum of accounts offered by the financial professional (*i.e.*, both brokerage and advisory accounts, taking into account any eligibility requirements such as account minimums), and not just brokerage accounts. Similarly, where the financial professional is only registered as a Representative of a broker-dealer (regardless of whether that broker-dealer entity is a dual-registrant or affiliated with an investment adviser), he or she would need to take into consideration only the brokerage accounts available. However, even if a broker-dealer only offered brokerage accounts, the Representative would nevertheless need to have a reasonable basis to believe that the recommended account was in the best interest of the retail customer.

5. Application of Care Obligation to IRA Rollovers and Related Recommendations

Regulation Best Interest also applies to recommendations to open an IRA or to roll over assets into an IRA.[31] Thus, the Care Obligation requires a broker-dealer to have a reasonable basis to believe that the IRA or IRA rollover is in the best interest of the retail customer at the time of the recommendation and does not place the financial or other interest of the broker-dealer ahead of the interest of the retail customer, taking into consideration the retail customer's investment profile and other relevant factors, as well as the potential risks, rewards, and costs of the IRA or IRA rollover compared to the investor's existing 401(k) account or other circumstances. When making a recommendation to open an IRA, or to roll over workplace retirement plan assets into an IRA rather than keeping assets in a previous employer's workplace retirement plan (or rolling over assets to a new employer's workplace retirement plan), broker-dealers should consider a variety of factors, the importance of which will depend on the particular retail customer's needs and circumstances.

[30] *Id*. at 291.

[31] *Id*. at 295.

C. Conflict of Interest Obligation

The Conflict of Interest Obligation creates an overarching obligation to establish written policies and procedures to identify and disclose, or eliminate, all conflicts of interest associated with a recommendation.[32] This Obligation also requires broker-dealers to establish policies and procedures which are reasonably designed to mitigate or eliminate certain conflicts of interest.

Specifically, the Conflict of Interest Obligation requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to identify and mitigate any conflicts of interest associated with recommendations that create an incentive for a Representative of a broker-dealer to place the interest of the broker-dealer, or the Representative making the recommendation, ahead of the interest of a retail customer. Such policies and procedures must also be designed to (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 the conflicts of interest associated with those limitations, and (2) prevent such limitations and associated conflicts from causing the broker-dealer or Representative to make recommendations that place the interests of the broker-dealer or Representative ahead of the interests of the retail customer. Finally, broker-dealers must identify and eliminate conflicts associated with sales contests, sales quotas, bonuses, and other non-cash compensation plans that are based on the sales of specific securities or specific types of securities within a limited period of time.

1. "Reasonableness" Standard for Conflicts of Interest Policies and Procedures

In imposing the requirement for written policies and procedures to address conflicts of interest, the Commission adopted a standard of reasonableness rather than a strict liability standard that would have required a review of each and every recommendation.[33] In addition, rather than prescribing specific policies and procedures, the Commission recognized that broker-dealers should be permitted to reasonably design policies and procedures that are tailored to their business model, in view of the structure and characteristics of their customer relationships, including the varying degrees of recommendations provided and the types of conflicts that may arise. As the Commission noted, this reasonableness standard is consistent with Commission rules and regulations in other contexts, including under the Advisers Act. The Commission also suggested that broker-dealers consider including in their supervisory and compliance programs certain components, though not required as part of the Conflicts of Interest Obligation, that may be relevant in determining the reasonableness of the written policies and procedures. Specifically, these components include: (1) policies and procedures outlining how the firm identifies conflicts, identifying such conflicts and specifying how the broker-dealer intends to address each conflict; (2) robust compliance and monitoring systems; (3) processes to escalate non-compliance for remediation; (4) procedures that designate responsibility to business line personnel for supervision of functions and persons, including determination of compensation; (5) processes for escalating conflicts of interest; (6) processes for periodic review and testing of the adequacy and effectiveness of policies and procedures; and (7) training on policies and procedures.

It will not be enough for broker-dealers to rely on compliance with current FINRA rules to satisfy their obligations under Regulation Best Interest. The Commission believes that while FINRA rules address specific conflicts of interest, Regulation Best Interest imposes a broader obligation to address conflicts of interest both at the firm level and at the Representative level.

[32] *Id*. at 316.

[33] *Id*. at 307.

2. Conflicts of Interest – No Materiality Requirement

As proposed, Regulation Best Interest would have required broker-dealers to adopt policies and procedures to identify, disclose, mitigate, and eliminate "material" conflicts of interest associated with recommendations. However, the Commission determined to eliminate "material" as a qualifier to "conflict of interest," and instead codified the definition of a conflict of interest to mean an interest that might incline a broker-dealer – consciously or unconsciously – to make a recommendation that is not disinterested.[34] Although "material" was eliminated, broker-dealers are reminded of the Disclosure Obligation, which requires broker-dealers to disclose all material facts relating to conflicts of interest associated with recommendations. With respect to the application of the Conflicts of Interest Obligation to recommendations and not to the full range of services and products offered by broker-dealers, the Commission determined that it was not necessary to expand the scope of the Conflicts of Interest Obligation to non-recommendation-related services and products as such services and products were already subject to general antifraud liability and specific requirements to address associated conflicts of interest.

3. Identifying Conflicts of Interest

According to the Commission, having a process to identify and appropriately categorize conflicts of interest is a critical first step to ensure that broker-dealers have reasonably designed policies and procedures to address conflicts of interest in order to comply with the Conflict of Interest Obligation.[35] Therefore, a reasonably designed policies and procedures to identify conflicts of interest generally should:

- define such conflicts of interest in a manner that is relevant and appropriate to the broker-dealer's business (i.e., conflicts of both the broker-dealer and its Representatives), and in a way that enables employees to understand and identify those conflicts of interest;
- establish a structure for identifying the types of conflicts that the broker-dealer and its Representatives may face;
- establish a structure to identify conflicts as the broker-dealer's business evolves;
- provide for an ongoing and regular, periodic 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 Representatives, how to identify such conflicts of interest, as well as defining employees' roles and responsibilities with respect to identifying such conflicts of interest.

4. Overarching Obligation Related to Conflicts of Interest

As stated above, the first component of the Conflicts of Interest Obligation requires a broker-dealer to establish, maintain, and enforce written policies and procedures reasonably designed to identify and disclose, or eliminate, all conflicts of interest associated with recommendations covered by Regulation Best Interest. This overarching obligation reflects the Commission's view that 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 reduce the conflict such that full and fair disclosure under the Disclosure Obligation is possible. However, the Commission determined not to provide specific examples of how broker-dealers might eliminate conflicts of interest. Instead, the Commission decided to focus the rule text on specific conflicts of interest

[34] *Id*. at 309-10.

[35] *Id*. at 315.

associated with certain sales practices based on the sale of specific securities or specific types of securities.

5. Mitigation of Certain Incentives to Representatives

In proposing the overarching obligation described above, the Commission recognized the importance of the brokerage model as a potentially cost-effective option for investors. The Commission also recognized that certain compensation structures and arrangements within such business model create inherent conflicts of interest but that such compensation may be appropriate in light of the time and experience necessary for Representatives to understand investments. Therefore, rather than requiring broker-dealers to eliminate the compensation structures that give rise to inherent conflicts of interest, the Commission chose instead to preserve and promote investor choice and access to product by requiring broker-dealers to adopt policies and procedures to mitigate such conflicts of interest.[36] The Commission was also persuaded by concerns raised that requiring broker-dealers to establish policies and procedures to mitigate all financial incentives, including any compensation, may result in broker-dealers narrowing their product offerings and compensation structures, which would not be consistent with the Commission's desire to promote investor choice and access. Therefore, the Commission stated that broker-dealers need not eliminate transaction-based compensation to comply with Regulation Best Interest.

Rather than requiring the mitigation of all firm-level financial incentives, the Commission determined to allow such conflicts to generally be addressed through disclosure. Notwithstanding this general approach, there are certain compensation structures the Commission believes should be addressed through mitigation and not disclosure because of the potential impact that certain conflicts have on recommendations to retail customers. Specifically, as set forth in the Conflicts of Interest Obligation, broker-dealers must identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sale of specific securities or specific types of securities within a limited period of time. The Commission believes that this approach appropriately balances its goal of reducing the potential harm conflicts of interest may have on broker-dealers' recommendations to retail customers and preserving retail customers' access to brokerage products and services.

Guidance on Covered Incentives

The Commission clarified that the requirement to identify and mitigate any conflicts of interest that create an incentive for the Representative to place the interest of the broker-dealer or such Representative ahead of the interest of the retail customer only applies to incentives provided to the Representative, whether by the broker-dealer or third parties controlled by or associated with the broker-dealer.[37] The requirement would not apply to external interests of the Representative that are not within the control of or associated with the broker-dealer's business. For example, a Representative's compensation for participating in a securities transaction that is an outside business activity would not be covered by this requirement even though the broker-dealer would need to approve the transaction and maintain appropriate books and records. For a dually registered person, this requirement would generally only apply to the incentives provided to the Representative when making a recommendation of a brokerage product or service and not when making recommendations in an investment advisory capacity.

[36] While the Commission seeks to promote access and choice to investors, certain conflicts of interest are deemed to create too strong of an incentive for a broker-dealer to make a recommendation that places the broker-dealer's interest ahead of the retail customer's interest and must, therefore, be eliminated. *See infra* Section II.C.7 – Elimination of Certain Conflicts of Interest.

[37] *Id*. at 312.

The Commission generally considers the following as examples of incentives provided to a Representative that would need to be addressed under this requirement:

- 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 that is not expressly prohibited by the Conflicts of Interest Obligation); 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.

Each of the above examples focuses on compensation that varies depending on the advice given, such as commissions, markups/markdowns, loads, revenue sharing, and Rule 12b-1 fees.

Guidance on Mitigation Methods

Whether or not a broker-dealer's policies and procedures are reasonably designed to mitigate conflicts that arise from incentives provided to Representatives depends on whether they are reasonably designed to reduce the incentive for the Representative to make a recommendation that places the interests of the Representative or the broker-dealer ahead of the retail customer's interest.[38] In lieu of mandating specific mitigation measures or a "one-size fits all" approach, broker-dealers have the flexibility to develop and tailor reasonably designed policies and procedures that include conflict mitigation measures that are tailored to each firm's circumstances. Reasonably designed policies and procedures should include mitigation measures that depend on the nature and significance of the incentives provided to the Representative and a variety of factors related to the broker-dealer's business model, and the complexity of the security or investment strategy. For example, the Commission stated that more stringent mitigation measures may be necessary where it is apparent that the retail customer base displays less understanding of the incentives associated with particular securities or investment strategies, where the compensation is less transparent, or in situations involving complex securities or investment strategies.

While not required elements, the Commission believes that the following non-exhaustive list of practices could be used as potential mitigation methods:

- 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 within comparable product lines by, for example, capping the credit that a Representative 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;

[38] *Id*. at 330-31.

- Involve higher compensating products;
- Proprietary products or transactions in a principal capacity; or
- Involve the rollover or transfer of assets from one type of account to another or from one product class to another;
- Adjusting compensation for Representatives who fail to adequately manage conflicts of interest; and
- Limiting the types of retail customers to whom a product, transaction, or strategy may be recommend.

The Commission cautioned against broker-dealers relying on industry practice to mitigate conflicts of interest. Instead, each firm must consider the facts and circumstances surrounding the mitigation methods employed, its particular business model, and whether or not the policies and procedures were reasonably designed to reduce the impact of the incentive to prevent the incentive from causing the Representative to place the broker-dealer's or Representative's interest ahead of the retail customer's interest.

With respect to a suggestion made by the Commission in the Proposing Release that the sophistication of retail customers might require different levels of conflicts of interest protections, the Commission clarified that the suggestion was an example and not a requirement. However, the Commission pointed to the Care Obligation, which requires that a broker-dealer, among other things, have a reasonable basis to believe that the recommendation is in the best interest of the particular retail customer. Specifically, existing suitability obligations require a broker-dealer to exercise "reasonable diligence" to ascertain and consider the retail customer's investment profile, including the investor's investment sophistication. Therefore, even if a broker-dealer is able to mitigate incentive conflicts, the broker-dealer may violate Regulation Best Interest if the recommendation does not comply with the Care Obligation.

6. Mitigation of Material Limitations on Recommendations to Retail Customers

The Conflict of Interest Obligation requires, among other things, that broker-dealers establish, maintain, and enforce written policies and procedures reasonably designed to: (1) identify and disclose any material limitations broker-dealers place on their securities offerings or investment strategies involving securities and any associated conflicts of interest; and (2) prevent such limitations and associated conflicts of interest from causing the broker-dealer to make recommendations that place the broker-dealer's interest ahead of the interest of the retail customer (the "Limitations Requirement").[39] While the Commission believes that a broker-dealer should be able to limit its product offerings, the broker-dealer should have a process in place to disclose and address negative effects of such limitations so that retail customers are aware that the broker-dealer has a limited product offering that may make an informed investment decision by the retail customer difficult. The Commission also expressed concerns that such limitations may harm retail investors if the limitations may result in recommendations that are not in the best interest of retail customers.

For purposes of the Limitations Requirement, a "material limitation" would include recommending only proprietary products, a specific asset class, or products with third-party arrangements (*e.g.*, revenue sharing). In addition, the fact that the broker-dealer recommends only products from a select group of issuers could also be a material limitation. The Commission recognized, however, that almost all broker-dealers limit their offering of securities and investment strategies to some degree. Therefore, the fact that a broker-dealer does not offer the entire possible range of securities and investment strategies would not be a material limitation. Instead, whether the limitation is material will depend on the facts and circumstances of the extent of the limitation. Accordingly, broker-dealers will have the flexibility to develop and tailor reasonably designed policies and procedures to prevent such limitations from violating the Limitation Requirement. In crafting such policies and procedures, broker-

[39] *Id*. at 340-41.

dealers should consider establishing product review processes for products that may be recommended, including establishing procedures for identifying and mitigating 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 of particular products.

The Commission also noted that the risk that limited product offerings may result in recommendations that are not in the retail customer's best interest is also addressed through the Care Obligation and the Disclosure Obligation.

7. Elimination of Certain Conflicts of Interest

The Commission determined that it was in the public interest and consistent with the protection of investors to require that broker-dealers establish, maintain, and enforce 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 specific types of securities within a limited period of time (collectively, "Elimination Requirement").[40] The Commission adopted the Elimination Requirement as certain sales contests and compensation structures create high-pressure situations for Representatives to engage in sales conduct contrary to the best interest of retail customers. The Commission believes that sales contests are so pervasive that they cannot be reasonably mitigated and must be eliminated in their entirety.[41]

Business Focus Not Prohibited

However, the Commission recognized that some broker-dealers and Representatives focus their business on the sale of certain general categories of securities, such as mutual funds, variable annuities, bonds, or equities, and that such broker-dealers may provide compensation or other incentives related to such sales. The Commission does not believe that the Elimination Requirement necessarily requires a prohibition against a broker-dealer's focus on certain categories of securities and compensating its Representatives to further such business objectives.[42] The Commission does not view the providing of such incentives as being prohibited under the Conflict of Interest Obligation so long as they do not create high-pressure sales environments. Specifically, the Elimination Requirement does not apply to compensation practices based on total products sold, or asset growth or accumulation, and customer satisfaction. Thus, the Elimination Requirement would not necessarily prohibit non-cash compensation arrangements relating to the sale of investment company securities permitted under FINRA Rule 2341(l)(5) since the rule requires the compensation be "based on the total production of [Representatives] with respect to all investment company securities distributed by the member."[43] In addition, the Elimination Requirement does not prevent firms from limiting their offerings to proprietary products or incentivizing the sale of such products through its compensation practices, so long as the incentive is not based on the sale of specific securities or types of securities within a limited period of time.

[40] *Id*. at 347.

[41] *But see* "FINRA to Tighten Sales Contest Rules but Raise Client-Gift Limit," AdvisorHub (May 9, 2016) (quoting FINRA Chief Executive Richard Ketchum for having "congratulated the securities industry for 'moving away mostly' from product-specific sales contests"[), https://advisorhub.com/finra-to-tighten-sales-contest-rules-but-raise-client-gift-limit/.

[42] *Id*. at 352-53.

[43] FINRA Rule 2341(l)(5)(D).

Employment Related Benefits Permitted

The Commission also recognized that certain production requirements may exist for other reasons, specifically to maintain a contract of employment.[44] The Commission did not intend to apply the Elimination Requirement to the receipt of certain employee benefits by statutory employees, as the Commission does not consider such benefits to be non-cash compensation for purposes of Regulation Best Interest. The Elimination Requirement also does not prohibit training or education meetings, including attendance at company-sponsored meetings such as annual conferences, provided such meetings are not based on the sale of specific securities or type of securities within a limited time period.

Other Incentives

The Commission clarified that its emphasis on prohibiting certain incentives in the Adopting Release does not mean that all other incentives are presumed to be compliant with Regulation Best Interest.[45] Other incentives and practices that are not expressly prohibited are permissible if the broker-dealer establishes reasonably designed policies and procedures to disclose and mitigate the incentive created, and the broker-dealer and its Representatives comply with the Care Obligation. However, where the conflicts associated with incentives and practices are too difficult to disclose and mitigate, the broker-dealer should carefully assess whether it is able to satisfy its best interest obligation in light of the identified conflict of interest and may, in certain circumstances avoid such practice entirely.

For purposes of this requirement, "non-cash compensation" means 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, and meals and lodging. Non-cash compensation does not include certain employee benefits, including healthcare and retirement benefits.

D. Compliance Obligation

The Compliance Obligation requires, in addition to the policies and procedures required by the Conflict of Interest Obligation, that broker-dealers establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.[46] 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. The Commission stated that the Compliance Obligation is important to help ensure that broker-dealers have strong systems of controls in place to prevent violations of Regulation Best Interest, including the component Disclosure and Care Obligations, in addition to the policies and procedures required pursuant to the Conflict of Interest Obligation, and to protect the interests of retail customers.

As with the policies and procedures requirement included in the Conflict of Interest Obligation, whether policies and procedures are reasonably designed to comply with Regulation Best Interest will depend on the facts and circumstances of a given situation. As such, the Compliance Obligation does not enumerate specific requirements that broker-dealers must include in their policies and procedures as broker-dealers are too varied in their operations for rules to impose a single set of universally applicable specific required elements. Each broker- dealer when adopting policies and procedures should consider the nature of that firm's operations and how to design such policies and procedures to prevent violations from occurring, to detect violations that have occurred, and to correct promptly any violations that have occurred.

[44] *Id*. at 355.

[45] *Id*. at 356.

[46] *Id*. at 358.

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. As such, the Commission did not mandate specific requirements pursuant to the Compliance Obligation. In addition to the required policies and procedures, depending on the size and complexity of the firm, the Commission noted that a reasonably designed compliance program generally would also include controls, remediation of non-compliance, training, and periodic review and testing.

III. Collateral Issues

The Adopting Release more briefly addresses several issues that are important to the application of Regulation Best Interest.

A. Interaction with Other Standards

Regulation Best Interest applies in addition to any other obligations of laws or regulations. The Adopting Release specifically mentions the antifraud and antimanipulation provisions of the securities laws, including Section 17(a) of the Securities Act of 1933 and Sections 9, 10(b), and 15(c) of the Exchange Act and the rules thereunder.[47] Thus, as under existing law, a broker-dealer recommending a security generally may be liable under the antifraud provisions if it does not give honest and complete information or disclose any material adverse facts or material conflicts of interest, including any economic self-interest.[48]

Broker-dealers and their Representatives will also continue to be subject to the suitability requirement of FINRA Rule 2111. This rule generally requires that a FINRA member or Representative must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through reasonable diligence to ascertain the customer's investment profile. FINRA guidance under Rule 2111 states that a broker's recommendations must be consistent with his customers' best interests.[49] The Commission reviewed Rule 2111 and drew upon it and enhanced the suitability requirement in developing Regulation Best Interest. Although FINRA officers have suggested that the adoption of Regulation Best Interest might render Rule 2111 superfluous with respect to recommendations to retail investors,[50] FINRA responded to the proposal of Regulation Best Interest by considering a rule change to enhance its suitability obligation and bring it closer to the proposed Commission standard.[51]

B. Intent Required to Show Violation

The Commission will not have to show scienter (i.e., an intention to deceive, manipulate, or defraud) in order to establish a violation of Regulation Best Interest. However, the rule will not be subject to strict liability; the Commission generally will have to show that a rule-breaker was at least negligent.

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[47] Adopting Release, *supra* note 2, at 43 & n.80.

[48] *Id.* at 139 n.303.

[49] Suitability: Additional Guidance on FINRA's New Suitability Rule, FINRA Regulatory Notice 12-25 (May 2012), http://www.finra.org/industry/notices/12-25.

[50] Alison Noon, *Best Interest Standard Likely End [of FINRA Suitability Rule*, Law360 (May 16, 2019), https://www.law360.com/articles/1160646/best-interest-standard-likely-end-of-finra-suitability-rule.

[51] *See* Quantitative Suitability: FINRA Requests Comment on Proposed Amendments to the Quantitative Suitability Obligation Under FINRA Rule 2111, FINRA Regulatory Notice 18-13 (April 20, 2018), http://www.finra.org/industry/notices/18-13.

C. Waivers of Regulation Best Interest

The Adopting Release states that 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.[52] The Commission explains that this statement is based on Section 29(a) of the Exchange Act, which states that any condition, stipulation, or provision binding any person to waive compliance with any provision of the Exchange Act, or of any rule or regulation thereunder, shall be void.

D. Private Right of Action

The Commission stated in the Adopting Release that it does not believe Regulation Best Interest creates any new private right of action or right of rescission, nor does it intend such a result.[53] Notwithstanding the Commission's intent and guidance, there remains a possibility that courts may take Regulation Best Interest into account in applying existing private rights of action (such as the private right of action under Exchange Act Rule 10b-5), particularly in light of the required disclosure in the Form CRS relationship summary that the broker-dealer must act in the retail customer's best interest and not put its interest ahead of the customer's.

E. Effect on State Law

Several commenters argued that the Commission should explicitly state that Regulation Best Interest preempts, or does not preempt, state law. The Commission avoided taking a position on this point, saying only that the preemptive effect of Regulation Best Interest on any state law governing the relationship between regulated entities and their customers would be determined in future judicial proceedings based on the specific language and effect of that state law.[54] Among the unknown factors, the Commission said, are the final language in any proposed state legislation or regulation adopting a fiduciary or other standard for broker-dealers, and whether that language would constitute the type of law, rule, or regulation that is expressly preempted by the securities law or impliedly preempted under principles applied by courts.[55]

Starting on the day of the inauguration of President Trump,[56] a handful of states started to pass resolutions, introduce bills, initiate enforcement actions, and propose regulations, in an attempt to either impose a uniform standard of care on broker-dealers and investment advisers or, at a minimum, highlight the differences in existing standards. These states, New York, New Jersey, Nevada, Massachusetts, Maryland and Illinois, (correctly) predicted that the Trump Administration would take a long, hard look at the 2016 DOL Fiduciary Rule. With the Fifth Circuit Court of Appeals' decision to vacate the DOL Fiduciary Rule in June 2018, the states felt emboldened to craft their own approach to standards of conduct. To date, this state action suffers from various interpretive issues on scope, questions over whether they will survive a preemption challenge, as well as industry concern that a patchwork approach will prove untenable from a compliance standpoint. Immediately below, we discuss the most important state developments in terms of broker-dealer and investment adviser standards of conduct.

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[52] Adopting Release, *supra* note 2, at 44.

[53] *Id.*

[54] *Id.* at 43, 514 n.1163.

[55] *Id.* at 514 n.1163. Any express preemption presumably would arise under Section 15(i)(1) of the Exchange Act, which prohibits states from establishing differing or additional capital, custody, margin, financial responsibility, making and keeping records, bonding, or financial or operational reporting requirements for broker-dealers.

[56] The first iteration of New York's proposed Investment Transparency Act was introduced by Assemblyman Jeffrey Dinowitz on Jan. 20, 2017.

Less than ten days after the adoption of Regulation Best Interest, the Massachusetts Securities Division proposed a regulation that would impose a fiduciary standard of care on broker-dealers and investment advisers when making recommendations to retail investors with respect to (1) an investment strategy; (2) the opening of, or transfer of assets to, any type of account (including recommendations to open IRA roll-over accounts); or (3) the purchase, sale or exchange of any security. Notably, the standard of care would require a broker-dealer, agent or adviser to avoid conflicts of interest, and would also require that each recommendation or advice be made without regard to the financial or any other interest of the broker-dealer, agent, adviser, any affiliated or related entity or its officers, directors, agents, employees or contractors, or any other third party. Moreover, the sale of proprietary products, principal transactions, and broad-based sales contests/quotas may be subject to a presumption of a breach of fiduciary duty. The comment period closes on July 26.[57]

The Massachusetts proposed regulation is quite similar to the already-introduced New Jersey uniform fiduciary regulatory proposal, which leads us to wonder if a state regulation model is emerging. As with the Massachusetts proposal, New Jersey's proposed regulation provides that there is no presumption that disclosing a conflict of interest will satisfy the fiduciary duties. Moreover, while both Massachusetts and New Jersey seemingly preserve commissions as a compensation method, the proposed regulations raise significant interpretive questions over how a broker-dealer could receive transaction-based compensation in a manner consistent with the fiduciary standard of care. New Jersey will hold a public hearing on July 17 and its comment period has been extended to July 18.[58]

Nevada, meanwhile, has proposed a complicated regulation that would impose a fiduciary duty standard on broker-dealers and investment advisers. The standard of care would require that recommendations be made in the best interest of the client and that broker-dealers and investment advisers not put their interests, or the interests of others, ahead of the client's. The scope of the proposal is quite broad; seemingly any information about a specific security to a specific client could be deemed to constitute investment advice, even such general information as price and historical performance (for this reason, communications by fund managers with prospective and current investors regarding their interests in the fund may also amount to fiduciary investment advice under the proposal). Broker-dealers, but not investment advisers, may qualify for the Episodic Fiduciary Duty Exemption, which would limit the fiduciary duty to the specific investment advice provided, but not, unless otherwise required by law, have an ongoing fiduciary duty towards the client. This means that, under the Episodic Fiduciary Duty Exemption, the broker-dealer or sales representative would not have an ongoing duty to keep informed about the client's financial circumstances and obligations. It is uncertain if the Nevada Securities Division will move forward with that regulation.[59]

Related bills in New York, New Jersey, Illinois and Maryland have been introduced but, so far, have not garnered enough votes to pass.[60] These bills, with the exception of Maryland, were all disclosure-based (rather than the imposition of a standard of care). The particular political dynamics of the particular state will likely dictate whether legislation and/or regulatory action will be the preferred path, rendering it difficult to predict outcomes.

[57] For a complete analysis, please see, *Massachusetts Follows in New Jersey's Footsteps by Proposing Similar Fiduciary Duty Rule Applicable to Broker-Dealers and Investment Advisers*, https://fiduciarygovernanceblog.com/2019/06/17/massachusetts-proposes-fiduciary-duty-rule/.

[58] For a complete analysis, please see *New Jersey Proposes Uniform Fiduciary Standard*, https://fiduciarygovernanceblog.com/2019/04/16/new-jersey-proposes-uniform-fiduciary-standard/.

[59] For a complete analysis, please see *Nevada Proposes Sweeping Fiduciary Regulation*, https://fiduciarygovernanceblog.com/2019/01/22/nevada-proposes-sweeping-fiduciary-regulation/.

[60] For an overview, please see *A Fiduciary's 2018 Retrospective (and Predictions for 2019)*, https://fiduciarygovernanceblog.com/2019/01/07/a-fiduciarys-2018-retrospective-and-predictions-for-2019/.

F. Potential Legal Challenges

There has been considerable speculation as to whether there will be a court challenge to Regulation Best Interest. For example, Barbara Roper, director of investor protection at the Consumer Federation of America, stated the day before its adoption that the rule package is vulnerable to a court challenge,[61] and some have interpreted this as a threat to bring such a challenge. Section 25(b) of the Exchange Act authorizes review of Commission rules by a federal court of appeals. A petition initiating such a review must be filed within 60 days after the rule's promulgation.

As of this writing, it is unclear whether any challenge will in fact be brought or, if brought, what chance it will have of success. It is assumed that any such challenge would come from investor advocates rather than the broker-dealer industry, which has been supportive of the rule.

G. Possible Congressional Limits on Implementation

The U.S. House of Representatives has added a provision to the appropriations bill for the fiscal year ending September 30, 2020, to provide that none of the appropriated funds for that fiscal year may be used by the Commission to implement, administer, enforce, or publicize any part of the package.[62] The provision is not expected to be included in the Senate version of the appropriations bill.

IV. Record-Making and Recordkeeping

In adopting Regulation Best Interest, the Commission has amended Rules 17a-3 and 17a-4, which specify minimum requirements for records that broker-dealers must make, and how long those records and other documents must be kept, respectively. The rules require, for each retail customer to whom a recommendation is provided, that a record be kept of all information collected from and provided to the retail customer pursuant to Regulation Best Interest, as well as the identity of each Representative of a broker-dealer responsible for the account. According to the Commission, it designed the new requirements of Rule 17a-3 to provide a means by which they can demonstrate, and Commission examiners can confirm, their compliance with the new substantive requirements of Regulation Best Interest, and that broker-dealers should already be collecting much information pursuant to the FINRA suitability rule and existing Exchange Act books and records rules. However, the Commission also stated that its current books and records requirements are not sufficient to meet the Regulation Best Interest recordkeeping requirements. 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."

V. Steps to Comply with Regulation Best Interest

Registered broker-dealers that recommend securities transactions or investment strategies to their retail customers must comply with Regulation Best Interest on and after June 30, 2020. While most commenters requested an implementation period of 18-24 months, the Commission "determined, in light of the importance of the protections afforded by Regulation Best Interest to retail customers, that a Compliance Date of one year after effectiveness is an appropriate timeframe for firms to conduct the requisite operational changes to their systems to establish internal processes to comply with Regulation Best Interest."[63] It reasoned that broker-dealers are currently subject already to supervisory obligations under Section 15(b)(4)(E) of the Exchange Act and SRO rules, including the establishment of policies and procedures reasonably designed to

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[61] Mark Schoeff Jr., *Investor Advocates Slam SEC Advice Reform on Eve of Reg BI Vote*, Investment News (June 4, 2019), https://www.investmentnews.com/article/20190604/FREE/190609978/investor-advocates-slam-sec-advice-reform-on-eve-of-reg-bi-vote.

[62] Financial Services and General Government Appropriations Act, 2020, § 1003, 116th Cong., 1st Sess. (2019), https://www.congress.gov/116/bills/hr3351/BILLS-116hr3351eh.pdf.

[63] Adopting Release, *supra* note 2, at 372-73.

prevent and detect violations of, and to achieve compliance with, the federal securities laws and regulations, as well as applicable SRO rule. Thus, broker-dealers "would likely establish policies and procedures to comply with Regulation Best Interest pursuant to Section 15(b)(4)(E)."[64] To the extent broker-dealers elect to follow this path, they could simply "adjust their current systems of supervision and compliance, as opposed to creating new systems."[65]

While this may be true, the Commission's reasoning fails to take into account the fact that Regulation Best Interest imposes on broker-dealers for the first time substantive disclosure and conflict of interest compliance obligations. Additional time will be needed to carefully consider these new obligations and how to best comply with them. Thus, achieving compliance with Regulation Best Interest will not simply involve the adjustment of existing supervision and compliance systems. For this reason, it seems quite possible that some broker-dealers may find meeting the compliance deadline a considerable challenge. Such firms may include smaller full service brokers with limited resources, as well as much larger full service firms, regardless of their available resources. We therefore encourage broker-dealers to get the ball rolling on the Regulation Best Interest compliance process as expeditiously as possible.

How they do so, of course, will vary from firm to firm. Nonetheless, in light of the number of separate moving parts under Regulation Best Interest that ultimately must mesh together into a whole, some firms may want to consider forming a Regulation Best Interest Compliance Committee ("BI CIC") comprised of individuals from legal, compliance, senior management, marketing, product development, and other important stakeholder groups throughout their organizations. This BI CIC may then serve as a centralized mechanism for overseeing the various work streams through to successful completion.

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[64] *Id.* at 358 n.809.

[65] *Id.*