

Harter Secrest & Emery LLP

ATTORNEYS AND COUNSELORS

SECURITIES AND CAPITAL MARKETS

SEC ADOPTS REGULATION BEST INTEREST

Author: Kayla E. Klos and Jonathan R. Jasinski

Over the summer, the Securities and Exchange Commission adopted *Regulation Best Interest: The Broker-Dealer Standard of Conduct*. Reg BI, as it is called, requires broker-dealers to act in the best interest of their retail customers when making a recommendation of any securities transaction or investment strategy, as opposed to the current standard that requires a broker-dealer to confirm that the investment is suitable for its customer. Reg BI was designed to enhance and clarify the standards of conduct applicable to broker-dealers, help retail investors better understand and compare services offered, and foster greater consistency in the level of protections provided by broker-dealers. By enhancing the standard of conduct for broker-dealers beyond FINRA's suitability rule, Reg BI continues the SEC's trend of harmonizing the standards for broker-dealers and registered investment advisors. Broker-dealers have until June 30, 2020 to come into compliance with Reg BI.

Summary

Reg BI requires a broker-dealer to act in the best interest of a retail customer at the time a recommendation to purchase a security is made. Although the best interest standard does not necessarily obligate a broker-dealer to recommend the least expensive or least remunerative security or investment strategy, when making recommendations, the broker-dealer must be sure to put the retail client's interests ahead of its own financial interests. To do so, a broker-dealer must fulfill four specific obligations: (i) the Disclosure Obligation, (ii) the Care Obligation, (iii) the Conflict Obligation, and (iv) the Compliance Obligation.

The Disclosure Obligation

Before or at the time of making a recommendation to a retail customer, a broker-dealer must disclose, in writing, to the retail customer all the material facts with respect to its relationship with the customer, including: (i) disclosure that the firm is acting as a broker-dealer and not as an investment advisor; (ii) the material costs to the customer; (iii) the type and scope of services that the customer will be provided, including any material limitations involving the recommended securities or investment strategies; and (iv) all material facts relating to conflicts of interest associated with a recommendation. In accordance with this disclosure obligation, broker-dealers will be required to provide retail customers with the Form CRS Relationship Summary.

The Care Obligation

A broker-dealer must exercise reasonable diligence, care and skill in recommending any transaction or series of transactions. A broker-dealer must: (i) understand the risks, rewards and costs of any recommendation; (ii) have a reasonable basis to believe the recommendation is in the best interest of a particular retail customer based upon the customer's investment profile and the potential risks, rewards, and costs; and (iii) have a reasonable basis that a series of recommended transactions is not excessive in light of the customer's investment profile. The SEC clarified this obligation by identifying important factors for

broker-dealers to consider when making a recommendation, as described in great detail in the SEC's adopting release.

The Conflict Obligation

A broker-dealer is required to establish, maintain, and enforce written policies and procedures reasonably designed to address the broker-dealer's conflicts of interest with respect to a recommendation. Broker-dealers must: (i) monitor and mitigate (or eliminate, if possible) conflicts that incentivize sales persons to prioritize their interests over those of a retail customer; (ii) prevent limitations on offerings (such as only selling proprietary products) from causing the firm or the firm's personnel to place their interest or the interests of the firm ahead of the customer's interest; and (iii) eliminate sales contests or other compensation based on the sale of specific securities within a limited period of time.

Pursuant to Reg BI, a conflict of interest associated with a recommendation includes any interest that might incline a person, consciously or unconsciously, to make a recommendation that is not disinterested. However, the disclosure obligation, discussed above, only applies to material facts relating to conflicts of interest. As a result, the broker-dealer must be aware and review all conflicts of interests, but only material facts regarding the conflicts must be disclosed. For clarity, the SEC provided a list of the types of compensation that will not be deemed a conflict of interest for purposes of Reg BI, such as neutral commission grids, fee leveling, and fee capping.

The Compliance Obligation

A broker-dealer must maintain and enforce written policies and procedures reasonably designed to comply with Reg BI. This obligation also requires compliance with the policies and guidelines described above under "The Conflict Obligation."

Broker-dealers will have to go beyond satisfying the elements of FINRA's suitability rule to comply with Reg BI. Under current FINRA standards, broker-dealers are only required to make recommendations that are not at odds with a client's interests. Under Reg BI, broker-dealers are required to ensure that their recommendations are in the customer's best interest.

Form CRS

At the same time the SEC adopted Reg BI, it adopted Form CRS. The relationship summary, as Form CRS is commonly called, is a short and accessible disclosure to be provided by broker-dealers to retail investors at the beginning of their relationship. The relationship summary helps the SEC compare information about broker-dealers and investment advisory offerings and promote effective communication between firms and their retail investors. Form CRS will also include a link to a dedicated page on the SEC's investor education website, Investor.gov, which offers educational information about broker-dealers and investment advisers, and other materials.

Any SEC registered broker-dealer or registered investment advisor that offers services to a retail investor must prepare and deliver a Form CRS relationship summary. The relationship summary must be (i) delivered to each retail investor and (ii) posted on the broker-dealer's website.

With respect to timing, a relationship summary must be delivered before a broker-dealer recommends a securities transaction or an investment strategy involving securities, places an order for a retail investor, or opens a brokerage account for a retail investor. For existing retail customers, a broker-dealer must deliver a relationship summary before or at the time of opening up a different account type for the customer, recommending a rollover from a retirement account to a new existing account, or recommending or providing a new brokerage or investment service. A relationship summary must be updated within 30 days of any information in the summary becoming materially inaccurate, and changes must be communicated to a retail investor within 60 days.

Additional Interpretations

At the same time the SEC adopted Reg BI, it also issued two interpretive releases: one regarding the investment advisor fiduciary duty and the other regarding the solely incidental exemption for broker-dealers. With the SEC's fiduciary duty interpretation, the SEC confirmed that there is a fiduciary duty owed by investment advisors to its clients that applies to the entire relationship between adviser and client. The SEC also confirmed and clarified that the solely incidental exemption provides that broker-dealers who incidentally perform advisory services and who receive no special compensation for those services are excluded from the definition of investment advisor and therefore from the application of the Investment Advisers Act of 1940.

Compliance Suggestions

As a result of the adoption of Reg BI, broker-dealers who provide recommendations to retail customers should consider additional compliance or defensive measures, including:

- Develop a comprehensive risk disclosure statement that is periodically reviewed and expanded as necessary to reflect changes in the firm's business and market practice.
- Disclose limitations on services provided and as to securities made available or that may be recommended.
- Institute a monitoring procedure so disclosure is promptly updated and redistributed as required.
- Establish an approved list of securities or types of securities that a sales representative may recommend to a retail customer considering what information may be required by a firm concerning a security before it can be recommended.
- Develop procedures as to the types of retail customers eligible to receive recommendations in light of their profiles.
- Review on a regular basis the firm's compensation system. Consider whether compensation that salespersons receive is appropriately related to the types of securities they sell and does not motivate them in an inappropriate manner.
- Establish a conflicts committee to determine where the firm has conflicts in making sales to retail customers, such as where the firm or its affiliates receive indirect compensation beyond the commission charged to the client. Consider whether such indirect compensation is appropriate and sufficiently disclosed.
- Establish procedures to maintain the information required by Reg BI.

- Institute additional training procedures to demonstrate that salespersons understand and can meet the Reg BI obligations.

A complete copy of *Regulation Best Interest*, as adopted by the SEC, is available at [this link](#). For more information, please contact a member of Harter Secrest & Emery LLP's Securities and Capital Markets group at 716.853.1616, 585.232.6500, or visit www.hselaw.com.

Kayla E. Klos, 716.844.3751, kklos@hselaw.com

Jonathan R. Jasinski, 716.844.3771 jjasinski@hselaw.com

Attorney Advertising. Prior results do not guarantee a similar outcome. This publication is provided as a service to clients and friends of Harter Secrest & Emery LLP. It is intended for general information purposes only and should not be considered as legal advice. The contents are neither an exhaustive discussion nor do they purport to cover all developments in the area. The reader should consult with legal counsel to determine how applicable laws relate to specific situations. © 2019 Harter Secrest & Emery LLP

