Federated Hermes

SEC Regulation Best Interest

Despite the Pandemic, Reg BI and Form CRS Take Effect on June 30th—What BD Representatives Should Know about FAQ Guidance and Next Steps

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Reg BI FAQ Guidance at a Glance

Selected SEC FAQs:

- "Advisor" or "Adviser" can't be in BD firm name unless an RIA under Federal or state law (affiliation with an RIA not enough).
- "Advisor" or Adviser" generally can't be in title of representative unless referring to certain services other than investment advice to retail customers (municipal advisor, commodity trading advisor, etc.).
- Dual registrants must take into account both brokerage and advisory options; if only a registered representative of a BD, need only take into account available brokerage accounts BUT must have a reasonable basis to believe brokerage account is in customer's best interest.
- General invitation to a prospective client to discuss services offered is not itself a recommendation under Reg BI.
- Retirement plan and IRA educational information is not a recommendation—no material change to current interpretation.
- Reg BI requires disclosures at the time a recommendation is made:
  - Oral or "post recommendation" disclosures can be made only in limited circumstances—BDs will need to monitor closely to comply.
  - Form CRS is not sufficient to meet Reg BI's separate disclosure requirements.
  - Attachments to quarterly statements do not meet Reg BI's timing requirement.

While the Federal government may be handing out financial and regulatory relief left and right in response to the global COVID-19 pandemic, not everything has been delayed. For broker-dealers (BD) and their registered representatives, two big things are still coming right on schedule—the Securities and Exchange Commission's (SEC) new Regulation Best Interest (Reg BI) and Form CRS relationship disclosure.

Despite the pandemic, Chair Clayton announced in April that these two rules will stay on schedule because of their importance to "Main Street investors" and the progress made by "firms with account relationships comprising a substantial majority of retail investor assets" in preparing for compliance. To help broker-dealers get ready, the SEC has been issuing guidance and enforcement risk alerts—it has also indicated that its "initial" enforcement activities will take into account "good faith efforts" to comply, given the current circumstances.

What Happened to the State Lawsuits and Other Efforts to Stop Reg BI?

The opponents of Reg BI are still active, but it doesn't appear that they will succeed in stopping the rule before it goes into effect (if at all). The lawsuits by seven states and some private litigants claiming the SEC didn't have the authority to issue Reg BI are scheduled for oral argument in June, making a ruling on the case before June 30 very unlikely.

While Massachusetts finalized a state regulation making broker-dealers fiduciaries under state law (and New Jersey is considering a similar rule), these won't stop Reg BI—instead, they will substantially conflict with its requirements. This is setting the stage for litigation over who regulates broker-dealers (but not before June 30th).

"Good Faith Effort" With an Emphasis on "Effort"

So, while Reg BI and Form CRS will move forward as scheduled, there are likely to be some bumps in the road to compliance, especially given the effects of the virus. Broker-dealers and their representatives may take some comfort from the statement that "initial" enforcement activities will recognize "good faith efforts," but they shouldn't read too much into that. The key word is "effort"—the SEC examination staff will be looking for substantial progress towards all elements of compliance in its reviews.

The challenge for broker-dealers is that Reg BI is a shift from a predominately rules-based regime to a more principles-based regime. Broker-dealers have to adopt new policies and procedures to achieve the required goals of the new rule, but the SEC did not mandate the specific details of those policies and procedures. As a result, broker-dealers are trying to decide what to change—including reviewing and changing registered representative compensation to mitigate conflicts—but are reaching somewhat different conclusions about what to do.

In response to numerous requests, the SEC began rolling out guidance occasionally over the past few months.

Selected SEC FAQs:

The SEC Division of Trading and Markets maintains and occasionally adds to its "Frequently Asked Questions on Regulation Best Interest" (SEC FAQs). These FAQs provide specific guidance on a variety of Reg BI issues, including disclosure obligations, recommendations, duty of care obligations and conflict of interest obligations.

Disclosure Issues

Restrictions on Using "Advisor" or "Adviser"

Generally, a broker-dealer firm can't use these terms in its name unless the firm is also a registered investment advisor. Similarly, representatives of a broker-dealer can't use these terms in their titles unless they are also supervised persons of a registered investment advisor. The FAQs clarify that being an investment advisor under state law permits the use of the terms, but that merely having an affiliated registered investment advisor does not.

The narrow exception to these restrictions is when broker-dealers are acting in a defined role "that does not entail providing investment advisory services to retail customers, for example, as a municipal advisor, commodity trading advisor, or advisor to a special entity."

This will likely be an early focal point of examinations, and representatives should look to their broker-dealers for new policies and procedures regarding business cards, website descriptions, social media and other common means of describing their services.

Form CRS and Reg BI Disclosures are Different and Separately Required

The SEC guidance reiterates that REG BI requires specific disclosures to a client at the time the recommendation is made. These are separate and distinct from the Form CRS relationship summary disclosures. Addressing several specific questions, the guidance makes it clear that each separate element of both Form CRS and Reg BI must be met, and that the timing of disclosures related to Reg BI is vital for compliance. Oral disclosure and post-recommendation disclosures are permitted "[o]nly in limited circumstances," and quarterly benefit statements or providing the Form CRS do not meet the specific Reg BI requirements. Disclosure issues are going to be the subject of significant scrutiny by the SEC and FINRA going forward.

Recommendation Issues

Recommending Brokerage vs. Advisory Services

Type of account recommendations raised many questions, especially regarding the respective responsibilities of dually-registered financial professionals (an associated person of a broker-dealer and a supervised person of an investment adviser) compared to registered representatives of only a broker-dealer. The short answer is that dually-registered financial professionals have to consider both brokerage and advisory account recommendations (taking into account eligibility

requirements such as account minimums), while someone who is only a registered representative of a broker-dealer only considers brokerage accounts available at his/her firm (but can't recommend brokerage where it is not in the best interest of the retail customer).

Offering Services vs. Making a Recommendation

The SEC clarified that a general invitation to discuss services is not a recommendation. The guidance illustrates this with an example in which the registered representative states, "I would love to talk with you about the types of services my firm offers, and how I could help you meet your goals. Here is my business card. Please give me a call on Monday so that we can discuss." The SEC explains that absent other factors, this communication would not be a recommendation under Reg BI because, "…the staff does not believe this communication in and of itself would reasonably be viewed as a 'call to action' to open an account, engage in a securities transaction or act on an investment strategy."

Education vs. Recommendation

In the context of retirement accounts and IRAs, the SEC guidance generally retains the current interpretation of the line between general educational information and a recommendation. The FAQ provides that, "Consistent with existing broker-dealer regulation, certain communications are treated as 'education' rather than 'recommendations." Therefore, Reg BI still allows for investment education (or descriptive information about a retirement plan) where there is no suggestion regarding specific securities to be transacted.

Conflict of Interest Issues

Prohibited and Permitted Incentives

Reg BI prohibits sales contests, sales quotas, bonuses, and non-cash compensation based on the sales of specific securities or types of securities within a limited time period. It permits, but requires mitigation, of conflicts resulting from other types of sales incentives.

The guidance starts out by warning that just because some incentives are always prohibited, it doesn't mean that all other incentives "are presumptively compliant" with Reg BI. These other incentives "…are permitted provided that the broker-dealer establishes reasonably designed policies and procedures to disclose and mitigate the incentives created."

Mitigation of Conflicts

Registered representatives can expect changes by many broker-dealers to compensation arrangements as they respond to these conflict mitigation requirements, and these decisions may vary quite a bit from broker-dealer to broker-dealer. The SEC guidance offers "…the following non-exhaustive list" of things broker-dealer may wish to consider:

- Avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales;
- Minimizing compensation incentives for employees to favor one type of account or product over another, such as by basing the differential compensation on neutral factors;
- Eliminating compensation incentives within comparable product lines;
- Implementing enhanced supervisory procedures to monitor certain recommendations, such as those involving rollovers or near compensation thresholds;
- Adjusting compensation for representatives who fail to manage conflicts; and
- Limiting the types of retail customers to whom certain products may be recommended.

For example, a number of broker-dealers appear to be considering retaining incentives linked to overall performance, but eliminating incentives linked to particular products as a means to mitigate conflicts. Representatives should be hearing about compensation changes soon, if they have not already.

Conclusion:

The bottom line is that things are going to change for registered representatives as broker-dealers finish developing and roll out their new policies and procedures. June 30 is a hard deadline for compliance—both SEC and FINRA will be examining these issues starting July 1, and they expect to see good faith efforts to meet the requirements.

Registered representatives can expect these new policies and procedures to substantially increase the process and documentation requirements for making recommendations, and to see more emphasis placed on cost analysis for the customer. It is also very likely that compensation methods will change, though how significant these changes are likely will vary from broker-dealer to broker-dealer. Supervision overall is likely to increase, and mid-course adjustments after June 30 are probable, as SEC, FINRA and broker-dealers come to terms with the new rule.

We will all stay tuned for any new SEC or FINRA guidance interpreting the rule, and whether the lawsuits against the rule affect its timing. In the meantime, focus on doing what's best for your clients, and expect that there are some significant changes in your day-to-day operations coming soon (if they haven't started already).

About the Author

Bradford Campbell, partner at Faegre Drinker Biddle & Reath LLP, advises financial service providers and plan sponsors on ERISA Title I issues, including fiduciary conduct and prohibited transactions. A nationally-recognized figure in employer-sponsored retirement plans, Brad is the former Assistant Secretary of Labor for Employee Benefits and head of the Employee Benefits Security Administration. As ERISA's former "top cop" and primary federal regulator, he provides his clients with insight and knowledge across a broad range of ERISA-plan related issues. He also serves as an expert witness in ERISA litigation. Brad has been listed as one of the 100 Most Influential Persons in Defined Contribution by 401kWire and has been listed as one of the top 15 ERISA attorneys in the country by a poll of the National Association of Plan Advisors. In addition, he testified before four Congressional Committees regarding the effects of the Department of Labor fiduciary regulation.

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