

# SEC Regulation Best Interest

## *Implementation of the New SEC Regulation Best Interest is Only a Few Months Away—Where are We and Where are We Headed?*

A year can be a long time or a short time depending on what you're doing. When it comes to implementing the sweeping changes required by the Securities and Exchange Commission's (SEC) new Regulation Best Interest (Reg BI), which replaces the current "suitability" standard for broker-dealers with a new "best interest" standard, a year is not very long at all.

### Regulation Best Interest at a Glance

#### From the SEC FAQs:

- Dual registrants must take into account both brokerage and advisory options; if only a registered representative of a broker-dealer, 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—broker-dealers 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.

#### From SEC/FINRA 2020 Enforcement Plans:

- Enforcement will begin July 1.
- FINRA issued specific questions identifying key issues policies and procedures should address.

This is especially true because the effect of Reg BI is to 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 requirements 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. Helpfully, the SEC and the Financial Industry Regulatory Authority ("FINRA") did recently release some much-awaited guidance that makes things a little more clear, and that likely will have an impact on the new policies and procedures currently under consideration. We'll summarize the high points affecting registered representatives here.

### But First, Is Reg BI on Schedule?

Yes—and though opponents are still trying to stop it, the deadline is coming fast and broker-dealers effectively have no choice but to keep working. It is unlikely that attempts to stop the rule will come to fruition before June 30 (if at all). For example, House Financial Services Committee Chair Maxine Waters' effort to defund SEC implementation failed, and the lawsuits by seven states and some private litigants claiming the SEC didn't have the authority to issue Reg BI are still in their early stages. It's not clear what the outcome of the lawsuits will be, and it will probably take quite a while to find out. We're also still waiting to see what states like Massachusetts and New Jersey are going to do with their proposed uniform fiduciary regulations for securities recommendations—while these wouldn't stop Reg BI, they likely would substantially conflict with its requirements, setting the stage for new litigation against those state rules.

## SEC Provides Some Clarity:

The SEC Division of Trading and Markets recently released “Frequently Asked Questions on Regulation Best Interest” (SEC FAQs). These FAQs provide specific guidance on a variety of important topics covered by Reg BI, including recommendations, disclosure obligations, duty of care obligations and conflict of interest obligations.

### *Recommendation Issues*

The guidance addresses a number of common questions about how to apply Reg BI with regard to recommendations, some of which are especially important to registered representatives.

#### *Recommending Brokerage vs. Advisory Services*

Many registered representatives have been asking about their responsibilities when recommending what type of account a customer should have. Do both brokerage and advisory accounts need to be taken into consideration when making an account type recommendation? What if I only offer brokerage accounts? The SEC clarified this issue, identifying the respective responsibilities of dual registrants compared to registered representatives of only a broker-dealer.

The SEC wrote that, “If you are a dually registered financial professional (i.e., an associated person of a broker-dealer and a supervised person of an investment adviser...) making an account recommendation, you would need to make this evaluation taking into consideration the spectrum of accounts that you can offer (i.e., both brokerage and advisory taking into account any eligibility requirements such as account minimums), and not just brokerage accounts.”

However, “If you are only registered as an associated person of a broker-dealer (regardless of whether you work for a dual-registrant or a broker-dealer affiliated with an investment adviser), you would need to take into consideration only the brokerage accounts available at your firm.” But, the guidance also warns that, “...even if your firm only offers brokerage accounts, you would still need to have a reasonable basis to believe that the recommended account is in the best interest of the retail customer.”

#### *Offering Services vs. a Recommendation*

Registered representatives also have been asking about the line between offering services to a prospective client and making a recommendation to open an account. 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.

### *Disclosure Issues*

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. In short, this issue is going to be a matter of scrutiny by the SEC and FINRA going forward.

## **Conflict of Interest Issues**

### *Prohibited and Permitted Incentives*

Registered representatives know that 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. However, there have been a lot of questions regarding permissible incentives. The guidance first warns that just because some incentives are always prohibited, this "...does not mean that all other incentives are presumptively compliant..." with Reg BI.

Instead, the guidance states that other incentives, "...are permitted provided that the broker-dealer establishes reasonably designed policies and procedures to disclose and mitigate the incentives created, and the broker-dealer and its associated persons comply with the Care Obligation and the Disclosure Obligation." It goes on to note that, "...elimination of conflicts of interest is one method of addressing the conflict...which broker-dealers may find appropriate in certain circumstances even when not required by Regulation Best Interest." In other words, each broker-dealer is going to have to decide whether it can sufficiently mitigate conflicts caused by a particular incentive.

### *Mitigation of Conflicts*

As a result, registered representatives can expect changes by many broker-dealers to compensation arrangements as they identify, disclose and mitigate conflicts. The guidance reiterates that the SEC is not requiring specific actions, but is instead requiring each broker-dealer to develop and adopt its own policies and procedures. The guidance did discuss some practices broker-dealers may consider, and it is likely that registered representatives may see some of these in the new policies and procedures adopted by their broker-dealers. The guidance provides, "...the following non-exhaustive list:

- 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 an associated person may receive across mutual funds or other comparable products across providers;
- Implementing supervisory procedures to monitor recommendations that are: near compensation thresholds; near thresholds for firm recognition; involve higher compensating products, proprietary products or transactions in a principal capacity; or, involve the roll over or transfer of assets from one type of account to another (such as recommendations to roll over or transfer assets in an ERISA account to an IRA) or from one product class to another;
- Adjusting compensation for associated persons who fail to adequately manage conflicts of interest; and
- Limiting the types of retail customer to whom a product, transaction, or strategy may be recommended."

Given this, it is likely, for example, that a number of broker-dealers are considering how to move incentives from the purchase of particular products to a registered representative's overall performance.

## **SEC and FINRA Reg BI Enforcement in 2020:**

The SEC and FINRA also provided some useful insight into upcoming Reg BI enforcement in their recently released 2020 enforcement plans. Unsurprisingly, the SEC explains that Reg BI and the Form CRS Relationship Summary "will be FY 2020 examination priorities." The report goes on to note that "After [June 30, the SEC] intends to assess implementation of the requirements of Regulation Best Interest, including policies and procedures regarding conflicts disclosures, and for both broker-dealers and RIAs, the content and delivery of Form CRS." Examinations "will focus on recommendations and advice given to retail investors, with a particular focus on: (1) seniors, including recommendations and advice made by entities and individuals targeting retirement communities; and (2) teachers and military personnel."

FINRA's priorities include some very detailed factors it will take into consideration when reviewing for compliance with Reg BI after June 30, 2020, including:

- Does your firm have procedures and training in place to assess recommendations using a best interest standard?
- Do your firm and your associated persons apply a best interest standard to recommendations of types of accounts?

- If your firm and your associated persons agree to provide account monitoring, do you apply the best interest standard to both explicit and implicit hold recommendations?
- Do your firm and your associated persons consider the express new elements of care, skill and costs when making recommendations to retail customers?
- Do your firm and your associated persons consider reasonably available alternatives to the recommendation?
- Do your firm and your registered representatives guard against excessive trading, irrespective of whether the broker-dealer or associated person “controls” the account?
- Does your firm have policies and procedures to provide the disclosures required by Reg BI?
- Does your firm have policies and procedures to identify and address conflicts of interest?
- Does your firm have policies and procedures in place regarding the filing, updating and delivery of Form CRS?

These questions provide registered representatives a good understanding of the issues their broker-dealers will be facing when finalizing their policies and procedures.

## 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 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.



### About the Author

Bradford P. Campbell, partner at Drinker Biddle & Reath LLP, is a nationally recognized figure in employer-sponsored retirement plans. The former Assistant Secretary of Labor for Employee Benefits and head of the Employee Benefits Security Administration (EBSA), Mr. Campbell served as ERISA’s former “top cop” and primary federal regulator. As an attorney in private practice, Mr. Campbell advises financial service providers and plan sponsors with insight and knowledge across a broad range of ERISA plan-related issues.