SEC Regulation Best Interest
History and Adoption of Final Regulation

Part 1 of 3 – Overview of General Obligations

Vince Micciche CRCP, GFS
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Forward

To study the regulation thoroughly and provide meaningful interpretation and guidance, this paper will be presented in a series of three parts. I begin, in this paper, with a brief review of the history and development of **Regulation Best Interest** and a broad overview of the General Obligations it imposes on Broker/Dealers. The next edition will explore **Form CRS**, in depth, and the final edition will explain the Commission's reinterpretations of the Fiduciary Obligations of RIA's and the **"Solely Incidental"** exemption for broker/dealers.

I. A Brief History of the Initial Proposal (2017 – 2018)

During his confirmation hearings in early 2017, SEC Chairman Jay Clayton clearly stated that his highest priority was to propose regulation that would harmonize the professional standards that apply to financial advisors, whether they be insurance agents, financial planners, securities brokers or investment advisors. He would do this by engaging the Department of Labor, FINRA and the State Securities, and Insurance regulators.

In developing the proposal, the commissioners considered input and commentary from the public, the industry, and various regulators. The debacle that followed the introduction of the Department of Labor Fiduciary Rule ("DOL Rule), certainly informed the SEC's ("the Commission") approach. The Commission wanted to avoid the unresolvable problems the DOL Rule presented and develop a straightforward framework focused on preserving investor's choice and access to investments while improving investor protection. They hoped to achieve this by mandating clear disclosures, raising the broker/dealer standard to "Best Interest," and clarifying investment advisors' standards of conduct.

Advocates of investor protection felt these were reasonable criteria were hopeful that this prudent approach would result in the creation of a uniform fiduciary standard for the financial services industry. Opponents, however, believed it would create yet another layer of unnecessary regulation to an already overregulated business, further restricting the provision of valuable financial products and services.

On April 18, 2018, the Commission panel reluctantly voted to approve the over 1,000-page proposal. Each of the Commissioners that voted in favor voiced serious misgivings while Commissioner Kara Stein dissented completely. This quote probably best summarizes her position; "Despite the hype, today's proposals fail to provide comprehensive reform or adequately enhance existing rules." I also recall her saying something to the effect of, "[W]e should call this Regulation Status Quo." She was highly critical of the proposal in its entirety felt it would not accomplish any the Commission's previously stated goals.

What the Proposal Would Do

In a nutshell, the proposal, which was formally called **"Regulation Best Interest,"** would raise the existing standard for broker-dealers from FINRA's Rule 2111 "suitability" standard to one requiring brokers to give recommendations in the best interests of their customer. Specifically, the proposal would impose three primary obligations on Broker/Dealers:

Disclosure

Brokers must disclose the key facts about their relationship with their customers.
Hoping to alleviate confusion, both brokers and RIAs would need to create and disseminate **Form CRS** (client summary disclosure), which would contain standardized information highlighting the differences in services offered, legal standards that apply, fees, and conflicts of interest.

Care

A broker must exercise reasonable diligence, care, skill and prudence to understand the product, have a reasonable basis to believe that the product is in the customer's best interest, and have a reasonable basis to believe that a series of transactions is in the client's best interest.
If you think this sounds strikingly similar to the FINRA Suitability Rule 2111, you are correct. It is essentially a cut and paste.

Conflicts

Brokers must establish, maintain and enforce policies and procedures reasonably designed to identify and, at a minimum, disclose and mitigate conflicts of interest arising from financial incentives. Other material conflicts must at least be disclosed.

This was a big point of contention for the critics of the proposal. This language would create a "reasonability" standard for broker/dealers as opposed to the stricter "full and fair" standard that applies to RIAs.

In addition to these three pillars, the proposal would restrict the use of the label "adviser" or "advisor" to Registered Investment Advisors only.

What the Proposal Would Not Do

It is important to note, however, that there are certain aspects of industry practice that Regulation Best Interest would not change. For example, the Regulation would not:

- Create or impose a fiduciary standard on broker/dealers;
- Define "Best Interest;"
- Have any effect on Insurance Agents;
- Require the brokers to provide customers with the best option available;
- Create a private right of action or right of rescission, or;
- Prohibit conflicts of interest.

Shortly following the release of the proposal, the Commission opened a 90-day comment period that drew more than 6,000 responses from the public and the industry. Most of the comments focused on three primary concerns: Whether broker-dealer and RIA standards should be fully harmonized (i.e., Everyone is a Fiduciary); Whether Form CRS would really be effective at communicating the differences between broker-dealer and RIA services, costs, and standards of conduct and; Would it make more sense to scrap the Proposal and simply enforce the existing rules.

II. Adoption of the of the Final Regulation (June 15, 2019)

Please bear in mind that the following is a condensed summary of key elements of the new regulation and its impact on broker/dealers, RIAs and their associates. It is in no way, a detailed description of the full regulation (the final rule is over 1350 pages long!). If you are interested in reading the full text, the links below will bring you to each section.

After considering the volumes of public comments it received, the Commission made modifications to the original proposal, and on June 5, 2019 issued a Final Rule for Regulation Best Interest and Form CRS that have a Compliance Date of June 30, 2020. The Final Rule provided interpretations of what RIAs must do to comply with their fiduciary duty, and when exactly a broker-dealer's advice services cross the line and are no longer "solely incidental" to its brokerage services.

In general, the final version of Regulation Best Interest closely resembles the original proposal, with several changes in language and details but little in substance. Similarly, the final version of Form CRS also followed the original proposal closely. The Commission managed to pare down the proposed 5-page document to 2 pages. They also relaxed the language allowing firms more flexibility to use their own words to explain their own services while following a standardized flow of key sections that must be covered and key information that must be provided.

In the final analysis, the Commission did not attempt to harmonize the regulation applicable to broker/dealers and RIAs. Rather, it concluded that while the services of each are equally valuable to consumers, they are different, and those differences do not lend well to uniform regulation.

Specifically, the SEC's final rules and interpretations prescribed the following:

Under Regulation Best Interest (Reg BI), broker-dealers will have a General Obligation to "act in the best interest of a retail customer when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer," and broker-dealers "may not put [their] financial interests ahead of the interests of a retail customer when making recommendations."

Ultimately, to comply with the rule's General Obligation, broker-dealers will be required to meet four key obligations:

1. **Disclosure Obligation**. Providing certain prescribed disclosure before or at the time of recommendation about the recommendation and the relationship between the retail customer and the broker-dealer;

In order to do so, broker/dealers must provide, "full and fair disclosure, in writing, of all material facts," relating to both the scope and terms of the relationship as well as the conflicts of interest that are associated with any recommendations provided. This document is called the Customer Relationship Summary (Form CRS).

Key aspects of the broker-dealer's relationship disclosure obligation include:

- The nature of the relationship (the capacity in which the b/d is acting);
- The material fees and costs that will apply to the retail customer's transactions, holdings, and accounts and;
- The type and scope of services provided, including any material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer such as a restricted product menu or required use of proprietary products.

In disclosing the nature of the relationship with the customer, if the broker-dealer is operating *solely* as a broker-dealer, the SEC states that *it will generally be a violation of Reg BI for brokers to use the titles "adviser" or "advisor"*. In the case of dual-registered individuals (as a broker/dealer *and* an RIA), the fact that they can legally operate as a Registered Investment Advisor means they are permitted to hold out as such.

Given the wide range of products that broker/dealers may implement with clients, the SEC is generally only requiring that brokers disclose the fact *that* the nature of the compensation may create conflicts of interest and not the exact levels of all types of commissions and other costs. Instead, the broker/dealer may refer customers to the relevant prospectus or similar sales documents where that information can be found.

2. **Care Obligation**. Exercising reasonable diligence, care, and skill in making the recommendation;

The Care Obligation for broker-dealers under Reg BI virtually mirrors the existing care obligation under FINRA Suitability Rule 2111.05, which has three components: Reasonable Basis; Customer-

Specific (based on the customer's individual investment profile), and Quantitative Suitability (that a series of recommendations, as a whole, were still appropriate in the aggregate).

Under the new Regulation Best Interest Care Obligation, broker-dealers will have similar requirements:

The broker, dealer, or natural person who is an associated person of a broker or dealer, in making the recommendation, exercises reasonable diligence, care, and skill to:

(A) Understand the potential risks, rewards, and costs associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers;

(B) 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 such natural person ahead of the interest of the retail customer;

(C) 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 such natural person making the series of recommendations ahead of the interest of the retail customer.

While the language is virtually identical, there is a subtle difference. Under Reg BI, the standard by which these items are judged is not merely whether they are "suitable," but also whether they avoid placing the financial interests of the broker-dealer ahead of the customer… and also that in the customer-specific evaluation, "costs" are explicitly cited as a factor that must now be considered.

3. **Conflict of Interest Obligation**. Establishing, maintaining, and enforcing policies and procedures reasonably designed to address conflicts of interest;

In Reg BI, the SEC has taken an approach to handling conflicts of interest that appears to be a blend of the DOL Rule and the SEC Fiduciary definitions. In Reg BI, there is different treatment for broker-dealers and the brokers they oversee. Specifically, the Conflict of Interest Obligation stipulates that:

The broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to:

(A) Identify and at a minimum disclose, or eliminate, all conflicts of interest associated with [their] recommendations;

(B) Identify and mitigate any conflicts of interest associated with recommendations that create an incentive for a [registered representative] to place the interest of the broker, dealer, or such natural person ahead of the interest of the retail customer;

(C) Identify and disclose any material limitations placed on the securities or investment strategies involving securities that may be recommended to a retail customer and any conflicts of interest associated with such limitations, and prevent such limitations and associated conflicts of interest from causing the [registered representative] to make recommendations that place [his/her interest] ahead of the interest of the retail customer; and

(D) Identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period.

Broker/dealers may still be permitted to have proprietary products, revenue-sharing, and shelf-space agreements, or even engage in principal trading around or against their customer. As long as it's disclosed to the customer, it's permitted. *However*, broker/dealers will be limited in their ability to *incentivize* their brokers towards those behaviors/products.

4. **Compliance Obligation**. Establishing, maintaining, and enforcing policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.

Per the SEC itself, such policies and procedures might include "controls; remediation of non-compliance; training; and periodic review and testing."

Form CRS

Both broker/dealers and RIAs will be required to create and deliver a new Form CRS (Customer/Client Relationship Summary) before or at the time that advice is provided. For CRS will explain the types of client/customer relationships, the services the firm offers, the fees, costs, conflicts of interest, required standard of conduct associated with those relationships and services,

and whether the firm and its financial professionals currently have any reportable legal or disciplinary history.

While the regulation allows for flexibility in wording, firms must follow a standardized question and answer format. Standardized questions will serve as headings in a prescribed order to promote consistency and comparability from firm to firm. Broker/dealers and RIAs will be limited to 2 pages in length and "dual registrants" will limited to 4 pages.

Form CRS will include the following:

- **Introduction with Link to Commission Information**. The relationship summary will include a more streamlined introductory paragraph that will provide a link to https://www.investor.gov/CRS, a page on the Commission's investor education website, Investor.gov, which offers educational information about investment advisers, broker/dealers, individual financial professionals, and other materials.

- **Separate Disciplinary History Section**. Firms will be required to indicate under a separate heading whether they or any of their financial professionals have reportable disciplinary history and where investors can conduct further research on these events.

- **Conversation Starters**. The proposed Key Questions to Ask have generally been integrated into the relationship summary sections either as question-and-answer headings or as additional "conversation starters" to provide clearer context for the questions. Retail investors can use these questions to engage in dialogue with their financial professionals about their individual circumstances.

Fiduciary Obligations of RIAs

An Interpretation of an RIAs obligations as a fiduciary to clients, specifically with regard to when/whether it's sufficient for RIAs to simply acknowledge they "may" have a conflict of interest (versus more concretely explaining conflicts and their potential impact), and how RIAs should disclose their conflicts of interest pertaining to the allocation of investment opportunities amongst their clients.

Exemption for Broker/Dealers

An Interpretation of the "solely incidental" exemption for broker/dealers to avoid the requirement to register as (fiduciary) investment advisers, stipulating that "a broker/dealer's provision of advice as to the value and characteristics of securities or as to the advisability of transacting in securities is consistent with the solely incidental prong if the advice is provided in connection with and is reasonably related to the broker-dealer's primary business of effecting securities transactions."

Miscellaneous Observations

A Dual Registrant May Avoid Regulation Best Interest

Regulation Best Interest only applies to broker/dealers – and not RIAs. Therefore, when it comes to dual-registered advisors (who are both a registered representative of a broker-dealer *and* an investment adviser representative of an RIA), the obligations of Reg BI apply only to a broker *while wearing the broker "hat" and not when acting in their capacity as an investment advisor*.

At the same time, the SEC emphasized that a dual-registrant is only an investment adviser with respect to accounts for which he/she actually provides advice and receives compensation (i.e. for advisory accounts). For any brokerage accounts – as well as the overall relationship with the client – the dual-registrant remains first and foremost a broker, and therefore *is* subject to Regulation Best Interest. Put another way, Regulation Best Interest only means the broker is subject to a Best Interests standard for a particular *recommendation*, (as a broker), and not with respect to the overall relationship with the client as an RIA.

The fact that a broker has *any* relationship to an investment adviser does allow him/her to use the "advisor" or "adviser" titles and hold out as being in the advice business if he or she are *solely* brokers without an RIA affiliation. For example, LifeMark Securities Corp. is both a registered broker/dealer and an SEC Registered Investment Advisor and has a variety of representatives. They fall into one of three categories:

1. Registered Representatives – securities only (series 6, 7, etc.)
2. Investment Advisory Representatives only (IAR's)
3. Dual Registrants (both securities brokers and IAR's)

Category 1 will always be subject to Reg BI, Category 2 will never be subject to Reg BI and Category 3 will be subject to the Reg when the individual is acting in the capacity of a broker.

Discussion of what constitutes a "Recommendation"

Because Reg BI will be triggered when a broker makes a recommendation to a customer, it's crucial to understand what constitutes a "recommendation".

Reg BI's interpretation of "recommendation" is virtually identical to FINRA's. The question of whether a recommendation is made will be based on the facts and circumstances of the situation, but the SEC notes that, generally, the determination will be made based on whether the communication "could reasonably be viewed as a 'call to action'" to the customer, whether it "reasonably would influence an investor to trade a particular security or group of securities," and that "the more individually tailored the communication to a specific customer or targeted group, the greater the likelihood that the communication may be viewed as a recommendation." A recommendation must generally have some level of specificity to the particular client and to a particular action that client would take as opposed to general education that is non-specific in nature.

Like FINRA, the definition pertains not only to recommendation of a securities transaction itself, but also to an "investment strategy," which the SEC suggests might include recommendations such as to invest in a bond ladder, to engage in day trading, to liquify home equity to invest, or to engage in margin investing.

Furthermore, "recommendations" are deemed to include not only securities and investment strategies themselves, but *how* they are invested and implemented. Consequently, recommendations as to the *type* of account (e.g., fee-based advisory vs. commission-based brokerage), whether to roll over or transfer assets from an employer retirement plan to an IRA (that will invest in securities), or to take a plan distribution (to open up an investment account with the proceeds) are also recommendations to which Reg BI would apply.

The Regulation does not define "Best Interest"

The SEC suggests that examples of "acting in a customer's best interest" will emerge over time. They do note that "best interest" is about understanding a recommendation in the context of a customer's entire situation. Notably, it is not about finding the best product, lowest cost or

evaluating every possible solution; the Commission recognizes that a higher cost option could be in the client's best interest if its features and benefits were commensurate with the cost.

Duration of Obligation Defined

The best interest obligation applies at the time the recommendation is made. The best interest obligation does not: (a) extend beyond a particular recommendation or generally require a broker/dealer to have a continuous duty to a retail customer or impose a duty to monitor the performance of the account; (b) require the broker-dealer to refuse to accept a customer's order that is contrary to the broker/dealer's recommendation; or (c) apply to self-directed or otherwise unsolicited transactions by a retail customer who may otherwise receive other recommendations from the broker/dealer. The scope of Reg BI cannot be reduced by contract. That is, even if the broker/dealer agrees contractually to hold itself to a higher standard, Reg BI still only applies to recommendations.

Regulation BI May be Problematic to Registered Representatives Selling Fixed Annuities

Based on the Commission's definition of a recommendation, advising a customer to liquidate securities positions and move into a fixed annuity may trigger the applicability of Reg BI. As a registered representative of a broker dealer such advice would be seen as "customer specific," a "call to action," and a strategy.

Final Thoughts

Although there are more than 8 months until the Compliance Date, it is highly suggested that all advisors begin a review of their individual practices and business models to determine the extent of modification required to conform to Regulation BI. FINRA has created a page on their site that is loaded with helpful resources including a compliance checklist https://www.finra.org/rules-guidance/key-topics/regulation-best-interest.

In Part 2 of this series, you will find an in-depth analysis of Form CRS together with practice management and compliance guidance concerning Regulation BI.