Clients&FriendsMemo

SEC Adopts Regulation Best Interest[1]

June 6, 2019

The Securities and Exchange Commission (the "**SEC**") on June 5 adopted Regulation Best Interest: The Broker-Dealer Standard of Conduct ("**Reg BI**"), which requires that broker-dealers act in the "best interest" of their "retail customers." The SEC also adopted (i) a rule requiring that each broker-dealer and investment adviser send its retail clients and file with the SEC a "Client Relationship Summary" providing information about that broker-dealer or adviser (including a standardized question-and-answer format intended to help investors compare various firms); (ii) guidance as to the fiduciary obligations to which an investment adviser is subject in serving its clients; and (iii) guidance as to the ability of a broker-dealer to provide advice that is "solely incidental" to its transaction execution services without being required to register as an investment adviser. This memorandum focuses entirely on Reg BI; further Cadwalader analysis on the other SEC actions will follow.[2]

Somewhat remarkably, while the final version of Reg BI is only about three pages, the accompanying release runs over 700 pages. The first 350 pages of the release in particular contain a good deal of substantive discussion that firms will need to review to implement Reg BI. While the length of the release seems disproportionate to that of the rule, Reg BI will have at least 700 pages worth of significance to the manner in which the securities industry operates going forward, and in particular to the way in which so-called "full-service brokerage" for retail customers (where any fees for incidental investment advice are embedded in the costs of execution) is offered, to the extent that continues to be a viable product offering.

Part I of this memorandum provides a brief summary of Reg BI; Part II discusses problematic aspects of Reg BI; Part III provides an overview of the SEC Commissioners' statements regarding Reg BI; and Part IV provides some compliance suggestions. We have attached to the end of the

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1 The hyperlinks in the memorandum are generally to the Cadwalader Cabinet (www.FindKnowDo.com) and are in some cases password-protected for Cabinet subscribers. If you wish to sign up for our free daily newsletter, you may do so at the bottom of the www.FindKnowDo.com home page. Nonsubscribers interested in a demonstration or trial of the Cabinet may contact William Sadd at william.sadd@findknowdo.com. See some of our awards and honors: https://www.findknowdo.com/endorsements.

2 SEC Release No. 34-86031 (the "**Adopting Release**"). Reg BI will be codified as Rule 15*l*-1 under the Securities Exchange Act of 1934 ("**SEA**").

memorandum a comparison of the adopted version of the Regulation BI as against the proposed version.

I. Summary of the Regulation. Reg BI requires that a broker-dealer, when making a recommendation to a client that is a natural person who may use the advice for non-commercial purposes (a "**Retail Customer**"), act in the "best interest" of the Retail Customer. Reg BI provides that the "general obligation" to act in a Retail Customer's best interest will be satisfied by complying with four more specific obligations:

- providing required disclosures before or at the time of any recommendation (the "**Disclosure Obligation**");
- exercising "reasonable diligence, care, and skill" in making any recommendation (the "**Care Obligation**");
- establishing, maintaining and enforcing policies reasonably designed to address conflicts of interest (the "**Conflict Obligation**"); and
- maintaining procedures reasonably designed to obtain compliance with Reg BI (the "**Compliance Obligation**").

A. 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 of the "material facts" as to its relationship with the customer. According to the SEC, this must include (i) disclosure that the firm is acting as a broker-dealer (and not as an investment adviser); (ii) the material costs to the Retail Customer; (iii) the type and scope of services that the Retail Customer will be provided, including any "material limitations" involving the securities or investment strategies that may be recommended to the Retail Customer; and (iv) all material facts relating to conflicts of interest that are associated with a recommendation.

The third requirement is particularly significant for firms that sell only, or mostly, proprietary products. However, all firms, as part of their Reg BI compliance process development, should consider what types of recommendations they might want to provide to their Retail Customers going forward. For example, firms first might determine that it is prudent to limit their recommendations to listed equities, or to large caps, or to investment grade debt, and so on. While proprietary investments are likely the focus of the SEC, it makes sense for firms to provide disclosure that is as extensive as possible.

B. The Care Obligation. In order to fulfill the care obligation, a broker-dealer must exercise reasonable "diligence, care, and skill" in recommending any transaction or "series of transactions."

To fulfill this obligation, a broker-dealer is required to (i) understand the "risks, rewards and costs" of any recommendation and have a reasonable basis to believe such recommendation could be in the best interest of at least some Retail Customers; (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 does not place the interests of the broker-dealer ahead of such customer; and (iii) have a "reasonable basis" that a series of recommended transactions is not excessive in light of the customer's investment profile.[3] In effect, the broker-dealer will have to satisfy, at a minimum, all of the elements of FINRA's suitability rule (FINRA Rule 2111), plus some undefined element more.

Notably, the Reg BI proposal also required that a broker-dealer exercise "prudence," a term that is generally understood to mean that recommendations should tend towards the conservative.[4] The prudence requirement was dropped from the final version of Reg BI. The Reg BI Proposal only required a broker-dealer to consider "risks" and "rewards"; the adopted version also requires consideration of "costs," a perfectly sensible addition.

C. The Conflict Obligation. A broker-dealer must establish, maintain and enforce written policies and procedures that identify and address conflicts of interest, either by disclosing or by eliminating them. This obligation requires firms to (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 Retail Customer's interest; and (iii) eliminate sales contests or other compensation based on the sale of specific securities within a limited period of time.

Reg BI defines a "conflict of interest" associated with a recommendation as "an interest that might incline a person . . . consciously or unconsciously . . . to make a recommendation that is not disinterested." By contrast, the Reg BI Proposal only referenced a "material conflict of interest," and further looked to the expectations of a "reasonable person," without regard to the person's unconscious.[5] However, the disclosure obligation in Reg BI only applies to "material facts" relating to conflicts of interest. In sum, *all conflicts of interest* will be within the scope of Reg BI, but only *material facts* regarding the conflicts will be required to be disclosed.

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[3] The prong regarding a "series of transactions" is essentially aimed at churning, or excessive trading. That is, the SEC is making clear that the fact that a particular transaction viewed in isolation is reasonable does not mean that numerous such transactions viewed in the aggregate continue to be reasonable.

[4] SEC Release No. 34-83062; 83 Fed. Reg. 21574 (Aug. 7, 2018) (the "**Reg BI Proposal**").

[5] Adopting Release at pages 194-195.

D. The Compliance Obligation. The Compliance Obligation is satisfied if, in addition to policies required under the Conflict Obligation, a broker-dealer establishes, maintains and enforces written policies and procedures that are reasonably designed to obtain compliance with Reg BI.

E. Retail Customers. Obligations imposed by Reg BI apply when a broker-dealer makes a recommendation to a "Retail Customer"—a term that the Regulation defines to mean a natural person acting for his or her own account (but not for the account of a business for which the person works), including an individual plan participant, where the recommendation is to be used for personal, family or household purposes. The Regulation would apply where the natural person is represented by a "nonprofessional" agent, but not by a professional adviser or other similar fiduciary.[6]

As was the case with the Reg BI Proposal, the term Retail Customer includes all natural persons acting for personal use, regardless of wealth or sophistication; *e.g.,* Warren Buffet acting for personal use is in the protected class. Further, investors are not permitted to contract out of the Regulation.[7]

F. Recommendations. In the Reg BI Proposal, the SEC determined that it would rely on the FINRA guidance as to the meaning of the term "recommendation" (as such guidance has been developed, primarily in notices to members) rather than creating its own separate definition of the term, so as to avoid confusion.[8] The problem with that approach was that FINRA's guidance is itself open-ended and ambiguous.[9] Hence, there has been no attempt to define a minimum level of information provided by a broker-dealer that would not constitute a recommendation. In the Adopting Release, the SEC states that "what constitutes a recommendation is highly fact-specific and not conducive to an express definition in the rule text," and that "being more prescriptive could result in a definition that is over inclusive, under inclusive, or both."[10] Notably, Reg BI may apply not only to "buy" and "sell" recommendations, but also as to explicit *and implicit* "recommendations to hold" that result from agreed-upon account monitoring.[11]

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6 Adopting Release at pages 110-111.

7 While one might think that all investors would want the protections provided by Reg BI, this may not be the case. Reg BI would seem to discourage any recommendations or suggestions of a casual nature, and thus potentially discourage some information flow that investors might wish to receive. There also could be instances in which it is unclear whether a family office or family trust with extensive investments would be considered a Retail Customer, subject to Reg BI.

8 *See* Adopting Release at 80-81.

9 FINRA has not established a single rule (or other document) where the term "recommendation" is defined. For more detail on this definition, see LOFCHIE'S GUIDE TO BROKER-DEALER REGULATION, CUSTOMERS CHAPTER.

10 Adopting Release at pages 80-81.

11 Adopting Release at page 94.

G. Recordkeeping. Reg BI also amends SEA Rules 17a-3 and 17a-4 to require additional records relating to Retail Customers. Specifically, for each Retail Customer to whom a recommendation is provided, the broker-dealer must create a record of (i) all information collected from and provided to the Retail Customer pursuant to Reg BI; and (ii) the identity of each registered representative responsible for the account.

These records must be retained until at least six years after the earlier of the date the information was collected or updated or the date the account was closed. Although commenters argued that this created significant additional recordkeeping obligations, the SEC states that the requirement is designed to provide a means for demonstrating compliance with Reg BI, but that much of the information already should be collected and retained under existing rules.[12]

II. A Few Problematic Aspects of the Reg BI. Our initial memorandum on the Reg BI Proposal was entitled: "Choose One: Best Interest or Full Service." The premise of the analysis in that memorandum was that the adoption by the SEC of a "best interest" standard for broker-dealers was arguably inconsistent with broker-dealers providing incidental investment advice to customers as part of full-service brokerage, in that the compensation that broker-dealers are paid for transaction execution by a Retail Customer trading infrequently and in small dollar amounts cannot really support the individualized attention that the SEC demands of a firm providing a recommendation under the best interest standard. Accordingly, we suggested that some investors would be injured by the adoption of a best interest requirement in that they would be essentially either forced to pay for an investment adviser (at a greater expense than would be worthwhile to them) or go without any personal attention.

The SEC acknowledged this concern in its adopting release, noting:

> Our concerns about the ramifications for investor access, choice, and cost . . . are not theoretical. . . . With the adoption of the now vacated [Department of Labor] 'Fiduciary Rule,' there was a significant reduction in retail access to brokerage services, and we believe that the available alternative services were high priced in many circumstances.[13]

In a related footnote, the SEC reports that, even though the DOL Fiduciary Rule never actually went into effect, "53% of firms participating in a SIFMA study eliminated or reduced access to brokerage advice services and 67% migrated away from open choice to fee-based or limited brokerage services."[14]

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[12] Adopting Release at page 361.

[13] Adopting Release at pages 21-22.

[14] Adopting Release at page 22, footnote 33.

In light of the concern that an overly burdensome Regulation BI would effectively kill full-service brokerage, the SEC reported that it tried to "balance the concerns of the various commenters of enhancing retail investor protection . . . while preserving, to the extent possible, retail investor access (in terms of choice and cost) to differing types of investment services and products."[15]

In this admittedly difficult, and perhaps impossible, balancing act, the SEC tilted in favor of retail investor protection and against retail investor access. This is because the SEC has not been keen to confront two fundamental issues:

- Broker-dealers have a fundamental conflict of interest with their clients because they only get paid when a transaction is done, and the conflict is amplified when a broker-dealer is acting as principal and not as agent. This conflict is best illustrated where a broker-dealer is acting as an underwriter in an initial public offering. The broker-dealer has a clear interest in selling its underwriting allotment and it only makes a profit when it does so. Accordingly, it is not clear how a broker-dealer acting as an underwriter, and, arguably making "recommendations" in connection therewith, could ever demonstrate that it had put its client's interest ahead of its own, or that it was "disinterested" as to the sale. (To deal with the risk created by Reg BI, as a practical matter, a broker-dealer may simply prefer to sell underwritten IPO shares to persons other than Retail Customers.)

- The expense of fully understanding an investor's risk "profile" is arguably reasonably substantial, and is greater than can be justified by the commissions paid by a Retail Customer. Suppose a Retail Customer buys $10,000 or $20,000 of stocks in a year. How much commission does that generate and is it worthwhile for a broker-dealer to analyze the customer's "profile" each time a recommendation may be made? To make an analogy, suppose you go into a restaurant and ask the waiter "what's good?" It's one thing to recommend what is good on the menu, but it's another thing if the waiter is required to know your health profile before making a recommendation.

III. The Commissioners. The Reg BI Proposal generated significant divisions among the Commissioners, with then-SEC Commissioner Kara M. Stein pointedly dissenting and saying that the proposal did not go far enough in imposing obligations on broker-dealers as to their customers'

[15] Adopting Release at page 23.

interests.[16] Commissioner Robert J. Jackson Jr. agreed with Ms. Stein in concept, though he voted for the proposal to go forward for comment.[17]

In the vote on the final version of Reg BI, SEC Chair Jay Clayton expressed his support for the rulemaking package and characterized criticism against the package as "misguided." Mr. Clayton responded to specific criticism, saying that (i) Reg BI cannot be implemented through disclosures alone; (ii) the Form CRS Relationship Summary is a huge improvement for investors over existing disclosures and (iii) the fiduciary interpretation does not weaken the existing fiduciary duty for investment advisers.[18] SEC Commissioner Elad L. Roisman also approved of the rulemaking package and advised the SEC to work with the industry and the public to complete a smooth transition.[19]

Consistent with the views he expressed when Reg BI was proposed, SEC Commissioner Jackson dissented, saying that the rulemaking package does not sufficiently raise the bar for broker-dealer conduct[20]. Commissioner Jackson is not focused on a potential diminution of investor choice and potentially higher resulting costs resulting from damage to the full-service brokerage model. His focus is the potential benefits of a high standard of obligation imposed on broker-dealers. In this regard, he cites a recent study arguing that broker-dealers subject to a fiduciary standard sell investors better products than those not subject to such a standard.[21] In the choice between best interest and full service, Commissioner Jackson comes down in favor of choosing best interest and allowing full service to fall by the wayside, if that is the outcome.

IV. Going Forward. In light of both the potential for regulatory enforcement action and counterparty claims,[22] broker-dealers providing recommendation to Retail Customers should

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[16] SEC Commissioner Kara M. Stein, Statement on Proposals Relating to Regulation Best Interest, Form CRS, Restrictions on Use of Certain Names or Titles, and Commission Interpretation Regarding the Standard of Conduct for Investment Advisers (Apr. 18, 2018).

[17] SEC Commissioner Robert J. Jackson Jr., Proposed Rulemakings Relating to Investment Adviser / Broker Dealer (IABD) Standards of Conduct (Apr. 18, 2018).

[18] SEC Chairman Jay Clayton, Statement at the Open Meeting on Commission Actions to Enhance and Clarify the Obligations Financial Professionals Owe to our Main Street Investors (June 5, 2019).

[19] SEC Commissioner Elad L. Roisman, Statement at the Open Meeting on Regulation Best Interest, the Interpretation of the Standard of Conduct for Investment Advisers, the Form CRS Relationship Summary, and the Interpretation of "Solely Incidental" (June 5, 2019).

[20] SEC Commissioner Robert J. Jackson Jr., Statement on Final Rules Governing Investment Advice (June 5, 2019).

[21] *See* Vanguard, HOW AMERICA SAVES 44 (2018).

[22] The SEC stated that "we do not believe [Reg BI] creates any new private right of action or right of rescission, nor do we intend such a result." Adopting Release at 44. However, it would not be surprising if the adoption of Reg BI resulted in FINRA toughening its own suitability rule (FINRA Rule 2111), which gives investors the right to assert claims before an SRO forum. Further, individual states are likely at least to consider adopting requirements imposing liability that are based upon

consider what compliance measures are required and what additional defensive measures are prudent. Such measures will include:

- Development of a comprehensive risk disclosure statement. This statement should be periodically reviewed and expanded as necessary to be consistent with changes in business at the firm and market practice.

- Disclosures should be very explicit as to limitations on the services provided and as to the securities made available or that may be recommended.

- Institute a monitoring procedure so that the disclosure may be 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. Firms should consider what information they may require concerning a security before it can be recommended to a client. By way of example, SEA Rule 15c2-11 requires that a firm have certain information before posting quotes as to a security.

- Consider limiting the types of securities that may be recommended to certain types of Retail Customers.

- Develop procedures as to the types of Retail Customers that are eligible to receive recommendations in light of their "profiles." Consider whether all customers should be eligible to receive recommendations.

- Review on a regular and ongoing basis the firm's compensation system. Consider whether the compensation that salespersons receive is appropriately related to the types of securities that they sell and does not motivate them in a manner that could be deemed improper. This does not mean that different compensation rates are inappropriate for different types of securities.

- Establish a Conflicts Committee to determine on a regular and ongoing basis where the firm has conflicts in making sales to Retail Customers (*e.g.*, where the firm or its affiliates receive indirect compensation beyond the commission or mark-up charged to the

Reg BI, and in fact Commissioner Jackson in his dissent to Reg BI seems to encourage the states to do so ("We can and should say unequivocally that [Reg BI] sets a federal floor, not a ceiling, for investor protection.").

client). Consider on a regular and ongoing basis whether such indirect compensation is appropriate and is sufficiently disclosed.

- Establish procedures to keep the records required by Reg BI. Firms should note that (i) the record maintenance period required by Reg BI is substantially longer than is required for most broker-dealer records; and (ii) Reg BI records will be "consumer" records and so subject to Regulation S-P and other privacy requirements.

- Institute additional training procedures as necessary to demonstrate that salespersons can meet the "skill" requirement of Reg BI.

- Consider how to keep track of any recommendations made to Retail Customers and of the time at which they were made.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

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§ 240.15*l*–1 Regulation Best Interest.

(a) Best Interest Obligation.

(1) A broker, dealer, or a natural person who is an associated person of a broker or dealer, when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer, shall act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker, dealer, or natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer.

(2) The best interest obligation in paragraph (a)(1) shall be satisfied if:

(i) Disclosure Obligation. The broker, dealer, or natural person who is an associated person of a broker or dealer, prior to or at the time of ~~such~~the recommendation, ~~reasonably discloses to~~provides the retail customer, in writing, ~~the~~full and fair disclosure of:

(A) All material facts relating to the scope and terms of the relationship with the retail customer, including ~~all material~~;

(i) that the broker, dealer, or such natural person is acting as a broker, dealer, or an associated person of a broker or dealer with respect to the recommendation;

(ii) The material fees and costs that apply to the retail customer's transactions, holdings, and accounts; and

(iii) The type and scope of services provided to the retail customer, including any material limitations on the securities or

investment strategies involving securities that may be recommended to the retail customer; and

(B) All material facts relating to conflicts of interest that are associated with the recommendation.

(ii) Care Obligation. 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~~, and prudence~~ to:

(A) Understand the potential risks ~~and~~, 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 ~~and~~, 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; ~~and~~

(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.

(iii) Conflict of Interest ~~Obligations~~Obligation.~~(A)~~ The broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to ~~identify~~:

(A) Identify and at a minimum disclose, in accordance with subparagraph (a)(2)(i), or eliminate, all ~~material~~ conflicts of interest ~~that are~~ associated with such recommendations~~.~~;

(B) ~~The broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material~~ Identify and mitigate any conflicts of interest ~~arising from financial incentives~~ associated with such recommendations~~.~~ that create an incentive for a natural person who is an associated person of a broker or dealer to place the interest of the broker, dealer, or such natural person ahead of the interest of the retail customer;

(C) (i) 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, in accordance with subparagraph (a)(2)(i), and

(ii) Prevent such limitations and associated conflicts of interest from causing the broker, dealer, or a natural person who is an

associated person of the broker or dealer to make recommendations that place the interest of the broker, dealer, or such natural person 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 of time.

(iv) Compliance Obligation. In addition to the policies and procedures required by paragraph (iii), the broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.

(b) *Definitions*. Unless otherwise provided, all terms used in this rule shall have the same meaning as in the [Securities Exchange Act of 1934]. In addition, the following definitions shall apply for purposes of this section:

(1) *Retail Customer* means a natural person, or the legal representative of such natural person, who:

(A) Receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer, or a natural person who is an associated person of a broker or dealer; and

(B) Uses the recommendation primarily for personal, family, or household purposes.

(2) *Retail Customer Investment Profile* includes, but is not 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.

(3) *Conflict of Interest* means 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.

3. Amend § 240.17a-3 by adding new ~~paragraph~~paragraphs (a)(~~25~~24) – (a)(35) to read as follows:

§ 240.17a-3 Records to be made by certain exchange members, brokers and dealers.

(a) * * *

(24) [Reserved.]

(25) [Reserved.]

(26) [Reserved.]

(27) [Reserved.]

(28) [Reserved.]

(29) [Reserved.]

(30) [Reserved.]

(31) [Reserved.]

(32) [Reserved.]

(33) [Reserved.]

(34) [Reserved.]

(35) For each retail customer to whom a recommendation of any securities transaction or investment strategy involving securities is or will be provided:

(i) A record of all information collected from and provided to the retail customer pursuant to § 240.15*l*--1, as well as the identity of each natural person who is an associated person, if any, responsible for the account.

(ii) For purposes of this paragraph (a)(~~25~~35), the neglect, refusal, or inability of the retail customer to provide or update any information ~~required under~~described in paragraph (a)(~~25~~35)(i) of this section shall excuse the broker, dealer, or associated person from obtaining that required information.

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4. Amend § 240.17a--4 by revising paragraph (e)(5) to read as follows:

§ 240.17a--4 Records to be preserved by certain exchange members, brokers and dealers.

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(e) * * *

(5) All account record information required pursuant to § 240.17a--3(a)(17) and all records required pursuant to § 240.17a--3(a)(~~25~~35), in each case until at least six years after the earlier of the date the account was closed or the date on which the information was collected, provided, replaced, or updated.

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