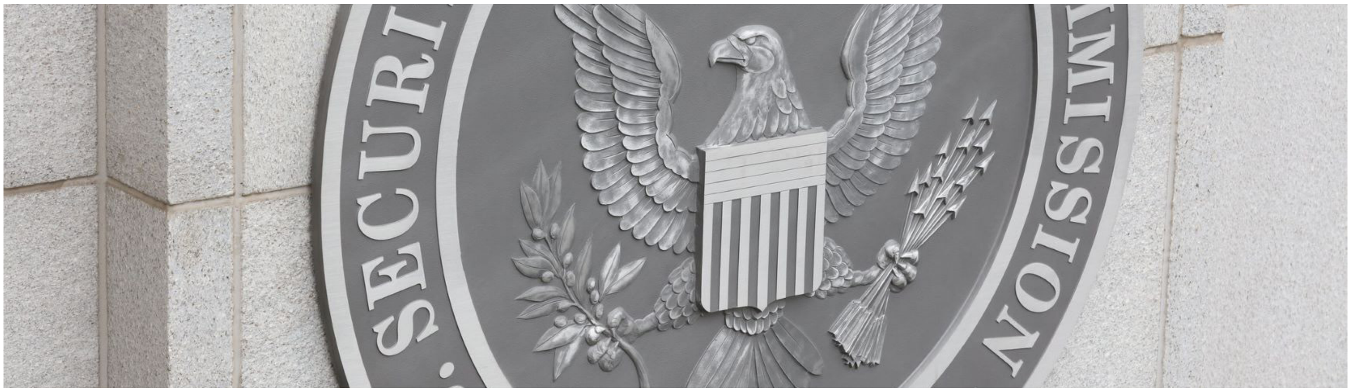
SEC's Regulation Best Interest:
Perspectives on Firm Compliance



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INTRODUCTION

From the moment it was proposed, Regulation Best Interest ("Reg BI") was a lightning rod for adherents and detractors of all stripes. Regulators have long been searching for the holy grail of financial advisory standards—a holistic yet simple solution that would balance robust and meaningful protections for main street investors with clear and flexible rules that would ensure the health and vitality of the marketplace in broker-dealer and financial advisory services. Detractors, on the other hand, say that Reg BI does not go far enough.

Previous attempts ended in a one-size-fits-all "fiduciary" approach for both brokers and investment advisers that, in the end, failed to withstand repeated challenges in the courts. For the SEC, this search has culminated in the adoption of Reg BI, a package of rules, interpretative guidance and new reporting mechanisms that direct broker-dealers to act in the "best interest" of retail investor clients, while maintaining the fiduciary standard long required for investment advisers. Although "best interest" is not explicitly defined, the best interest standard is intended to differentiate the obligations owed to retail investors based on the types of services and products offered by registered broker-dealers and registered investment advisers.

The adoption of the Reg BI package in June 2019 was the defining moment in the history of these standardization efforts. It triggered adherence to compliance schedules as part of the rule and requires registered broker-dealers and advisory firms to retool internal policies and procedures. The passage of Reg BI, however, did not quell the ongoing debate over the appropriateness and adequacy of current standards and investor protections. Like its U.S. Department of Labor ("DOL") Fiduciary Rule predecessor, Reg BI is undergoing challenges from numerous quarters, most immediately from state initiatives that purport to offer state residents greater protection than Reg BI, but also from anticipated legal objections over interpretative provisions. Despite these challenges, the obligations Reg BI imposes on financial firms are real and immediate. They require considerable preparation, and the consequences for failure to comply are heavy.

This two-part article is an overview of the current state of play on the impending SEC Reg BI rule: how we got here, what the rule requires and what firms need to have in place before the final compliance implementation dates. Whether the new rule survives in the long run remains an open question; current compliance with it is not.

PART 1 – UNDERSTANDING REG BI

A Short but Relevant History

The Rise and Fall of the Department of Labor Fiduciary Rule

After years of debate and push-and-pull among various federal agencies, in April 2016 the DOL issued a rule[1] (the "DOL Rule") redefining the term "fiduciary" under the Employee Retirement Income Security Act of 1974 ("ERISA") to cover not only qualified retirement plans, but to expand the fiduciary standard to retirement plan advice. Reaction to the DOL rule was swift and heated. Within a few weeks of its issuance, numerous lawsuits were filed[2] in federal courts, and both houses of Congress voted a resolution[3] of disapproval seeking its nullification. The day after the June 2016 effective date, President Barack Obama vetoed the resolution[4] from Congress saying that the DOL Rule was "critical to protecting Americans' hard-earned savings and preserving their retirement security."

Ostensibly, the DOL Rule was intended to address outdated DOL regulations dating from 1975 which set a "narrowing" five-part test for establishing when a person can be treated as a fiduciary adviser. The DOL argued that the five-part test was "adopted prior to the existence of participant-directed 401(k) plans, the widespread use of IRAs, and the now commonplace rollover of plan assets from ERISA-protected plans to IRAs." Without amendments to the regulation, the DOL asserted, non-fiduciary investment professionals, consultants, and advisers, "may operate with conflicts of interest that they need not disclose…and…may give imprudent and disloyal advice; steer plans and IRA owners to investments based on their own, rather than their customers' financial interests; and act on conflicts of interest in ways that would be prohibited if the same persons were fiduciaries."

The DOL's new definition under the proposed "fiduciary duty" rule was meant to replace the 1975 regulations in order to better "protect plans, participants, beneficiaries, and IRA owners from conflicts of interest, imprudence, and disloyalty." As part of the rulemaking, the DOL incorporated a number of specific exemptions, notably the "Best Interest Contract Exemption[5]," which accommodated and addressed a range of compensation practices; a Principal Transactions Exemption[6], which permitted certain types of transactions in certain investments; and a Prohibited Transaction Exemption[7] allowing for certain transactions involving, e.g. insurance and annuity contracts. The ERISA DOL Rule set an applicability date for April, 2017, assuming that ten months would be enough time for financial services and other service providers to transition from non-fiduciary to fiduciary status.

In February 2017, as one of his first acts in office, President Donald Trump issued a Presidential Memorandum[8] directing the new Secretary of Labor to examine whether the DOL Rule may "adversely affect the ability of Americans to gain access to retirement information and financial advice." Over the course of the year following that directive, the Labor Secretary issued public information requests, extended transition period deadlines, and released non-enforcement bulletins[9] effectively slowing the applicability of the rule.

Legal claims against the DOL's regulation eventually culminated in a decision,[10] handed down by the Fifth Circuit Court of Appeals in March, 2018, to vacate the DOL Rule. The Court found that the DOL exceeded its statutory authority by promulgating the rule. Later, in June, 2018, the Fifth Circuit closed the legal door on the matter by refusing to reconsider its decision to vacate the DOL Rule, as well as the Best Interest Contract and related transaction exemptions. This effectively ended the DOL's approach to its standard-setting efforts.

The Rise of the Securities and Exchange Commission's Best Interest Regulation

In April, 2018, one month after the Fifth Circuit decision to vacate the DOL Rule, the SEC introduced an alternative standards proposed rulemaking. SEC Chair Commissioner Jay Clayton would later argue[11] that Reg BI improved upon the DOL Rule, which had, during its brief existence, the "unintended consequences" of reducing "retail access to brokerage services." Reg BI, he said, will "enhance the broker-dealer standard of conduct in line with reasonable investor expectations, while avoiding other aspects of the [DOL] rule that appear to have been primary drivers of the rule's unintended consequences, such as the introduction of a best interest contract exemption and private right of action, and the uncertainty of whether, and if so to what extent, a commission-based fee model was compatible with the DOL Fiduciary Rule."

Reg BI consists of a package of rules, form requirements and interpretive guidance for investment advisers and broker-dealers. The "best interest" rule, itself, is only a few pages. But the over-700 pages of interpretations and practical considerations for firm compliance with it are more complicated. Adopted[12] on June 5, 2019, the Reg BI package is best understood as a principles-based, non-prescriptive approach to oversight and enforcement—an approach that places a heavy burden on financial firms to identify and rectify gaps or potential conflicts in its own practices and procedures.

The Reg BI Approach

Reg BI is drawn from—as the SEC repeatedly notes[13]—"key fiduciary principles." The core rule is a short statement which requires a broker-dealer to act in the "best interest" of a client investor. Though brief, the new rule "enhance[s] the standard of conduct for broker-dealers beyond existing suitability obligations and make[s] clear that a broker-dealer may not put its financial interests ahead of a retail customer when making recommendations."

Broker-Dealer Duties under "Best Interest"

For firms preparing for the compliance obligations imposed by Reg BI, the SEC's principles-based approach means that mere checklists will not be enough to satisfy the new standard of care obligation. For broker-dealers that make recommendations to their retail customers, Reg BI makes clear that there are four obligations owed to them. These include a "disclosure" obligation, a "duty of care" obligation, a "conflicts of interest" obligation, and a "compliance" obligation.

The ***disclosure obligation*** requires a broker-dealer to provide in writing to a retail client all "material facts" about the broker-dealer's relationship with that client. This includes (i) disclosing that the broker- dealer is acting as such, (i.e. not as an investment adviser); (ii) the type and scope of services provided by the broker-dealer; (iii) the costs of those services; (iv) any "material limitation" the broker-dealer may have on offering certain recommendations or investment strategies; and (v) all material conflicts of interest.

The ***duty of care obligation*** requires a broker-dealer to exercise reasonable "diligence, care and skill" when making investment recommendations. This obligation is similar to, but perceived as broader than, FINRA's suitability rules (see below). In order to satisfy this Reg BI obligation, a broker-dealer must (i) understand and communicate the "risk, rewards and costs of any recommendation;" (ii) have a reasonable basis to believe that the recommendation is in the best interest of the customer (and not, for example, put the broker-dealer or the Registered Representative's interests over that of the customer); and (iii) ensure that any recommendation must not be "excessive" given the customer's investment profile.

The ***conflicts of interest obligation*** requires a broker-dealer to create written policies and procedures to monitor, mitigate or eliminate conflicts. A conflict is defined as "an interest that might incline a [broker-dealer]. . .consciously or unconsciously. . .to make a recommendation that is not disinterested." Consequently, the obligation requires firms to eliminate sales contests and sales quotas, or other techniques that are based on the sale of specific securities in a limited period of time and/or to prevent incentive compensation that may lead to broker-dealers prioritizing their interests over those of a customer.

The ***compliance obligation*** is an enforcement provision requiring a broker-dealer to establish, maintain and enforce written policies and procedures reasonably designed to obtain compliance with the entirety of the best interest regulatory package.

Advisers vs. Brokers

The second part of the Reg BI package provides interpretive guidance for investment advisers who must already comply with fiduciary obligations to clients under the Investment Advisers Act of 1940 (the "Advisers Act.") For these Registered Representatives, the new guidance has been described by Chair Clayton as formalizing the existing standards. As distinguished from the described duties owed to investment clients by broker-dealers, Reg BI reaffirms that the fiduciary duty owed by investment advisers requires the satisfaction of both a duty of care and a duty of loyalty.

Within the duty of care, several obligations are required, including a duty to provide advice that is in the best interest of the client, a duty to seek best execution, and a duty to provide advice and monitoring over the course of the relationship. The new guidance clarifies that an investment adviser's duties apply to the entirety of the adviser-client relationship.

A duty of loyalty is violated by actions that divert assets, opportunities, or information for personal gain. To address the duty of loyalty obligation, Reg BI guidance provides additional clarity on full and fair disclosure and informed consent as it applies to retail as well as institutional investors.

The Client Relationship Summary ("Form CRS")

The third part of the rule package requires that both broker-dealers and investment advisers provide new Form CRS to retail investors. Form CRS highlights key differences between investment advisers and broker-dealers based on the types of services offered. The SEC provided for significant flexibility in the design of a firm's Form CRS, as it is intended to provide simple and understandable information to retail investors about their relationship with their investment professional. The regulators expect the form to provide specifics in a number of ways. For example, the Form CRS must include information on fees and costs, compensation structures, relationship models, types of services offered, differences between investment advisers and broker-dealers, and conflicts of interest. It also prohibits broker-dealers from using the term "advisor" or "adviser" (regardless of how the word is spelled by a firm) when communicating with retail customers, unless the adviser is working in such capacity with the client, and that capacity is made clear.

Exemptions for "Solely Incidental" Advice

The SEC approved a new interpretation of the "solely incidental" provision of the Advisers Act.[14] Specifically, the guidance clarifies that if a broker-dealer's advice is "solely incidental" to the conduct of their business and if they do not receive a "special compensation," broker-dealers would be exempt from investment adviser registration requirements under the Advisors Act. The Commission said that the extent of the discretion that a broker-dealer exercises over a client account is relevant to whether he/she is providing "advice" to customers related to securities transactions and hence whether the broker-dealer could claim an exemption. As stated, broker-dealers who provide such "solely incidental" advice cannot receive "special compensation." Additional or alternative types of compensation would evidence that the broker-dealer was providing advice not exempt from the requirements.

Reg BI: Proponents and Critics

Congressional Opposition

Criticism of Reg BI has been robust. The locus of that criticism in Congress centers on the House Financial Services Committee, and attempts[15] by Chair Maxine Waters of that Committee, to challenge the Rule using the appropriations process and committee oversight. That criticism largely centers on allegations that the new best interest standard is weaker than its predecessor fiduciary rule and, therefore, will not fulfill its main purpose to protect retail investors.

Chair Clayton has taken on these larger criticisms directly. Among his key point-by-point defenses,[16] the Chair argues that Reg BI not only substantially enhances the standard of conduct for broker-dealers, but also affords an investor the ability to choose between the broker-dealer transaction-based model and an investment adviser portfolio-based model. Addressing other pointed complaints, Chair Clayton contends that Reg BI (i) reaffirms and formalizes Advisers Act standards for investment advisers consistent with "decades of administering this standard;" (ii) fully addresses broker-dealer conflicts of interest; (iii) adds additional obligations beyond disclosure for both broker-dealers and investment advisers; and (iv) through the Form CRS, will provide "material assistance to retail investors in understanding the duties they are owed by financial service providers."

State Authorities: New Regulation and Lawsuits

A more serious challenge to Reg BI comes from state legislators and state securities regulators who assert their authority to protect in-state resident investors from harm. New Jersey, New York, Massachusetts, and Maryland, among others, have taken the lead[17] in making the case for a uniform fiduciary standard of care for broker-dealer recommendations to investors. The New Jersey proposal,[18] echoing the DOL Fiduciary Duty Rule, is likely to become the first to go live, perhaps as early as April, 2020.

Massachusetts Secretary of the Commonwealth William Galvin has submitted comments to the SEC on Reg BI.[19] He argued that the Reg BI package: (i) failed to establish a strong and uniform standard; (ii) failed to define key terms like "best interest" and set "ambiguous requirements" for addressing "longstanding conflicts;" (iii) failed to prohibit known problematic practices in the securities industry; and (iv) contradicted "years of data gathered by studies and reports on disclosure and the conduct standards applicable to broker-dealers." In December, 2019, Galvin submitted a revised uniform fiduciary conduct standard[20] for broker-dealers, agents, investment advisers and investment adviser representatives that provide financial advice to clients and client prospects in the state. In general, the regulation establishes a fiduciary duty and makes a violation of that duty a sanctionable "unethical or dishonest conduct or practice."

Additionally multiple State Attorneys General ("AGs") have also gone on the offensive against Reg BI.[21] In September, multiple states joined in a lawsuit[22] arguing that Reg BI (i) "undermines" consumer protections for retail investors; (ii) "increases the confusion about the standards of conduct that apply when investors receive recommendations and advice from broker-dealers or investment advisers;" and (iii) allows brokers to hold themselves out as trusted advisers despite inherent conflicts of interest. The State AGs argue that Reg BI exceeds the SEC's statutory authority and that it is arbitrary and capricious under the Administrative Procedures Act. They are arguing for the Courts to vacate the rule and to permanently prevent the SEC from "implementing, applying, or taking any action" under it.

PART 2 – GETTING REG BI READY

A Conversation about Compliance with Bates Compliance Leaders and Experts

The obligations Reg BI imposes on financial firms are real and immediate. Reg BI poses two broad compliance challenges. The first is the challenge for firms to identify gaps or potential conflicts in their own practices and procedures based on the revised and less prescriptive rule guidance. The second is to systematically address those gaps and conflicts and to ensure adequate supervision and compliance with updated procedures and practices.

From an enforcement and examinations perspective, the compliance requirements necessitated by Reg BI for investment adviser and broker-dealer firms are both intrusive and comprehensive. As stated by Bates Managing Director Hank Sanchez, "it is no understatement to say that firms will need to review all aspects of their business and compliance programs and, if firms haven't done so already, have in place a process for a top-to-bottom review of conflicts of interest."

That perspective has been a concern in recent industry conferences as attendees have raised implementation questions across the spectrum, including on examination expectations, technology, monitoring, disclosure, state requirements, disclosure and conflicts.

The Interplay between Reg BI Standards and FINRA Rules

A growing concern for firms, raised at industry conferences, was around the need for more clarity around the interplay between Reg BI and existing FINRA rules. As the regulator that will enforce compliance with Reg BI, FINRA has committed[23] to "adhere to SEC guidance and interpretations" and to "work with SEC staff to ensure consistency in examining broker-dealers and their associated persons." FINRA has committed to reviewing its rules to ensure that they are "aligned" with the SEC regulation. They have also announced that they plan to check when visiting member firms to ascertain the firm's Reg BI readiness. Thus, even prior to the implementation date, firms can expect that FINRA examiners will be asking for information related the firms' Reg BI progress.[24] This is not speculation. In FINRA's most recent Priorities Letter[25] the agency highlighted its intent to assess firm sales practice and supervision compliance under Reg BI.

FINRA CEO Robert Cook recognized the uncertainty created by the new Regulation. He stated[26] that Reg BI would likely prompt changes to FINRA rules on a host of issues, "like aligning non-cash compensation rules with the SEC's ban on sales contests under the new standard" and shifting FINRA examiners away from using the current suitability standard for broker recommendations. "That was our rule, but this is not our rule," Cook was quoted as saying as he stressed that FINRA will be working to "develop a really good process with the SEC to make sure that the interpretive questions come up in the exam process…I don't want us to be interpreting the rule now."

Mr. Sanchez notes that Reg BI does not create a new private right of action or right of rescission. For examination and enforcement purposes, that means that firms' policies and procedures will be assessed using the SEC's newly articulated obligations, but under existing FINRA rules. Consequently, firms must comply with the new Reg BI as implicated, for example, by FINRA rules governing standards of commercial honor and principles of trade[27] and of suitability.[28] How that will play out in execution and reviews will not be known for some time. Other than providing directive on the Form CRS, at the time of the publishing of this article, the SEC has not issued FAQs on implementation, but has indicated during the recent FINRA Reg BI conference in December that they may be forthcoming.[29] Others have speculated that guidance will come in the form of enforcement actions.[30]

Sanchez, a former regulator, expects that the ambiguity contained in the language of Reg BI will be treated like similar ambiguity in the existing FINRA regulations—on a case-by-case basis. That is to say, FINRA commercial standards and suitability rules under the SEC's Reg BI language will "all come down to someone's subjective analysis of the facts and circumstances in a particular situation." Notably, Chair Clayton has echoed that sentiment. In a response to criticism[31] for failing to define the term "best interest" in the new regulation, the Chairman stated that "the facts and circumstances of how the specific components of the rule are satisfied" is the best approach to ensuring high standards and to determining whether a broker-dealer acted in a customer's best interest.

That said, Sanchez warned that "firms must get their processes in line with both the word and the spirit of Reg BI" if they are going to be fully prepared to withstand examination. He cites three divergent examples:

First, to the extent that current "commercial honor" standards serve regulators as a catch-all mechanism for enforcement, he sees a similar approach coming with Reg BI.

Second, when it comes to suitability, he warned that Reg BI standards may be broader. As a consequence, current FINRA rules on suitability may become a "non-factor" for firms, and he expects, as a result, for the "volume" of SEC cases on suitability to increase.

Third, he cautions that under Reg BI, the underlying motivation of the recommendations made by broker-dealers may be subject to greater scrutiny, particularly in connection with potential firm conflicts and indirect compensation. Current FINRA rules on fair prices and commissions,[32] he said, require a registered member to "not charge his customer more than a fair commission or service charge, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense of executing the order and the value of any service he may have rendered by reason of his experience in and knowledge of such security and the market therefore." On this point, Bates Compliance Director Jill Ehret advises firms to pay "special attention" to ensure that compensation received is not of a type that might "improperly motivate a salesperson when offering securities to a retail customer."

These examples demonstrate that firms must be prepared to show how their programs respond to Reg BI principles, as well as the letter of existing rules.

Bates Compliance Recommendations

The need to start preparing *right now* is the common theme shared by all the members of the Bates Compliance team. Here are a few additional thoughts on preparation for Reg BI compliance:

Risk and Process

The short implementation deadline places a heavy burden on firms to formulate a Reg BI readiness plan as soon as possible. In anticipation of examinations that will review for Reg BI compliance, Bates Group practice experts have said that the regulators will likely scrutinize how risk and conflicts have factored into the development of compliance programs and policies. To start with, "diligence and preparation require a well-documented Regulatory Change Management process where all changes are memorialized to ensure that all aspects of the rule are addressed," noted Bates Compliance Managing Director Bob Lavigne. That means, from the outset, "firms should be getting feedback from partners in all areas of the firm, including Compliance, Legal, Operations, Finance, Sales Business Development, Internal Audit and Risk/Governance when designing new controls, policies and procedures," and they should be building in periodic health checks to monitor adherence.

Product Suitability and Conflicts

Lavigne emphasized the importance of product review in the earliest stages of Reg BI compliance assessments. "Firms must consider a myriad of issues that affect the business, from how to handle rollovers to product rationalizations," he said. Before "assessing their policies and procedures for enhancement or development," a methodical "review of the suitability risks presented by existing products offered and a process to identify conflicts of interest that could exist within the firm given those products is critical." This "due diligence is necessary before the development of any comprehensive risk disclosure policy that covers the firm's business and practice," he said. Lavigne and the Bates Compliance team are currently assisting companies in creating conflicts teams to develop an approach to the conflicts assessments.

Bates Compliance Director Jill Ehret agreed, stating that "firms should undertake an assessment of their current offerings and product shelf to decide if any changes will have to be made in order to comply with Reg BI." She stated that "firms must be particularly alert to any known conflicts or the potential for conflicts of interest that might be perceived." If found, the goal must be to "determine whether conflicts can be (a) eliminated, (b) mitigated, and (c) if not eliminated, how to fully disclose the conflicts and risks to clients." She further cautioned, "firms must own up to conflicts of interest that cannot be mitigated away with disclosures. They may need to cease doing business in certain products or business lines if they cannot mitigate such conflicts under Reg BI."

Ehret acknowledged that "compliance, supervision and operations will have to work hand-in-hand in order to make sure any changes made have a minimal impact to the business." In addition, she noted that "firms should be mindful of their current supervisory technology suite and make sure any changes in the supervisory program are able to be implemented within existing technology platforms. New reports, dashboards and reporting will likely need to be developed, tested and rolled out prior to the implementation date."

The Client Relationship Summary and Training

On the crafting of an acceptable Customer Relationship Summary, Lavigne offered that "firms must satisfy both the letter and the intent of the new regulations." He said that "examiners will expect, for example, that the more types of products sold, the greater levels of training and supervision will be needed." Ehret added "that means that firm training on products and product types will have to be well documented by Registered Representatives in order to prove 'best interest.' And appropriate policies will have to go beyond looking at just compensation, especially for more complex products."

State Requirements

On the added complications of having to comply with state requirements, Lavigne said that "varying state mandates regarding duty of care will have to be considered as part of the development of new policies and procedures. Firms will have to assess the impact of each state requirement and implement a risk-based methodology when making decisions on how to supervise."

CONCLUSION

This article offers a brief review of the recent history, core elements and key uncertainties of Reg BI, as it continues on a path to becoming the final accepted standard for the financial industry.

As Chair Clayton reminded the financial community at an open meeting of the Commission[33]: "there are an estimated 43 million American households that have a retirement or brokerage account; there are over 2,700 SEC-registered broker-dealers that provide services to retail investors, with nearly $4 trillion in total assets and almost 139 million customer accounts; there are over 8,000 SEC-registered investment advisers that provide services to retail investors, with over $41 trillion in assets under management and over 40 million client accounts; and there are approximately 960,000 women and men employed by broker-dealer and investment advisory firms that provide services to retail investors." Given that context, the stakes could not be higher.

ABOUT BATES COMPLIANCE

Bates Compliance helps firms navigate the compliance challenges presented by the new Reg BI requirements. Please visit our Reg BI service page to learn more about our Reg BI implementation support, or contact one of our representatives to discuss your Reg BI needs.

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