Regulation Best Interest Has Arrived, Are You Ready?

On Friday, June 26, 2020, the U.S. Court of Appeals for the Second Circuit upheld the Securities and Exchange Commission's Regulation Best Interest in a unanimous opinion, following much controversy in the industry surrounding the rule.[1] The plaintiffs, which included multiple state attorneys general, XY Planning Network and Ford Financial Solutions, argued that the Commission, in promulgating the rule, ignored the congressional intent of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Plaintiffs argued that Section 913(g) of the Dodd-Frank Act requires the Commission to promulgate rules to hold broker-dealers to a *standard of conduct not less stringent* than the standard to which investment advisers are held under the Investment Advisers Act, i.e., a fiduciary standard.[2] As such, according to plaintiffs, the rule was arbitrary and capricious. The Commission, on the other hand, argued that Section 913(f) of the Dodd-Frank Act grants the Commission broad rulemaking authority and that promulgating Regulation Best Interest falls within the discretion granted to the Commission. Furthermore, the Commission argued that the new rule is consistent with congressional intent to protect consumers because it establishes a heightened standard of conduct for broker-dealers and associated persons when recommending securities transactions or investment strategies to retail investors.[3] In a unanimous decision, the three-judge panel held that the Commission acted properly in crafting Regulation Best Interest and that the rule was not arbitrary and capricious.[4]

The Commission also adopted Form CRS, which requires SEC-registered investment advisers and SEC-registered broker-dealers to provide a brief relationship summary that discloses client or customer relationships and any conflicts of interest. The compliance date for Regulation Best Interest and Form CRS filing is June 30, 2020. Form CRS must be delivered to (1) existing retail investors by July 30, 2020 and (2) new retail investors before or at the time of entering into an advisory agreement. The Commission expects to implement the rule immediately.

---

[1] *XY Planning Network, LLC v. Securities Exchange Commission*, No. 19-2886 (2d Cir. 2020) available at https://www.ca2.uscourts.gov/decisions/isysquery/8d1f35c7-da51-497d-a3b2-febdd069c970/1/doc/19-2886_complete_opn.pdf#xml=https://www.ca2.uscourts.gov/decisions/isysquery/8d1f35c7-da51-497d-a3b2-febdd069c970/1/hilite/. (Last visited June 27, 2020).

[2] XYPN argued that Regulation Best Interest will put investment advisers at a competitive disadvantage by making it more difficult for them to differentiate their standard of care from that of broker-dealers when advertising to customers, especially because XYPN highlights its adherence to the higher standard of care for investment advisers as a selling point to attract customers. The State Attorneys General Petitioners claimed that Regulation Best Interest will diminish their tax revenues from investment income by allowing broker-dealers to provide conflicted investment advice to customers, which would be prohibited under a uniform fiduciary standard.

[3] On June 5, 2019, as part of a rulemaking package, the U.S. Securities and Exchange Commission adopted Regulation Best Interest under the Securities Exchange Act of 1934. *See* Securities and Exchange Commission, *Regulation Best Interest: The Broker-Dealer Standard of Conduct,* Release No. 34-86031 (June 5, 2019), https://www.sec.gov/rules/final/2019/34-86031.pdf available at (Last visited June 20, 2020). *Hereinafter* "Regulation Best Interest Release".

[4] In analyzing the language of Section 913, the court emphasized that Section 913(f) provided that the Commission "*may* commence a rulemaking, as necessary or appropriate in the public interest and for the protection of retail customers . . . to address the legal or regulatory standards of care for" broker-dealers." As such, this broad grant of permissive rulemaking authority included promulgating Regulation Best Interest as adopted by the Commission.
Furthermore, the court addressed whether plaintiffs had Article III standing to petition the court. The court unanimously agreed that the state attorneys general lacked standing, but split on whether XY Planning Network and Ford Financial Solutions had standing to challenge the rule.

This memorandum will take a closer look at Regulation Best Interest, discussing the historical background of the rule, the difference between standards of conduct for investment professionals, and the key points and requirements of the rule, and provide best-practice recommendations for compliance with the rule.

BACKGROUND OF REGULATION BEST INTEREST

Since the New Deal Era legislations, regulation of the financial industry has centered on balancing investor protection against overregulation. As it was then in the 1930's Great Depression , so it is now: Congress and regulators are faced with the challenge of crafting legislation in response to an economic crisis, while navigating the economic and political undertones surrounding the legislation. In that vein, after the passing of the Dodd-Frank Act in 2010, the Department of Labor (DOL) under the Obama Administration introduced rules that considered certain financial professionals to be "fiduciaries" by virtue of providing investment advice to employee benefit plans under the Employee Retirement Income Security Act of 1974 (ERISA).[5] Essentially, the proposed DOL Fiduciary Rule required financial professionals to act in their clients' best interests and held financial advisors, brokers, and insurance agents to a fiduciary standard of conduct.

Furthermore, the DOL Fiduciary Rule provided for a "best interest contract exemption" that mandated "objective standards of care and undivided loyalty."[6] Not only did the rule require advisers to seek the "best interest of their clients", but it also provided clients legal recourse if the "best interest standard" was violated.[7] Essentially, the rule provided a private right of action. As expected, the rule was met with mixed reception by industry participants and was subject to several legal challenges, most notably in March 2018 when the U.S. Court of Appeals for the Fifth Circuit vacated the rule based on procedural issues and noted that the rule was "arbitrary and capricious and exceeded the agency's regulatory authority under ERISA" because the provision of the Best Interest Contract Exemption created a private right of action. The court held that Congress, not the DOL, has the sole authority to create such a right.[8]

In response to the DOL Fiduciary Rule having been struck down, the Commission introduced Regulation Best Interest in April 2018.[9] Regulation Best Interest was intended to be less stringent than the DOL Fiduciary Rule by not seeking to hold broker-dealers to the fiduciary standard. However, it is intended to be stricter than the current suitability standard. Again, as expected, and as with the DOL Fiduciary Rule,

---

[5] Definition of the Term ''Fiduciary, 75 FR 65263, October 22, 2010, available at https://www.federalregister.gov/documents/2010/10/22/2010-26236/definition-of-the-term-fiduciary. (Last visited June 10, 2020).

[6] The proposed rule was withdrawn and re-proposed in 2016. The 2016 version included a best interest contract exemption (BICE). See Best Interest Contract Exemption, 81 FR 21002, April 8, 2016, available at https://www.federalregister.gov/documents/2016/04/08/2016-07925/best-interest-contract-exemption. (Last visited on June 10, 2020).

[7] *Id.*

[8] *Chamber of Commerce of the U.S.A., et al. v. U.S. Dep't of Labor, et. al*., No. 17-10238 (5th Cir.) (Mar. 15, 2018).
On June 29, 2020, the DOL released a revised fiduciary rule. The proposed rule, which will apply to registered investment advisers, broker-dealers, banks, insurance companies, and their employees, agents and representatives, outlines a five-part test under ERISA to determine who is considered a fiduciary. The rule includes a proposed exemption that would be available to investment advice fiduciaries who adhere to the best interest standard set out in Regulation Best Interest. See U.S. Department of Labor Proposes to Improve Investment Advice And Enhance Financial Choices for Workers and Retirees, June 29, 2020. Available at https://www.dol.gov/newsroom/releases/ebsa/ebsa20200629. (Last visited on June 29. 2020).

[9] The rule was proposed on April 18, 2018 and published in the Federal Register on May 06, 2018. *See* Regulation Best Interest, 83 FR 21574, May 09, 2018, available at https://www.federalregister.gov/documents/2018/05/09/2018-08582/regulation-best-interest. *See also* https://www.sec.gov/rules/proposed/2018/34-83062.pdf , (Last visited June 10, 2020).

Regulation Best Interest was met with mixed reviews by industry participants and several state attorneys general.[10] In attempting to balance the criticism, the Commission inadvertently created two classes of opponents to the rule. On the one hand, some argued that the rule is too stringent and costly to comply with, and the cost of compliance will inadvertently affect the very investors that the rule intends to protect. On the other hand, others have argued that the rule has not gone far enough as intended by or consistent with Section 913(g) of the Dodd-Frank Act, which requires Congress to create a broker-dealer standard of care "no less stringent than the standard applicable to investment advisers".[11]

Nevertheless, Regulation Best Interest has survived industry criticism, legal challenges, and COVID-19, for that matter.

WHAT IS REGULATION BEST INTEREST?

Standards of Conduct

Suitability Standard

The crux of the controversy surrounding Regulation Best Interest and the DOL Fiduciary Rule focuses on the standards to which investment professionals are held. Currently, broker-dealers are held to a suitability standard as outlined in FINRA Rule 2111.[12] Rule 2111 requires broker-dealers to have a reasonable basis to believe that a recommended transaction or investment meets the customer's investment objective and profile, provided that the recommendation is based on reasonable diligence after considering factors such as the investor's age, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, and risk tolerance.[13] Under the suitability standard, broker-dealers are not required to put the interests of clients above those of the broker-dealers. In essence, a broker-dealer will not have violated his legal obligation under Rule 2111 if he recommends a product that is not necessarily the "best product" for the client, provided that the product is suitable for the client.[14]

---

[10] As mentioned above, the States of California, Connecticut, Delaware, Maine, New Mexico, New York, Oregon and the District of Columbia brought action to challenge the validity of Regulation Best Interest in the Southern District of New York. The plaintiff States claimed that Regulation Best Interest does not meet Congress's directives under the Dodd-Frank Act and will harm both the plaintiff States and their residents. The case was moved from SDNY to the U.S. Circuit Court of Appeals for the Second Circuit for lack of subject-matter jurisdiction. See *State of New York et al v. United States Securities and Exchange Commission et al*. As mentioned above, on June 26, 2020, the Second Circuit Court of Appeals upheld the validity Commission's rule and disagreed with plaintiffs' contention that the rule was arbitrary and capricious.
Note also, that unlike the DOL Fiduciary Rule, Regulation Best Interest does provide a private right of action. As such, the court's analysis did not focus on whether the Commission exceeded its authority, but rather, whether the Commission acted within the broad authority granted by Congress under Section 913 of the Dodd-Frank.

[11] *Id.*

[12] FINRA Rule 2111. Suitability, available at https://www.finra.org/rules-guidance/rulebooks/finra-rules/2111. (Last visited on June 10, 2020).

[13] *Id.*

[14] The suitability rule prohibits churning, the act of excessive trading in a customer account for the purpose of generating commissions with disregard of the client's interests. However, to be found liable of churning, the trades must be excessive and the broker-dealer must have discretionary control over the customer account, as in Rule 2111's "quantitative suitability." *See* FINRA Rule 2111.05(c). Moreover, although the terms "churning" and "excessive trading" are often used interchangeably, the former requires scienter in order to prove a fraud, whereas

Fiduciary Standard

Registered investment advisers, on the other hand, have been held to a fiduciary standard as required by the Investment Advisers Act.[15] The Fiduciary standard includes the duty of care and duty of loyalty. The duty of care includes providing advice in the client's best interest, seeking the best execution where the adviser has the responsibility to select broker-dealers to execute trades, and monitoring the client's portfolio throughout the relationship. Of course, in order to discharge its duty, the investment adviser must have knowledge of the client's profile and objectives. The duty of loyalty requires that the adviser not subordinate its clients' interests to its own.[16] Moreover, the adviser must disclose all material facts and conflicts of interest relating to the advisory relationship with sufficiently specific facts to enable the client to understand the conflicts when deciding whether to consent to such conflicts or reject them.[17] Finally, the adviser must eliminate or at least expose all conflicts of interest that might incline an investment adviser—consciously or unconsciously—to render advice that was not disinterested.[18] Note that the duty of loyalty, as it has been consistently applied by the Commission, requires that the adviser not subordinate its clients interest to its own, which is different from requiring the adviser to put the client's interest above or ahead of those of the adviser.[19] As such, in some cases, it is permissible that the client and the adviser (or the adviser's other clients) share similar interests, provided that the adviser has disclosed the conflicts, the client has provided informed consent, and the adviser can ensure that such conflicts would not cloud its advice.

Best Interest

As mentioned above, Regulation Best Interest was intended to be more relaxed than the DOL Fiduciary Rule but stricter than the current Rule 2111 suitability standard, with respect to broker-dealers. Industry participants have referred to Regulation Best Interest as an "enhanced suitability standard" and have criticized that the overlapping or amalgamation of the fiduciary standard and Regulation Best Interest not only fails to protect investors as intended but also causes more confusion in the industry. For example, both standards of conduct require firms and financial professionals to act in the best interest of the retail investor and not place the financial professionals' interests ahead those of the retail investor; both

"excessive trading," does not require scienter and is an element of churning. Churning is commonly interpreted to have three elements: (1) control of the customer's account by the broker, either explicit or de facto; (2) excessive trading in light of the customer's investment objectives; and (3) scienter — the required state of mind for liability under Section 10(b) and Rule 10b-5. See *David A. Roche, 53 S.E.C. 16, 22 (1997*). *SEC v. Rizek*, 215 F.3d at 162.

[15] See Investment Advisers Act of 1940, Section 206 - Prohibited Transactions by Investment Adviser; *See also*, *SEC v. Capital Gains Research Bureau, Inc*., 375 U.S. 180, 194 (1963).

[16] Investment Advisers Act Release 3060 (adopting amendments to Form ADV and stating that "under the Advisers Act, an adviser is a fiduciary whose duty is to serve the best interests of its clients, which includes an obligation not to subrogate clients' interests to its own," *citing* Investment Advisers Act Release 2106).

[17] Securities and Exchange Commission, Commission Interpretation Regarding Standard of Conduct of Investment Advisers, Release No. IA-5248 (June 5, 2019), at p. 24. Available at https://www.sec.gov/rules/interp/2019/ia-5248.pdf. Hereinafter "Fiduciary Interpretation." *See also* Regulation Best Interest Release at p. 215.

[18] Fiduciary Interpretation at p.8. *See also* Regulation Best Interest Release at p. 195.

[19] Securities and Exchange Commission, *Commission Interpretation Regarding Standard of Conduct for Investment Advisers,* Release No. IA-5248, Footnote 53. Available at https://www.sec.gov/rules/interp/2019/ia-5248.pdf. (Last visited on June 10, 2020).

standards provide methods for addressing conflicts; [20] and both standards require full and fair disclosure of material facts. [21] The Commission acknowledged the basis of the confusion with respect to understanding the two standards.[22] In response, the Commission sought to differentiate between the two standards. For example, the Chairman has distinguished that one of the key differences between the two standards focuses on the manner in which the two types of professionals are compensated. Broker-dealers are compensated in commissions, on transaction-per-transaction basis at the time the recommendation is made; whereas investment advisers are compensated quarterly or annually for services rendered throughout the life of a portfolio.[23] Moreover, the fiduciary duty of the investment adviser is broader and applies to the entire relationship between adviser and client, including providing non-securities advice, whereas Regulation Best Interest only applies at the time the recommendation of any securities transaction or investment strategy is provided to the retail investor by a broker-dealer.

Furthermore, an investment adviser has an ongoing duty to monitor over the course of its relationship with its client, while a broker-dealer generally does not—unless the broker-dealer agrees to monitor the client's account.[24] Finally, the Commission distinguished that the fiduciary duty standard for investment advisers is generally principle-based, whereas the obligation components of Regulation Best Interest are generally more prescriptive than the fiduciary obligations under the Investment Advisers Act. [25]

REG BI: Disclosure, Care, Conflict of Interest, and Compliance Obligation

Regulation Best Interest requires a broker-dealer to act in the best interest of the retail customer at the time the recommendation is made, without placing its own financial or other interests ahead of the retail customer's interest. The Commission does not define the term "best interest"; in fact, the Commission explicitly declined to define the term.[26] Instead, the Commission outlined the rule in four prescriptive obligations to which the broker-dealers must adhere prior to or at the time of providing recommendations to retail investors.

Before addressing the components of Regulation Best Interest, it is necessary to unpack the key elements of the rule. First, the rule applies primarily to broker-dealers. [27] As mentioned above, registered

[20] Regulation Best Interest requires BD to (i) to establish written policies and procedures reasonably designed to identify and at a minimum, disclose, or eliminate, all conflicts of interest; and (ii) to establish written policies and procedures reasonably designed to mitigate or eliminate identified conflicts of interest. The fiduciary standard for investment adviser relies on full and fair disclosure and *informed consent*.
[21] Regulation Best Interest Release at p. 636.
[22] Regulation Best Interest Release at p. 636.
[23] *Id*.
[24] Regulation Best Interest does not impose a duty to monitor. However, a broker-dealer may agree to monitor the client accounts only to the extent that it is solely incidental to the primary brokerage business. To the extent that the broker-dealer agrees to provide account monitoring services to the retail investor (1) the broker-dealer is required to disclose the material facts (including scope and frequency) of those services pursuant to the Disclosure Obligation. Also, such agreed-upon account monitoring services involve an implicit recommendation to hold (i.e., an implicit recommendation not to buy, sell, or exchange assets pursuant to that securities account review), which is a recommendation "of any securities transaction or investment strategy involving securities covered by Regulation Best Interest.
[25] Regulation Best Interest Release at p. 636.
[26] Regulation Best Interest Release at p. 73 and p. 251.
[27] Regulation Best Interest applies to broker-dealers and associated persons registered with a broker-dealer. Regulation Best Interest may apply to a dually-registered person or an associated person of a broker-dealer who also is a supervised adviser of an investment adviser to the extent

investment advisers are already held to a higher standard of conduct under the Investment Advisers Act and Regulation Best Interest does not seek to modify that standard of conduct. Secondly, Regulation Best Interest applies to retail investors. It defines a retail investor as any natural person, or the legal representative of such natural person, who (i) receives a recommendation of any securities transaction or investment strategy involving securities from a broker-dealer and (ii) uses the recommendation primarily for personal, family, or household purposes.[28] Finally, the rule applies to *recommendations* that are given to such retail investors. The determination of what communication constitutes a "recommendation" requires a facts and circumstances analysis.[29] The Commission differentiated between general educational information and recommendations. For example, a communication such as informing a retail customer regarding making cash contributions in an IRA up to the annual IRS contribution limit does not rise to the level of a "recommendation.[30] Furthermore, general communication regarding retirement planning, such as providing a company's retirement plan options to a retail customer does not rise to the level of a recommendation. To the extent that such communication does not involve a recommendation regarding specific securities to be sold or purchased, such communication is considered investment education or descriptive information.[31] On the other hand, Regulation Best Interest also applies to investment strategies involving securities.[32] For example, recommendations to open an IRA or other brokerage accounts, as well as recommendations to roll over or transfer assets from one type of account to another are covered by Regulation Best Interest because such recommendations give rise to a "call to action" on the part of the investor. Finally, an explicit or implicit recommendation to hold a security is subject to Regulation Best Interest.[33]

Compliance with the Regulation Best Interest requires satisfying the four components of the rule prior to or at the time the recommendation is made. More importantly, scienter is not required to establish a violation under Regulation Best Interest[34].

Disclosure Obligation

Under the Disclosure Obligation, the broker-dealer must provide, in writing, full and fair written disclosure before or at the time of the recommendation. The Release noted that "full and fair disclosure should give sufficient information to enable a retail investor to make an informed decision with regard to the

---

the person was acting as a broker when the recommendation was made. (A dual-registrant is defined as a firm that is dually registered as a broker-dealer under Section 15 of the Exchange Act and an investment adviser under Section 203 of the Investment Advisers Act and offers services to retail investors as both a broker-dealer and an investment adviser). Regulation Best Interest does not apply to investment advice provided to a retail customer by a dual-registrant when acting in the capacity of an investment adviser, even if the retail customer has a brokerage relationship with the dual-registrant or the dual-registrant executes the transaction in a brokerage capacity.

[28] The definition of "retail investor" does not exclude high-net-worth persons.

[29] According to the Commission the analysis of what constitutes a recommendation considers: (1) whether the communication reasonably could be viewed as a "call to action"; (2) whether the communication would influence an investor to trade a particular security or group of securities; and (3) whether the communication is more individually tailored to a specific customer or targeted group of customers.

[30] Frequently Asked Questions on Regulation Best Interest, available at https://www.sec.gov/tm/faq-regulation-best-interest#:~:text=Under%20Regulation%20Best%20Interest%2C%20a,recommendation%20that%20is%20not%20disinterested.%E2%80%9D

[31] *Id.*

[32] Id.

[33] An implicit recommendation to hold can arise where the broker-dealer has agreed to perform account monitoring services for the retail investor but remained silent regarding the securities in the account. *Supra* note 24.

[34] Regulation Best Interest Release at p. 43.

recommendation".[35] The broker must disclose (a) all material facts relating to the scope and terms of the relationship with the retail customer, including (i) that the broker-dealer is acting as a broker-dealer with respect to the recommendations; (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. The broker-dealer must also disclose all material facts relating to conflicts of interest that are associated with the recommendation, including whether the recommendation is associated with proprietary products, payments from third parties, and compensation arrangements.[36] To the extent that the disclosure contains inaccurate statements or fails to account for material changes, the broker-dealer must supplement, clarify or update written disclosures as soon as practical, generally no later than 30 days after the material change.[37]

Care Obligation

As mentioned above, the Care Obligation is similar to the requirements of the suitability standard under FINRA Rule 2111. The Care Obligation standard is an enhanced suitability standard with an added analysis of whether the recommendation is in the best interest of the investor in addition to being suitable for the investor.[38] The Care Obligation requires the broker-dealer to exercise reasonable diligence, care, skill, and prudence to: (1) understand the potential risks and rewards 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; (2) 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 associated with the recommendation; and (3) 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.[39] The Commission noted that while cost, like potential risks and rewards, is a factor in determining whether a recommendation is in the best interest of the client, it is not dispositive or the only factor. As such, a recommendation that has the lowest cost may not necessarily be in the best interest of the client. The Commission analogized the evaluation of cost to the Best Execution analysis under FINRA Rule 5310, which does not require the lowest possible cost, but rather considers whether the transaction represents the best qualitative execution for the customer using cost as one factor.[40]

In comparing the Care Obligation with the current suitability standard under FINRA Rule 2111, the Commission noted that the latter has been interpreted through cases and FINRA enforcement actions to require that a broker's recommendations are *consistent with his customers' best interests*, which

[35] Regulation Best Interest Release at p. 213.
[36] Exchange Act Rule 15l-1(a)(2)(i).
[37] Regulation Best Interest Release at p. 244.
[38] Regulation Best Interest Release at p. 245.
[39] Exchange Act Rule 15l-1(a)(2)(ii). The Care Obligation is also similar to the duty of care prong for the fiduciary standard under which investment advisers are held.
[40] Regulation Best Interest Release at pp. 249-250.

translates to prohibiting a broker-dealer from placing his interests ahead of the customers' interests. This obligation is not explicit under the current suitability standard outlined in Rule 2111. Regulation Best Interest, on the other hand, explicitly requires broker-dealers to put the clients' interests ahead of those of the broker-dealers.[41] Moreover, the Commission distinguished between FINRA's quantitative suitability standard under Rule 2111 and the Care Obligation with respect to a series of transactions. Both standards view a series of transactions as a whole, rather than evaluating each transaction in isolation. However, FINRA's quantitative suitability standard requires that the broker-dealer have actual or *de facto* control over the client's account,[42] whereas Regulation Best Interest does not require an element of control to be subject to the Care Obligation with respect to a series of transactions.[43] As mentioned above, to be found liable for churning, the broker-dealer must also have control over the client's account.[44] By removing the control element, Regulation Best Interest lowers the burden to prove churning,[45] especially since scienter is not required to establish a violation of Regulation Best Interest[46].

Conflict of Interest Obligation

The Conflict of Interest Obligation requires the broker-dealer to establish, maintain, and enforce written policies and procedures reasonably designed to address conflicts of interest.[47] The Commission interprets a conflict of interest as "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.[48] The Commission does not necessarily require broker-dealers to develop policies and procedures to disclose and mitigate *all* conflicts of interest; however, it requires broker-dealers to develop policies and procedures that are reasonably designed to "at *a minimum disclose*, or eliminate" all conflicts.[49] This requirement goes beyond simple disclosure. As outlined below, the broker-dealer must eliminate certain compensation and incentive-driven practices that foster situations where the possibility of violating the Conflict of Interest Obligation is prevalent, such as sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sale of specific securities or specific types of securities within a limited period.[50] To that end, the Commission provided a non-exhaustive list of practices that could be used as potential mitigation methods for firms to comply with the Conflict of Interest Obligation:

- Avoiding compensation thresholds that disproportionately increase compensation through incremental increase in sales;

[41] *Id* at pp. 251-252.
[42] FINRA Rule 2111.05(c).
[43] Regulation Best Interest Release at p. 298.
[44] *Supra* note 14.
[45] Regulation Best Interest Release at p. 61.
[46] *Id* at p. 43.
[47] Exchange Act Rule 15l-1(a)(2)(iii).
[48] Regulation Best Interest Release at p. 312.
[49] *Id* at p. 319.
[50] The Exchange Act Rule 15l-1(a)(2)(iii).

- 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 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.[51]

Compliance Obligation

The Compliance Obligation requires a broker-dealer to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.[52] In addition to policies and procedures that address conflicts of interest, the Compliance Obligation requires implementation of policies and procedures for compliance with the Disclosure and Care Obligations. Compliance policies and procedures should be proportionate to the scope, size, and risks associated with the operations of the firm and the types of business in which the firm engages. Finally, as with any effective compliance program, the Compliance Obligation requires that policies and procedures include remediation of non-compliance and implement controls, training, and periodic review and testing.

FORM CRS--CUSTOMER RELATIONSHIP SUMMARY

As mentioned above, the Commission also issued Form Customer Relationship Summary ("CRS") and Part 3 of Form ADV as part of the rulemaking package. Form CRS, in the case of a broker-dealer, and Form ADV Part 3, in the case of an investment adviser, impose an obligation on broker-dealers and investment advisers to provide to retail investors with a basic introduction to the firm, description of fees and costs, and disclosure of any relevant disciplinary history of the broker-dealer firm or investment advisory firm and their principals.

[51] Regulation Best Interest Release at p. 336.
[52] Exchange Act Rule 15l-1(a)(2)(iv).

Broker-dealers must file Form CRS electronically through the Central Registration Depository (Web CRD®). Investment advisers, on the other hand, must file Form ADV Part 3 electronically through the Investment Adviser Registration Depository ("IARD"), post the form prominently on the investment adviser's website (to the extent that the investment adviser maintains a website), and deliver to the adviser's retail investors. The contents of the forms should be limited to two pages. Dual registrants and affiliated investment advisory firms, on the other hand, are permitted to prepare two separate forms or a single Form CRS, in which case the disclosure will be limited to four pages using IARD and Web CRD®.

As noted above, the compliance date for Form CRS filings is June 30, 2020 and must be delivered to (1) existing retail investors by July 30, 2020 and (2) new retail investors before or at the time of entering into an advisory agreement.

COMPLIANCE WITH REGULATION BEST INTEREST

After the June 30th compliance date, the SEC's Office of Compliance Inspections and Examinations ("OCIE"), in conjunction with FINRA, anticipate to begin examinations to assess the implementation of Regulation Best Interest. According to OCIE, initial examinations will primarily evaluate the extent to which firms have established policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.[53] According to John Polise, Executive Director of the Broker-Dealer and Exchange Group in OCIE, examinations will assess whether firms have made a good faith effort to comply with the new rules.[54] To that end, the Commission and FINRA remind firms to document all steps taken to demonstrate a good faith effort to comply with the requirements of Regulation Best Interest.

BEST-PRACTICE TIPS FOR COMPLIANCE WITH REG BI

As mentioned above, scienter is not required to establish a violation under Regulation Best Interest. Moreover, the rule does not include a grandfather provision for existing firms. As such, firms should assess their current business models to determine the extent to which Regulation Best Interest will affect them by reviewing the respective firm's activities, services and products, and type of clients .

As a preliminary matter firms and compliance professionals should consider the following practical tips.

- Determine whether the firm's customer base includes retail investors and assess the size of the client base and if it includes retail investors.
- Review brokerage account agreements to determine whether the firm has agreed to monitor customer account activity. As mentioned above, account monitoring services may give rise to an implicit recommendation to hold (i.e., an implicit recommendation not to buy, sell, or exchange

[53] U.S. Securities and Exchange Commission, Office of Compliance Inspections and Examinations, RISK ALERT, Examinations that Focus on Compliance with Regulation Best Interest, April 07, 2020. Available at https://www.sec.gov/files/Risk%20Alert-%20Regulation%20Best%20Interest%20Exams.pdf. (Last visited on June 10, 2020).

[54] FINRA, Virtual Conference Panel: Regulation Best Interest: Compliance Inspections and Examinations, Released May 12, 2020. Available at https://www.finra.org/video-conference-panels/video-regulation-best-interest-compliance-inspections-and-examinations. (Last visited June 20, 2020).

assets pursuant to that securities account review), which is a recommendation covered by Regulation Best Interest.

- Draft disclosure documents describing all material facts relating to the scope and terms of the relationship with retail customers and conflicts of interest that are associated with client recommendations.
- Review and update firm's marketing material communications consistent with the requirement of the Disclosure Obligation of Regulation Best Interest.
- Train all associated persons and supervisory staff who interact with retail investors, especially regarding "hire me" communication. To the extent the communication gives rise to a "call to action", such communication will be considered as a recommendation, thereby triggering obligations under Regulation Best Interest. Once Regulation Best Interest is triggered, the broker is obligated to comply with the components of the rule and provide adequate disclosure.[55]
- Avoid using the term "advisor" or "adviser" in name or title, unless registered as an investment adviser or a supervised person of an investment adviser. Improper use of the term may give rise to violation of the Disclosure Obligation.[56]
- To the extent the firm recommends securities or investment strategies that are complex, such as inverse or leveraged exchange-traded products, take particular care to ensure that associated persons recommending such products understand the terms, features, and risks associated with such products in order to establish a reasonable basis to recommend the products to retail investors. Failure to understand the product may give rise to violation of the Care Obligation of the Regulation Best Interest. Further, consider reviewing the firm's customer accounts to determine whether such products are included in accounts of retail investors and whether additional disclosure is required.
- Implement policies and procedures to identify and eliminate sales contests, bonuses, non-cash compensation and quotas based on specific sales.
- Update the firm's policies and procedures to ensure compliance with Regulation Best interest recordkeeping obligations.

If you should have any questions about issues covered in this memo, please don't hesitate to get in touch with us.

Jephte Lanthia | Of Counsel
BurgherGray LLP
1350 Broadway, Suite 406 | New York, NY 10018
Office: (646) 513-3231 Ext: 134 | Fax: (646) 561-9866
jlanthia@burghergray.com | www.burghergray.com

Brian Idehen | Associate
BurgherGray LLP
1350 Broadway, Suite 406 | New York, NY 10018
Office: (646) 513-3231 | Direct: (212) 913-9767
bidehen@burghergray.com | www.burghergray.com

[55] Regulation Best Interest requires the broker-dealers or associated persons to provide retail customers, in writing, full and fair disclosure of all material facts prior to or at the time of the recommendation given. Oral disclosures are allowed in limited circumstances that are fact-specific. See Regulation Best Interest Release at p. 136.

[56] The Commission does not expressly prohibit the use of these names and titles by broker-dealers. For example, broker-dealers may use these terms when acting in a role specifically defined by *federal statute* that does *not entail providing investment advisory services to retail customers*, such as a municipal advisor, commodity trading advisor, or advisor to a special entity.