

CLIENT ALERT

SEC Adopts Rule 15l-1 to Require Broker-Dealers Act in the Best Interest of Retail Customers

On June 5, 2019, the SEC adopted Regulation Best Interest (“Reg. BI”), which not only required the disclosure of conflicts of interest, but also imposed a standard of conduct on broker-dealers (“BDs”) when making a recommendation to a retail customer of any securities transaction or investment strategy.¹ According to the SEC, Reg. BI is meant to address (1) the potential harm to retail customers resulting from BD recommendations where conflicts of interest exist, and (2) the insufficiency of existing BD regulatory requirements to address these conflicts when BDs make recommendations to retail customers.² The compliance date of Reg. BI is June 30, 2020.

STANDARD OF CONDUCT

As new Rule 15l-1, Reg. BI requires a BD or associated person, when making a recommendation of any securities transaction or investment strategy to a retail customer, to 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 BD or associated person making the recommendation ahead of the interest of the retail customer (the “General Obligation”).³

To comply with the General Obligation, a BD must comply with four specified components to ensure that it acts in a customer’s best interest:

- (1) Disclosure Obligation:** Provide certain prescribed disclosure before or at the time of the recommendation, about the recommendation and the relationship between the retail customer and the BD;
- (2) Care Obligation:** Exercise reasonable diligence, care, and skill in making the recommendation;
- (3) Conflict of Interest Obligation:** Establish, maintain, and enforce policies and procedures reasonably designed to address conflicts of interest;
- (4) Compliance Obligation:** Establish, maintain, and enforce policies and procedures reasonably designed to achieve compliance with Reg. BI.

These four components should not be viewed as a safe harbor but are mandatory requirements to satisfy the General Obligation. Additional detail with respect to each of the four components is discussed below.

Definitions of terms used in the new rule are important to understanding the scope of a BD’s obligations.

¹ Securities Exchange Act Release No. 86031 (June 5, 2019), available at <https://www.sec.gov/rules/final/2019/34-86031.pdf>.

² The SEC stated that Reg. BI does not create a new private right of action or right of rescission. The SEC stated that any preemptive effect of Reg. BI on any state law governing the relationship between regulated entities and their customers would be determined in future judicial proceedings based on the specific language and effect of that state law.

³ The SEC intentionally avoided referring to Reg. BI as a fiduciary standard. While the SEC noted the potential overlap between Reg. BI and an investment adviser’s (“IA”) fiduciary duty, the SEC did provide examples of some slight differences between the obligations. First, while an IA’s fiduciary duty is an ongoing duty, Reg. BI imposes no such duty and instead only requires acting in the customer’s best interest at the time a recommendation is made. Additionally, Reg. BI imposes more specific obligations than the principles-based requirements under the Investment Advisers Act of 1940 (“Advisers Act”).

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FOR MORE INFORMATION:

Paul Merolla
212-880-3960
pmerolla@mmlawus.com

James Dombach
202-661-7019
jdombach@mmlawus.com

KEY DEFINITIONS

Retail Customer

Reg. BI's obligations only apply with respect to recommendations to "retail customers." In Reg. BI, "retail customer" is defined as any natural person, or the legal representative of such person, who receives a recommendation of a securities transaction or investment strategy from a BD or an associated person, and uses the recommendation primarily for personal, family, or household purposes. This definition of "retail customer" includes high net-worth individuals.

The inclusion in the definition of legal representatives of a natural person is designed to only cover non-professional legal representatives, such as a non-professional trustee, executor, conservator, or person holding a power of attorney. Legal representatives would not include regulated financial industry professionals. The inclusion of "personal, family, or household purposes" is designed to exclude natural persons seeking services for commercial or business purposes. Examples would include an employee seeking services for an employer or an individual seeking services for a small business or on behalf of a non-natural person entity like a charitable trust. The "personal, family, or household purposes" language also covers retirement accounts and recommendations to plan participants; however, it would not include recommendations made to plan representatives of workplace retirement plans.

Recommendation

Determining whether a "recommendation" occurs that triggers the application of Reg. BI is a facts and circumstances analysis. The SEC listed the following factors as to whether a recommendation occurred: (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. Where a BD agrees to monitor a retail customer's account, such agreed-upon monitoring involves an implicit recommendation to hold the position at the time the monitoring occurs where the BD does not make a buy or sell recommendation, thereby triggering the application of Reg. BI.⁴ Finally, recommendations would include account recommendations, such as rolling over or transferring assets from one type of account to another.

The SEC provided the following list of communications that would not be considered recommendations:

- General financial and investment information, including basic investment concepts, historic differences in the return of asset classes, effects of inflation, estimates of future retirement income needs, and assessment of a customer's investment profile;
- Descriptive information about an employer-sponsored retirement or benefit plan, participation in the plan, benefits of plan participation, and investment options available under the plan;
- Certain asset allocation models; and
- Interactive investment materials that incorporate these items.

Conflict of Interest

Reg. BI defines a "conflict of interest" as "an interest that might incline a broker, dealer, or natural person who is an associated person of a broker or dealer—consciously or unconsciously—to make a recommendation that is not disinterested."

DISCLOSURE OBLIGATION

*Before or at the time of the recommendation, a BD must disclose, in writing, all material facts about the scope and terms of its relationship with the customer.*⁵

⁴ Reg. BI also imposes an obligation to disclose the scope and frequency of the monitoring as part of the Disclosure Obligation.

⁵ Separate from Reg. BI, the SEC adopted a requirement that registered investment advisers and registered broker-dealers provide a brief relationship summary to retail investors by completing Form CRS. See Securities Exchange Act Release No. 86032 (June 5, 2019), available at <https://www.sec.gov/rules/final/2019/34-86032.pdf>. Form CRS is intended to inform retail investors about: (i) the types of client and customer relationships and services the firm offers; (ii) the fees, costs, conflicts of interest, and required standard of conduct associated with those relationships and services; (iii) whether the firm and its financial professionals currently have reportable legal or disciplinary history; and (iv) how to obtain additional information about the firm.

The SEC has listed the following examples as material facts requiring disclosures: (1) that the firm or representative is acting in a BD capacity;⁶ (2) the material fees and costs the customer will incur;⁷ and (3) the type and scope of the services to be provided, including any material limitations on the recommendations that could be made to the retail customer.⁸ Additionally, with respect to conflicts of interest, a BD must disclose material facts such as conflicts associated with proprietary products, payments from third parties, and compensation arrangements. The SEC stated that the above examples are not an exhaustive list and whether a fact is “material” is based on the standard of materiality articulated by the Supreme Court in *Basic v. Levinson*.⁹

The SEC also considers that the general basis for a BD’s recommendation is a material fact relating to the scope and terms of the relationship with the BD that must be disclosed. The general investment approach, philosophy, or strategy of a BD can be disclosed in a standardized format, but particularized disclosures may be necessary in the event of a unique investment approach. The SEC also required a disclosure of the risks associated with a BD’s recommendations in standardized terms.¹⁰ But the SEC did not go as far as to require a disclosure in connection with each particular recommendation.

The written disclosures required by the Disclosure Obligation may identify the material facts in standardized disclosures that can later be supplemented. The written disclosure should note that further specifics will be delivered at the time of the recommendation. And although the Disclosure Obligation requires written disclosures, the SEC has stated that oral disclosures may be provided to update any written disclosures to reflect facts not reasonably known at the time the written disclosure is provided. Such oral disclosures must be made no later than the time of the recommendation and the BD must maintain a record of the fact that the oral disclosure was provided. Further, where existing regulations permit disclosure after the recommendation is made, such as trade confirmation and prospectus delivery, a BD may satisfy the Disclosure Obligation regarding information in such disclosure documents after the recommendation.

The written disclosures required by the Disclosure Obligation must be updated to reflect material changes or inaccuracies as soon as practicable, and generally should not be later than 30 days after the material change. A BD should use oral disclosures while an update is pending.

CARE OBLIGATION

A BD must exercise reasonable diligence, care, and skill when making a recommendation to a retail customer.

The SEC stated that the Care Obligation is substantially similar to the duty of care under the Advisers Act. Under the Care Obligation, a BD must understand potential risks, rewards, and costs associated with the recommendation and must consider those risk, rewards, and costs in light of the customer’s investment profile. The BD must have a reasonable basis to believe that the recommendation is in the customer’s best interest and does not place the BD’s interest ahead of the retail customer’s interest. For a series of transactions, the BD must have a reasonable basis that all transactions, taken together, are not excessive even if individual transactions made be viewed as in the customer’s best interest.

The SEC confirmed that the Care Obligation goes beyond suitability requirements. Unlike Reg. BI, the SEC noted that suitability requirements do not explicitly require that recommendations be in the best interest of a retail

⁶ The SEC noted that the use of the term adviser or advisor by a BD not also registered as an investment adviser or an associated person that is not also a supervised person of an investment adviser presumably would be a violation of this obligation. The SEC also noted that capacity disclosure could be made orally at the time of recommendation.

⁷ In describing fees, the SEC stated that the description of a fee should not disguise the fee’s true nature. Additionally, in describing potential fee ranges, the range should be reflective of what most likely could be charged and note possible exceptions.

⁸ A BD would be required to disclose the fact that it agrees to provide monitoring services for securities transactions and investment strategies, and the frequency and duration of this monitoring. Additionally, the BD must disclose whether it has account minimums or similar requirements.

⁹ A fact is material if there is “a substantial likelihood that a reasonable [retail customer] would consider it important.”

¹⁰ The SEC specifically provided the following language to include in a disclosure: “While we will take reasonable care in developing and making recommendations to you, securities involve risk, and you may lose money. There is no guarantee that you will meet your investment goals, or that our recommended investment strategy will perform as anticipated. Please consult any available offering documents for any security we recommend for a discussion of risks associated with the product. We can provide those documents to you, or help you to find them.”

customer, instead only requiring that the recommendations be consistent with the customer's best interest. Further, under Reg. BI, a BD should consider reasonably available alternatives as part of having a reasonable basis to believe that a recommendation is in the best interest of a retail customer. Finally, current suitability requirements do not incorporate cost into the analysis.

According to the SEC, whether a BD has satisfied the Care Obligation is an objective evaluation that will turn on the facts of and circumstances of a particular recommendation and particular retail customer. The SEC noted that a BD should consider the following with respect to a security or investment strategy when making a recommendation: investment objectives; characteristics (any special or unique features); liquidity; volatility; likely performance in a variety of market and economic conditions; expected return; and financial incentives to the BD. Where a recommendation appears inconsistent with a retail customer's investment objectives, the SEC stated that a BD may want to document the basis for the particular recommendation.

With respect to account recommendations, the SEC listed the following factors that should be considered: (1) the services and products provided in the account (ancillary services provided in conjunction with an account type, account monitoring services, etc.); (2) the projected cost to the retail customer of the account; (3) alternative account types available; (4) the services requested by the retail customer; and (5) the retail customer's investment profile. With respect to dually registered associated persons, account recommendations must consider both brokerage and advisory accounts, not just brokerage accounts. With respect to making a recommendation to open an Individual Retirement Account, the SEC provided further guidance that the following factors should be considered: fees and expenses; level of service available; available investment options; ability to take penalty-free withdrawals; application of required minimum distributions; protection from creditors and legal judgments; holdings of employer stock; and any special features of the existing account.

CONFLICT OF INTEREST OBLIGATION

A BD must establish, maintain, and enforce reasonably designed written policies and procedures addressing conflicts of interest associated with its recommendations to retail customers.

The SEC stated that the Conflict of Interest Obligation is substantially similar to the duty of loyalty under the Advisers Act. A BD's policies and procedures must identify all conflicts associated with recommendations to retail customers and, at a minimum, disclose (pursuant to the Disclosure Obligation), or eliminate them.¹¹ If there are any material limitations¹² on recommendations that may be made to a retail customer, the policies and procedures must be designed to disclose the limitations and associated conflicts and to prevent the limitations from causing the BD or associated person from placing their own interests ahead of the retail customer's interest. Further, the policies and procedures must be designed to identify and eliminate sales contests, sales quotas, bonuses, and non-cash compensation¹³ that are based on the sale of specific securities or specific types of securities within a limited period of time.¹⁴

The SEC stated that BDs have flexibility to tailor policies and procedures to their particular business model, focusing on specific areas of their business that pose the greatest risk of noncompliance and greatest risk of potential harm to retail customers. A BD should consider including the following components: (1) policies and procedures outlining how the firm identifies conflicts, identifying such conflicts, and specifying how the BD intends to address each conflict;

¹¹ The SEC did not provide clear guidance as to whether a BD should focus on disclosure or elimination of conflicts of interest. But the SEC noted that, in some cases, a conflict of interest may be of a nature and extent that it would be difficult to provide adequate disclosure, and in those situations, a BD should eliminate or mitigate the conflict.

¹² The SEC stated that a material limitation would include recommending only proprietary products, a specific asset class, products with third-party arrangements, or products from a select group of issuers.

¹³ Non-cash compensation is any form of compensation received in connection with the sale and distribution of specific securities or specific types of securities that is not cash compensation, such as merchandise, gifts and prizes, travel expenses, meals, and lodging.

¹⁴ A BD would not be prohibited from offering only proprietary products, placing material limitations on the menu of products, or incentivizing the sale of such products through its compensation practices so long as the incentive is not based on the sale of specific securities or types of securities within a limited period of time; however, such practices would presumably need to be disclosed under the Disclosure Obligation. Additionally, the prohibition does not apply to total products sold or asset accumulation and growth.

(2) robust compliance and monitoring systems; (3) processes to escalate identified instances of noncompliance for remediation; (4) procedures that designate responsibility to business line personnel for supervision of functions and persons, including determination of compensation; (5) processes for escalating conflicts of interest; (6) processes for periodic review and testing of the adequacy and effectiveness of policies and procedures; and (7) training on policies and procedures.

In identifying conflicts of interest, policies and procedures should: (1) define such conflicts in a manner that is relevant to a BD's business (i.e., conflicts of both the BD entity and the associated persons), and in a way that enables employees to understand and identify conflicts of interest; (2) establish a structure for identifying the types of conflicts that the BD (and associated persons) may face; (3) establish a structure to identify conflicts in the BD's business as it evolves; (4) provide for an ongoing (e.g., based on changes in the BD's business or organizational structure, changes in compensation incentive structures, and introduction of new products or services) and regular, periodic (e.g., annual) review for the identification of conflicts associated with the BD's business; and (5) establish training procedures regarding the BD's conflicts of interest, including conflicts of associated persons, how to identify such conflicts of interest, as well as defining employees' roles and responsibilities with respect to identifying such conflicts of interest.

The SEC provided interpretive guidance about the Conflict of Interest Obligation as well as conflict mitigation techniques. A BD would need to address the following types of incentives to associated persons: (1) compensation from the BD or from third-parties, including fees and other charges for the services provided and products sold; (2) employee compensation or employment incentives (e.g., incentives tied to asset accumulation, special awards, differential or variable compensation, incentives tied to appraisals or performance reviews); and (3) commissions or sales charges, or other fees or financial incentives, or differential or variable compensation, whether paid by the retail customer, the BD, or a third-party. The SEC further provided the following mitigation methods: (1) avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales; (2) minimizing compensation incentives for employees to favor one product/account over another; (3) eliminating compensation incentives within comparable product lines; (4) implementing supervisory procedures to monitoring recommendations where conflicts of interest are higher; (5) adjusting compensation for associated persons who fail to adequately manage conflicts of interest; and (6) limiting the types of retail customers to whom a product, transaction, or strategy may be recommended.

COMPLIANCE OBLIGATION

A BD must establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Reg. BI as a whole.

The Compliance Obligation goes beyond the policies and procedures requirements of the Conflict of Interest Obligation by also requiring systems of controls related to Reg. BI as a whole, including the Disclosure and Care Obligations. The Compliance Obligation does not have specific required elements, so each BD will need to consider the nature of the firm's operations in designing its policies and procedures. The SEC stated that the compliance program should include controls, remediation of non-compliance, training, and periodic review and testing.

RECORDKEEPING REQUIREMENTS

The SEC amended Rule 17a-3 to require a BD to record, for each retail customer to whom a recommendation is made, all information collected from and provided to the retail customer pursuant to Reg. BI, as well as the identity of each associated person responsible for the account.¹⁵ The requirement includes both written and oral information provided to comply with Reg. BI. Neglect, refusal, or inability of a retail customer to provide or update information would excuse a BD from obtaining that information. A BD would not be required to duplicate existing records; a BD could rely upon existing records and create a new record noting which pre-existing documents were provided to the retail customer. A BD would be required to retain such records for at least six years after the earlier of the date the account was closed or date on which the information was replaced or updated.

¹⁵ A BD is not required to maintain records to evidence best interest determinations on a recommendation-by-recommendation basis. The SEC did note, however, that a BD may want to adequately document an evaluation of a recommendation and the basis for that recommendation in particular contexts, such as the recommendation of a complex product, or where a recommendation may seem inconsistent with a retail customer's investment objectives on its face.