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SEC UPDATE

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How the SEC May Yet End Up Defining "Best Interest" under Its New Regulation

The US Securities and Exchange Commission (SEC) received adverse criticism for its recently-adopted[1] Regulation Best Interest rule (Reg B.I.) for broker-dealers. However, this criticism may have overlooked adoption of a requirement that the SEC did not propose.[2] This requirement could go a long way toward defining "best interest" in the broker-dealer context—but in an unexpected way.

Adverse Criticism

Perhaps the most authoritative adverse criticism of Reg. B.I. came from the SEC's own Commissioner Robert J. Jackson, Jr. In voting against the SEC's adoption of Reg. B.I., he complained that

> [t]he rule does not "defin[e] . . . the term 'Best Interest,'" and in fact goes out of its way to say that it doesn't "require broker-dealers to recommend [one] 'best' product."[3]

Commissioner Jackson admonished the SEC that "the core standard of conduct set forth in Regulation Best Interest remains far too ambiguous about a question on which there should be no confusion."[4] "Moreover," he concluded, "the rule relies on a weak mix of measures that are unlikely to make much difference in improving the advice ordinary Americans receive from brokers."[5]

New Requirement

The SEC, however, adopted a requirement that the SEC did not propose and, consequently, may have been overlooked or under appreciated by critics of Reg. B.I. The new requirement arguably has the potential of answering at least some portion of the complaints of Commissioner Jackson and others.

The new requirement is for a broker-dealer to "establish, maintain and enforce written policies [and] procedures reasonably designed to achieve compliance with Regulation Best Interest."[6] The SEC described this requirement in sweeping terms, stating that it "creates an affirmative obligation under the Exchange Act with respect to the rule *as a whole*."[7]

The SEC had proposed to require that broker-dealers adopt various policies and procedures, but to a more limited extent. For example, in the context of compliance, the proposal was for broker-dealers to adopt policies and procedures "reasonably designed to":

- "identify, and disclose, or eliminate all material conflicts of interest associated with

recommendations covered by Regulation Best Interest," and

- "identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations."[8]

The SEC did not explain why it adopted a broader policies-and-procedures regulatory approach than proposed, except to say that it did so "[a]fter considering the comments received"[9] and it believes that it "is important to help ensure that broker-dealers have strong systems of controls in place to prevent violation of Regulation Best Interest . . . and to protect the interests of retail customers."[10]

Policies-and-Procedures Approach

Of course, the SEC's policies-and-procedures regulatory approach adopted in Reg. B.I. is not new. In adopting Reg. B.I., the SEC noted that

> broker-dealers are currently subject to supervisory obligations under Section 15(b)(4)(E) of the Exchange Act and SRO rules, including the establishment of *policies and procedures* reasonably designed to prevent and detect violations of, and to achieve compliance with, the federal securities laws and regulations, as well as applicable SRO rules.[11]

The SEC also has adopted the policies-and-procedures regulatory approach under the Investment Advisers Act of 1940[12] and Investment Company Act of 1940.[13]

Under this regulatory approach, the SEC Staff reviews registrants' policies and procedures during routine inspections and issues deficiency letters where it believes policies and procedures on particular matters are missing and should be adopted. The Staff also finds deficiencies where a registrant has particular policies and procedures in place, but has not implemented or followed them. In the latter situation, the Staff, in effect, elevates or transforms a policy or procedure into a regulatory requirement and cites a violation of that requirement.

Reg. B.I. Policies and Procedures

In adopting the expanded requirement for policies and procedures that are coextensive with the *entirety* of Reg. B.I., the SEC can be said to require each broker-dealer to define the concept of "best interest" in the context of that individual broker-dealer. To do so, a broker-dealer will have to think through what "best interest" means and articulate that standard in terms of specific actions that the broker-dealer must implement and follow.

This approach may prove to be more effective in protecting the public than an SEC definition of "best interest." An SEC definition would have had to be very general to encompass a broad range of broker-dealer business models[14] and, consequently, run the risk of not being sufficiently specific for individual broker-dealers. The policies-and-procedures regulatory approach is one that, at least at first blush, enables the SEC to hold a broker-dealer to a "definition" of "best interest" of that broker-dealer's *own making*.

SEC Enforcement

But at the same time, the SEC has pointed out its authority to second guess a broker-dealer's policies and procedures in order to assure compliance with Reg. B.I. as a whole. The SEC has warned that it intends to review broker-dealer policies and procedures "early on, reducing the chance of retail customer harm."[15] The SEC has said that it will "identify and address potential compliance deficiencies or failures (such as *inadequate* or *inaccurate* policies and procedures . . .)."[16]

This regulatory process means that the SEC will measure the adequacy and accuracy of a broker-dealer's policies and procedures[17] against what the *SEC* deems to be adequate and accurate. This is a process of *comparing* what is with what should be. In determining what should be, the SEC will be establishing a standard of comparison that is arguably a "best interest" standard—the functional equivalent of a "best interest" definition that the SEC stopped short of adopting.

To this extent at least, Commissioner Jackson may have the last laugh.

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NOTES

1 *Regulation Best Interest: the Broker-Dealer Standard of Conduct*, Securities Exchange Act Release No. 86031 (June 5, 2019) (adopting Rule *15l*-1 under the Securities Exchange Act of 1934) [hereinafter SEC Adopting Release], available at *https://www.sec.gov/rules/final.shtml*.

2 The Commission proposed Reg. B.I. in *Regulation Best Interest*, Securities Exchange Act Release No. 83062 (Apr. 18, 2018), available at *https://www.sec.gov/rules/proposed/proposedarchive/proposed2018.shtml#secondq*; *see also* Staff of the U.S. Securities and Exchange Commission, *Study on Investment Advisers and Broker-Dealers As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Jan. 2011), available at *www.sec.gov/news/studies/2011/913studyfinal.pdf* (discussing the range of brokerage and dealer services provided by broker-dealers).

3 Commissioner Robert J. Jackson Jr., Public Statement, Statement on Final Rules Governing Investment Advice I (June 5, 2019) (footnote omitted), available at *https://www.sec.gov/news/public-statement/statement-jackson-060519-iabd.*

4 *Id.*

5 *Id*.

6 SEC Adopting Release, *supra* n.1, at 358 (emphasis added). The word "and" was dropped between "policies" and "procedures."

7 *Id*. (emphasis added) (footnote omitted).

8 *Id*. at 357.

9 *Id*. at 358.

10 *Id.* at 359 (footnote omitted).

11 *Id*. at 358 n.809 (emphasis added). The SEC went on to state that "[w]hile the Compliance Obligation creates an explicit requirement, we believe that broker-dealers would likely establish policies and procedures to comply with Regulation Best Interest pursuant to Section 15(b)(4)(E). In order to comply, broker-dealers could adjust their current systems of supervision and compliance, as opposed to creating new systems." *Id*.

12 The SEC equated its policies-and-procedures approach for broker-dealers with that for investment advisers, as follows:

> This approach is similar to the one taken under rule 206(4)-7 under the Advisers Act which requires policies and procedures reasonably designed to prevent violations of the Advisers Act, which should be tailored to address compliance considerations relevant to the operations of each adviser. *See* Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Release No. 2204 (Dec. 17, 2003) (Advisers Act Release 2204). *See also Questions Advisers Should Ask While Establishing or Reviewing Their Compliance Programs* (May 2006), available at *https://www.sec.gov/info/cco/adviser_compliance_questions.htm* ("No one standard set of policies and procedures will address the requirements established by the Compliance Rule for all advisers because each adviser is different, has different business relationships and affiliations, and therefore, has different conflicts of interest."). *Id.* at 359 n.810.

[13] Rule 38a-1.

[14] The SEC recognized that its policies-and-procedures regulatory approach needed to provide "sufficient flexibility to allow broker-dealers to establish compliance policies and procedures that accommodate a broad range of business models." SEC Adopting Release, *supra* n.1, at 358-359 (footnote omitted).

[15] *Id*. at 359 n.811.

[16] *Id.* (emphasis added).

[17] The same holds true for the various disclosure requirements that Reg. B.I. imposes on broker-dealers. The SEC will measure the adequacy and accuracy of a broker-dealer's disclosure against what the *SEC* deems to be adequate and accurate. In doing so, the SEC will be establishing a standard that is arguably a "best interest" standard.