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NASAA Report on BD Compliance With Reg BI: Finds Progress, but Specifies Work To Be Done

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A September report of the North American Securities Administrators Association (NASAA) on broker-dealer compliance with the SEC's Regulation Best Interest (Reg BI) finds:

- There's "helpful and steady implementation progress."
- But "firms are still relying heavily on suitability policies and strategies that pre-dated Reg BI."
- And "[e]fforts to address the standard of care concepts established by Reg BI remain perfunctory."

These findings result from NASAA's examination of FINRA firms in years two and three of Reg BI. The examination focused on four product types characterized as "complex, costly, risky products" (CCRs): leveraged and inverse exchange-traded funds, non-traded real estate investment trusts, private placements, and variable annuities. Most of the findings, summarized below, relate to all four of the CCRs, but some findings relate to only variable annuities. The report characterizes variable annuities as being "complex and costly, routinely paying commissions of 6% or more." It singles out that variable annuities "require long-term holding to fully maximize benefits like favorable tax deferral and certain guarantees." There was no mention of registered indexed-linked annuities known as RILAs. **Care Obligation Findings** The report notes that the "care obligation" under Reg BI "requires firms to exercise due care in matching the right customer to the right product." The first step is for a firm to have a clear understanding of each customer. Although the report finds that "[f]irms have been updating their investor profile forms," NASAA also observed firms' "[f]ailure to include customers' education level on investor profile forms as relevant to the customers' financial sophistication and ability to understand complex terms." The second step is to develop policies and procedures governing the matching of product to investor. The report finds that,

generally speaking, "[f]irms recommending CCR products are imposing product-specific restrictions based on [customers'] age, net income/worth, and risk profiles and are using exception reports to monitor compliance with those restrictions." However, the report observes that "some firms failed to investigate the activity that generated an exception report." The third step is to develop processes to consider available alternatives to CCRs to help avoid conflicts of interest. The report seems to find the most shortcomings in this area, to the extent that some firms:

- Are "using helpful cost-comparison tools to better consider reasonably available alternatives, but are still ignoring common lower-cost and lower-risk products when recommending CCRs."
- Exhibit a "[f]ailure to educate or otherwise provide guidance to associated persons on the firm's process for consideration of reasonably available alternatives."
- Use "[c]heckbox-style attestations with a naked claim that other investment options were discussed with the client or that the associated person considered unidentified reasonably available alternatives."
- Have "[p]olicies that require consideration of lower-cost, lower-risk alternatives without documentation or explanation of which, if any, alternatives were actually considered in a recommendation."

Additional report findings (mentioning only variable annuities): On the positive side, "[g]enerally, firms did have restrictions in place, such as [annuity] product concentration as a percentage of [customer] net worth, and certain firms used variable annuity specific forms to document these considerations and provide specific disclosures." On the negative side, however, "multiple firms had no restrictions tied to key features of a variable annuity, like limiting sales to customers with a documented need for a death benefit and/or lifetime income payments," features that the SEC's release adopting Reg BI deemed important in making a best-interest determination. Furthermore, "[w]hile firm supervisory procedures and compliance manuals typically included provisions to address variable annuity recommendations and related sales practice concerns, certain firms failed to include or implement procedures to identify perhaps the biggest sales practice risk of variable annuities: a customer incurring substantial surrender charges as variable annuities are repeatedly replaced." NASAA notes that some firms offering variable annuities "simply did not specifically require agents to consider lower-cost, or lower-risk products." **Disclosure Obligation Findings** NASAA noted that Reg BI's "disclosure obligation" requires that "a broker-dealer, prior to or at the time of [a] recommendation, must provide to [a] retail customer, in writing, full and fair disclosure of all material facts related to the scope and terms of the relationship with the retail customer." NASAA's overall compliance assessment is mixed in that "[f]irms have not enhanced point-of-sale disclosure, but they have devoted significant time, energy, and effort to compliance with Reg BI's Disclosure Obligation by crafting the Form CRS and detailed supplemental Reg BI disclosures, along with disclosure information available via link to the firm's website." At the same time, the report notes a "[f]ailure to disclose the anticipated amount of the up-front sales commission or the material risks associated

with a product at the time of the recommendation, outside of the Form CRS and product prospectus." The report also notes a "[f]ailure to document or require documentation ensuring the delivery of the primary disclosure document or Form CRS to customers." The report finds deficiencies in disclosure language. These include the "[u]se of the term 'advisor' or 'adviser' by dually-registered firms, even for associated persons that are not dually registered as an investment adviser representative and broker-dealer agent" and the "[u]se of confusing boilerplate and complex financial jargon regarding fees and costs that reasonable retail customers would likely have difficulty deciphering." **Conflict of Interest Obligation Findings** Finally, the report notes that Reg BI's "conflict of interest obligation" requires a firm to (i) "establish written policies and procedures to identify and at a minimum disclose, pursuant to the Disclosure Obligation, or eliminate all conflicts of interest associated with [a] recommendation" and (ii) "establish policies and procedures … reasonably designed to mitigate or eliminate certain identified conflicts of interest." The report finds a low level of compliance with this obligation, observing that "[f]irms are still relying on financial incentives to sell CCR products and there is little uniformity in implementing effective firm mitigation strategies." Indeed, according to NASAA, "[t]he only mitigation step in place for a vast majority of firms was limiting the types of customers to whom a product may be recommended." More specific shortcomings include that certain firms had procedures that "did not contain information on how the firm identifies conflicts, nor did the firm have a list of conflicts, such as a conflict register or matrix," and other firms "had no procedures to mitigate conflicts of interest of an associated person potentially recommending a higher commission product and placing their own interest ahead of the customer's interest." **Looking Ahead** The report warns that, "as states begin adopting their own regulations that incorporate Reg BI principles, more will be issuing deficiency letters with specific citations to these regulations and, potentially, bringing regulatory enforcement actions." Moreover, securities and insurance administrators in some states have been adopting such regulations that impose duties that in various respects are significantly more rigorous than those in Reg BI. See "Mass. High Court Plays Wild Card, Upholds Broad Fiduciary Duty for Broker-Dealers," Expect Focus – Life, Annuity, and Retirement Solutions (September 2023). State regulators, therefore, appear poised to play an increasing role in policing firms' conduct in the sale of many types of securities.

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