

New SEC Regulation Defines ‘Best Interest’ Flexibly

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Each Broker-Dealer Can Help Shape Concept Appropriately to Its Business

The SEC’s new Regulation Best Interest (Reg BI) requires broker-dealers to:

- Disclose business practices in dealing with retail customers; and
- Adopt policies and procedures to comply with Reg BI requirements.

Reg BI gives broker-dealers a good bit of flexibility in tailoring their disclosures and business practices. In doing so, each broker-dealer, in effect, will be defining what acting in the customers’ “best interest” means for that broker-dealer. Each broker-dealer will be subjecting itself to legal exposure for failure to comply with its disclosures and policies and procedures.

Some quarters harshly criticized the SEC for not defining “best interest.” For example, SEC Commissioner Robert J. Jackson Jr. voted against the Commission’s adoption of Reg BI. 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.’”

Commissioner Jackson admonished the Commission 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.” He concluded that “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.”

The Commission, however, adopted a requirement that it hadn’t included in its original proposal and that 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 as a whole.” The Commission declared that this requirement “creates an affirmative obligation under the Exchange Act with respect to the rule *as a whole*. ...” (emphasis added).

In adopting the expanded requirement for policies and procedures that are coextensive with the entirety of Reg BI, the Commission 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, each broker-dealer will have to think through what “best interest” means in light of that broker-dealer’s unique business model and articulate the implementation of that standard in terms of specific actions that the broker-dealer must implement and follow.

But at the same time, the Commission has pointed out its authority to second-guess a broker-dealer’s policies and procedures (as well as disclosure) in order to assure compliance with the provisions and objectives of Reg BI as a whole. The Commission has warned that it intends to review broker-dealer policies and procedures “early on, reducing the chance of retail customer harm.” The Commission has said that it will “identify and address potential compliance deficiencies or failures (such as inadequate or inaccurate policies and procedures. ...).”

This regulatory process means that the Commission will measure the adequacy and accuracy of a broker-dealer’s policies and procedures (as well as disclosure) against what the Commission deems to be adequate and accurate. This is a process of comparing what is with what should be in light of each broker-dealer’s particular business model. In determining what should be for a given broker-dealer, the Commission arguably will be establishing the functional equivalent of a “best interest” standard that the Commission stopped short of defining with specificity.

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