# Unpacking the SEC's Regulation Best Interest Package

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**Ann Young Black**


**Richard T. Choi**


**Ann Began Furman**


**Thomas C. Lauerman**

On June 5, 2019, the SEC adopted a four-part regulatory package that includes: new Regulation Best Interest (Reg. BI), the related "Relationship Summary" disclosure form (Form CRS), and two interpretations of the Advisers Act, one on the standard of conduct applicable to investment advisers (IAs) (the IA Interpretation) and the other on the "solely incidental" prong of the broker-dealer (BD) exemption from IA registration. The SEC set June 30, 2020, as the compliance date for Reg. BI and Form CRS. The Advisers Act interpretations, while technically effective on the date of their publication in the Federal Register, purport to "reaffirm" existing interpretations of an IA's fiduciary duties. We address below some of the preliminary questions firms and their legal and compliance staffs may have as they try to unpack the SEC's regulatory package.

How does a BD's standard of conduct under Reg. BI differ from that of an IA?

According to the SEC, a BD's standard of conduct obligations under Reg. BI are "more prescriptive" than an IA's fiduciary duty obligations, which are principles-based. Reg. BI generally requires a BD and its natural associated persons (Associated Persons) to act in their retail customers' best interest and not place their own interests ahead of their customers' interests when recommending securities transactions or investment strategies involving securities (Securities Recommendations). However, this general obligation can be satisfied only by satisfying Reg. BI's four prescriptive component obligations: the "Disclosure Obligation," the "Care Obligation," the "Conflict of Interest Obligation," and the "Compliance Obligation."

The IA Interpretation describes an IA's fiduciary duty as including both a "duty of care" and a "duty of loyalty," both of which it says are encompassed by the "overarching principle" to act in the "best interest" of a client. In other words, according to the SEC, in fulfilling its fiduciary duty to act in the best interest of a client, an IA must satisfy both a duty of care and a duty of loyalty. Although Reg. BI does not describe a BD's best interest standard of conduct to include an explicit duty of loyalty, it does impose obligations that are consistent with an IA's duty of loyalty, such as the following:

| An IA | A BD |
|---|---|
| Must not subordinate its client's interests to its own, i.e., cannot place its interest ahead of a client's interest | Cannot place its own interest ahead of the customer's interest when making a Securities Recommendation |
| Must make full and fair disclosure, in writing, of all material facts relating to the advisory relationship and the capacity in which it is acting, including through the Relationship Summary and the IA's Form ADV brochure | Must, under the Disclosure Obligation, including through the Relationship Summary, disclose the capacity of the BD, material fees and costs that apply, types and scope of services to be provided, including any material limitations on Securities Recommendations |
| Must eliminate or make full and fair disclosure of all material conflicts of interest | Must eliminate or mitigate certain conflicts of interest and make full and fair disclosure of all material facts relating to conflicts of interest |

What standard applies to a dually registered financial professional?

The standard of conduct that applies is based on the nature of the relationship the financial professional will have with the retail investor. The capacity in which the financial professional is acting would be set forth in a Relationship Summary that is delivered to the investor. Reg. BI treats an account recommendation (e.g., advisory or brokerage account) as an investment strategy recommendation. Whether Reg. BI applies, however, would depend on the capacity in which the financial professional is acting. According to the SEC, Reg. BI would not apply, for example, to a dually registered financial professional of a dually registered IA/BD who acts in the capacity of an IA in recommending a fee-based account. In that case, the Advisers Act standard of conduct would apply according to the SEC. This type of line-drawing, however, may present potential difficulties for firms responsible for supervising the activities of their dually registered financial professionals.

For retail customer accounts in existence on or before June 30, 2020, when must firms provide the Relationship Summary?

Firms must deliver their Relationship Summaries to all existing retail investors on an initial one-time basis within 30 days after the date when the firm is first required to file its Relationship Summary through Web CRD (for BDs) and IARD (for IAs).

Will BDs be able to satisfy the Disclosure Obligation by providing the Relationship Summary?

Generally no. The SEC expects that in most instances, BDs will need to provide information beyond that contained in the Relationship Summary (including as reflected in the below Q&A's).

How can a BD make the various disclosures required by the Disclosure Obligation?

The Disclosure Obligation requires full and fair disclosure of various matters to be in writing. That said, the SEC acknowledged the need for flexibility in various situations, such as oral updates to supplement written disclosures with information not reasonably known at the time the disclosures were provided, e.g., disclosures relating to conflicts of interest or the capacity in which a dual registrant is acting. Also, in the case of product-level fees, the SEC would permit "an initial standardized disclosure of product-level fees generally (e.g., reasonable dollar or percentage ranges), noting that further specifics for particular products appear in the product prospectus, which will be delivered after a transaction in accordance with the delivery method the retail customer has selected, such as by mail or electronically."

Must BDs disclose the basis for each Securities Recommendation?

No. The SEC stated in the adopting release for Reg. BI that it did not require BDs to disclose to retail customers the basis for each Securities Recommendation.

Can firms satisfy their disclosure obligations by merely stating that they "may have a conflict of interest"?

Not if a conflict actually exists. In this regard, the IA Interpretation notes that:

> [D]isclosure that an adviser "may" have a particular conflict, without more, is not adequate when the conflict actually exists. ... On the other hand, the word "may" could be appropriately used to disclose to a client a potential conflict that does not currently exist but might reasonably present itself in the future.

Must a BD recommend the least costly or least remunerative security or investment strategy?

No. According to the SEC, merely doing so would not satisfy the Care Obligation. A BD must also evaluate the facts and circumstances of the particular recommendation and the particular retail customer's investment profile. As an example of factors to consider, the SEC noted:

> [P]rior to recommending a variable annuity to a particular retail customer, broker-dealers should generally develop a reasonable basis to believe that the retail customer will benefit from certain features of deferred variable annuities, such as tax-deferred growth, annuitization, or a death or living benefit.

Must a BD conduct an evaluation of every possible investment alternative, either on the firm's platform or outside the firm, such as where the firm only offers proprietary products or a limited range of products?

No. The SEC did not require a BD to recommend the "single 'best' of all possible alternatives that might exist, in part because many different options may in fact be in the retail customer's best interest." In addition, the SEC did not require an Associated Person of the broker-dealer "to be familiar with every product on a broker-dealer's platform." An Associated Person is required "to conduct a review of such reasonably available alternatives that is reasonable under the circumstances" and firms are required to have a reasonable process for establishing and understanding the scope of what reasonably available alternatives would be considered.

Must BDs mitigate or eliminate all "firm-level" financial incentives that could be considered to give rise to a conflict of interest?

No. The SEC decided to allow most firm-level conflicts to be addressed through disclosure.

Must BDs eliminate all sales contests, sales quotas, etc.?

No. The requirement to eliminate sales contests, sales quotas, bonuses, and noncash compensation applies to sales of specific securities or specific types of securities within a limited period, but not to compensation practices based on, for example, "total products sold or asset growth or accumulation, and customer satisfaction." In addition, Reg. BI would not necessarily prohibit BDs from:

- Providing incentives to Associated Persons who may focus their business on general categories of securities (such as variable annuities); or
- Offering proprietary products or a limited menu of products and incentivizing the sale of such products, provided the incentive is not based on the sale of specific securities or types of securities within a limited period of time.

May a BD or its Associated Person offer or recommend only proprietary products or limited product or investment strategy menus?

Yes. However, the BD or Associated Person must disclose material limitations and any related conflicts of interest and must prevent such limitations and conflicts from causing the BD or Associated Person to make Securities Recommendations that place their interests ahead of their retail customers' interests.

Must BDs identify and mitigate certain Associated Person-level conflicts?

Yes. The Conflict of Interest Obligation requires BDs to identify and mitigate conflicts of interest that create an incentive for an Associated Person to place his or her interests or the interests of the firm ahead of the interests of the retail customer. According to the SEC, examples of incentives that need to be addressed include an Associated Person's (i) compensation for services provided and products sold; (ii) employee compensation or employment incentives; and (iii) commissions or other fees or financial incentives or differential or variable compensation.