



SEC Regulation Best Interest Rule

In keeping with the recent string of regulatory changes, on June 5, 2019, the SEC adopted Regulation Best Interest (Reg BI), setting out a series of obligations, all designed to require broker-dealers (BDs) to act in the best interest of their retail customers when making a recommendation. In conjunction with Reg BI, the SEC also adopted Form CRS Relationship Summary (Form CRS), which requires RIAs and BDs to deliver to retail investors a succinct, plain English summary of the relationship and services provided by the firm. It also sets out the required standard of conduct associated with the relationship and services provided. Both Reg BI and Form CRS became effective August 5, 2019, and the SEC is requiring full compliance by June 30, 2020.

Reg BI applies to recommendations made to a “retail customer” (who is a natural person or the representative of such natural person) if that retail customer receives a recommendation of any securities transaction or investment strategy involving securities from a BD or person associated with a BD, and if they then use that recommendation primarily for personal, family, or household purposes which includes retirement accounts, whether to take a distribution from that account, and how to invest said distribution. Reg BI does not include a “qualified investor” exception for the definition of “retail customer.”

GENERAL OBLIGATION

The general obligation created by Reg BI has four component obligations: disclosure, care, avoiding conflict of interest, and compliance. The general obligation requires BDs and their associated persons who are natural persons, when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer (including account recommendations), to act in the best interest of the retail customer at the time the recommendation is made. This general obligation is not intended to require a BD to make conflict-free recommendations; rather, the BD must take steps to reduce or eliminate conflicts that would create an incentive to place the BDs interest above the retail customer’s interest and to make recommendations in the customer’s best interest even where conflicts continue to exist.

Whether the BD has complied with the four component obligations will be determined on a “principles basis” – an evaluation of the facts and circumstances of the particular recommendation and the particular retail customer at the time that the recommendation was made – not in hindsight. The BD will be deemed to have discharged this general obligation by complying with the four component obligations, although complying with the four component obligations does not create a “safe harbor” for the BD. Failure to comply with any of the four component obligations is a violation of the general obligation.

DISCLOSURE OBLIGATION

The disclosure obligation requires a BD, prior to or at the time of the recommendation, to provide in writing to the retail customer full and fair disclosure of all material facts relating to the scope and terms of the relationship with the retail customer, and all material facts relating to the conflicts of interest that are associated with the recommendation. These material facts include:

- That the BD is acting as a BD with respect to the recommendation
- The material fees and costs that apply to the retail customer’s transactions, holdings, and accounts
- The type and scope of services provided to the retail customer, including any material limitations on the securities or investment strategies involving securities recommended to the retail customer

Reg BI states that “material facts” and “material fees and costs” are those with a substantial likelihood that a retail customer would consider them important. A “conflict of interest” is defined as “an interest that might incline a broker, dealer, or a natural person associated with a broker or dealer – consciously or unconsciously – to make a recommendation that is not disinterested.”

CARE OBLIGATION

The care obligation requires that the BD, in making the recommendation, exercise reasonable diligence, care, and skill to:

- Understand the potential risks, rewards, and costs associated with the recommendation, and have a reasonable basis to believe the recommendation could be in the best interest of at least some retail customers
- Have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and potential risks, rewards, and costs associated with the recommendation, and does not place the financial or other interest of the BD (or such natural person making the recommendations) ahead of the interest of the retail customer
- Have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in the light of the retail customer's investment profile, and does not place the financial or other interest of the BD (or such natural person making the recommendations) ahead of the interest of the retail customer

Reg BI added "cost as a consideration; however, although cost will always be relevant to a recommendation and should be a required consideration, the reg points out that costs are not the only consideration. Although the care obligation does not require a BD to document the basis for a recommendation, it may wish to document an evaluation of a recommendation and the basis therefor in certain circumstances, such as in connection with the recommendation of a complex product or where a recommendation may seem inconsistent with a retail customer's objectives on its face.

CONFLICT OF INTEREST OBLIGATION

To satisfy the conflict of interest obligation, the BD must establish, maintain, and enforce written policies and procedures reasonably designed to:

- Identify and, at a minimum, disclose all conflicts of interest associated with such recommendations in accordance with the disclosure obligation, or if possible, eliminate them in the interest of the retail customer
- Identify and mitigate any conflicts of interest associated with such recommendations that create an incentive for an associated person of a BD to place the interest of the BD or such natural person ahead of the interest of the retail customer
- Identify and disclose any material limitation placed on the securities or investment strategies involving securities that may be recommended to a retail customer and any conflicts of interest associated with such limitations, in accordance with the disclosure obligation
- Prevent such limitations and associated conflicts of interest from causing the BD or an associated person to make recommendations that place the interest of the BD, or such associated person, ahead of the interest of the retail customer
- Identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time

Some examples of incentives paid to an associated person that would need to be addressed under the conflict of interest obligation include:

- Compensation from the BD or third parties, including fees and other charges for the services provided and products sold to an associated person of a BD to place the interest of the BD or such natural person ahead of the interest of the retail customer
- Employee compensation or incentives, special awards, differential or variable compensation, and incentives tied to appraisals or performance reviews
- Compensation or sales charges, other fees or financial incentives, or difference or variable compensation (whether paid by the retail customer, the BD, or a third party)

COMPLIANCE OBLIGATION

A BD must establish, maintain, and enforce written policies and procedures designed to achieve compliance with Reg BI as a whole. These procedures must not only address conflicts of interest, but also compliance with the disclosure and care obligations. The BD is required to retain a record of all information collected from the retail customer under Reg BI and to identify the natural person responsible for the account. These records must be retained for at least six years after the earlier of the date that the account was closed or the date on which the information was collected, provided, replaced, or updated.

FORM CRS RELATIONSHIP SUMMARY

The SEC also adopted new rules and forms that require both the BDs and RIAs to provide retail investors with information intended to clarify the relationship through a proposed Form CRS Relationship Summary. The Form CRS will require a Q&A format, and will be subject to page limits and will encourage the use of charts, graphs, and tables. It will feature a combined section that discusses fees, costs, conflicts of interest and standards of conduct. The Form CRS must be delivered by BDs to each new or prospective client before a recommendation, order, or account opening.

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