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SEC Adopts A New Best Interest Standard of Conduct

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Securities firms should begin reviewing their business models and account types to determine if they will be subject to a sweeping investor-protection regulatory regime recently adopted by the Securities and Exchange Commission ("SEC" or "Commission"). This new regulatory regime is primarily incorporated in Regulation Best Interest under the Securities and Exchange Act of 1934 ("Exchange Act"). Firms impacted by the SEC's new regulatory initiatives have slightly more than one year -- June 30, 2020 deadline -- to implement significant disclosure, compliance systems, and training programs.

Below, we summarize generally Regulation Best Interest and considerations of the implications and impact of Regulation Best Interest. In a separate *Alert*, "Triggering Regulation Best Interest: What Are 'Retail Customers' and "Recommendations?'" found here we discuss in more detail the meaning of the key trigger points for applying Regulation Best Interest. That is, Regulation Best Interest will apply to a firm, business unit, or associated person making a recommendation (*i.e.,* registered sales professional) only if a "recommendation" of securities or an investment strategy is made to a "retail customer." Regulation Best Interest expressly defines "retail customer" generally to mean a natural person or a legal representative of a natural person who receives a securities or investment strategy recommendation for personal, family, or household use. Regulation Best Interest does not define "recommendation," but instead relies on longstanding legal and industry interpretations.

Key takeaways are, as follows:

- Regulation Best Interest does not change traditional commission or transaction-based compensation structures for broker-dealers.
- Regulation Best Interest introduces a more fulsome disclosure regime on the retail brokerage industry than what has previously been the case.
- Regulation Best Interest will require a closer look at sales contests and other incentive programs because conflicts management expressly requires the elimination of sales contests and other incentive programs that are based on sales of specific securities or specific types of securities within a limited period.
- Regulation Best Interest applies a duty of care at the time of a recommendation, and does not require ongoing account monitoring.
- Regulation Best Interest will apply to recommendations to high net-worth individuals, family trusts administered by "non-professional legal representatives," family offices relying on an exclusion from investment adviser registration, and plan participants of defined contribution retirement plans. It also applies to recommendations of investment strategies, which include recommendations of account types, such as individual retirement account rollovers, college-tuition savings accounts, and advisory accounts.

What is this new regulatory regime?

The SEC adopted a new standard of conduct for broker-dealers and their registered sales professionals, codified in Regulation Best Interest [17 C.F.R. §240.15*l*-1]. This rule requires firms and their registered sales professionals to act in the "best interest" of their "retail customers" and prohibits them from placing their interests ahead of the customer's interests when making a recommendation of securities and/or investment strategies. In short, Regulation Best Interest requires firms to: (i) act in the best interest of customers; (ii) clearly disclose the nature of the customer relationship; (iii) observe a standard of care when making recommendations; (iv) manage conflicts of interest through disclosure or, if disclosure is insufficient, mitigate or eliminate them; and (v) establish a supervisory system reasonably designed to comply with Regulation Best Interest.

Key to the application of Regulation Best Interest is the meaning and scope of a "retail customer" and "recommendation," each of which is discussed in more detail here. Regulation Best Interest is not a safe harbor, but a mandatory set of prescriptive rules to determine if a firm and its registered sales professionals have acted in a retail customer's best interest.

Separately from the adoption of Regulation Best Interest, the SEC adopted a disclosure regime that requires a succinct and short-form "relationship summary," as directed by Form CRS.[1] The requirement to deliver Form CRS applies to broker-dealers and investment advisers serving retail customers. In addition, the SEC published formal interpretative guidance on the scope of the broker-dealer exclusion from the definition of investment adviser in the Investment Advisers Act of 1940 ("Advisers Act") to the extent a firm conveys advice that is solely incidental to brokerage. **Importantly, the SEC's interpretation of the "solely incidental" element of the broker-dealer exclusion from investment adviser regulation extends to firms engaged in an institutional business. It is not limited to retail brokerage firms.**

Finally, the SEC published formal interpretative guidance as to the fiduciary duties owed by investment advisers to their clients.

What does "best interest" mean?

The SEC did not legally define the term "best interest." In short, broker-dealers and their registered sales professionals cannot place their own interests ahead of the retail customer's interest when making recommendations. Rather than define best interest, the SEC codified four elements necessary to satisfy the best interest standard, as follows: a duty of full and fair disclosure, duty of care, conflicts management, and a formalized compliance program. If these four elements are satisfied, the best interest standard of care is deemed to be met. The best interest standard is intended to enhance current standards of conduct applicable to the brokerage industry, such as the duty of fair dealing, observance of just and equitable principles of trade, best execution, and suitability, each of which has historically applied to broker-dealers and their registered sales professionals. A best interest standard, however, is not a fiduciary standard, although (according to the SEC) best interest principles are derived from fiduciary principles established under the Advisers Act.

[1] 17 C.F.R. §240.17a-14; and 17 C.F.R. §249.640.

Notably, Regulation Best Interest does not mean that a broker-dealer is prohibited from charging commissions or other transaction-based charges, receiving differential compensation or forms of revenue sharing from third parties (*e.g.,* mutual funds/fund sponsors), engaging in principal transactions, limiting product line-ups, or offering proprietary products. These potential conflicts, some of which the SEC expressly concluded were inherent in a brokerage relationship, must instead be disclosed and managed.

Is the duty of "best interest" merely "fiduciary lite" and, therefore, functionally creating an advisory relationship between a retail customer and a broker-dealer?

The SEC emphasized the benefits of, and declined to overhaul, the traditional brokerage relationship. The SEC emphasized that Regulation Best Interest is intended to balance customer protection, on one hand, with preserving customer choice and investment options, on the other. Thus, Regulation Best Interest is not intended to require modification or the elimination of the retail brokerage relationship, including the traditional "pay-as-you-go" commission model. Furthermore, Regulation Best Interest applies "before or at" the time of a recommendation, not on a continuing basis. Thus, it does not impose mandatory and ongoing account monitoring obligations in the way a fiduciary duty of loyalty would. Consequently, application of Regulation Best Interest does not mean broker-dealers and their registered sales professionals are acting in a fiduciary capacity when making recommendations.

Of course, it remains to be seen if the SEC has struck the balance between customer protection and investment choice particularly in the case of high net-worth individuals, and whether certain customer relationships may be transitioned to an advisory arrangement or whether complex or illiquid investment products may be less available to high net-worth individuals or other retail customers.

Who is and who is not generally impacted by these rules?

Retail Brokerage Business: Regulation Best Interest will apply to a brokerage firm or business unit where registered sales professionals solicit orders or recommend securities (including account types and rollovers) or investment strategies to retail customers. Additionally, a firm that is subject to Regulation Best Interest (and its registered sales professionals) could not use any form of "adviser" or "advisor" in its name or title unless the firm was also registered as an investment adviser ("dual registrant") or registered as a municipal advisor or commodity trading adviser, or some other very unique circumstances existed justifying the name or title. The firm's professionals seeking to use these terms (*e.g.,* "financial advisor") could not permissibly do so unless they are giving advice as a supervised person of an investment adviser or there is another basis to use the title.

Execution-Only Business: Regulation Best Interest will not apply to firms or business units that engage solely in a discount brokerage/execution-only business where customers direct orders and are not solicited, and recommendations of securities or investment strategies are not otherwise made. It also will not apply to a firm that executes at the customer's request even though the customer direction was contrary to a previous recommendation.

Alternative Trading System: An alternative trading system, or "ATS," is a registered broker-dealer that brings purchasers and sellers of securities for purposes of trading in an alternative marketplace to a securities exchange. If an ATS has subscribers that are institutional only, it would not have "retail customers" and Regulation Best Interest would not apply, without the need to assess whether holding out the trading venue and the posting of quotes is somehow a tacit "recommendation" or call to action to invest. Conversely, an ATS that may include retail customers as subscribers would need to assess the functionality of the ATS to ensure that it is not "recommending" securities before determining if Regulation Best Interest would or would not apply.

Clearing Firms: Clearing firms perform the back-office functions of securities clearance and settlement for other financial intermediaries that introduce customer accounts on a fully disclosed or an omnibus basis. In the case of a fully disclosed arrangement, a customer of an introducing firm is deemed to be a customer of the clearing firm, but only for purposes of SIPC coverage and no other purpose, including presumably for purposes of Regulation Best Interest since the customer and the clearing firm would not be expected to interact. The same would apply to omnibus arrangements. Self-clearing firms, on the other hand, may be subject to Regulation Best Interest if they make recommendations to retail customers in addition to clearing and settling customer securities transactions.

Institutional Business: Regulation Best Interest does not apply to firms or business units that engage in an institutional-only business even if the business is solicited or recommendations are made; however, high net-worth individuals are not treated as "institutional" business for purposes of Regulation Best Interest, even though rules of the Financial Industry Regulatory Association ("FINRA") treat eligible accounts of high net-worth individuals as institutional for certain suitability and advertising purposes. We discuss the distinction between institutional clients and retail customers and the particular cases of family trusts, family offices, and other client relationships in "Triggering Regulation Best Interest: What Are 'Retail Customers' and "'Recommendations?'" here.

Wholesale Business: A firm or business unit that conducts a "wholesale" business is not subject to Regulation Best Interest to the extent no recommendations of securities or investment strategies are made to retail customers. Generally, a wholesale firm markets proprietary securities products to other financial intermediaries, such as banks, insurance companies, investment management firms, or other securities firms in order to secure space on the intermediaries' investment platforms or as part of a menu of products that these intermediaries, in turn, will recommend to their customers. Typically, a wholesaler will not engage with the end-user investor or, if it does, it will do so solely for "educational" purposes. We discuss in more detail the distinction between investor interactions that are "educational" and interactions that are "recommendations" in "Triggering Regulation Best Interest: What Are 'Retail Customers' and "'Recommendations?'" here.

Fund Principal Underwriter: Mutual funds and funds dedicated to variable insurance products engage the services of broker-dealers as "principal underwriters" or "distributors." These firms are disclosed in a fund's registration statement and would be "statutory underwriters" as a result, but certain of these firms do not typically engage in direct sales or direct marketing efforts with the investing public. With such a limited business, they have not historically been subject to FINRA's suitability obligations insofar as these firms conduct the limited roles of serving as statutory underwriter and approving fund sales materials and advertising. They do not typically target specific groups of investors for fund investment or make recommendations of fund shares to specific investors. As a result, they should also not be subject to Regulation Best Interest on the theory that disclosure of the firm's principal underwriter capacity in a registration statement alone is not a "call to invest" (*i.e.*, a recommendation). Their status as the "broker of record" on a fund's books for fund-direct accounts for purposes of receiving "12b-1 fees" for distribution may have different implications for Regulation Best Interest. The status of principal underwriters under Regulation Best Interest in light of their varying business models, however, may need greater clarity from the Commission staff in the form of an FAQ, interpretative guidance, or no-action position.

Placement Agent Business: Placement agents offer and sell securities in unregistered offerings exempt from registration under the Securities Act of 1933 ("1933 Act"). These offerings can be for operating companies or they can be for private investment funds, such as hedge funds, private-equity funds, real estate investment funds, or venture capital funds whose offerings are not registered pursuant to the 1933 Act and, in the case of fund offerings, the funds themselves are not registered as investment companies pursuant to exclusions from the Investment Company Act of 1940. Notably, the Commission did not exempt from the definition of "retail customer" high net-worth individuals based on their status as "accredited investors," "qualified clients," and/or "qualified purchasers," each of which has traditionally been used as a proxy for investor sophistication and knowledge. Thus, the extent to which a placement agent is subject to Regulation Best Interest depends on the types of investors eligible to invest in an unregistered offering. For example, a placement agent that only conducts business with "qualified institutional buyers" in transactions structured in reliance on Rule 144A under the 1933 Act would not be subject to Regulation Best Interest because QIBs are not natural persons or constructs that otherwise promote investing for personal, family, or household purposes. In contrast, fund raising from high net-worth individuals would trigger application of Regulation Best Interest, irrespective of their eligibility as accredited investors, qualified clients, and/or qualified purchasers, if investments are made for a non-commercial or non-business purpose.

Dual Registrant (Advisory Capacity): The Commission refers to "dual registrants" for purposes of Regulation Best Interest as firms that are registered as both broker-dealers and investment advisers. Regulation Best Interest does not apply to a dual registrant acting in an advisory capacity. In this case, the customer interaction is subject to well-established fiduciary standards for investment advisers. The Commission noted that a dual registrant acting as adviser would not be subject to Regulation Best Interest, even if its trading desk performed executions of securities transactions to implement the advice. Additionally, a dual registrant could permissibly have the term "adviser" or "advisor" as part of its name (and its advisory representatives who act in an advisory capacity as "supervised persons" could use titles, such as "financial advisor").

Dual Registrant (Brokerage Capacity): Regulation Best Interest will apply to a dual registrant that makes recommendations of securities or investment strategies to retail customer through brokerage accounts, in contrast to advisory accounts or programs. Furthermore, registered sales professionals who are not also "supervised persons" acting in an advisory capacity could not permissibly use titles containing "adviser" or "advisor" as part of the title.

Wrap Business: Generally, wrap accounts bundle investment advice, securities execution, and custody into a single account for a wrap fee. The actual securities recommendations for the account constitute advice and are typically handled by the sponsoring investment adviser subject to duties and requirements of the Advisers Act, while execution is handled by a broker-dealer participating in the program. The executing broker-dealer may also market the wrap program to its retail customers. The Commission generally interpreted investment strategies to include "account types" that, if recommended to a retail customer, would be subject to Regulation Best Interest. Although the Commission did not expressly identify wrap programs as an "account type" for this purpose, wrap accounts presumably would appear to be an investment strategy given the breadth of the SEC's interpretation. Thus, if offered to a retail customer by a participating broker-dealer, the recommendation of the account could be subject to Regulation Best Interest at the time of the recommendation, even though all underlying securities recommendations and investment strategies are actually made by the investment adviser subject to the adviser's fiduciary duty and extensive disclosures relating to, among others, the risks and suitability of a wrap account. Even more anomalous, if the wrap program is sponsored by a dual registrant, Regulation Best Interest will not apply on the theory that the dual registrant is acting in an advisory capacity and, based on the Commission's own views that, its execution activities related to the program do not change the firm's advisory capacity. Because of the unique characteristics of wrap accounts, greater clarity from the SEC staff in the form of an FAQ, interpretative guidance, or no-action position may be necessary before subjecting wrap accounts to, or excluding them from, Regulation Best Interest.

Financial Planning Business: Broker-dealers provide financial planning to retail customers in which they recommend securities or investment strategies, and may or may not execute transactions in furtherance of the financial plan. Financial planning firms or business units generally are able to give solely incidental investment advice without having the status of an investment adviser in reliance on an exclusion from the Advisers Act, provided that the advice is incidental to a brokerage business and no "special compensation" is paid. Because these firms are not investment advisers, Regulation Best Interest would apply to firms or business units that provide financial planning services. The Commission published an interpretative release addressing advice that is solely incidental to brokerage at the same time it adopted Regulation Best Interest. Consideration of this interpretation will be necessary to assure that financial planning advice may continue to be conducted through a broker-dealer arrangement rather than an advisory relationship. Registered sales professionals who are Certified Financial Planners ("CFPs") are separately subject to a Code of Ethics and Standards of Conduct ("Code"), which was revised in March of last year and set to go into effect on October 1, 2019. Among several material changes to the Code is a broadened and heightened fiduciary duty that will require CFPs to act as a fiduciary, including the duty of loyalty, and therefore, in the best interests of the customer, at all times when providing "financial advice," a term which encompasses financial planning. Thus, one relevant question is whether compliance by CFPs with Regulation Best Interest will constitute compliance with the revised Code.

Funding Portals: Funding portals facilitate the crowdfunding of securities offerings that are exempt from registration pursuant to 1933 Act statutory exemptions and crowdfunding rules that require broker-dealer and funding portal intermediaries to participate in a crowdfunded offering. These offerings must be of limited size and are often offered to retail investors online. Because funding portals are not permitted to make recommendations, Regulation Best Interest does not apply to them. Broker-dealers, on the other hand, that act as crowdfunding intermediaries will need to assess their activities in crowdfunded offerings to determine if their intermediation is with "retail customers" and if their participation constitutes a "recommendation."

What must a firm do if its business is subject to Regulation Best Interest?

A firm subject to Regulation Best Interest must have a compliance program in place by June 30, 2020. Although this new regulatory regime does not specifically require a designation of a "best interest compliance officer," the compliance duties appear to be significant. This would include establishing and implementing policies and procedures that address compliance with Regulation Best Interest generally and with disclosure, duty of care and conflicts management specifically. That is, the procedures must address the firm's and registered sales professionals' duties to act in the best interest of a retail customer at the time of a recommendation <u>and</u> not place the firm's or registered sales professionals' financial or other interests ahead of the retail customer's interests.

If a firm sponsors sales contests or other incentive programs based on sales, the firm will need to review them in light of their ongoing consistency with Regulation Best Interest.

Disclosure

In the words of the Commission, Regulation Best Interest imposes a "more explicit and broader disclosure obligation" on broker-dealers than what has previously existed. In this regard, broker-dealers must make "full and fair" written disclosure of all material facts regarding the scope and terms of the customer relationship. The following are highlights of this duty:

- **<u>Mandatory Items of Disclosure</u>.** The disclosure must expressly disclose: (i) that the recommendation is being made by a broker, dealer, or an associated person of a broker-dealer (*e.g.,* capacity); (ii) applicable material fees and costs; (iii) the type and scope of the brokerage services including material limitations on the investment products or strategies recommended; and (iv) material facts about conflicts of interest in connection with a recommendation.
- **<u>Separate Disclosure Regime</u>.** Regulation Best Interest disclosure requirements are separate from other disclosure requirements under the federal securities laws, such as trade confirmation disclosure, prospectus disclosure, and the new customer relationship summary required by Form CRS, although each of these disclosure documents can form the basis for complying, in part, with the Regulation Best Interest disclosure requirements. Thus, firms will need to assess the mediums of disclosure and how they will interact for compliance purposes, such as what could be covered in, or supplemented by, the account agreement, other account-opening documentation, customer relationship summary, trade confirmation, and/or prospectus versus what disclosure may need to be more particularized and delivered potentially at the "point of sale," such as particularized conflicts applicable to the characteristics of a specific transaction.
- **<u>Disclosure Can Be Standardized</u>.** Disclosure can be standardized in the sense that certain material facts are likely to be universal and disclosed in a single document delivered at one time before or at the time of a recommendation. The Commission noted, however, that more particularized disclosure may be necessary if the material facts regarding a particular recommendation cannot be disclosed via standardized disclosure.

This raises the question whether "point-of-sale" disclosures may be required under certain circumstances. Disclosures, such as potential "point-of-sale" disclosures, may be made orally because of the exigencies of a transaction, if other pre-existing disclosure has clarified or other written disclosure will supplement the oral disclosure.

- **Minimum Account Size and Low-Balance Accounts.** Conditions of minimum account size to open or maintain an account or fees assessed for low account balances are material facts that must be disclosed and are presumably best set forth in an account agreement.
- **Fee and Account Disclosure Need Not Be Individualized.** Fees and cost disclosure can be standardized and stated as a percentage or range of fees generally, rather than depicted in specific amounts, with a transaction confirmation or a prospectus disclosing in more specificity fees and costs associated with a particular recommendation. Remuneration paid to the broker-dealer also would need to be part of the conflicts of interest disclosure regime. This would need to include the types and sources of remuneration paid at the firm level, and could also be standardized, provided it sufficiently explained the conflicts the form and/or source of compensation create.
- **No Express Updating Requirements.** Regulation Best Interest does not prescribe a specific time for updating the uniform disclosure; however, we recommend an annual review and immediate updates, such as a 30-day update, where a firm's business changes or events make disclosure materially inaccurate or incomplete.
- **"Adviser/Advisor" Titles.** The use of the term "adviser" or "advisor" as part of the firm's name or registered sales professionals' title, absent a dual registrant or business as a municipal or commodity trading advisor, or other extremely unique circumstances is presumed to violate the disclosure obligation of Regulation Best Interest, and potentially evidence that the firm is holding itself out as an investment adviser without registration as such. Thus, firms may need to consider the rebranding issues raised if they have any form of the term "adviser" or "advisor" in their name or as descriptive of their registered sales professionals' job titles.

Duty of Care

A broker-dealer and its registered sales professionals must exercise reasonable diligence, care, and skill when recommending securities and/or investment strategies to retail customers, such that they understand the risks, rewards, and costs of a recommendation generally (*i.e.*, reasonable basis to believe the recommendation is in the best interests of some retail customers), specifically (*i.e.,* reasonable basis to believe that the recommendation is in the best interests of a particular retail customer in a particular transaction based on the customer's investment profile), and cumulatively (*i.e.,* reasonable basis to believe a series of transactions is in the best interest of the retail customer collectively). Neither a broker-dealer nor its registered sales professionals may permissibly place their interests ahead of the customer's interest. The following discusses certain aspects of the duty of care:

- **Does Not Require the Lowest Cost Investment.** Although cost is an essential factor in assessing the duty of care, it is not the sole factor. Thus, the duty of care does not restrict recommendations to the lowest cost or least remunerative investment option. Indeed, if a firm solely considered cost, without looking at other qualitative factors to confirm a recommendation was in the best interest of the retail customer, the firm or its registered sales professional could violate the duty of care.

- **Assessment Must Review Qualitative and Quantitative Factors.** Like the duty of best execution, the execution of the duty of care requires an evaluation of cost (quantitative) and other qualitative factors that should weigh in the customer's best interest. Thus factors, such as investment objectives, product characteristics, liquidity, volatility, performance, expected returns, and firm reputation, may permissibly factor in the recommendation apart from merely looking at cost or the least remunerative product to the broker-dealer or registered sales professional. Although Regulation Best Interest does not prescribe transaction documentation requirements (apart from what is already required), firms may consider making a contemporaneous record of transactions where qualitative factors weighed in recommending an investment that was not the least expensive to the retail customer or otherwise permissibly deviates from the customer's investment profile.
- **Risky or Complex Products.** The duty of care does not *per se* prohibit risky or complex products but may impose a higher level of review and assessment of their compatibility with the best interests of a retail customer both generally and specifically as to the customer's investment profile. The SEC identified specific products in this context, such as inverse or leveraged-exchange traded products, penny stocks, and variable insurance products as potentially being risky or complex. Although Regulation Best Interest does not prescribe transaction documentation requirements (apart from what is already required), firms may consider making a contemporaneous record of the decision to recommend risky or complex investments.
- **Recommendations Must Be Informed.** The care obligation requires recommendations that are informed. That is, a firm and its registered sales professionals must obtain enough information about the product to understand its features and risks and obtain sufficient information to formulate a customer investment profile in order to tailor a recommendation that is informed and reasonable under the circumstances. This obligation should not effectively add anything new, inasmuch as FINRA's current suitability rule, Rule 2111(a), requires a customer investment profile that tracks precisely Regulation Best Interest. Like in the suitability context, a firm should not proceed with a recommendation where a customer has failed to convey sufficient information for the firm or its registered sale professional to formulate a customer investment profile.
- **Assessment of Alternatives.** Regulation Best Interest does not require a firm or its registered sales professionals to recommend the "best alternative" or, in the case of a diverse firm offering an extensive menu of products, all alternatives on the firm's approved product list. A firm that offers a limited product line-up or proprietary products only, although not *per se* prevented from doing so, should consider disclosure of the effects these limitations will have on assessing reasonable alternatives for recommendation so that a retail customer can give informed consent to the potential conflict.
- **Assessments of a Series of Transactions.** A firm cannot apply its duty of care solely to a single transaction if it recommends a series of transactions. The series of transactions must collectively be in the best interest of the retail customer to distinguish from impermissible churning where recommendations were designed to generate revenues for

the firm or income for the registered sales professional. For these purposes, a firm's policies should consider turnover rate, cost-to-equity ratios, and other measures as guideposts for determining the permissibility of a series of recommended transactions.

Management of Conflicts of Interest

According to Regulation Best Interest, a firm manages its conflicts of interest by establishing written policies and procedures that are reasonably designed to identify and disclose conflicts of interests with retail customers. Conflicts that cannot be disclosed or mitigated must be eliminated. For example, the SEC cited the case of a recommendation of the "same securities" where a recommendation of the more expensive alternative would violate Regulation Best Interest because the conflict could not be mitigated. The firm's policies and procedures also must be reasonably designed to identify and mitigate conflicts that create incentives for registered sales professionals to place the firm's or their interests ahead of a retail customer's interests. If limitations exist that materially affect recommendations, firms must disclose the material limitations, such as offering only proprietary or a limited range of investment products, and prevent interests associated with those limitations from taking priority over a retail customer's interests. Incentive programs, such as sales contests, that are based on sales of specific securities or types of securities within a discrete period must be eliminated entirely.

- **Components of a Conflicts Management Oversight Program.** The Commission offered specific elements of a system of oversight bearing on the reasonableness of a firm's policies and procedures to identify and disclose and/or mitigate or eliminate conflicts of interest. Effective policies would need to memorialize the process by which the firm identifies and handles conflicts. They should include a system of monitoring and escalating conflicts, as well as assign responsibility for review of compensation structures and violations of conflicts management. They should prescribe a schedule of review (*e.g.*, annually or as business evolves), testing, and training and, for noncompliance, ways of remediation.
- **Compliance with FINRA's Supervisory Rules Does Not Ensure Compliance with Regulation Best Interest.** Regulation Best Interest does not prescribe a safe harbor assuring compliance because a firm complied with other conflicts oversight requirements prescribed by FINRA or other law.
- **Incentives to Registered Sales Professionals.** A firm's system of conflicts management would need to address the types of compensation paid to its registered sales professionals in order to address disclosure and, if necessary, mitigation. Thus, mitigation might avoid payment schemes that favor one product or product type over another and focus more on revenue generation over an extended period as a measure of performance and productivity.
- **Sales Contests and Other Incentive Programs.** Firms will need to carefully review any existing incentive programs, such as sales contest, sales quotas, prizes, or bonuses to determine if they must be eliminated. Regulation Best Interest requires the elimination of incentive programs that target specific securities or specific securities types for a discrete period, such that they could foster high-pressure sales tactics. The SEC clarified that the prohibition on incentives, however, would not extend to compensation payments tied to total production, asset growth, or customer satisfaction that would be common rewards

for performance and productivity over an extended period. This may be an area needing greater clarification in light of FINRA's non-cash compensation rules.

Compliance

A Regulation Best Interest compliance program would need to address disclosure obligations, frequency of review of disclosures, the process by which conflicts are identified, disclosed, and mitigated or eliminated, and training. A firm's annual report should address the testing and certifications of compliance with Regulation Best Interest all as part of a firm's overall duties of supervisory controls under FINRA rules.

For firms that are impacted by Regulation Best Interest, what is the effect on any continuing suitability obligations?

In the proposing release to Regulation Best Interest, the SEC stated that the duty of care requirement "*incorporates* and enhances" FINRA's suitability requirements. In the adopting release, however, the SEC stated that the duty of care merely enhances the suitability duty and did not expressly state that the duty of care incorporated or replaced FINRA's suitability rules in the case of recommendations to retail customers. Thus, how suitability continues to apply to retail customers subject to Regulation Best Interest is unclear, although it would appear that compliance with the duty of care in Regulation Best Interest should mean that a recommendation to a retail customer is *per se* suitable for purposes of FINRA rules. Furthermore, FINRA will need to address Regulation Best Interest's different treatment of certain high net-worth individuals. High net-worth individuals are "retail customers," if they receive a recommendation and their investments are for personal, family, or household purposes. For purposes of FINRA rules, certain high net-worth individuals are treated as institutional investors to the extent they have account assets of $50 million or more. The effect of Regulation Best Interest on any remaining vestiges of suitability likely will be a topic needing, and probably receiving, greater clarity from the SEC staff and FINRA.

What liability exposure does Regulation Best Interest impose?

Regulation Best Interest imposes a negligence standard, not a standard of strict liability. The SEC noted that Regulation Best Interest establishes no private rights of action or *new* rescission rights, although the rescission rights long established by Section 29(b) of the Exchange Act before Regulation Best Interest presumably would continue to be available for transactions in violation of Regulation Best Interest. Regulation Best Interest does, however, establish a standard of care that could be used as a basis for private lawsuits for breaches of contract or suits in common law.

Can states impose their own standards of care aside from Regulation Best Interest?

Regulation Best Interest has no express preemption provision. States, therefore, may impose their own standards of conduct. This issue of fragmentation has been a stated concern for the industry. That is, Regulation Best Interest sets the standard of conduct at the federal level, but is not necessarily the last word at the local level. States could establish a standard of conduct that is higher and with more substantive obligations than Regulation

Best Interest. For instance, in January of this year the Nevada Securities Division released its proposed fiduciary duty regulations, which states that a broker-dealer or its sales representatives will owe a fiduciary duty to customers if it: (i) provides investment advice to customers; (ii) manages assets; (iii) performs discretionary trading; or (iv) otherwise establishes a fiduciary relationship with customers. Investment advice under the Nevada proposal is defined to include the types of recommendations that have long been given by broker-dealers and that would be subject to Regulation Best Interest.

The Commission did not expressly address preemption when it adopted Regulation Best Interest, although Commissioner Jackson all but invited states to adopt their own separate standards in an impassioned dissent to the adoption of Regulation Best Interest. A little more than one week after the SEC adopted Regulation Best Interest, the Commonwealth of Massachusetts, Securities Division issued a preliminary solicitation for public comments related to fiduciary conduct standards for broker-dealers, sales agents, investment advisers, and investment adviser representatives.[2]

We expect to issue additional *Alerts* discussing specific matters implicated by Regulation Best Interest as well as the other matters addressed at the June 5th open meeting: Form CRS, the solely incidental interpretation under the Advisers Act, and the investment adviser fiduciary duty interpretation. Please refer to the K&L Gates Hub for these additional *Alerts*.

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[2] http://www.sec.state.ma.us/sct/sctfiduciaryconductstandard/fiduciaryconductstandardidx.htm