

BENEFITS LAW JOURNAL

Regulation Best Interest: You May Be More Prepared Than You Thought

Kristina M. Zanotti

From the time it was finalized on April 6, 2016,¹ until the Fifth Circuit's decision to vacate it on March 15, 2018,² many brokers, investment advisers, and other financial institutions took significant steps to prepare for full compliance with the Department of Labor's (DOL) Fiduciary Rule³ and the related Best Interest Contract (BIC) Exemption.⁴ If fully implemented, the DOL Fiduciary Rule could have significantly changed how investment advice was provided to retirement plan clients, but, before its transition period was over, the Fifth Circuit stepped in and vacated the rule. Those entities implementing changes to prepare for full compliance were now faced with decisions: did everything done get unwound? Were all their preparation wasted? And complicating factors even further, what action would the Securities and Exchange Commission (SEC) take?

On June 5, 2019, the SEC adopted Regulation BI (the BI stands for Best Interest)⁵ along with a new disclosure form, Form CRS (for Customer Relationship Summary).⁶ In addition, the SEC issued two new interpretations under the Investment Advisers Act of 1940, one regarding the fiduciary standard of conduct for investment advisers⁷ and the other regarding the "solely incidental" prong

Kristina M. Zanotti is a partner in the investment management practice group at K&L Gates LLP. She is based in the DC office. Her practice concentrates in the ERISA fiduciary and derivatives practice areas.

of the broker-dealer exclusion from the definition of investment adviser.⁸ This article focuses on Regulation BI.

Broker-dealers and natural persons who are associated persons of a broker or a dealer (such as registered representatives) (collectively, “broker-dealers,” unless otherwise indicated) must comply with Regulation BI by June 30, 2020.

When considering the new requirements under Regulation BI, broker-dealers may be pleased to learn that not all of their work preparing to implement the now defunct DOL Fiduciary Rule has gone to waste. While not the same, Regulation BI has some of the same principles, and some of the same preparation done to prepare for the DOL Fiduciary Rule translates well into compliance with Regulation BI. Although the DOL Fiduciary Rule technically only applied to retirement plans, many market participants intended to implement compliance more broadly, as it would be difficult to maintain different structures for retirement customers versus taxable accounts. Regulation BI applies to all accounts for retail customers, whether retirement or otherwise.

A “retail customer” means a natural person, or the legal representative of a natural person,⁹ who receives a recommendation regarding a securities transaction or investment strategy from a broker-dealer and who uses the recommendation primarily for personal, family, or household purposes. Unlike Financial Industry Regulatory Authority (FINRA) rules, which define a natural person with total assets of at least \$50 million as having an “institutional” account,¹⁰ Regulation BI does not have a wealth-based exclusion from the definition of retail customer. Regardless of the total amount of assets, a natural person using a securities recommendation primarily for personal, family, or household purposes would be considered to have a “retail” account. Individual retirement accounts (IRAs), 401(k)s, and other participant-directed retirement plans are considered accounts for retail customers, as saving for retirement is a “personal, family or household” purpose.¹¹

Regulation BI requires broker-dealers to act in the best interest of retail customers when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations such as recommendations to roll over assets). This includes making such recommendation without placing the financial or other interest of the broker-dealer making the recommendation ahead of the interest of the retail customer. If the broker-dealer complies with four obligations in connection with making the recommendation, Regulation BI considers the best interest obligation satisfied.

1. **Disclosure obligation.** The broker-dealer must provide the retail customer full and fair disclosure, in writing, of all material facts relating to the scope and terms of the relationship with the retail customer, including the broker-dealer's role in providing the recommendation and scope of services, applicable fees and costs, and conflicts of interest. The SEC also indicated that the use of the terms "adviser" or "advisor" by a broker-dealer that is not also a registered investment adviser or a supervised person of a registered investment adviser would violate Regulation BI's disclosure obligation.
2. **Care obligation.** The broker-dealer must exercise reasonable diligence, care, and skill to understand the potential risks, rewards, and costs associated with the recommendation. Not only must the broker-dealer have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers but the broker-dealer must also have a reasonable basis to believe that the recommendation is in the best interest of the particular retail customer, based on the customer's investment profile and the potential risks, rewards, and costs associated with the recommendation. If the recommendation relates to a series of transactions, the broker-dealer must have a reasonable basis to believe that such series is not excessive and is in the retail customer's best interest when taken together. In each case, the broker-dealer cannot place its own financial or other interest ahead of the interest of the retail customer.
3. **Conflict of interest obligation.** The broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to identify and disclose, or eliminate, all conflicts of interest associated with its recommendations. This includes:
 - Identifying and mitigating any conflicts that create an incentive for a person associated with a broker-dealer, such as a registered representative, to place the broker-dealer's interest ahead of the interest of the retail customer.
 - Identifying and disclosing any material limitations placed on the recommendations that may be made to the retail customer—such as if recommendations are limited to only proprietary products—and any associated conflicts those limitations may have. The broker-dealer must prevent such limitations and associated conflicts from causing the

broker-dealer from placing its own interest ahead of the interest of the retail customer.

- Identifying and eliminating any sales contests, sales quotas, bonuses, and noncash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time.
4. **Compliance obligation.** In addition to the written policies and procedures specifically designed to address conflicts of interest, the broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to comply with Regulation BI as a whole.

A number of common steps that financial institutions, including broker-dealers, were taking to prepare for the DOL Fiduciary Rule translate well into compliance with the obligations imposed by Regulation BI, including the following:

1. **Best interest verification.** To comply with the DOL Fiduciary Rule, many financial institutions prepared “best interest checklists” or other tools to evaluate an investor’s profile and verify that a recommendation was in the best interest of the customer. Don’t throw out those checklists! These or similar tools may be useful in complying with Regulation BI’s care obligation and documenting such compliance.
2. **Written policies and procedures.** In preparation for compliance with the DOL Fiduciary Rule and related BIC Exemption, financial institutions were expected to adopt policies and procedures reasonably designed to mitigate conflicts of interest. These policies and procedures can be adapted and expanded to cover the policies and procedures required by Regulation BI.
3. **Conflicts of interest.** The DOL Fiduciary Rule focused financial institutions on identifying, disclosing, and mitigating or eliminating conflicts of interest, and that same focus continues as an important component of Regulation BI.
4. **Compensation.** Preparing for compliance with the DOL Fiduciary Rule and BIC Exemption caused many financial institutions to examine their compensation structures, particularly the same types of high-pressure sales contests that would need to be eliminated under Regulation BI. In addition, while Regulation BI does not require broker-dealers to change their traditional

compensation structures, allowing them to continue to receive commissions or transaction-based compensation (the types of compensation that would have required exemptive relief if broker-dealers were fiduciaries under ERISA under the defunct DOL Fiduciary Rule), Regulation BI continues the broader focus on fee transparency, requiring full disclosure of costs and fees.

5. **New products.** The DOL Fiduciary Rule spurred the creation of new products and share classes, such as “clean” shares. The continuing focus on investment cost as an important, although not the only, factor means that products with greater fee transparency and lower cost are likely to survive and may become even more prominent as broker-dealers make recommendations designed to comply with Regulation BI.

Rulemaking in the standards of conduct/fiduciary area may not be finished. DOL still has the issue on its agenda with a potential release date for proposed rulemaking slated for December 2019. Upheaval at DOL, with Secretary of Labor Acosta’s resignation and his replacement by Eugene Scalia leaves the timeline for any rebooted DOL fiduciary rulemaking uncertain. If DOL, however, does issue new rulemaking, it is likely to have considerable overlap with Regulation BI. Just as preparing to comply with the vacated DOL Fiduciary Rule has led to many financial institutions taking steps that remain applicable in preparing to comply with Regulation BI, steps taken to comply with Regulation BI are likely to be helpful in complying with any future DOL rulemaking.

NOTES

1. 81 *Fed. Reg.* 20946 (Apr. 8, 2016).
2. *Chamber of Commerce, et. al. v. Acosta*, No. 17-10238 (5th Cir. March 15, 2018), mandate issued June 21, 2018.
3. Definition of the Term “Fiduciary”; Conflict of Interest Rule—Retirement Investment Advice, 81 *Fed. Reg.* 20946 (Apr. 8, 2016).
4. Best Interest Contract Exemption, 81 *Fed. Reg.* 21002 (Apr. 8, 2016).
5. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 *Fed. Reg.* 33318 (July 12, 2019).
6. Form CRS Relationship Summary; Amendments to Form ADV, 84 *Fed. Reg.* 33492 (July 12, 2019).
7. Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 *Fed. Reg.* 33669 (July 12, 2019).

8. Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion From the Definition of Investment Adviser, 84 *Fed. Reg.* 33681 (July 12, 2019).
9. The SEC indicated that it interprets “legal representative” to include only “nonprofessional” legal representatives, such as a nonprofessional trustee who represents the assets of a natural person. 84 *Fed. Reg.* at 33325.
10. FINRA Rule 4512(c)(3).
11. 84 *Fed. Reg.* at 33343.

Copyright © 2019 CCH Incorporated. All Rights Reserved.
Reprinted from *Benefits Law Journal*, Winter 2019,
Volume 32, Number 4, pages 29–33, with permission from
Wolters Kluwer, New York, NY, 1-800-638-8437,
www.WoltersKluwerLR.com

