Alert

July 9, 2019

COZEN O'CONNOR

SEC Final Regulation Best Interest Regarding Duties of Broker-Dealers

Regulation Best Interest: The Final Rule

On June 5, 2019, the Securities and Exchange Commission (SEC) adopted Rule 15l-1 under the Securities and Exchange Act of 1934, as amended, (Exchange Act), "Regulation Best Interest: The Broker-Dealer Standard of Conduct" (Regulation Best Interest or final rule). The SEC designed Regulation Best Interest to draw on key principles underlying fiduciary obligations, including those that apply to investment advisers under the Investment Advisers Act of 1940, while providing specific requirements to address certain aspects of the relationships between broker-dealers and their retail customers. Regulation Best Interest enhances the broker-dealer standard of conduct beyond existing suitability obligations and aligns the standard of conduct with retail customers' expectations.

To achieve this goal, Regulation Best Interest requires broker-dealers to, among other things, (1) act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker-dealer ahead of the interests of the retail customer, and (2) address conflicts of interest by establishing, maintaining, and enforcing policies and procedures reasonably designed to identify and fully and fairly disclose material facts about conflicts of interest and, in certain circumstances, mitigate or even eliminate the conflict of interest. This Alert addresses the final rule, Release No. 34-86031 (Regulation Best Interest), and the notable departures from the SEC's originally proposed rule (proposed rule).[1]

The final rule generally retains the overall structure and scope of the proposed rule. Pursuant to Regulation Best Interest, broker-dealers are subject to a General Obligation that demands that a broker-dealer act in the retail customer's best interest and refrain from placing their own interests ahead of the customer's interest when making a recommendation (General Obligation). The General Obligation was adopted as proposed in the proposed rule. Broker-dealers satisfy the General Obligation by complying with its four component obligations: (1) the Disclosure Obligation; (2) the Care Obligation; (3) the Conflict of Interest Obligation; and (4) the Compliance Obligation. Each of the component obligations are described below with discussion of the material modifications to the proposed rule that are included in the final rule.

Disclosure Obligation

Consistent with the proposed rule, the final rule requires broker-dealers to fulfill the Disclosure Obligation in order to satisfy the General Obligation. The Disclosure Obligation specifically requires that a broker-dealer make certain prescribed disclosures before or at the time of a recommendation about the recommendation itself and the relationship between the retail customer and the broker-dealer.

The SEC acknowledges that broker-dealers are already subject to a number of specific disclosure requirements when they affect certain transactions and under antifraud provisions of federal securities law. However, broker-dealers are not currently subject to an explicit disclosure requirement under the Exchange Act. Under Regulation Best Interest, broker-dealers are required to provide retail customers, prior to or at the time of the recommendation, in writing, full and fair disclosure of all material facts related to (1) the scope and terms of the relationship with the retail customer and (2) conflicts of interests that are associated with the recommendation. This standard is largely consistent with the proposed rule, but the SEC has expanded on the proposed rule to

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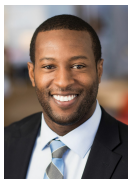

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include in the text of the final rule certain disclosures that were merely provided as examples in the proposed rule. Specifically, the final rule text requires full and fair disclosure of the material facts related to a broker-dealer's capacity, fees and charges, and type and scope of services. Disclosure relating to the type and scope of services must include, at a minimum, whether or not account monitoring services will be provided (and if so, the scope and frequency of those services), account minimums, and any material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer. It should be noted that the SEC views the use of the terms "adviser" and "advisor" in a name or title by a broker-dealer who is not also registered as an investment adviser or by person that is not also a supervised person of an investment adviser to be a violation of the capacity disclosure requirement under Regulation Best Interest. The SEC has explicitly included these items as required disclosures to reduce the potential marketplace confusion between brokerage services and the advisory services provided by investment advisers.

Notably, the final rule also departs from the proposed rule by requiring disclosure of "*all material facts relating to conflicts of interest*." The proposed rule merely required broker-dealers to disclose "all material conflicts of interest." This seemingly trivial modification expands the Disclosure Obligations and, according to the SEC, makes the Disclosure Obligation more consistent with the intent of the proposed rule. The SEC bridges the divide between the language of the proposed rule and final rule by defining a "conflict of interest" as "an interest that might incline a broker, dealer or a natural person who is an associated person of a broker or dealer — consciously or unconsciously — to make a recommendation that is uninterested." Unlike the proposed rule, there is no materiality modifier or reasonableness qualifier directly built into the conflict of interest definition. The result is an increase in the breadth and depth of Disclosure Obligations that broker-dealers must satisfy under the General Obligation. Instead, a broker-dealer must disclose all "material facts" relating to conflicts of interest, and the compensation associated with recommendations to retail customers is deemed to be a conflict of interest about which material facts must be disclosed as part of the Disclosure Obligation.

The SEC has also affirmed in the final rule guidance provided in the proposed rule that grants broker-dealers flexibility to determine the most appropriate manner, form, and frequency of disclosure. Disclosures should generally be concise, clear, and understandable to promote effective communication between a broker-dealer and retail customer.

Care Obligation

The Care Obligation under Regulation Best Interest is three-pronged. Broker-dealers are required to exercise reasonable diligence, care, and skill to (i) understand the potential risks, rewards, and costs associated with the recommendation and have a reasonable basis believe that the recommendation is in the best interest of at least some retail customers; (ii) have a reasonable basis to believe that the recommendation is in the best interest of a particular customer based on that retail customer's investment profile, and the potential risks, rewards, and costs associated with the recommendation and does not place the financial or other interest of the broker, dealer, or such natural person ahead of the interest of the retail customer; and (iii) 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 light of the retail customer's investment profile and does not place the financial or other interest of the broker-dealer or such natural person making the series of recommendations ahead of the interest of the retail customer.

The final rule elevates costs to a higher consideration than previously understood in the proposed rule. Under Regulation Best Interest, the SEC explicitly chooses to include "costs" in the final rule text as a required consideration under the first two prongs of the Care Obligation, along with "risks" and "rewards." The SEC made this modification to make clear that a broker-dealer must always consider cost when making a recommendation. The SEC does, however, clarify that the inclusion of cost in the text of the final rule does not require that a broker-dealer necessarily recommend the lowest cost option. Cost, like risk and reward, is not presumptively dispositive.

The final rule affirms that a broker-dealer must not only understand the potential risks, rewards, and costs of their recommendation, but the broker-dealer must also have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers. Both components are necessary to satisfy the first prong of the Care Obligation. In addition, a broker-dealer must have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer. A broker-dealer should base its reasonable belief on its understanding of the investment or strategy, in light of the retail customer's investment profile, while considering risk, reward, and costs. This standard of conduct embraces and heightens the previously applicable suitability standard.

The final component of the Care Obligation under Regulation Best Interest requires broker-dealers to 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. Even if individual recommendations are in the retail customer's best interest, those recommendations, when viewed in the aggregate, must not be excessive. The SEC has specifically designed this requirement to prevent practices commonly outlawed under federal securities law: churning, switching, and unsuitable recommendations. Like the proposed rule, the final rule offers no single test to identify excessive trading but highlights cost-to-equity ratio, turnover rate, and use of in-and-out trading as potentially useful metrics to evaluate excessiveness.

The SEC has adopted additional language in the second and third prong of the Care Obligation that was not included in the proposed rule: "and does not place the financial or other interest of the broker, dealer, or such natural person [making the series single or series of recommendations] ahead of the interest of the retail customer." By including this language, the SEC seeks to ensure that the best interest principle permeates each level of a broker-dealer's decision making process.

Conflict of Interest Obligation

The Conflict of Interest Obligation of the final rule retains the principals outlined in the proposed rule but expands the text of the rule to further protect retail customers. The Conflict of Interest Obligation has four component parts. The broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to: (i) identify and at a minimum disclose or eliminate all conflicts of interest associated with such recommendations; (ii) identify and mitigate any conflicts of interest associated with recommendations that create an incentive for a natural person who is an associated person of the broker-dealer to place the interest of the broker, dealer, or such natural person ahead of the interest of the retail customer; (iii)(A) identify and disclose any material limitations 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 and (B) prevent such limitations and associated conflicts of interest from causing the broker, dealer, or a natural person who is an associated person of a broker or dealer to place the interest of the broker or dealer ahead of the interest of the retail customer; and (iv) identify and eliminate 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. Regulation Best Interest creates an overarching obligation to establish, maintain, and enforce written policies and procedures to, at a minimum, disclose, or eliminate conflicts of interest. The final rule sets forth specific requirements with respect to such policies and procedures to mitigate and eliminate the identified conflicts.

The final rule adopted by the SEC modifies the proposed rule in three principal areas: mitigation of associated person conflicts of interest, disclosure of material limitations on recommendations, and elimination of certain conflicts of interest. First, with respect to mitigating conflicts of interests of an associated person, the SEC has eliminated the distinction between conflicts of interest arising from financial incentives and other conflicts of interest and removed the affirmative mitigation requirement at the firm level.

The second notable enhancement of the Conflict of Interest Obligation in the final rule relates to material limitations placed on the securities or investment strategies involved in a recommendation,

such as recommendations being based only on proprietary products or offering a limited range of products. Under Regulation Best Interest, broker-dealers will be required to establish, maintain, and enforce written policies and procedures reasonably designed to: (i) identify and disclose any material limitations 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, and (ii) prevent such limitations and associated conflicts of interest from causing the broker, dealer, or a natural person who is an associated person of the broker or dealer to make recommendations that place the interest of the broker, dealer, or such natural person ahead of the interest of the retail customer.

Finally, the SEC has enhanced the proposed rule by including the obligation to identify and eliminate sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities and specific types of securities within a limited period of time. The SEC believes that these practices, particularly when coupled with a time limitation, create high-pressure situations for associated persons to engage in sales conduct contrary to the best interest of retail customers and should be eliminated. The SEC clarified in the final rule that non-cash compensation is not intended to cover certain employee benefits, including health care and retirement benefits.

The final rule also affirms the SEC's understanding that a one-size-fits-all framework would prove unnecessarily burdensome and restrictive for broker-dealers. Accordingly, the final rule offers guidance that grants flexibility for a broker-dealer to use its discretion to determine if a conflict can be effectively disclosed, what mitigation methods may be appropriate, and how to, if necessary, eliminate a conflict. The SEC takes special care to note that simply creating written policies and procedures would not satisfy the General Obligation under Regulation Best Interest. Broker-dealers must maintain and faithfully adhere to their rules as noted in the General Compliance Obligation discussed below.

General Compliance Obligation

The final rule includes an additional obligation, which was not separately addressed in the proposed rule: the General Compliance Obligation. That obligation states that in addition to the policies and procedures required under the Conflict of Interest Obligation, the broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest. The General Compliance Obligation creates an affirmative obligation under the Exchange Act with respect to Regulation Best Interest as a whole. However, the SEC recognizes that compliance policies and procedures must accommodate a wide range of business models. Without offering explicit guidance, the SEC states that a broker-dealer's compliance policies and procedures should be reasonably designed to address and be proportionate to the scope, size, and risks associated with the broker-dealer's operations.

Lastly, the final rule adds new paragraph (a)(35) of Rule 17a-3 of the Exchange Act requiring broker-dealers to maintain a record of the information collected from a retail customer by the broker-dealer pursuant to Regulation Best Interest. The final rule does not require the creation of extensive new and potentially duplicative records for each and every recommendation to a retail customer, some of which may already be required under pre-existing recordkeeping requirements; instead, a broker-dealer must maintain records sufficient to be able to demonstrate that it had a reasonable basis to believe each particular recommendation made to a retail customer was in the best interest of the customer at the time of the recommendation based on the customer's investment profile and the potential risks, rewards, and costs associated with the recommendation. Such records will be required to be maintained for at least six years after the earlier of the date the account was closed or the date on which the information was replaced or updated.

The compliance date for the final rule is June 30, 2020.

To discuss any questions you may have regarding the issues discussed in this Alert, or how they may apply to your particular circumstances, please contact Ingrid Welch at (215) 665-4616 or iwelch@cozen.com or Greg Patton at (215) 665-5571 or cpatton@cozen.com.

[1] On April 18, 2018, the SEC introduced the proposed rule in Release No. 34-83062. The SEC solicited and received a substantial number of comments to the proposed rule many of which are referenced or addressed in the final rule.