

# SEC Regulation Best Interest: The Broker-Dealer Standard of Conduct

## Brief Outline<sup>1</sup>

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Effective Date: 60 days after date of publication in the Federal Register (Date TBD)  
 Compliance Date: Transition Period in effect until June 30, 2020

**Summary:** Regulation Best Interest enhances the broker-dealer standard of conduct beyond existing suitability obligations, and aligns the standard of conduct with retail customers’ reasonable expectations by requiring broker-dealers, among other things, to: (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 instances where [the SEC] have determined that disclosure is insufficient to reasonably address the conflict, to mitigate or, in certain instances, eliminate the conflict.<sup>1</sup>

**Applicability:** Regulation BI applies to broker-dealers (and any associated persons) when making a "recommendation" of any securities transaction or investment strategy involving securities to a retail customer (a "natural person").

**Broker/Dealers will have evaluation and work to do, particularly in the following areas:**

- Full coverage of product shelf due diligence, especially if menus expand to fill gaps in the client need spectrum
- Creating or enhancing disclosures to meet Form CRS and Component Obligation requirements
- Identifying conflicts of interest, revisiting compensation and the creating the ability to compare fees across products
- Product analysis of neutral factors and documentation of rationale for recommendations

**Firms are using DDW for help in meeting Obligation guidance and requirements**

<b>Care Obligation</b>	<ul style="list-style-type: none"> <li>– Product menu optimization and due diligence</li> <li>– FC access to approved product fact sheets for comparisons</li> <li>– Product due diligence documentation</li> </ul>
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<sup>1</sup>See Securities and Exchange Commission 17 CFR Part 240, Regulation Best Interest: The Broker-Dealer Standard of Conduct, available at <https://www.sec.gov/rules/final/2019/34-86031.pdf>

<b>Conflict of Interest Obligation</b>	<ul style="list-style-type: none"> <li>– Neutral product review, due diligence and recommendations</li> </ul>
<b>Compliance Obligation</b>	<ul style="list-style-type: none"> <li>– Product governance process and controls</li> <li>– Product “Committee in a Box”</li> </ul>

The General Obligation

**The “General Obligation”.** The core of Regulation Best Interest is outlined in the rule’s General Obligation of a B/D when making a recommendation to a Retail Customer:

- “A broker-dealer must act in the retail customer’s best interest and cannot place its own interests ahead of the customer’s interests.”
- In order to satisfy the General Obligation, B/Ds have to comply with four specified *component obligations*:
  1. Disclosure Obligation: providing certain prescribed disclosure before or at the time of the recommendation, about the recommendation and the relationship between the retail customer and the broker-dealer.
  2. Care Obligation: exercising reasonable diligence, care, and skill in making the recommendation.
  3. Conflicts of Interest Obligation: establishing, maintaining, and enforcing policies and procedures reasonably designed to address conflicts of interest.
  4. Compliance Obligation: establishing, maintaining, and enforcing policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.

Preparing for Regulation Best Interest Component Obligations

**1. Disclosure Obligation**

Before or at the time of the recommendation, the B/D must disclose material facts related to the scope and terms of the relationship with the customer. The Regulation outlines three material facts as the **minimum** of what must be disclosed as part of this Obligation:

- 1) That the broker, dealer or such natural person is acting as a broker, dealer or an associated person of a broker-dealer with respect to the recommendation;
- 2) Material fees and costs that apply to the retail customer’s transactions, holdings, and accounts; and
- 3) The type and scope of services provided to the retail customer, including: any material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer.

*Key take-aways from the Disclosure Obligation:*

- Understand the definition of a material fact. A fact is material if there is “a substantial likelihood that a reasonable shareholder would consider it important.”
- At the very least. . . The minimum disclosure requirement will include that the broker-dealer is acting as a broker-dealer, costs and fees of the transactions, holdings and accounts, and the scope of services and any limitations.

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- ***AND, prepare Form CRS:*** The SEC will also require B/Ds to deliver a Relationship Summary, Form CRS, to customers at the beginning of the relationship. The CRS is a separate requirement from the Disclosure Obligation, and it is meant to complement the material facts disclosed as part of the Disclosure Obligation. Your firm’s Form CRS will need to inform clients about:
  - The types of client and customer relationships and services the firm offers.
  - The fees, costs, conflicts of interest and required standards of conduct associated with these relationships and services.
  - If the firm or your financial consultants or associates have any reportable legal or disciplinary history.
  - How to obtain additional information about the firm.
- ***Remember :*** *Though there are disclosures in the Relationship Summary that **could satisfy** the Disclosure Obligation, in most instances the Relationship Summary **will not be sufficient to fulfill** the Disclosure Obligation.*

## 2. Care Obligation

A recommendation must be in the best interest of the customer and not put the interests of the B/D ahead of the customer’s interests. This must be based on:

- 1) Information reasonably known to the associated person (based on his/her reasonable diligence, care, and skill) at the time the recommendation is made.
- 2) The associated person should exercise reasonable diligence, care, and skill to consider reasonably available alternatives offered by the broker-dealer. This exercise would require the associated person to conduct a review of such reasonably available alternatives that is reasonable under the circumstances.
- 3) a broker-dealer should have a reasonable process for establishing and understanding the scope of such “reasonably available alternatives” that would be considered by particular associated persons or groups of associated persons (e.g., groups that specialize in particular product lines) in fulfilling the reasonable diligence, care, and skill requirements.

### *Key take-aways from the Care Obligation:*

A “funnel approach” for B/Ds:

- When looking at your product universe, consider the needs of your entire client base. B/Ds should allow for a wide enough product set to meet various needs of its’ client base, rather than limiting or restricting products, which the SEC notes, “is contrary to the purpose and goals or Regulation Best Interest.”<sup>2</sup>
- Use the decision tree for product selection at the firm and client levels. The selection of the product set should be based on a defined process or method for limiting the scope of the universe, the universe considered for a particular customer, category of customers or the retail customer base more generally.
- Compare and document at the firm level. B/Ds will highly benefit from a well-selected product shelf that allows their FCs to compare the qualitative and quantitative aspects of the approved universe, identify appropriate solutions and document product differences.

Considerations for Financial Consultants:

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- Compare, evaluate costs and document at the FC level. Financial Consultants must consider reasonably available alternatives offered by the firm and document the comparative analysis and rationale for the final recommendation. This analysis must include review of costs.
- The “best” solution may not be the least expensive. Product characteristics matter. Because products differ in both qualitative and quantitative characteristics that may apply differently based on the particular customer, other characteristics may apply that lead to recommendation of a costlier product as being in the best interest of the client. The FC is not required to recommend the least expensive product if the structure or benefits of another product are a better fit for the customer’s needs.

### 3. **Conflict of Interest Obligation**

This Obligation requires broker-dealers to focus upon mitigating conflicts of interest associated with recommendations that create an incentive for an associated person to place the interest of the firm or his or her interests ahead of the interests of the retail customer. The b-d must:

- 1) Establish, maintain and enforce written policies and procedures to identify, disclose and eliminate, when possible, all conflicts of interest associated with a recommendation.
- 2) Establish policies and procedures reasonably designed to mitigate or eliminate certain *identified* conflicts of interest, including:
  - Material limitations placed on securities or investment strategies (for example, to only recommend proprietary or other limited range of products)
  - Conflicts associated with sales contests, bonuses, and non-cash compensation that are based on the sales of specific types of securities within a limited period of time

#### *Key take-aways from the Conflict of Interest Obligation:*

- Understand the definition. The rule defines conflict of interest to mean: “an interest that might incline a broker-dealer—consciously or unconsciously—to make a recommendation that is not disinterested.”
- Conflicts come in many forms. Make sure to review and consider ALL potential conflicts of interest; those related to financial incentives, proprietary products, product menu limitations and otherwise.
- Review your policies and procedures to make sure that they are reasonably designed to do the following:
  - Clearly define your firm’s conflicts. Define conflicts in a way that is relevant to your business (i.e., conflicts of both the broker-dealer entity and of the associated persons of the broker-dealer).
  - Make it easy to identify conflicts. Define conflicts of interest and in a way that enables employees to understand and identify them.
  - Determine how to identify conflicts. Establish a structure for identifying the types of conflicts that your broker-dealer (and associated persons) may face.
  - Think ahead. Establish a structure to identify conflicts in the broker-dealer’s business as it evolves.
  - Monitor, monitor. Provide for an ongoing (e.g., based on changes in the broker-dealer’s business or organizational structure, changes in compensation incentive structures, and introduction of new products or services) and regular, periodic (e.g., annual) review for the identification of conflicts associated with the broker-dealer’s business.
  - Train your teams. Establish training procedures regarding the broker-dealer’s conflicts of interest, including conflicts of natural persons who are associated persons of the

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broker-dealer, how to identify such conflicts of interest, as well as defining employees' roles and responsibilities with respect to identifying such conflicts of interest.

#### **4. Compliance Obligation**

The Compliance Obligation requires broker-dealers to establish, maintain and enforce written policies procedures reasonably designed to achieve compliance with Regulation Best Interest. The Compliance Obligation creates an affirmative obligation under the Exchange Act with respect to the rule as a whole, while providing sufficient flexibility to allow broker-dealers to establish compliance policies and procedures that accommodate a broad range of business models.

#### *Key Take-aways from the Compliance Obligation:*

- Design policies to operate in your firm's business model. The Obligation acknowledges that B-Ds are too varied in their operations for rules to impose a single set of universally applicable specific required elements that must be included in policies and procedures. A firm's compliance policies and procedures should be reasonably designed to address and be proportionate to the scope, size, and risks associated with the operations of the firm and the types of business in which the firm engages.
- Prevent, Detect, Correct. Each B-D should consider the nature of the firm's operations and how to design policies and procedures to
  - prevent violations from occurring
  - detect violations that have occurred
  - correct promptly any violations that have occurred.
- Key elements are important to everyone's framework. Depending on the size and complexity of the firm, a reasonably designed compliance program generally would include: controls; remediation of non-compliance; training; and periodic review and testing.

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