SCHNEIDER DOWNS
Wealth Management

Schneider Downs

Regulation Best Interest

Executive Summary

On June 5, 2019 the Securities and Exchange Commission (SEC) adopted Regulation Best Interest. Regulation Best Interest (Rule 15/-1 under the Securities Exchange Act of 1934) has multiple components to it. This summary will serve as a high level overview of the impact Regulation Best Interest will have when it goes into effect on June 30, 2020. Regulation BI requires broker-dealers and their associated natural persons to act in the best interest of their retail customers when making a recommendation. The SEC adopted Form CRS Relationship Summary as part of Regulation BI. Form CRS requires registered investment advisers (RIAs) and broker-dealers to provide, in plain English, information about the relationships and services the firm offers to retail investors, fees and costs that retail investors will pay, specified conflicts of interest and standards of conduct, and disciplinary history among other things.

The General Obligation

The best interest obligation would generally be satisfied if the following four specific obligations are met:

1.) Disclosure Obligation
2.) Care Obligation
3.) Conflict of Interest Obligation
4.) Compliance Obligation

The general obligation does not apply the existing RIA fiduciary standard to BDs, and is not a separate fiduciary standard. A broker-dealer may recommend products with higher costs, higher risks, and that will result in greater compensation to a retail customer. However, each of the four components of the obligation must be satisfied. Whether the BD complied with the obligations will be judged on a principles basis. This will be an evaluation of the facts and circumstances of the retail customer and the specific recommendation at the time the recommendation was made (this won't be determined in hindsight).

A recommendation is not defined but is interpreted similar to current BD regulation under the federal securities laws and FINRA rules. Below is a list of activities that are outside the scope of a "recommendation":

1.) General financial and investment information;
2.) Descriptive information about an employer-sponsored retirement or benefit plan;
3.) Certain asset allocation models; and
4.) Interactive investment materials that incorporate the above

"Account recommendations" include recommendations by BDs of securities account types generally, as well as recommendations to roll over or transfer assets from one type of account to another (e.g., workplace retirement plan account to an IRA account).

Compliance with the four component obligations does not create a "safe harbor." Compliance with each component obligation is necessary, and failure to comply with any would violate the general obligation.

Disclosure Obligation

The disclosure obligation requires a BD to provide in writing a "full and fair disclosure" prior to or at the time of a recommendation of:

All material facts relating to the scope and terms of the relationship with the retail customer, which include:

1.) That the broker dealer was acting in a BD capacity with respect to the recommendation;
2.) Fees and charges that would apply to the retail customer's transactions, holding, and accounts; and
3.) Type and scope of services provided by the BD, including, for example, monitoring the performance of the retail customer's account.

The BD can make supplemental or oral disclosures not later than the time of the recommendation, provided that it maintains a record that the oral disclosures was provided. As to what constitutes a "material" fact related to the "scope and terms of the relationship," the standard for materiality for purposes of the Disclosure Obligation is consistent with the one the Supreme Court articulated in Basic v. Levinson. Specifically, a fact is material if there is "a substantial likelihood that a reasonable shareholder would consider it important." In the context of Regulation Best Interest, the standard is the retail customer, as defined in the rule.

Use of Terms "Adviser" or "Advisor"

Given that the titles "adviser" and "advisor" are closely related to the statutory term "investment adviser," their use by broker-dealers can have the effect of erroneously conveying to investors that they are regulated as investment advisers, and have the business model, including the services and fee structures, of an investment adviser. As a result, it is presumed that the use of the terms "adviser" and "advisor" in a name or title by (i) a broker-dealer that is not also registered as an investment adviser or (ii) an associated 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.

Care Obligation

The care obligation requires that the BD, or an associated person of the BD, in making the recommendation, exercises reasonable diligence, care and skill to:

1.) 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;
2.) 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 the 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 ahead of the interest of the retail customer; and
3.) 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 BD or such natural person making the series of recommendations ahead of the interest of the retail customer.

The final rule added "cost" as a consideration; however, although cost will always be relevant to a recommendation and should be a required consideration, the Release points out that costs are not the only consideration. An additional enhancement to the FINRA suitability requirements provided b Regulation BI is that it is the SEC's view that a BD should consider reasonably available alternatives in determining whether it has a reasonable basis to believe that the recommendation is in the best interest of the customer.

A BD must obtain and analyze enough customer information to have a reasonable basis to believe that the recommendation is in the best interest of the particular retail customer. The significance of any particular type of customer information will be determined based on a facts and circumstances analysis. In forming a reasonable basis belief that a recommendation is in the best interest of a particular customer, a BD does not have to simply recommend the least expensive or least remunerative security without further analysis.

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:

1.) Identify and, at a minimum, disclose, in accordance with the disclosure obligation, or eliminate, all conflicts of interest associated with such recommendations;
2.) 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;
3.) 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;
4.) Prevent such limitations and associated conflicts of interest from causing the BD or an associated person of the BD to make recommendations that place the interest of the BD or such associated person ahead of the interest of the retail customer; and
5.) Identify and eliminate any sales contests, sales quotas, bonuses and non-cash compensation that are based on the sales of specific securities or of 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:

1.) Compensation from the BD or from third parties, including fees and other charges for the services provided and products sold;
2.) Employee compensation or incentives, special awards, differential or variable compensation, incentives tied to appraisals or performance reviews; and
3.) Compensation or sales charges, or other fees or financial incentives, or different or variable compensation, whether paid by the retail customer, the BD or a third party.

Under Rule 15l-1(a)(2)(iii)(D), sales contents, quotas, bonuses and non-cash compensation based on sales of securities within a specific period of time must be identified and eliminated (in contrast to conflicts of interest arising from material conflicts of interest arising from financial incentives, as in the proposing release).

Recordkeeping

The SEC added a new paragraph (a)(35) to Rule 17a-3 under the Exchange Act. Rule 17a-3(35) requires a BD to retain a record of all information collected from the retail customer under Regulation BI and to identify the natural person responsible for the account. The 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

The SEC has adopted new rules and forms that will require both BD and RIAs to provide retail investors with information intended to clarify the relationship through a Form CRS. Form CRS will require a Q&A format, and will be subject to page limits. Form CRS must include a section on disciplinary proceedings/record. The Form must be delivered by BDs to each new or prospective client before a recommendation, order, or account opening. The Form CRS would be provided to investors, filed with the SEC and available online.

Form CRS will require broker-dealers to provide retail investors a high-level summary of principal fees and costs, including transaction-based fees, as well as a narrative discussion of other fees that retail investors will pay directly or indirectly. The Relationship Summary is meant to be a high-level summary, and may not contain all material facts about costs and fees that apply to a particular recommendation. Firms may file their initial summaries with the SEC beginning on May 1, 2020.

The SEC's Investment Adviser Interpretation

The Investment Adviser Interpretation (SEC IA Interpretation) reaffirms, interprets, clarifies, and provides guidance regarding the fiduciary duty derived from common law that an investment adviser owes to its clients under the Investment Advisers Act of 1940 (Advisers Act). The SEC IA Interpretation provides that this duty is principles-based and applies to the entire relationship between an investment adviser and the client. The SEC IA Interpretation describes the underlying duties that constitute an investment adviser's fiduciary duty: the Duty of Care and the Duty of Loyalty. It further breaks down the Duty of Care as follows: (i) a Duty to Provide Advice that is in the Best Interest of the Client; (ii) a Duty to Seek Best Execution; and (iii) a Duty to Provide Advice and Monitoring over the Course of the Relationship. The discussion of the "Duty to Provide Advice that is in the Best Interest of the Client" includes a subsection with a detailed discussion on the requirement for a "reasonable belief that advice is in the best interest of the client."

Conclusion

The effect of Regulation Best Interest in regards to an RIA is limited. One major change will be the addition of Form CRS. Essentially Regulation BI has taken long-recognized fiduciary duties into a finalized interpretive release. The changes implemented by Regulation Best Interest at this point are "final." Setting aside whether they may be subject to legal challenges, firms need to complete their implementation efforts by June 30, 2020.