SECURITIES DISPUTES AND ENFORCEMENT LAW ALERT
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Firms Need to Improve Compliance with Regulation Best Interest (Reg BI)

Regulation BI: Effective June 30, 2020, the Securities and Exchange Commission (SEC) promulgated Regulation Best Interest (Reg BI) under the Securities Exchange Act of 1934, which establishes a "best interest" standard of conduct for broker-dealers and associated persons when they make a recommendation to a retail customer of any securities transaction or investment strategy involving securities, including recommendations of types of accounts. The SEC also adopted new rules and forms to accompany Reg BI, which require broker-dealers and investment advisers to provide a brief relationship summary, Form CRS, to retail investors. The SEC also published interpretations concerning the standard of conduct required of investment advisers under the Investment Advisers Act of 1940, and the "solely incidental" prong of the broker-dealer exclusion from the Advisers Act.

This Alert is intended to serve as a high level overview (and friendly reminder) of Reg BI and Form CRS, and the obligations they impose upon broker-dealers and associated persons making "recommendations" to "retail customers" regarding their accounts.

What changed? Regulation BI essentially expands the broker-dealer standard of conduct beyond the existing suitability obligations to require them to act in their customers' best interests at the time a recommendation is made, ahead of their own financial incentives. The Financial Industry Regulatory Authority (FINRA) is a self-regulatory organization authorized by Congress, tasked with protecting America's investors by making sure the broker-dealer industry operates fairly and honestly. FINRA enforces various industry rules, including FINRA Rule 2111 on suitability, which requires the member or associated person to collect information and perform reasonable diligence, in order to have reasonable grounds to recommend a certain product of investment. FINRA Rule 2111 does not impose a fiduciary standard, which would require the registered representative to act solely in the client's best interests. In other words, broker-dealers could – until the enactment of Regulation BI – make recommendations as investment advisers that would boost their compensation even if they were not in the customer's best interest, provided they met the suitability requirements and did not violate any other rule. The SEC has stepped-in with Regulation BI to hold broker-dealers to a fiduciary standard with respect to recommendations to retail customers. This also raises the possibility of customers seeking to use Reg BI to impose liability against broker-dealers and their registered representatives. Broker-dealers and associated persons can expect to see customer claims alleging violations of Reg BI, including acts and omissions that were not in the "best interests" of the customers.

What is a "recommendation"? A call to action regarding securities or investment strategies, or inaction in the case of a hold recommendation. But the SEC has been clear that the determination of what is considered a "recommendation" will depend on "the facts and circumstances of a particular situation, and therefore, whether a recommendation has been made is not susceptible to a bright line definition." One guiding principle is: "The more individually tailored the communication to a specific customer or targeted group of customers about a security or group of securities, the greater the likelihood that the communication may be viewed as a 'recommendation.'" Notably, Regulation BI does not apply to investment advice provided to a retail customer by a dual-registrant when acting in the capacity of an investment adviser.

Who is a "retail customer"? Notably, the definition of "retail customer" does not include non-natural persons – e.g. corporations and institutions – but it does include high net-worth individuals who might be excluded or have more difficult claims under FINRA's suitability rule.

What does Regulation BI require? Essentially, there are four components or obligations imposed upon broker-dealers and associated persons under Reg BI: (1) disclosure; (2) care; (3) conflict of interest; and (4) compliance. Under the "Disclosure Obligation," customers must receive written, full and fair disclosure of all material facts about conflicts of interest surrounding a recommendation. There are additional details on what the disclosure should include, but Form CRS provides the first layer of disclosure. Under the "Care Obligation," broker-dealers and their associated persons must consider the costs, reasonably available alternatives, and factors in the customer's investment profile as they prepare a recommendation. In addition, the "Care Obligation" expands upon FINRA's suitability rule, in that it goes beyond securities and related investment strategies, to account-type recommendations and rollovers. Under the "Conflict of Interest Obligation," broker-dealers must establish policies and procedures "reasonably designed" to identify, eliminate, mitigate, and disclose conflicts of interest. Last, under the "Compliance Obligation," covered parties must establish, maintain and enforce written policies and procedures for complying with Reg BI.

What is Form CRS? The Form CRS Relationship Summary rule applies to broker-dealers and SEC-registered investment advisers, but does not apply only when making a recommendation. Investment advisers must send Form CRS to clients and prospective clients before or at the time they enter into an investment advisory contract with the retail investor (including oral agreements); and broker-dealers must send Form CRS to clients and prospective clients before recommending an account type, securities transaction, or investment strategy involving securities or before placing an order for a retail investor.

From the prospective customer's perspective, Form CRS is the key to understanding why someone is making a recommendation, what it will cost, and what their legal obligations are to you as the customer. The SEC provides instructions for the CRS Form: https://www.sec.gov/rules/final/2019/34-86032-appendix-b.pdf

FINRA offers a "Reg BI and Form CRS Firm Checklist" for those attempting to "assess their obligations," which includes twenty (20) questions that must be affirmatively answered to ensure compliance with Reg BI. https://www.finra.org/sites/default/files/2019-10/reg-bi-checklist.pdf

What will compliance examinations look like? According to the SEC "Risk Alert – Regulation Best Interest Exams," initially, examinations for compliance "will focus on assessing whether firms have made a good faith effort to implement policies and procedures reasonably designed to comply with Regulation Best Interest, including the operational effectiveness of broker-dealers' policies and procedures." The SEC's Risk Alert includes an Appendix, which provides a sample list of information and documents that the SEC's Office of Compliance Inspections and Examinations (OCIE) may request when conducting examinations.

Have there been any No Action Letters? There appears to be only one No Action Letter with respect to Regulation BI and Form CRS. On December 23, 2020, the SEC responded to an inquiry from an attorney on behalf of her client seeking assurances that the SEC would not take enforcement action against broker-dealers that do not treat family offices that qualify as "Institutional Family Offices" as "retail customers" for purposes of Regulation BI when they make recommendations. In its response, the SEC stated that the staff of the Division of Trading and Markets will not recommend enforcement action to the SEC in such circumstances. The SEC specifically declined to respond to any other questions or to adopt any of the attorney's analyses or conclusions.

Are Broker-Dealers Complying with Regulation BI? According to the 2021 Reg BI Phase Two Report related in November 2021, broker-dealer firms have made "incremental progress" but still fall short of complying with this key regulation intended to protect consumers. The 2021 Report notes that it covered state examiners from 35 jurisdictions which were examining 443 broker-dealer firms. Just by way of example, according to the Report, 40% of broker-dealers surveyed that recommended leveraged or inverse exchange-traded funds had compensation conflicts.

Another report indicated that after the SEC took aim at certain firms to ensure compliance with properly filing their Form CRS documents, the SEC settled with more than two dozen broker-dealers that had not properly distributed the forms which provide information about potential conflicts of interest.

Conclusion. Although compliance with Reg BI has apparently fallen short of perfection, firms should be wary of ignoring these relatively new obligations. The SEC may not be aggressively pursuing violations at this point, but no one can know when that might change, and it is of course best practice to acknowledge and comply with a fiduciary standard that puts a retail customer's interests ahead of one's own financial incentives. Should you have any questions about compliance with Reg BI or other regulations, please do not hesitate to contact Sheryl, Ross, or one of the other members of our Securities Disputes and Enforcement Practice Group.

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