Fiduciary Duties and Regulation Best Interest

June 18, 2019

On June 5, 2019, the U.S. Securities and Exchange Commission (the "SEC") adopted a package of rulemakings and interpretations designed to enhance the quality and transparency of the duties owed by broker-dealers to retail investors and clarify the duties of registered investment advisers ("RIAs"). These actions include (1) Regulation Best Interest (or the "Rule") under the Securities Exchange Act of 1934 (the "Exchange Act"); (2) requirements to deliver a client relationship summary ("Form CRS"); and (3) two separate interpretations under the Investment Advisers Act of 1940 ("Advisers Act").[1]

Debevoise & Plimpton

This Debevoise in Depth summarizes Regulation Best Interest, highlighting the material differences from the original proposal published on April 18, 2018 (the "Proposal")[2] and also provides a brief description of Form CRS requirements and the SEC's new interpretation of the Advisers Act exclusion for broker-dealers engaged in advisory activities that are "solely incidental" to brokerage.[3] The new interpretation of fiduciary duties under the Advisers Act is addressed in a separate Debevoise in Depth.[4]

Regulation Best Interest is intended to substantially heighten the duties that broker-dealers owe to retail customers, in line with those of registered investment advisers, while preserving retail access to "full-service" brokerage.[5] While the SEC states that the Rule is intended to bring duties in line with the reasonable expectation of investors, the regulation imposes what is, in several ways, a quite paternalistic view of the relationship between broker-dealers and individuals. For example, the regulation will impose

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1 *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, Exchange Act Release No. 34-86031 (June 5, 2019) ("Adopting Release"), *available* here; *Form CRS Relationship Summary; Amendments to Form ADV*, Exchange Act Release No. 34-86032 (June 5, 2019); *Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser*, Release No. IA-5249 (June 5, 2019); *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Release No. IA-5248 (June 5, 2019). As of the date of this Debevoise in Depth, the Rule has not yet been published in the Federal Register.

2 *Regulation Best Interest*, Release No. 34-83062 (Apr. 18, 2018), 83 Fed. Reg. 21574 (May 9, 2018).

3 *See* Section 202(a)(11)(C) of the Advisers Act.

4 The Debevoise in Depth addressing the fiduciary duties of investment advisers is available here.

5 *See generally* Press Release No. 2019-89, SEC, SEC Adopts Rules and Interpretations to Enhance Protections and Preserve Choice for Retail Investors in Their Relationships with Financial Professionals (June 5, 2019), https://www.sec.gov/news/press-release/2019-89.

substantial new duties on broker-dealers that distribute private fund interests to ultra-high-net-worth investors.[6] It is something of a sign of the array of political forces that the Rule—which is likely to require broker-dealers to produce encyclopedic disclosures and materially burden their ability to communicate with their customers—was approved by the three Republican Commissioners while Commissioner Jackson voted no.

Regulation Best Interest: Three Definitions, Four Duties

Though the SEC generally retained the overall structure and scope of the Proposal, the Rule incorporates a number of significant modifications, and the Adopting Release provides numerous interpretations addressing points raised during the comment process.[7]

The Rule, like the Proposal, draws on key elements of classic fiduciary duties (*e.g.*, care and loyalty) to impose four component sets of requirements under the rubric "best interest." At a high level, these requirements can be described as imposing: (i) very extensive and detailed disclosure requirements (the "Disclosure Obligation"); (ii) requirements for providing "recommendations" based on FINRA's existing suitability requirements but with materially heightened standards (the "Care Obligation"); (iii) duties to mitigate conflicts of interest in employee compensation arrangements and to eliminate certain sales practices entirely (the "Conflict of Interest Obligation"); and (iv) related compliance policies and procedures obligations (the "Compliance Obligation").

Three Definitions

The key requirement of Regulation Best Interest is that both broker-dealers and their associated persons must act in a customer's "**best interest**" when making a "**recommendation**" to a "**retail customer.**" Each of these terms is discussed in detail in the Adopting Release, although only "retail customer" is actually defined in the Rule.

- **Best Interest**. The general obligation under Regulation Best Interest is to act in a retail customer's best interest. As the Rule states, this entails not placing the interest of the broker-dealer or an associated person ahead of the customer's interests.

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[6] As discussed below, high-net-worth individuals are included within the category of "retail customer." However, the Regulation Best Interest duties are not triggered when a broker-dealer speaks to a professional investment manager representing such an individual. See Adopting Release at p. 112.

[7] While Regulation Best Interest itself is a slim four pages, the non-federal register version of the Adopting Release includes more than 750 pages of discussion. As of the date of this Debevoise in Depth, the Rule has not yet been published in the Federal Register.

Beyond this, "best interest" is not technically defined, but the Rule makes clear that the general obligation is satisfied when each of the four component obligations described below is satisfied. In this sense, "best interest" is really a new title for a functional test rather than a term that carries a dictionary meaning.

- **Recommendation**. In the Proposal, the SEC proposed to follow the understanding of "recommendation" developed in connection with FINRA's suitability rule. In the Rule, the SEC also declined to provide a definition on the basis that the determination of whether the related duties should be triggered is a "facts and circumstances analysis" not susceptible to a definition. However, the Adopting Release does indicate that rather than relying on FINRA (which has also never defined the term and has provided elastic descriptions over the years), the SEC will consider specific factors, consistent with the current interpretation: in particular whether a communication "reasonably could be viewed as a 'call to action'" and "reasonably would influence an investor to trade a particular security or group of securities." In addition, the more individually tailored or targeted the communication, the more likely it will be viewed as a recommendation.[8]

  The Rule also provides that recommendations of both securities transactions and investment strategies are trigger events under the Rule. Importantly, recommendations regarding accounts have also been included, clearly bringing within scope recommendations to: (i) open accounts with varying fee models (commission or fee based) or service components (brokerage vs. advisory, cash vs. margin etc.), (ii) roll over or transfer assets in a workplace retirement plan account to an IRA, and/or (iii) take a plan distribution for the purpose of opening a securities account. Per the SEC, this approach is generally consistent with the types of recommendations that have been treated as investment strategies under existing suitability rules.

  - *Account monitoring and implicit hold recommendations*. While Regulation Best Interest does not include a duty to monitor (which, as discussed below, could under certain circumstances cause a broker-dealer to be required to register as an investment adviser), additional obligations will apply when a broker-dealer contractually agrees to monitor a retail customer's account. In such circumstances, the absence of a recommendation to sell at a time when an agreed review is supposed to take place will be deemed an implicit recommendation to hold subject to the regulation. This position is arguably a departure from FINRA guidance, which generally states that the absence of communication is not an implicit hold recommendation.

[8] *See* Adopting Release at 80.

- *Dual-registrants*. The SEC provides additional guidance for dual registrants (broker-dealers that are dually registered as investment advisers) confirming that Regulation Best Interest does not apply to giving advice in the capacity of an investment adviser to an advisory account. When this is the case will be determined on a facts and circumstances basis with no one factor being determinative. The SEC will consider, among other factors, the type of account, how the account is described, the type of compensation and the extent to which the dual registrant made clear to the customer the capacity in which it was acting.

- **Retail Customer**. The Rule adopts the definition of "Retail Customer" from the Proposal largely unaltered. The definition includes all natural persons and legal representatives of natural persons who receive recommendations for personal, family or household use. While this definition provides a relatively bright line rule that is easy to interpret, it is obviously also inconsistent with the approach to defining "retail" in other rules, where the SEC has consistently recognized wealth and access to independent resources as surrogates for sophistication.[9] In particular, the SEC chose not to align the definition of retail customer with FINRA's definition of "institutional account,"[10] which currently provides a carve-out from FINRA's suitability obligation and includes individual investors with more than $50 million as well as definitions of "accredited investor," "qualified investor" and the like.[11]

  - *Use of the recommendation*. Regulation Best Interest applies to a customer that receives and "uses" a recommendation. The SEC views a customer (or prospective customer) as using a recommendation when: (1) as a result of the recommendation, the customer opens a brokerage account with the broker dealer; (2) the customer has an existing account with the broker-dealer and receives a recommendation from the broker-dealer; or (3) the broker dealer receives or will receive compensation, directly or indirectly, as a result of that recommendation, even if that customer does not have an account at the firm. As this list makes clear, Regulation Best Interest applies to the marketing of securities to prospective investors who do not have an account and where there is not necessarily an established relationship creating a natural expectation of duty. Accordingly, broker-dealers primarily engaged in distributing products for affiliates and other issuers on a delivery versus payment basis will need policies and procedures to address the new requirements.

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[9] *See*, *e.g.*, 84 Fed. Reg. 6713, 6714 (Feb. 28, 2019) (providing that "[t]he Commission's rules have long recognized that QIBs and accredited investors have a level of financial sophistication and ability to sustain investment losses that render the protections of the Securities Act's registration process unnecessary.").

[10] *See* FINRA Rule 4512(c).

[11] *See* Adopting Release at 112, n.238.

Four Duties

In order to satisfy the general best interest duty, broker-dealers will be required to satisfy component obligations relating to disclosure, care, mitigating certain conflicts of interest and eliminating others and establishing reasonably designed policies and procedures.

- **Disclosure Obligation**. In the Rule, the SEC imposes extensive and detailed disclosure obligations on broker-dealers. The Rule requires that prior to or at the time of the recommendation, all material facts[12] relating to: (i) the scope and terms of the relationship with the retail customer and (ii) conflicts of interest relating to the recommendation, must be disclosed in writing. Regarding the scope and terms of the relationship, disclosures must at a minimum include: (i) that the firm or representative is acting in a broker-dealer capacity (the "capacity" disclosure requirement); (ii) the material fees and costs the customer will incur; and (iii) the type and scope of the services to be provided including any material limitations on the recommendations that could be made to the retail customer

  While the discussion in the Adopting Release provides that disclosures can be made in the form of account opening or other documentation provided at the beginning of a relationship and provides useful guidance relating to the adequacy of standardized disclosures in a variety of circumstances, it also makes clear that provision of the standardized Form CRS Relationship Summary will not generally be adequate.

  Importantly, the preamble also states that where a standardized disclosure would not sufficiently identify and describe all of the material facts related to a specific recommendation, it would need to be supplemented so that it is tailored to the particular recommendation.[13] In connection with the requirement that disclosure be "full and fair" and related discussion about investment adviser disclosure (see in particular footnote 467), this guidance at least leaves open the degree of specificity required in common circumstances where the conflict is a function of the broker-dealer's changing position at a particular time (e.g., because it happens to be long or short a particular security or is also trading for other customers with conflicting interests). Obviously a strict interpretation requiring specificity in a frequently changing environment would make it extremely difficult (arguably impossible) for broker dealers with large and diverse operations to comply with the disclosure requirements as to conflicts at all times. The SEC does note that compliance with the disclosure obligation will be measured against a negligence standard rather than

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[12] The materiality standard in Regulation Best Interest is if there is "a substantial likelihood that a reasonable [retail customer] would consider it important," consistent with *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

[13] *See* Adopting Release at 224.

strict liability.[14] Nevertheless, the uncertainty created by the discussion of specificity in particular is likely to require broker-dealers to adapt with one eye firmly on industry practice and the other on further SEC action taken through informal staff guidance and enforcement.

- *Fees and costs*. Fees and costs applicable to the customer's transactions, holdings and accounts are deemed per se material facts relating to the terms and scope of the relationship that must be disclosed. The obligation does not generally require individualized disclosure of the fees to a particular customer or transaction, and the use of reasonable dollar or percentage ranges is permissible. The disclosure should, however, accurately convey why a fee or charge is being imposed and when the fee is to be assessed.

    - *Product-level fees*. Though neither a term of the relationship nor necessarily a conflict of interest, the SEC also states that product-level fees and costs imposed by issuers and other third parties are material facts that must be disclosed. To satisfy this requirement, a broker dealer can rely on the current regulatory regime for product disclosures (e.g., prospectus delivery and content requirements) by providing an initial standardized disclosure and advising where further specifics will appear and how to obtain the necessary documents.

- *Conflicts of interest*. Instead of limiting the disclosure requirement to "material conflict of interest," the Rule requires disclosure of "material facts" related to all "conflicts of interest." The latter are defined broadly as conflicts that might incline a broker-dealer—consciously or unconsciously—to make a recommendation that is not disinterested, following the approach under the Advisers Act as articulated in *S.E.C. v. Capital Gains Research Bureau*.[15] This approach avoids controversy over what is a "material" conflict and relies instead on the accepted concept of facts material to a reasonable information recipient.

- *Limitations on recommendations*. In contrast to the Proposal, the Rule explicitly requires a broker-dealer to disclose any material limitations it may have with respect to the securities or investment strategies that it may recommend to the customer. A material limitation includes recommending only proprietary products and limitations as to asset classes or products with third-party arrangements. As discussed elsewhere in the Adopting Release, this requirement is to address "systemic" practices at a broker-dealer that would otherwise have

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[14] *See* Adopting Release at footnote 479.

[15] 375 U.S. 180 (1963).

been addressed by a proposed duty to mitigate "financial" conflicts that was removed.

- *Investment approaches*. The general basis for a recommendation is deemed a material fact that must be disclosed, which will require development of disclosures about the investment approach, philosophy, strategy and process for developing recommendations.

- *Associated persons*. Associated persons may have conflicts of interest beyond those of the broker-dealer, may use investment approaches different from that of the firm, or may have limits (based on licensing) on what they can recommend. Under the Rule, any of such material facts about the particular associated person making a recommendation also must be disclosed in writing. Where an associated person knows or should have known that the broker-dealer's disclosure is insufficient to describe all material facts, the associated person must supplement that disclosure.

- *Form and manner*. The SEC does not require any standard written disclosures other than the Form CRS Relationship Summary. Broker-dealers are permitted to use existing disclosures and standardized documents, such as a product prospectus, relationship guide, account agreement or fee schedule to help satisfy the Disclosure Obligation. In appropriate circumstances, the disclosure requirement may be satisfied by making supplemental oral disclosures not later than the time of the recommendation provided that a record is maintained of the fact that the oral disclosure was provided. However, the broker-dealer must provide an initial written disclosure describing the process through which disclosures may be supplemented, clarified or updated. Existing SEC guidance relating to paper and electronic delivery of disclosure documents applies.

- "*Financial Advisors*." The titles that many brokers use to characterize their registered representatives—particularly the term "financial advisor"—have been a long-standing issue for the industry and consumer organizations. The Adopting Release notes that, given that these titles are "closely related" to the term "investment adviser," their use "can have the effect of erroneously conveying to investors that associated persons of a broker-dealer are regulated as investments advisers, and operate under the business model, including the services and fee structures, of an investment adviser." Thus, the Rule provides that using the title "adviser" and "advisor" to describe a broker-dealer representative creates a rebuttable presumption that the Disclosure Obligation (particularly the capacity disclosure requirement) was violated. While use of these terms is not expressly prohibited, in practice, they will likely only be usable in limited circumstances where there is a distinct advisory role

specifically defined by federal law such as municipal advisor commodity trading adviser or advisor to a special entity.

- **Care Obligation**. Under the Care Obligation, the broker dealer must exercise reasonable diligence, care and skill to understand the potential risks, rewards and costs associated with the recommendation and have a reasonable basis to believe: (a) the recommendation could be in the best interest of at least some retail customers; (b) the recommendation is in the best interest of a particular retail customer based on such customer's investment profile and does not place the financial or other interest of the broker-dealer ahead of the interest of the retail customer; and (c) a series of recommended transactions are not excessive and are in the retail customer's best interest when taken together.

  - *Cost*. While the factors that a broker-dealer should consider when making a recommendation may vary depending on the product or strategy, in the Adopting Release, the SEC states that cost—along with potential risk and rewards—will always be a factor that must be considered. However, the SEC makes clear that cost is not dispositive, and the standard does not necessarily require the "lowest cost option."

  - *Reasonably available alternatives and otherwise identical securities*. Guidance in the Adopting Release provides that a broker-dealer and its associated person should consider any reasonable alternative offered by the broker-dealer in determining whether there is a reasonable basis for making the recommendation. It is not necessary to consider every possible alternative (either offered outside of the firm or available on the firm's platform) or offer a single "best" of all possible alternatives. Accordingly, associated persons need not be familiar with every product on a broker-dealer's platform in order to satisfy the obligation but rather only the "reasonably available alternatives." However, where all reasonably available alternatives considered would be inconsistent with a customer's investment profile, a broker-dealer could not make a buy recommendation satisfying the Care Obligation.

  - *Account type recommendations*. Similarly, broker-dealers need to consider available account options in determining whether a particular account is in a particular retail customer's best interest. Again, a limited selection of account types would not excuse a broker-dealer from making a recommendation not in the best interest of the customer. When recommending a rollover from an existing 401(k) or similar product, the potential risks, rewards and costs must be compared to the investor's existing product.

- *Series of transactions*. Under Regulation Best Interest, a broker-dealer must have a reasonable basis to believe that a series of recommended transactions is in the customer's best interest and is not excessive trading, even if each transaction is in the customer's best interest when viewed in isolation. Where a retail customer expresses a desire for "active trading," a broker-dealer may take this factor into consideration when evaluating a recommendation; however it will still need to reasonably determine that the series of recommended transactions is in the customer's best interest.

- **Conflict of Interest Obligation**. The Conflict of Interest Obligation has three basic components: (1) all conflicts of interest must be fully and fairly disclosed in accordance with the Disclosure Obligation; (2) certain specified types of sales contests, quotas, bonuses and noncash compensation arrangements must be eliminated; and (3) compensation arrangements that create an incentive for an associated person of the broker-dealer to place the interest of the firm or an associated person ahead of the interest of the retail customer must be mitigated. Unlike the Proposal, the Rule does not attempt to differentiate between "financial" and "non-financial" conflicts, but focusses instead on financial arrangements for employees.

  - *Elimination of certain conflicts*. The Rule requires broker dealers to identify and eliminate sales contests, sales quotas, bonuses and noncash compensation arrangements that are based on the sale of specific securities or specific types of securities within a limited period of time. It is the SEC's view that these arrangements create conflicts that are sufficiently severe that they cannot be addressed with disclosure or monitoring. Other incentive arrangements are permitted as long as the broker-dealer establishes reasonably designed policies and procedures to disclose the arrangements and to mitigate adverse incentives.

  - *Mitigation of compensation-related conflicts of interest*. Conflicts of interest that create incentives for an associated person of the broker-dealer to place the interest of the firm or associated person ahead of the interest of the retail customer must be "mitigated." As the preamble makes clear, this requirement only applies to incentives provided to the associated person and does not cover external interests not within the control of or associated with the broker-dealer's business. Compensation that varies based on advice given, such as commissions, markup/markdowns, loads, revenue sharing and distribution (or Rule 12b-1) fees generally needs to be addressed. Among other factors, the mitigation measures employed should depend on the nature and significance of the incentives provided. Potential mitigation methods may include:

- Avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales;
- Minimizing incentives for employees to favor one type of account or product over another;
- Eliminating compensation incentives to shift among comparable product lines by, for example, capping the credit that an associated person may receive across mutual funds or other comparable products across providers;
- Implementing supervisory procedures to monitor recommendations that are near compensation or recognition thresholds, involve higher compensation products or involve rollovers or product transfers;
- Adjusting compensation for associated persons who fail to adequately manage conflicts of interest; and
- Limiting the types of retail customer to whom a product, transaction or strategy may be recommended.

- **Compliance Obligation**. Finally, the SEC established a new general Compliance Obligation in the Rule requiring broker-dealers to establish policies and procedures to comply with Regulation Best Interest in its entirety.

Additional SEC Notes on Standards and Enforcement

Three additional notes on standards and enforcement from the Adopting Release are worth highlighting. First the SEC notes that Regulation Best Interest is separate from Exchange Act antifraud rules and does not require scienter for a violation.[16] At least with respect to the Disclosure Obligation, the SEC intends to apply a negligence standard rather than strict liability. In addition, the SEC states that it does not intend the Rule to create private rights of action or believe that it does so. Finally, with regard to the interaction with state laws imposing similar duties, the SEC notes that whether or not the Rule will preempt such state laws, is a question for the courts and may depend on the specific scope and language of the state regulation at play.

[16] *See* Adopting Release at 218.

II. Form CRS Relationship Summary

In conjunction with the adoption of Regulation Best Interest, the SEC also adopted new rules and forms under the Advisers Act and the Exchange Act to require both investment advisers and broker-dealers to use the Form CRS relationship summary to state key facts regarding their relationships with retail investors, i.e., natural persons, or the legal representatives of such natural persons, who seek to receive or receive services "primarily for personal, family or household purposes."[17] These facts are designed to describe the differences between the broker-dealer and investment adviser business models and to assist retail investors in their decision on whether or not to engage an investment advisor or broker-dealer. Required descriptions include: (i) types of customer relationships and services the firm offers; (ii) the fees, costs, conflicts of interest and required standard of conduct associated with those relationships and services; (iii) whether the firm and its financial professionals currently have a reportable legal or disciplinary history; and (iv) how to obtain additional information about the firm. The Relationship Summary is required to be provided at the beginning of a relationship with a retail investor and should be updated upon the occurrence of certain events. While there is some overlap between the required content in Form CRS and Regulation Best Interest requirements, the Form CRS relationship summary should only be viewed, at most, as a baseline for meeting Regulation Best Interest obligations for broker-dealers.

III. Guidance on Activities that are Solely Incidental to Brokerage

In the Proposal, the SEC requested comment on Section 201(a)(11)(C) of the Advisers Act (the so-called "broker-dealer exclusion"). The broker-dealer exclusion is a carve-out from the definition of investment adviser (and thus from the application of the Advisers Act) applicable when a broker-dealer provides any advisory services that are "solely incidental to the conduct of his business as a broker-dealer" and receives no "special compensation" for those services (the "solely incidental prong"). The SEC determined that an interpretation of the solely incidental prong was warranted based on comments received that indicated disagreement about its meaning.[18] The Solely Incidental

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[17] *See* General Instruction 11.E. to Form CRS. Form CRS will be filed as Part 3 of the investment adviser's Form ADV.

[18] Securities and Exchange Commission, *Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser*, Release No. IA-5249 (June 5, 2019), *available* here.

Interpretation also reinstates an interpretation previously published in 2005[19] that was vacated by the D.C. Court of Appeals for unrelated reasons.[20]

In general, the Solely Incidental Interpretation states that a broker-dealer's provision of advice with respect to securities is consistent with the solely incidental prong "if the advice is provided in connection with and is reasonably related to the broker-dealer's primary business of effecting securities transactions." This facts and circumstances determination is, in part, based on the specific services offered.

The Solely Incidental Interpretation focuses in particular on instances where a broker-dealer exercises investment discretion (including temporary or limited discretion) with respect to client accounts. The interpretation asserts that the broker-dealer "is not providing advice to customers that is in connection with and reasonably related to effecting securities transactions [when acting with discretion]; rather, the broker-dealer is making investment decisions relating to the purchase or sale of securities on behalf of customers on an ongoing basis."

While unlimited discretion indicates that the investment relationship "is primarily advisory in nature," the Solely Incidental Interpretation recognizes that there are certain circumstances of limited discretion which may be consistent with the broker-dealer exclusion, including:

- discretion as to the price at which or the time to execute an order given by a customer for the purpose or sale of a definite amount or quantity of a specific security;

- discretion, on an isolated or infrequent basis, to purchase or sell a security or type of security when a customer is unavailable for a limited period of time;

- discretion as to cash management, such as to exchange a position in a money market fund for another money market fund or cash equivalent;

- whether to purchase or sell securities to satisfy margin requirements or other customer obligations that the customer has specified;

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[19] Securities and Exchange Commission, *Certain Broker-Dealers Deemed Not to Be Investment Advisers*, Release No. 2376 (Apr. 12, 2005).

[20] *See Financial Planning Associates v. SEC*, 482 F.3d 481 (D.C. Cir. 2007). *See also* Securities and Exchange Commission, *Interpretative Rule Under the Advisers Act Affecting Broker-Dealers* , Release No. 2652 (Sept. 24, 2007); *Thomas v. Metropolitan Life Insurance Company*, 631 F.3d 1153 (10th Cir. 2011).

- whether to sell specific bonds or other securities and purchase similar bonds or other securities in order to permit a customer to realize a tax loss on the original position;

- whether to purchase a bond with a specified credit rating and maturity; and

- whether to purchase and sell a security or type of security limited by specific parameters established by the customer.

The Solely Incidental Interpretation also recognizes that account monitoring by a broker may be consistent with the broker-dealer exclusion. For example, when a broker-dealer "voluntarily and without any agreement with the customer, reviews the holdings in a retail customer's account for the purpose of determining whether to provide a recommendation to the customer," the broker-dealer's actions would be considered "in connection and reasonably related to the broker-dealer's primary business of effecting transactions." Declining to delineate all instances where agreed-upon account monitoring would be incidental to a broker-dealer's primary business, the SEC suggests that broker-dealers "consider adopting policies and procedures that, if followed, would help demonstrate that any agreed-upon monitoring is in connection with and reasonably related to the broker-dealer's primary business."

The SEC will consider comments to the Solely Incidental Interpretation and may publish an updated interpretation if appropriate.

Next Steps

The compliance date for Regulation Best Interest and filing of Form CRS is June 30, 2020, which the SEC acknowledges to be a fairly short timeline relative to the transition requirements. Given this aggressive timeline, the complexity of the new rule, the daunting new requirements for disclosure and the importance of this regulation in the SEC agenda, there will likely be substantial enforcement risk attached to the new requirements. Risk could be particularly high in the early years of implementation as the details of compliance requirements are fleshed out.

Accordingly, broker-dealers providing recommendations to retail customers will likely need to quickly undertake a systematic review of practices around communications with retail customers and compensation of sales personnel and take variety of measures including:

- **Disclosures**. Development of a comprehensive set of relationship, conflicts and risk disclosures for both the firm and associated persons. In developing and updating these disclosures, it will be important to monitor for formal and informal staff guidance on matters relating to specificity and to regularly benchmark against evolving practices at other similarly situated firms to the extent feasible. It will also be important to consider additional processes around reviewing product materials in order to establish the adequacy of risk and fee disclosures.

- **Conflict monitoring and change management**. Instituting robust practices around monitoring conflicts of interest and identifying new conflicts as they arise,[21] particularly around new products, new businesses and changes in business operations. Broker-dealers should consider establishing a conflicts committee to manage and oversee this process on a regular basis. Similarly, broker-dealers should revisit their new product review and approvals process and ensure that a robust conflicts review and management element is included.

- **Recommendation policies**. Revising and potentially expanding and formalizing policies and methodologies for making recommendations (that are consistent with mandatory disclosures on the same topic) including guidelines on the "who, when, where and how" of making recommendations. Broker-dealers should also consider the process for assessing and categorizing investment profiles and imposing limits on the types of securities that may be recommended to investors with different profiles.

- **Compensation practices**. Review of the compensation system to eliminate any practices banned by the Rule and address any other practices that may be deemed to improperly motivate sales of particular securities. Procedures for compliance monitoring of recommendations should also be reviewed and updated;

- **Compliance program**. Updating the program of controls, remediation practices, training and periodic review and testing should also be incorporated.

While this is particularly true for firms that were not subject to the DOL's defunct fiduciary rule, firms that did adopt policies and procedures to comply with that rule will also need to make a robust showing that they comply with the specific scope and requirements of Regulation Best Interest.

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[21] The Adopting Release notes at page 244 that conflicts disclosures should generally be updated within 30 days of a material change.

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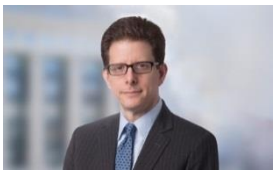

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