

SEC Announces Reg BI-Focused Examinations to Begin in January 2021

January 7, 2021

On December 21, 2020, the Securities and Exchange Commission's ("SEC") newly renamed Division of Examinations ("DOE," formerly the Office of Compliance Inspections and Examinations) released updated guidance concerning its planned examination program involving Regulation Best Interest ("Reg BI" or the "Regulation").¹ Since the Regulation's June 30, 2020 compliance date, DOE has undertaken preliminary examinations designed to assess whether firms have developed and implemented policies, procedures, and systems reasonably designed to achieve both procedural and substantive compliance with Reg BI. In 2021, DOE's exams will focus on firms' compliance with Reg BI's specific mandates (including the requirement of a "reasonable basis" for investment recommendations), including by conducting "enhanced transaction testing" to assess broker-dealers' policies and procedures.

Findings from the Initial Phase of Reg BI Exams. The SEC and Financial Industry Regulatory Authority ("FINRA") have analyzed and discussed findings from the first phase of Reg BI exams, including publicly at an October 2020 interagency roundtable.² During the roundtable, staff from the SEC's DOE and Division of Trading and Markets, and FINRA's Member Supervision Department relayed observations about the initial four months of firms' Reg BI implementation efforts.

The SEC and FINRA staff also provided detailed feedback on each of the four component obligations under Reg BI: compliance, enhanced care, conflicts management, and disclosure to retail investors:

¹ Public Statement, U.S. Sec. & Exch. Comm'n, Statement on Recent and Upcoming Regulation best Interest Examinations from the SEC Division of Examinations (Dec. 21, 2020), <https://www.sec.gov/news/public-statement/examinations-regulation-best-interest-2020-12-21>.

² See Press Release, U.S. Sec. & Exch. Comm'n, SEC Staff to Host October 26 Roundtable on Regulation Best Interest and Form CRS (Sept. 28, 2020), <https://www.sec.gov/news/press-release/2020-229>; U.S. Sec. & Exch. Comm'n, Roundtable on Regulation Best Interest & Form CRS (Oct. 26, 2020), https://www.sec.gov/video/webcast-archive-player.shtml?document_id=102620-best-interest-roundtable.

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- **Compliance obligation.** Both the SEC and FINRA staff noted that some firms' new policies lacked specificity, detail, controls, and/or the compliance testing provisions required by the Regulation.
 - **Duty of care requirement.** FINRA staff distinguished FINRA's suitability Rule 2111 from Reg BI's requirements, noting that they are not coterminous with respect to covered customers—in particular, FINRA-based suitability provisions in firms' policies do not necessarily guarantee compliance with Reg BI's different requirements. Most notably, Reg BI requires covered persons to consider the costs of investment opportunities to customers, in addition to the risks and potential rewards, in making recommendations.
 - **Conflict management requirement.** Under Reg BI, a conflict of interest is defined 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 not disinterested.” At a minimum, therefore, firms must implement policies and procedures that identify material conflicts of interest and either eliminate those conflicts or mitigate and disclose them to customers. The SEC staff observed that its examinations largely found that firms had made good faith efforts to disclose material conflicts, but cautioned firms that, for example, reimbursement or gift programs that might encourage registered representatives to engage in high-pressure sales tactics would be closely scrutinized and might constitute conflicts that should be eliminated or mitigated and disclosed.
 - **Disclosure to retail investors.** The panel emphasized Reg BI's requirement that disclosures be made to retail investors in plain language, and noted some instances in which firms had used relatively complex legal terms that could be simplified.

Both the SEC and FINRA staff agreed that although Reg BI's requirements can be implemented on top of existing compliance architecture, simply quoting the requirements of the Regulation in a firm's written supervisory procedures is insufficient to ensure regulatory compliance. Instead, firms must go beyond reciting the rules and focus on describing key personnel, timing, and actual implementation steps in their policies.

Next Phase of Reg BI Exams. Consistent with both its April 2020 Reg BI Risk Alert and its feedback at the October 2020 interagency roundtable, DOE's December 21, 2020 guidance aims to provide transparency to firms about the scope of its upcoming Reg BI examinations, which will commence in January 2021. Many of the enumerated exam priorities appear to flow directly from inadequacies discovered during the initial phase of Reg BI examinations. The SEC staff has announced several forthcoming examination components:

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- **Continued evaluation of firm policies and procedures**, including evaluating specific firm processes for Reg BI compliance, and **alterations to firm product offerings**, including whether firms are removing higher cost products when lower cost products are available.
 - **Evaluation of how firms have considered costs in making a recommendation**, which may include what information is available to firm personnel to identify relevant costs, how any such information has been used, and any documentation of the consideration of costs.
 - **Evaluation of the processes that firm personnel have used to make recommendations to new customers**, including, for example, if a firm recommended a rollover from an employee benefit plan, examiners will assess what information was gathered from new customers, what disclosures were made at the time, how investment alternatives were considered, and what documentation was retained.
 - **Evaluation of the processes that firm personnel have used to recommend complex products**, including what information was available and used to consider reasonably available investment alternatives.
 - **Evaluation of the processes that firms have used to identify and address conflicts related to recommendations.**

The SEC staff also announced that it will conduct “enhanced transaction testing” to assess whether the policies and procedures required by the Regulation have been implemented. It cautioned that failure to have adequate policies and procedures—including in particular policies governing supervision and compliance oversight—may indicate recurring failures to satisfy one or more of the duties created under the Regulation.

Given DOE’s repeated public statements and guidance, we expect that Reg BI examinations in 2021 will be less forgiving than the preliminary round, especially as COVID-19-related leniency abates. While DOE signaled that the six-month phase immediately after the Regulation’s effective date was an adjustment period, the SEC staff has now made clear that firms should be prepared to be in full compliance with Reg BI and should expect close examination scrutiny of all components of the Regulation in 2021. We expect this to be especially true among firms that were examined for Reg BI compliance during 2020 and received feedback from the staff. Moreover, under the incoming Biden Administration SEC, we expect that Reg BI examinations will be aggressive and that DOE will refer the most egregious violations to

the Division of Enforcement, which will be eager to show its commitment to protecting retail investors by bringing cases of first impression under the new Regulation.

To prepare for these examinations, firms should:

- Ensure that written supervisory procedures are current, address with specificity the requirements of Reg BI as applicable, and accurately reflect firm practices. In particular, firms should examine whether reimbursement or gift programs to sales personnel may require adjustments (or elimination) to address the SEC staff's recent observations.
- Assess whether procedures that may have been adopted by repurposing the pre-Reg BI approach to suitability are adequate to address the broader scope defined under the Regulation.
- Consider whether recommending certain complex products might require additional care to be taken by covered persons.
- Evaluate their policies for documenting recommendations as they relate to the adequacy of supervision for compliance with the care and conflicts obligations.
- Continuously monitor new and ongoing business arrangements for potential conflicts that must be either eliminated or mitigated and disclosed to customers.
- Consider whether registered representative training programs are sufficient in light of new and enhanced duties under Reg BI.
- Ensure that disclosures to retail investors are made in plain and accurate language.

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Please feel free to contact us should you have any questions about compliance with the Rule.

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