

# Components of Regulation Best Interest

On June 5, 2019, the Securities and Exchange Commission (SEC) adopted Regulation Best Interest (Rule 15l-1 under the Securities Exchange Act of 1934 (Exchange Act)), which requires broker-dealers (BDs) and their associated persons who are natural persons to act in the best interest of their retail customers when making a recommendation. The final regulation includes obligations relating to disclosure, care, conflict of interest and compliance, which are each specific components to the general obligation. Regulation Best Interest will become effective 60 days after their publication in the Federal Register. The compliance date is June 30, 2020.

The chart below summarizes the components of Regulation Best Interest. The SEC's adopting release for Regulation Best Interest is available at <http://bit.ly/2KbhJE8>.

PURPOSE/INTENT	REQUIREMENT	EXAMPLES
<p><b>1 DISCLOSURE OBLIGATION</b></p>	<p>To facilitate the retail customer's awareness of certain key information regarding the relationship with the BD by requiring more explicit disclosures.</p> <p>Requires a BD or "<b>natural person who is an associated person</b>" of a BD to, "<b>prior to or at the time</b>" of a "<b>recommendation</b>" of any securities transaction or investment strategy involving securities to a "<b>retail customer</b>" is made, provide to the retail customer, in writing, the full and fair disclosure of:</p> <p>(A) all <u>material facts</u> relating to the scope and terms of the relationship with the retail customer, including:</p> <ul style="list-style-type: none"> <li>(i) that the broker, dealer or such natural person is acting as a broker, dealer, or an associated person of a BD with respect to the recommendation;</li> <li>(ii) the material fees and costs that apply to the retail customer's transactions, holdings, and accounts;</li> <li>(iii) 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; and</li> </ul> <p>(B) all <u>material facts</u> relating to conflicts of interest associated with the recommendation.</p> <p><u>Form of disclosure</u>: disclosure should be clear and concise, applying plain English principles, using short sentences and active voice, and avoiding legal jargon, technical terms and multiple negatives.</p>	<p>Examples of <u>material facts</u> relating to the scope and terms of the relationship with the retail customer:</p> <ul style="list-style-type: none"> <li>(i) that the BD is acting in a <u>broker-dealer capacity</u> with respect to the recommendation;</li> <li>(ii) <u>fees and costs</u> that apply to the retail customer's transactions, holdings and accounts; and</li> <li>(iii) <u>type and scope of services</u> provided by the BD, including, for example, monitoring the performance of the retail customer's account.</li> </ul> <p>Examples of material facts relating to <u>conflicts of interest</u> associated with a recommendation include:</p> <ul style="list-style-type: none"> <li>• conflicts of interest identified in Form CRS;</li> <li>• how associated persons are compensated; and</li> <li>• benefits to a BD from recommending a proprietary product, such as additional fees.</li> </ul>
<p><b>2 CARE OBLIGATION</b></p>	<p>To incorporate and enhance existing suitability requirements applicable to BDs under the FINRA requirements by, among other things, imposing a "best interest" requirement, which requires the BD not put its own interest ahead of the retail customer's interest when making recommendations.</p> <p>Requires a BD, when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer, to exercise reasonable diligence, care and skill to:</p> <p>(A) understand the potential risks, rewards, and costs associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers (i.e., <u>reasonable-basis suitability</u>);</p> <p>(B) 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 broker, dealer, or such natural person ahead of the interest of the retail customer (i.e., <u>customer-specific suitability</u>); and</p> <p>(C) 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 broker, dealer, or such natural person making the series of recommendations ahead of the interest of the retail customer (i.e., <u>quantitative suitability</u>).</p> <p>The Care Obligation cannot be satisfied through disclosure alone.</p>	<p>Sample factors for assessing <u>reasonable-basis suitability</u> of a security or investment strategy include evaluating the associated costs, investment objectives, characteristics (including any special or unusual features), liquidity, volatility and likely performance of market and economic conditions, the expected return of the security or investment strategy, as well as any financial incentives to recommend the security or investment strategy.</p> <p>Sample factors for assessing <u>customer-specific suitability</u> include the retail customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the retail customer may disclose to the BD.</p> <p>Sample factors for assessing <u>quantitative suitability</u> by providing a basis for determining that a series of recommended transactions may be excessive include turnover rate, cost-to-equity ratio, use of in-and-out trading in a customer's account, and any other factors that can be indicative of the magnitude of investor harm caused by the accumulation of high trading costs.</p>

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<p><b>3 CONFLICT OF INTEREST OBLIGATIONS</b></p>	<p>To enhance the disclosure of conflicts of interest in order to educate retail customers about such conflicts and help them evaluate recommendations received from BDs, and to impose an obligation on BDs to not just disclose, but also mitigate conflicts of interest arising from financial incentives associated with their recommendations.</p>	<p>Requires BDs to establish, maintain and enforce written policies and procedures reasonably designed to:</p> <p>(A) identify and, at a minimum, disclose, in accordance with the Disclosure Obligation, or eliminate, all <b>"conflicts of interest"</b> associated with its recommendations to retail investors;</p> <p>(B) identify and mitigate any <b>"conflicts of interest"</b> associated with such recommendations that create an incentive for a <b>"natural person who is an associated person of a broker or dealer"</b> to place the interest of the broker, dealer or such natural person ahead of the interest of the retail customer;</p> <p>(C) (i) 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; and</p> <p>(ii) prevent such limitations and associated <b>"conflicts of interest"</b> from causing the broker, dealer, or a <b>"natural person who is an associated person of the broker or dealer"</b> make recommendations that place the interest of the broker, dealer, or such natural person ahead of the interest of the retail customer; and</p> <p>(D) identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time.</p> <p>BDs cannot comply with the Conflict of Interest Obligations of Regulation Best Interest by simply creating policies and procedures. The policies and procedures must also be effectively maintained and enforced.</p>
<p><b>4 COMPLIANCE OBLIGATION</b></p>	<p>To create an affirmative obligation with respect to the regulation as a whole, while providing sufficient flexibility to allow BDs to establish compliance policies and procedures that accommodate a broad range of business models.</p>	<p>Requires BDs to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.</p>
<p><b>5 RECORKEEPING (added to Rule 17a-3 under the Exchange Act)</b></p>	<p>To allow BDs to demonstrate their compliance with the substantive requirements of Regulation Best Interest.</p>	<p>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.</p> <p>If the <b>"retail customer"</b> neglects, refuses, or is unable to provide or update such information, the BD will be excused from obtaining that information.</p> <p>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.</p>
<p>There is no one-size-fits-all approach; reasonably designed policies and procedures should be tailored to account for the business practices, size and complexity of the BD, range of services and products offered and associated conflicts presented.</p> <p>The SEC has stated that it would be reasonable for BDs to use a risk-based compliance and supervisory system to promote compliance (rather than conducting a detailed review of each recommendation).</p> <p>Examples of potential methods to mitigate conflicts of interest that would create an incentive for an associated person to place his or her interest of those of the retail customer include:</p> <ul style="list-style-type: none"> <li>• avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales;</li> <li>• minimizing compensation incentives for employees to favor one type of account over another, or to favor one type of product over another, proprietary or preferred provider products, or comparable products sold on a principal basis, for example, by establishing differential compensation based on neutral factors;</li> <li>• eliminating compensation incentives within comparable product lines;</li> <li>• implementing supervisory procedures to monitor recommendations that are near compensation thresholds; near thresholds for firm recognition; involve higher compensating products, proprietary products or transactions in a principal capacity; or involve the rollover or transfer of assets from one type of account to another;</li> <li>• adjusting compensation for associated persons who fail to adequately manage conflicts of interest; and</li> <li>• limiting the types of retail customer to whom a product, transaction or strategy may be recommended.</li> </ul>		
<p>The Compliance Obligation does not enumerate specific matters that BDs must address in their policies and procedures. Each BD should consider the nature of that BD's operations and how to design such policies and procedures to:</p> <ul style="list-style-type: none"> <li>• prevent violations from occurring;</li> <li>• detect violations that have occurred; and</li> <li>• correct promptly any violations that have occurred.</li> </ul>		
<p>The SEC noted that it does not intend this requirement to create extensive, new and potentially duplicative records for each and every <b>"recommendation"</b> to a <b>"retail customer."</b> BDs should be able to explain in broad terms the process by which it determines what <b>"recommendation"</b> are in its customers' best interests and explain how that process was applied to any particular <b>"recommendation"</b> to a <b>"retail customer."</b> The rule is designed to suggest that BDs may wish to adequately document an evaluation of a <b>"recommendation"</b> and the basis for that recommendation in particular contexts, such as the <b>"recommendation"</b> of a complex product, or where a <b>"recommendation"</b> may seem inconsistent with a <b>"retail customer's"</b> investment objectives on its face.</p>		

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## KEY DEFINITIONS (IN ALPHABETICAL ORDER)

TERM	DEFINITION
1 CONFLICT OF INTEREST	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.
2 NATURAL PERSON WHO IS AN ASSOCIATED PERSON OF A BROKER-DEALER	A natural person who is an associated person as defined under Section 3(a)(18) of the Securities Exchange Act of 1934: “any partner, officer, director or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer, except that any person associated with a broker or dealer whose functions are solely clerical or ministerial shall not be included in the meaning of such term for purposes of section 15(b) of this title (other than paragraph 6 thereof).”
3 PRIOR TO OR AT THE TIME A RECOMMENDATION IS MADE	The Disclosure Obligation of Regulation Best Interest would apply when a BD is making a recommendation about any securities transaction or investment strategy to a retail customer. The timing of the disclosure is critically important to whether it may achieve the effect contemplated by the proposed rule. Investors should receive information early enough in the process to give them adequate time to consider the information and promote the investor’s understanding in order to make informed investment decisions, but not so early that the disclosure fails to provide meaningful information (e.g., does not sufficiently identify material conflicts presented by a particular recommendation, or overwhelms the retail customer with disclosures related to a number of potential options that the retail customer may not be qualified to pursue). The timing of the required disclosure should also reflect the various ways in which retail customers may receive recommendations and convey orders.
4 RECOMMENDATION	In determining whether a BD has made a recommendation, factors that have historically been considered in the context of BD suitability obligations include whether the 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.” 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.”  “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).  “Any securities transaction or investment strategy involving securities” not only includes explicit hold recommendations, but also includes implicit hold recommendations that are the result of agreed-upon account monitoring between the BD and its retail customer. Consequently, account recommendations are subject to Regulation Best Interest even if there is not a recommendation of a securities transaction.
5 RETAIL CUSTOMER	A natural person, or the legal representative of such person, who: (1) receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer or a natural person who is an associated person of a broker or dealer, and (2) uses the recommendation primarily for personal, family, or household purposes.  “Personal, family or household purposes” includes retirement accounts; accordingly, a retirement plan participant receiving a recommendation about whether to take a distribution from a 401(k) plan and how to invest that distribution would be a “retail customer” for purposes of Regulation Best Interest.