Reg BI Final Rules and Guidance

Preliminary Summary

June 10, 2019

SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over $2.9 trillion for businesses and municipalities in the U.S., serving clients with over $20 trillion in assets and managing more than $72 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

1. Regulation Best Interest – Standard of Conduct for Broker-Dealers

Best Interest Obligation (p.46)[1]

- Applies when making a recommendation (as defined under FINRA guidance). (p. 80-81)
- Applies to recommendations about *account-types* (even if there is not a *recommendation* of a securities transaction) and *IRA rollovers* (regardless of whether it is tied to a specific securities transaction). (pp. 85, 96, 98)
- Reg BI does *not* impose a duty to monitor accounts. (p. 106) If a BD *voluntarily* monitors an account, then Reg BI would apply to *explicit* recommendations to *hold*. (p. 105) If a BD engages in *agreed-upon* account monitoring, then Reg BI applies to both explicit and *implicit* recommendations to *hold*. (p. 94).
- Retains the language from the original proposal: "without placing the financial or other interest of the broker … ahead of the interest of the retail customer." Does not incorporate the "without regard to the financial or other interest of the [BD]" language from Dodd-Frank Section 913(g) and the DOL Best Interest Contract Exemption. (pp. 62-67)
- Is satisfied by meeting the Disclosure, Care, Conflict of Interest, and Compliance Obligations.
- Firms are subject to *all* of the Obligations. Associated persons (who are natural persons) are subject to the Best Interest, Disclosure, and Care Obligations. (p. 140)

Disclosure Obligation. (p. 130)

BDs must provide, prior to or at the time of the recommendation[2], in writing[3], *full and fair disclosure*[4] of:

[1] Available at https://www.sec.gov/rules/final/2019/34-86031.pdf

[2] Notwithstanding this requirement, firms have some flexibility as to the timing and frequency of disclosure, and may supplement, clarify, or update information *after* making a recommendation. (pp. 233, 237, 239)

[3] A BD may update its written disclosures *orally* (not later than the time of the recommendation) in order to reflect facts not reasonably known at the time the written disclosure is made, provided that the BD maintains a record of the fact that the oral disclosure was made. (pp. 137, 227, 229)

[4] This term is intended to more closely align the Disclosure Obligation with the existing disclosure standard for IAs. (pp. 211-212).

(A) All *material*[5] facts relating to the scope and terms of the relationship[6] (p. 142), including[7] (i) the capacity in which the BD is acting, (ii) material fees and costs, including why and when a fee or charge will be imposed (p. 173), and (iii) any material limitations on the securities or products that may be recommended (e.g., *limited product menu, proprietary products* only, etc.) (p. 175); and

(B) All *material* facts relating to conflicts of interest[8] associated with the recommendation. (p. 194)

- Monitoring Services. BD must disclose whether it provides agreed-upon monitoring services. (p. 183, fn 167, fn 402)
- Titles. If the BD is not dually registered, then the use of the titles "advisor" or "adviser" would violate the Disclosure Obligation. (pp.148-149, 157-158)
- Individualized Disclosure. Individualized disclosure of fees and costs is not mandated by the Disclosure Obligation. (pp.166, 168, 170)
- Reliance on Other Disclosures and Regulatory Requirements. BDs are permitted to utilize disclosures and standardized documents, such as a prospectuses, trade confirms, account agreement or fee schedule to help satisfy the Disclosure Obligation. (pp. 223, 224, 239)

Care Obligation. (p. 245)

- The BD must exercise *reasonable diligence, care, and skill*[9] to: (A) *understand* the risks, rewards, and *costs*[10] associated with the recommendation, (B) have a *reasonable basis* to believe the recommendation is in the

[5] As the term "materiality" is defined in the Supreme Court's *Basic v. Levinson* decision. (pp.199, 201)
[6] The requirement to disclose material facts relating to the *scope and terms* of the relationship is intended to be a subset of material facts relating "to the relationship." (pp. 213-241).
[7] In addition to these three required disclosures, BDs must disclose other material facts such as the general basis for and risks associated with recommendations. While not required to make particularized disclosure of the basis for and risks associated with each recommendation, BDs should disclose generally the process by which they develop recommendations and describe the risks in standardized terms. (pp. 188-190)
[8] See p. 195 for examples of material conflicts of interest that should be disclosed.
[9] The word "prudence" was removed under the view that it was redundant and created unnecessary legal uncertainty. (pp. 247, 257)
[10] While "cost" was added as a factor that must always be considered along with risks and rewards, cost is not dispositive and should never be the only consideration. (p. 249)

customer's best interest, and (C) have a *reasonable basis* to believe that a series of recommended transactions are in the customers' best interest.

- The Care Obligation is stronger than the existing suitability standard because it: (1) explicitly requires that the recommendation be in the customer's best interest and that the BD does not place its interests ahead of the customer; (2) explicitly requires that cost be a consideration; (3) applies the quantitative suitability requirement *irrespective of* whether the BD has actual or de facto control over the customer's account; and (4) requires the BD to consider "reasonably available alternatives" as part of having a "reasonable basis to believe" that the recommendation is in best interests of the customer. (pp. 253-254)

- The Care Obligation applies to recommendations of account types and IRA rollovers. (pp. 291-296)

Conflict of Interest Obligation (p. 302)

BDs must have policies and procedures to identify and:

- Disclose. (A) Disclose – in accordance with the Disclosure Obligation - all conflicts of interest associated with recommendations.[11]
- Mitigate. (B) Mitigate any conflict that creates an incentive for a BD's associated person to place the interest of the BD or associated person ahead of the interest of the customer.[12]
  - This provision applies only to conflicts created by incentives provided to the associated person (whether by the BD itself or third parties) that are within the control of or associated with the BD's business. (pp. 329-330)
- Disclose and Mitigate Material Limitations. (C) Disclose any material limitations on securities or products that may be recommended (e.g., *limited product menu, proprietary products* only, etc.), and prevent such limitations from causing the BD to place its interest ahead of the customer.[13] (pp. 340-342)

[11] Although Reg BI adopts the *Capital Gains* definition of "conflicts of interest," the Disclosure Obligation requires disclosure only of material facts relating to conflicts of interest. (pp. 133, 202)

[12] The Commission provides a non-exhaustive list of suggested practices that could be used as potential mitigation methods. (p. 334-336). "Neutral factors" are not required for mitigation. (p. 333)

[13] The Commission provides examples of mitigation to prevent such conflicts from causing violations of the Reg BI standard. (pp. 344-345)

- Eliminate. (D) Eliminate sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sale of specific securities or specific types of securities within a limited period of time. (p. 337) Non-cash compensation includes any form of compensation, including but not limited to merchandise, gifts and prizes, travel expenses, meals and lodging. (p. 352)

Compliance Obligation (p. 357)

BDs also must have policies and procedures reasonably designed to achieve compliance with Reg BI as a whole.

- Definitions.
  - Retail Customer. A *natural* person, or the legal representative of such natural person, who uses the recommendation for personal, family, or household purposes. (pp. 110-111) The natural person's wealth or sophistication is irrelevant. This definition and the related definition of "retail investor" under Form CRS have been revised to generally conform to each other. Still, the Form CRS definition is broader, given that Form CRS is required whether or not there is a recommendation and also covers both prospective and existing customers. (pp. 123-124)
    - The Commission clarified that "legal representative" is intended to capture non-professional legal representatives and does not apply to financial industry professionals. (p. 114)
  - Conflict of Interest. An interest that might incline a BD or associated person of a BD – consciously or unconsciously – to make a recommendation that is not disinterested. (pp. 194-195)
- Recordkeeping. (p. 361) BDs must create a record of "all information collected from and provided to the retail customer" and the identity of each registered representative responsible for the account. These records must be maintained for 6 years after the earlier of the date the account was closed or the date on which the information was replaced or updated. (p. 369)
- Private Right of Action. Reg BI does not create a new private right of action or right of rescission. (pp. 43-44) Form CRS also does not create a private right of action (p. 43 of CRS)
- Scienter. Scienter is not required to establish a violation of Reg BI. (p. 43) The Disclosure Obligation is subject to a negligence standard, not strict liability (p. 217)
- Common law fiduciary duty. The Reg BI obligation is a separate federal legal obligation from the question of whether a BD may owe a fiduciary duty under state common law (e.g., where the BD exercises discretion or control over customer assets, etc.). (p. 68, fn 137)
- Federal Preemption. The preemptive effect of Reg BI on any state regulation of BD conduct standards will be determined in future judicial proceedings based on the specific provisions of the state regulation. (p. 43, fn 1163)
- Effective Date / Compliance Date: Effective 60 days from publication in the Federal Register. Compliance date is June 30, 2020.

2. Form CRS Relationship Summary[14]

- Length. In paper form, the CRS may not exceed 2 pages. For dual registrants that choose to include the brokerage and advisory services in a single CRS, the CRS may not exceed 4 pages. For dual registrants that choose to prepare separate Forms CRS, the limit is 2 pages for each.
- Form. Paper is not required. Electronic and graphical formats are encouraged. Allows flexibility in wording and layered disclosure.
- Delivery Requirements:
  - Initial Delivery. CRS must be delivered to each retail investor at or before the earliest of: (i) a recommendation of an account type, securities transaction, or investment strategy, (ii) placing an order,[15] or (iii) opening a brokerage account.
  - If a retail investor contacted the firm through electronic means, the firm may provide electronic delivery of the CRS. (p. 220)
  - Existing Customers. In addition to delivering CRS to all existing retail investor customers after the Effective Date, CRS must be redelivered to an existing customer at or before: (i) opening a new account that is different from the existing account, (ii) recommending a roll-over of assets from a retirement account, (iii) recommending or providing a new brokerage service or investment that does not involve the opening of a new account and would not be held in an existing account.
  - Updates. To existing customers within 60 days after amendments are made.
  - Upon Request. To each retail investor within 30 days upon request.
  - Firm Website. Where the BD has a public website, CRS must be posted there.
  - Electronic Filing. BDs file using Web CRD; IAs file using IARD; dual registrants do both. Must be filed in text-searchable format with machine-readable headings.
- Definition of Retail Investor. "[A] natural person, or the legal representative of such natural person, who seeks to receive or receives services primarily for personal, family or household purposes." As with Reg BI, the legal

[14] Available at https://www.sec.gov/rules/final/2019/34-86032.pdf

[15] This provision would apply to "check and application" arrangements where a retail investor places an unsolicited order without opening an account. (pp. 223, 238)

representative does not include regulated financial services professionals, such as RIAs, BDs, corporate fiduciaries (such as banks, trust companies, and similar financial institutions), insurance companies, and their employees. (p. 195)

- Application. CRS applies to every BD "that offers services to a retail investor" (p. 224) This definition excludes clearing and carrying BDs that solely provide services to third party or affiliated introducing BDs. It also excludes BDs that serve solely as a principal underwriter to a mutual fund or variable annuity or variable life insurance contract issuer. (pp. 224-225)
- Form CRS Disclosure Items:
  1. Introduction. Include the date. State registration status. State that brokerage and advisory services and fees differ and the retail investor should understand the differences. Include a link to investor.gov/CRS.
  2. Relationships and Services. *What investment services and advice can you provide me?* Describe services. State whether you provide *account monitoring*. Describe your discretionary authority (IAs) or limited discretionary authority (BDs, permitted but not required). State whether you have *limited investment offerings* and/or *account minimums*. Include required links to additional information. Include required conversation starters, including for dual registrants: *Given my financial situation, should I choose an investment advisory service? Should I choose a brokerage service? Should I choose both types of service? Why or why not?*
  3. Fees, Costs, Conflicts, and Standards of Conduct. *What fees will I pay?* Describe principal fees and costs. Describe other fees and costs the investor will pay directly or indirectly. Describe the applicable standard of conduct, and conflicts associated with it. Include required conversation starters.
  4. Disciplinary History. Do you or your financial professionals have legal or disciplinary history? Direct the investor to investor.gov/CRS for a free search tool. Include required conversation starters.
  5. Additional Information. State where you can find additional info about the firm's services and request a copy of the CRS (include a phone number). Include the following conversation starters: *Who is my primary contact person? Is he or she a representative of an investment adviser or a broker-dealer? Who can I talk to if I have concerns about how this person is treating me?*
- Recordkeeping. (p. 243) BDs must create and retain a record of the date on which each CRS was provided to each retail investor, including any CRS provided *before* the investor opens an account.
- Effective Date / Compliance Date: Effective 60 days from publication in the Federal Register. Compliance date is June 30, 2020. CRS must be filed in a text searchable format with the SEC beginning May 1, 2020 but no later than June 30, 2020.

3. Guidance on the Interpretation of "Solely Incidental"[16]

- The "solely incidental" prong of section 202(a)(11)(C) of the Investment Advisers Act states that BDs who give investment advice are *excluded* from the definition of "investment adviser" (and thus application of the Advisers Act) if the advice they give is "solely incidental" to the conduct of their business as a BD, and they receive "no special compensation" for the advice.
- To avoid application of the Advisers Act, BDs must satisfy two separate prongs: (1) "no special compensation" *and* (2) "solely incidental" advice.
- "No special compensation" generally means that BDs can charge only commissions, and *not* asset-based fees like investment advisers.
- "Solely incidental" advice, however, encompasses virtually *all* investment advice provided by BDs to their retail clients. The SEC has historically recognized that the advice provided by BDs was often substantial in amount and importance to their customers.
- The SEC's new interpretive guidance reinforces that BDs may continue to give substantial advice to their customers. The amount, frequency, or importance of the advice does not determine whether the solely incidental prong is satisfied.
- Following is guidance on how the solely incidental prong applies with respect to (i) investment discretion and (ii) account monitoring.
- Investment Discretion.
    - *Unlimited*. If a BD exercises unlimited discretionary authority with respect to an account, then such BD's advice is *not* solely incidental; thus, the BD is subject to the Advisers Act.
    - *Limited*. If, however, the BD's discretion is limited in time, scope, or other manner, and lacks the comprehensive and continuous characteristics of full discretion, then such BD's advice may be deemed solely incidental and thus, the BD would not be subject to the Advisers Act.
        - This is a totality of the facts and circumstances test. The staff provides examples of such limited discretion on page 17 of the Interpretive Guidance.

[16] Available at https://www.sec.gov/rules/interp/2019/ia-5249.pdf

  - This approach to limited discretion is consistent with SIFMA's longstanding advocacy on this issue. *See* SIFMA comment to SEC (Feb. 7, 2005), *available at* https://www.sifma.org/resources/submissions/sia-submits-comments-to-the-sec-on-the-secs-release-relating-to-broker-dealers/.
- Account monitoring.
  - *Voluntary*. When a BD voluntarily and without any agreement with the customer reviews the holdings in a customer's account for purposes of deciding whether to make an investment recommendation, such monitoring is "solely incidental" and the SEC staff does not consider it to be "account monitoring."
  - *Agreed-upon*. A BD that agrees to monitor a customer's account *on a periodic basis* or *at specific time frames (e.g., quarterly)*, for example, for purposes of providing investment recommendations is also "solely incidental." Agreed-upon, continuous and ongoing monitoring, however, would likely *not* be "solely incidental." Reg BI would apply to any implicit hold recommendation in both the periodic and continuous monitoring situations.
- Effective Date of Guidance. The date of publication in the Federal Register.

4. Guidance on the Standard of Conduct for Investment Advisers[17]

- Duty of Care. An IA's fiduciary duty under the Advisers Act comprises a duty of care and a duty of loyalty. The duty of care requires an IA to provide investment advice in the best interest of the client, based on the client's objectives.
- Duty of Loyalty. Under the duty of loyalty, "an IA must eliminate or make full and fair disclosure of all conflicts of interest which might incline an IA – consciously or unconsciously – to render advice which is not disinterested such that a client can provide informed consent to the conflict."
    - If, however, an IA cannot fully and fairly disclose a conflict such that the client can provide informed consent, then the IA should either *eliminate* or adequately *mitigate* the conflict, such that disclosure and informed consent are possible. (p. 28)
    - *It is unclear under what circumstances, if any, this would be necessary. Thus, in virtually every case, an IA could presumably satisfy its fiduciary duty through disclosure alone.*
- No Waiver. An adviser's federal fiduciary duty may not be waived, although it will apply in a manner that reflects the agreed-upon scope of the relationship between the adviser and the client.
- Account-Types and IRA Rollovers. Consistent with Reg BI, an IAs fiduciary duty applies to advice about account types and advice about whether to roll over assets from one account (e.g., a retirement account) into another.
- IA / BD Regulatory Harmonization. With respect to the staff's request for comments on prospective enhancements to IAs' licensing, continuing education, and financial responsibility requirements, the staff is continuing to evaluate the comments. (fn 8)
- Effective Date of Guidance. The date of publication in the Federal Register.

[17] Available at https://www.sec.gov/rules/interp/2019/ia-5248.pdf

5. Coordination with DOL Regulation

- Although workplace retirement plans are not generally covered by the definition of “retail customer” in Regulation Best Interest, based on preliminary discussions with DOL staff, SEC staff understands that the DOL is considering regulatory options in light of the Fifth Circuit’s decision vacating the DOL Fiduciary Rule. DOL Regulatory Agenda, Fall 2018, available at https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201810&RIN=1210AB82. (fn 254)

6. Cost Benefit Analysis of Reg BI

- Overview. The economic analysis considers the costs and benefits to retail investors and BDs, and takes into account the implications of Reg BI on efficiency, competition, and capital formation. The analysis is based on the conclusion that retail customers are subject to inefficient recommendations, resulting in agency costs that arise from a BD's conflicts of interest, information asymmetry, bounded rationality, and financial literacy levels, among other things.
- Market Failure. In response to comments critical of the description of the "principal-agent" relationship and arguments that the market failure is a result of the commission-based model, the SEC more specifically and fully describes the relationship between the BD and the client, the related market failure, and the resulting potential economic effects of Reg BI. The SEC concludes that agency costs, not conflicts of interest themselves, are the source of the market failure.
- Economic Baseline. The SEC analyzed and ultimately dismissed comments that its rulemaking proposal did not adequately account for existing economic analyses produced in 2015 by the Council of Economic Advisors (the "CEA study") and by the DOL in its Regulatory Impact Analysis (the "RIA"). The SEC concluded that the CEA study and RIA are dated, not reflective of the current market, and flawed in other ways.
    - The staff included updated economic and regulatory baselines to reflect the most recently available data, and to address current market practices, state fiduciary standards, FINRA guidance and best practices, and the DOL fiduciary rule and temporary enforcement policy.
- Benefits and Costs. SEC analyzes the costs and benefits relative to their updated economic and regulatory baselines.
    - The staff reviewed 68 new studies and literature (in addition to the 10 studies included in the original proposal) to support its conclusion that Reg BI will deliver broad investor protection benefits that outweigh potential costs.
    - The analysis estimates costs where possible but notes several factors make meaningful quantification of the effects difficult (i.e., lack of data, compliance flexibility, differences in business models, and dependence on assumptions).
    - The analysis directly addresses specific criticisms of Reg BI by: SEC Former Chief Economists, Consumer Federation of America, and AARP, among others.
    - In response to comments to quantify the existing harm and specific benefits expected, the SEC includes a new analysis using a variety of methodologies to attempt to quantify the potential benefits (i.e., reduction in fees and reduction in the relative underperformance of broker versus direct-sold mutual funds).
- Competition, Capital Formation and Efficiency. The staff includes an updated analysis of how the new obligations may affect competition, capital formation, and efficiency.

- Competition: Reg BI may increase competition between BDs and IA for retail customers, resulting in lower fees. Potential lower costs may increase demand resulting in a positive competitive effect, and may offset other negative potential competitive effects such as a higher cost of entry into the market for investment advice.
- Capital formation and efficiency: Retail customers receiving more efficient recommendations would increase the efficiency of the portfolio allocation, which in turn may enhance the attractiveness of BD services. If more retail customers are willing to participate in the securities markets through BDs, Reg BI would have a positive effect on capital formation.

- Reasonable Alternatives. The staff considered several reasonable alternatives, including (1) applying the Advisers Act fiduciary standard to BDs, (2) adopting a new uniform standard of conduct for BDs and IAs, (3) adopting similar standards to the DOL fiduciary rule, and (4) other approaches including prescribed disclosure formats and a disclosure-only regime.

Contacts

Kevin Carroll
Managing Director and Associate General Counsel
kcarroll@sifma.org
202.962.7382

Ira Hammerman
Executive Vice President and General Counsel
ihammerman@sifma.org
202.962.7373