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The Final Reg BI Package: What to Know and What's Next

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Introduction

On June 5, 2019, the Securities and Exchange Commission (SEC), led by Chairman Jay Clayton, [voted 3 to 1 to approve](#) the four agenda items that encompassed the “Reg BI Package.” These four items were Regulation Best Interest – Standard of Conduct for Broker-Dealers; Form CRS Relationship Summary; Standard of Conduct for Investment Advisers; and Interpretation of “Solely Incidental.” Below we summarize the meeting, certain statements, and each of these items, and we delve deeper into the “Reg BI” rule and offer perspectives on how all of this may impact the industry in the future.

A Summary of the Meeting and Certain Guiding Statements

The 3 to 1 vote was not a surprise. After the detailed and positive overview provided by Chairman Clayton, Commissioner Robert J. Jackson gave a scathing dissent that criticized Reg BI for not being strict enough, and he subsequently voted against each of the items. Not surprisingly, however, Commissioners Hester M. Peirce and Elad L. Roisman echoed the Chairman’s positive comments in their statements before voting with Chairman Clayton to pass all four agenda items. The Commission then published the two final-rule releases and the two final interpretations, totaling over 1,300 pages. The rules and forms will be effective 60 days from publication in the Federal Register, and the interpretations will be effective upon publication in the Federal Register. The SEC is allowing firms a transition period until June 30, 2020, to come into compliance with Reg BI and Form CRS.

Since the [issuance of the proposals on April 18, 2018](#), the SEC received over 3,000 unique comment letters (over 6,000 comment letters in total) from individuals, consumer advocacy groups, financial services firms, investment professionals, industry and trade associations, state securities regulators, bar associations, and others. Interestingly though, the changes from the proposals to finalization were limited. In fact, one issue noted at the open meeting for the proposals and addressed in numerous comment letters was the lack of a definition for the term “best interest” in the text of the proposed Reg BI. Yet the SEC elected not to define this term in the final rule text:

After careful consideration of these comments, we continue to believe that our proposed approach for

enhancing the standards of conduct that apply to broker-dealers’ recommendations to retail customers is the appropriate approach, and therefore we are adopting as proposed the structure and scope of Regulation Best Interest, including the phrasing of the General Obligation, and are not expressly defining “best interest” in the rule text. (See <https://www.sec.gov/rules/final/2019/34-86031.pdf>, p. 54.)

The SEC also did not waiver from its proposal and its position not to adopt a uniform standard of conduct for broker-dealers and investment advisers. Chairman Clayton specifically addressed this in his [statement at the meeting](#): “The staff has not recommended the approach advocated for by some groups to adopt a uniform rule set that would apply equally to both broker-dealers and investment advisers.” The final rule provided additional perspective on this controversial topic:

Moreover, the Commission has chosen not to create a new uniform standard applicable to both broker-dealers and investment advisers which, among other things, would discard decades of regulatory and judicial precedent and experience with the fiduciary duty for investment advisers that has generally worked well for retail clients and our markets. (See <https://www.sec.gov/rules/final/2019/34-86031.pdf>, p. 56.)

The Chairman’s statement and the text of the final rule release, however, did state repeatedly and without reservation that they drew on “fiduciary principles.” Specifically, Chairman Clayton stated,

Regulation Best Interest, which will substantially enhance the broker-dealer standard of conduct beyond existing suitability obligations, requiring broker-dealers, among other things, to act in the best interest of their retail customers when making a recommendation, including not placing their financial or other interests ahead of the interests of the retail customer. The standard of conduct **draws from key fiduciary principles** and cannot be satisfied through disclosure alone. (Emphasis added.)

Consistent with this, the Chairman and the final rule release cited to the now-vacated fiduciary rule by the Department of Labor (DOL) and the positive working relationship between the staffs of the SEC and DOL. Chairman Clayton’s statement provided as follows:

The recommendations today reflect a careful study of the DOL Fiduciary Rule, incorporating certain aspects of the rule that will enhance the broker-dealer

standard of conduct in line with reasonable investor expectations, while avoiding other consequences, such as the introduction of a best interest contract exemption and private right of action, and the uncertainty of whether, and if so to what extent, a commission-aspects of the rule that appear to have been primary drivers of the rule's unintended based fee model was compatible with the DOL Fiduciary Rule.

Our senior staff and DERA [Division of Economic and Risk Analysis] economists have met with staff at the Department of Labor on many occasions, both during and after the development of the DOL Fiduciary Rule and during the development of our standards of conduct rulemaking, to discuss the approaches taken by our respective staffs.

As a result of this collaboration, one of the enhancements from the proposal, as described by the Chairman, involved the SEC's increasing focus on retirement accounts and specifically roll-overs:

Account Recommendations: Regulation Best Interest will now expressly apply to account recommendations, including recommendations to roll over or transfer assets in a workplace retirement plan account to an IRA, recommendations to open a particular securities account (such as a brokerage account or advisory account), and recommendations to take a plan distribution for the purpose of opening a securities account. These recommendations are often provided at critical moments (such as at retirement) and may be irrevocable, can involve a substantial portion of a retail investors net worth, and can have significant long-term impacts on the retail investor.

The Final Reg BI Rule

Turning to the text of the Reg BI rule, it is made up of these four "obligations":

- **Disclosure Obligation:** Broker-dealers must disclose material facts about the relationship and recommendations, including specific disclosures about the capacity in which the broker is acting, fees, the type and scope of services provided, conflicts, limitations on services and products, and whether the broker-dealer provides monitoring services
- **Care Obligation:** A broker-dealer must exercise reasonable diligence, care, and skill when making a recommendation to a retail customer. The broker-dealer must understand potential risks, rewards, and costs associated with the recommendation. The broker-dealer must then consider these factors in light of the retail customer's investment profile and make a recommendation in the retail customer's best interest. The final regulation, which is an enhancement from the proposal, explicitly requires the broker-dealer to consider the costs of the recommendation.
- **Conflict-of-Interest Obligation:** The broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to identify and at a minimum disclose or eliminate conflicts of interest. This obligation, which is an enhancement from the proposal, specifically requires policies and procedures to:
 - Mitigate conflicts that create an incentive for the firm's financial professionals to place their interest or the interests of the firm ahead of the retail customer's interest;
 - Prevent material limitations on offerings, such as a limited product menu or offering only proprietary products, from causing the firm or its financial professional to place his or her interest or the interests of the firm ahead of the retail customer's interest; and
 - Eliminate sales contests, sales quotas, bonuses, and noncash compensation that are based on the sale of specific securities or specific types of securities within a limited period.
- **Compliance Obligation:** In an enhancement from the proposal, broker-dealers must establish, maintain, and enforce policies and procedures reasonably designed to achieve compliance with Regulation Best Interest as a whole (by June 30, 2020).

A closer look at the requirements for complying with the "Care Obligation" subsection of Reg BI reveals that this language tracks the three aspects of FINRA's suitability rule, specifically, reasonable basis suitability, customer specific suitability, and quantitative suitability. With this in mind, the three pillars of Reg BI become clear and they are not new: 1) suitability; 2) certain aspects of the DOL's vacated fiduciary rule; and 3) the requirement to disclose material conflicts of interest, which appears to be consistent with the regulatory regime for the investment advisory industry. While these three pillars are familiar, the concept of and guidance regarding the mitigation of conflicts for broker-dealers remains novel.

Moving onto the other three items from the agenda, we summarize them below.

Final Form CRS

The Form CRS relationship summary will require investment advisers and broker-dealers to deliver a relationship summary to retail clients at the beginning of their relationship. Firms will summarize information about services, fees and costs, conflicts of interest, the respective legal standard of conduct, and whether the firm and its financial professionals have any disciplinary history. The relationship summary will have a standardized question-and-answer format to promote comparison by retail clients in a way that is distinct from existing disclosures. The relationship summary will permit the use of layered disclosure so that retail clients can more easily access additional information from the firm about these topics. It also will highlight

the Commission's investor education website (Investor.gov), which offers the investing public educational information, including a series of educational videos designed to provide ordinary retail clients with some basic information about broker-dealers and investment advisers.

The SEC's Investment Adviser Interpretation

The Investment Adviser Interpretation (SEC IA Interpretation) reaffirms, interprets, clarifies, and provides guidance regarding the fiduciary duty derived from common law that an investment adviser owes to its clients under the Investment Advisers Act of 1940 (Advisers Act). The SEC IA Interpretation provides that this duty is principles-based and applies to the entire relationship between an investment adviser and the client. In essence, with the SEC IA Interpretation, the SEC has consolidated these long-recognized, court-established fiduciary duties into a finalized interpretive release. The SEC IA Interpretation also describes the underlying duties that constitute an investment adviser's fiduciary duty: the Duty of Care and the Duty of Loyalty. It further breaks down the Duty of Care as follows: (i) a Duty to Provide Advice that is in the **Best Interest** of the Client; (ii) a Duty to Seek Best Execution; and (iii) a Duty to Provide Advice and Monitoring over the Course of the Relationship. (Emphasis added.) The discussion of the "Duty to Provide Advice that is in the Best Interest of the Client" includes a subsection with a detailed discussion on the requirement for a "reasonable belief that advice is in the best interest of the client."

The Interpretation of "Solely Incidental"

Regarding the Solely Incidental Interpretation, the broker-dealer exclusion under the Advisers Act excludes from the definition of investment adviser, and thus from the Advisers Act, a broker or dealer whose performance of advisory services is solely incidental to the conduct of her or his business as a broker or dealer and who receives no special compensation for those services. The interpretation confirms and clarifies the Commission's interpretation of the "solely incidental" prong of the broker-dealer exclusion of the Advisers Act. Specifically, the final interpretation states that a broker-dealer's advice as to the value and characteristics of securities or as to the advisability of transacting in securities falls within the "solely incidental" prong of this exclusion if the advice is provided in connection with and is reasonably related to the broker-dealer's primary business of effecting securities transactions.

The SEC Encourages Engagement

In terms of next steps, the Commission is establishing an inter-Divisional Standards of Conduct Implementation Committee, composed of representatives from the Division of Investment Management, the Division of Trading and Markets, the Division of Economic and Risk Analysis, the Office of Compliance Inspections and Examinations (OCIE), and the Office of the General Counsel to assist firms with planning for compliance. The SEC is encouraging firms to engage with this committee as questions arise in planning for implementation.

Conclusion

After much debate and controversy, these rules and interpretations are in fact "final." Setting aside whether they may be subject to legal challenges, firms need to complete their implementation efforts by June 30, 2020. OCIE will begin examining for compliance soon thereafter. With the Chairman's and SEC's continuing and aggressive focus on "Main Street" issues, we can expect these efforts to be a priority for OCIE for the foreseeable future thereafter. We also need to expect that when significant compliance failures are discovered, they will likely be referred to the SEC's Division of Enforcement for investigation and possible charges. To avoid running afoul of OCIE and Enforcement, firms need to closely analyze these two final rules and two final interpretations and determine how they apply to their businesses, and review, revise, and remediate their policies, procedures, and processes accordingly.

Drinker Biddle's Best Interest Compliance Team

Our [Best Interest Compliance Team](#) assists clients with the evolving and overlapping federal and state regulations related to the standard of care for broker-dealers, investment advisers, and insurance companies, agents, and brokers. This interdisciplinary team consists of more than 25 attorneys from the firm's Investment Management, SEC and Regulatory Enforcement Defense, ERISA, Litigation/FINRA Arbitration, and Insurance Regulatory and Transactional practice areas. The team includes experienced regulatory compliance attorneys, former regulators, litigators, and legislative professionals.

Best Interest Compliance Team

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