



Final Rule on Regulation Best Interest Now Complete

IN SHORT

The Situation: The U.S. Securities and Exchange Commission ("SEC") has adopted: (i) new regulations relating to the relationship between broker-dealers and their retail customers; and (ii) interpretations of the standard of conduct between investment advisers and their clients and of the broker-dealer exclusion from the definition of investment adviser.

The Result: When the new regulations are implemented, broker-dealers will have a heightened duty toward their retail customers, intended to more closely match the duties owed by investment advisers to their clients, and will have new disclosure obligations as well.

Looking Ahead: Broker-dealers serving retail customers should review their business practices in light of the adoption of the new regulations and disclosure requirements and take steps to ensure they satisfy the new standards for disclosure, care, conflict of interest, and compliance obligations.

On June 5, 2019, the SEC adopted its long-awaited Regulation Best Interest ("Reg BI"), requiring broker-dealers making recommendations to retail customers to act in their customers' best interest. While purposely not defining "best interest," Reg BI will now require significant review of both broker-dealer and advisory offerings for an expanded level of conflict disclosure and, in certain circumstances, mitigation or elimination of those conflicts. Financial institutions with multiple—and often competing—channels will be particularly affected.

Under Reg BI, broker-dealers and investment advisers will need to prepare a Client Relationship Summary ("Form CRS")—a two-page disclosure of key information regarding their relationship with customers and any potential conflicts, along with a series of layered disclosures at the product and registered representative levels. The SEC also issued an interpretation of the fiduciary duty owed by investment advisers to their clients and a view of the "solely incidental" prong of the broker-dealer exclusion from the definition of "investment adviser" under the Investment Advisers Act of 1940. The SEC included an interpretation of the best execution obligation for dual registrants in its discussion as well.

Reg BI and the Form CRS disclosure requirements will become effective 60 days after publication in the *Federal Register*, but the SEC is granting firms until June 30, 2020, to comply with the new rules.



Regulation Best Interest requires broker-dealers to 'act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker-dealer ahead of the interests of the retail customer.'



Regulation Best Interest

Reg BI enhances the current suitability standard for broker-dealers by requiring them to "act in

the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker-dealer ahead of the interests of the retail customer." While seemingly noncontroversial, the Commission has detailed specific steps and diligence that must be undertaken to satisfy this obligation, and that is where the hard work of policy and procedure crafting will take place.

Despite the mandate of Dodd-Frank, the Commission did not impose a blanket fiduciary standard on broker-dealers. Nonetheless, the Commission did acknowledge that in many circumstances, broker-dealer and investment adviser duties are nearly identical, although broker-dealers have no obligation to provide ongoing advice and monitoring. As a result, the Commission primarily focused on the duties owed by broker-dealers to their retail customers when they make recommendations to those investors.

Reg BI obligations arise for broker-dealers at the time they "recommend" to a "retail customer" a securities transaction or investment strategy involving securities, including "recommendations of account types," "rollovers or transfers of assets," and "implicit hold recommendations resulting from agreed-upon account monitoring." In Reg BI's adopting release, the SEC discussed at length the recommendation and retail customer triggers, including narrowing the definition of "retail customer" to *natural* persons and excluding commercial and professional customers from the definition in the Final Rule.

Broadly, the standard imposes four obligations on broker-dealers:

1. **Disclosure Obligation:** Firms must disclose, "in writing, all material facts about the scope and terms of its relationship with the customer," including their capacity as broker-dealers, fees incurred, scope of services provided, limitations, and conflicts of interest.
2. **Care Obligation:** Firms must have "a reasonable basis to believe that the recommendation is in the customer's best interest and does not place the broker-dealer's interest ahead of the ... customer's," including understanding the risks, rewards, and costs associated with the recommendation and considering them in light of the customer's investment profile.
3. **Conflict of Interest Obligation:** Firms must establish and enforce policies "reasonably designed to mitigate conflicts of interests that create an incentive for an associated person of the broker-dealer to place its interests or the interest of the firm ahead of the retail customer's interest" and "identify all such conflicts and at a minimum disclose or eliminate them."
4. **Compliance Obligation:** Firms must implement policies "reasonably designed to achieve compliance with Regulation Best Interest as a whole."

In addition, Reg BI requires broker-dealers to document their compliance by maintaining records of all information received from and provided to each retail customer to whom a recommendation is provided. Broker-dealers and registered representatives who are not dually registered as investment advisers also face new limitations on the use of "adviser" or "advisor" in their titles.

While other regulators will continue to propose and promulgate rules in this area, such as the June 14, 2019 proposed fiduciary standard from Massachusetts, broker-dealers should keep in mind that, going forward, Reg BI will be the minimum standard by which all regulators effectively measure their conduct.

FOUR KEY TAKEAWAYS

1. Broker-dealers with individual retail customers will not only have to act in those customers' best interests when making recommendations to them but also must adhere to disciplined conflict of interest identification, disclosure, mitigation, and potentially elimination norms.
2. Broker-dealers will need to review their policies and procedures on the methodology for making



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recommendations to ensure compliance with the Care Obligation.

3. The SEC, FINRA, and state regulators will be seeking robust documentation of broker-dealers' compliance with Reg BI as firms incorporate it into their policies and procedures.
4. Reg BI will permeate nearly all client-facing aspects of the industry. Employment arrangements with broker-dealer personnel, cross-border businesses, and multichannel distribution businesses will all be significantly affected.



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