AN OVERVIEW OF THE REGULATION BEST INTEREST RULE PACKAGE

Christine Lazaro

On June 5, 2019, the SEC adopted the Regulation Best Interest Rule Package. The package consists of (I) Regulation Best Interest: The Broker-Dealer Standard of Conduct;[1] (II) Form CRS Relationship Summary and Amendments to Form ADV;[2] (III) the SEC Interpretation Regarding Standard of Conduct for Investment Advisers;[3] and (IV) the SEC Interpretation Regarding the "Solely Incidental" Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser.[4] Each of these four releases is summarized below. Additionally, FINRA has issued its own rules changes in response to the adoption of Regulation Best Interest. FINRA's changes are also discussed below.

I. Regulation Best Interest

a. General Obligation

Regulation Best Interest requires that brokerage firms and their brokers must act in the best interests of their retail customers when making recommendations of securities or investment strategies.[5] Put simply, the

1. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 17 C.F.R. § 240.15 ***l***-1 (2019).

2. Form CRS Relationship Summary; Amendments to Form ADV, 84 Fed. Reg. 33,492 (July 12, 2019) (to be codified at 17 C.F.R. pts. 200, 240, 249, 275, and 279).

3. Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. 33,669 (July 12, 2019).

4. Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion From the Definition of Investment Adviser, 84 Fed. Reg. 33,681 (July 12, 2019).

5. 17 C.F.R. §240.15 ***l*** -1(a)(1) (2019).

brokerage firm and the broker may not place their own interests ahead of the customers' interests.[6]

For purposes of this standard, the term "recommendation" has the same meaning that it currently has under FINRA rules.[7] It is a fact-based determination.[8] The SEC recognizes that factors to consider are "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.'"[9]

The SEC provides some guidance as to what would not be considered a recommendation, including communications such as general financial and investment information; descriptive information about an employer-sponsored retirement plan; certain asset allocation models; and interactive investment materials incorporating those topics.[10]

Recommendations include, for example, advice about the type of securities account to open, as well as advice to roll over or transfer assets from one account to another.[11] Additionally, a broker may be deemed to have made an implicit hold recommendation, triggering the obligations of the Rule, if the broker has agreed to perform periodic account monitoring.[12]

Brokerage firms and brokers owe this obligation to "retail customers." The SEC defines retail customer to focus on natural persons and their legal representatives, seeking advice for personal, family, or household purposes.[13]

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6. *Id.*

7. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318, 33,337.

8. *Id.* at 33,335 ("[W]hether a broker-dealer has made a recommendation that triggers application of Regulation Best Interest should turn on the facts and circumstances of the particular situation and therefore, whether a recommendation has taken place is not susceptible to a bright line definition.").

9. *Id.*

10. *Id.* at 33,337-38.

11. *Id.* at 33,338.

12. *Id.* at 33,340.

13. 17 C.F.R. §240.15 ***l*** -1(b)(1) (2019).

b. Component Obligations

Regulation Best Interest is comprised of four components: (i) the Disclosure Obligation; (ii) the Care Obligation; (iii) the Conflict of Interest Obligation; and (iv) the Compliance Obligation.[14]

i. Disclosure Obligation

The Disclosure Obligation requires that a broker or brokerage firm make full and fair disclosure in writing of "material facts relating to the scope and terms of the relationship" with the customer; and "material facts relating to such conflicts of interest that are associated with the recommendation."[15] "Materiality" has the same meaning that the Supreme Court articulated in *Basic v. Levinson*.[16]

Material facts related to the scope of the relationship explicitly include the following types of information: (i) the capacity in which the broker is acting (as a broker-dealer or investment adviser); (ii) fees and costs associated with the transactions and the accounts more generally; and (iii) the type and scope of services the brokerage firm will offer, including any limitations on those services.[17]

Regardless of whether the firm and individual are dually-registered, both still have to disclose the capacity in which they are acting. If the firm or individual is not dually-registered but uses the term "advisor" or "adviser", they will likely be in violation of this obligation because their disclosure about capacity will not be accurate.[18]

With respect to fees and costs, the SEC expects that brokerage firms will build on the disclosure of fees and costs that are set forth in Form CRS (to be discussed in further detail below).[19] The obligation does not require that the brokerage firm provide "individualized" costs and fees, but rather may provide

14. 17 C.F.R. §240.15*l*-1(a)(2) (2019).

15. 17 C.F.R. §240.15*l*-1(a)(2)(i) (2019).

16. 84 Fed. Reg. at 33,347. *See also Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

17. 84 Fed. Reg. at 33,349.

18. *Id.* at 33,352.

19. *Id.* at 33,354.

standardized or hypothetical amounts or percentage ranges.[20] Brokerage firms may also satisfy this part of their disclosure obligations by providing mandated disclosure documents, such as prospectuses, and trade confirmations.[21]

With respect to the type of services the brokerage firm offers, the firm must disclose whether it monitors transactions and strategies.[22] As part of this disclosure, the brokerage firm must be specific as to the frequency and duration of the services offered.[23] The brokerage firm may rely on information disclosed in the Form CRS (as will be discussed below), but it will likely need to expand on that information to meet this disclosure obligation.[24] However, the brokerage firm may rely on other documents, including account agreements, to make these disclosures.[25] As part of this disclosure, brokerage firms must also disclosure whether they require any account balance minimums.[26]

The brokerage firm must also disclose any limitations on its offerings.[27] Limitations include for example, if the brokerage firm only offers proprietary products.[28] Additionally, if the brokerage firm is dually registered but the broker is not, the broker must disclose that he cannot offer advisory services.[29]

The conflicts of interest disclosure obligation should summarize how the brokerage firm and the brokers are compensated for their recommendations as well as the conflicts that the compensation arrangements create.[30] These conflicts need not be disclosed on a recommendation by recommendation basis.[31]

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20. *Id.* at 33,355.

21. *Id.*

22. *Id.* at 33,356.

23. *Id.*

24. *Id.* at 33,357.

25. *Id.*

26. *Id.* at 33,358.

27. *Id.* at 33,357.

28. *Id.*

29. *Id.*

30. *Id.* at 33,363.

31. *Id.*

While the disclosure obligation requires that the disclosures be made in writing, the SEC recognizes that it may be necessary to supplement, clarify, or update written disclosures with oral disclosures.[32] If the brokerage firm does supplement the written disclosures, however, the brokerage firm must keep a record of the fact that an oral disclosure was provided.[33]

ii. Care Obligation

The Care Obligation, in many ways, mirrors the FINRA Suitability Rule. It requires that the broker, when making a recommendation, exercise "reasonable diligence, care, and skill to:"

(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;

(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; and

(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.[34]

The first prong is similar to the "reasonable basis" obligation under the FINRA Suitability Rule.[35] As a threshold issue, the broker must understand the security or investment strategy recommended before being capable of determining whether the recommendation is in the best interest of a particular

32. *Id.* at 33,368.

33. *Id.*

34. 17 C.F.R. §240.15*l*-1(a)(2)(ii) (2019).

35. *See* FINRA Rule 2111.05(a) (2020).

customer.[36] The SEC sets forth factors that the broker or brokerage firm should consider when investigating the security or investment strategy: "the security's or investment strategy's investment objectives, characteristics (including any special or unusual features), liquidity, volatility, and likely performance in a variety 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."[37]

The SEC has included "costs" as a factor in evaluating securities or strategies because it recognizes that cost will always be a relevant factor.[38] "Costs" includes both costs associated with purchasing a security, as well as future costs associated with exchanging or selling a security.[39] However, the SEC cautions that cost is not a dispositive factor. The Rule does not require that a broker recommend the lowest cost option.[40]

The second prong incorporates the "customer specific" prong of the FINRA Suitability Rule,[41] but enhances it by replacing "suitable" with a best interest standard.[42] In sum, the broker must determine that a recommendation is in the customer's best interest based on that customer's investment profile. The customer's investment profile includes "age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance," and any other information that the customer may have disclosed.[43] This is the same information that firms must currently consider as part of the investor's profile under the FINRA Suitability Rule.[44] If a customer does not provide the information, the SEC cautions that a firm may not have sufficient information to make a best interest determination.[45]

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36. 84 Fed. Reg. at 33,375-76.

37. *Id.* at 33,376.

38. *Id.* at 33,372-73.

39. *Id.* at 33,373.

40. *Id.*

41. *See* FINRA Rule 2111.05(b).

42. 84 Fed. Reg. at 33,377.

43. 17 C.F.R. §240.15*l*-1(b)(3) (2019).

44. *See* FINRA Rule 2111(a).

45. 84 Fed. Reg. at 33,379.

In evaluating whether a recommendation is in the customer's best interest, the broker should consider reasonably available alternatives offered by the broker's firm.[46] The broker need not recommend the "best" of all possible alternatives.[47] The Rule also does not require that the broker be familiar with every product available by the brokerage firm.[48] The scope of the reasonably available alternatives that are considered with respect to any particular recommendation will depend on several factors, including, the broker's customer base; the products available to the broker to recommend; and specific limitations on the available products, including that products may only be available in certain geographical locations or to particular types of accounts.[49] For dually registered brokers, the options with respect to account type must be considered as reasonably available alternatives.[50] If the broker may only offer brokerage accounts, the broker must consider the customer's objectives before recommending a brokerage account.[51] For example, if the customer is requesting that the broker have unlimited discretion, a brokerage account would not be appropriate.[52]

When recommending a rollover, the broker must consider a number of factors, including, "fees and expenses; level of service available; available investment options; ability to take penalty-free withdrawals; application of required minimum distributions; protection from creditors and legal judgments; holdings of employer stock; and any special features of the existing account."[53] A broker may not just consider whether the rollover may offer additional options beyond the customer's current plan.

The final component is similar to the "quantitative suitability" requirement,[54] except that the "control" element has been eliminated.[55] This

46. *Id.* at 33,381.

47. *Id.*

48. *Id.*

49. *Id.* at 33,382.

50. *Id.* at 33,383.

51. *Id.*

52. *Id.*

53. *Id.*

54. *See* FINRA Rule 2111.05(c).

55. 84 Fed. Reg. at 33,384.

component is intended to prevent trading that is so excessive that a positive return is virtually impossible.[56]

iii. Conflict of Interest Obligation

The Conflict of Interest Obligation requires a firm to adopt policies and procedures designed to identify and, at a minimum, disclose all conflicts associated with a recommendation.[57] The obligation further requires that a brokerage firm mitigate or eliminate certain types of conflicts.[58]
With respect to the content of the policies and procedures, the SEC contemplates that brokerage firms will have the flexibility to design policies and procedures that are risk-based rather than requiring a detailed review of each recommendation.[59] The SEC suggests certain components that a brokerage firm should consider when adopting policies and procedures including:

> [P]olicies and procedures outlining how the firm identifies conflicts, identifying such conflicts and specifying how the broker-dealer intends to address each conflict; robust compliance and monitoring systems; processes to escalate identified instances of noncompliance for remediation; procedures that designate responsibility to business line personnel for supervision of functions and persons, including determination of compensation; processes for escalating conflicts of interest; processes for periodic review and testing of the adequacy and effectiveness of policies and procedures; and training on policies and procedures.[60]

Under this obligation, the brokerage firm has a duty to, at a minimum, disclose all conflicts of interest.[61] Disclosure must be full and fair; if it is not

56. *Id.*

57. 17 C.F.R. §240.15*l*-1(a)(2)(iii)(A) (2019).

58. 17 C.F.R. §240.15*l*-1(a)(2)(iii)(B) (2019).

59. 84 Fed. Reg. at 33,386.

60. *Id.* at 33,386 n.688.

61. *Id.* at 33,388.

possible to fully and fairly disclose a conflict, it must be mitigated such that full and fair disclosure is possible.[62]

Brokerage firms also have a duty to identify and mitigate conflicts of interest that create an incentive for the broker to place the interests of the broker or the firm ahead of the interests of the customer.[63] The SEC has primarily chosen to limit the duty to mitigate to broker-level conflicts, allowing the brokerage firms to generally deal with firm-level conflicts through disclosure.[64] The requirement to identify and mitigate broker-level conflicts applies only to incentives provided to the broker, either by the firm or third parties that are within the control of or associated with the firm.[65] Accordingly, the requirement does not create an obligation with respect to private securities transactions.[66] The SEC does provide examples of conflicts that must be mitigated: (i) compensation from the brokerage firm or third parties, including fees and other charges associated with the service or recommendation provided; (ii) employment incentives, including those tied to asset accumulation, special awards, variable compensation, and compensation tied to performance reviews; and (iii) commissions, sales charges, or other fees whether paid by the customer, the brokerage firm, or a third party.[67]
Mitigation measures should be based on the nature and significance of the incentive, as well as other factors related to the brokerage firm's business model, such as the size of the firm, the types of customers, and the complexity of the security product or strategy.[68]

The SEC provides a list of best practices for brokerage firms developing policies and procedures for mitigation methods:

- Avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales;
- 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

62. *Id.* at 33,388-89.

63. *Id.* at 33,390.

64. *Id.*

65. *Id.* at 33,391.

66. *Id.* at *note* 744.

67. *Id.* at 33,391.

68. *Id.*

sold on a principal basis, for example, by establishing differential compensation based on neutral factors;

- Eliminating compensation incentives within comparable product lines by, for example, capping the credit that an associated person may receive across mutual funds or other comparable products across providers;
- 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 roll over or transfer of assets from one type of account to another (such as recommendations to roll over or transfer assets in an ERISA account to an IRA) or from one product class to another;
- Adjusting compensation for brokers who fail to adequately manage conflicts of interest; and
- Limiting the types of retail customer to whom a product, transaction or strategy may be recommended.[69]

If a brokerage firm materially limits its securities offerings or investment strategies, the brokerage firm must prevent such limitations from causing the firm to put its interests ahead of the customers'.[70] The SEC considers that recommending only proprietary products, products with revenue sharing arrangements, or a specific asset class would be material limitations.[71] The SEC recommends that brokerage firms offering limited menus consider establishing a "product review process" that includes evaluating the use of preferred lists; restrictions on the customers to whom a product may be sold; requiring brokers selling certain products to have minimum knowledge requirements; as well as period product reviews to further evaluate conflicts.[72] Certain practices are completely prohibited pursuant to this obligation. For example, brokerage firms must eliminate "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 time."[73] Non-cash compensation includes merchandise, gifts and prizes, travel expenses, meals

69. *Id.* at 33,392.

70. *Id.* at 33,393.

71. *Id.*

72. *Id.* at 33,394.

73. 17 C.F.R. §240.15*l*-1(a)(2)(iii)(D) (2019).

and lodging.[74] This obligation is not intended to eliminate all incentives, only those that create high-pressure situations to sell specific securities within a limited period of time.[75] It likely will not capture contests or other incentives tied to total products sold or asset accumulation and growth.[76] Brokerage firms may also continue to hold annual conferences, so long as attendance is not premised on the sale of specific securities within a limited period of time.[77]

iv. Compliance Obligation

The Compliance Obligation is an overarching requirement to adopt policies and procedures that are reasonably designed to achieve compliance with the Rule as a whole.[78] The Rule does not specify which policies and procedures must be adopted. The SEC expects brokerage firms to design policies and procedures that "prevent violations from occurring, detect violations that have occurred, and to correct promptly any violations that have occurred."[79] Brokerage firms are expected to tailor their policies and procedures to account for the "scope, size, and risks associated with the operations of the firm and the type of business in which the firm engages."[80]

II. Form CRS Relationship Summary

In addition to adopting a new standard of conduct for brokers and brokerage firms, the SEC also adopted a new disclosure obligation for both brokerage firms and investment advisers.[81] The SEC will require that brokerage firms and investment advisers create and deliver a relationship summary to prospective and existing customers. The relationship summary and the firms' delivery obligations are described in this section.

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74. 84 Fed. Reg. at 33,396.

75. *Id.*

76. *Id.*

77. *Id.* at 33,396-97.

78. 17 C.F.R. §240.15*l*-1(a)(2)(iv) (2019).

79. *Id.* at 33,397.

80. *Id.*

81. 84 Fed. Reg. 33,492.

a. Presentation and Format

The SEC allows firms to use a mix of prescribed wording along with firm-authored wording in drafting the relationship summary.[82] For example, firms will be able to describe their services, investment offerings, fees, and conflicts of interest.[83] Firms will be required, however, to use prescribed headings, conversation starters, and a statement describing their standard of conduct when providing investment advice.[84]

The SEC requires that headings be in the form of prescribed questions, in a set order.[85] The relationship summary may not exceed four pages for a dual registrant that includes both its brokerage and advisory services in a single summary.[86] Otherwise, the relationship summary may not exceed two pages for brokerage firms and investment advisers that are describing one of their services.[87]

The SEC is encouraging the use of graphics to facilitate comprehension, including charts, graphs, tables, text colors, and graphical cues such as dual-column charts.[88] Additionally, firms may include QR codes and hyperlinks to facilitate layered disclosure.[89] However, a firm may not satisfy its disclosure obligations of the relationship summary through the use of "incorporation by reference."[90]

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82. *Id.* at 33,502.

83. *Id.*

84. *Id.*

85. *Id.* at 33,504.

86. *Id.* at 33,505.

87. *Id.*

88. *Id.* at 33,506-07.

89. *Id.*

90. *Id.* at 33,508.

b. Content

i. Introduction

Firms are required to open the relationship summary with a standardized introduction that includes (i) the name of the firm and whether it is a brokerage firm or investment adviser; (ii) a statement that brokerage and advisory services and fees differ; and (iii) a statement that research tools are available at Investor.gov/CRS.[91]

ii. Relationships and Services

Following the introduction, firms must summarize the relationships and services that they offer under the heading, "What investment services and advice can you provide me?"[92] Additionally, firms must include any material limitations on the services that they offer to investors.[93] In the description of services, firms must address (i) monitoring; (ii) investment authority; (iii) limited investment offerings; and (iv) account minimums and other requirements.[94]

With respect to monitoring, firms must explain whether they monitor an investor's accounts, including the frequency of the monitoring and any limitations on the monitoring.[95] If an investment adviser accepts discretionary authority, the firm must describe how the authority will be exercised.[96] For example, if the firm requires investor input before exercising discretion in certain circumstances, the firm must explain that.[97] Both investment advisers and brokerage firms that offer non-discretionary services must explain that the investor is the ultimate decision-maker.[98] If a firm has a limited menu of offerings, such as only proprietary products or a specific asset class, the firm

91. *Id.* at 33,513.

92. *Id.* at 33,515.

93. *Id.* at 33,516.

94. *Id.* at 33,517.

95. *Id.* at 33,518.

96. *Id.* at 33,518-19.

97. *Id.* at 33,519.

98. *Id.*

must explain those limitations.[99] Firms must also disclose whether there are any required minimums to open an account or place a trade, or if there is a tiered fee schedule.[100]

In the relationship and services section of the form, firms must also provide additional information that further explains the firms' services.[101] This section should provide the information about services that would be available in an investment adviser's Form ADV, Part 2A brochure, or that a brokerage firm otherwise has to provide under Reg. BI.[102] This section of the disclosure may be layered, providing hyperlinks or other ways of directing the investor to the source of the information.[103]

The relationship and services section will also contain three conversation starters.[104] The first conversation starter will be tailored to the nature of the firm's business. For firms that are not dual registrants, the firm will include, "Given my financial situation, should I choose a brokerage service? Why or why not?" or "Given my financial situation, should I choose an investment advisory service? Why or why not?"[105] Dual registrants will include, "Given my financial situation, should I choose an investment advisory service? Should I choose a brokerage service? Should I choose both types of services? Why or why not?"[106]

Additionally, firms will also include the following two questions: (i) "How will you choose investments to recommend to me?;" and (ii) "What is your relevant experience, including your licenses, education and other qualifications? What do these qualifications mean?"[107]

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99. *Id.* at 33,520.

100. *Id.* at 33,520-21.

101. *Id.* at 33,521

102. *Id.*

103. *Id.*

104. *Id.*

105. *Id.*

106. *Id.*

107. *Id.*

iii. Summary of Fees, Costs, Conflicts, and Standards of Conduct

Firms will begin the discussion of fees, costs, conflicts, and standards of conduct with the heading, "What fees will I pay?"[108] In this section, the firm must summarize the principal costs and fees that investors will incur, including how frequently they are assessed and what conflicts of interest the fees may create.[109] Additionally, firms must describe other fees and costs associated with their services or investments, whether paid directly or indirectly.[110] The SEC provides some examples of the other fees and costs that may need to be disclosed, including: custodian fees; account maintenance fees; fees related to mutual funds and variable annuities; distribution fees; platform fees; and shareholder servicing fees.[111]

Finally, firms are required to include the following statement: "You will pay fees and costs whether you make or lose money on your investments. Fees and costs will reduce any amount of money you make on your investment over time. Please make sure you understand what fees and costs you are paying."[112] Firms must also include a conversation starter about fees: "Help me understand how these fees and costs might affect my investments. If I give you $10,000 to invest, how much will go to fees and costs, and how much will be invested for me?"[113]

Following the fees and costs discussion, firms must discuss the legal standard of conduct that applies, using prescribed language.[114] Additionally, this section must include a summary of certain firm-level conflicts.[115]

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108. *Id.* at 33,524.

109. *Id.*

110. *Id.* at 33,526.

111. *Id.*

112. *Id.* at 33,527.

113. *Id.* at 33,528.

114. *Id.* at 33,530.

115. *Id.* at 33,529.

The disclosure that a firm has to make will vary based on whether it is [a broker making a recommendation], [an investment adviser], or [a dual registrant]:

> [***When we provide you with a recommendation,***] [***When we act as your investment adviser,***] [***When we provide you with a recommendation as your broker-dealer or act as your investment adviser,***] we have to act in your best interest and not put our interest ahead of yours. At the same time, the way we make money creates some conflicts with your interests. You should understand and ask us about these conflicts because they can affect the [recommendations] [investment advice] [recommendations and investment advice] we provide you. Here are some examples to help you understand what this means.[116]

Following the prescribed wording, a firm must summarize the following ways that the firm makes money that involve conflicts: (i) from proprietary products; (ii) from third-party payments; (iii) by revenue sharing; and (iv) by principal trading.[117] If the firm does not have any of these conflicts, it must describe one material conflict of interest that will affect retail investors.[118] In this section, firms must include the following conversation starter: "How might your conflicts of interest affect me, and how will you address them?"[119] Finally, firms must include the heading, "How do your financial professionals make money?" and include a description of how their financial professionals are compensated, including both cash and non-cash compensation, as well as the conflicts that the payments create.[120]

iv. Disciplinary History

The relationship summary will also include a section about whether the firm or its financial professionals have any disciplinary history, as well as where an investor may find additional information.[121] This section will begin

116. *Id.* at 33,532–33 nn.507–09.

117. *Id.* at 33,533.

118. *Id.*

119. *Id.* at 33,535.

120. *Id.* at 33,536.

121. *Id.*

with the following question: "Do you or your financial professionals have legal or disciplinary history?"[122] Firms will have to answer yes if they have any of a number of disclosable events as set forth in the instructions.[123] For example, firms will have to answer yes if a broker has any items disclosed pursuant to question 14 A though M on the Form U4.[124]

This section must also include the following conversation starter: "As a financial professional, do you have any disciplinary history? For what type of conduct?"[125]

v. Additional Information

The final section of the relationship summary will state where the investor can find additional information.[126] This section will also 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?"[127] Finally, this section must include a phone number where investors can request up-to-date information as well as a copy of the relationship summary.[128]

c. Filing, Delivery, and Updating Requirements

Firms must file the relationship summary with the SEC; and the SEC will make the forms publicly available through the website, Investor.gov.[129] Additionally, firms must make the forms available on their own websites.[130]

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122. *Id.* at 33,537.

123. *Id.* at 33,537 – 33,538.

124. *Id.* at 33,538.

125. *Id.* at 33,539.

126. *Id.*

127. *Id.* at 33,540.

128. *Id.*

129. *Id.* at 33,545.

130. *Id.*

Firms may deliver the relationship summary electronically, so long as the firm complies with the SEC's rules regarding electronic delivery.[131] Essentially, the firm must make the investor aware that the form is available electronically; the access to the information must be comparable to that which would have been provided in paper form; and the firm must maintain evidence of delivery.[132]

Brokerage firms must deliver the relationship summary before or at the earliest of: (i) a recommendation as to account type, a securities transaction, or an investment strategy; (ii) placing an order; or (iii) opening a brokerage account.[133] Investment advisers must deliver the relationship summary before or at the time of entering into an investment advisory contract with an investor.[134]

After the initial delivery of the form, firms must re-deliver the relationship summary whenever: (i) an account is opened that is different than the investor's existing account(s); (ii) there is a recommendation to roll over assets; or (iii) there is a recommendation for a new service or product that would not be held in an existing account.[135] This last item contemplates recommendations for investments such as direct-sold mutual funds or insurance products.[136]

Finally, firms must update the relationship summary within 30 days whenever the relationship summary becomes materially inaccurate.[137] At that time, the revised relationship summary must be filed with the SEC and posted to the firm's website.[138] Firms will have 60 days to deliver the revised relationship summary to existing clients.[139] When delivering the revised relationship summary, firms must highlight any changes by either marking the revised text or including a summary of the changes.[140]

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131. *Id.* at 33,546-47.

132. *Id.* at 33,547.

133. *Id.* at 33,550.

134. *Id.* at 33,551.

135. *Id.* at 33,552.

136. *Id.*

137. *Id.* at 33,554.

138. *Id.*

139. *Id.*

140. *Id.*

III. Investment Adviser Interpretation

As part of the Regulation Best Interest Rule package, the SEC issued an interpretation of the investment adviser standard of conduct.[141] The SEC recognized that the investment adviser's fiduciary duty follows the contours of the relationship with the client.[142] Further, an investment adviser can shape that relationship by agreement, so long as there is full and fair disclosure, and informed consent by the client.[143] The specific duties that an investment adviser owes to a client will depend on the services that the adviser has agreed to perform for the client.[144] However, an investment adviser cannot have a client waive the fiduciary duty.[145]

a. Duty of Care

An investment adviser's fiduciary duty includes a duty of care. This duty includes: (i) the duty to provide advice that is in the best interest of the client; (ii) the duty to seek best execution of a client's transactions where the adviser has the duty to select the broker-dealer that will execute the client's trades; and (iii) the duty to provide advice and monitoring over the course of the relationship.[146]

The duty to provide advice that is in the best interest of the client is a duty to provide advice that is suitable for the client.[147] To be able to satisfy this duty, the investment adviser must make a reasonable inquiry into the client's financial situation, financial sophistication, investment experience, and financial goals, among other things.[148] Further, the investment adviser must determine that the client can and is willing to tolerate the risks of any

141. 84 Fed. Reg. 33,669.

142. *Id.* at 33,671.

143. *Id.*

144. *Id.*

145. *Id.* at 33,672.

146. *Id*.

147. *Id.*

148. *Id.* at 33,673.

recommended investment, and that the potential benefits of the investment recommendation justify the risks.[149]

Next, the investment adviser must conduct a reasonable investigation into the investment being recommended.[150] As part of the investigation, the investment adviser must consider a number of factors relating to the investment, including the cost associated with the investment advice; as well as the investment product's or strategy's investment objectives, characteristics, liquidity, risks and potential benefits, volatility, likely performance in a variety of market and economic conditions, time horizon, and cost of exit.[151] This duty applies to advice about investment strategy, engaging a sub-adviser, and account type.[152] Accordingly, advice to open a particular type of account (brokerage or investment advisory) as well as advice about rolling over assets would trigger this duty.[153]

In seeking best execution, an investment adviser must try to execute trades such that the costs or proceeds from each transaction are the most favorable for the client.[154]

The duty to monitor means the investment adviser must monitor a client's account at a frequency that is in the best interest of the client.[155] However, if the investment adviser has been engaged for a limited duration, such as for the provision of a one-time financial plan for a one-time fee, the investment adviser is unlikely to have a duty to monitor.[156]

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149. *Id.*

150. *Id.* at 33,674.

151. *Id.*

152. *Id.*

153. *Id.*

154. *Id.*

155. *Id.* at 33,675.

156. *Id.*

b. Duty of Loyalty

In simple terms, an investment adviser has a duty of loyalty, which prohibits the investment adviser from subordinating its clients' interests to its own.[157] As part of this duty, the investment adviser must make full and fair disclosure of any material facts relating to the advisory relationship.[158]

Additionally, the investment adviser must eliminate or at least expose through full and fair disclosure all conflict of interest that might incline an adviser to render advice that is not disinterested.[159] For disclosure to be full and fair, the disclosure must be specific enough so that the client can understand the material fact or the conflict of interest and be able to make an informed decision as to whether to provide consent.[160]

As part of its disclosure, an investment adviser may not state that the adviser "may" have a conflict if the conflict actually exists; however, "may" could be appropriate if the conflict does not currently exist but might reasonably present itself in the future.[161] In other words, disclosure will not be full and fair if the adviser states that a conflict "may" exist if the conflict already does exist.

Investment advisers do not have to determine whether the client actually understood the disclosure that was made.[162] The investment adviser merely has to put the client into the position to be able to understand the disclosure.[163] However, if the investment adviser actually knows, or reasonably should know, that the client does not understand the disclosure, the adviser cannot accept the client's consent.[164]

If the conflict is of a nature and to an extent that it would be difficult to be able to fully explain the conflict in a way that it could be understood by a client, the investment adviser must eliminate or mitigate the conflict.[165]

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157. *Id.*

158. *Id.*

159. *Id.* at 33,676.

160. *Id.*

161. *Id.* at 33,676-77

162. *Id.* at 33,677.

163. *Id.*

164. *Id.*

165. *Id.*

IV. Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser

In the last item of the Regulation Best Interest Rule package, the SEC provided an interpretation of the "solely incidental" prong of the broker-dealer exclusion from the definition of "investment adviser."[166] In this interpretation, the SEC clarified that if a broker exercises unlimited discretion, such conduct would not be "solely incidental" to the business of the broker-dealer, and accordingly, the brokerage firm would meet the definition of investment adviser.[167] However, discretion that is temporary or limited in scope would not necessarily turn a brokerage firm into an investment adviser.[168]

With respect to monitoring a customer's account, if the monitoring is at specific intervals for the purpose of determining whether to provide a buy, sell, or hold recommendation, such conduct would be considered "solely incidental" to the broker-dealer's primary business of effecting securities transactions.[169] It would not turn the brokerage relationship into an advisory relationship.

V. FINRA Changes and Guidance

On June 19, 2020, FINRA issued Regulatory Notice 20-18, "Reg BI-Related Changes to FINRA Rules."[170] FINRA has explained that FINRA Rule 2111 (the "Suitability Rule") will not apply to recommendations subject to Regulation Best Interest.[171] FINRA also explained that there remained certain recommendations to which Regulation Best Interest would not apply.[172] For example, Regulation Best Interest only applies to recommendations to retail customers seeking advice for personal, family, or household purposes.

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166. 84 Fed. Reg. 33,681.

167. *Id.* at 33,686.

168. *Id.*

169. *Id.* at 33,687.

170. FINRA Reg. Notice 20-18, "Reg BI-Related Changes to FINRA Rules" (June 19, 2020), available at https://www.finra.org/sites/default/files/2020-06/Regulatory-Notice-20-18.pdf.(last accessed Aug. 30, 2020).

171. *Id.* at 2. *See also* FINRA Rule 2111.08.

172. FINRA Reg. Notice 20-18 at 2 n.3.

Accordingly, the Suitability Rule would continue to apply to recommendations to entities and institutions, such as pension funds.[173] The Suitability Rule will also apply to recommendations made to natural persons who will not be using the investment recommendation for personal, family, or household purposes, such as small business owners or charitable trusts.[174] In those instances when the Suitability Rule would apply, FINRA has modified the quantitative suitability component to remove the control element, thereby making it consistent with Regulation Best Interest.[175]

Finally, certain FINRA rules restrict, but do not forbid, the payment and receipt of non-cash compensation in connection with the sale and distribution of certain types of securities, including direct participation programs, variable insurance contracts, and investment company securities.[176] As discussed above, Regulation Best Interest requires firms to eliminate non-cash compensation that is based on the sales of specific securities or specific types of securities within a limited time. Accordingly, to the extent the referenced FINRA rules permit non-cash compensation, FINRA makes it clear that such compensation must be consistent with the requirements of Regulation Best Interest.[177] The changes set forth in the Regulatory Notice were effective on June 30, 2020, the compliance date of Regulation Best Interest.[178]

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173. *Id.*

174. *Id.*

175. *Id.* at 2. *See also* FINRA Rule 2111.05(c).

176. *See* FINRA Reg. Notice 20-18 at 2. *See also* FINRA Rules 2310, 2320, 2341, and 5110.

177. FINRA Reg. Notice 20-18 at 2. *See also* FINRA Rules 2310(c)(2), 2320(g)(4), 2341(l)(5), 5110(h)(2).

178. FINRA Reg. Notice 20-18 at 1.

PLEADING AND ADVOCATING A NEGLIGENCE CLAIM THROUGH THE REGULATION BEST INTEREST LENS

Christine Lazaro and Michael S. Edmiston[1]

On June 5, 2019, the SEC adopted the Regulation Best Interest Rule Package, consisting of (i) Regulation Best Interest: The Broker-Dealer Standard of Conduct ("Reg. BI");[2] (ii) Form CRS Relationship Summary and Amendments to Form ADV;[3] (iii) the SEC Interpretation Regarding Standard of Conduct for Investment Advisers;[4] and (iv) the SEC Interpretation Regarding the "Solely Incidental" Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser.[5] Brokers were obligated to begin compliance with Reg. BI as of June 30, 2020.

Reg. BI contains four component sections mandating duties for brokers and firms: Disclosure, Care, Conflicts of Interest, and Compliance. While it is the SEC 's position that Reg. BI does not create any new private right of action or right of rescission,[6] the Rule does set forth duties to which brokers and firms must adhere. Therefore, these obligations may be used as support for a negligence claim[7] for (i) a recommendation that is not in the investor's best interests; or (ii) failure to supervise. While this article will address how to assess the various Reg. BI obligations when pleading and advancing a potential

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1. Christine Lazaro is a Professor of Clinical Legal Education and the Director of the Securities Arbitration Clinic at St. John's University School of Law. Michael S. Edmiston is an attorney with the Law Offices of Jonathan W. Evans & Associates.

2. Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318 (July 12, 2019) (to be codified at 17 C.F.R. pt. 240).

3. Form CRS Relationship Summary; Amendments to Form ADV, 84 Fed. Reg. 33,492 (July 12, 2019) (to be codified at 17 C.F.R. pts. 200, 240, 249, 275, and 279).

4. Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fe. Reg. 33,669 (July 12, 2019).

5. Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion From the Definition of Investment Adviser, 84 Fed. Reg. 33,681 (July 12, 2019).

6. *See* 84 Fed. Reg. at 33,327.

7. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cheng*, 697 F. Supp. 1224, 1227 (D.D.C. 1988).

negligence claim in FINRA arbitration, such conduct may also support other claims such as breach of contract, negligent or intentional misrepresentation, and state Blue Sky law violations.

I. When does Regulation Best Interest Apply?

While Reg. BI is similar to FINRA's Suitability Rule,[8] there are also some differences. For both Reg. BI and the Suitability Rule to apply a broker must make a *recommendation*. As used in Reg. BI, the term "recommendation" has the same meaning it has currently under FINRA rules.[9] It is a fact-based determination. Factors to consider are "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.'"[10]

Recommendations include: advice to purchase, sell, and exchange securities; as well as advice about investment strategies; and explicit advice to hold securities.[11] Recommendations also include advice about the type of securities account to open, as well as advice to roll over or transfer assets from one account to another.[12] Additionally, a broker may be deemed to have made an implicit hold recommendation, triggering the obligations of the Rule, if the broker has agreed to perform periodic account monitoring.[13] Communications such as general financial and investment information; descriptive information about an employer-sponsored retirement plan; certain asset allocation models; and interactive investment materials are not considered recommendations.[14]

While the recommendation language is the same, Reg. BI applies to a different subset of customers than the Suitability Rule. Brokerage firms and brokers only owe their Reg. BI obligations to "retail customers," which is defined as natural persons and their legal representatives, seeking advice for personal, family, or household purposes.[15] Significantly, Reg. BI does apply to

8. FINRA Rule 2111.

9. 84 Fed. Reg. 33,318, 33,337.

10. *Id.* at 33,335.

11. *Id.* at 33,338.

12. *Id.* at 33,338.

13. *Id.* at 33,340.

14. *Id.* at 33,337 – 33,338.

15. *Id.* at 33,343.

recommendations to individuals regardless of their sophistication so long as the advice is for personal purposes. Under the plain language of the rule, Reg. BI does not apply to recommendations to *entities.* The Suitability Rule still applies to any accounts that are not captured by Reg. BI.[16]

II. What are the Broker's Specific Obligations?

Reg. BI is comprised of four sections: (i) the Disclosure Obligation; (ii) the Care Obligation; (iii) the Conflict of Interest Obligation; and (iv) the Compliance Obligation.[17] If a broker or firm violates any of these duties, and the investor has been damaged as a result, there may be a claim for negligence.

a. Disclosure Obligation

i. Duties Under Regulation Best Interest

The Disclosure Obligation requires that a broker or brokerage firm make full and fair disclosure in communicating the "material facts relating to the scope and terms of the relationship" with the customer; and "material facts relating to such conflicts of interest that are associated with the recommendation" prior to or at the time of the recommendation.[18] "Materiality" has the same meaning that the Supreme Court articulated in *Basic v. Levinson*: a fact is material if there is "a substantial likelihood that a reasonable shareholder would consider it important."[19]

Disclosures related to the scope and terms of the relationship will be made primarily through the account agreements, usually completed at the beginning of the relationship. Some of these initial disclosures will also now be made

16. The FINRA Suitability Rule has been amended to indicate it does not apply to recommendations subject to Regulation Best Interest. *See* FINRA Rule 2111.08.

17. 17 C.F.R. §240.15l-1(a)(2).

18. 84 Fed. Reg. at 33,347.

19. *Id. See also Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

through the Form CRS.[20] There is no requirement that these disclosures be made every time a recommendation is made.

Material facts related to the scope of the relationship must include the following types of information: (i) the capacity in which the broker is acting (as a broker-dealer or investment adviser); (ii) fees and costs associated with the transactions and the accounts more generally; and (iii) the type and scope of services the brokerage firm will offer, including any limitations on those services.[21]

Regardless of whether the firm and individual are dually registered as both brokers and investment advisers, both still have the duty to disclose the capacity in which they are acting. Reg. BI also limits who may use the term "advisor" or "adviser" in their title. A broker may be called an "advisor" or "adviser" if that broker is also registered as an investment adviser, regardless of whether they are acting in an advisory capacity with a specific client. If a broker represents that they are an "advisor" or "adviser" and that broker is not dually registered, this will likely violate their disclosure obligation.[22] It remains unclear whether the broker will need to make any further disclosures when acting as both a broker and an investment adviser with the same client or acting solely in a brokerage capacity with an investor while dually registered. If the brokerage firm is dually registered but the broker is not, the broker must disclose that they cannot offer advisory services.[23]

With respect to fees and costs, the SEC expects that brokerage firms will build on the disclosure of fees and costs that are set forth in Form CRS.[24] The obligation does not require that the brokerage firm provide "individualized" costs and fees. Instead, the firm may provide standardized or hypothetical amounts or percentage ranges.[25] Brokerage firms may also satisfy this part of their disclosure obligations by providing mandated disclosure documents, such as prospectuses, and trade confirmations.[26]

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20. While Reg. BI is triggered only if a recommendation is made, the Form CRS is required to be delivered by every brokerage firm and SEC registered investment adviser. *See* 17 C.F.R. §240.17a-14; 17 C.F.R. §275.203-1.

21. 84 Fed. Reg. at 33,349.

22. *Id.* at 33,352.

23. *Id.* at 33,357.

24. *Id.* at 33,354.

25. *Id.* at 33,355.

26. *Id.*

With respect to the type of services the brokerage firm offers, the firm must disclose whether it monitors transactions and strategies.[27] As part of this disclosure, the brokerage firm must be specific as to the frequency and duration of the services offered.[28] The brokerage firm may rely on information disclosed in the Form CRS, but it will likely need to expand on that information to meet this disclosure obligation.[29] However, the brokerage firm may rely on other documents, including account agreements, to make such disclosures.[30] As mentioned previously, the broker may be deemed to have made an implicit recommendation if the broker has agreed to periodic monitoring.

The conflicts of interest disclosure obligation should summarize how the brokerage firm and the brokers are compensated for their recommendations as well as the conflicts that the compensation arrangements create.[31] These conflicts need not be disclosed on a recommendation-by-recommendation basis.[32]

While the disclosure obligation requires that the disclosures be made in writing, the SEC recognizes that it may be necessary to supplement, clarify, or update written disclosures with oral disclosures.[33] If the brokerage firm does supplement the written disclosures, however, the brokerage firm must keep a record of the fact that an oral disclosure was provided.[34]

ii. FINRA's Perspective on Inadequate Procedures

While Reg. BI is new, guidance as to what procedures are deemed to be inadequate can be found it the 2022 Report on FINRA's Examination and Risk Monitoring Program. In that report, FINRA identified ineffective practices

27. *Id.* at 33,356.

28. *Id.*

29. *Id.* at 33,357.

30. *Id.*

31. *Id.* at 33,363.

32. *Id.*

33. *Id.* at 33,368.

34. *Id.*

found during routine exams.[35] FINRA found that some firms failed to make full and fair disclosures of material fees received as a result of the recommendation, including whether the firm received revenue sharing.[36] Brokers did not adequately disclose conflicts, including whether they were trading in the same security in their own personal account.[37] Additionally, firms did not adequately disclose material limitations in their securities offerings.[38] Brokers also improperly used the term "advisor" or "adviser" in their title even though they were not dually registered.[39]

iii. Important Considerations and Documents

Firms now have a number of affirmative disclosure obligations that did not exist under the Suitability Rule. If firms are not accurately or fully making these mandated disclosures, those failures may be evidence that the firm has not made the required changes to their policies and procedures to ensure compliance with Reg. BI. Moreover, failure to adequately disclose conflicts of interest may indicate the firm has not properly assessed its conflicts, as will be discussed in further detail below. Failures to disclose, if combined with other failures discussed below, may help support a claim for negligence if the investor has been damaged as a result.

One of the more significant aspects of Reg. BI's Disclosure Obligation is the requirement to set forth the degree to which a firm or a broker will monitor an investor's account and holdings. This information will appear in the Form CRS and may also now be included in other account documents such as the account agreement. A review of the Form CRS and other account documents will help to determine what duties a broker has assumed with respect to monitoring. Additionally, the Rule recognizes that such disclosures may be supplemented orally. Therefore, if a broker has stated to an investor that they will review the investor's account annually, this should form the basis of the

35. *See* FINRA, 2022 Report on FINRA's Examination and Risk Monitoring Program, Communications and Sales (Feb. 9, 2022) (the "FINRA Report"), https://www.finra.org/rules-guidance/guidance/reports/2022-finras-examination-and-risk-monitoring-program/reg-bi-form-crs.

36. *Id.*

37. *Id.*

38. *Id.*

39. *Id.*

broker's obligations, regardless of whether the Form CRS states that the firm does not monitor accounts. If the broker or firm represents that the account will be monitored or reviewed periodically, the broker may be deemed to have made an implicit recommendation to hold at the timing of the review if no changes are made to the investor's account. If, at the review, circumstances have changed, and a security that was appropriate at the time of the recommendation is no longer appropriate, and the broker does not make a recommendation to sell, this may be deemed an implicit recommendation to hold, triggering the Care Obligation, to be discussed next.

The restriction on the use of the term "advisor" or "adviser" is also a new provision in Reg. BI. If a broker who is not also registered as an investment adviser has used either term in their title, such as calling themself a financial advisor, the broker will have made a misleading statement. One may therefore argue that brokers holding themselves out as advisers are therefore subject to the investment adviser's obligations, including the duty to monitor the investor's account.

Most of the Reg. BI disclosure obligations must be in writing. Therefore, when initially assessing a case, it will be important to review the Form CRS and the account agreements to determine the represented scope of the broker's duties. In discovery, it will be important to seek all documents reflecting any supplemental oral disclosures made pursuant to Reg. BI, as the brokerage firm is obligated to keep such records. To the extent oral disclosures have not been documented, the firm will have violated its recordkeeping obligations, which may be relevant to further support a negligence claim.

b. Care Obligation

i. Duties Under Regulation Best Interest

The Care Obligation, in many ways, mirrors FINRA's Suitability Rule. It contains a multi-factor test requiring that that the broker, when making a recommendation, exercise reasonable diligence, care, and skill to:

(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;

(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; and
>
> (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.[40]

The first prong of the Care Obligation is similar to the "reasonable basis" obligation under the Suitability Rule.[41] As a threshold issue, the broker or brokerage firm must understand the security or investment strategy recommended before determining whether the recommendation is in the best interest of a particular customer.[42] Factors that the broker or brokerage firm should consider when investigating the security or investment strategy include: "the security's or investment strategy's investment objectives, characteristics (including any special or unusual features), liquidity, volatility, and likely performance in a variety 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."[43]

The cost of the investment is now an explicit factor in evaluating securities or strategies, as it is always relevant when evaluating the appropriateness of a recommendation.[44] "Costs" includes both costs associated with purchasing a security, as well as future costs associated with exchanging or selling a security.[45] However, cost is just one factor and the Rule does not require that a broker recommend the lowest cost option.[46]

The second prong of the Care Obligation incorporates the "customer specific" analysis of the Suitability Rule,[47] but enhances it by replacing

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40. 17 C.F.R. §240.15l-1(a)(2)(ii) (2019).

41. *See* FINRA Rule 2111.05(a).

42. 84 Fed. Reg. at 33,375 – 33,376.

43. *Id.* at 33,376.

44. *Id.* at 33,373.

45. *Id.*

46. *Id.*

47. *See* FINRA Rule 2111.05(b).

"suitable" with a best interest standard.[48] In sum, the broker must determine that a recommendation is in the customer's best interest based on that customer's investment profile. The customer's investment profile includes "age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance," and any other information that may be disclosed.[49] This is the same information that firms must currently consider as part of the investor's profile under the Suitability Rule.[50] If a customer does not provide the information, the SEC cautions that a firm may not have sufficient information to make a best interest determination.[51] Note the presumption that the lack of customer-specific information is the responsibility of the firm to either resolve or not make the recommendation.

Additionally, in evaluating whether a recommendation is in the customer's best interest, the broker must consider reasonably available alternatives offered by the broker's firm.[52] The broker need not recommend the "best" of all possible alternatives.[53] The Rule also does not require that the broker be familiar with every product available by the brokerage firm.[54] The scope of the reasonably available alternatives that are considered with respect to any particular recommendation will depend on several factors, including the broker's customer base; the products available to the broker to recommend; and specific limitations on the available products, including that products may only be available in certain geographical locations or to particular types of accounts.[55]

For dually registered brokers, the options with respect to account type must be considered as reasonably available alternatives.[56] If the broker does not also offer advisory accounts, the broker must consider the customer's

48. 84 Fed. Reg. at 33,377.

49. 17 C.F.R. §240.15l-1(b)(3) (2019).

50. *See* FINRA Rule 2111(a).

51. 84 Fed. Reg. at 33,379.

52. *Id.* at 33,381.

53. *Id.*

54. *Id.*

55. *Id.* at 33,382.

56. *Id.* at 33,383.

objectives before recommending a brokerage account.[57] For example, if the customer is requesting that the broker have unlimited discretion, a brokerage account would not be appropriate and should not be offered even if it is the only option available to the broker.[58]

When recommending that an investor rollover a retirement account into an IRA, the broker must consider a number of factors, including "fees and expenses; level of service available; available investment options; ability to take penalty-free withdrawals; application of required minimum distributions; protection from creditors and legal judgments; holdings of employer stock; and any special features of the existing account."[59] A broker may not just consider whether the rollover may offer additional investment options beyond the customer's current plan. While there is no requirement to document the basis for the recommendation, it is likely that firms will require some documentation when a broker makes a rollover recommendation.

The final component is similar to the "quantitative suitability" requirement,[60] except that the "control" element has been eliminated.[61] Previously, FINRA required that the broker have actual or de facto control of a customer account before the quantitative suitability obligation was triggered. However, after Reg. BI was adopted, FINRA also removed the "control" element from the Suitability Rule.[62] The SEC determined that it would not absolve a broker of this obligation simply because the investor has "*some* knowledge of financial markets or *some* 'control'" over their account.[63] This component is intended to prevent trading that is so excessive, colloquially defined as "churning," that a positive return is virtually impossible.[64]

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57. *Id.*

58. *Id.*

59. *Id.*

60. *See* FINRA Rule 2111.05(c).

61. 84 Fed. Reg. at 33,384.

62. *See* FINRA Rule 2111.05(c).

63. 84 Fed. Reg. at 33,384.

64. *Id.*

ii. FINRA's Perspective on Inadequate Procedures and Best Practices

In the 2022 Report, FINRA also discussed deficiencies found with respect to the Care Obligation. For example, FINRA found that brokers made recommendations that were not in the investor's best interests based on their investment profile and the potential risks, rewards, and costs associated with the investment.[65] Brokers also made trading recommendations that were excessive, violating this obligation.[66]

The FINRA Report included examples of practices that it deemed effective in implementing Reg. BI mandates discovered during its routine exams. For example, firms (i) created worksheets for the broker to compare costs and reasonably available alternatives; (ii) explicitly set forth the factors to consider when evaluating reasonably available alternatives, such as considering similar investment types from the same issuer or considering less complex or risky products at the firm; and/or (iii) updated their client relationship management (CRM) tools to automatically compare reasonably available alternatives.[67]

Other useful Reg. BI tools highlighted by FINRA in its Report included firm procedures that (i) limited high-risk or complex products or strategies to particular categories of clients; (ii) required heightened supervision of any recommendations of complex or high-risk products; and/or (iii)established new exception reports to track the sale of the same product to high numbers of clients.[68]

iii. Important Considerations and Documents

The Care Obligation is the part of Reg. BI most similar to the Suitability Rule. Thus, many of the same considerations and documents will be relevant when assessing whether there was a violation of this obligation. This section will focus on the considerations and documents that may be new under Reg. BI.

65. *See* FINRA Report, *supra* note 35.

66. *Id.*

67. *Id.*

68. *Id.*

1. Reasonable Basis Component Considerations

Pursuant to the Rule's reasonable basis component, the broker or the brokerage firm must understand the investment in the same way as under the Suitability Rule. As a threshold issue, if the reasonable basis component is violated, the broker and the firm are not capable of performing the assessment under the customer specific component of the obligation.

The Rule sets forth relevant factors, including potential risks, rewards, and costs, to consider when assessing whether it is likely that the broker has satisfied the reasonable basis component of the obligation. In evaluating a potential case regarding a complex investment, it will be important to review the offering documents for information such as the stated objectives for the investment as well as the risks involved. Notes, e-mails, and memoranda from the brokerage firm's due diligence committee should detail the degree of understanding the firm, its officers, directors, and control persons had of the product or strategy at issue. Importantly, the broker or the firm should be aware of how the investment or strategy is likely to perform in volatile, bullish and/or bearish market conditions. The broker and the firm must also evaluate financial incentives to recommend the investment, including whether the firm or the broker receives any additional compensation from the recommendation.

If the investment is particularly complex, it may be easier to establish that the broker did not adequately understand the investment. Additionally, misrepresentations or omissions about the nature of the investment may also be evidence that the broker did not understand the investment. If the firm or the broker has done little or no due diligence with respect to a complex investment, the firm and the broker have likely violated this component of the obligation.

2. Customer-Specific Component Considerations

The customer-specific component is very similar to its corresponding component under the Suitability Rule. Once the investment is evaluated and approved, the next step is to determine whether it falls within the investor's profile. The information the firm and the broker must gather about the investor is the same as that required by the Suitability Rule: age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance.

Unlike the Suitability Rule, the Reg. BI customer-specific best interest analysis does not stop after a finding that the investment at issue was suitable for the investor. The broker must also have considered reasonably available

alternatives. While the investment need not be the "best" investment, the burden will be on the broker to establish whether the recommendation was reasonable in light of the reasonably available alternatives. This will likely be most relevant in the context of complex products. If a simpler investment with lower costs is available and aligns with the investor's profile, it will be difficult to defend the recommendation of the costly, more complex investment.

The addition of the requirement to compare reasonably available alternatives may also make it easier to support a claim for well managed account damages. Well managed account damages compare the investor's actual outcome with what the outcome would have been had they been appropriately invested. In theory, the well managed account will be a reasonably available alternative that the broker should have considered, or did consider and rejected, when making the recommendation at issue. Therefore, the comparison between the two accounts will be one the broker and the firm should have engaged in prior to making the recommendation.

3. Quantitative Component Considerations

One of the biggest differences between the Care Obligation under Reg. BI and the Suitability Rule is with respect to excessive trading under the quantitative component. The investor is no longer required to demonstrate actual or *de facto* control over the account by the broker. Rather, the investor need only establish that the frequency of the trading is excessive based on their investor profile. Cost to equity ratios and turnover will continue to be relevant in assessing whether trading is excessive.

4. Final Considerations for the Care Obligation

It is likely that firms will require their brokers to document decisions they have made throughout the recommendation process. For example, FINRA recognized that a best practice would be for the firm to utilize a worksheet to establish that the broker assessed the investment and considered alternatives.[69] Therefore, in discovery, it will be important to request documents that reflect the broker's and the firm's assessment that the investment satisfies the reasonable basis and customer-specific components of the obligation. Additionally, there may be documents setting forth the reasonably available

69. FINRA Report, *supra* note 35.

alternatives considered. In connection with the election of account type when the firm is dually registered as a broker and an investment adviser, the firm may document why a brokerage account is more appropriate for the investor rather than an advisory account. Finally, the broker may be required to document why the rollover of a retirement account is appropriate. In discovery, a catchall document request should broadly seek all documents reflecting the rationale or basis for the recommendation at issue.

c. Conflict of Interest Obligation

i. Duties Under Regulation Best Interest

The Conflict of Interest Obligation requires a firm to adopt policies and procedures designed to identify and, at a minimum, disclose all conflicts associated with a recommendation.[70] The obligation further requires that a brokerage firm mitigate or eliminate certain types of conflicts.[71]

With respect to the content of the policies and procedures, like FINRA's Supervision Rule,[72] the SEC contemplates that brokerage firms will have the flexibility to design policies and procedures that are risk-based rather than requiring a detailed review of each recommendation.[73] The SEC suggests certain components that a brokerage firm should consider when adopting policies and procedures including:

> [P]olicies and procedures outlining how the firm identifies conflicts, identifying such conflicts and specifying how the broker-dealer intends to address each conflict; robust compliance and monitoring systems; processes to escalate identified instances of noncompliance for remediation; procedures that designate responsibility to business line personnel for supervision of functions and persons, including determination of compensation; processes for escalating conflicts of interest; processes for periodic review and testing of the adequacy and effectiveness of policies and procedures; and training on policies and procedures.[74]

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70. *Id.* at 33,385.

71. *Id.*

72. FINRA Rule 3110.

73. *Id.* at 33,386.

74. *Id.* at *note* 688.

Under this conflict of interest obligation, the brokerage firm has a duty to, at a minimum, disclose all conflicts of interest.[75] Disclosure must be full and fair; if it is not possible to fully and fairly disclose a conflict, it must be mitigated such that full and fair disclosure is possible.[76]

Brokerage firms also have a duty to identify and mitigate conflicts of interest that create an incentive for the broker to place their interests ahead of the interests of the customer.[77] The SEC has primarily chosen to limit the duty to mitigate broker-level conflicts, allowing the brokerage firms to generally deal with firm-level conflicts through disclosure.[78] The requirement to identify and mitigate broker-level conflicts applies only to incentives provided to the broker, either by the firm or third parties that are within the control of or associated with the firm.[79] Accordingly, the requirement does not create an obligation with respect to private securities transactions.[80] The SEC provides examples of conflicts that must be mitigated: (i) including fees and other charges associated with the service or recommendation provided; (ii) employment incentives, including those tied to asset accumulation, special awards, variable compensation, and compensation tied to performance reviews; and (iii) commissions, sales charges, or other fees whether paid by the customer, the brokerage firm, or a third party.[81]

Mitigation measures should be based on the nature and significance of the incentive, as well as other factors related to the brokerage firm's business model, such as the size of the firm, the types of customers, and the complexity of the security product or strategy.[82]

The SEC lists the best practices for brokerage firms developing policies and procedures for mitigation methods:

- Avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales;
- Minimizing compensation incentives for employees to favor one type of account over another; or to favor one type of product over another,

75. *Id.* at 33,388.

76. *Id.*

77. *Id.* at 33,390.

78. *Id.*

79. *Id.* at 33,391.

80. *Id.* at *note* 744.

81. *Id.* at 33,391.

82. *Id.*

proprietary or preferred provider products, or comparable products sold on a principal basis, for example, by establishing differential compensation based on neutral factors;

- Eliminating compensation incentives within comparable product lines by, for example, capping the credit that an associated person may receive across mutual funds or other comparable products across providers;
- Implementing supervisory procedures to monitor recommendations that: are near compensation thresholds; are near thresholds for firm recognition; involve higher compensating products, proprietary products or transactions in a principal capacity; or, involve the roll over or transfer of assets from one type of account to another (such as recommendations to roll over or transfer assets in an ERISA account to an IRA) or from one product class to another;
- Adjusting compensation for brokers who fail to adequately manage conflicts of interest; and
- Limiting the types of retail customer to whom a product, transaction or strategy may be recommended.[83]

If a brokerage firm materially limits its securities offerings or investment strategies, the brokerage firm must prevent such limitations from causing the firm to put its interests ahead of its customers'.[84] The SEC considers that recommending only proprietary products, products with revenue sharing arrangements, or a specific asset class would be material limitations.[85] The SEC recommends that brokerage firms offering limited menus consider establishing a "product review process" that includes evaluating the use of preferred lists; restrictions on the customers to whom a product may be sold; requiring brokers selling certain products to have minimum knowledge requirements; as well as period product reviews to further evaluate conflicts.[86]

Certain common practices are completely prohibited pursuant to this obligation. For example, brokerage firms must eliminate "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 time."[87] Non-cash compensation includes merchandise, gifts and prizes, travel expenses,

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83. *Id.* at 33,392.

84. *Id.* at 33,393.

85. *Id.*

86. *Id.* at 33,394.

87. 17 C.F.R. §240.15l-1(a)(2)(iii)(D) (2019).

meals and lodging.[88] However, this obligation is not intended to eliminate all incentives, only those that create high-pressure situations to sell specific securities within a limited period of time.[89] Brokerage firms may also continue to hold annual conferences, so long as attendance is not premised on the sale of specific securities within a limited period of time.[90]

ii. FINRA's Perspective on Inadequate Procedures and Best Practices

In the 2022 Report, FINRA also discussed deficiencies found with respect to the Conflict of Interest Obligation. For example, certain firms did not identify conflicts, or if identified, did not adequately address them.[91] In terms of best practices, some firms flattened their commission schedules within particular product types.[92] Flattening commission schedules may work to eliminate the financial incentives for recommending certain product types or products favored by firms because of their revenue sharing or proprietary nature.

iii. Important Considerations and Documents

Pursuant to this obligation, firms will have greater documentation duties than they had previously. For example, the firm must identify conflicts of interest and then assess whether the conflict should be disclosed, mitigated, or eliminated. Therefore, firms will have to review their compensation programs, paying particular attention to any incentives offered. In addressing this component in a claim, it will be important to assess what conflicts have been disclosed and whether disclosure was appropriate. When disclosure is not appropriate, the firm must take additional steps to mitigate or eliminate the conflict. In discovery, it will be important to request any documents reflecting the identification of conflicts of interest and how the firm addressed each of the conflicts. While the SEC has not set forth specific obligations, as discussed above, it has set forth best practices. It may be appropriate to argue that if a

88. 84 Fed. Reg. at 33,396.

89. *Id.*

90. *Id.*

91. FINRA Report, *supra* note 35.

92. *Id.*

firm's policies and procedures fell short of the best practices outlined in the release, then the firm's supervision of the conflicts was not reasonable.

Reg. BI's focus on Conflicts of Interest makes the broker's compensation structure quite relevant. Like with the Disclosure Obligations, if a firm has not made any changes to its compensation structures following Reg. BI, it may be difficult for the firm to establish that it has adequately identified and mitigated conflicts of interest, and therefore it has not adequately supervised its brokers. Additionally, under Reg. BI, disclosure and mitigation are distinct. Accordingly, the firm will have to demonstrate how it has managed those conflicts that incentivize the broker to sell particular products or otherwise put their interests ahead of its investors. Failure to do so can be further support for a claim of negligence focused on failure to supervise.

d. Compliance Obligation

i. Duties Under Regulation Best Interest

The Compliance Obligation is an overarching requirement to adopt policies and procedures that are reasonably designed to achieve compliance with the Rule as a whole.[93] The Rule does not specify which policies and procedures must be adopted. The SEC expects brokerage firms to design their own policies and procedures that "prevent violations from occurring, detect violations that have occurred, and to correct promptly any violations that have occurred."[94] Brokerage firms are expected to tailor their policies and procedures to account for the "scope, size, and risks associated with the operations of the firm and the type of business in which the firm engages."[95] The Compliance Obligation is one that is already captured by the FINRA Supervision Rule, which requires that the establishment of a supervisory system "reasonably designed to achieve compliance with applicable securities laws and regulations."[96] More robust supervisory systems will be required to comply with the new standards set out in Reg. BI.

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93. *Id.* at 33,397.

94. *Id.*

95. *Id.*

96. FINRA Rule 3110.

ii. FINRA's Perspective on Inadequate Procedures and Best Practices

In the 2022 Report, FINRA also discussed deficiencies found with respect to the Compliance Obligation. For example, FINRA found that some firms' written supervisory policies were not adequately precise because they did not identify individuals responsible for supervising compliance with Reg. BI or they had not addressed how the firm would, in practice, comply with their obligations under the Rule.[97] Some firms failed to modify their policies and procedures to reflect the new requirements of Reg. BI. For example, FINRA identified firms that did not address (i) how costs and reasonably available alternatives were to be considered when a broker makes a recommendation; (ii) recommendations of account types; and/or (iii) conflicts of interest that create incentives for the broker to place their own interests ahead of the investor's interests. Finally, some firms did not create procedures to ensure the new recordkeeping obligations were captured, and did not include testing of the policies, procedures, and controls.[98]

FINRA also found that some firms adopted new policies and procedures to comply with the Rule. For example, some firms (i) limited high-risk or complex products or strategies to particular categories of clients; (ii) required heightened supervision of any recommendations of complex or high-risk products; and/or (iii) established new exception reports to track the sale of the same product to high numbers of clients.[99]

iii. Important Considerations and Documents

At a fundamental level, the Compliance Obligation replicates the Supervision Rule's requirement that the firm adopt policies and procedures that will ensure compliance with the Rule. Firms should have explicit sections of their Compliance Manual that address the assessment and recordkeeping obligations of Reg. BI. As discussed above, required disclosures must be documented, certain Care Obligation assessments must or should be documented, and the required analysis of Conflicts of Interest should be documented. Additionally, it will be important to determine whether the firm has adopted any restrictive policies and procedures. For example, some firms have determined that certain products should not be sold to certain investors.

97. *See* FINRA Report, *supra* note 35.

98. *Id.*

99. *Id.*

If a firm has adopted such policies, then a recommendation of such an investment to that type of investor will likely be deemed to be unreasonable under the Rule.

e. The SEC's First Reg. BI Enforcement Action Focuses on the Compliance Obligation

In its first enforcement action under Reg. BI, the SEC alleged that the firm violated its Compliance Obligation because it did not adequately establish, maintain, and enforce policies and procedures designed to achieve compliance with Reg. BI.[100] The firm and the brokers charged allegedly recommended high-risk debt securities to investors, many of whom were on fixed incomes with moderate risk tolerances.[101] The issuer of the securities stated that the securities were high-risk, illiquid, and suitable for investors with substantial financial resources.[102] Therefore, the SEC has alleged that the brokers did not have a reasonable basis to believe the recommendations were in the investors' best interests.[103] The assessment in the SEC's action is very similar to the assessment that would have occurred under the Suitability Rule.

III. Conclusion

For the practitioner considering a potential case, Reg. BI's Care and Compliance Obligations will be front and center for any claims sounding in negligence. The Disclosure and Conflict of Interest Obligations will also be important and may further support claims of negligence, especially when focused on failure to supervise. The article has focused on claims based on negligence, but Reg. BI may be used to support other claims as well, including breach of contract, negligent or intentional misrepresentation, and state Blue Sky law claims. For other claims, the obligations, FINRA's perspective, and the important considerations and documents will be largely the same.

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100. *See* SEC, SEC Charges Firm and Five Brokers with Violations of Reg BI (June 16, 2022) ("SEC Action"), https://www.sec.gov/news/press-release/2022-110.

101. *Id.*

102. *Id.*

103. *Id.*

In discovery, Reg. BI's new recordkeeping obligations should lead to relevant, discoverable documents. While many of the documents may fall into one or more categories of presumptively discoverable documents enumerated in the FINRA Discovery Guide, practitioners need to be well versed in identifying and/or describing the Reg. BI specific documents. In meeting and conferring with opposing counsel, explaining the Reg. BI documents that should exist in their clients' possession, custody, and/or control should be part of the early sensitization of this new regulatory scheme and its recordkeeping requirements. In addition to reviewing what the SEC has included in the rulemaking package, many defense oriented law firms are publishing guides, which will also be useful in describing documents within a discovery request and supporting motions to compel.

Further, while Reg. BI does not directly address damages, it strengthens claims seeking well managed account damages through the Care Obligation's requirement to consider reasonably available alternatives to the investment recommended. The requirement to consider and compare similar investments that may accomplish the same investment objective gives strong support for damage theories other than Net-Out-Of-Pocket damages. Thought should be given as to how damages are presented in the pleadings and at the hearing on the merits. Moreover, it may be advantageous to retain an expert early in the process to identify reasonably available alternatives while drafting the Statement of Claim.

The Reg. BI Obligations are new for practitioners but will also be new for the arbitrators. It will be important for counsel to educate arbitrators about the new Obligations and the firms' recordkeeping obligations in the pleadings, during the discovery process, and during any hearing on the merits.