



## **Regulation Best Interest: A Quiet First Anniversary for Brokerage Firms**

Welcome to this edition of the Investments & Wealth Institute *Legislative Intelligence*. This column focuses on the question of when the Securities and Exchange Commission (SEC or Commission) will begin to actively enforce the much-anticipated Regulation Best Interest (Reg BI), the new best-interest standard promulgated by the SEC for retail brokerage advice. A year after the June 30, 2020, compliance deadline, the Commission still seems to be taking an educational, rather than an enforcement, approach to investment advisory activities by broker–dealers.

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### **‘More Focused Examinations’ by SEC on Brokerage Firms’ Policies and Procedures, Not Enforcement, on Anniversary of Reg BI Compliance Deadline**

On December 21, 2020, the newly renamed Division of Examinations (DoE or Division), formerly known as the Office of Compliance Inspections and Examinations, announced it would begin the next phase of its Reg BI examination program by assessing implementation efforts of brokerage firms’ policies and procedures.

The whole process of enhancing the SEC’s longstanding suitability requirement for broker–dealers began on April 18, 2018, when Reg BI was first released for public comment. On June 5, 2019, a divided Commission approved the rule 3-1 largely as proposed, with a compliance deadline of June 30, 2020.

Similar to the Department of Labor’s (DOL) efforts to slowly transition brokers and insurance producers from a suitability standard to fiduciary accountability, the SEC and the Financial Industry Regulatory Authority (FINRA) have emphasized a go-slow, educational approach based on a “good faith” effort to comply with Reg BI, a quasi-fiduciary standard. However, in December the SEC released a statement indicating that the next round of exams would be tougher.

“Building on [SEC] staff’s initial assessments, Division staff intends to expand the scope of examinations in 2021 that focus on specific requirements of the regulation,” the statement said, “including those that go beyond suitability standards and require broker–dealers to have a reasonable basis to believe that recommendations are in retail customers’ best interests.”

As reported by *Investment News*, during a February 2021 webcast by the Securities Industry and Financial Markets Association (SIFMA), a DoE official, John Polise, affirmed this general message of regulatory restraint. However, he clarified that the Division’s new posture is “something beyond good faith.”

On the other hand, he said that “We’re not looking to do gotcha exams or make enforcement referrals per se.” Polise added that in the first round of exams last year, firms generally were trying to comply, resulting in deficiency letters rather than referrals to the SEC’s Division of Enforcement.

This regulatory constraint can be seen in the absence of any references to Reg BI violations in the litigation releases and disciplinary sanctions reported routinely by the SEC and FINRA over the past 12 months. It also appears that the SEC is going out of its way to avoid waving red flags with the securities industry because the agency could have used suitability violations by brokers—a core component of Reg BI—by publicizing suitability violations as violations of Reg BI. Both agencies often highlight an enforcement action, sanction, or settlement to call attention to systemic compliance problems.

In announcing the SEC’s examination priorities this year, the agency appeared to go out of its way to emphasize the various activities promoting compliance, beginning with “communicating our intentions.” The agency noted some of the outreach efforts, including reporting on the initial results of its examinations, publishing risk alerts, and hosting a roundtable to “highlight to the industry preliminary observations.”

**SEC Exam Focus Going Forward.** In addition to what appears to be the primary focus on policies and procedures (P&P) in 2021, SEC staff noted that in 2020 some firms had simply taken a cookie-cutter approach to P&P by restating some of the rule’s core requirements without providing any meaningful guidance. In this next assessment phase, DoE plans to focus on the following areas in addition to P&P:

- How firms evaluate investment costs in making a recommendation to retail customers;
- Processes used by firm personnel in recommending complex products;
- Whether firms have removed higher-cost products when lower-cost alternatives are available; and
- Any documentation used in considering costs.

Interestingly, Reg BI does not require documenting investment recommendations by brokers, possibly making it more difficult for the SEC or FINRA to assess a firm's compliance with suitability obligations under the rule, or to make referrals for enforcement purposes. In contrast, procedures utilized by investment fiduciaries in developing recommendations under the Employee Retirement Income Security Act of 1974 often center around prudent processes focused on consistency with the retirement plan's investment policy statement (IPS). The procedures used to adhere to the investment goals and objectives of the IPS often are heavily documented.

**Future Regulatory Changes Still Unknown.** SEC Chairman Gary Gensler is being lobbied by consumer advocates reportedly to define "best interest" in Reg BI by rule, and also to actively enforce Reg BI as an indirect way of defining the core obligations comprising the "best-interest" standard. The core components of the rule comprise duties to disclose and mitigate conflicts of interest consistent with the brokerage customer's investment profile, and the customer's investment goals and objectives.

However, a new rulemaking to amend or replace Reg BI is conspicuous by its absence in the SEC's recently [published regulatory agenda](#) for spring 2021. Instead, it appears that enforcement measures and regulatory guidance may be the primary approach that the SEC, for the time being, takes in response to the previous administration's adoption of Reg BI as a substitute to a traditional fiduciary standard for a broker's investment advice.

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