Regulation Best Interest: Higher Standards for Broker-Dealers, Stronger Protections for Investors

By Michael P. Shaw, Esq., CRCP
Regulation Best Interest
HIGHER STANDARDS FOR BROKER–DEALERS, STRONGER PROTECTIONS FOR INVESTORS

By Michael P. Shaw, Esq., CRCP

On June 5, 2019, the Securities and Exchange Commission (SEC) approved a higher standard of care for broker–dealers (brokerage firms) and their financial professionals (brokers) when making a recommendation to an investor regarding a securities transaction. This new higher standard, referred to as Regulation Best Interest or Reg BI, was intended to narrow the gap between the different standards of care that a broker and an investment advisor must abide by when making recommendations to an investor.

For more than two decades, brokers have been held to a suitability standard of care. In other words, a broker’s recommendation to an investor has, before Reg BI, been limited to an analysis of whether the broker’s recommendation is appropriate given the investor’s age, risk tolerance, investment objectives, and other factors. Suitability was thought to be aligned with the transactional nature of a broker’s relationship with an investor. Investment advisors, on the other hand, have been held to a fiduciary standard of care, which refers to a requirement to act in a client’s best interest. Because investment advice is considered ongoing in nature and can cover a broad array of services, investment advisors have been deemed to be in a relationship with a client that requires loyalty and trust, hence the need for a higher standard of care than the suitability standard. Over time, the distinction between the services offered by brokers and investment advisors has become less clear, prompting the SEC to reevaluate the applicable regulatory regimes and to bring the standards of care owed by these two groups of investment professionals closer together.

The key tenet of Reg BI is that when a broker makes a recommendation of a securities transaction or an investment strategy involving securities to an investor, the broker must: (1) act in the best interest of the investor at the time the recommendation is made; and (2) not place the financial or other interest of the broker ahead of the interest of the investor.

Reg BI has four components. A broker is required to comply with each component to remain in compliance with the regulation. The discussion below presents the key elements of these four components, as described in the SEC’s Final Rule in Release No. 34-86031.

DUTY OF CARE

Before making a recommendation to a retail investor (as opposed to a corporate or institutional investor), a broker is now required under Reg BI to understand the risks and costs associated with the recommendation and consider these factors in view of the investor’s age, investment objectives, and risk tolerance.

The care obligation of Reg BI requires a broker to exercise reasonable diligence, care, and skill in making the recommendation. This requires the broker to understand potential risks, rewards, and costs associated with the recommendation, then consider those risks, rewards, and costs in view of the investor’s investment profile, and have a reasonable basis to believe that the recommendation is in the investor’s best interest. A broker must consider reasonable alternatives, if any, offered by the brokerage firm in determining whether there is a reasonable basis for making the recommendation. And the broker must not place his/her interests ahead of the investor’s.

CONFLICTS OF INTEREST

Under Reg BI’s conflict of interest obligation, a brokerage firm must have written policies and procedures to identify conflicts of interest, and the brokerage firm must enforce these policies and procedures to address conflicts of interest.

At a minimum, a brokerage firm is required to disclose its conflicts to investors, such as the conflict that arises with respect to a broker’s compensation. Some conflicts can be avoided entirely, such as allowing unnecessary transactions in a client’s account that generate commissions for the broker. Another example of a conflict that can be avoided is a broker favoring the brokerage firm’s proprietary products over other products that may be more appropriate for the investor because of financial incentives offered by the brokerage firm to sell its products. In such cases, the brokerage firm’s policies and procedures must be reasonably designed to disclose any limitations in its product offerings and associated conflicts, and to prevent the limitations from causing the broker to place personal interests or the brokerage firm’s interests ahead of the investor’s.
In general, brokers are required to eliminate conflicts of interest wherever possible, and brokerage firms are required to identify and address incentives that can lead their brokers to put their own interests ahead of their investors’.

Finally, the policies and procedures must be reasonably designed to identify and eliminate sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sale of specific securities or specific types of securities within a limited time period.

**DISCLOSURE**

Reg BI now requires brokerage firms to disclose the fees they charge, the type and scope of the services they offer as well as any limitations on those services, any conflicts that exist, and whether the brokerage firm provides ongoing monitoring of an investor’s account.

Under Reg BI’s disclosure obligation, a broker must provide certain prescribed disclosures before or at the time of the recommendation about the recommendation and the relationship between the investor and the broker. These disclosures must include: (1) that the broker is acting in a broker–dealer capacity with respect to the recommendation; (2) the material fees and costs that apply to the investor’s transactions, holdings, and accounts; and (3) the type and scope of services to be provided, including any material limitations on the securities or investment strategies that may be recommended to the investor. Additionally, brokers must disclose all material facts relating to conflicts of interest associated with the recommendation that could benefit the broker, such as conflicts associated with proprietary products, payments from third parties, and compensation arrangements.

**COMPLIANCE**

Brokerage firms are required to develop, maintain, and enforce policies and procedures to comply with Reg BI. Under Reg BI’s compliance obligation, a broker must establish, maintain, and enforce policies and procedures reasonably designed to achieve compliance with Reg BI. The SEC does not intend a brokerage firm’s compliance with Reg BI to create new and potentially duplicative records for each recommendation to an investor. Rather, the SEC believes that brokerage firms should be able to explain in broad terms the process by which the firm determines what recommendations are in an investor’s best interest, and to explain how that process was applied to a specific recommendation to the investor. The SEC is not, however, mandating that brokerage firms create and maintain a record of each such determination.

In conjunction with approving Reg BI, the SEC also approved and now requires that both brokers and investment advisors, at the beginning of an investor relationship, provide an investor with a customer relationship summary (Form CRS) to allow the investor to compare one financial professional’s services to another. Form CRS must contain a summary of the services offered, fees charged, costs, conflicts of interest, standard of conduct, and disciplinary history, if any, of the firm and its financial professionals.

In promulgating Reg BI, the SEC also provided guidance on two areas of federal securities laws that have led to some confusion. First, the SEC clarified the federal fiduciary duty that an investment advisor owes to a client under the Investment Advisers Act of 1940 (Advisers Act). Second, the SEC clarified the long-standing exemption that applies to a broker who provides advice to an investor that is considered “solely incidental” to the brokerage transaction, and where the broker does not receive special compensation for that advice. Now, according to the SEC’s new interpretation of “solely incidental,” the advice provided by a broker must be “reasonably related to the broker–dealer’s primary business of effecting securities.”

Reg BI and Form CRS became effective on September 10, 2019. The SEC’s new interpretations of the federal fiduciary duty and “solely incidental” also became effective on this date. The SEC, however, extended the enforcement date of Reg BI and Form CRS until June 30, 2020, to give brokerage firms time to modify their compliance programs.

This article has evaluated the components of Reg BI, and the effect that this new regulation has on brokerage firms and their brokers. But what about investors? Are investors able to discern any noticeable difference that Reg BI brings about in a broker’s recommendations? Certainly, investors who pay close attention to disclosure documents are aware of the new Form CRS that Reg BI requires a broker and investment advisor to complete and provide to the investor. For most investors, however, Reg BI has not led to any noticeable change in the way that a broker or investment advisor makes a recommendation. This is not to say that Reg BI has not had an impact on investors. The four obligations that a broker must satisfy to comply with Reg BI—care, conflict of interest, disclosure, and compliance—impact investors by raising the standard of care and due diligence required of a broker in making a recommendation in a way that goes well beyond that which is required by the suitability standard of care.

As with any new regulation, Reg BI has had its detractors. Public interest groups, including the Consumer Federation of America, the Financial Planning Coalition, and others, believe the SEC did not go far enough in raising the standards for brokers. These groups urged the SEC to create for brokers a fiduciary duty similar to the fiduciary duty that applies to investment advisors. Applying the fiduciary standard to brokers, however, is fraught with
insurmountable challenges. For one, the broker-dealer model is based on commission compensation, the sale of proprietary products, and conducting principal trades, i.e., trading from the brokerage firm’s own account. Therefore, brokers would not be able to satisfy the duties of care and loyalty, as required by the fiduciary standard.

Additionally, the attorneys general in seven states and the District of Columbia (DC) filed a lawsuit against the SEC in federal court in an effort to block implementation of Reg BI. These states and DC argued that in issuing Reg BI the SEC exceeded its authority under the Administrative Procedure Act by failing to follow the mandate of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which authorized the SEC to conduct rulemaking that would harmonize the standard of conduct between brokers and investment advisors. In their lawsuit, the states and DC contended that Reg BI would undermine investor protections provided by the Advisers Act and increase investor confusion over the standards of conduct that apply when an investor receives an investment recommendation from a broker versus a recommendation from an investment advisor. Ultimately, these lawsuits were dismissed.

For its part, the Securities Industry and Financial Markets Association, which represents the broker-dealer, banking, and asset management industry, believes that the obligation under Reg BI to eliminate or mitigate conflicts of interest provides even greater protections for investors than is required under the fiduciary standard that applies to investment advisors.

Although proponents and opponents of Reg BI are deeply divided over whether Reg BI will enhance or diminish protections for investors, where these two sides agree is that investors have been confused over the different standards of care that apply to brokers and investment advisors when providing recommendations to investors. Has Reg BI cleared up this confusion? Unfortunately, the adoption by the SEC of this new standard of best interest, which essentially builds on the current suitability standard, has continued to cause confusion over the fiduciary standard that applies to investment advisors.

**Unfortunately, the adoption by the SEC of this new standard of best interest, which essentially builds on the current suitability standard, has continued to cause confusion over the fiduciary standard that applies to investment advisors.**

Where Reg BI and the Advisers Act have something in common, it is that they each were created using a principles-based approach to regulation. Therefore, the determination of whether a brokerage firm or a broker has violated Reg BI requires the same analysis in determining whether an investment advisor has violated the Advisers Act—an analysis of the facts and circumstances of the alleged violation. As with any new regulation, the challenge that Reg BI has presented for brokerage firms and investment advisory firms (with respect to Form CRS) has been in drafting policies and procedures to comply with this new regulation.

**REG BI’S IMPACT**

In March 2023, the Financial Industry Regulatory Authority (FINRA) announced it would begin ramping up its enforcement efforts regarding Reg BI. Despite this regulation going into effect in June 2020, there have been relatively few Reg BI enforcement actions since then, which has been due, in part, to complications caused by the COVID-19 pandemic. Rather than imposing a sanction and/or fine when a firm was found by FINRA to be in violation of Reg BI, FINRA has issued a notice to inform the firm of the violation and give the firm time to comply.5 By way of example, during calendar year 2022, FINRA found violations in half of the Reg BI exams it conducted,4 which reveals that firms have been slow to implement all of Reg BI’s requirements in their policies and procedures.5 During SEC exams, a common issue identified is that firms are using outdated technology that does not ensure compliance with the new regulation,6 because the current system used by many firms lacks the monitoring system or tool necessary for brokers to ensure they are complying with Reg BI.7

In October 2022, FINRA imposed its first Reg BI enforcement action. FINRA acted following its review of a customer-initiated arbitration, which alleged that a broker was performing an excessive number of transactions in the customer’s account.8 The excessive trading caused the account to lose value while generating commissions and trading costs for the broker and the broker’s firm.9 The enforcement action resulted in a $5,000 fine and six-month suspension of the broker.10

In other significant enforcement actions related to Reg BI, FINRA suspended two brokers at a firm in February 2023 for similar churning conduct.11 Each broker was fined $5,000 and suspended.

For the remainder of 2023, firms can expect to see a significant increase in Reg BI examinations. According to Bill St. Louis, executive vice president and head of the National Cause and Financial Crimes Detection Program at FINRA, FINRA is aiming to conduct Reg BI examinations on 1,000 broker-dealers in 2023.12

Continued on page 52 →
Michael P. Shaw, Esq., CRCF, ChFC, CLU, is founder and managing partner of The Shaw Law Group, legal advisors to financial advisors nationwide. He earned a BS in economics from Marquette University and a JD from The Catholic University of America. Contact him at michael@theshawlawgroup.com.

ENDNOTES
3. M. Rozen, “Finra Targets 1,000 Reg BI Exams by Year-End, Expects More

4. See endnote 3.
7. See endnote 6.
9. See endnote 8.
12. See endnote 8.