Ellenoff Grossman & Schole LLP

Client Memorandum

December 9, 2019

SEC REGULATION BEST INTEREST: PART I

WILL THESE RULES EFFECT YOU?

Effective Date June 30, 2020

Now is the time to determine if your broker-dealer or investment adviser is covered by SEC Regulation Best Interest

Background

The Time is Now

The June 30, 2020 compliance date for ***SEC Regulation Best Interest,*** SEC Rule 15l-1 ("Regulation BI"), is fast approaching. It is comparatively easy for small or specialized broker-dealers or investment advisers to misunderstand the breadth of Regulation BI's coverage. Private placement, "institutional," and "high net worth" broker-dealers and advisers to individual investors and certain family offices in particular should undertake a careful review *now* to determine if they are covered Regulation BI's extensive compliance requirements.

As Robert Cook, CEO of FINRA, recently stated it will not be enough to say: ***"this rule requires me to act in the best interest of my customers. No problem. I do that every day. That's the kind of firm I am."***[1] Some nasty surprises may be in store if you later discover that you are a covered entity and do not have sufficient time to comply with the Rule. *The purpose of this Client Alert is to help you avoid these surprises.*

Will it Be Delayed?

The SEC provided a one year compliance period at the rule's June 2019 adoption;[2] you should *not* assume there will be further delays. No judicial stays or injunctions currently prevent the rule going into effect.[3] In October, 2019 FINRA's Northeast Regional Director stated FINRA will begin to examine the "preparedness" of firms toward Regulation BI compliance this year.[4] And, the SEC has established a dedicated email to answer Regulation BI questions, IABDQuestions@sec.gov , and has just begun to post "Frequently Asked Questions." for Form CRS: https://www.sec.gov/investment/form-crs-faq

What about the States?

Applying the *fiduciary duty* standard required of investment advisers to broker-dealers is a hot topic among state securities regulators. Three states - Massachusetts, New Jersey and Nevada - have proposed rules mandating such a fiduciary duty standard but none of these states has promulgated a final rule as of the date

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[1] *Reg BI Will Be Heavy Lift for B-D Firms, FINRA Chief Warns, quoted in* Financial Advisor IQ, November 13, 2019: https://www.financialadvisoriq.com/c/2572983/299613/will_heavy_lift_firms_finra_chief_warns?

[2] *See* 84 Fed. Reg. 33318 (July 12, 2019).

[3] A consolidated federal court action to enjoin (and to invalidate) the Rule by seven states and the District of Columbia was dismissed in favor of parallel petitions for review of the rulemaking still pending in the United States Court of Appeals for the Second Circuit. *See* Decision and Order, *State of New York, et al., v. United States Securities and Exchange Commission, et al,* No. 1:19-cv-08365-VM, Docket No. 27 (S.D.N.Y. Sept. 27, 2019). A financial planners group also filed a separate action that was consolidated with the states' action. Consolidation Order, Id., Docket No. 13 (S.D.N.Y. Sept. 12, 2019).

[4] *See Finra Reveals Reg BI 'Preparedness Reviews' Starting in November,* Financial Advisor.com (Oct. 23, 2019). FINRA apparently hopes to help the firms it examines. It has also posted a Regulation BI compliance checklist. https://www.finra.org/sites/default/files/2019-10/reg-bi-checklist

of this Memorandum.[5] Firms operating in those states must closely monitor local developments. All intermediaries need to be alert for other states jumping on this bandwagon.

The SEC's Rule

While not identical to the higher investment adviser fiduciary standard many advocated for during the rulemaking, the SEC Regulation BI's core "best interest" duty nevertheless substantially increases the obligations owed by broker-dealers to retail clients:

> A broker, dealer, or a natural person who is an associated person of a broker or dealer, *when making a recommendation* of any securities transaction or investment strategy involving securities (including account recommendations) to a *retail customer*, shall act in the *best interest of the retail customer* at the time the recommendation is made, without placing the financial or other interest of the broker, dealer, or natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer (*italics added*).[6]

The Rule imposes four core obligations in addition to a new *mandatory* disclosure Form CRS: 1) *disclosure* (partially via Form CRS); 2) *due care;* 3) *conflict of interest* (disclosure and mitigation); and 4) *compliance* (procedures, monitoring and training).[7] These obligations are briefly outlined in the final section of this Memorandum and will be covered in more detail in future EGS publications.

How do I Determine if I am Covered?

The starting point to determine coverage is Regulation BI's definition of "retail customer" and its linked requirement of a "recommendation."

Who is a Retail Customer?

Regulation BI, SEC Rule 15l-1 (a) (1) provides:

> *Retail Customer* means *a natural person*, or the *legal representative* of such
> Natural person, who: (A) Receives a *recommendation* of any securities transaction or investment strategy involving securities from a broker, dealer, or a natural person who is an associated person of a broker or dealer; and (B) Uses the *recommendation* primarily for *personal, family, or household purposes*. [*Italics added*].

"Natural Person"

Use of *natural person* as the *only* synonym for "retail customer" in the above definition was not accidental. Commenters on the SEC's proposed rule pointed out different definitions in other rules

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[5] After receiving preliminary comments this Summer, on November 29, 2019 Massachusetts, issued a proposed uniform fiduciary standard rule, beginning formal public comment and hearings process toward adopting a rule. *See* https://www.thinkadvisor.com/2019/12/02/galvin-signs-off-on-massachusetts-fiduciary-rule

[6] SEC Rule 15l-1 (a) (1), 17 CFR 240.15l-1(a) (1). *See* 84 Fed. Reg. at 33329-33333 (SEC discussion of standard chosen).

[7] SEC Rule 15l-1 (a) (2) (i)-(iv).

and requested similar treatment as existing rules like FINRA Rule 4512's treatment of a high net worth individual investor with assets over $ 50 million as an "institutional investor" for suitability and other purposes.[8] The SEC expressly declined to carry over any of these different definitions or exceptions into Regulation BI. [9] The result: to trigger Regulation BI well-established statuses like "accredited investor," "qualified purchaser," or a "high net worth investor" equivalent to an "institutional customer," simply do *not* matter. A "natural person" is a natural person, no matter if it is Warren Buffet or Bill Gates.

Two other parts of the above definition -- a) is there a "recommendation" and b) is it primarily for "personal, family, or household purposes."--do qualify this broad definition to some degree.

What is a "Recommendation"?

The SEC declined to provide a "bright line definition" of "recommendation" in Regulation BI. From the authority cited in the SEC's adopting release, the *SEC did intend* to carry forward the "existing framework" for determining if a recommendation has been made, primarily found in FINRA rules and guidance, *e.g.,* FINRA Regulatory Notice 11-02 (2011)(discussing "recommendation" in the suitability context). The SEC quoted with approval the following rules of thumb: "whether the communication could "'reasonably could be viewed as a "call to action"' or "'reasonably would influence an investor to trade a particular security or group of securities.'"[10] While this is helpful it is also rather cold comfort since firms will still end up performing a facts and circumstances analysis with only a few areas of comparative clarity to rely upon and attendant compliance risk. [11]

Consistent with FINRA rules and guidance, there are some communications expressly defined in the rule as "recommendations." For example, since the adoption of FINRA Rule 2111 it has been clear that "recommendations" can be for:

1. securities transactions.
2. investment strategies.
3. whether to open a specific type of account (*e.g.*, simple IRA vs. Roth IRA; brokerage account vs. advisory) or to transfer or rollover an account.
4. an explicit recommendation to "hold" a security.

More controversially, Regulation BI also covers an "implicit" recommendation to hold a security, at least to the extent it results from an account review and account monitoring is agreed upon by an associated person and his/her retail client.[12]

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[8] *See* 84 Fed. Reg. at 33335. Section 913 (a) of the Dodd Frank Act uses the same definition.
[9] *See id.* at 33341-42.
[10] Id. at 33335.
[11] See *id*. at 33335: "We believe that what constitutes a recommendation is highly fact-specific and not conducive to an express definition in the rule …broker-dealers generally are familiar with the existing framework … and this approach should continue…."
[12] Id. at 33336 & note 170 (noting this is *not* covered *by* FINRA's suitability rule.

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By contrast, providing *gener*al financial and investment education pieces on subjects like taxation, investment terminology, financial concepts or account types is *not* usually seen as giving rise to a "recommendation" and for Regulation BI the SEC has endorsed following the usual understanding of what these are.[13] This treatment also extends to "financial models" and "investment analysis tools," as used in FINRA Rule 2214, if that Rule is complied with."[14]

"Primarily for personal, family, or household purposes"

This phrase seems commonsensical. For example, a natural person acting for a business account or for business purposes, such as an employee acting for an employer's business or for a legal entity like a charitable trust, is plainly not meant to be covered. By contrast vehicles commonly used by individuals for personal purposes like trusts and retirement savings vehicles like an IRA or a SEP plan are covered, as are 529 education savings accounts and the like.

The analysis becomes less clear when the term "legal representative" is added into the mix. Read one way "legal representative" simply is descriptive shorthand to categorize individuals acting in capacities like that of executor, guardian, conservator or power of attorney. The SEC, however, also distinguishes between types of representatives. "Financial services industry professionals" retained by individual investors for advice (*e.g.,* registered advisers, broker-dealers, corporate fiduciaries and insurance companies), *are not* legal representatives covered by Regulation BI. "Non- professionals" (*i.e.,* unregistered funds or family offices *not* managed or advised by *financial services industry professionals*), *are* covered.[15] Regardless of their assets managed or advised, the latter entities will be converted into Regulation BI covered "retail customers" if not advised by *financial services industry professionals.* Further SEC guidance may well be necessary on how this will apply to specific situations.

Examples of Broker-Dealers Who Could Be Effected

Private Placement Agents

Broker-dealers who concentrate on private placements of securities to retail customers will see the most serious change in their compliance obligations, especially so-called "nickel BDs". Private placement brokers may be engaged in securities placements for a variety of issuers and issuances, including private issuer start-ups and operating companies, as well as for private investment vehicles such as hedge funds, private equity funds and venture capital funds. The lack of Regulation BI carve-outs for "accredited investors," "qualified purchasers" and "high net worth investors" will increase new compliance burdens and costs for placement agents who deal with covered "retail investors."

Private placement agents are typically engaged by the private issuer for a fee and may provide a range of services, such as advice on deal structuring and market appetite for particular offerings, preparation of offering and marketing materials and due diligence to arranging investor meetings and referring or soliciting potential investors. True private placement only *nickel BDs* typically do not even introduce (or

[13] See *id*. at 33337-8 (characterizing the distinction between investor "education" and recommendations as "well-understood by broker-dealers").
[14] Id.
[15] Id. at 33342.

carry) customer accounts. Historically, these broker-dealers had argued they had no investor-facing obligations since the client they were engaged by was the issuer, (and especially if they had no customer accounts). FINRA Rule 2111's suitability rule rejected that approach at least where there is some degree of recommending or soliciting retail clients to invest, imposing duties to assess: the suitability of a product for any investor; to determine suitability of a particular investment for a specific investor; and to undertake reasonable due diligence on the issuer and the investment. FINRA Regulatory Notice 12-55, *Suitability-Guidance on FINRA's Suitability Rule* (Dec. 2012); FINRA Regulatory Notice 10-22, *Obligations of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings,* (April 2010). For Regulation BI, the SEC citing FINRA authority favorably, eliminated any doubt a recommendation is covered as long as "the broker-dealer receives or will receive compensation, directly or indirectly, as a result of the recommendation, even if the retail investor does not have an account at the firm [*footnote omitted*]."[16]

Of course, coupling this with ignoring FINRA's exception to the suitability rule for investors with assets over $ 50 million dollars and issues around coverage of certain family offices and private funds discussed above will have an inarguable impact on smaller *nickel BDs* and other placement agents. As discussed in the following section to the extent placement agents are not engaged to refer or solicit investors, and they do not otherwise make a "recommendation to retail investors," they may not be subject to Regulation BI.

Institutional broker-dealers

Regulation BI will also cause unwelcome changes for broker-dealers conducting "mini-institutional" businesses focusing on smaller "institutional" clients and on high-net worth individual investors deemed "institutional." Not only are "high net worth investors" "retail" investors under Regulation BI, no matter their net worth or income, but as discussed above Regulation BI also converts certain family offices and exempt funds to "retail customers" for Regulation BI purposes. Broker-dealers will need to exercise particular care in onboarding due diligence for "middle market" or "mini-institutional" customers.

Related questions on which further SEC guidance may be necessary include how to treat associated persons of brokers-dealers, their family and friends for whom a broker-dealer introduces or carries personal accounts. This is an issue for all broker-dealers, who often accept such accounts as an accommodation to their associated persons and to facilitate employee account compliance reviews. Absent further SEC guidance, institutional broker-dealers will need to weigh if they wish to continue this practice against the resulting compliance burden. Similar questions arise over how to treat accounts opened for purchases of shares directed to individuals by issuers in offerings or opened for officers, directors and employees of issuers and their affiliates in offerings. To the extent these purchasers are truly "directed" they could be argued to be "unsolicited transactions" not resulting from "recommendations" of the broker-dealer, but greater clarity from the SEC may be in order on this point.

Most clients of institutional broker-dealers should, of course, still fall into the non-retail category. For example, to the extent benefit plans or fiduciary nominees are the entities for whom accounts are established for the benefit of others there will be less concern since they will be managed or advised by the financial services industry professionals with whom the broker-dealer interacts. Likewise, dealing with registered

[16] 84 Fed. Reg. at 33344 & note 259.

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investment advisers acting for individual investors would not seem to trigger Regulation BI coverage, even in a separately managed account relationship where an adviser may open a subaccount to allocate trades directly. A few outliers do need to be watched out for, however, such as single client LLCs and the like which could be seen as retail clients with a veneer over them, especially if they lack an independent business purpose other than "personal or household" investing or are controlled by a non-professional decision maker.

Broker-Dealers with Limited Business Models

Some other broker-dealers engaged in specialized business activities will not be covered by Regulation BI. For example, clearing or carrying brokers will not be required by the SEC to provide a Form CRS to retail investors introduced to them by other broker-dealers because of their limited relationship to the retail investor and to avoid the confusion of multiple summaries since it is the introducing broker who deals with the client directly. [17]

"Underwriters"

The SEC stated in the adopting release a "principal underwriter" for variable annuities or mutual funds is not covered, since that broker-dealer's role is that of a wholesaler who typically interacts only with other broker-dealers.[18] Although not expressly discussed in the SEC's Adopting Release, this same logic should also exclude lead/"book-running" and managing underwriters in public offerings to the extent they assign solicitation of and distribution to retail clients to other broker-dealers in the selling group or syndicate and do in not solicit retail clients. Broker-dealers in private placements who "wholesale" only, that is provide the investments to other broker-dealers who sell them to "retail clients" should be similarly exempt. Generally, acting as both a "wholesaler" and a "retailer" will, of course, cause the latter activities to be covered by Regulation BI.

Executing brokers and similar intermediaries like "broker's brokers," should be exempt from Regulation BI if they only execute trades routed to them by *other* broker-dealers for those broker-dealers or their undisclosed customers. Broker-dealers who offer only self-directed investing such as *online execution only* platforms and "pure" execution-only discount brokerages are also excluded as long as transactions are "unsolicited" and no additional activity smacking of a "recommendation" is undertaken.[19] Adding on additional pieces, such as neutral investment tools or models, may not change the analysis but a fact-specific analysis will have to be undertaken by each firm to determine if Regulation BI applies to it. Seeking SEC guidance may be appropriate in close cases.

What if You Are Covered?

New SEC Form CRS

The content and distribution requirements for new **Form CRS** are discussed in a separate lengthy adopting release issued by the SEC simultaneously with *Regulation Best Interest.*[20] Firms must prepare Form CRS, file it with the SEC and provide it to existing and new retail accounts as follows:

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[17] Form CRS Relationship Summary, 84 Fed. Reg. 33492, 33550-51 (July 12, 2019) (Adopting Release for Form CRS)

[18] Id.

[19] 84 Fed. Reg. at 33334-35.

[20] *See* 84 Fed. Reg. at 33492.

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a. *Form Filing and Distribution*

Form CRS must be written in "plain English" and be no more than two pages (or four pages for a dually-registered BD/RIA). It must be electronically filed with the SEC in machine readable text searchable format (which can be a .PDF file using bookmarks for headings). **Form CRS must be initially filed with the SEC between May 1, 2020 and no later than June 30, 2020, posted to a broker-dealer's website, and delivered to existing retail customers within 30 days after filing.** Each prospective or new retail investor client at or before a recommendation is made must receive Form CRS. The Form must be updated and filed with the SEC within 30 days of each "material change" in it, posted on the firm's website with changes indicated, and the update must be sent to each retail investor within 60 days of the change. The reader should also note carefully that while Form CRS *must* delivered to all retail clients that delivery does not provide a "safe harbor" for Regulation BI compliance and is not necessarily the only disclosure that has to be made in connection with any specific recommendation.

b. *Form CRS Content*

Initially, the SEC proposed a prescribed form with mostly required content, but ultimately rejected that approach in favor of requiring five topics to be covered, each separated by topic headings, and with insertion at several points of questions for investors to ask (called "conversation teasers"). Covered firms must realize Form CRS will take time/resources to prepare for, especially the narrative, and to comply with SEC filing, client delivery and website posting.

EGS plans to provide its clients a more detailed analysis of Regulation BI's new compliance obligations and new SEC Form CRS in additional EGS publications planned to be available in the New Year. The following touches briefly upon the four basic Regulation BI obligations firms covered in whole or part need to be aware of and planning for:

1. **Disclosure**: The broker-dealer or a natural person who is an associated person of a broker-dealer, *before or at the time of each recommendation* must reasonably disclose to the retail customer, in writing, the material facts relating to the scope and terms of the relationship, and the material facts of conflicts of interest associated with each recommendation. Disclosures must include: i) that it is a broker-dealer; ii) the material costs to a retail investor; iii) the broker-dealer's product offerings and any material limits on its product offering(s) to retail investors; and iv) all material facts related to conflicts of interest in the recommendation. This will be especially important for broker-dealers with limited product offerings and those selling proprietary products. Also, merely providing a Form CRS may not alone be adequate disclosure.
2. **Care:** The broker-dealer or a natural associated person of a broker-dealer, in making a recommendation, must act in the *best interest* of the retail investor and exercise reasonable diligence, care and skill in deciding the recommendation in view of its risks rewards and costs is appropriate to any investor and to the specific investor. "Best interest" is not defined in Regulation BI. It is the added element that makes the overall obligation more than just suitability since the other duties track the suitability obligations of FINRA Rule 2111.

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3. **Conflicts of Interest**: The broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to identify and, at a minimum disclose, all material facts, and eliminate or manage conflicts of interest that are associated with its recommendation(s). Disclosure of "conflicts of interest" is not limited to "material" conflicts.
4. **Compliance Obligations:** The broker-dealer must establish, maintain and enforce written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with recommendations. Training will also clearly be necessary.

Also embedded in these provisions are two very specific prohibitions worth separate mention: i) associated persons of broker-dealers will not be able to identify themselves to investors as a "financial advisor" unless they are registered as an investment advisory representative *and* acting in that capacity; and ii) most forms of *sales incentive programs* such as product-specific sales contests will be banned.

Still Have Coverage Questions?

If you are an existing client of EGS or have worked with EGS in the past, you may want to call or write the EGS attorney you work(ed) with. You can also contact EGS financial regulatory partner, William B. Peterson, bpeterson@egsllp.com, the author of this Client Memorandum.

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