January 24, 2020

SEC Division of Trading and Markets Issues Interpretive Guidance on Regulation Best Interest

On January 10, 2020, the SEC's Division of Trading and Markets posted on its public website "Frequently Asked Questions on Regulation Best Interest" (the "FAQs").

The FAQs provide SEC staff responses to questions regarding the applicability and scope of Regulation Best Interest and the disclosure, care and conflict-of-interest obligations.

A summary of the FAQs is set forth below.

Regulation Best Interest Question	**Summary of Staff Response**
Recommendation	
What account recommendations does Regulation Best Interest cover?	Regulation Best Interest applies to recommendations of securities account types (e.g., to open an IRA) and recommendations to roll over or transfer assets between different account types (e.g., from a workplace retirement plan account to an IRA).
Are there considerations specific to a dually registered financial professional making an account recommendation?	Regulation Best Interest requires the dually registered financial professional, when making an account recommendation, to take into consideration the spectrum of accounts the professional is able to offer (i.e., advisory and brokerage accounts).
If a person is registered only as an associated person of a broker-dealer, but the firm is a dually registered broker-dealer and investment adviser, does the person, when making an account recommendation, have to consider both brokerage and advisory accounts?	No. However, the associated person only would be required to take into consideration brokerage accounts available at the firm, and the associated person must still have a reasonable basis to believe that the recommended account is in the retail customer's best interest.
Does Regulation Best Interest extend to informal communications between an associated person of a broker-dealer and a prospective retail customer, for example on the golf course or at social gatherings?	The setting and location of a communication have no bearing on whether a communication is subject to Regulation Best Interest. Rather, the determination hinges on whether the associated person makes a recommendation to a retail customer. This FAQ notes that the question of whether a communication is a recommendation should be determined by reference to precedent under the anti-fraud provisions of the federal securities laws and the way in which those provisions have been applied under FINRA's rules. Under this existing framework, factors to consider include:

	• whether the communication reasonably would be viewed as a "call to action"; or • the extent to which the communication is tailored to a specific retail customer or group of retail customers. ***Example:*** This FAQ states that the following communication in this context, absent other factors, would not be considered a recommendation: "I have been working with our mutual friend, Bob, for fifteen years, helping him to invest for his kids' college tuition and for retirement. I would love to talk with you about the types of services my firm offers, and how I could help you meet your goals. Here is my business card. Please give me a call on Monday so that we can discuss."
Would the analysis in the previous question change if an individual leaving a firm communicates with an existing retail customer to tell the retail customer about a move to a new firm?	No. As stated above, the determination hinges on whether the associated person makes a recommendation to a retail customer. However, this FAQ notes that in this case, given that the associated person is attempting to persuade customers to move their accounts to the associated person's new firm, there exists a significant possibility that the communication will be a "call to action" constituting a recommendation subject to Regulation Best Interest. ***Example:*** This FAQ provides the following example of a communication that, absent other factors, the staff would not consider a recommendation: "I wanted to let you know that I am leaving Firm A after today. As of Monday, I will be joining Firm B. It has been really great working with you all of these years, and I would love to continue our relationship. I will give you a call next week to tell you more about Firm B and discuss what it has to offer."
Does Regulation Best Interest extend to a communication in which an associated person of a broker-dealer provides educational information about retirement accounts?	Generally, no, provided that the associated person does not also make a recommendation to the retail customer. ***Examples:*** This FAQ provides the following examples of communications in this context that, absent other factors, the staff would view as "education" and not a "recommendation": • informing a retail customer that the retail customer may make a cash contribution to an IRA in an amount up to the annual limit; • providing a company's retirement plan options to the retail customer; and

	• informing a retail customer that he or she must take a required minimum distribution under the Internal Revenue Code.
Disclosure Obligation	
Are there circumstances in which an associated person may provide oral disclosures – or written disclosures after a recommendation is made – without violating the Regulation Best Interest obligation to provide written disclosures "prior to or at the time of the recommendation"?	Only in limited circumstances. Regulation Best Interest generally requires disclosure in writing to the retail customer of all material facts relating to (i) the scope and terms of the relationship with the retail customer and (ii) conflicts of interest associated with the recommendation. However, the SEC has provided a degree of flexibility with respect to the "in writing" and the timing requirements by allowing oral and/or subsequent communications in certain circumstances to supplement, clarify or update a previous written communication, provided that (i) the associated person has provided the retail customer an initial, written disclosure identifying the relevant material fact and describing the process through which the fact may be supplemented, clarified or updated and (ii) the associated person's firm records (and maintains record of) the oral disclosure. ***Examples:*** This FAQ provides the following examples of permissible oral and/or subsequent communications (in each case, subject to the conditions set forth in the previous paragraph): • The associated person may provide oral updates to written disclosures to reflect facts the associated person reasonably did not know when the associated person first provided the written disclosure; and • Where existing regulations permit disclosure subsequent to a recommendation (e.g., trade confirmations and prospectus delivery), the written disclosure may be provided to the retail customer subsequent to the recommendation.
Can a broker-dealer satisfy its disclosure requirement under Regulation Best Interest with the broker-dealer's Form CRS?	In most instances, the summary information provided in Form CRS would not be sufficient to satisfy the disclosure obligation.
If a broker-dealer's Form CRS includes a hyperlink to the broker-dealer's Regulation Best Interest disclosures, can the broker-dealer satisfy its obligation to deliver Regulation Best Interest	Neither Regulation Best Interest nor Form CRS permits a "notice plus access" or "access equals delivery" method of electronic delivery. Rather, broker-dealers may provide electronic delivery within the framework of the SEC's existing guidance regarding electronic delivery.

disclosures by delivering Form CRS to a new or prospective retail customer?	
Can a broker-dealer satisfy the Disclosure Obligation for an existing retail customer by delivering disclosure of all requisite material facts along with the retail customer's June 2020 quarterly account statement?	While a broker-dealer may satisfy the Disclosure Obligation of Regulation Best Interest by including the disclosures in retail customers' June 2020 quarterly account statement, that mailing would not satisfy the broker-dealer's Disclosure Obligation with respect to recommendations made between June 30, 2020 and the time the broker-dealer provides the requisite disclosures (i.e., disclosure has to be made before or at the time of the recommendation).
Care Obligation	
For purposes of the Care Obligation under Regulation Best Interest, what constitutes a "series of transactions" and how does one determine whether a particular transaction is part of a "series of transactions"?	Under Regulation Best Interest, whether a recommendation is part of a "series" of recommendations should be determined by referring to the well-established approach under federal securities laws and SRO rules of what constitutes a series of recommended transactions, which depends on the facts and circumstances and must be evaluated on a case-by-case basis.
Conflict of Interest Obligation	
In addition to sales contests, sales quotas, bonuses, and non-cash compensation, are there other specific conflicts based on the sales of specific securities or types of security within a limited period that a broker-dealer must eliminate in order to comply with the Care Obligation)?	Incentives and practices that Regulation Best Interest does not explicitly prohibit are permissible as long as (i) the broker-dealer has policies and procedures reasonably designed to disclose and mitigate the incentives and (ii) the broker-dealer and the associated person comply with the Care Obligation and the Disclosure Obligation. In addition, under the broker-dealer's Conflicts of Interest Obligation, the broker-dealer may find it appropriate to eliminate certain conflicts even when elimination of those conflicts of interest is not expressly required by Regulation Best Interest.
Does the SEC require any particular mitigation methods? For example, do broker-dealers have to provide "level fee" compensation or use neutral factors for differential compensation?	No. Regulation Best Interest does not require that a broker-dealer establish differential compensation based on neutral factors. Instead, the broker-dealer has flexibility to develop and tailor reasonably designed policies and procedures that include conflict mitigation measures based on the applicable firm's circumstances. ***Examples:*** The SEC provided a non-exhaustive list of examples of practices that a broker-dealer could adopt as mitigation methods for the firm to comply with its Conflict of Interest Obligation, including:

	• avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales; • minimizing compensation incentives for employees to favor one type of account or product over another, 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 (i) are near compensation thresholds, (ii) are near thresholds for firm recognition, (iii) involve higher compensating products, proprietary products or transactions in a principal capacity or (iv) involve the roll over or transfer of assets from one type of account or product class to another; • adjusting compensation for associated persons who fail to adequately manage conflicts of interest; and • limiting the types of retail customers to whom a product, transaction, or strategy may be recommended.

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For more information about the FAQs or Regulation Best Interest generally, please contact your usual attorney contact within Ropes & Gray's asset management practice group.