REGULATION BEST INTEREST (REG BI) AND ASSOCIATED MATERIALS

QUEST CE

TABLE OF CONTENTS

INTRODUCTION

On June 5, 2019, the Securities and Exchange Commission (“SEC”) approved a package of new rules and interpretations designed to improve transparency for retail investors. These included:

- **Regulation Best Interest (Reg BI)** is a new standard of conduct for a broker-dealers and their associated persons when making recommendations to retail customers regarding securities transactions or investment strategies.
- **New Form CRS Relationship Summary (Form CRS)** is a disclosure document which provides prospective and existing clients with certain specified information about a broker-dealer or investment adviser.
- **The Investment Adviser Interpretation** clarifies certain aspects of the standard of conduct applicable to registered investment advisers under the Investment Advisers Act of 1940 (“Advisers Act”).
- **A Solely Incidental Interpretation** is intended to clarify the broker-dealer exclusion from the definition of Investment Adviser under the Advisers Act.

Regulation Best Interest and Form CRS will become effective 60 days after they are published in the Federal Register. A transition period will extend until June 30, 2020 to give firms sufficient time to come into compliance.

REGULATION BEST INTEREST

Reg BI provides a new standard of conduct that is not an explicit fiduciary standard, but that does draw upon certain fiduciary concepts found in the Advisers Act. The intent was to create a “fiduciary-like” standard, while accommodating and preserving the broker-dealer model. The distinction between Broker Dealers (BD) and Registered Investment Advisors (RIA) will remain, and with respect to retail customers, a financial services firm will apply Reg BI’s standard of conduct when acting as a BD and the fiduciary standard under the Advisers Act when acting as an RIA.

At the heart of Reg BI is this statement from the SEC: “When making a recommendation of a securities transaction or an investment strategy involving securities, a broker-dealer must act in the retail customer's best interest and cannot place its own interests ahead of the customer's interests.”

REGULATION BEST INTEREST

What is a recommendation?
The meaning of the term “recommendation” for purposes of Reg BI is basically the same as that used in other SEC regulations. The following are examples of recommendations under Reg BI:

- Recommendations of a securities transaction
- Implicit hold recommendation (if a broker agrees to monitor a customer's account and subsequently makes no subsequent recommendation to buy or sell a security); and
- “Account recommendations” including recommendations to roll over or transfer assets from one type of account to another (e.g., a 401(k) to an IRA).

REGULATION BEST INTEREST

Who is a retail client?
Reg BI covers recommendations to a “retail customer.” A retail customer is an individual, or their legal representative, who:

- Receives a recommendation of any securities transaction or investment strategy involving securities from a broker-dealer; and
- Uses the recommendation primarily for personal, family, or household purposes.

A retail customer does not include the representative of an ERISA-covered plan, so long as the representative is acting on behalf of the plan. However, Reg BI does apply to participants in retirement plans receiving recommendations involving investment of plan assets in their *individual account*. These accounts would include a 401(k), 403(b) or 457 plans, IRAs, health savings accounts, Coverdell education savings accounts, and Archer medical savings accounts as well taxable and nonqualified accounts. It also apples to recommendation related to rollover distributions from retirement plans.

REGULATION BEST INTEREST

What Reg BI requires of broker-dealers
When making recommendations to a retail customer, a broker-dealer and their representatives must comply with the standard of conduct set forth in Reg BI. The “General Obligation” requires that the broker-dealer act in the best interest of the retail customer without putting the financial or other interest of the broker-dealer ahead of the interest of the customer. Although the term “best interest” is not defined, the SEC did provide four obligations for broker-dealers: Care, Conflicts of Interest, Disclosure and Compliance.

KNOWLEDGE CHECK

A retail brokerage client comes to you and asks your opinion of high tech stocks. You tell them that although you think many are currently overpriced, you still believe that the long-term prospects for high tech is excellent. **Would this conversation be covered under Reg BI?**

Yes

Try Again

You have not made a specific brokerage recommendation, but simply provided general information about the market for high tech stocks.

No

Correct

You have not made a specific brokerage recommendation, but simply provided general information about the market for high tech stocks.

REGULATION BEST INTEREST

Care Obligation
The broker-dealer must exercise reasonable diligence, care, and skill to do the following:

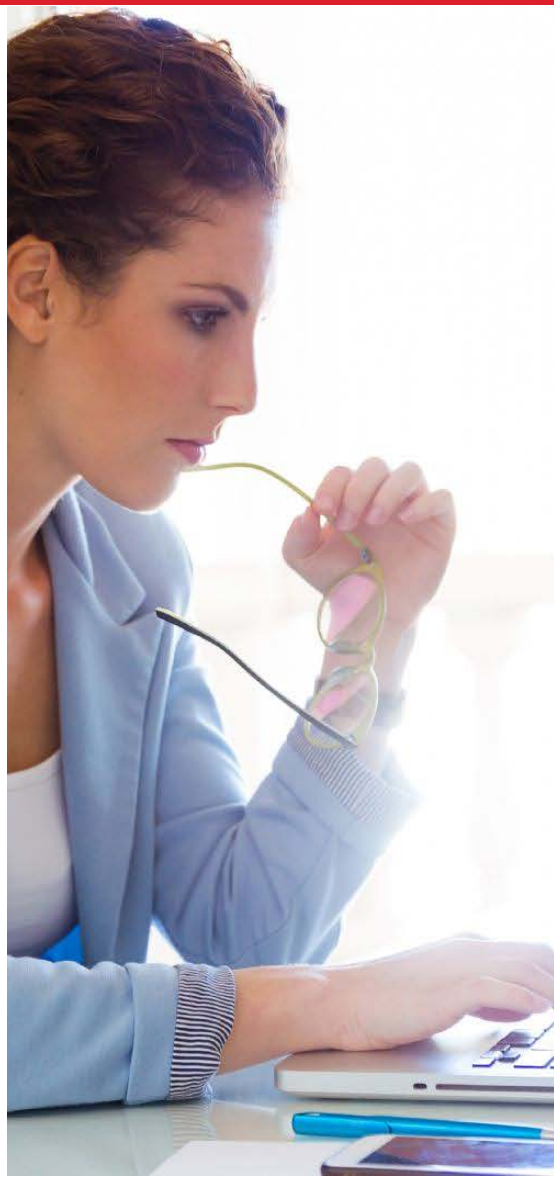
- Understand the potential risks, rewards, and costs associated with a recommendation
- Have a reasonable basis that a recommendation is in the best interest of retail customers generally.
- Believe that a recommendation is in the best interest of the specific customer.
- Believe that a series of recommendations are in the best interest of the specific customer.
- Believe that a recommendation would not place the interest of the broker-dealer ahead of the retail customer.

In all cases, the broker-dealer must believe that a recommendation is in the best interest of a particular customer based on that customer's investment profile and the potential risks, rewards, and costs associated with the recommendation, and that the recommendation does not place the financial or other interest of the broker-dealer ahead of the interest of the customer. In addition, any series of recommended transactions, even if each individual recommendation is in the retail customer's best interest when viewed in isolation, may not be excessive (e.g., churning).

REGULATION BEST INTEREST

The SEC says that the Care Obligation does not require a broker-dealer to consider every security available in the marketplace or only recommend the lowest cost security or strategy. But it does require that cost be considered as one factor among many. A costlier recommendation may be made as long as other factors would be in the best interest of the retail customer. The care obligation is generally the same as FINRA's existing suitability standard with the addition of the requirement to not place the firm's interest ahead of the customer.

Broker-dealers are not required to create records to evidence best interest recommendations on a recommendation-by-recommendation basis. But, broker-dealer should be able to explain in "broad terms" the process by which they determine what recommendations are in a customers' best interests, and be able to explain how that process was applied for any particular recommendation.

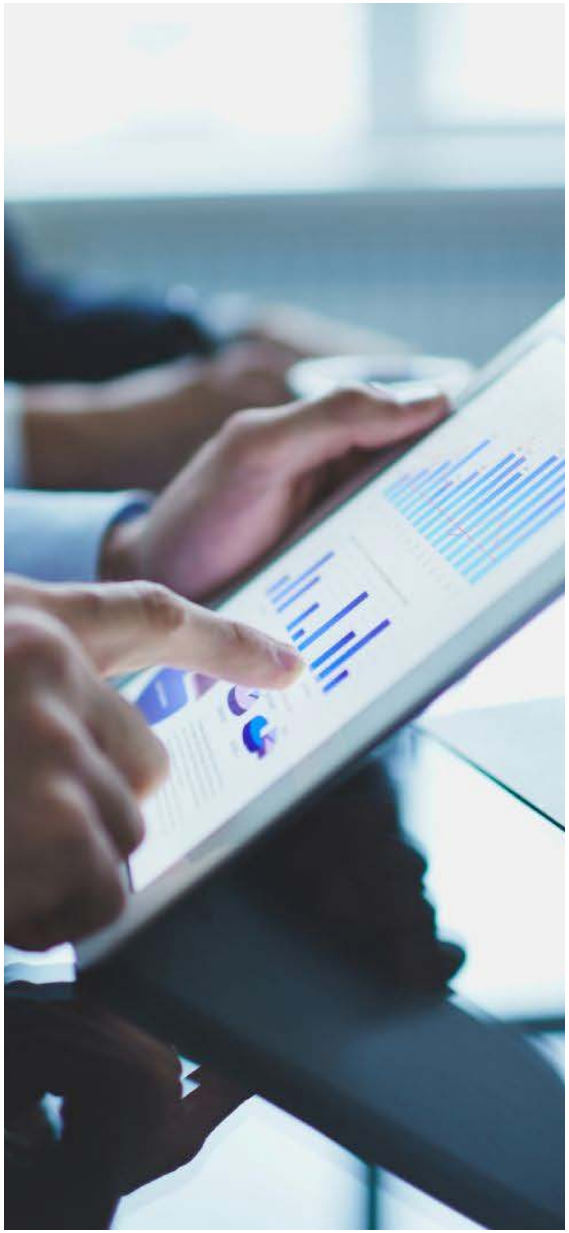


REGULATION BEST INTEREST

Conflict of Interest Obligation
The broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to do the following:

- Identify, and at a minimum disclose in accordance with the Disclosure Obligation, or eliminate all conflicts of interest, whether material or not;
- Identify and eliminate all sales contests, quotas, bonuses, and non-cash compensation based upon the sales of specific securities or specific types of securities;
- Identify and mitigate any conflicts of interest that create an incentive for a representative associated with the broker-dealer to put the interest of the broker-dealer or representative ahead of the interest of the retail investor; and
- Identify and disclose material limitations of securities and investment strategies and prevent these limitations from causing the interest of the broker-dealer or representative ahead of the interest of the retail investor.

A “conflict of interest” is defined as “an interest that might incline a broker-dealer – consciously or unconsciously – to make a recommendation that is not disinterested.” While some conflicts may be mitigated by disclosure others may not. For example, the regulation outright prohibits certain sales contests, quotas, bonuses, and non-cash compensation.



REGULATION BEST INTEREST

Conflict policies and procedures
The Conflict of Interest Obligation requires a broker-dealer to establish, maintain, and enforce written policies and procedures reasonably designed to identify, disclose, and mitigate or eliminate conflicts of interest. These policies and procedures must be subject to periodic (e.g., annual) review. The firm should also establish training that helps firm representatives identify conflicts of interest, and defines employees' roles and responsibilities in identifying conflicts of interest.

REGULATION BEST INTEREST

Types of incentives to be mitigated
The regulation requires firms to identify and mitigate conflicts of interest associated with recommendations that create an incentive for the firm or its representatives to place their interest ahead of the customer's interest. These incentives would generally include:

- Compensation from the broker-dealer or from third-parties, including fees and other charges for the services provided and products sold;
- Employee compensation or employment incentives; and
- Commissions or sales charges, or other fees or financial incentives, or differential or variable compensation, whether paid by the retail customer, the broker-dealer or a third-party."

Firms are still able to reward employees for performance, as long as those rewards do not create a conflict of interest. For example, incentives tied to asset accumulation, special awards, differential or variable compensation, appraisals or performance reviews are not prohibited.

REGULATION BEST INTEREST

Developing mitigation methods
The regulation does not mandate specific mitigation measures and firms have flexibility in developing policies and procedures applicable to the firm's particular circumstances. But these policies and procedures must be designed to "reduce the incentive for the associated person to make a recommendation that places the associated person's or firm's interests ahead of the retail customer's interest."

The SEC has also provided some potential mitigation methods:

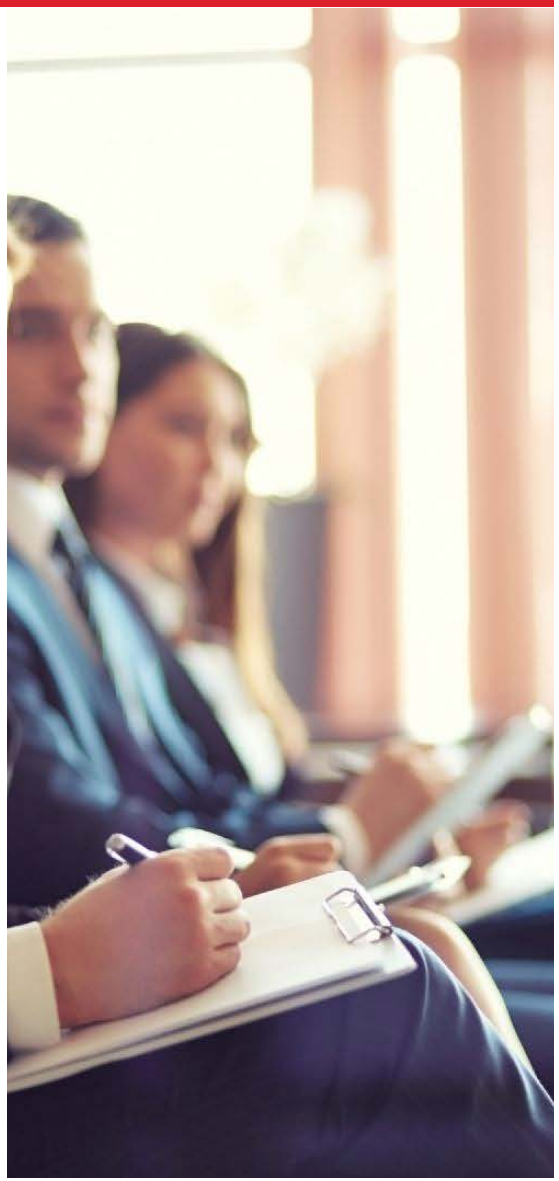
Method 1Method 2Method 3Method 4Method 5Method 6

Limit the types of retail customer to whom a product, transaction or strategy may be recommended
Adjust compensation for associated persons who fail to adequately manage conflicts of interest
Implement supervisory procedures to monitor recommendations that are near compensation thresholds or for firm recognition 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)
Eliminate 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
Minimize compensation incentives for employees to favor one type of account over another or one type of product over another by establishing differential compensation based on neutral factors
Avoid compensation thresholds that disproportionately increase compensation through incremental increases in sales

REGULATION BEST INTEREST

Not all potential conflicts need to be eliminated
Broker-dealers may still provide incentives related to sales of “certain general categories of securities (e.g., such as mutual funds, variable annuities, bonds, or equities.” Additionally, firms may base compensation upon total products sold, asset growth or accumulation, and customer satisfaction.

Broker-dealers can still offer only proprietary products, place limitations on the menu of products offered, and incentivize representatives to sell such products through its compensation practices, so long as the incentive is not based on the sale of specific securities or types of securities within a limited period. Broker-dealers can also offer “training[s]… education meetings… company-sponsored meetings” to representatives as long as such events are not based on the sale of specific securities or type of securities within a limited period. But if these incentives are not outright prohibited, a firm still should be able to demonstrate that the firm and its representatives are complying with Reg BI.



REGULATION BEST INTEREST

Mitigation of conflicts involving material limitations on recommendations
The regulation creates a new requirement mandating broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to:

- Identify and disclose any material limitations broker-dealers place on their securities offerings or investment strategies involving securities and any associated conflicts of interest and;
- Prevent such limitations and associated conflicts of interest from causing the broker-dealer to make recommendations that place the broker-dealer's interest ahead of the interest of the retail customer.

When drafting these policies and procedures, firms should “consider establishing product review processes for products that may be recommended, including establishing procedures for identifying and mitigating the conflicts of interests associated with the product, or declining to recommend a product where the firm cannot effectively mitigate the conflict, and identifying which retail customers would qualify for recommendations from this product menu.”

KNOWLEDGE CHECK

A prospective brokerage client comes to a Rep's office looking for an aggressive investment that could maximize her returns. A colleague had mentioned to you that he had found a new fund that invests in private equity deals, and that in addition to potential for high returns, the trail commission looked favorable. Although you have not reviewed the prospectus, you do have a copy of the disclosures which described the compensation. The disclosure has been approved by your firm's compliance department. You provide this disclosure, along with all other documents required by your firm, to the prospective client, who agrees to open a new account and invest $20,000 into the fund. **Would this transaction be a violation of Regulation BI?**

Yes

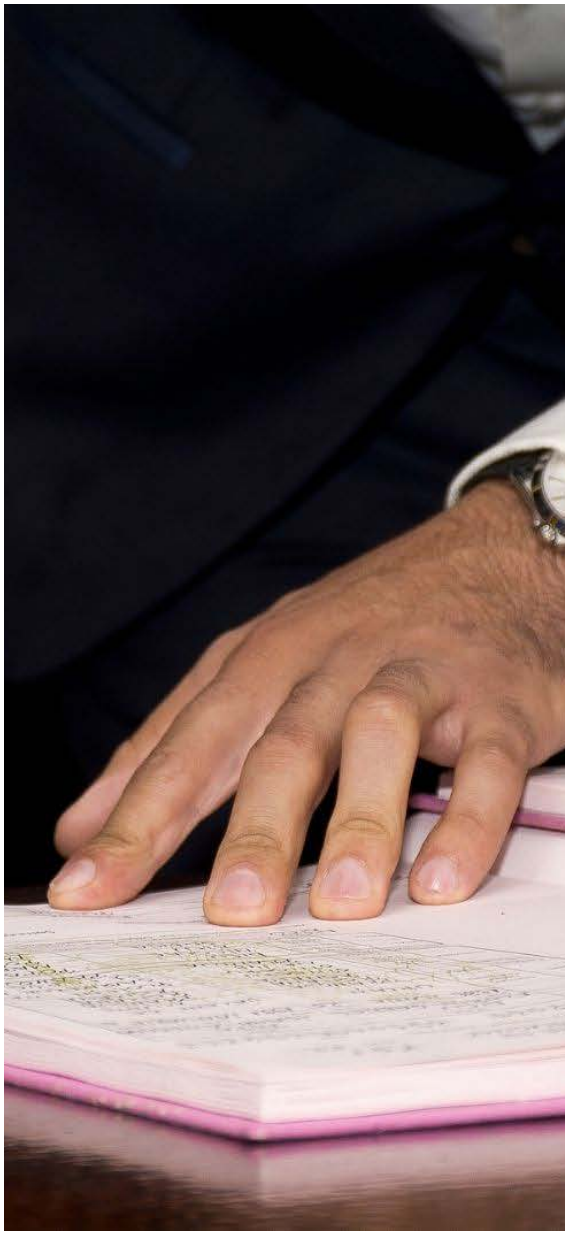
Correct

Although the Rep disclosed the potential conflicts of interest related to the product's compensation, he has violated the Care Obligation. There is no mention that he made any effort to determine if the investment was in fact in the customer's best interest. He has also made no effort to understand the potential risks, rewards, and costs associated with a recommendation and therefore has no reasonable basis to make the recommendation.

No

Try Again

Although the Rep disclosed the potential conflicts of interest related to the product's compensation, he has violated the Care Obligation. There is no mention that he made any effort to determine if the investment was in fact in the customer's best interest. He has also made no effort to understand the potential risks, rewards, and costs associated with a recommendation and therefore has no reasonable basis to make the recommendation.



REGULATION BEST INTEREST

Disclosure Obligation
The broker-dealer, at or prior to the time of the recommendation, must provide a customer with written, full, and fair disclosure of:

- The scope and terms of the services being offered, including material fees and costs associated with a customer's transactions, holdings, and accounts;
- Material limitations on the securities or strategies recommended. For example, if the broker-dealer is limited to only recommending proprietary products; and
- All material facts relating to conflicts of interest associated with the recommendation. The general rule of thumb is that if there is “a substantial likelihood that a reasonable shareholder would consider it important,” it needs to be disclosed.

In addition, broker-dealers must disclose the capacity in which they are acting, and not use the term “adviser” or “advisor” when they are only acting as a broker-dealer. Broker-dealers are prohibited from holding themselves out as an “adviser” or advisor” unless they are also registered as such. If they are dually registered, they need to disclose which “hat” they are wearing related to any given recommendation.

REGULATION BEST INTEREST

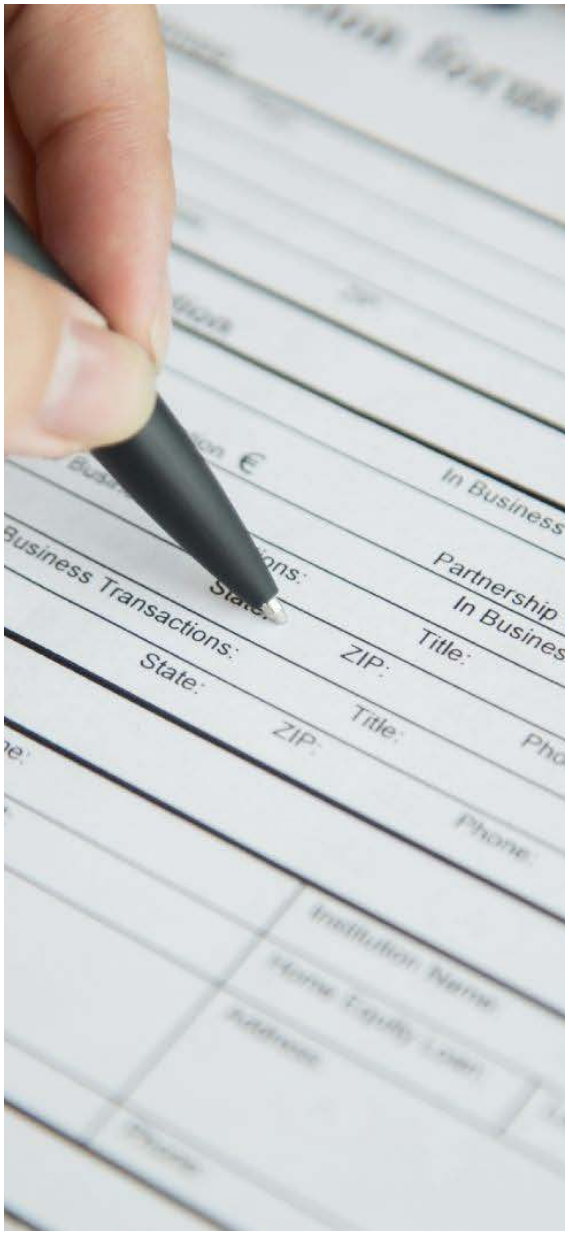
Scope of services
At a minimum broker-dealers need to disclose whether account monitoring services will be provided, the scope or frequency of such monitoring, account minimums, and any material limitations on the securities or investment strategies that may be recommended.

Material facts also include the firm's investment approach, philosophy or strategy, and the risks associated with the strategy. Since all broker-dealers limit their offerings of securities and investment strategies, broker dealers are not required to state that they do not offer the entire possible range of securities and strategies. But disclosure would be required if a broker-dealer limited their offerings to proprietary products, or a select number of issuers.

REGULATION BEST INTEREST

Fee disclosure
The disclosure of material fees and costs relating to a customer's transactions, holdings and accounts does not require individualized disclosure. Reasonable ranges are permissible.

Conflicts of interest disclosure
The disclosure of material conflicts of interest is something new for broker-dealers. A “conflict of interest” means an interest that might incline a broker, dealer or associated person to make a recommendation that is not disinterested. The disclosure needs to include the sources and types of direct and indirect compensation. The standard is similar to that applied under the Advisers Act.



REGULATION BEST INTEREST

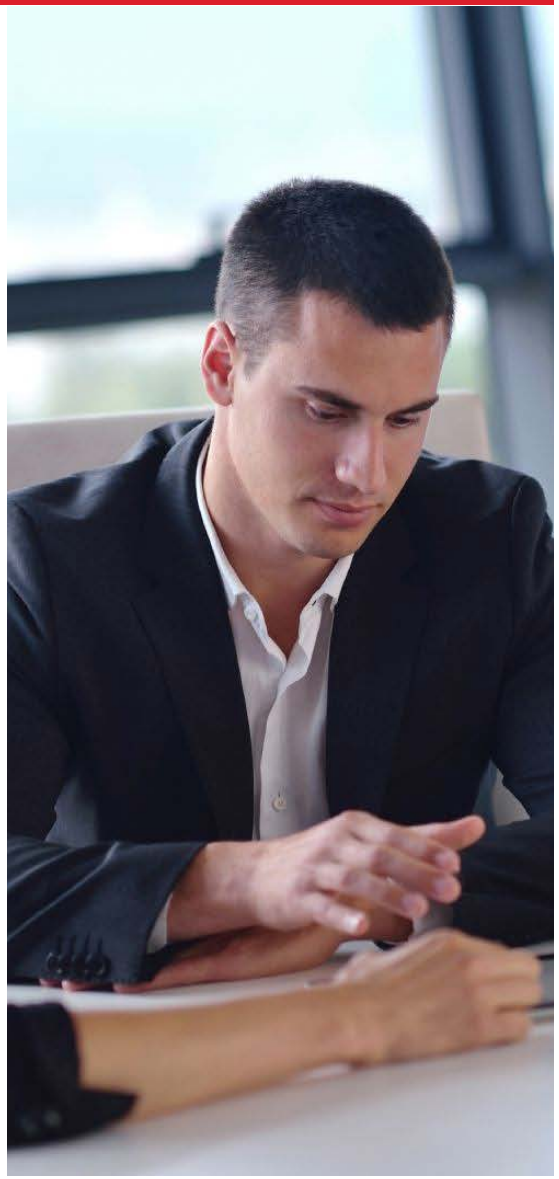
Disclosure form and timing
Broker-dealers may choose to standardize their disclosure and use existing disclosures such as prospectuses, account agreements, or fee schedules to satisfy their disclosure obligations. The SEC has stated that compliance to the standard will be measured against a negligence rather than strict liability standard.

Timing and frequency are left up to the broker-dealer as long as it is prior to or at the time of the recommendation. A broker-dealer may decide to initially provide a general disclosure with specific information regarding material facts or conflicts of interest to follow, but must state when and how the more specific information would be provided. Disclosure after the recommendation such as in a trade confirmation alone would not satisfy the disclosure obligation because the disclosure would not be prior to, or at the time of the recommendation, however it can be used to supplement, clarify or update the initial general disclosure.

Any material changes or updates to the disclosure should be provided no later than 30 days after the material change. The disclosure can be delivered electronically with the client's consent with paper delivery available on request. Written disclosures may be updated, supplemented or clarified orally as long as firms maintain a record that such oral disclosure was provided to the customer.

REGULATION BEST INTEREST

Compliance Obligation
In addition to the policies and procedures required to comply with the Conflict Obligation, the broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Reg BI, which is called the Compliance Obligation. In addition to policies and procedures related to the Conflicts of Interest Obligation, the firm should also have policies and procedures designed to promote compliance with the Disclosure Obligation and the Care Obligation. Registered representatives should look to their compliance department to advise them on how to conduct business within the scope of these new regulations.



KNOWLEDGE CHECK

Sue is a Compliance Officer for a large financial services company. She is contacted by the SVP of retail distribution concerning new business cards that have been proposed for use by dually registered representatives of the firm. "Our clients need to understand that we provide a wide array of services. To highlight that, we plan to begin referring to our reps as Financial Advisers and put that title, along with titles such as CFP and CLU on their business cards. All our Advisers have taken their Series 7 and many are also licensed to sell life insurance, P&C, and a variety of other products." **Should Sue be concerned with the use of the term Financial Adviser?**

Yes

Correct

Although the representatives are dually registered as both Broker-Dealer and Registered Investment Advisor (RIA) reps, it's important that clients understand that different transactions and services may fall under different categories of registration. By calling the reps "Advisers," clients may believe they are always acting under the fiduciary obligations of an RIA. Clients must be informed which "hat" a representative is wearing before any recommendations are made.

No

Try Again

Although the representatives are dually registered as both Broker-Dealer and Registered Investment Advisor (RIA) reps, it's important that clients understand that different transactions and services may fall under different categories of registration. By calling the reps "Advisers," clients may believe they are always acting under the fiduciary obligations of an RIA. Clients must be informed which "hat" a representative is wearing before any recommendations are made.

FORM CRS

A separate but related requirement is the Form CRS Relationship Summary. Form CRS is intended to assist retail investors in their initial selection of, and ongoing decision to maintain, a relationship with a representative or firm. The Form summarizes, in one place, specific information about the broker-dealer or investment adviser including services, fees and costs, conflicts of interest, legal standard of conduct, and disciplinary history.

The SEC has imposed a two-page (or an equivalent length for electronic disclosure) limit on Form CRS (four pages for dual registrants) in which the representative or firm must describe:

- The types of client and customer relationships and services the firm offers.
- The fees, costs, conflicts of interest, and required standard of conduct associated with those relationships and services.
- Whether the firm and its financial professionals currently have reportable legal or disciplinary history; and how to obtain additional information about the firm.

The Form must be organized under a question and answer format, with the expectation that retail investors will be able to engage in a “dialogue with their financial professionals about their individual circumstances.” The Form “should be concise and direct, and firms must use plain English and take into consideration retail investors’ level of financial experience.”

FORM CRS

Content of Form CRS
Form CRS requires that the introductory paragraph:

- State the name of the broker-dealer or investment adviser and whether the firm is registered with the Securities and Exchange Commission as a broker-dealer, investment adviser, or both;
- Indicate that brokerage and investment advisory services and fees differ and that it is important for the retail investor to understand the differences; and
- State that free and simple tools are available to research firms and financial professionals at the SEC's investor education website .

The link to the SEC's website will direct investors to various investor education information, including information about "investment advisers, broker-dealers, and individual financial professionals and other materials," including general investing information and guidance on fees.

FORM CRS

Description of Services
Form CRS requires firms to state whether they offer “brokerage services, investment advisory services, or both” and “to summarize the principal services, accounts, or investments the firm makes available to retail investors” as well as any “material limitations” that may inhibit the firm from providing such services.

Form CRS must also address, if applicable, the following four aspects of a firm’s services:

MonitoringInvestment AuthorityLimited Investment OfferingsAccount Minimums and Other Requirements

Firms must explain “whether or not the firm has any requirements for retail investors to open or maintain an account or establish a relationship, such as minimum account size or investment amount.”
Firms must explain “whether or not they make available or offer advice only with respect to proprietary products, or a limited menu of products or types of investments. If so, they must also describe the limitations.”
Discretionary investment advisers are required to describe those services and any material limitations on the discretionary authority that they will accept. Broker-dealers “may, but are not required, to state whether they accept limited discretionary authority.” In addition, “both investment advisers that offer non-discretionary services and broker-dealers must explain that the retail investor makes the ultimate decision regarding the purchase or sale of investments.”
Both broker-dealers and investment advisers are required “to explain whether or not they monitor retail investors’ investments, including the frequency and any material limitations of that monitoring, and if so, whether or not the monitoring services are part of the firm’s standard services.”

FORM CRS

Description of Fees, Conflicts of Interest, and Standard of Conduct
Form CRS must “summarize the principal fees and costs that retail investors incur with respect to their brokerage and investment advisory accounts, and the conflicts of interest they create." The Form also must “describe other fees and costs related to their brokerage and investment advisory services and investments, in addition to the firm’s principal fees and costs, that the retail investor will pay directly or indirectly,” such as “custodian fees, account maintenance fees, fees related to mutual funds and variable annuities, and other transactional fees and product-level fees.”

FORM CRS

In addition, the rule requires that the Form CRS include the following statements and “conversation starters” regarding fees:

- “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.”
- “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.”
- “How might your conflicts of interest affect me, and how will you address them?”

Broker-dealers, investment advisers, and dual registrants must also include a brief statement describing the standard of conduct to which they are subject. Both broker-dealers and investment advisers must state that they are required to act in the “best interest” of the retail investor.

FORM CRS

Definition of Retail Investor
The definition of retail investor is similar to that used in Reg BI and does not include any limitation or distinction based on net worth. A retail customer is an individual, or their legal representative, who:

- Receives a recommendation of any securities transaction or investment strategy involving securities from a broker-dealer; and
- Uses the recommendation primarily for personal, family, or household purposes.

It does include individuals seeking services for their own retirement account, including IRAs and individual accounts in workplace retirement plans, such as 401(k) plans. While Form CRS must be delivered to a retirement plan participant seeking advice on the distribution of their retirement account assets or the investment of the proceeds, the requirement would not apply to plan participants “when making certain ordinary plan elections” nor plan representatives seeking services for a retirement plan.

FORM CRS

Delivery of Form CRS for Broker-Dealers
A broker-dealer must deliver an initial Form CRS to each new or prospective retail customer at or before the *earliest* of:

- Recommending an account type, a securities transaction, or an investment strategy involving securities;
- Placing an order for a retail investor;
- The opening of a brokerage account for a retail investor;
- Opening a new account that is different from a retail investor's existing account(s);
- Recommending that a retail investor roll over assets from a retirement account into a new or existing account or investment; or
- Recommending or providing a new brokerage service or investment that would not necessarily involve the opening of a new account and would not be in an existing account.

For broker-dealers registered with the SEC prior to June 30, 2020, the initial Form CRS must be filed with the SEC by June 30, 2020 and furnished to existing clients and customers within 30 days of the date on which it is required to be filed.

Broker-dealers must post a current copy of the Form CRS on their website, deliver an updated copy of the broker-dealer's Form CRS within 30 days of a request and deliver and communicate any changes to the Form CRS to its existing clients or customers within 60 days of the date that the Form CRS must be updated.

FORM CRS

Delivery of Form CRS for Registered Investment Advisers (RIA)
An investment adviser must deliver an initial Form CRS to each new or prospective customer who is a retail investor before or at the time of entering into an investment advisory contract. Additionally, an investment adviser must deliver an updated Form CRS to an existing client before or at the time of:

- Opening a new account that is different from the retail investor's existing account(s);
- Recommending that the retail investor roll over assets from a retirement account into a new or existing account or investment; or
- Recommending or providing a new investment advisory service or investment that does not necessarily involve the opening of a new account and would not be in an existing account.

Posting and delivery requirements are the same for RIAs as they are for broker-dealers. Dual registrants are required to deliver a Form CRS at the earlier of the requirements for investment advisers or broker-dealers.

KNOWLEDGE CHECK

Tom, a dually registered representative, is beginning a relationship with a new, affluent client. The client qualifies as an accredited investor and is only seeking advice on, and occasional transactions in, exempt securities, including hedge funds and private placement offerings. Tom believes that he should still deliver Form CRS at or prior to signing an agreement with his client. **Is he correct?**

Yes

Correct

A retail customer is an individual, or their legal representative who receives a recommendation of any securities transaction or investment strategy involving a securities from a broker-dealer; and uses the recommendation primarily for personal, family, or household purposes. Net worth does not impact the definition of a retail client.

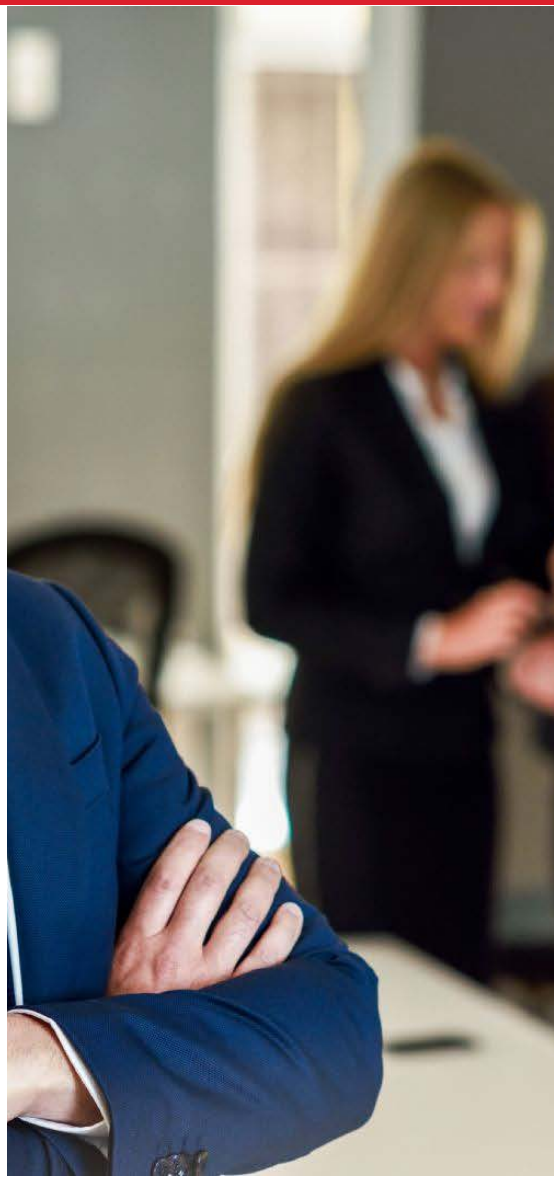
No

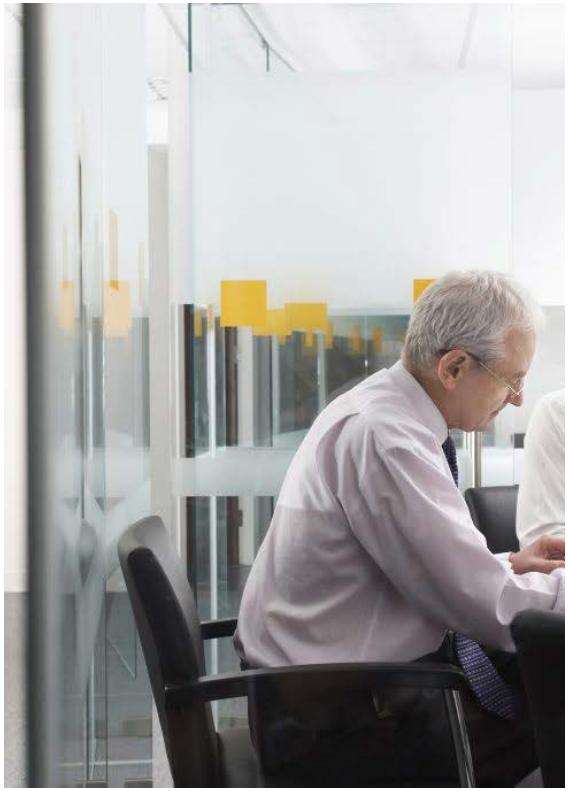
Try Again

A retail customer is an individual, or their legal representative who receives a recommendation of any securities transaction or investment strategy involving a securities from a broker-dealer; and uses the recommendation primarily for personal, family, or household purposes. Net worth does not impact the definition of a retail client.

INVESTMENT ADVISER INTERPRETATION

The third part of the SEC's June 5 package is the "final interpretation" (the Adviser Interpretation) regarding investment advisers' standard of conduct under the Advisers Act. These interpretations do not impose any new requirements for investment advisors, but reaffirms that investment adviser owes a fiduciary duty to its clients under the Advisers Act Investment advisers have fiduciary duties of care and loyalty, must serve the best interest of its client and not subordinate its client's interest to its own. The adviser must also eliminate or make full and fair disclosure of all conflicts of interest which might cause the adviser to give advice that is not disinterested.





INVESTMENT ADVISER INTERPRETATION

Contracting Flexibility and Client Needs
The Adviser Interpretation clarifies that investment advisers and their clients can determine the scope of their advisory relationship, and that the fiduciary duty owed by investment advisers “follows the contours of the relationship between the adviser and its client.” The Adviser Interpretation also acknowledges that an investment adviser's obligations may differ depending on whether the client is a retail investor or an institutional investor. This flexible approach to shaping the advisory relationship and the recognition that different clients have different needs are themes that run throughout the Adviser Interpretation.

INVESTMENT ADVISER INTERPRETATION

Fiduciary Duty of Care
The Adviser Interpretation affirms that the duty of care comprises three components:

- The duty to provide advice in the best interest of clients;
- The duty to seek best execution of client transactions; and
- The duty to provide advice and monitoring over the course of the advisory relationship.

The duty applies to *all* investment advice, including advice about retirement plan roll overs, advice regarding investment strategy, advice to engage a subadvisor and advice about account type (commission-based or fee-based).

In providing “best interest” advice, an investment adviser must make a reasonable inquiry into its client’s financial situation, level of financial sophistication, investment experience, and financial goals. This inquiry may differ for retail clients and institutional clients and advisers should generally apply “heightened scrutiny” to their assessment of high-risk products for retail clients. “Best execution” of client transactions should not be determined simply based on cost, but “whether the transaction represents the best qualitative execution.”

INVESTMENT ADVISER INTERPRETATION

Fiduciary Duty of Loyalty
The duty of loyalty requires an adviser to not subordinate his client's interests to its own, and to make full and fair disclosure of all material facts relating to the advisory relationship, including the capacity in which the advisor or firm is acting. Investment advisers must eliminate or expose through full and fair disclosure all conflicts which might cause them to render advice that is not disinterested. Disclosures must be sufficiently specific so that clients can understand material facts or conflicts of interest and make informed decisions regarding consent. Moreover, investment advisers are not required to make affirmative determinations that particular clients understood the disclosure and that the client's consent to the conflict was informed. Nor must disclosures be in writing. However, the SEC cautions that some conflicts may be incapable of full and fair disclosure and consent. In those cases, conflict elimination or mitigation is required.

THE SOLELY INCIDENTAL INTERPRETATION

The SEC’s regulatory package also included an interpretation of the broker-dealer exclusion from the definition of “investment adviser” under the Advisers Act. Under the Solely Incidental Interpretation, a broker-dealer that provides advisory services solely incidental to the conduct of its business as a broker-dealer and receives no special compensation for those services, is not considered to be acting as Investment Advisors. Two specific examples of this exclusion would be exercising limited discretion over customer accounts and certain types of account monitoring.

The SEC indicated the neither the importance nor the frequency of any investment advice furnished by broker-dealers has any bearing on whether the solely incidental exclusion is satisfied. But, if a broker-dealer's primary business is giving advice as to the value and characteristics of securities or the advisability of transacting in securities or are not reasonably related to the broker-dealer's business of effecting securities transactions, the broker-dealer's advisory services are not solely incidental to its business as a broker-dealer.

THE SOLELY INCIDENTAL INTERPRETATION

The Interpretation identifies the following examples of temporary or limited discretion that would be considered incidental.

- To determine the price at which or the time to execute an order by a customer for the purchase or sale of a definite amount or quantity of a specified security;
- On an isolated or infrequent basis, to purchase or sell a security when a customer is unavailable for a limited period of time;
- To exchange a position in a money market fund for another money market fund or cash equivalent for cash management purposes;
- To purchase of sell securities to satisfy margin requirements, or other customer obligations as specified by the customer;
- To purchase a bond with a specified credit rating and maturity; and
- To purchase or sell a security or type of security limited by specific parameters established by the customer.

These examples are typically ones that would not require a discretionary agreement in the first place. With respect to account monitoring, the Interpretation indicates that monitoring would also be considered incidental if the purpose of the monitoring is to provide recommendations that are reasonably related to effecting securities transactions. This monitoring activity may either be performed voluntarily, without any agreement with the customer, or by agreement so long as the monitoring occurs periodically for purpose of providing buy, sell or hold recommendations at regular intervals.

If, however, a broker-dealer monitors an account in a manner that effectively results in the provision of advisory services that are not reasonably related to the broker-dealer's primary business of effecting securities transactions, the activity would not be considered solely incidental.

CONCLUSION

For many years, there has been a move to introduce a fiduciary standard that would apply equally to all financial service firms in their dealing with retail investors. Although avoiding the use of the term fiduciary, Regulation Best Interest has created a new standard that is similar in many respects to that applied to Registered Investment Advisor firms under the Investment Advisers Act of 1940. Both regulations have at their core a requirement to place the best interests of the customer ahead of the interests of the firm and its representatives. These regulations also require that firms identify, and either eliminate, mitigate, and/or disclose potential conflicts of interest that might result in recommendations that could infringe on the duties that a firm owes to its customers.

CONCLUSION

After June 30, 2020, all broker-dealer firms will be required to be in compliance with Reg BI. All broker-dealers and all registered investment advisers will also be required to create a new disclosure form, Form CSR, and provide that disclosure to retail clients at or prior to initiating a new relationship. These requirements are designed to provide retail investors with the information they need to make informed decisions regarding initiating, and continuing a business relationship with a given firm.

While placing both BD and RIA firms under similar requirements, there will still be two separate sets of regulations that govern dealings with members of the public. In addition, firms that are dually registered will need to disclose the “hat” they are wearing in the offering of any given product or service, and will be required to follow whichever set of regulations that would be applicable.