LATHAM&WATKINS

Client Alert Commentary

Latham & Watkins Financial Regulatory Practice

July 8, 2019 | Number 2520

What Institutional Broker-Dealers Need to Know About Regulation BI

The SEC's Regulation Best Interest has important implications for institutionally focused broker-dealers and investment bankers.

On June 5, 2019, the US Securities and Exchange Commission (SEC) adopted Regulation Best Interest (Rule 15l-1 under the Securities Exchange Act of 1934), a rule that requires a broker-dealer registered with the SEC to act in the best interest of its retail customers when making a recommendation of any securities transaction or investment strategy involving securities. Notably, Regulation BI's definition of "retail customer" is substantially more broad than the Financial Industry Regulatory Authority's (FINRA's) definition, and therefore firms that view their business as exclusively institutional under existing definitions may need to consider adopting new policies and procedures in advance of June 30, 2020, the implementation date.

Broad Definition of "Retail Customer"

A "retail customer" for the purposes of Regulation BI includes any *natural person* (or the legal representative of such person) who receives a recommendation from a broker-dealer with respect to any transaction or investment strategy involving securities and who uses such recommendation primarily for personal, family, or household purposes, irrespective of the person's net worth, financial literacy, sophistication, or experience in investment-related matters. This definition differs substantially from the approach taken under the existing FINRA rules, pursuant to which qualifying high-net-worth individuals (in general, persons or entities with assets of US$50 million or more) may be excluded from the full scope of FINRA's retail suitability requirements if certain other conditions are met. Accordingly, registered representatives that deal with natural person customers — regardless of their financial status, and including those qualifying as "institutional accounts" for purposes of FINRA's suitability rule — will be required to comply with Regulation BI. This includes natural person qualified purchasers and other individuals that have traditionally participated in private placements, as well individual shareholders/ investors who participate in M&A transactions in connection with their personal investment.

The SEC's definition of "legal representation" encompasses only "nonprofessional" legal representatives, such as trustees, executors, conservators, and persons holding a power of attorney for a retail customer. Regulation BI would therefore not apply to cases in which a recommendation is made to certain institutions, registered advisers, or other regulated financial industry professionals acting on behalf of natural persons.

The purpose of Regulation BI, according to the SEC, is to make clear that a broker-dealer may not put its own financial interests ahead of the best interests of a retail customer when making recommendations. The final rule does not explicitly define "best interest." Instead, the SEC provided in the final rule an extensive set of requirements that a broker-dealer must comply with to meet the overarching Regulation BI obligation.

Meeting New Obligations

Regulation BI includes the following four components:

Disclosure Obligation: Broker-dealers must disclose material facts about the relationship between the broker-dealer and the customer, risks and fees associated with recommendations made, and any conflicts of interest related to the recommendations.

Care Obligation: Broker-dealers must exercise reasonable diligence, care, and skill when making a recommendation to a retail customer.

Conflict of Interest Obligation: Broker-dealers must establish, maintain, and enforce written policies and procedures reasonably designed to identify and at a minimum disclose or eliminate conflicts of interest.

Compliance Obligation: Broker-dealers must establish, maintain, and enforce policies and procedures reasonably designed to achieve compliance with Regulation BI as a whole.

Regulation BI applies to every transaction in which a broker-dealer can be deemed to be making a recommendation to a client (the SEC did not newly define "recommendation" but indicated that it sought to preserve the clarity of the "principles-based approach underlying existing Commission precedent and guidance" as well as existing FINRA rules and guidance on what constitutes a recommendation). If a broker-dealer advises a customer on more than one transaction, each transaction must be treated as a distinct recommendation, and the broker-dealer must determine that each transaction serves the customer's best interest, and also that the cumulative result of the series of transactions is in the best interest of the customer.

Investment bankers, boutique broker-dealers, and limited-purpose broker-dealers — with what Regulation BI calls "a limited product menu" — would not be precluded from making such offerings merely because alternatives are not offered. The SEC conceded in the final release that "as a practical matter, almost all broker-dealers limit their offerings of securities and investment strategies to some degree." The SEC indicated that for instances in which a limited or restricted range of offerings is made, the broker-dealer may meet Regulation BI requirements by demonstrating compliance with the Disclosure, Care, Conflict of Interest, and Compliance obligations, and by acting in the client's best interest. The onus is on the broker-dealer to establish and maintain the documentation and processes that would serve to demonstrate adherence to the best interest standard.

The SEC noted that broker-dealers can take several actions to mitigate the risks inherent in offering proprietary products, products with a limited range of issuers, or limited investment strategies, including:

- Developing and enforcing written policies and procedures to disclose and prevent conflicts of interest that may accompany limited offerings

- Disclosing to clients any existing material limitations with respect to the product to enable the client to make an informed investment decision
- Establishing product review processes
- Declining to recommend a product if the firm cannot effectively mitigate conflicts of interest
- Identifying the conditions under which a retail customer would qualify for specific limited recommendations
- Implementing the use of "preferred lists" that would restrict the retail customers to whom a product may be offered
- Prescribing minimum knowledge requirements for associated persons to be able to recommend certain products in a limited offering

By establishing strong procedures and controls reasonably designed to identify and prevent any conflicts of interest that result from a limited menu of offerings, a firm may be able to demonstrate that it is not placing its own interests ahead of the retail customer's best interest.

As described above, a core aspect of Regulation BI is the requirement that broker-dealers disclose, mitigate, and eliminate conflicts of interest with the client, for each recommendation made. The disclosure obligation is primarily addressed through the use of the Form CRS Relationship Summary, which is similar to the Form ADV Part II required of registered investment advisers under the Investment Advisers Act of 1940. The purpose of the Form CRS Relationship Summary is to provide retail investors with simple, easy-to-understand information about the nature of their relationship with their financial professional, at the inception of the relationship. The Form CRS Relationship Summary requirement reflects an initial layer of disclosure upon initiation of the relationship, while the Disclosure Obligation requires additional layers of ongoing disclosure, as required over the course of the relationship to mitigate possible conflicts of interest. The Disclosure Obligation will be of particular importance to firms with a limited product menu. For example, private funds that are marketed by affiliated broker-dealers will need to underscore the affiliate relationship and the fact that they do not offer investments from non-affiliated parties and that such conflict of interest cannot be avoided.

Generally, only investment advisers registered under the Investment Advisers Act of 1940 (or SEC-registered broker-dealers that are dual-registrants) and registered personnel that are supervised persons of an investment adviser will be permitted to use the term "adviser" or "advisor" in their name or title. Since Regulation BI makes no mention of grandfathering with respect to firm names, it appears that broker-dealers that are not dual registrants will need to seek a name change if they currently include "adviser" or "advisor" in their name and are not otherwise able to rebut the presumption that the use of the term "adviser" or "advisor" is a violation of the Disclosure Obligation.

Conclusion

The SEC has established a compliance date of June 30, 2020. All broker-dealers (and their associated persons) that are registered with the SEC will be subject to the requirements of Regulation BI. Impacted broker-dealers and investment advisers, especially those without developed compliance functions, or documentation delivery and recordkeeping systems, should not delay their implementation efforts.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Dana G. Fleischman
dana.fleischman@lw.com
+1.212.906.1220
New York

Stephen P. Wink
stephen.wink@lw.com
+1.212.906.1229
New York

Laura N. Ferrell
laura.ferrell@lw.com
+1.312.876.7616
Chicago

Deric M. Behar
Knowledge Management Lawyer
deric.behar@lw.com
+1.212.906.4534
New York

You Might Also Be Interested In

Is the SEC's Proposed "Best Interest" Standard for Broker-Dealers in Anyone's Best Interest?

FCA Fires Warning Shot to Brokers in Wholesale Markets

US Digital Asset Bills: Will April Legislation Bring May Flowers?

New SEC Token Guidance: This Is *Howey* Do It