

Regulation Best Interest Update – OCIE Risk Alert on Initial Examinations

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Overview

On April 7, 2020, the Securities and Exchange Commission's (the "SEC" or the "Staff") Office of Compliance Inspections and Examinations ("OCIE") issued a Risk Alert¹ to provide broker-dealers and their associated persons (collectively, "broker-dealers" or "firms") with information about the scope and content of initial examinations related to Regulation Best Interest ("Reg BI" or the "Rule").

Importantly, the Financial Industry Regulatory Authority ("FINRA") has stated it will take the same approach as the SEC when conducting its initial examinations for compliance with the Rule.² Firms should be aware that these initial examinations are likely to occur within the first year of Reg BI's June 30, 2020 compliance date, which the SEC has not extended in light of the COVID-19 pandemic.³

Moreover, not every broker-dealer is subject to Reg BI. The Rule establishes a new standard of conduct under the Securities Exchange Act of 1934 for broker-dealers when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer.

Also, even if a broker-dealer is subject to Reg BI, that firm's examination will be based on its unique profile, meaning OCIE will tailor its requests for information pursuant to a firm's business model. Accordingly, not every document listed in the OCIE Risk Alert or noted in the sample document request Appendix of the Risk Alert will be applicable to every firm.

Guidance on Examinations

According to the Risk Alert, initial examinations will focus on two main issues: (i) whether firms have made a good-faith effort to establish policies and procedures reasonably designed to achieve compliance with Reg BI and (ii) whether firms have made reasonable progress in implementing those policies and procedures. With respect to the second issue, OCIE or FINRA plans to send an initial document request prior to an examination and use the provided documents to determine whether the firm is in compliance with Reg BI.⁴

For example, a specific requirement of the Disclosure Obligation is to provide written disclosure of how a broker-dealer is compensated for its recommendations to retail customers. To monitor this requirement, OCIE will ask a firm for its disclosure documents AND a schedule of fees and charges assessed against retail customers. OCIE will then cross-reference the disclosure documents to ensure the firm has made proper disclosure of these fees and charges.

¹ See, <https://www.sec.gov/files/Risk%20Alert-%20Regulation%20Best%20Interest%20Exams.pdf>.

² See, <https://www.finra.org/media-center/newsreleases/2020/finra-statement-secs-ocie-risk-alerts-reg-bi-and-form-crs>.

³ On April 2, 2020, SEC Chairman Jay Clayton released a public statement noting the June 30, 2020 compliance date would not be extended in light of the COVID-19 pandemic (<https://www.sec.gov/news/public-statement/statement-clayton-investors-rbi-form-crs>).

⁴ See the Appendix of the Risk Alert, which provides a sample list of information OCIE may request when conducting examinations of broker-dealers regarding Reg BI.

Pursuant to this approach, OCIE's Risk Alert identified the following areas of focus within Reg BI's four component obligations and the specific documents it may request to monitor a firm's compliance.

Disclosure Obligation

OCIE may assess how a firm has met the requirement to disclose all material facts relating to the scope and terms of its relationship with a retail customer, including: (i) the capacity in which the recommendation is being made, (ii) material fees and costs that apply to the retail customer's transactions, holdings and accounts and (iii) material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer.

Document Requests

- Any and all disclosure documents provided to retail customers pursuant to the Disclosure Obligation, including disclosures related to account monitoring and material limitations on accounts or services recommended by the broker-dealer;
- Fee schedules and charges assessed against retail customers (e.g., custodian fees, account fees, mutual fund/variable annuity fees, transactional fees and specific product-level fees);
- Compensation methods or how registered personnel are paid, such as (i) when personnel make a recommendation, (ii) the source of payment (e.g., direct from investor or from a product sponsor) or (iii) when payment is associated with certain conflicts of interest (e.g., payments from proprietary products or from product menus); and
- Lists of proprietary products sold to retail customers.

Care Obligation

OCIE may assess how a firm exercises reasonable diligence, care and skill when making a recommendation to a retail customer, specifically related to the "Reasonable-Basis"⁵ and "Customer-Specific"⁶ components of the Care Obligation.

Document Requests

- Information the broker-dealer collected to develop a retail investor's investment profiles (e.g., new account forms, correspondence and any agreements);
- The broker-dealer's process in how it satisfies the Customer-Specific component (e.g., what factors are considered to assess the product against the customer's investment profile and whether the firm has a process regarding reasonably available alternatives);
- How the broker-dealer makes recommendations related to account rollovers and opening a brokerage account; and
- How the broker-dealer makes recommendations related to complex, risky or expensive products (e.g., inverse or leveraged ETFs, penny stocks or illiquid securities).

Conflict of Interest Obligation

OCIE may assess how a firm establishes, maintains and enforces written policies and procedures reasonably designed to address conflicts of interest associated with its recommendations.

Document Requests

- The firm's written policies and procedures. Upon receipt, OCIE will likely assess whether and how the policies identify and either mitigate or eliminate conflicts of interest;
- The mitigation of conflicts that create an incentive for associated persons to place their interests, or the interests of the broker-dealer, ahead of the retail customer;
- The mitigation of conflicts associated with material limitations (e.g., limited product menus, only offering proprietary products or offering products that involve third-party arrangements); and
- The elimination of certain conflicts of interest (e.g., sales contests, sales quotas, bonuses and non-cash compensation based on the sale of specific securities or specific types of securities within a limited period of time).

⁵ A broker-dealer must understand the potential risks, rewards and costs associated with a recommendation and have a reasonable basis to believe the recommendation could be in the best interest of at least some retail customers.

⁶ A broker-dealer must have a reasonable basis to believe the recommendation is in the best interest of a particular retail customer in light of that customer's investment profile and does not place the broker-dealer's interest ahead of the retail customer.

Compliance Obligation

OCIE may assess how a firm establishes, maintains and enforces written policies and procedures reasonably designed to achieve compliance with Reg BI as a whole.

Document Requests

- The firm's written policies and procedures. Upon receipt, OCIE will likely assess the procedures and evaluate any controls, remediation of noncompliance, training and periodic review and any testing requirements included within the procedures.

Conclusion

As noted in this Update, not every document listed above will be applicable to every firm. Both OCIE and FINRA plan to tailor their requests for information pursuant to each firm's business model. In addition, the Risk Alert urges firms to engage with the Staff if there is an inability to comply with Reg BI by June 30, 2020 due to the effects of the COVID-19 pandemic. Chairman Clayton previously noted his expectation that the Staff would take such difficulties into account during SEC examinations and enforcement actions.

For additional information, please contact **James A. Arpaia** at +1 (312) 609 7618, **David W. Soden** at +1 (312) 609 7793, or another Vedder Price attorney with whom you have worked and review our COVID-19 resource webpage for additional information.

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