Thompson Hine

Broker-Dealer Update

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Overview of Regulation Best Interest and Care Obligations

In 2020, the Securities and Exchange Commission (SEC) implemented Regulation Best Interest (Reg BI) to ensure that broker-dealers prioritize their clients' interests over their own by establishing a standard of conduct that broker-dealers must follow when recommending any investment strategy. Practitioners should be aware that recent regulatory enforcement demonstrates the SEC's increasing interest in broker-dealer compliance with Reg BI.

Although Reg BI falls short of imposing fiduciary duties on broker-dealers, it still requires, among other things, that they recommend only investment strategies and products in their client's best interest at the time of the recommendation. Previously, broker-dealers were only required to satisfy a "suitability" standard, which requires a broker-dealer's investment strategy to be "appropriate" for the client. Although broker-dealers are now obligated to exercise a greater degree of care under the new standard, the exact meaning of "best interest" remains murky.

Among other things, Reg BI imposes at least five obligations on broker-dealers:

- *Conflict-of-interest obligations* require broker-dealers to actively manage conflicts, including by eliminating or mitigating them when possible.
- *Disclosure obligations* emphasize the importance of transparency and trust, requiring that conflicts – when not eliminated – be clearly presented to customers.
- *Recordkeeping obligations* require broker-dealers to maintain exhaustive records of all recommendations made, including the basis for making the recommendations.
- *Compliance obligations* require that broker-dealers (but not registered representatives) develop detailed compliance programs.
- *Care obligations* require that broker-dealers exercise diligence when recommending investments to retail customers.

The scope of care obligations is particularly vague. To date, the SEC has published three bulletins to resolve some of the ambiguities.

To comply with the care obligations, a broker-dealer should adopt a comprehensive approach, review the objective aspects of the investment strategy, consider the expected return of the security or investment strategy, and review the retail investor's profile and personal objectives. Thus, a broker-dealer must consider factors such as the client's age, other investments, finances and needs, and tax status.

Moreover, Reg BI requires that broker-dealers have a reasonable basis to believe that a series of recommended transactions is not excessive. As emphasized in a recent FINRA enforcement matter, no single test defines when trading on behalf of a retail customer is excessive, but factors such as the turnover rate and cost-to-equity ratio are relevant[1] to determine if a broker-dealer has excessively traded a customer's account. In that enforcement matter, a broker-dealer consented to the imposition of a 20-month suspension and restitution of over $60,000 plus interest when it was determined that some of his investment strategies resulted, for example, in turnover rates exceeding 93% and an annualized cost-equity ratio exceeding 280%.

Although the SEC bulletins and guidance do not have legal force or effect, in light of the many ambiguities presented by Reg BI and murky distinctions between the requirements of fiduciary duties, "suitability," and "best-interest" standards, broker-dealers should seek advice regarding establishing procedures prescribed by SEC, FINRA, and state guidance and continue to keep abreast of enforcement decisions to guide their compliance.

FOR MORE INFORMATION

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[1] Generally, a turnover rate of six or a cost-to-equity ratio above 20% may indicate a series of recommended transactions was excessive.