

SEC Staff Raises the Bar for Broker-Dealers Under Regulation Best Interest

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On April 20, 2023, the Securities and Exchange Commission (SEC) released a Staff Bulletin (Bulletin) on the care obligations for broker-dealers and investment advisors, pursuant to Regulation Best Interest (Reg BI) and the Investment Advisers Act of 1940, respectively.¹ Though styled as questions and answers “reiterating” the relevant standards of conduct, several portions of the Bulletin appear designed to impose heightened requirements on broker-dealers.

The SEC adopted Reg BI as part of a package of rulemakings in June 2019, and the regulation became effective a year later. In broad terms, Reg BI raised the standard of conduct for broker-dealers in making investment recommendations to retail customers by imposing four primary obligations:²

- The Disclosure Obligation requires a broker-dealer to disclose in writing all material facts about the scope and terms of its relationship with the customer.³
- The Care Obligation requires a broker-dealer to exercise reasonable diligence, care and skill when making recommendations to retail customers.⁴
- The Conflict of Interest Obligation requires a broker-dealer to establish, maintain and enforce reasonably designed written policies and procedures addressing conflicts of interest associated with its recommendations to retail customers.⁵
- The Compliance Obligation requires a broker-dealer to establish, maintain and enforce written policies and procedures reasonably designed to achieve compliance with Reg BI as a whole.⁶

Reg BI was promulgated prior to Chairman Gary Gensler’s appointment, and some expected it to be reworked to impose higher standards on broker-dealers. However, in testimony on May 6, 2021, before the House Committee on Financial Services, Chairman Gensler stated that he planned to “ensure that [Reg BI] is fully complied with *as written*” [emphasis added].⁷

The new Bulletin states that it is “designed to assist firms and their financial professionals with meeting their care obligations such that they comply with their obligations to provide advice and recommendations in the best interest of retail investors.”⁸ It includes questions and answers for broker-dealers and investment advisors to consider regarding recommended investments and strategies, the retail investor’s investment profile, reasonably available alternatives, and special considerations for complex or risky products and dual registrants.⁹

The Bulletin is guidance from the SEC staff, not the Commission itself. Unlike rulemakings, guidance is not subject to public notice and comment and is not put to a vote of the commissioners. As a result, the Bulletin acknowledges that it has “no legal force or effect” and does not “alter or amend applicable law, [or] create . . . new or additional

¹ SEC Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Care Obligations (Apr. 20, 2023).

² 17 C.F.R. § 240.15l-1 (2023).

³ *Id.* § 240.15l-1(a)(2)(i).

⁴ *Id.* § 240.15l-1(a)(2)(ii).

⁵ *Id.* § 240.15l-1(a)(2)(iii).

⁶ *Id.* § 240.15l-1(a)(2)(iv).

⁷ *Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide, Part III: Virtual Hearing Before the H. Comm. on Fin. Servs.*, 117th Cong. 14 (2021).

⁸ Bulletin.

⁹ *Id.*

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obligations for any person.”¹⁰ At the same time, the SEC staff says that it is “[e]xtending” points in Reg BI and urges broker-dealers to “strongly consider” establishing policies and procedures not mandated by the rule.¹¹

Historically, when the SEC has sought to require that broker-dealers or investment advisers establish policies and procedures on a particular topic, it has done so through rulemaking.¹² In fact, Reg BI is one such rule, as it imposed on broker-dealers requirements to establish policies and procedures as a means to raise the standard of conduct for broker-dealers.¹³

The Bulletin seems to go farther than Reg BI in three ways:

- *First*, under Reg BI representatives should apply heightened scrutiny when recommending a “potentially high risk product” to a retail customer.¹⁴ In contrast, the Bulletin refers to applying heightened scrutiny in the context of “complex *or* risky” products [emphasis added],¹⁵ thereby expanding the requirement of heightened scrutiny to complex products as well as to their costs and reasonably available alternatives. While there is overlap between the two types of products, some complex products may not be high risk, such as annuities, life insurance and certain structured notes with downside protection.
- *Second*, Reg BI requires broker-dealers to “establish[], maintain[], and enforce[] written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.”¹⁶ The Bulletin, however, builds on this general obligation by stating that firms should have a specific “process” for the evaluation of

reasonably available alternatives, a requirement not included at this level of detail in Reg BI.¹⁷ Under the Bulletin, this “process” should include “guidance (*e.g.*, policies and procedures, employee training) for the firm’s financial professionals that defines the scope of alternatives that should be considered and the factors that should be weighed (*e.g.*, costs, potential benefits and risks as well as compatibility with the retail investor’s investment profile) in evaluating the available alternatives.”¹⁸

- *Third*, after noting that Reg BI requires compliant policies and procedures, the Bulletin “[e]xtend[s] that point,” stating that the staff believes that firms that recommend complex or risky products should “strongly consider establishing procedures specifically designed to address recommendations of, or advice about, complex or risky products.”¹⁹ It goes on to provide the example of “developing procedures outlining the due diligence process for complex or risky financial products, to help ensure that these products are assessed by qualified and experienced firm personnel.”²⁰

One would hope that the SEC will continue to follow its historical practice of not finding securities law violations based solely on failures to follow staff guidance. Even with adherence to that practice, there still may be regulatory risk in failing to heed the staff. Reg BI sometimes turns on whether a broker-dealer has acted reasonably, or has reasonably designed policies and procedures, and the SEC may well consider compliance with the Bulletin when assessing whether a broker-dealer’s conduct, in the aggregate, was reasonable. Similarly, the Bulletin may well become a consideration during FINRA or SEC exams.

To be sure, broker-dealers would be well-served to assess their Reg BI policies and procedures in the light of the Bulletin with a view to whether there is sufficient coverage of the items discussed above. Even if the three items above are merely suggested best practices, the Bulletin is a helpful window into the SEC staff’s thinking on a new and important rule, and its contents are likely to inform thinking by SEC staff on rule interpretations as well as during examinations and investigations.

¹⁰ *Id.* at n.1.

¹¹ *Id.* at Questions 10, 18, 19.

¹² *E.g.*, Regulation S-ID, Regulation S-P, Regulation SHO, Regulation AC, Rule 206(4)-7 under the Investment Advisers Act of 1940.

¹³ Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 86031, 84 Fed. Reg. 33318, 33397 (June 5, 2019) (Reg BI Adopting Release) (“The Commission believes that the Compliance Obligation [requiring written policies and procedures reasonably designed to achieve compliance with Reg BI] is important to help ensure that broker-dealers have strong systems of controls in place to prevent violations of Regulation Best Interest, including the component Disclosure and Care Obligations, in addition to the policies and procedures required pursuant to the Conflict of Interest Obligation, and to protect the interests of retail customers.”).

¹⁴ *Id.* at 33376.

¹⁵ Bulletin at Question 18 (emphasis added).

¹⁶ 17 C.F.R. § 240.151-1(a)(2)(iv).

¹⁷ Bulletin at Question 10.

¹⁸ *Id.*

¹⁹ *Id.* at Question 19.

²⁰ *Id.*