

# Takeaways From SEC Staff's Latest Reg BI Expansion

By **Daniel Michael, Heather Cruz and Sophia Harris-Dyer** (May 3, 2023, 3:01 PM EDT)

On April 20, the U.S. Securities and Exchange Commission **released** a staff bulletin on the care obligations of broker-dealers and investment advisers pursuant to Regulation Best Interest 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.

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]

These obligations raised the standard of conduct for broker-dealers from the previous "suitability" requirements recognized in case law,[7] but they did not go so far as to impose a fiduciary duty. In particular, the standard of care under Reg BI "draws upon principles underlying the investment adviser fiduciary duty," but "maintain[s] a regulatory distinction between broker-dealers and investment advisers." [8]

Reg BI was promulgated prior to Chair Gary Gensler's appointment, and some expected it to be reworked to impose even higher standards on broker-dealers. Such a revision may have been in keeping with Gensler's tenure, which has been marked by an expansive rulemaking agenda.

However, in testimony on May 6, 2021, before the House Committee on Financial Services, Gensler stated that he planned to "ensure that [Reg BI] is fully complied with as written." [9]



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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." [10] It includes questions and answers for broker-dealers and investment advisers 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. [11]

Although bulletins and other SEC guidance often specify the concerns or market practices that prompted or influenced the guidance issued, the bulletin offers no indication as to why the staff chose to issue it or what, if any, market practices informed its drafting.

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 commission vote.

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 obligations for any person." [12] At the same time, the SEC staff says that it is extending points in Reg BI and urges broker-dealers to "strongly consider" establishing policies and procedures not mandated by the rule. [13]

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. [14] 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. [15]

Although the current SEC has embraced the rulemaking process, demonstrated by the dozens of rules it has introduced or reopened, the bulletin offers no indication as to why it is the vehicle for extending Reg BI instead of a rulemaking process.

Some insight may be gleaned from the fact that the process for proposing and adopting Reg BI appears to have been fraught within the commission [16] as well as in the market, as reflected by the comment letters submitted. It was also subject to comment from members of Congress. [17]

In light of that, the SEC may have viewed reopening Reg BI rulemaking as not feasible or, at the very least, challenging.

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. [18]

In contrast, the bulletin refers to applying heightened scrutiny in the context of "complex or risky" products, [19] 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 certain types of annuities, life insurance products and 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." [20]

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 in this level of detail in Reg BI. [21]

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." [22]

Third, after noting that Reg BI requires compliant policies and procedures, the bulletin expands on 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." [23]

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." [24]

The SEC previewed some of these new requirements and best practices in a risk alert issued by its Division of Examinations in late January. [25] That alert highlighted deficiencies the agency had observed in broker-dealers' compliance with Reg BI and included examples that pertain to the potentially new obligations. [26]

For example, the risk alert described deficient policies and procedures that directed financial professionals to consider reasonably available alternatives or costs "without providing any guidance as to how to do so (e.g., by establishing the scope of alternatives to consider or ... how to consider costs when making a recommendation)." [27]

The new items introduced by the bulletin appear to be more significant than any introduced in the risk alert for several reasons.

First, SEC staff guidance from the relevant rulemaking divisions — here, the Division of Trading and Markets, and the Division of Investment Management — tend to be given more weight than other forms of SEC staff guidance.

Second, the Division of Examinations in its risk alert offered its suggestions in a less pointed fashion than the bulletin. For example, the risk alert recognized, as does Reg BI itself, that the reasonableness of a firm's policies and procedures would depend on the size and complexity of the firm. [28] The bulletin, however, appears to offer its guidance broadly to all broker-dealers.

In addition, to the extent that the risk alert introduced new responsibilities for broker-dealers, its approach is less prescriptive. It does not couch its statements as reiterating what Reg BI requires, but it instead offers examples of ways broker-dealers could meet their Reg BI obligations.

Collectively, the three items introduced by the bulletin significantly increase the already robust process created by Reg BI for making investment recommendations. And, when combined with Reg BI's existing requirements, the standard of conduct required of broker-dealers begins to look more onerous than the fiduciary duty owed by investment advisers.

Further, the bulletin raises the question of how the SEC will apply it. One would hope that the commission will continue to follow its historical practice of not finding securities law violations based solely on failures to follow staff guidance.

Even if it adheres to that practice, however, 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 influence whether and how deficiencies are cited in Financial Industry Regulatory Authority 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. 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.

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

[2] 17 C.F.R. § 240.15I-1.

[3] *Id.* § 240.15I-1(a)(2)(i).

[4] *Id.* § 240.15I-1(a)(2)(ii).

[5] *Id.* § 240.15I-1(a)(2)(iii).

[6] *Id.* § 240.15I-1(a)(2)(iv).

[7] E.g., [Hanly v. SEC](#), 415 F.2d 589, 597 (2d Cir. 1969).

[8] SEC Chairman Jay Clayton, Address at Babson College: Regulation Best Interest and the Investment Adviser Fiduciary Duty: Two Strong Standards that Protect and Provide Choice for Main Street Investors (July 8, 2019).

[9] 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).

[10] Bulletin.

[11] *Id.*

[12] *Id.* at n.1.

[13] *Id.* at Questions 10, 18, 19.

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

[15] 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.").

[16] SEC Commissioner Robert J. Jackson Jr., Statement on Final Rules Governing Investment Advice (June 5, 2019).

[17] E.g., Letter from Rep. Maxine Waters, et al., to SEC Chairman Jay Clayton (Sept. 12, 2018); Patrick Temple-West, "Warren, Waters Blast SEC Financial Advice Rule as Wall Street Cheers," Politico (June 5, 2019).

[18] Reg BI Adopting Release at 33376.

[19] Bulletin at Question 18.

[20] 17 C.F.R. § 240.15I-1(a)(2)(iv).

[21] Bulletin at Question 10.

[22] *Id.*

[23] Ibid. at Question 19.

[24] Id.

[25] Department of Examinations, "Risk Alert: Observations from Broker-Dealer Examinations Related to Regulation Best Interest" (January. 20, 2023).

[26] Id.

[27] Id. at 3.

[28] Id. at 4.