



Regulatory Alert

Financial Services Regulatory Insight Center



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SEC Regulation Best Interest

SEC regulation to enhance broker-dealers' standard of conduct when dealing with retail investors

Key points

- The SEC adopted the new Regulation Best Interest (Reg BI), which is intended to go beyond existing suitability standards currently imposed by FINRA. Notably, Reg BI was issued in concert with the Standards of Conduct for Investment Advisers.
- The SEC concurrently adopted a new Form CRS Relationship Summary, and two separate interpretations under the Investment Advisers Act of 1940 (Advisers Act) that will impact broker-dealers and investment advisers.
- Reg BI does not institute a fiduciary standard for broker-dealers equivalent to the standards under the Advisers Act; however it does not preempt state fiduciary regulations, and it continues to delineate between broker-dealers and investment advisers.

Key Obligations – Regulation Best Interest

[Reg BI](#) is intended to enhance the broker-dealer standard of conduct by requiring broker-dealers to both:

- Act in the best interest of the retail customer at the time a recommendation is made about a securities transaction or investment strategy involving securities, without placing the financial or other interest of the broker-dealer ahead of the interests of the retail customer (commonly, the “General Obligation”).
- Address conflicts of interest by “establishing, maintaining, and enforcing policies and procedures reasonably designed to identify and fully and fairly disclose material facts about conflicts of interest,” and when mere disclosure is insufficient, by mitigating or in some cases eliminating the conflict.

The SEC denoted practices of broker-dealers versus investment advisers and related activity in the issuance of the regulation. The SEC did not institute a fiduciary standard for broker-dealers under Reg BI. In addition, the SEC did not preempt state fiduciary regulations with the issuance of Reg BI.

The General Obligation is satisfied only if the broker-dealer complies with four key areas of obligation:

1. The Disclosure Obligation

The “Disclosure Obligation” requires the disclosure of all “material facts” related to the scope and terms of the broker-dealer’s relationship with the retail customer. The minimum material facts of the scope and terms of the relationship to be disclosed,



in writing, prior to or at the time of recommendation include:

- That the broker-dealer is acting in a broker-dealer capacity with respect to the recommendation
- Material fees and costs that would apply to the retail customer's transactions, holdings, and accounts
- The type and scope of services provided by the broker-dealer and any material limitations, including, for example, monitoring the performance of the retail customer's account
- All "material facts" relating to conflicts of interest that are associated with a recommendation (see Conflict of Interest Obligation below).

With the newly issued [Form CRS Relationship Summary](#) and Form ADV Amendments, the SEC is also requiring broker-dealers and investment advisers to deliver to retail investors a standard-formatted "Relationship Summary" that describes the relationships and services the firm offers to retail investors, fees and costs that retail investors will pay, specified conflicts of interest and standards of conduct, and disciplinary history.

2. The Care Obligation

To fulfill the "Care Obligation," a broker-dealer must exercise reasonable "diligence, care and skill" in recommending a "transaction" or "series of transactions" to retail customers. The Care Obligation requires the broker-dealer to satisfy, at a minimum, all the elements of FINRA'S Suitability Rule (FINRA Rule 2111) in addition to the following:

- Understand the potential "risk, rewards and costs" of any recommendation and have a reasonable basis to believe such recommendations could be in the best interest of at least some retail customers.
- Have a reasonable basis to believe the recommendation is in the best interest of a particular retail customer based upon the customer's investment profile and potential risks, rewards, and costs associated with the recommendation and does not place the interests of the broker-dealer ahead of the customer.
- Have a reasonable basis to believe that a series of recommended transactions, when taken

together, is not excessive in light of the retail customer's investment profile.

3. The Conflict of Interest Obligation

The SEC views policies and procedures as critical to identifying and addressing conflicts of interest, either by disclosing or eliminating them. Reg BI defines a "conflict of interest" associated with a recommendation as an interest that might incline a person consciously or unconsciously to make a recommendation that is not disinterested. Although the Disclosure Obligation only requires the disclosure of material facts associated with conflicts of interest, ALL conflicts of interest remain in scope for purposes of Reg BI. As such, the "Conflict of Interest Obligation" requires broker-dealers to have written policies and procedures reasonably designed to:

- Monitor and mitigate (or eliminate if possible) conflicts that incentivize sales persons to prioritize their interests over those of a retail customer.
- Prevent limitations on offerings, such as only selling proprietary products, from causing the firm or the firm's personnel to place their interests, or the interests of the firm, ahead of a retail customer's interest.
- Eliminate sales contests or other compensation based on the sale of a specific security within a limited period of time.

4. The Compliance Obligation

The "Compliance Obligation" requires the establishment, maintenance, and enforcement of written policies and procedures reasonably designed to meet compliance with Reg BI, thus creating affirmative obligation under the Exchange Act. The SEC denotes that a firm's compliance policies and procedures should be reasonably designed to the size and complexity of the firm and in keeping with reasonably designed compliance programs. A reasonably designed compliance program generally should include controls; remediation of non-compliance; training; and periodic review and testing controls.

Recordkeeping

In final form, Reg BI amends Rules 17a-3 and 17a-4 to require, for each retail customer to whom a recommendation of any securities transaction or

investment strategy involving securities is or will be provided:

- A record of all information collected from and provided to the retail customer pursuant to Reg BI.
- The identity of the broker or dealer responsible for the account.
- Retention of all record information collected from or provided to the retail customer pursuant to Reg BI for at least six years after the earlier of the date that the account was closed or the date on which the information was collected, provided, replaced, or updated.

Interpretations

Coincident with the adoption of Reg BI, the SEC issued two interpretations:

- One interpretation is intended to reaffirm and clarify the SEC's views regarding the [standard of conduct for investment advisers](#) under the Advisers Act.
- The second interpretation is intended to confirm and clarify the SEC's position with respect to the "[solely incidental](#)" prong of the broker-dealer exclusion under the Advisers Act, which allows broker-dealers to provide certain advisory services without becoming an investment adviser.

Compliance

Reg BI and Form CRS will become effective 60 days after they are published in the Federal Register, and will include a transition period until June 30, 2020. The Interpretations under the Advisers Act will become effective upon publication in the Federal Register.

KPMG Perspectives

The SEC notes that "whether a broker-dealer has acted in the retail customer's best interest under the General

Obligation will turn on an objective assessment of the facts and circumstances of how these specific components of Regulation Best Interest are satisfied at the time that the recommendation is made (and not in hindsight)". As such, the SEC's adoption of Reg BI demonstrates a continued focus on financial services conduct and sales practices, and is in keeping with the spirit of bank regulatory risk and governance focus on conduct, as well as consumer protection standards of UDAAP/UDAP.

Though the regulation directly impacts broker-dealers, all providers of retail financial service offerings should:

- Inventory all conflicts of interest.
- Evaluate existing governance around identification, mitigation, and disclosure of conflicts of interest, in particular those related to product sales and financial incentives.
- Review, and update as necessary, all retail customer disclosures.
- Determine processes and controls for the delivery of all required disclosures to a retail customer that must be delivered at the time of recommendation due to an inability to deliver prior.
- Consider the obligations of this regulation both for direct applicability as well adoption to better practices.
- Update policies and procedures.
- Ensure that practices align via ongoing reviews, testing and audits.
- Continue to focus on building out and enhancing existing conduct and culture and compliance programs.

For more information, please contact [Tracy Whille](#), [Bill Meehan](#), or [Larry Godin](#).

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