cefli
COMPLIANCE & ETHICS FORUM FOR LIFE INSURERS

Executive Summary
Highlights
SEC Regulation Best Interest and Form CRS Roundtable
October 26, 2020
Washington, DC

On October 26, the SEC conducted a virtual Roundtable with faculty comprised of SEC and FINRA staff who shared insights concerning their observations from examination activities designed to confirm compliance with the requirements of the SEC's Regulation Best Interest and Form CRS requirements.

Executive Summary

An Executive Summary of the highlights of the SEC Roundtable are set forth below:

- Chairman Clayton confirmed that Regulation Best Interest applies when broker-dealers or investment advisers are offering recommendations to retail customers but also includes account recommendations such as recommendations pertaining to a retirement plan rollover.

- Chairman Clayton stated that firms are "generally meeting their compliance obligations" with respect to Regulation Best Interest and Form CRS but also commented that there are areas where compliance improvements may be warranted. Specifically, with respect to Form CRS, he cited instances identified by the SEC staff where firms did not disclose their disciplinary history.

- Firms should develop policies and procedures that go beyond restating the applicable standards and incorporate guidance to allow investment professionals to understand how to comply with the applicable rules and regulations. Policies and procedures alone may not be sufficient to determine appropriate compliance.

- Updated policies and procedures must consider new obligations under Regulation Best Interest such as cost and reasonably available alternatives. Supervisory reviews should confirm compliance with these requirements.

- Regulation Best Interest covers a broader set of investors when compared to the former suitability rule. Previously, investors who may have been considered to be "institutional" may be considered to be "retail" investors under Regulation Best Interest.

- Many firms have simply added Regulation Best Interest requirements to existing suitability policies and procedures without recognizing the distinctions between Regulation Best Interest and suitability.

- Cost must always be considered when making a recommendation under Regulation Best Interest. However, it does not mean that the lowest cost option should always be recommended. Costs may also include deferred sales charges or other liquidation costs.

- Firms should utilize a risk-based approach to determining whether it may be appropriate to document the basis for a recommendation under Regulation Best Interest. Firms may want to document recommendations involving more complex products or recommendations inconsistent with an investor's investment objectives.

- Regulation Best Interest did nothing to change the analysis of a recommendation. The obligation to make a recommendation in a customer's best interest applies at the time of the recommendation regardless of whether the recommendation is implemented.

- Conflicts of interest represent a key area for which merely applying former suitability standards will be insufficient to demonstrate compliance with Regulation Best Interest. Firms should consider whether conflicts of interest may arise when a financial advisor may be recommending a transfer of assets from a broker-dealer to an investment advisory firm. Firms should take steps to ensure that they are mitigating or possibly eliminating any incentives that would place the financial advisor's interest before the retail customer's interest.

Background

Overview:

Chairman Jay Clayton offered introductory remarks to begin the SEC Roundtable. Chairman Clayton noted that the SEC adopted Regulation Best Interest and Form CRS to "enhance significantly the quality and transparency of relationships between broker-dealers and investment advisers and their retail investors." Regulation Best Interest codifies the fundamental principle that investment professionals should not place their interest ahead of the interest of their clients and customers.

Chairman Clayton also confirmed that Form CRS is designed to allow retail investors to have a better understanding of the services that they can receive and how they will be charged for those services.

Regulation Best Interest - Policies and Procedures:

Staff from the SEC's Office of Compliance Inspections and Examinations (OCIE) as well as staff from the SEC's Division of Trading & Markets (who are involved in drafting key elements of Regulation Best Interest) participated in a panel discussion along with representatives of FINRA's Market Regulation staff to share their findings with regard to the initial examinations of firms to determine compliance with Regulation Best Interest and Form CRS.

Regulators from the SEC and FINRA encouraged firms to tailor their policies and procedures to conform with their unique business models. Specifically, they indicated that policies and procedures should go beyond merely restating the applicable standards and should incorporate guidance to allow investment professionals to understand how to comply with the standards. (This point was repeated several times throughout the Roundtable.)

Areas of concern identified by FINRA with respect to Policies and Procedures included:

- Policies and procedures that have been implemented but not memorialized or not memorialized adequately;
- Policies and procedures that lack the who, what, where and how compliance should take place (e.g., responsible individuals may not be identified in the policies and procedures);
- Policies and procedures may lack specific steps as well as the cadence of those steps;
- Some firms lack controls or a plan for testing the policies and procedures; and
- Some firms lack controls or a plan for testing the record-keeping requirements of Regulation Best Interest.

Regulation Best Interest - Training:

With respect to Training, SEC and FINRA staff indicated they were flexible with regard to virtual training efforts undertaken in light of the COVID-19 pandemic. Several firms were commended for conducting post-Training tests to evaluate comprehension of the material offered during Training.

Areas of concern identified by FINRA with respect to Training included:

CEFLI presentations, discussions and resource material do not constitute legal advice. Such information is intended to offer compliance perspectives and opinions of a general nature. Individuals with specific questions about a law or regulation should consult with legal counsel.

- Late Training (i.e., Training which took place after the June 30 effective date of Regulation Best Interest);
- Simply handing out updates to Written Supervisory Procedures; and
- Training that merely restated the rules rather than focusing on how to comply with Regulation Best Interest.

Regulation Best Interest - Care Obligation:

With respect to the Care Obligation, SEC staff indicated that some firms have developed internal proprietary systems to compare investment alternatives and to document the basis for a recommendation.

FINRA has observed that firms are evaluating information collection practices and many firms are developing new questionnaires to obtain additional information concerning their investors. Some firms are using this information to develop "risk scores" based upon an investor's risk tolerance and investment objectives as a means to reconcile the investment recommendation with the "risk score."

Some firms are requiring registered representatives to insert comments about each recommendation as a way to document their efforts to comply with the Care Obligation into allow supervisors to be able to access this information to monitor for compliance with the Care Obligation.

Areas of concern identified by FINRA with respect to the Care Obligation included:

- Some firms are confusing suitability and Regulation Best Interest;
- Many firms have "layered on" Regulation Best Interest on existing suitability policies and procedures without recognizing the distinctions between Regulation Best Interest and suitability and attempting to "harmonize" the rules;
- FINRA Rule 2111 (suitability) is still relevant with a narrower focus which pertains to recommendations to non-retail investors. (FINRA indicated that it is important to highlight the distinctions between the new FINRA Rule 2111 and Regulation Best Interest and their applicability.);
- FINRA Rule 2111 was amended to remove the control element with respect to excessive trading to conform with Regulation Best Interest but FINRA has observed some firms that have policies and procedures that contain the control language from rule 2111 but haven't adjusted their policies and procedures to comply with the amended Rule.

The SEC staff confirmed that cost must always be considered when making a recommendation under Regulation Best Interest. However, the SEC staff also confirmed that, while cost is a consideration, it does not mean that the lowest cost option should always be recommended. In fact, a recommendation of the lowest cost option or least remunerative option may not comply with the requirements of Regulation Best Interest without considering the retail investor's investment profile and objectives.

The SEC staff also observed that some firms may be providing certifications suggesting that the recommendations were made consistent with the requirements of Regulation Best Interest. Staff commented that the certification alone may not be sufficient absent being able to demonstrate compliance with all of the elements of Regulation Best Interest.

SEC staff suggested that compliance professionals should increase focus on analyzing the communication between the financial advisor and the customer. However, where the analysis and communication are the same, the coverage of recommendation has expanded to include account type recommendations as well as rollovers or transfers of assets from a workplace retirement plan to an IRA.

CEFLI presentations, discussions and resource material do not constitute legal advice. Such information is intended to offer compliance perspectives and opinions of a general nature. Individuals with specific questions about a law or regulation should consult with legal counsel.

Another area of concern identified by the SEC staff is the nature of conversations that may take place between a financial advisor and a customer when the financial advisor recommends that the customer transfer their assets from a broker-dealer to an investment advisor. Advisors were reminded to consider the impact of such a recommendation on mutual fund A shares. In the view of the SEC staff, this type of transaction incorporates a two-part analysis:

- First, the financial advisor must consider whether the recommendation to rollover the assets is in the customer's best interest; and
- Second, the financial advisor must consider whether the type of account is in the customer's best interest.

And, overall, cost must be another important consideration in this analysis.

Regulation Best Interest - Conflicts of Interest:

With respect to Conflicts of Interest, SEC staff noted that conflicts of interest represent a key area for which merely applying former suitability standards will be insufficient to demonstrate compliance with Regulation Best Interest. SEC staff indicated that many firms have already conducted various conflicts of interest analyses and were well prepared to meet the requirements of Regulation Best Interest. They also commented that several firms created detailed lists of conflicts of interest and the remediation measures deemed appropriate to mitigate those conflicts of interest.

FINRA representatives also commented that several firms are developing procedures to require an annual review of compensation agreements, their affiliates' businesses and associated persons' activities to identify potential conflicts of interest.

SEC staff commented that conflicts of interest may arise when a financial advisor may be recommending a transfer of assets from a broker-dealer to an investment advisory firm. They suggested firms should take steps to ensure that they are mitigating or possibly eliminating any incentives that would place the financial advisor's interest before the retail customer's interest. Firms were encouraged to implement supervisory policies and procedures to address circumstances in which a financial advisor recommends the transfer of assets from one type of firm to another or one type of product class to another.

SEC staff indicated that the conflicts of interest requirements embedded within Regulation Best Interest are principles-based and, therefore, firms were encouraged to consider the facts and circumstances of their business models to determine whether policies and procedures were reasonably designed to reduce the impact of any incentives which would place the firm's or the financial advisor's interest before the customer's best interest.

The SEC does not mandate any particular mitigation method in order to provide financial flexibility to design policies and procedures appropriate to a firm's business models.

SEC staff also confirmed that forgivable loans (often used to entice an advisor to switch firms) would be considered a conflict of interest under Regulation Best Interest. The SEC's FAQs on Regulation Best Interest offers guidance concerning how to mitigate such a conflict of interest and whether to eliminate it entirely.

The SEC also confirmed that they will continue to update their FAQs on Regulation Best Interest on the SEC's website.

CEFLI presentations, discussions and resource material do not constitute legal advice. Such information is intended to offer compliance perspectives and opinions of a general nature. Individuals with specific questions about a law or regulation should consult with legal counsel.

Form CRS:

With respect to Form CRS, many of the comments during the Roundtable focused on the ability of firms to comply with technicalities of the new rules. The Form should be easy to read and written in language that could be easily understood at an eighth-grade reading comprehension level. Firms were reminded to display the completed Form CRS on the firm's website.

The most specific concern relative to Form CRS was the lack of disciplinary history disclosures identified through initial examination activities. Firms were encouraged to review the SEC's FAQs on Form CRS which include critical aspects of disciplinary history disclosure for Form CRS.

CEFLI presentations, discussions and resource material do not constitute legal advice. Such information is intended to offer compliance perspectives and opinions of a general nature. Individuals with specific questions about a law or regulation should consult with legal counsel.