

CEFLI Joint Educational Webinar

How Reg BI May Be Enforced Under The New SEC Chair

Thank you for joining CEFLI's Joint Educational Webinar today!

- The webinar will begin on, or shortly after, the top of the hour. You may not hear sound until the webinar begins.
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June 16, 2021

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How Reg BI May Be Enforced Under The New SEC Chair

June 16, 2021

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Agenda

- CEFLI's Antitrust Policy
- Introductions
- Presentation
- Questions (Q&A button)
- Administrative Reminders



Faculty



James G. Lundy
Partner
Faegre Drinker



Reg BI Refresher

The Disclosure Obligation

The Division of Examinations (“Examinations Division” and f/k/a “OCIE”) advised that it may assess specific disclosures regarding: the capacity in which the recommendation is being made; the material fees and costs that apply to transactions, holdings and accounts; and material limitations on the securities or investment strategies.



Reg BI Refresher - The Disclosure Obligation

The Examinations Division specifically advised that it may review firm documents such as –

- Schedules of fees and charges assessed against retail customers and disclosures regarding such fees and charges, including disclosures regarding the fees and costs related to services and investments that retail customers will pay or incur directly and indirectly (e.g., custodian fees, account maintenance fees, fees related to mutual funds and variable annuities, and other transactional fees and product level fees).
- The broker-dealer's compensation methods for registered personnel, including: (i) compensation associated with recommendations to retail customers; (ii) sources and types of compensation (e.g., direct payments by an investor, payments by a product sponsor); and (iii) related conflicts of interest (e.g., conflicts associated with recommending proprietary products or with receiving payments for inclusion on a product menu).
- Disclosures related to monitoring of retail customers' accounts
- Disclosures on material limitations on accounts or services recommended to retail customers
- Lists of proprietary products sold to retail customers.



Reg BI Refresher - The Care Obligation

For the Care Obligation, and to assess compliance with it, the Examinations Division may review -

- Information collected from retail customers to develop their investment profiles (including any new account forms, correspondence, and any agreements the customer has with the broker-dealer)
- The broker-dealer's process for having a reasonable basis to believe that the recommendations are in the best interest of the retail customer (which may include, e.g., any process for establishing, understanding and implementing the scope of reasonably available alternatives when making a recommendation).
 - The factors the broker-dealer considers to assess the potential risks, rewards and costs of the recommendations in light of the retail customer's investment profile.
 - The broker-dealer's process for having a reasonable basis to believe that it does not place the financial or other interest of the broker-dealer ahead of the interest of the retail customer.
- How the broker-dealer makes recommendations related to significant investment decisions, such as rollovers and account recommendations, and how the broker-dealer has a reasonable basis to believe that such investment strategies are in a retail customer's best interest.
- How the broker-dealer makes recommendations related to more complex, risky, or expensive products and how the broker-dealer has a reasonable basis to believe that such investments are in a retail customer's best interest.



Reg BI Refresher - The Conflict of Interest Obligation

The Examinations Division may review broker-dealer's policies and procedures to assess -

- Whether and how the policies and procedures address the following, as required by Reg BI:
 - Conflicts that create an incentive for an associated person to place its interest or the interest of a broker-dealer ahead of the interest of the retail customer;
 - Conflicts associated with material limitations (e.g., a limited product menu, offering only proprietary products or products with third-party arrangements) on the securities or investment strategies involving securities that may be recommended to a retail customer; and
 - The elimination of the following conflicts: sales contests, sales quotas, bonuses and non-cash compensation based on the sale of specific securities or specific types of securities within a limited period of time.
- How the policies and procedures establish a structure for identifying the conflicts that the broker-dealer or its associated person may face. Staff may request documentation identifying all conflicts associated with the broker-dealer's recommendations.
- How the policies and procedures provide for disclosure of conflicts and what conflicts are disclosed.
- How the policies and procedures provide for mitigation or elimination of conflicts and what conflicts are mitigated or eliminated.





Reg BI Refresher - The Compliance Obligation

In this part of the Risk Alert, the Examinations Division advises much more succinctly that it will assess compliance with this obligation by reviewing the broker-dealer’s “policies and procedures and evaluate any controls, remediation of noncompliance, training, and periodic review and testing.”



Concluding Guidance For the Reg BI Risk Alert

The Examinations Division specifically advised that their “[i]nitial examinations will focus on assessing whether firms have made a good faith effort to implement policies and procedures reasonably designed to comply with Regulation Best Interest, including the operational effectiveness of broker-dealers’ policies and procedures.”

- This “good faith” assessment is important and allows firms a reasonable explanation for any work impacted by the pandemic or perhaps other resource constraints to explain proactively to OCIE staff or in response to a finding or a significant deficiency.



Roundtable on Reg BI and Form CRS

The highlights included the following:

- **Documenting Recommendations:** Reg BI does not require that representatives document the rationale for every recommendation, but firms should consider a documentation requirement for recommendations of complex products or investments that are ostensibly inconsistent with a customer's risk or investment profile to show why the recommendation was in the customer's best interest.
- **Revise suitability-based Procedures to meet the Reg BI standard.**
- **Train to cover the Process, Not Just the Letter of the Reg BI Rule:** Training should address compliance with new requirements and not just summarize the new rules. Firms should consider disciplinary measures such as fines for representatives that fail to complete required training.
- **Conduct Periodic Reviews of Financial Conflicts.**
- **Customer Risk Profiles:** Some firms have developed client questionnaires to assign risk scores to customers and assist supervisors in reviewing recommendations for best interest concerns.

On October 26, 2020, the SEC and FINRA held a joint roundtable on initial observations and best practices from the first four months of Reg BI and Form CRS implementation (https://www.sec.gov/video/webcast-archive-player.shtml?document_id=102620-best-interest-roundtable).



Statement on Recent & Upcoming Reg BI Exams

The statement provided the following that may be covered in upcoming examinations:

- Continued evaluation of firm policies and procedures, including evaluating specific firm processes for compliance with the Regulation, and alterations to firm product offerings, including the removal of higher cost products when lower cost products are available.
- Evaluation of how firms have considered costs in making a recommendation, which may include:
 - what information is available to firm personnel to identify relevant costs;
 - how any such information has been used; and
 - any documentation of the consideration of costs.

On December 21, 2020, the Examinations Division issued a statement in recent and upcoming Reg BI examinations (<https://www.sec.gov/news/public-statement/examinations-regulation-best-interest-2020-12-21>).



Statement on Recent & Upcoming Reg BI Exams, Cont.

The statement provided the following that may be covered in upcoming examinations:

- Evaluation of the processes firm personnel have used to make recommendations to new customers – for example, if a firm recommended a rollover from an employee benefit plan, examiners will assess: what information was gathered from new customers; what disclosures were made at the time; how alternatives were considered; and what documentation was retained.
- Evaluation of the processes firm personnel have used to recommend complex products, including what information was available and used to consider reasonably available alternatives.
- Evaluation of the processes that firms have used to identify and address conflicts related to recommendations.

This statement concluded by encouraging “firms to continue to evaluate their processes and, in particular, to consider whether the initial programs adopted by the June 30, 2020 compliance date are, in practice, reasonably designed to achieve compliance with Regulation Best Interest.^[6] Failure to have adequate written policies and procedures and failure to have adequate supervisory and compliance oversight may indicate recurring issues in complying with Regulation Best Interest.”



SEC 2021 Examination Priorities

- After discussing the pandemic, the lead topic of the SEC's 2021 Examination Priorities released on March 3, 2021 was Reg BI and Form CRS.
- That said, the examination priorities simply summarized the information on the above slides.
- (Then) Acting Chair Lee also did not address Reg BI much in her public statements.



Testimony Before the House Committee on Financial Services

- On May 6, 2021, Chair Gensler testified before the House Committee on Financial Services (<https://www.sec.gov/news/testimony/gensler-testimony-20210505>).
- In addition to his prepared testimony, the following comments were attributed to Chair Gensler regarding Reg BI (see <https://www.investmentnews.com/gensler-vows-to-ensure-compliance-with-reg-bi-as-written-206185>):
 - “It’s important that investors actually have brokers take their best interests at heart, and that’s what we’re going to do through examinations and enforcement [and] guidance to ensure that that rule is fully complied with as written.”
 - “We’re going to vigorously get the most out of Regulation Best Interest, but we’re also going to evaluate. If it’s not serving the purpose of investors, then we will update and freshen that rule as well as other rules. We always have to be evaluating that investors come first.”



Remarks at FINRA's 2021 Annual Conference

On May 20, 2021, Chair Gensler provided remarks regarding Reg BI at FINRA's 2021 Annual (Virtual) Conference (<https://www.finra.org/events-training/conferences-events/2021-finra-annual-conference>).

The following comments were attributed to Chair Gensler regarding Reg BI (see <https://www.advisorhub.com/stop-searching-for-some-ambiguity-in-reg-bi-compliance-sec-chief-says/>):

- Best Interest means best interest.
- So, if you're asking a lawyer, an accountant or advisor if something is over the line, maybe it's time to step back from the line a bit. Remember that going right up to the edge of a rule, or searching for some ambiguity in the text or a footnote, may not be consistent with the law or its purpose.
- Now we're in the examination phase. This is when you're going to lay your cards on the table and see what the SEC or FINRA are going to say back to you.
- What would you want somebody to be advising your sister, your brother, your son, your daughter, your parents—in their best interests? That's just a common-sense way to think about it.



The SEC's 2021 Annual Regulatory Agenda

On June 11, 2021, the SEC released its “Annual Regulatory Agenda” and rulemaking list (<https://www.sec.gov/news/press-release/2021-99>).

With Reg BI already being implemented and examined for (not surprisingly) the agenda and rulemaking list do not cover Reg BI.



Concluding Thoughts

- It appears that Chair Gensler in the short-term plans for the Staff of the Examinations Division to examine for Reg BI compliance for the rule as is.
- That said, the Chair's comments indicate that the SEC may be taking a more expansive (and likely more aggressive) view of what constitutes Reg BI compliance than his predecessor, not surprisingly.
- In the longer term, Chair Gensler will likely also be more supportive of Reg BI enforcement actions than his predecessor.



Questions?



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Jim Lundy co-leads Faegre Drinker's White Collar Defense & Investigations team and co-founded the Best Interest Compliance team. In his practice, Jim partners with investment advisory firms, broker-dealers, hedge funds, futures trading firms, public and private companies, and their boards, committees and management, to work through enforcement investigations and regulatory examinations. He also leads internal investigations, serves as an independent monitor, provides counsel on governance, compliance and policy issues, defends complex financial services litigation and handles cybersecurity regulatory investigations. Prior to joining Faegre Drinker, Jim served at the Securities and Exchange Commission (SEC) in the Division of Enforcement for almost a decade and completed his final years of service with the SEC in the Division of Examinations. With this deep financial regulatory enforcement and examination experience, he is also called upon by peers to serve as an expert witness and consulting witness regarding SEC and Commodity Futures Trading Commission (CFTC) practices. [View Jim's full biography.](#)

Thank you!



CEFLI Reminders:

- Please complete the **post-webinar survey**.
- To receive a **Certificate of Attendance** template form (for those who attended the live webinar broadcast), for your use in self-submitting for CLE or CE credit, please email: NancyPerez@CEFLI.org

CEFLI Upcoming Webinars & Events:

- July 28: **Webinar – Charts, Graphs, and Benchmarking Data—Oh My!**
Join us for a presentation covering the key trends and learnings from CEFLI's 2021 Compliance & Ethics Benchmarking Survey.
- Please mark your calendar for **CEFLI's Annual Conference** which will take place virtually on September 22 and 23.



Thank You!