

Regulation Best Interest: SEC Highlights Deficiencies and Weak Practices Related to Compliance

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On January 30, 2023, the Division of Examinations (the “Division”) of the US Securities and Exchange Commission (“SEC”) released a risk alert (the “Risk Alert”) that highlights common deficiencies and perceived weaknesses in broker-dealers’ compliance with the obligations of Regulation Best Interest (“Reg BI”) that were noted by the Division’s recent examinations of broker-dealers.

Generally, Reg BI requires that broker-dealers comply with four obligations:

1. Providing certain prescribed disclosures, before or at the time of the recommendation, about the recommendation and the relationship between the retail customer and the broker-dealer (“Disclosure Obligation”);
2. Exercising reasonable diligence, care, and skill in making the recommendation to, among other things, understand the potential risks, rewards, and costs associated with a recommendation, and having a reasonable basis to believe that the recommendation is in the best interest of a retail customer (“Care Obligation”);
3. Establishing, maintaining, and enforcing written policies and procedures reasonably designed to identify and address conflicts of interest (“Conflict of Interest Obligation”); and
4. Establishing, maintaining, and enforcing written policies and procedures reasonably designed to achieve compliance with Reg BI (“Compliance Obligation”).

The following is a summary of the Division’s key observations in the Risk Alert as it relates to broker-dealers’ compliance with Reg BI.

Compliance Obligation

- Many broker-dealers did not have adequate policies and procedures reasonably designed to achieve compliance with the Disclosure and Care Obligations; several broker-dealers had generic written policies and procedures in place that were not tailored specifically to the firm’s business model or otherwise were limited to restating Reg BI’s requirements.

- The policies and procedures in place to comply with the Disclosure Obligation lacked details regarding when disclosures should be created or updated, how to identify material changes that may result in new or updated disclosures, or how the updated disclosures should be delivered to retail customers.
- The policies and procedures in place to comply with the Care Obligation were deficient in providing guidance to the broker-dealer's financial professionals on considerations for available alternatives, costs, and documentation of their recommendations.
- When adopting Reg BI, broker-dealers failed to tailor and amend their policies and procedures related to periodic reviews, testing, surveillance systems and training programs, which were in place prior to the effective date of Reg BI, to the size and complexity of the firm, resulting in a failure to capture and prevent violations or only capturing executed transactions rather than all recommendations provided to the retail customers. The Division found that, as a result, firms were unable to review such recommendations for compliance with Reg BI.
- Although broker-dealers offered employee training that included information on Reg BI, the training did not adequately identify the firms' processes for compliance with Reg BI, or the methods and tools that employees could utilize to comply with Reg BI.

Conflict of Interest Obligation

- Broker-dealers had deficient written policies and procedures and lacked specificity regarding how conflicts are to be identified and addressed. As an example, the Division noted that additional detail should be added to procedures regarding identifying and addressing conflicts such as assigning responsibility to identify and address conflicts to a specific position or unit.
- Written policies and procedures commonly failed to prohibit certain types of incentives that would create conflicts, including sales contests, sales quotas, bonuses and non-cash compensation that were based on the sales of specific securities as required under the Conflict of Interest Obligation.
- Some broker-dealers limited the identified conflicts to those associated with prohibited activities or used high-level, generic language that did not identify the actual conflict and did not reflect all conflicts of interest associated with the recommendations made by the firm or its financial professionals.
- The Division observed that broker-dealers relied on disclosure to mitigate conflicts of interest that appeared to create an incentive for a financial professional to place his or her interest ahead of the interest of the retail customer and did not establish ways to mitigate those conflicts. The Division notes that the Conflict of Interest Obligation requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to identify and mitigate by, as an example, modifying practices to reasonably reduce conflicts of interest at the professional level (i.e., interests that might consciously or unconsciously include the financial professional to make a recommendation that is not disinterested).

Disclosure Obligation

- Several broker-dealers only posted the pertinent disclosures on their websites or referenced the disclosures in other documents delivered to customers, which the Division believes does not satisfy the Disclosure Obligation.
- Broker-dealers with dually licensed financial professionals failed to establish reasonably designed policies and procedures to ensure that such professionals were disclosing to retail customers the capacity in which they were acting and potential conflicts that are specific to the professionals that interact with retail customers in multiple capacities.

In the Risk Alert, the Division describes risks that broker-dealers may consider to: (1) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (2) make any changes as may be appropriate to address or strengthen such systems. The Division does not provide context or additional details about many of the observations made in the Risk Alert, raising questions about the staff's expectations. In sharing these observations, the Division encourages broker-dealers to review their practices, policies, and procedures with

respect to Reg BI to address the non-exhaustive list of issues raised in this Risk Alert. As the broker-dealer industry enters the third year of the Reg BI compliance requirement, additional guidance provided by the SEC may signal additional enforcement activity in this area.

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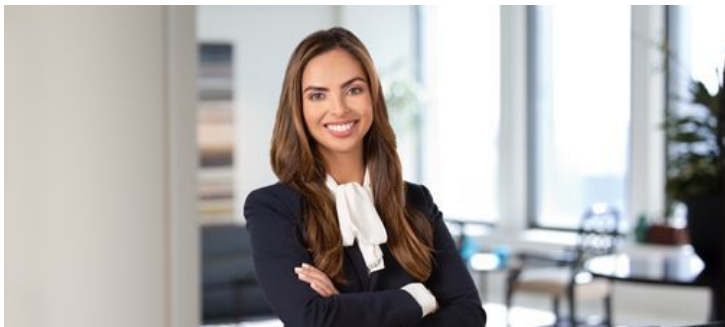
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