

Chapter 52

Private Banking and Wealth Management

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§ 52:1 Broker-Dealer Regulation: Private Banking and Wealth Management

§ 52:1.1 Overview: “Standard of Care” for Securities Recommendations to Non-Institutional Investors

Historically, the broker-dealer standard of care when dealing with a customer was generally considered to be a suitability standard. That is, a broker-dealer’s recommendation for an investment transaction must be suitable for the customer, taking into account the customer’s investment profile and the nature of the prospective investment. A customer’s investment profile includes, among other things, the customer’s age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and other information the customer may disclose to the broker-dealer or representative in connection with such recommendation. This “suitability” standard is often viewed as a lower standard than a fiduciary standard (which applies to recommendations of investment advisers, banks acting in a fiduciary capacity, and under the Employee Retirement Income Security Act of 1974, as amended (ERISA)). Under the suitability standard, the recommended transaction does not necessarily have to be the best one possible for the client, or free from conflicts of interest, but the specific transaction nonetheless must be “suitable” for the specific customer. (We further describe the differences between a suitability standard and a fiduciary standard below.) The broker-dealer suitability standard draws its roots from the “shingle theory,” a common-law standard of care for broker-dealers based on the concept that a person who holds out his or her “shingle” as a broker-dealer must bring a certain level of skill, knowledge, and professionalism to his or her dealings with customers.

On June 5, 2019, the SEC adopted Regulation Best Interest (“Regulation BI”), which implements a “best interest” standard for broker-dealers that are dealing with retail customers. Regulation BI significantly changes the standard of care for broker-dealers recommending transactions to retail customers, adding and enumerating substantial duties to the broker-dealer’s relationship with retail customers. At root, however, the standards of care for broker-dealers have always involved a professional matching of the investor and the investment. A more detailed description of Regulation BI is found below at section 52:1.2.

When considering standards of care and conduct for broker-dealers, suitability of recommendations (or other standards of care) are always considered in light of conflicts of interest. Recognition and regulation of conflicts of interest lies at the heart of the securities broker-dealer industry: by definition, U.S. broker-dealers are compensated only if and when a transaction occurs, giving a broker a “salesman’s stake” in the transaction.¹ While such conflicts are necessarily inherent in many sales-based industries, the securities and financial services industry are of particular concern because of the speculative nature of investment, the risk of loss of principal, and the trust that the retail customer (or, in many cases, the institutional customer) places in his or her (or its) broker-dealer’s recommendations.

Accordingly, the SEC and FINRA consider compensation of registered representatives to be a major source of conflicts of interest. FINRA has noted that financial compensation can be a major source of conflicts of interest that may influence registered representatives of broker-dealers to behave in ways that affect customer interests negatively. FINRA has noted in its 2013 Report on Conflicts of Interest (the “FINRA Conflicts Report”²) that it is a best practice to:

- Use neutral compensation grids that do not favor particular products; and
- Monitor activity of registered representatives approaching compensation thresholds.

Similarly, when adopting Regulation BI, the SEC made a point to note that certain compensation schemes are simply not in the best interests of customers. FINRA has also noted that conflicts may arise in recommending the type of account that a customer should open with a firm. For example, a firm that is dually registered as

1. See, e.g., 1st Global, Inc., SEC No-Action Letter (May 7, 2001).
2. FINRA, Report on Conflicts of Interest (Oct. 2013) [hereinafter FINRA Conflicts Report], <https://www.finra.org/sites/default/files/Industry/p359971.pdf>.

a broker-dealer and an investment adviser should consider whether a commission-based or fee-based account is more appropriate for a customer.

§ 52:1.2 Regulation Best Interest

[A] 2018 Proposal for Standards of Conduct for Broker-Dealers Under Proposed Regulation Best Interest

In April 2018, the SEC issued proposed rules, interpretations, and guidance that sought to enhance and clarify the standards of care applicable to broker-dealers and to investment advisers when dealing with retail clients.³ With respect to the broker-dealer standard of care, the SEC proposed Regulation Best Interest, which was implemented under the Securities Exchange Act of 1934 (“Exchange Act”). Regulation Best Interest creates a principles-based, best-interest standard, which applies solely to broker-dealers. The SEC noted that the standards of conduct for broker-dealers and investment advisers retain differences on account of “different relationship types and models for providing advice.”⁴

Under Regulation Best Interest, brokers, dealers, or associated persons of a broker-dealer are required to act in the best interest of a retail-investor customer,⁵ without placing financial or other interests ahead of the customer, when recommending a securities transaction or investment strategy involving securities.⁶ This best interest

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3. Regulation Best Interest, Exchange Act Release No. 34-83062 (Apr. 18, 2018), <https://www.sec.gov/rules/proposed/2018/34-83062.pdf> [hereinafter Regulation Best Interest Release]. See Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 34-86031 (June 5, 2019), <https://www.sec.gov/rules/final/2019/34-86031.pdf> [hereinafter Regulation BI Adopting Release].
 4. See Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, Release No. IA-4889 (Apr. 18, 2018), <https://www.sec.gov/rules/proposed/2018/ia-4889.pdf>.
 5. Regulation Best Interest defines “retail investor” as “a person, or the legal representative of such person, who: (A) Receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer, or a natural person who is an associated person of a broker or dealer; and (B) Uses the recommendation primarily for personal, family, or household purposes.”
 6. See Regulation Best Interest Release, *supra* note 3, sec. II.A, at 44. For the purposes of Regulation Best Interest, the definition of “recommendation” incorporates FINRA’s definition of recommendation and also includes recommendations to roll over a retail investor’s IRA. See *id.* sec. II.C.2.a, at 72–78, sec. II.C.3, at 82–83.

obligation is satisfied if the broker, dealer, or associated person complies with four separate obligations: (a) a disclosure obligation; (b) an obligation of care; and (c) an obligation to identify, disclose, and/or mitigate (or eliminate) conflicts of interest. Regulation BI also creates (d) a “compliance” obligation to maintain appropriate policies and procedures to achieve compliance with the three aforementioned care obligations. These are described at section 52:1.2[B] below.

[B] Regulation Best Interest

The goal of Regulation BI is to improve investor protection by: (1) enhancing the obligations that apply when a broker-dealer makes a recommendation to a retail customer and (2) reducing the potential harm to retail customers from conflicts of interest that may affect such recommendations. As a practical matter, Regulation BI also significantly modifies the timing and recordkeeping requirements of many critical aspects of the relationship between a broker-dealer and its retail customers.

Regulation BI modifies the broker-dealer standard of care by requiring broker-dealers to:

- (1) act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker-dealer ahead of the interests of the retail customer; and
- (2) 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 in instances where the SEC has determined that disclosure is insufficient to reasonably address the conflict, to mitigate the conflict, or, in certain instances, eliminate the conflict.

Regulation BI, as promulgated, streamlined the definitional language of the proposed rule regarding “retail customers” to focus on natural persons and their legal representatives, defining a retail customer as “a natural person, or the legal representative of such natural person, who: (A) receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer, or a natural person who is an associated person of a broker or dealer; and (B) uses the recommendation primarily for personal, family, or household purposes.”⁷

7. Regulation BI Adopting Release, *supra* note 3.

This definition has caused a certain amount of confusion with respect to the treatment of family accounts and family offices, which can often straddle the line between institutional and retail customer status in this respect. To help alleviate the situation, the SEC staff issued a “no action” letter further delineating institutional from retail family office customers.⁸

In adopting a “best interest” standard for retail broker-dealer recommendations, the SEC chose to make use of concepts underlying the fiduciary standard, including those applicable to investment advisers under the Investment Advisers Act to create a central regulatory obligation. The general regulatory requirement of the best interest standard (referred to in the Regulation BI adopting release as the “General Obligation”) provides that when making a recommendation of any securities transaction or investment strategy involving securities, a broker-dealer, or a natural person who is an associated person of a broker-dealer, “shall act in the best interest of the retail customer at the time the recommendation is made,” prioritizing the interests of the retail customer above any interests of the broker-dealer or associated persons thereof (emphasis added).⁹

The Commission declined to expressly define “best interest” in the rule text, deciding in favor of the four specific component obligations noted above: (1) the Disclosure Obligation, (2) the Care Obligation, (3) the Conflict of Interest Obligation, and (4) the Compliance Obligation. These component obligations collectively set forth the meaning of acting “in the best interest” of the retail customer in accordance with the general obligation noted above. The SEC added that the specific component obligations of the rule are mandatory, stating that Regulation BI does not establish a “safe harbor.”

[B][1] Disclosure Obligation

The Disclosure Obligation requires a broker-dealer, prior to or at the time of the recommendation, to provide to the retail customer, in writing, full and fair disclosure of (A) all material facts related to the scope and terms of the relationship with the retail customer; and (B) all material facts relating to conflicts of interest that are associated with the recommendation.¹⁰ Specifically, this obligation explicitly requires the following disclosures: (1) that the broker, dealer, or such natural person, is acting as a broker, dealer, or an associated

8. Status of Institutional Family Offices for Purposes of Regulation Best Interest (Dec. 23, 2020), <https://www.sec.gov/divisions/marketreg/mr-noaction/2020/sifma-122320-regbi.pdf>.

9. Regulation BI Adopting Release, *supra* note 3.

10. *Id.*

person of a broker or dealer with respect to the recommendation; (2) the material fees and costs that apply to the retail customer's transactions, holdings, and accounts; and (3) the type and scope of services provided to the retail customer, including any material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer.

The Disclosure Obligation is particularly important for a broker-dealer that recommends securities issued, or managed, by an affiliate. In particular, consideration should be given to: disclosure that the issuer, or manager, is an affiliate, or disclosure of additional or increased fees and compensation to be received by the broker-dealer in exchange for sales of affiliate securities. The SEC has stated that where full disclosure of the nature of a conflict of interest is not possible, then the broker-dealer should eliminate or mitigate (that is, reduce) the conflict such that full and fair disclosure in accordance with the Disclosure Obligation is possible. The SEC states that in some cases, conflicts of interest may be of a nature and extent that it would be difficult to adequately convey the material facts or the nature, magnitude, and potential effect of the conflict of interest. In such cases, elimination or mitigation of the conflict of interest would be required.

[B][2] Care Obligation

The Care Obligation requires a broker, dealer, or associated person of a broker or dealer in making the recommendation to exercise reasonable diligence, care, and skill:

- Understand the potential risks, rewards, and costs associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least *some* retail customers;¹¹
- Have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks, rewards, and costs associated with the recommendation and does not place the financial or other interest of the broker, dealer, or such natural person ahead of the interest of the retail customer; and
- Have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best

11. This language is similar to that of FINRA Rule 2111 Supplementary Material .05(a) (the "reasonable-basis" component of suitability). See Regulation Best Interest Release, *supra* note 3, sec. II.A, at 44-45.

interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile and does not place the financial or other interest of the broker, dealer, or such natural person making the series of recommendations ahead of the interest of the retail customer.

[B][3] Conflict of Interest Obligations

The Conflict of Interest Obligation requires brokers and dealers to establish, maintain, and enforce written policies and procedures reasonably designed to:

- identify and, at minimum, disclose or eliminate all conflicts of interest associated with a recommendation;
- identify and mitigate any conflicts of interest associated with such recommendation that create an incentive for a natural person who is an associated person of a broker or dealer to place the interest of the broker, dealer, or such natural person ahead of the interest of the retail customer;
- (i) identify and disclose any material limitations placed on the securities or investment strategies involving securities that may be recommended to a retail customer and any conflict of interest associated with such limitation; and (ii) prevent such limitations and associated conflicts of interest from causing the broker, dealer, or a natural person who is an associated person of the broker or dealer to make recommendations that place the interest of the broker, dealer, or such natural person ahead of the interest of the retail customer; and
- identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time.

[B][4] Compliance Obligations

The Compliance Obligation requires the broker or dealer to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation BI.

[C] Form CRS Relationship Summary

Rule 17a-14 requires broker-dealers and investment advisers to deliver a relationship summary to retail investors at the beginning of their relationship. Intended to be a short and accessible disclosure form, the Form CRS requires firms to summarize information about

services, fees and costs, conflicts of interest, legal standard of conduct, and whether or not the firm and its financial professionals have disciplinary history.

Forms CRS are, and are meant to be, concise, plain-language Relationship Summaries that will be provided to customers. Forms CRS are posted online by the SEC in a compiled database, and available on a firm's website.

Rule 17a-14 will also require disclosure of whether a firm or financial professional is registered as a broker-dealer or associated person, an investment adviser or supervised person, or both, in communications with retail investors.

As part of the series of SEC releases issued at the same time as the Regulation Best Interest Release, the SEC published certain sample Forms CRS.

[D] Standards of Conduct for Investment Advisers and Enhancing Investment Adviser Regulation

Concurrent with the adoption of Regulation BI, the SEC also issued a series of interpretations to address aspects of the investment adviser's fiduciary duty. The Commission intends its investment adviser interpretive guidance "to reaffirm—and in some cases clarify—" various aspects of the fiduciary duty owed by an investment adviser to its clients under section 206 of the Investment Advisers Act. In addition, the interpretation seeks to align the Commission's guidance in light of Regulation BI, and, in our view, to harmonize the investment adviser's fiduciary duty with Regulation BI to the extent the Commission feels appropriate.

The SEC's guidance first outlines the framework of the fiduciary duty that investment advisers owe to their clients, stating that the duty must be viewed "within the context of the agreed-upon scope of the relationship between the adviser and the client." Specific obligations that flow from the adviser's fiduciary duty depend upon what functions the adviser has agreed to assume. The guidance notes, however, that the contract between the client and the adviser cannot negate or waive the adviser's federal fiduciary duty, regardless of the sophistication of the client.

The Investment Adviser Interpretation Release describes the investment adviser's fiduciary duty as being comprised of the following duties:

- *Duty of care.* The SEC describes the duty of care, noting that the investment adviser's duty of care includes, among other things: (1) a duty to act in the best interest of the clients, and a duty to provide advice that is in the best interests of the

clients; (2) a duty to seek best execution of client transactions; and (3) a duty to provide advice and monitoring throughout the client relationship.¹² In respect of the duty of care, the SEC makes the following notable observations:

- In providing personalized advice, the investment adviser's ability to provide advice that is in the best interests of the client is dependent on a reasonable inquiry and understanding of the client's objectives, which necessitates an understanding of the client's investment profile or mandate. The Commission notes that it will be necessary for an adviser to update the client's investment profile, to maintain a reasonable understanding of the client's objectives, and adjust the advice given to reflect changed circumstances.
- The duty to act in the best interests of the client requires a reasonable belief that the investment advice given is in the best interest of the client and their objectives, evaluated in the context of the portfolio being managed. This requires advisers to also conduct a reasonable investigation into the investment to sufficiently base advice on materially accurate and complete information.
- *Duty of loyalty.* The SEC notes that the duty of loyalty is rooted in specific principles: an investment adviser must not favor its own interests over those of a client, or unfairly favor one client over another, and an adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship, including all material conflicts of interest that could affect the advisory relationship. The disclosure must be clear and detailed, enabling the client to analyze and understand complex conflicts and their ramifications to make an informed decision to consent or reject advice involving conflicts of interest.

12. See Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. IA-5248 (July 12, 2019), <https://www.sec.gov/rules/interp/2019/ia-5248.pdf>.